UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1989

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TRADE AND DEVELOPMENT REPORT 1989

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Explanatory notes

Classification of countries and territories

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

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

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

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

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

Generally speaking, sub-groupings within geographical regions and analytical groupings (e.g. Major petroleum exporters, Major exporters of manufactures and Least developed countries (LDCs)) are those used in the UNCTAD *Handbook of International Trade and Development Statistics 1988.**

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

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

Commodity classification

Unless otherwise stated, the classification by commodity group used in this Report follows generally that employed in the *Handbook of International Trade and Development Statistics 1988.*

* United Nations publication, Sales No. E F.88.II.D.11.

Other notes

In the tables and in the text: references to "countries" are to countries, territories or areas as appropriate; references to annex tables are to the tables in the statistical annex (annex 5). References to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 1988* refers to *Trade and Development Report, 1988* (United Nations publication, Sales No. E.88.II.D.8).

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

The term 'billion' signifies 1,000 million.

The term 'tons' refers to metric tons.

Annual rates of growth and change refer to compound rates.

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

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

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

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

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

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

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

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

Abbreviations

ASEAN	Association of South-East Asian Nations
BOP	balance of payments
c and f	cost and freight
CCCF	Compensatory and Contingency Financing Facility
CEPAL	Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe)
c.i.f.	cost, insurance and freight
CMEA	Council for Mutual Economic Assistance
DAC	Development Assistance Committee (of OECD)
DMEC	developed market-economy country
ECAs	export credit agencies
ECE	Economic Commission for Europe
ECGD	Export Credits Guarantee Department (United Kingdom)
ECLAC	Economic Commission for Latin America and the Caribbean
ECU	European currency unit
EEC	European Economic Community
EMS	European Monetary System
ESCAP	Economic and Social Commission for Asia and the Pacific
ESCWA	Economic and Social Commission for Western Asia
EXIM	Export-Import Bank (United States)
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
f.o.b.	free on board
FY	fiscal year
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	generalized system of preferences
ICCO	International Cocoa Organization
IDA	International Development Association
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFIs	international financial institutions
ILDC	island developing country
ILO	International Labour Office
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification of All Economic Activities
LDC	least developed country

LIBOR	London Inter-Bank Offered Rate
MFA	Multi-Fibre Arrangement
MTNs	multilateral trade negotiations
MYRA	multi-year rescheduling agreement
NMP	net material product
ODA	official development assistance
ODF	official development finance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PSE	public sector enterprise
SAF	Structural Adjustment Facility
SAL	structural adjustment loan
SAP	Structural Adjustment Programme
SDR	special drawing right
SIGMA	System for Interlinked Global Modelling and Analysis
SITC	Standard International Trade Classification (revision 1)
SNA	System of National Accounts
SNPA	Substantial New Programme of Action for the Least Developed Countries for the 1980s
TNC	transnational corporation
UNCTAD	United Nations Conference on Trade and Development
UNCTC	United Nations Centre on Transnational Corporations
UNDP	United Nations Development Programme
UNDRO	Office of the United Nations Disaster Relief Co-ordinator
UNEP	United Nations Environment Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNICEF	United Nations Children's Fund
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development
USTR	United States Trade Representative
VAT	value added tax
VER	voluntary export restraint
WHO	World Health Organization
WIDER	World Institute for Development Economics Research
WIPO	World Intellectual Property Organization
WMO	World Meteorological Organization

OVERVIEW
by the
Secretary-General of UNCTAD

STAGNATION, DISORDER AND REFORM IN THE WORLD ECONOMY

Global output and trade expanded very rapidly last year and are continuing to grow, though at a somewhat reduced pace. The international economy is apparently in good health.

However, this appearance is misleading. The growth impulses that are present are quite fragile, and will need to be actively protected. What is more the true picture contains a double image. Some areas of the world have been repeatedly enjoying boom conditions. But others have been persistently in the grip of depression, and often disorder as well. This disorder - an external debt overhang, rapid inflation, large budget deficits, excessive money creation, rapid accumulation of internal debt, high real interest rates, flight from the currency, transfer of wealth abroad, and repeated currency depreciation - combines with stagnation to frustrate efforts to raise investment, reform trade policy and expand exports. It also exacerbates social conflicts and generates political instability.

The division of the world economy into high-growth and low-growth areas cannot be explained primarily by differences in growth potential or in the quality of policy-making. Depression, disorder and debt form a vicious and tenacious circle. Breaking out of it calls for a new level of solidarity within and among countries. Social groups must arrive at consensus on how to share the burdens and fruits of adjustment, and foreign creditors must lift the weight of debt on development.

Recent economic trends

Developed market-economy countries

The pace of activity in the developed market-economy countries has been particularly vigorous in the past several months. Although some slackening in this pace is already in evidence, current expectations are for a continuation into 1990 of the present expansion, which is already the longest of the post-war period.

Output growth in 1988 reached 4 per cent, a level that was significantly above what was foreseen in last year's *Trade and Development Report*, and which exceeded the forecasts of almost all observers. In retrospect it is apparent that this performance owes much to the policy response to the October 1987 stock market crash. In the wake of that crash, it was widely expected that the loss in wealth and in confidence would lead to a reduction in spending and to significantly worsened growth performance. However, in the productive sector confidence was little affected by the problems of the financial sector, and the magnitude and even direction of changes in wealth

were entirely dependent on the time period chosen for their measurement. The impact of the crash on macroeconomic policy, on the other hand, was immediate and substantial. Fiscal stances, responding to other concerns, were moving modestly in the direction of less restriction; during most of 1988 they were, on balance, neutral. Monetary policy, however, shifted decisively in the direction of ease, so that interest rates declined and remained lower until mid-1988. The combination of continued confidence in the productive sector and a major shift of macroeconomic policy in the direction of expansion then triggered the surge in activity that was experienced in 1988.

The experience since the stock market crash has moved the OECD economies and policy-making in those economies in a number of directions that should be helpful in the future. For one thing, monetary policy - especially in the United States - has been allowed to respond to the perceived needs of economies, rather than adhering to rules regarding the growth of monetary aggregates. This return to "fine tuning", with increased emphasis on targeting interest rates, has so far served well. Secondly, although inflation has been a constant worry in recent months, and may be a real threat in one or two countries, the most remarkable feature of the recent expansion has been the extremely modest response of prices to a significant move toward capacity limitations. On the whole, prices have accelerated only modestly, and in part in response to special factors unlikely to be repeated. This experience will require, in a number of countries, a revision of received wisdom regarding the pace of economic advance that is consistent with relative price stability. Thirdly, the composition of output has shifted in favour of investment. In large part this reflected the long-awaited response to improved profitability after an extended period of low investment. But it was also triggered by lower interest rates and by exchange rate changes: Japanese producers needed to invest to counteract the effect of yen appreciation, while United States producers needed to expand capacity in order to take advantage of their increased international competitiveness. In a number of countries with high unemployment, recent investment appears to be directed more toward expanding capacity, rather than increasing the efficiency of existing capacity. In consequence, investment will have a larger impact on employment than had hitherto been the case. The higher share of investment in output, if it continues, will also raise the longer-term sustainable rate of growth, and its role in this regard should not be underestimated.

Some aspects of the current situation, however, give rise to legitimate concern. Foremost among these is the apparent halt in the reduction of external imbalances. It is particularly important that the external position of the United States continue to improve. Failure to make further progress carries with it the danger that the deficit will sooner or later disrupt exchange markets, and the international economy generally. It could also give a new boost to protectionist forces within the United States. At the same time, it is essential that payments improvement continue to be sought in the context of vigorous growth. The international value of the dollar needs to respond more closely to the need to reduce the deficit than was the case during the first half of 1989, while the gap between home expenditure and output should be gradually cut, emphasis being given to the expansion of exports, rather than the reduction of imports. Demand growth should be moderated to the extent needed to avoid over-heating of the economy, and the fiscal deficit curbed to the extent needed to reduce interest rates, but without depressing activity.

Socialist countries of Eastern Europe

In 1988 growth in the socialist countries of Eastern Europe rebounded from the relatively low level recorded in the previous year. The most recent period continued to be characterized by the process of economic reform. It is now widely recognized that the management systems of the past entailed excessive centralization, insufficient attention to economic scarcity, and inadequate incentives to effort and efficiency. This was accompanied by sluggish technological advance, low efficiency of investment and a slowdown of the development of social infrastructure and the services sector.

To overcome these problems, it will be necessary to allow economic scarcity to be signalled to producers more effectively, with decision making being based on economic discipline and material incentives; the challenge is to find an entirely new balance between centralized management and producer initiative. Attention is also being given to exploiting more fully opportunities for international specialization. Increasing output and welfare will require these countries to raise labour productivity and improve the quality of output, ensuring that its composition meets more fully perceived consumer needs. The dilemma facing decision makers is that to be fully effective,

reform must be thorough and wide-ranging; yet, in practice reform - which for a number of countries entails a major social reorientation of their economies - can be accomplished only in stages. Reform in stages, however, presents its own set of formidable problems, including the possibility that its benefits would be less immediate and widespread than would be its costs.

During 1988 and early 1989 the process of reform in the socialist countries of Eastern Europe continued, with particular attention being given to the consolidation of the economic independence of individual enterprises, the definition of their rights and responsibilities, and to the managerial mechanisms required for structural adjustment. In the Soviet Union, for example, further measures were taken to enable enterprises to engage directly in international trade, and a major reform of the system of landholding in the agricultural sector was introduced. Likewise, in Bulgaria, Czechoslovakia and Hungary further major steps toward reform were taken.

The economic performance of the socialist countries of Eastern Europe varied considerably in 1988. In Poland and the Soviet Union, output rose quite vigorously, owing mainly to the good performance of industry. In both countries - but particularly in Poland - signs of inflationary pressures were in evidence. Bulgaria, Czechoslovakia and the German Democratic Republic continued to develop on the whole at stable rates in 1988. In Hungary growth decelerated, reflecting the uneven performance of industry; it also decelerated in Romania, reflecting in part the priority given to the elimination of external debt.

International markets

International markets played a key role in determining the pace, direction and intensity with which accelerated growth in industrial countries was transmitted to developing countries, and the extent to which developing countries themselves were able to contribute to the overall rise in trade and prosperity.

The volume of exports from developed market-economy countries rose vigorously in 1988 by some 7 per cent. The increase occurred across a wide spectrum of products, but was particularly steep for capital goods. The surge in capital goods exports, in turn, was a reflection of the increase in investment discussed above.

The overall expansion in world trade was facilitated by a sharp rise in international lending, led by an expansion of syndicated lending by banks and the return of new issues of international bonds to the high levels previously reached in 1986. Developing countries, however, did not participate in this overall increase in financial flows. Moreover, the role they played in the expansion of trade was largely conditioned by their financial position. Those with strong external asset positions (or which, regardless of that position, were able to use their international reserves) increased their imports sharply. These countries, mostly in East Asia, made an important contribution to the growth of world trade and prosperity, and helped to reduce trade imbalances.

Developing countries with weak external asset positions, on the other hand, were not able to expand their imports. In a few of these countries, mostly in Africa and Latin America, the growth of world trade helped boost export volumes, although the product composition of their exports and their traditional trade patterns were less favourable than those of developing countries in East Asia. Some of these countries, particularly those exporting ores, metals and agricultural raw materials, benefited from higher prices. Others - especially exporters of tropical beverages and petroleum - faced declining or stable export prices. Even when the net result of these various movements was a higher level of export earnings, however, these earnings could not be translated into increased imports. Thus, this part of the developing world did not contribute to more buoyant trading conditions: theirs was a dead weight on international trade.

This outcome was in part the result of higher debt service payments required of debtor countries since 1987 because of rising interest rates; the increase, which fell most heavily on middle income highly indebted countries, is estimated at around $6-8 billion annually. These higher interest payments were instrumental in bringing about a sharp increase in the transfer of resources from debtor countries to their creditors. For the highly indebted countries this transfer was twice as large in 1988 as in 1987, reaching $42 billion. These transfers also prevented the improvements in export earnings that occurred from having a clearly favourable impact on debt indicators, as discussed below.

Developing countries and China

The growth experience of developing countries in recent months has been sharply bifurcated. Growth in East Asian developing countries has continued to be quite vigorous, even though in some countries the rate slowed somewhat from the very high levels previously achieved. A rapid expansion of manufactured output facilitated by high levels of investment, including private foreign investment, has been a common ingredient in this experience. With a few exceptions - in particular the least developed countries of the region - growth performance in other parts of Asia has also been generally satisfactory in recent months.

In China, rapid expansion had already triggered measures in 1988 to cool an economy in danger of overheating and by early 1989 there were some signs that these were having the desired efect. It is as yet too soon to assess the influence that recent political developments might have on the pace and orientation of economic advance.

In Africa and Latin America, performance continues to be unsatisfactory or is actually worsening. In those few African countries for which foreign resource inflows made a tangible contribution to total resource availability, growth in 1988 was reasonably satisfactory. In many countries weather conditions and natural phenomena continued to be important determinants of agricultural output and thus of overall growth. On average, in spite of a slight improvement over 1987, *per capita* income in the region in 1988 continued to decline. In Latin America growth slowed markedly in 1988 and inflationary pressures intensified to unprecedented degrees. These developments were both the result of, and contributed to, a weakening of investment. Economic activity was virtually stagnant in many countries including the larger economies in the region. It fell in some smaller countries and *per capita* income declined in 12 of the 26 countries for which data are available. The outlook for 1989 is for even less growth and more price inflation.

The poor economic performance in much of Africa and Latin America during a period of vigorous expansion in world trade and overall improvement in commodity prices raises important questions regarding the relationship between the external economic environment and the economic performance of developing countries. Five or six years ago it was widely assumed that an improved international economic environment would play an important role in facilitating the resumption of growth and normal debt service in debt-burdened countries. It is increasingly apparent, however, that buoyancy in the world economy alone cannot refloat these economies, given the weight of their debt overhang and the cumulative damage they have sustained in recent years. The acute disorder currently afflicting the economies of many heavily indebted countries is one manifestation of that damage. Progress during the period ahead will thus depend critically on a proper understanding of the origins and character of disorder in debtor economies and of the role that the debt overhang plays in perpetuating it.

Macroeconomic disorder

Most developing countries which have been experiencing stagnation of output have also been suffering from a high degree of disorder in their main economic variables. Growth rates have been more unstable as well as lower, while inflation has become more virulent and unpredictable. Stagflation has typically been accompanied by financial malaise in the form of large and persistent budget deficits; an accumulation of much internal debt by the public sector, on top of an excessive level of external debt; rapid expansion of the supply of money and credit, combined with reduced demand for financial assets; extremely high interest rates; repeated currency depreciations alongside wide fluctuations in competitiveness; and the flight of wealth abroad and into assets denominated in foreign currency. Some countries are on the brink of hyperinflation, and demonetization of domestic currencies is underway.

The conventional analysis (which underlies the conditionality of the international financial institutions) puts the blame on budget deficits, excessive money creation and overvalued exchange rates, and ascribes these to policy errors. However, in analyzing the economic dynamics at work, one cannot take it for granted that the relationship between economic variables will remain stable regardless of their scale, and that variables which are causes in one situation will not become effects in another. Developing economies, like physical phenomena, are susceptible to turbulence. An external shock, if large enough, may interact with the initial conditions in such a way as to unleash explosive forces. During this process factors which had previously served as moving forces (e.g. the fiscal balance) may become passive, while factors that had previously been derivative (e.g. inflation) exert a major causative influence. Such transformations may make it impossible to exert control by manipulating the variables according to traditional theories (whether neoclassical economics or Newtonian physics).

There is much to suggest that the various shocks suffered by developing countries since the late 1970s indeed generated chaotic processes that have made financial disorder extremely difficult to dislodge. In some cases the initial conditions making for vulnerability were the product of policy errors; in others not. Largely regardless of such differences in historical background, the upshot in many countries was to inter-lock domestic financial instability, the foreign debt overhang and socio-economic stagnation. These have been fuelling each other, giving rise to a vicious circle whereby none of the problems can be durably resolved in isolation. To tackle over-indebtedness and restore development momentum requires macroeconomic stability. But, stability will be at best precarious until the debt overhang is greatly reduced, and productive capacities and living standards made to grow.

It is generally recognized that the external shocks disturbed not only the external accounts but also internal fiscal balances. The rise in international interest rates raised interest payments by the public sector, especially in countries where the government had borrowed heavily abroad; the fall in export earnings reduced government revenues, especially where the main export commodities were publicly-owned or where the export sector was an important source of tax receipts; and the drop in sovereign lending associated with the resulting debt crisis widened the financing gap. Much less attention has been paid to the fiscal damage caused by the process of adjusting to the deterioration in the balance of payments:

- Deflationary adjustment depressed economic activity and hence also tax revenues;
- Cuts in import volumes (undertaken for balance of payments reasons) and in tariffs (to improve resource allocation) reduced import tax receipts; export tax rates were in many cases also reduced;
- Currencies were sharply devalued, thus raising the domestic currency cost of debt servicing and public sector imports;
- Currency depreciations (as well as other manifestations of foreign exchange shortage) also fuelled inflationary pressures which, because of collection lags, reduced tax revenues in real terms;
- Because of inflation, depreciation and doubts about the government's creditworthiness, domestic interest rates were sharply increased in order to make financial assets denominated in domestic currency attractive and stem capital flight, thus greatly enlarging the public sector's domestic interest bill;
- Central banks also incurred losses, often the result of the public sector's assuming the external liabilities of private firms and granting private debtors exchange rate guarantees and preferential rates.

The dimension of the fiscal challenge was vast. The decline in net external financial flows to the public sector in many cases reached 20 per cent of total government expenditure. In percentage terms this swing was much the same for countries indebted to official creditors as for the highly indebted commercial bank borrowers. Offsetting such a loss without cutting public investment would have required doubling the government savings rate or halving non-interest spending. Besides, countries had to contend with the fiscal damage associated with external payments adjustment and central bank losses, as already noted. The "internal transfer" from the private to the public sectors required to make up for the budgetary losses typically amounted to several percentage points of GDP.

Most countries counteracted with substantial fiscal action, typically deep cuts in public investment (which hurt long-term growth) and higher prices for goods and services charged by public sector enterprises. The cuts in the budget deficits of the highly indebted countries between

1981-1982 and 1986-1987 were generally much larger than in major OECD countries during the same period. The extent of the policy effort and of success in fiscal correction were often remarkable. In many cases the public sector borrowing requirement was brought down to the levels prevailing before the external shocks. The magnitude of the policy response is only partially captured by this measure of the budget balance, however. Interest costs, over which the fiscal authorities have no control, rose steeply during this period. When these are excluded, the resulting budget balance (the "primary balance") moved into surplus, sometimes quite sharply; it was not unusual for this swing to have amounted to 6-10 per cent of GDP.

Budgetary correction involves deciding who will pay more to the public sector and who will receive less; in the process it is necessary to reconcile competing income claims. This is never easy when overall resource availability has declined. But when the resource shrinkage reaches dramatic proportions - as it has for developing countries in the 1980s - and when many of the individuals affected are living in extreme poverty, the task can become almost impossible. The relatively much smaller switch of resources from the private to the public sector now needed in certain developed market economies to balance the budget is proving to be exceedingly difficult, even in the climate of economic prosperity and buoyancy that characterizes those countries.

It is therefore not surprising that, in most developing countries experiencing external financial stringency, fiscal balance has not been fully achieved, that conflicts between competing income claims have remained unresolved, and that cuts in public investment, resort to borrowing and monetizing deficits have appeared to offer governments more viable options.

In many countries the financing gap has been large enough to give rise to an excessive rate of money creation or a rapid build-up of internal debt. Either way, interest rates have been driven up, together with the interest bill of the public sector, generating further expansions in the money supply and/or debt. In certain countries, this has led to a flight from the domestic currency, reducing the ability of governments to finance expenditures through money creation. Demonetization and hyperinflation have been increasingly in evidence. Thus, the heaviness of the adjustment burden has strengthened the feed-back mechanisms between variables such as the demand for and supply of money, interest rates, exchange rates and inflation to such an extent that violent surges in debt and inflation have occurred even when major adjustments have been made in those elements of the budget under government control.

Unresolved conflicts over income shares also underlie various other types of instability. The organized reactions of wage-earners, as well as various more automatic mechanisms such as indexation, have often served to offset the gain in competitiveness brought by currency depreciation, introducing wide fluctuations in the real exchange rate, and sometimes even in exchange rate policy. They have similarly eroded the changes in the internal terms of trade brought about by shifts in pricing policy. Moreover, resistance to impoverishment has in many cases created a wage-price spiral, which monetary contraction has only been able to break at an extremely high and unsustainable cost to output, employment and tax revenues.

One consequence has been financial disorder and stagnation, leaving little prospect of advancing structural adjustment and relieving the external resource constraint. Another has been to intensify class conflicts and political instability, often accompanied by violence and the threat of social upheaval. In a number of countries, hard-won gains in democratic institutions and human rights have been put in jeopardy.

Many countries have made repeated attempts to stabilize their economies and revive development without success. Failure to face the question of distribution head-on has been characteristic of both orthodox policies of monetary and financial retrenchment and heterodox policies centred around controlling prices and incomes.

Orthodox policies have often exacerbated inflationary pressures by requiring sharp currency depreciation and other price increases. Even when these have been overcome at the cost of recession, the halt to inflation has generally proved ephemeral owing to the reactions of those penalized by the increased unemployment and the rise in the cost of subsistence, and, more generally, the haphazard redistribution of national income.

Heterodox policies, on the other hand, have sought to eliminate inflation by reconciling income claims through reflation and by imposing controls on wages and prices. However, the degree of slack has generally not been sufficient to accommodate income claims through increases in capacity utilization. Wage demands have often aimed not merely to prevent further drops in living

standards, but to recoup losses already incurred. Moreover, because of the external payments constraint, it has generally not been possible to increase imports to avoid specific bottlenecks, as is generally required whenever growth is stepped up.

There are two main lessons to be drawn from the experience of stabilization:

- The external resource constraint must be greatly relaxed, to end the intolerable pressure on living standards and permit growth to resume;
- The various social classes must themselves forge a common understanding on how to share the remaining costs of adjustment and the fruits of recovery, and reform the fiscal system accordingly.

The first of these requirements in practice implies debt and debt service reduction on a significant scale. Unless it is met, the second cannot be.

It is therefore extremely important not to confine debt relief to countries that have already established a track record of macroeconomic stability. It is no less essential that adjustment programmes, which countries will need to adopt in order to be eligible for debt reduction, be designed to use the benefits to maximum effect. Part of these will need to be devoted to relieving fiscal pressure, so as to lessen financial tensions such as high interest rates and loss of monetary control. Part will need to be used to restore public expenditure on human resource development (including the protection of vulnerable groups), physical infrastructure and other types of public investment essential to social and economic development in the long term. Part will also need to be devoted to export expansion and import substitution. The right proportions will vary from country to country and over time.

The seven-year-long crisis has inflicted enormous damage on both the productive base and the financial systems of developing countries. It cannot be repaired overnight, and in many cases stability will not be fully realized until the resumption of growth has become firmly entrenched. Patience will therefore be needed - from private creditors, international financial institutions and creditor governments no less than from the debtors themselves.

Trade policy reform and export performance in developing countries in the 1980s

Prompted mainly by intense foreign exchange scarcities, in the course of the 1980s a large number of developing countries introduced trade policy reforms designed to increase exports and to improve their international competitiveness. These changes, which varied in intensity from country to country, involved a combination of reductions in non-tariff import barriers, reductions in the level and dispersion of tariffs, currency devaluation and greater reliance on the exchange rate as a balance of payments equilibrating mechanism, and the introduction or strengthening of export promotion measures.

Partly as a consequence of these policies, in most countries real exports tended to rise relative to real GDP. However, in many cases the shift in resources towards the production of tradeable goods did not take place in a context of economic growth. Usually because of the burden of servicing external debt, the ratio of imports to GDP failed to rise *pari passu* with the ratio of exports to GDP. Import compression and falling investment were widespread. Thus, the response of economies to more open trade policies in terms of aggregate economic growth and of underlying adjustments in the structure of production has often been weak.

Trade policy reform generally needs to be accompanied by real currency depreciation. In many countries, owing to acute foreign exchange shortages, currency depreciations were unexpectedly large, and led to increased inflationary pressures. When, for any of the reasons de-

scribed in the preceding section, these pressures could not be effectively countered, the resulting acceleration of inflation eroded the initial gain in competitiveness, making further devaluation necessary. The real exchange rate, therefore, has become extremely unpredictable, dampening investment in exports, one of the principal objectives of the trade policy reforms. Thus the liberalization-cum-devaluation packages have stood little chance of succeeding in the context of macroeconomic disorder.

There were significant exceptions to this general pattern, most of which were in East Asia. Several countries in this region were able to increase and diversify their exports substantially in a context of rising domestic output and to allow higher imports in support of new investment in both the tradeable goods and the domestic sectors. With output rising vigorously, they tended to enjoy greater price stability, and their real exchange rates were accordingly steadier. The greater stability in relative prices - of both domestic and foreign goods - encouraged investment in the desired directions, with a feed-back to the growth of output and exports. Here the circle was not a vicious, but a virtuous, one. Thanks to rising imports and investment, the shift in resources sought through more open trade policies was achieved.

During the entire post-war period, debates with regard to trade policy have figured prominently in discussions about development issues. The experiences of developing countries in the 1980s shed some light on these debates, particularly with regard to the relationship between trade policy and trade performance. During the 1980s (and also earlier), the countries which recorded the fastest rates of growth of exports followed policies of selective intervention rather than of neutrality of incentives. Experience also shows that selective intervention does not always lead to rapid export growth. Countries that supported industries with good possibilities of becoming internationally competitive in the longer term performed significantly better (in terms of both output and export growth) than countries where policies of selective intervention did not have as clear a development rationale. It is also true that most countries which introduced drastic trade liberalization packages during the 1980s have not yet been able to raise their export and output growth rates, and the prospects that they will succeed in doing so in the foreseeable future are not encouraging. Experience shows that a stable and remunerative exchange rate is also important, although not sufficient, for export success; and, as already noted, this has been rendered extremely difficult by the macroeconomic disorder prevailing in a large number of countries.

In all countries which have recorded high rates of growth of exports in real terms, export incentives have been important to export performance. The penetration of export markets is not an easy task for producers in developing countries, who have very inadequate information on and access to foreign markets. Therefore, orienting domestic producers to foreign markets requires special efforts. Duty drawback systems and other measures to provide domestic producers access to foreign inputs at world prices have been important factors in many countries.

A significant variable affecting the growth of manufactured exports has been the degree to which countries have been able to increase investment. In countries where investment and output have risen briskly, larger exports of manufactures have been part and parcel of the broader process of growth. By contrast, several countries which have had to curtail investment because of the foreign exchange and debt crises have generally exhibited weak economic growth or even retrogression, including in manufactured exports. Some countries have been able to expand exports strongly with weak or no growth in total investment and output. In most of these countries, recent successes remain fragile and could be reversed if and when domestic demand recovers. It is, therefore, of the utmost importance that investment growth be resumed. A combination of debt reduction and larger capital inflows to help countries enhance their supply capabilities, as appropriate in each individual case, is necessary for the recovery of investment and imports of needed capital goods.

A potentially serious problem of incoherence between trade policies in developed and developing countries is emerging. While an increasing number of developing countries are liberalizing their trade regimes in pursuit of their development objectives, the drift of trade policies in the developed countries is toward greater protectionism. Two recent events are particularly disturbing in this regard. The recent trade legislation in the United States, which puts the accent on bilaterally negotiating access to markets of foreign countries under the threat of retaliation, could become a cloak for the introduction of additional protectionist measures. Unless there is a high-level commitment to open markets, the process of bringing into conformity the non-tariff measures of individual member States of EEC in the context of the completion of the single European mar-

ket by 1992 could also lead to greater protectionism, if the most restrictive national measures are adopted at the Community level.

The protectionist environment which developing countries encounter at present implies that newcomers to international markets for manufactures may not be as successful in increasing their exports as the fast-growing East Asian economies have been over the past two decades or so; also, export growth in the latter countries could slow down significantly. Protectionism appears to be correlated with import penetration, particularly in traditional manufacturing sectors. The established exporters among developing countries are in the process of shifting their export structures towards more complex products, where protectionist measures are less intense, but are still significant in some sectors. But the exports of the newcomers are concentrated in the more traditional sectors. Therefore, as the exports of new entrants into world markets for manufactures grow, protectionist pressures in labour-intensive sectors could intensify. If the greater export efforts in the development strategies of these countries are to pay off, developed countries must resist these pressures and honour their commitments to roll back existing non-tariff measures.

Capital markets, payments and the debt problem

Decisive improvement in the debt situation of developing countries has continued to be elusive, and new lending to them from capital markets has continued to be low. The ratio of debt to exports improved somewhat for some developing countries (but not for those of sub-Saharan Africa), but it is still higher than in 1982-1984. Moreover, upward pressure on the ratio of interest payments to exports has been exerted by rising interest rates since the second half of 1988. Lending from the capital markets has remained depressed.

Net export credits to developing countries remain at low levels even though there was some recovery of gross lending in this form in 1988 after two years in which net flows were negative. Data for the export credit agencies of two major OECD countries indicate the continuing prevalence of restrictive conditions on such cover and the absence of any substantial improvement since 1986.

As a result of its adverse impact on the availability and cost of traditional financing and payments arrangements, the debt crisis has generated increased interest in alternatives such as countertrade and regional clearing and payments arrangements. In practice, however, both have proved for various reasons to be subject to limitations.

The growth of countertrade accelerated sharply in the first half of the 1980s but more recently appears to have slowed. Developing countries appear to be reassessing their involvement in the costlier forms of countertrade, leading to a reduction in the number of firms engaged in and promoting it. Nevertheless, the pressures and incentives to engage in countertrade persist: it remains useful to developing countries as a marketing tool for non-traditional exports; and external financial stringency continues to make conventional methods of financing trade very costly.

A major objective of regional clearing and payments arrangements is to lessen the dependence of members' mutual trade on the availability of convertible currencies. However, these arrangements have failed in most cases to prevent the spread of payments difficulties among developing countries during the 1980s. The shortages of foreign exchange experienced by members of these arrangements have led to large arrears in outstanding balances for settlement, this process on occasion being exacerbated by the tendency of some members to divert their exports away from others to third markets in order to increase earnings of convertible currencies for purposes such as servicing external debts.

The recent past has witnessed enhanced efforts to provide relief on developing countries official bilateral debt. The main initiative on this front has been action to implement the agreement reached at the Toronto economic summit in June 1988. Thirteen countries have benefited from concessional debt relief within the framework of the Paris Club since October 1988. However, the

implementation of the Toronto measures has shown a number of major shortcomings. So far all the countries benefiting from the measures belong to the group included in the World Bank's Special Programme of Assistance to sub-Saharan Africa. Thus most debt-distressed developing countries, including a number of low-income countries, have been excluded. The debt service reduction for the beneficiary countries has been relatively small because the degree of concessionality is generally too low, not all obligations to Paris Club creditors are covered, and the share of Paris Club debt in these countries' total debt is limited. Moreover, the consolidation period remains relatively short, so that serial reschedulings with their associated costs continue to be the norm. Furthermore, some creditors are financing the cost of debt relief by transferring funds from their aid budgets to their export credit agencies.

The foregoing underlines the necessity of:

- reviewing the eligibility criteria, so as to increase considerably the number of beneficiary countries - all least developed countries should be eligible;
- enhancing the grant element of the measures;
- widening the coverage of consolidation to 100 per cent of Paris Club obligations;
- applying multi-year rescheduling;
- ensuring additionality through a closer co-ordination between the Paris Club and donor groups;
- the consideration by other bilateral creditors of the adoption of comparable measures; and
- extending concessional relief to multilateral and bank debt.

Over the past few years, an increasing number of donor countries have applied more generous measures to ODA debt of poorer developing countries by converting them into grants, in line with UNCTAD resolution 165 (S-IX). More recently, the USSR has indicated its readiness to grant debt write-offs or 100-year moratoria to least developed countries. The French Government has announced its intention to cancel $2.5 billion equivalent of ODA debt owed by 35 IDA-eligible African countries. The United States has decided to write off up to $1.3 billion of ODA loans made to sub-Saharan African countries implementing adjustment programmes.

A fall in new lending, together with efforts by banks to reduce their exposure to troubled debtors, caused bank claims on developing countries to fall by 4 per cent in 1988. The problem is deep-rooted.

In the early years of the debt crisis, major creditor banks had a common interest in supplying new money because of their high exposure rates, and were in a position to oblige other creditors to participate pro rata. This is no longer the case. Many of the larger banks have succeeded in reducing their exposure and in building reserves against losses, and differences in prudential regulation and disclosure requirements, tax and accounting treatment, etc., have also helped fragment creditors. The process of concerted lending survives only with respect to very large debtors, and even then on a much reduced scale.

It is doubtful whether new bank lending can be revived. All banks have become more averse to risk, and most seem content simply to collect interest on past loans. Those which have managed to increase their capital ratio and to set aside sizable loan-loss provisions would prefer selling or swapping loans at a discount rather than attempting to improve the quality of their exposure by adding to it. But creditors that have not strengthened their financial positions are also extremely reluctant to add to their exposure and risk. New lending is also being discouraged by a number of other factors such as regulatory pressures to increase capital ratios; provisioning, which has raised the cost of new lending; equity markets, which are penalizing the share prices of banks with high exposure, making it more costly to raise capital and increasing vulnerability to hostile takeover bids; depositors' wariness of high exposure. Moreover, highly exposed banks have lost the power to force others to join in concerted lending. They can be expected to participate in concerted lending only for debtors big enough to pose a threat and when the alternative is loss of interest receipts.

Many banks have responded to the pressures on them to supply resources by searching for alternatives to new money, such as onlending and relending facilities, debt-equity conversion mechanisms, exchange offers with collateralization, debt buy-backs, and exit instruments such as exit bonds. This "menu" is attractive to creditor banks for a number of reasons, but some of the items on it pose problems for debtors. When undertaken on a large scale, relending and onlending and debt-equity swaps can lead to an overexpansion of the supply of money and credit. For this

and other reasons, several countries have had to suspend special debt-equity swap programmes established earlier under creditor pressure. On the other hand, the foreign exchange needed for "market-based" debt reduction of other kinds has been lacking. Consequently, although creditors have shown growing interest in reducing their developing country portfolios, the overall amount of debt reduction achieved has been only about 10 per cent of the total bank debt of the highly indebted countries outstanding when the process began.

Frustration with the low levels of both new lending and debt reduction has led to a major shift in official thinking on the debt problem. It is now accepted that reduction of debt and debt service must play a much greater role, and that creditor governments must be involved in the process. The main practical outcomes of the conceptual shift so far are the new policy guidelines adopted by IMF and World Bank:

- Around 25 per cent of a country's drawings from IMF under standby or extended arrangements can be "set aside" to support reduction of principal, as can around 25 per cent of its World Bank structural adjustment loans over a three-year period (10 per cent of total lending where lending is primarily for projects);
- In addition, up to 40 per cent of a country's Fund quota, and up to 15 per cent of its overall three-year lending programme from the Bank, can be used for interest support.

$10 billion will also be available in parallel lending from Japan. The total pool will be around $30 billion, but actual use is unlikely to approach this figure. For one thing, countries unable or unwilling to accept Fund and Bank conditionality will be ineligible even for monies "set aside" for principal reduction. For another, access to "additional" borrowing for interest support, and perhaps also the Japanese funds (which together make up well over half the total pool) will require special justification. Consequently, few countries other than the handful which have succeeded in fulfilling policy conditions for several years in succession are likely to be able to draw significant sums. Moreover, borrowing under "set asides" involves no additionality, and its impact is likely to be smaller than borrowing for interest support. The "strengthened debt strategy" may therefore bring little gain to those debtor countries which cannot achieve macroeconomic equilibrium without first receiving relief.

There is a danger that the bigger banks will collude to offer only modest discounts in debt and debt service reduction operations. If this is to be avoided, countervailing power will need to be exercised. The recent decision of IMF no longer to insist that a member be current on its debts to banks before drawing on its resources is a step in the right direction, but other pressures will also need to be exercised in order to ensure that no creditor shirks its responsibilities.[1] Even if the $30 billion were fully used and significant discounts obtained, the fall in developing countries' obligations would still be very modest, in part because reductions in the claims of banks will be financed by increased debt to IMF, the World Bank and Japan. On simple but reasonable assumptions, interest payments would fall by about 15 per cent for the highly indebted countries and principal by less than 20 per cent. The minimum needed, however, is about double these figures, as pointed out in last year's *Trade and Development Report*.

Thus, while the new thinking on debt represents significant and irreversible progress, more is required in terms of action:

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1 As the *Trade and Development Report, 1989* went to press, Mexico and its creditor banks announced an agreement which gives banks three options: to swap their loans for 30-year bonds at a 35 per cent discount; to swap them for 30-year bonds with the same face value but carrying a much-reduced interest rate (6.25 per cent); or to make new loans over 4 years totalling 25 per cent of their current exposure. The agreement thus involves new debt as well as reduction of debt and debt service. The extent of debt and debt service reduction is likely to be considerably less than the discounts agreed to, since not only will new lending by banks generate new debt (to banks) but so will the debt reduction operations themselves (to IMF, World Bank and Japan).

Creditor government pressure was a key ingredient of the negotiating process leading to the agreement, which is the first in the context of the "strengthened debt strategy". Further pressure may be needed to ensure that a sufficient number of banks opt for new money to allow the funds available for credit enhancement to meet other banks' demand for debt conversion at the agreed discounts. It is unclear what role will be played in the future by those banks that now prefer to provide new money, and whether a further round of debt conversion will be needed as their financial positions improve.

The implications of the agreement for other debtors are also unclear. Banks opting to provide new money to Mexico may become *pro tanto* more reluctant to extend their exposure to others; in any event they will remain extremely reluctant to provide new money to small debtors. Consequently, there may be need for heavier pressure to lend (even if the creditor governments' security and foreign policy stakes are smaller); and for greater emphasis on debt conversion in other cases.

- Creditor governments need to widen their role, and enlarge the scale of debt and debt service reduction by providing further inducements and/or imposing sanctions;
- No less important, the conditionality on adjustment programmes must adapt to take full account of the difficulty and complexity of overcoming disorder which has become entrenched, as well as the limits to which countries can engage in debt equity swaps and privatization without jeopardizing their public finances.

Many proposals and schemes have already been put forward. They should be given serious consideration by the international community, before developing countries' frustration with stagnation and disorder leads them to try and solve the debt problem unilaterally.

THE LEAST DEVELOPED COUNTRIES

Among the developing countries that are persistently in the grip of a vicious circle of poverty, slow economic growth and debt are the poor and economically disadvantaged least developed countries, which rose in number to 42 in 1989 as compared to 31 at the beginning of the decade. These countries share in common one overriding feature: totally inadequate levels of living for most people, reflected in acute hunger and malnutrition, high levels of infant mortality and disease, illiteracy and other stigma of mass poverty. Because of their structural weaknesses, the LDCs have been highly vulnerable to the vagaries of the world economy: they have thus been particularly affected by the worsened economic environment that has characterized the 1980s, and benefited very little from the recent expansion of global output and trade. They have, moreover, been induced to engage in adjustment and policy reform inspired by conventional analysis, which have at best had only a limited impact on their economic performance.

Special characteristics

A number of characteristics of the LDCs make these countries a special, particularly disadvantaged category of developing countries:

- Per capita income is only a quarter that of the developing countries as a whole;
- The share of agriculture in GDP is almost two and one half greater than in the developing countries as a whole and that of manufacturing is less than half. Almost three quarters of the labour force is in the agricultural sector, which is 30 per cent more than the corresponding share for the developing countries. Yet, the LDCs import almost twice as much food as the average for developing countries;
- The transport and communication links are less advanced than those of other developing countries, which has helped to perpetuate a dualistic economic structure;
- In the 1980s the value of LDCs' exports has grown at an annual rate (1.1 per cent), that is less than one sixth that for the non-oil developing countries. Whereas primary commodities account for 32.5 per cent of the total exports of the non-oil exporting developing countries, they represent 65 per cent of LDCs' exports, which makes these countries extremely vulnerable to fluctuations in the world markets for primary commodities.

The indicators of social characteristics show an even greater divergence on many counts:

- The coverage of primary health care is only two thirds that of the developing countries;
- Access to safe drinking water is considerably less widespread than in other developing countries;
- Adult literacy rates are barely more than half the average for the developing countries, and school enrolment ratios only two thirds at the primary level, one third at the secondary level and one quarter at the post-secondary level.

As regards the role of women in the process of development, major obstacles are the following:

- The fertility rate is more than half as high again as in the developing countries as a whole, and marriage and child-bearing begin earlier. Only 10 per cent of women use a contraceptive method, compared to 49 per cent in the developing countries;
- Infant and maternal mortality rates are 40 per cent and 20 per cent higher, respectively, than those of the developing countries as a whole;
- Fewer than one third of women are literate, compared to one half in the developing countries;

- The ratio of girls to boys attending primary school is low (48 per cent), and the difference becomes more pronounced at the secondary and higher levels of education.

Geographical disadvantages and ecological fragility constitute additional constraints to the development of LDCs:

- Land-lockedness is a phenomenon virtually peculiar to LDCs, 15 of the 20 land-locked developing countries being LDCs. The exports and imports of these countries often have to move over long distances through transit territories over which they have no control, thus raising the costs of both exports (actual and potential) and imports;
- The basic characteristic of island LDCs (of which there are nine) is their smallness. Since these countries face high unit costs in social and physical infrastructure, they have to devote a greater share of their financial and human resources to providing basic infrastructure and services than do larger countries. Moreover, island LDCs are more prone to natural disasters;
- A further characteristic of the LDCs is their environmental fragility. Their environmental degradation often arises from the misuse or overuse of arid and semi-arid land which, in the case of economically weak countries such as the LDCs, constitutes the inevitable response of a very poor population trying to cope with its subsistence needs. Environmental deterioration has been compounded by periods of drought, floods, cyclones, seismic disorders and other types of disasters.

Structural adjustment and policy reform

During the 1980s, the LDCs have been faced with the challenge of both carrying out the structural transformation of their domestic economies and dealing with a mounting debt burden and growing payments difficulties. It is essential to recall that the worsened economic environment of the 1980s has affected developing countries as a whole and LDCs in particular, and has conditioned the payments difficulties that most LDCs have experienced. Major elements of this situation as it has affected the LDCs, are:

- A fall in developed country demand for, and so world prices of, many raw materials, thus depressing LDCs' export earnings and weakening their debt servicing capacity;
- Increased protectionism, affecting exports and potential exports of LDCs such as garments (Bangladesh) and cereals;
- High world interest rates impinging on debt service;
- An inadequate volume of ODA flows to LDCs and insufficient debt relief for them;
- A strengthening of the conditions attached to aid.

In the period from mid-1981 to June 1989, 27 LDCs implemented stabilization programmes negotiated with IMF and received support through stand-by arrangements and/or the Fund's recently established Structural Adjustment Facility. The programmes have been increasingly supported by complementary long-term credits granted by the World Bank and by regional development banks. Other LDCs have implemented programmes of a similar nature but outside the IMF framework.

Devaluation has been one of the key elements of, if not a precondition for, the adjustment programmes negotiated with IMF, as a means both of enhancing the international competitiveness of locally produced goods and of encouraging import substitution. Quantitative restrictions on imports have been replaced by customs duties, and the marketing of exportable commodities liberalized so as to allow local producers to respond more directly to world market signals.

A large number of LDCs have had to implement demand-management measures aimed at reducing public expenditure, increasing public revenue and containing credit and monetary expansion. LDCs have introduced policies to encourage the growth of domestic savings by households and by governments, to streamline the tax system and to reduce capital flight.

Several LDCs have instituted programmes focused on improvement, privatization or liquidation, where appropriate, of public and parastatal enterprises. Many have undertaken a reform of their investment codes, or are in the process of doing so, in order to encourage private investment, including the establishment of foreign enterprises. With a view to promoting efficiency a

number of countries have launched major reforms in the agricultural, manufacturing, trade and financial sectors.

Impact of the adjustment programmes: lessons of experience

The performance of the 12 LDCs which have had consecutive programmes throughout most of the 1980s does not differ significantly from that of the LDCs as a whole. Only three of them registered a higher average annual rate of growth in 1980-1987 than that of the LDCs as a whole (2.3 per cent), and only two improved their growth performance in 1980-1987 as compared to the 1970s. As regards the current account deficit, its value as a proportion of the value of exports of goods decreased markedly or steadily in only 8 out of the 12 LDCs. Inflation rates were reduced significantly between the 1970s and the 1980s in half of these LDCs, whereas they increased noticeably in the other half.

The lack of any consistent relationship between the existence of adjustment programmes and economic performance as reflected in growth, the current account balance and inflation, leaves open the question of the adequacy of these programmes for the LDCs. As currently defined, these programmes could indeed bring about undesired effects, in particular in terms of high social costs and a weakening of the LDCs' ability to achieve long-term economic development.

Detailed assessments were made for Bangladesh, Botswana, Lesotho, Malawi, Nepal, Niger, Sudan and United Republic of Tanzania. The reviews of their experiences lead to a number of conclusions regarding the design and impact of structural adjustment programmes in the LDCs:

- In addition to the fact that the initial changes of policy cause some unavoidable distress to vulnerable groups, the adjustment programmes have so far produced mixed results and achieved, at most, limited success;
- Adjustment in LDCs has too often focused on demand-restraint measures, which have led already poor economies to operate at even lower levels of output;
- Devaluation, which is a common feature of the stabilization and adjustment programmes, appears to have had little effect in stimulating exports;
- The strong emphasis given by adjustment programmes to redirecting resources from public bodies to private entrepreneurs is also called into question. The programmes need to take into account that LDCs generally have a very poorly developed entrepreneurial class and depend on public institutions to sustain development;
- Social services have suffered under adjustment, largely on account of cuts in development budgets, and inadequate maintenance and operational budgets;
- Additional financial resources directed to LDCs appear not to have been sufficient to support their adjustment efforts. Moreover, the share of grants in aid disbursements has declined, and conditions attached to aid have become stringent;
- Adjustment programmes have not taken the problems of external debt sufficiently into acccount in their design;
- The specific characteristics and problems of individual LDCs have not always been adequately taken into account in the design of these programmes;
- The adjustment programmes have also failed to make provision for the flexibility to adapt - as the vulnerable LDCs must inevitably do - to unforeseen factors, be they internal, regional or global in origin, which are beyond LDCs' control;
- Finally, excessive emphasis on securing short-term payments correction has led to policy approaches that do not focus sufficiently on promoting long-run development. The sort of changes that are required call for additional resources, a longer timeframe and careful sequencing of policy implementation.

K.K.S Dadzie

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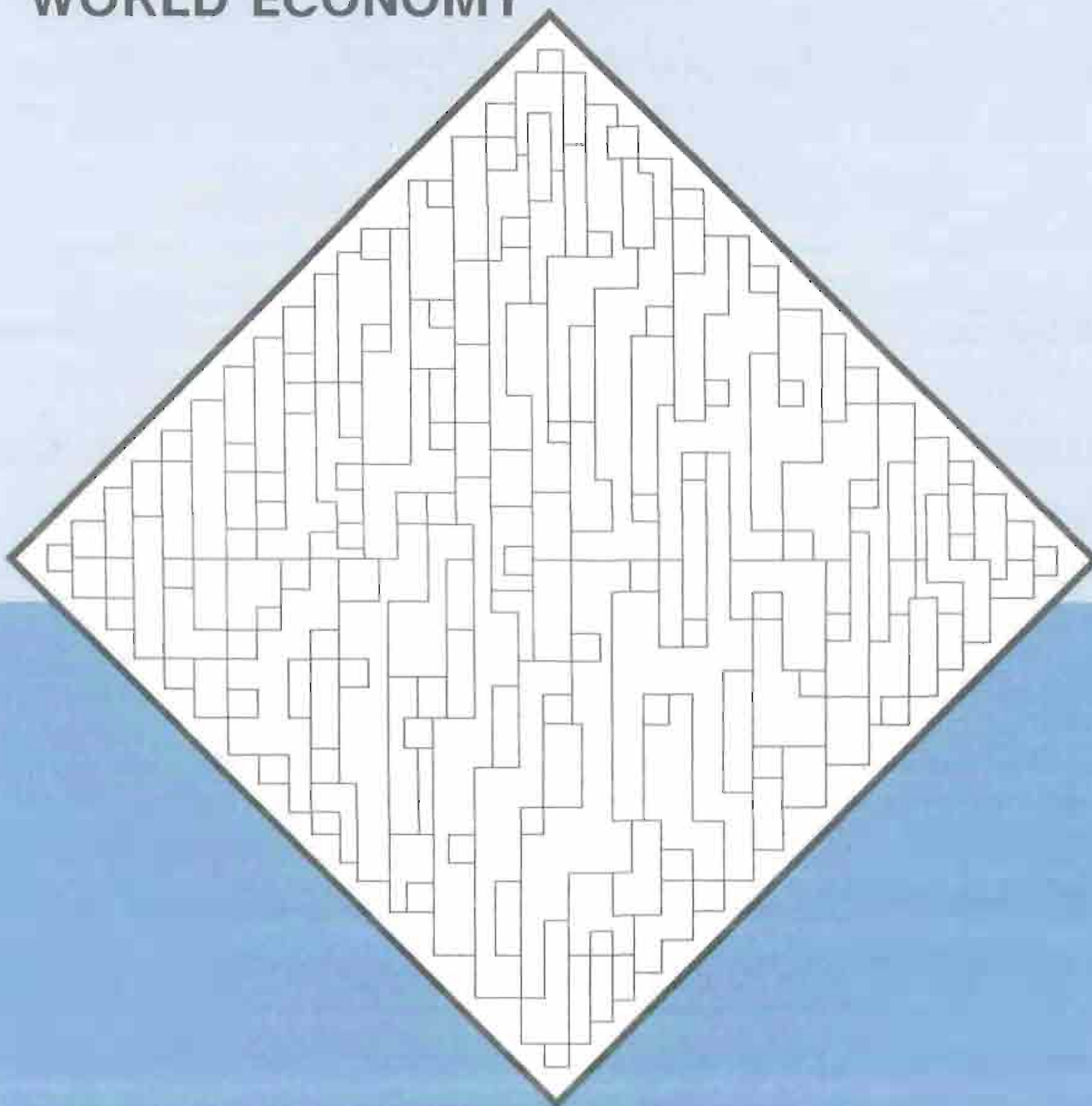
Part One

STAGNATION, DISORDER AND REFORM IN THE WORLD ECONOMY



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CURRENT TRENDS AND OUTLOOK

The current world economic situation is one of uncertainty, market volatility and uneven growth in production and trade. Exchange rate movements have been rapid and have often seemed both to contradict fundamental economic relationships and to be beyond the influence of policy. In recent months the major developed market-economy countries have had only modest success in holding exchange rates within agreed bounds, and fiscal policy has scarcely been used as an instrument for macroeconomic control. Growth remains largely concentrated in the developed market economies and Asian exporters of manufactures. Growth of GDP has remained below that of population in most of Africa and in the least developed countries of Asia, while in Latin America growth slowed down in 1987 and weakened again in 1988; a further deceleration is in prospect for 1989.

The experience in 1988 and so far in 1989 is instructive for what it says about the short-term growth linkages in the world economy. 1988 marked the most vigorous growth performance of developed market-economy countries since 1984; world trade likewise rose strongly. This stands in stark contrast to the weak performance of the Latin American countries since 1987. The sharp drop in growth in this region after six years of operation of the international debt strategy, and in the face of an unusually favourable international environment, calls for a thorough review of what needs to be done to overcome the economic crisis of the region.

Despite unexpectedly good performance in some parts of the world economy, a number of other features of recent experience are a cause of concern. First, the strong growth in 1988 in the developed market economies has given rise to concern over a possible renewal of inflation in some of the major economies among them. In most countries this concern is premature, and there is a risk that policy will be unnecessarily restrictive. The apparent inability to make effective use of fiscal policy has placed the entire burden of management on monetary policy and has led to a conflict between exchange rate policy and domestic demand management. Second, there are few signs of hope regarding a reversal of the deteriorating economic conditions in the African continent, which was little affected by the boom in world trade in 1988, and the least developed countries of Asia remain largely at the mercy of exogenous events. Finally, evidence is accumulating that the large, steady deterioration in the economic conditions facing many, if not most, developing countries is having a measurable impact on social and political stability.

The outlook for 1989 and 1990 (see table 1) is for a slackening in the overall rate of expansion of world economic activity, concentrated in the developed market-economy countries and the Asian developing countries. Africa is forecast to continue its weak performance of 1988 while Latin America is expected to show a further decline of growth in 1989. Rates of expansion of world trade are likely to remain somewhat higher than those of world production, while commodity prices, with the exception of petroleum and minerals, could show a significant weakening toward the end of the forecast period.

The following sections take up these and related issues.

Table 1

WORLD OUTPUT, 1986-1988, AND FORECASTS FOR 1989 AND 1990

(Percentage change)

Country group	1986	1987	1988	1989	1990
	Actual		Estimated	Forecasts	
World	3.1	3.3	4.2	3.3	3.3
Developed market-economy countries	2.7	2.9	4.0	3.1	2.8
of which:					
North America	3.0	3.5	4.0	2.6	2.2
Western Europe	2.5	1.9	3.5	3.1	2.7
Pacific developed	2.3	4.1	5.3	4.2	4.0
Socialist countries of Eastern Europe	4.2	2.9	3.9	4.1	4.1
Socialist countries of Asia	7.6	10.9	11.4	5.0	6.5
Developing countries	2.8	3.1	3.7	3.1	4.0
of which:					
Latin America	3.9	2.2	0.8	0.6	2.8
Africa	1.5	1.2	2.6	2.8	2.5
Asia	2.2	4.5	6.0	5.1	5.4
Memo item:					
Least developed countries	3.7	2.8	2.1	2.6	2.9

Source: UNCTAD secretariat calculations, based on national and international sources for 1986-1988 and SIGMA for forecasts.

A. The international economic environment in 1988

1. The regional experience: a lesson in uneven development

(a) Developing countries

Economic performance in developing countries in 1988 was heavily influenced by their international trade. Differences in trade performance, in turn, were conditioned, in part, by differences in the composition of exports and the performance of traditional export markets (see table 2 and box 2). The exporters of manufactures in East Asia, for example, were favoured by a very buoyant environment as demand in most countries in the region grew substantially, a reflection of both fast-growing consumer spending and of large business investment. Their exports continued to grow rapidly, although at a rate considerably lower

1 Moreover, as of 1 January 1989, the East Asian exporters of manufactures no longer qualified for benefits under the United States GSP scheme.

Box 1

SUMMARY OUTLOOK

World economic forecasts for 1989-1990 indicate a slackening of the rate of growth of world production over the next one to two years but there is little to suggest the imminence of a new period of serious recession. Nevertheless, serious trade imbalances, while showing some continued improvement, continue to plague the developed market-economy countries. Further, the recent substantial disparities in performance among developing countries will continue to persist. Because of the inherent resistance of the major imbalances in the world economy to corrective pressures, the state of confidence is such that a serious disruption of the adjustment process, e.g. a sharp rise in interest rates due to exchange rate instability, could produce a cumulative downward movement in economic activity.

Over the longer term, the SIGMA baseline projections for the 1990s indicate that there is little evidence on which to base an expectation of recovery in the world economy as a whole. This scenario is quite robust and insensitive to small changes in underlying assumptions. The present picture is unlikely to change unless concerted policy actions are undertaken to address current trade and financial imbalances in a manner supportive of growth. Asian economies will continue to outperform the rest of the world economy but are likely to experience some slackening in growth themselves. Further, the least developed among them will continue to face obstacles to their development. Disease, environmental damage and continued external constraints leave little hope for a recovery in Africa on the basis of current policy trends. While Latin American countries will continue to grow slowly over the next few years, they should be able to accelerate their rates of growth slightly in the latter half of the decade as their debt burdens decline. The growth prospects of the socialist countries of Eastern Europe are uncertain, with any acceleration largely dependent on the success of policy initiatives currently being pursued. China is likely to grow somewhat more slowly as its development proceeds and as it begins to face more pronounced internal and external constraints. Western Europe should maintain its recent relatively strong growth performance, while Japan is likely to grow significantly more slowly than in the 1970s and 1980s. In the case of the United States there is a large degree of uncertainty regarding the manner in which it will cope with its trade imbalances and debt burden. Indeed, there is some risk of an outcome worse than that depicted in this scenario, which would have a major impact on the actual evolution of the world economy in the 1990s.

in 1988 (15 per cent, compared with 20 per cent in 1987).[1] Actual 1988 export performance, however, varied quite markedly among these traditionally fast-growing exporters of manufactures and reflected in the main the influence of currency realignments on their competitive positions. For example, Taiwan Province of China, whose currency had appreciated the most with respect to the United States dollar, recorded a sharp deceleration in export volume growth, from 15 per cent in 1987 to only 1.4 per cent in 1988.[2] In contrast, Singapore, whose currency had appreciated much less vis-à-vis the dollar and may have even depreciated appreciably in real effective terms during the past few years, fared particularly well in 1988, with exports rising by almost one third. The intra-trade of the East Asian region has also shown a tendency to accelerate during recent months. In addition, interregional linkages had also been enhanced through direct investment by the more successful exporters, who had been experiencing rising costs at home and losses in competitiveness due to currency realignments.

The recent increase in demand for manufactures has also benefited major exporters in Latin America; the total volume of exports rose by about 17 per cent in both Argentina and Brazil, although this was also the result of higher commodity exports, especially from Argentina. Primary exporters in general also benefited from the enhanced demand for their products, although there were important exceptions. Thus, while producers of industrial raw materials, especially ores and metals, and of temperate zone foodstuffs, fared relatively well, especially in respect of their terms of trade, exporters of tropical beverages, notably those in Africa, continued to suffer from depressed international markets. Low prices continued to adversely affect the purchasing

2 In real effective terms the new Taiwan dollar was estimated to have appreciated by more than 12 per cent between 1986 and 1988.

power of the major oil exporters, whose terms of trade had fallen to half the 1980 level by 1988, the lowest level since the large price increase in 1974.

In Latin America a combination of the severe constraints on external resources and domestic imbalances, especially the large and chronic public sector deficits in many countries, led to a considerable tightening of fiscal policy. At the same time, in many countries inflationary pressures intensified to unprecedented degrees and investment slackened or declined, owing, in part, to the uncertainty regarding future economic policy. Economic activity was virtually stagnant in many countries, including the larger economies in the region - Argentina, Brazil and Mexico. It declined markedly in some smaller countries and satisfactory growth at 5 per cent or higher took place in only three countries. Per capita income declined in 13 out of the 26 countries for which data are available.

The growth experience of Latin America in 1988 reflected the inability to translate a vigorous expansion in external demand into satisfactory domestic expansion. The volume of exports from Latin America rose by 10 per cent in 1988, an increase in value of almost $13 billion. The expansion occured primarily in two of the larger economies; in a number of smaller countries export volume actually declined. Imports advanced rapidly in Mexico, where they played an important role in dampening inflation, and were financed, in part, by a drawing down of reserves, which were ample at the beginning of the year. Throughout the rest of Latin America, however, either there was no increase in export earnings or the rise in national savings was offset by higher interest payments and profit remittances, reduced availability of foreign credit, the need to reconstitute inadequate reserves or some combination of the three. Consequently, the net transfer from Latin America rose steeply, reaching $29 billion, or one third of the region's exports of goods and services.

In those African countries where foreign resource inflows had made a tangible contribution to total resource availability growth was maintained in 1988, albeit at modest levels. However, as has been common in recent years, growth performance in many developing countries in the region was affected in one way or another by weather conditions. North African countries in particular were badly hit by both drought and locust invasion. In some oil-exporting countries the declines from oil revenues more than offset relatively good export earnings from other sectors. Elsewhere, exceptionally good weather helped produce a reversal of the drought-induced decline in the agricultural sector in 1987. At the same time, output performance in many African countries suffered from reduced export earnings due to poor volume growth and adverse terms of trade. Altogether, in spite of a slight improvement in total real growth (2.3 per cent in 1988, as compared with 0.8 per cent in 1987), per capita income in the region continued to decline. Meanwhile, the trade balance deteriorated due to the large imports of agricultural products, a consequence of the drought in 1987.

Real growth in East Asian developing countries continued to be quite strong, although it slowed down in countries where domestic demand began to replace exports as the principal source of growth. This was particularly so in Taiwan Province of China, where exports rose 13 per cent in 1988 (a sharp drop from the 1987 rate of about 35 per cent); output growth was 7.3 per cent in 1988 (compared to 11.9 per cent in 1987). Indeed, the appearance in recent years of serious bottlenecks in the production of manufactured products had encouraged a number of manufacturing firms in the major exporting countries of East Asia to start operations in some lower-cost countries in the region. Thus, driven by buoyant exports and investment, activity in these countries picked up strongly. As a result, there was a noticeable convergence of real growth rates in the region in 1988. Thailand and Malaysia in particular have been successful in reducing their traditional reliance on primary exports; the former has benefited especially from foreign investment, and domestic economic activity grew by an estimated 9 per cent in 1988. In addition to the successful exporters of manufactures, both old and new, real growth in the other countries in the region was, on the whole, also quite satisfactory.

Growth in West Asia recovered in 1988 after having been very sluggish during most of the 1980s. Because of the losses of the purchasing power of exports, however, real absorption of goods remained low in the region. The cessation of hostilities should also improve the economic climate in the region. Performance, however, continued to be subject to the vagaries of the oil market. Nevertheless, recent developments outside the oil sector (e.g. in agriculture and in private industrial investment in Saudi Arabia) are encouraging. However, high inflation necessitated much tightening of policy to bring down demand, with a resulting reduction in output in some instances.

In South Asia an exceptional recovery in agriculture contributed to a particularly good output performance in India in 1988. Despite the earlier setbacks in agriculture and the changing international economic environment,

Box 2

TRADE PATTERNS IN DEVELOPING COUNTRIES IN 1988

The increases in world demand benefited both primary and manufactures exports and the improvement in the terms of trade recorded for the non-oil-exporting developing countries reversed to a degree the sharp fall in 1987, though they were still about 14 per cent below their 1980 level. The demand for manufactures was in general very brisk for the exports of some developing countries in both Latin America and East Asia. Trade in consumer durables in particular benefited from the steady increase in private consumption in many developed market-economy countries, but international commodity trade also responded to the fast growth of activity which took place in these economies. In general, since import volumes into Japan grew more than twice as fast as those into North America or Western Europe, countries relying more heavily on the Japanese or other East Asian markets as an outlet for their output were thus more favoured than others. Similarly, countries specializing in manufactures exports also tended to fare better than primary commodity exporters. The statistics in table 2 are intended to illustrate the influence of, on the one hand, geographical distribution and, on the other, the product composition of exports on overall export performance. They are hypothetical figures indicating the increase in export volumes which could have been expected of each group of developing countries as a consequence of changes in demand in its principal export markets and products assuming constant product and market shares. While the figures are rough, being based on estimates for only three product groups (agriculture, mining and manufacturing) and eight markets, [1] they are illustrative of the continued favourable conditions facing the East Asian major exporters of manufactures, in terms of both market and product growth. Other countries in Asia also shared in a buoyant trading environment but were less favoured by the types of products they exported during the past three years. In contrast, manufactures exporters in other regions, most notably Latin America, were facing relatively more sluggish market growth, a feature also shared by the primary exporters in the region. Compared with other developing regions, Africa was particularly handicapped by both slow market expansion and an unfavourable composition of exports, while West Asia suffered particularly from slow market growth.

1 EEC, North America, Japan, other developed market-economy countries, developing countries in Latin America, in Africa, in West Asia and in South and East Asia.

manufacturing out has continued to grow at a fast pace (as it has also in Pakistan) during recent years. Although exports grew substantially in 1988, large imports and debt service payments led to an important depletion of reserves, which may necessitate additional borrowing abroad. The thrust of policy is increasingly oriented towards managing the internal and external debt. Much emphasis will be placed on reducing the budget deficit by raising government revenue and reducing expenditure and on increasing the profitability of public sector enterprises. The real economy, on the other hand, has been steadily gaining strength and private investment is expected to be particularly buoyant in the coming months. Other countries in the region, in particular Bangladesh, continued to be plagued by national disasters.

(b) China

China maintained its place among the faster-growing economies in the world in 1988, with GDP growth exceeding 11 per cent. Due to rapid industrialization and high inflows of foreign direct investment, the industrial sector, which expanded by 21 per cent, was the major contributor to growth. Investment in the sector also increased substantially. Increasing exports, mostly from the coastal areas and special economic zones with port infrastructure facilities, have been particularly important to this growth. Agricultural performance was weaker, with output growing at 3.1 per cent in 1988, against 5.8 per cent in 1987, because of damage caused by drought and flood. In consequence, whereas China was a net exporter of food grains in 1985 and 1986, it became a net importer in 1988. In addition, coal and oil production and hydro-electric energy output

Table 2

HYPOTHETICAL EXPORT GROWTH OF DEVELOPING COUNTRIES IN 1986-1988 ASSUMING CONSTANT PRODUCT AND MARKET SHARES

(Percentage) [a]

		1986	*1987*	*1988*
Major exporters of manufactures				
East Asia	A	3.7	1.6	1.9
	B	0.8	1.0	2.6
Others	A	-0.5	-1.9	-2.1
	B	-0.6	0.5	0.1
Major oil exporters	A	1.9	0.0	0.3
	B	3.9	-2.8	-0.1
Other developing countries in:				
Latin America	A	1.6	-2.4	-2.1
	B	-1.0	-0.1	-1.3
Africa	A	-0.4	-0.5	-1.6
	B	-1.5	-0.1	-1.9
West Asia	A	-9.6	-2.1	-2.2
	B	0.4	0.3	0.9
South Asia	A	0.3	2.3	2.3
	B	-1.1	0.7	-0.2
East Asia	A	2.9	3.0	3.6
	B	-0.8	0.5	-0.0

Source: UNCTAD secretariat calculations (see box 2).

a Hypothetical difference, for each country group, between the growth of exports from the group and from developing countries as a whole resulting from A: market growth of total world demand and B: growth of world demand for different products.

were also adversely affected by weather conditions.

Inflation was a source of major concern throughout the year. A fast growth of aggregate demand, resulting from a rise in real wages due to incentive wage payments, from the existence of large private cash holdings, and also from a shortage of farm products, have pushed the inflation rate to a record high of 21 per cent in 1988, a sharp acceleration from the rate of 9 per cent in 1987. As a consequence, the monetary authorities tightened the money supply, reduced bank credit for investment and raised interest rates on bank lending. Furthermore, to moderate the impact of price reforms affecting various goods and services the Government reintroduced direct control of some key commodity prices.

The rise in the value of exports in 1988 was less vigorous than in the previous year (20 per cent, against the previous 35 per cent), while the value of imports, which was virtually unchanged in 1986 and 1987, increased by 27 per cent in 1988. Consequently, the trade deficit rose from $1.7 billion in 1987 to $4.6 billion. The surge in imports was due to several reasons. Poor harvests caused imports of grains, other agricultural products and fertilizer to increase. At the same time, cotton imports soared in order to meet the increased demand for textile processing. Also, private consumption rose rapidly, in particular for consumer durables, in reaction to which the Government increased import duties on certain consumer goods.

Net earnings from tourism have been on the rise since 1985, reaching $1.8 billion in 1987 and increasing further in 1988; as a consequence, the positive services balance partly offset the trade deficit. Exchange reserves grew steadily, reaching a level of $19 billion by the

end of the year. On balance, and with foreign capital inflows apparently strong, China is likely to have run a current account deficit of around $3 billion for 1988, after a small surplus of $0.3 billion a year earlier.

(c) *Developed market-economy countries*

In spite of turbulence in financial markets and uncertainties surrounding movements in key economic variables, the developed market economies posted an unexpectably high rate of expansion of some 4 per cent in 1988, marking the sixth year of continuous growth. The growth was widespread, taking place not only in the United States and Japan, where activity had been fairly robust since 1984, but also in Western Europe, which experienced its highest growth rate of the 1980s. In spite of the sharpest rise in output since the recovery of 1984, the inflation rate was only about one third of that prevailing at the end of the 1970s.[3] As is discussed in more detail in subsection 2(a) below, the market economies were unscathed by the stock market collapse of October 1987, due to the exceptional strength of underlying demand conditions in many countries in the period just preceding the collapse and the response by the authorities to the collapse itself, particularly as regards monetary management.

Capital formation was a major engine of growth in the developed market-economy countries in 1988, rising strongly in response to continued firm demand conditions, a recovery in profit shares and substantial business confidence. Indeed, profits were restored to the early-1970 levels in many countries as nominal wage increases were on the whole quite moderate, especially in Western Europe. In many cases increases in unit labour costs were further moderated by significant labour productivity gains. However, while higher profits stimulated the recent surge in fixed capital formation, the main impetus came from the confidence-boosting effects of the orderly behaviour of exchange rates and the steady growth of demand.[4] Private consumption also contributed to growth, accounting for more than 2 per cent of the rise in output (as it did in 1987). The strength of consumer demand stemmed in some cases from the rapid growth of employment and in others from readily available consumer financing. Surging import demand from Asian developing countries also played an important role in sustaining the level of effective demand in the developed market-economy countries during 1987-1988. In all, the increase in developing country imports from the developed market-economy countries in 1988 was equivalent to 0.4 per cent of the latter's combined GNP.

In the United States real GNP grew by close to 4 per cent in 1988, after a rise of 3.4 per cent in the previous year. At the same time, large gains in employment contributed to increased disposable personal incomes, so that consumption rose by 3.8 per cent. Consequently, while the 1987 stock market crash had generated expectations of a marked increase in saving rates, savings as a proportion of disposable income rose only modestly, from 3.3 per cent in 1987 to 4.0 per cent in 1988.

Growth in Western Europe in 1988 was 3.6 per cent, a record for the 1980s. Particularly buoyant economies were not only Italy and the United Kingdom, among the major countries, but also Portugal and Spain. It has been estimated that the United Kingdom alone helped to boost growth in other Western European countries by as much as half a percentage point during the year.[5] Domestic demand expanded significantly faster than output, reflecting in large part a strong demand for capital goods. In EEC, investment in equipment rose by more than 8 per cent during the year, influenced by the improved profitability of firms, high rates of capacity utilization and also, no doubt, by expectations of a unified market in 1992. Private consumption also contributed to growth in the Community in 1988, though to a lesser extent than in preceding years. The increase nevertheless exceeded that of real personal disposable incomes, and saving rates continued to drop significantly. In the Western European economies generally there was also a perceptible change in the pattern of demand since 1987. In the early phases of the current expansion, growth had been driven, to a large extent, by the external sector, responding to the rapid expansion of demand from the United States. Subsequently, in response to gains in the terms of trade (resulting from both the large fall in oil prices and the substantial appreciation of several currencies vis-à-vis the dollar), domestic demand became the dominant factor.

Business investment was also particularly important in Japan, as a result of the combi-

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3 See subsection 2(c) for a discussion of recent domestic price trends.

4 Also, the prices of capital goods fell relative to output prices.

5 See OECD, *Economic Outlook*, No. 43, December 1988.

nation of high profits and a strong recovery of domestic demand. Finance for investment was plentiful, as pre-tax profits of industry were estimated to have increased by more than 26 per cent in fiscal year 1988, a record rate for the second consecutive year. Public investment continued to be strong as well, thanks to existing high levels of appropriation for public works. Moreover, the steady growth of employment and increases in money wages and bonuses in the face of stable prices led to large gains in real incomes, with consequent strong growth in consumption. However, consumers' purchases of durables may have reached a peak during 1988, reflecting, in part, the ending of speculative housing starts.

(d) Socialist countries of Eastern Europe

In 1988 the impact of recent reassessments of economic policy started to be felt in many socialist countries of Eastern Europe. At the same time, new initiatives were launched to introduce additional reforms to improve the functioning of their economies. The reforms aimed at adjusting the management of the economies, both domestically and in their external transactions, to the requirements of the medium and longer term. The efforts centred mostly around the managerial mechanisms which were needed to foster the process of structural adjustment. Reliance was placed on economic instruments such as prices, taxes and customs tariffs, and the responsibility of individual enterprises in carrying out their operations was much broadened in scope. In consequence, the decision-making process and the operational autonomy of the producing and trading enterprises were considerably enhanced.

Important new measures were introduced in the Soviet Union as well as other countries in 1988 and the beginning of 1989. In particular, in Czechoslovakia the first specific law allowing the formation in the country of mixed-capital companies took effect at the beginning of 1989. In Hungary a package of new laws, among them a law on economic associations allowing the foreign partners in a joint venture to take out their share of profit in hard currency, and laws dealing with taxation and the protection of investment, offered new opportunities for foreign investors. In January 1989 the Bulgarian State Council adopted a decree which established the legal basis for economic activity in all sectors and branches of the national economy and substantially broadened the scope of independent transactions, both domestic and foreign. In the Soviet Union an important step toward a radical reform of the agricultural sector, which included the introduction of leasehold tenure, was taken in early 1989. Furthermore, a number of important decisions pertaining to foreign trade issues were adopted at the end of 1988 and the beginning of 1989. Thus, new opportunities have been opened up by legislation for enterprises involved directly in the production or consumption of goods and services to enter into international trade, establish direct contact with foreign partners and create domestic and foreign joint ventures. Legislation is currently in preparation to deal with shareholding companies, rules for competition, protection of consumer interests, procedures for foreign currency transactions and the economic activities of Soviet enterprises and organizations abroad.

The past five years were a period of relatively stable expansion for the socialist countries of Eastern Europe, reversing the slowdown in economic growth which prevailed during the 1970s and early 1980s. However, the overall growth rate of the region remained moderate. The expansion was evident in almost all countries but varied from one to another. The recovery was very pronounced in Poland and Romania and, to a lesser degree, in the German Democratic Republic. The growth of Hungarian net material product (NMP) varied from year to year, and was even negative in 1985. Expansion was most stable in the Soviet Union in 1984-1986, but the slowdown in 1987 was more marked than in the other countries.

As the effects of previous years' reforms started to be felt, growth in the Soviet Union in 1988 exceeded the preceding five-year average. GNP (in terms of SNA) grew by 5 per cent; it was sustained in the main by industrial output, whereas agricultural output rose only marginally. Export volumes grew by 4 per cent, but they declined in value by 1.9 per cent, on account of a drop in the prices of traditional exports. At the same time, imports rose only marginally in volume but by 6.5 per cent in value, owing to higher import prices. As a result of these movements, foreign trade turnover rose by 2.1 per cent.

While growth was high in Poland in 1988, the country continued to suffer from serious economic imbalances and rising inflation. National income rose by 4.5-5.0 per cent, while the value of realized industrial output of the public sector grew by 5.4 per cent. Gross farm output, however, grew by only 0.6 per cent; this poor performance was reflected in low output in a number of food industries. Foreign trade, on the other hand, continued its rapid expansion. Exports rose by 9.4 per cent in value (10.8 per cent to developed market-economy countries), while imports increased by 8.7 per cent (16.9

per cent from developed-market economy countries). Polish indebtedness to market-economy countries also fell slightly during the year.

While the main targets for 1988 were reached in Hungary, national income rose only marginally. The continuous process of industrial restructuring, combined with external constraints, largely explains the uneven performance of industry, where production virtually stagnated at the 1987 level. After a decline in 1987, agricultural output rose by 4.5 per cent. Furthermore, foreign trade recorded a surplus as exports grew both in value and volume terms, thanks to an increased supply of food and other agricultural products. On the other hand, the volume of imports, particularly those paid for in convertible currency, declined. For trade financed in convertible currency the deficit in 1987 turned into a surplus of more than $0.5 billion. However, this improvement was offset by the increase in interest payments. Nevertheless, the deficit on current account also shrank. Although external indebtedness increased, the rise was less than in previous years.

Bulgaria, Czechoslovakia and the German Democratic Republic continued to grow on the whole at stable rates in 1988. A number of difficulties, in particular unfavourable weather conditions, adversely affected the growth of NMP in the German Democratic Republic. Romania, on the other hand, recorded the lowest NMP growth rate since 1982, a consequence of the priority given to the eradication of its external debt.

2. *The 1988 experience: some issues*

(a) Background to the 1988 upturn in the developed market-economy countries

In the wake of the stock market crash of October 1987 the consensus among both the authorities in the developed market-economy countries and private observers was for a marked slowdown in activity. It was generally expected that the immediate consequence would be a more cautious approach to consumer spending and business investment. The adverse effects were expected to be, on the whole, more pronounced in the United States and Canada and, to a lesser extent, the United Kingdom - countries where direct ownership of stock by individuals was more widespread than in Japan and other developed market-economy countries. It was estimated that, as compared with peak stock price levels in August 1987, stock values fell by about $1,000 billion in the United States alone and total losses in all developed market-economy countries, taken together, were probably half as much again.

However, the estimates of losses were entirely dependent on the benchmark levels against which stock prices after the crash were measured. For example, as of mid-December 1987, the stock market valuation as a percentage of GNP in the United States was down by 17 points relative to end-September 1987, and by only 2 points relative to end-December 1986. In Japan the respective estimates were a loss of 16 percentage points and actually a gain of 15 points, respectively.[6] Thus, the peak-to-trough estimates of loss widely quoted at the time probably overstated the loss of wealth that actually occured.

While the losses in wealth were expected to lead to higher savings, the pessimistic climate generated by the turmoil in the stock market was tempered by subsequent declines in interest rates in many countries. Nevertheless, it was feared that it would take longer for the lower rates to influence positively activity than for the impact of a loss in consumer confidence to be felt. There was also the possibility that increased economic uncertainty would induce households to raise their propensity to save and would restrain business investment. In addition, it was expected that business might be forced to revise its investment plans downward because of costlier financing due to the decline in stock prices. In the event, this does not appear to have happened, as has been well documented by the results of surveys of business confidence carried out in the aftermath of the stock market crash.[7]

Although fiscal policy on the whole remained essentially restrictive in 1987 (and became, at best, neutral in 1988), monetary policy generally became more accommodating, especially toward the end of 1987. The easing of monetary policy was reflected in the lowering of interest rates which lasted well into the early part of 1988. It was also reflected in the fast expansion of the money supply in many major countries, in particular the United States and

6 See Morgan Guaranty Trust Company, *World Financial Markets*, November/December 1987, p. 2.

7 See, for example, Commission of the European Communities, *European Economy*, Supp. B, various issues.

Japan, and also the Federal Republic of Germany, where the growth of money aggregate M3 exceeded the official target.[8] Exchange rate stability provided by the European Monetary System (EMS) allowed both France and Italy to ease somewhat their monetary stance.[9] Official lending rates were also reduced in many of the smaller developed market-economy countries in early 1988, most notably in Belgium, the Netherlands and Switzerland.

The switch in monetary stance was adopted primarily to support financial intermediaries which were in danger of being severely undermined by the large losses in the value of their assets. An added reason was the expectation of a large increase in the demand for liquid assets as a result of financial turbulence. A generally more accommodating policy stance was also deemed necessary in view of a potential weakening of consumption demand, as households were expected to adjust their expenditures to the lower levels of real asset values. This easing of monetary policy represented a reversal of the general tightness then prevailing and resulted in a considerable relaxation of tensions in the stock and capital markets. Indeed, it provided a considerable impetus to economies which, in real terms, were on the whole very buoyant. Thus all in all, the potentially negative effects of the stock market crash were swamped by the positive impact of the gains in confidence by both the business sector and households, thanks to the timeliness and scope of the interventions by the monetary authorities.

Growth during the second half of 1987 was exceptionally rapid in the major countries, whereas during the first half it had been no better than during 1986. At an annual rate growth accelerated by more than 1.5 per cent between the first and second halves. This acceleration in 1988 took place in all the major countries but was especially marked in the Federal Republic of Germany, France and Japan. Real GNP in the Federal Republic of Germany rose by over 4 per cent (seasonally adjusted annual rate) during the second half of 1987, after having actually fallen during the first half. In particular, private consumption responded to falling interest rates and construction also recovered from an earlier slowdown due to bad weather conditions. Major leading indicators at the time, including orders and investment intentions, all pointed to higher activity in the period ahead. In France as well, there was a marked recovery in domestic demand during the second half of 1987, reflecting in particular an upturn in business capital spending. Exports also rose strongly, after having fallen steadily for two consecutive years. In Japan, stimulated by expansionary monetary policy, both investment and residential construction rose rapidly. As there was also a surge in government investment, final domestic demand accelerated to 7.7 per cent during the second half of 1987, i.e. almost double that of the first half.

In other major countries, though it was less pronounced, GDP growth was still impressive in the second half of 1987, particularly in the United Kingdom, where it amounted to 9 per cent (at a seasonally adjusted annual rate) in the third quarter. Especially rapid growth of consumer spending led to a strong expansion of output in both the manufacturing and the service sectors, and as in many other developed market economies, increased profitability and high levels of capacity utilization led to a recovery of business investment. Investment also made a major contribution to growth in Canada, where GDP grew by 5.6 per cent in the second half of 1987, compared with 4.3 per cent in the first half. In the United States, as manufacturing started to respond to improved competitiveness due to the depreciation of the dollar and increased profitability, business investment recovered substantially in the second half of 1987. At the same time, net exports began to make a positive contribution to overall growth for the first time in the 1980s. Although final domestic demand on the whole was quite sluggish toward the end of the year, reflecting in the main a marked slowdown in personal consumption, it began to stage a recovery at the beginning of 1988, thanks to the implementation of income tax cuts (under the Tax Reform Act). These tax cuts, together with the strong growth of employment, led to substantial increases in disposable personal incomes. Moreover, at the start of 1988 the capital goods industry had accumulated a substantial backlog of unfilled orders. Surveys of manufacturing industry's investment intentions at that time showed an expected growth of as much as 9 per cent for the year.

[8] In the United States, for example, monthly changes in M2 and M3 during the first quarter of 1988 averaged about 7.0 and 8.5 per cent (seasonally adjusted annual rate) respectively; at the same time, interest rate declines were widespread between December 1987 and February 1988. In Japan M2+CD (certificates of deposit) grew by 12 per cent (at a seasonally adjusted annual rate) during the first quarter of 1988, as compared with 9 per cent a year earlier.

[9] The Bank of France cut its money market intervention rate four times between December 1987 and February 1988 and the Bank of Italy also let interest rates fall during the first quarter of 1988. Because of the strength of the pound, the authorities in the United Kingdom also let interest rates fall in early 1988.

Table 3

UNITED STATES: CURRENT ACCOUNT BALANCES, 1987 AND 1988

(Billions of dollars)

	Year		*Quarter*					
			1987		*1988*			
	1987	*1988*	*III*	*IV*	*I*	*II*	*III*	*IV*
In current prices	-158.2	-126.1	-156.9	-161.3	-140.9	-122.5	-117.6	-123.8
In 1982 prices	128.9	-99.1	-130.7	-126.0	-108.9	-92.6	-93.9	-100.7
Services	30.0	27.8	27.7	30.4	25.1	27.4	31.1	27.6
Goods	-158.9	-126.9	-157.9	-156.4	-134.1	-120.0	-125.0	-128.4

Source: United States Department of Commerce, *Survey of Current Business*, January 1989.

In summary, in spite of the turmoil in financial markets, the developed market economies remained remarkably strong and expanded at an unexpectedly high rate of close to 4 per cent in 1988. Fixed capital formation by business, which rose over 11 per cent in volume, contributed 1.5 percentage points to overall GNP growth, about twice the 1987 contribution; the contribution from private consumption remained unchanged at about 2 points in both years.

(b) Payments imbalances

A major uncertainty at the beginning of 1988 was whether any progress would be made in reversing the steady increase in the United States trade deficit. In the event, the deficit was reduced significantly as trade flows moved in response to changes in trade determinants (see table 3 and box 3). Enhanced competitiveness and a strong expansion of demand in Japan and several Asian developing countries helped to boost export volumes.

Reversing the relationship prevailing during the period of steady deterioration in the United States external payments position, domestic demand in the major partner countries grew much faster than in the United States during 1988. Thus, compared with a rate of expansion of domestic demand in the latter country of about 3 per cent, the corresponding rates in Western Europe and in Japan were 4 per cent and 7 per cent, respectively. As their output growth in both cases was below the growth of demand, their volume of imports rose faster than that of their exports. In the United States, on the other hand, output growth exceeded domestic demand growth and the rise in exports (about 25 per cent in volume) was much greater than that of imports. As a result, the trade deficit was reduced by about $20 billion (though still amounting to $121 billion in 1988). Japan's trade surplus fell by only about $3 billion in 1988, while that of the Federal Republic of Germany reached a new peak; domestic demand did not expand faster than in partner countries but exports benefited substantially from the strong demand for investment goods throughout most of the developed world. Trade balances worsened in other Western European countries, most notably the United Kingdom. Thus, payments disequilibrium in Western European was accentuated by a relatively weak demand expansion in the Federal Republic of Germany and payments adjustment by the United States.

The improvement in the external payments position of the United States took place in the context of buoyant activity in that country. Growth was significantly above the OECD average, and was exceeded only by that of Japan and Canada among the major countries. The external adjustment was export-led and resulted, to a large extent, from the substantial depreciation of the dollar since 1985. At the end of 1988 the real effective rate of the dollar was 26 per cent below the average 1985

Box 3

INTERNATIONAL TRADE IN 1988

In 1988 buoyant economic activity, especially fixed capital formation, in the developed market-economy countries, was accompanied by a rapid expansion of world trade, which grew by more than 9 per cent in real terms, the fastest rate in the 1980s.

- Exports of manufactures from the developed market-economy countries accounted for more than two thirds of the $330 billion increase in world exports in 1988.
- Exports from the United States rose particularly fast in 1988 and contributed to reducing significantly the country's external trade deficit during the year. They appear however to have lost much of their momentum by the middle of the year thus putting in jeopardy the process of adjustment of the current account deficit which was over $130 billion in that year.
- Import volumes in some major surplus countries rose rapidly, especially Japan (16 per cent) and Taiwan Province of China (over 30 per cent): [1] the capacity of these economies to absorb additional resources is potentially larger than is commonly assumed.
- All in all, exports from developing countries also participated in the boom in international trade in 1988. Thanks to higher foreign exchange earnings from these exports, imports into some hitherto very sluggish markets had either resumed growth or stopped their steady decline. Consequently, developing country imports made a substantial positive contribution to activity in the developed market-economy countries during the year. [2] However, due to the continued heavy debt service payments, import levels in many debtor countries remained very depressed.
- There was a wide variation in individual developing country export performance. This was explainable, in part, by the product composition and the market orientation of their exports. Manufactures exporters in both East Asia and Latin America outperformed most others, thanks to the high demand for these products during the year. Moreover, the manufacturers in East Asia were also favoured by a very buoyant environment as demand in most countries in the region grew substantially, a reflection of both fast-growing consumer spending and of large business investment, especially foreign direct investment, in many economies in the region.
- Primary exporters also benefited from the enhanced demand for their products but there were important exceptions. Thus, while producers of industrial raw materials, especially ores and metals, and of temperate zone foodstuffs, fared relatively well, especially in respect of their terms of trade, exporters of tropical beverages, especially those in Africa, continued to suffer from depressed international markets. Low prices continued to affect adversely the purchasing power of the major oil exporters among the developing countries; their terms of trade had fallen to half the 1980 level by 1988, the lowest level since the large price increase in 1974.

1 Imports from the United States into Taiwan Province of China increased by more than 60 per cent in volume.

2 Estimated at about 0.4 per cent of developed market-economy countries' GNP.

level and about 9 per cent below that of 1980-1982.[10] United States manufacturing industries benefited considerably from the resulting enhanced price competitiveness.

Exports from the United States of both capital and consumer goods expanded considerably in 1988. The volume increase for capital goods (except automobiles) was over 30 per cent and for consumer goods it was 26 per cent. Total exports to Japan rose by more than one third and to EEC by more than one quarter. However, exports were most buoyant in the markets of developing countries in East Asia; in value terms[11] exports to Taiwan Province of China rose by over 60 per cent and to Hong Kong, the Republic of Korea and Singapore by about 40 per cent. The expansion was less rapid to other developing-country markets (about 24 per cent for the non-oil exporting

10 Based on data compiled by Morgan Guaranty Trust Company. See *World Financial Markets*, 1 April 1989.

11 Data on bilateral flows are not available in volume terms.

Table 4

CHANGES IN UNITED STATES EXPORTS BY MAJOR DESTINATIONS IN 1987 AND 1988

(Percentage)

Destination	Increase in value over previous years		Percentage share
	1987	1988	1988
Developed market-economy countries			
Japan	17.6	33.9	11.9
Federal Republic of Germany	11.6	21.0	4.4
Other EEC	14.4	24.9	17.5
Other DMECs	26.1	18.1	30.3
Developing countries			
Major oil exporters	8.2	35.1	11.3
Others	18.8	31.2	21.7
of which:			
Latin America	10.6	11.2	5.6
Africa	-0.5	23.6	1.3
West Asia	23.7	15.5	0.8
South Asia	-2.8	60.4	1.3
East Asia	29.3	41.8	12.8
World	18.3	26.6	100.0

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

countries in Africa and only 11 per cent for those of Latin America and 16 per cent for West Asia (see table 4)). Nevertheless, United States exports to each of these last two groups of countries in 1988 were lower in current dollar terms than in 1981. Exports to oil-exporting developing countries in 1988 also remained below their 1981 levels, notwithstanding their rapid expansion (due largely to an increase of over 40 per cent in exports to Mexico).

The reduction in the United States trade deficit in 1988 was accounted for mainly by an improvement in the balance of trade with Western Europe (other than the United Kingdom - see table 5); as regards trade with both the Federal Republic of Germany and Japan the improvement was modest but significant, being of the order of $3-4 billion. However, the worsened balance of those two countries with the United States was largely offset by improved balances with other trading partners, and thus both countries continued to record subtantial trade surpluses during the year. Other countries, in particular those with a higher-than-average growth of GDP (e.g. Italy and the United Kingdom), experienced a sharp worsening of their trade balances.

It should be noted that the marked improvement in the United States current account which occured toward the end of 1987 reflected, in part, the consequences of the depreciation of the dollar during those months on direct investment income. The effect was to raise the dollar value of United States direct investment holdings overseas as well as the dollar value of income receipts from those holdings. Excluding these valuation effects, the current account balance during 1988 showed roughly the same pattern of change as the trade balance.

The underlying pace of improvement in the United States trade balance slackened during the year. However, real net exports (i.e. net trade in constant prices) declined steadily dur-

ing the second half of 1988 as the volume of imports grew much faster than that of exports, in contrast to the situation in the first half of the year. Indeed, as 1989 progressed, there were growing indications that underlying adjustment may have become stalled (see box 4).

Table 5

UNITED STATES: CHANGES IN BILATERAL TRADE BALANCES, 1987 AND 1988
(Billions of dollars)

Partner	*1987*	*1988*
Developed market-economy countries		
Japan	-1.3	4.2
Canada	11.7	-0.4
Federal Republic of Germany	-0.8	3.1
United Kingdom	2.0	1.4
Other Western Europe	2.6	13.2
Developing countries		
Africa	1.1	0.5
Latin America	-1.0	4.5
West Asia	-2.5	0.9
South and East Asia	-7.6	5.9
World	-0.4	32.1

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

(c) Concerns over inflation in developed market-economy countries

There were signs of accelerating inflation during 1988 in many developed market-economy countries, although in a few major instances the sharp rise in some prices was due to exceptional factors such as the drought in the United States (as elaborated below). If such exceptional factors are discounted, the upward movement of prices since mid-1988 remained modest. While the private consumption deflator for the developed market-economy countries as a whole rose faster in the second half of 1988 than in the first half, for the year as a whole it was much the same as in 1987 (3.3 per cent - see table 6). The same broad picture also obtained with respect to the rate of increase in the prices of output, i.e. the GDP/GNP deflator: for the developed market-economy countries taken together this index rose by 3.6 per cent in 1988, as compared with 3.7 per cent in 1986 and 3.2 per cent in 1987 (see table 7) and available estimates indicate no marked acceleration in the latter part of 1988 and the first half of 1989.

The rate of inflation during the past three years has been substantially below that of the preceding ten years (see tables 6 and 7), principally because of the moderate rise of money wages in many countries. This has contributed to slowing down the rate of increase in unit labour costs, especially in Japan, the Federal Republic of Germany, France, Italy and some of the smaller countries. In Austria, Belgium and the Netherlands unit labour costs actually declined.

Although increases in the price level have generally been modest, inflation accelerated significantly in both the United Kingdom and the United States during the second half of 1988, though remaining well below the rate of the early 1980s. In particular, the acceleration in the United States followed the sharp drop in the country's inflation rate in both 1986 and 1987. Furthermore, in both countries, but especially in the United States, the acceleration during the second half of 1988 owed much to exceptional factors.

Drought in 1988 in the United States caused prices of many agricultural products, including grains, meat and poultry, to rise. For example, producer food prices rose by over 18 per cent (at an annual rate) during the third quarter of 1988 and for the year as a whole were more than 6 per cent higher than in 1987. Crop prices have recently reached very high levels and trading in futures indicates that they will keep rising well into 1989. Producer prices in non-agricultural sectors rose much less, and for the economy as a whole the increase over 1987 was only 4 per cent. This was the result of smaller increases in such sectors as machinery and equipment (2.5 per cent) and industrial goods (3.6 per cent); prices of refined petroleum products actually declined (by 5 per cent). A lower rate of increase in import prices also contributed to limiting the overall rise in the price level. Data compiled by the Department of Commerce showed that the prices of domestically produced goods and services increased somewhat faster in 1988 than in 1987 (4.2 per cent versus 3.6 per cent), whereas prices of goods and services purchased in the United States rose at about the same rate (4 per cent) in both years. The difference was due to the markedly smaller rise in import prices in 1988 (4.3 per cent, against 7.7 per cent in 1987), despite a drop of about 6 per cent in the effective exchange rate of the dollar.[12]

[12] *Survey of Current Business*, January 1989.

Box 4

MEDIUM-TERM OUTLOOK FOR THE UNITED STATES EXTERNAL BALANCE

Recent developments have tended to reinforce the view that, under present policy, instead of narrowing, the United States external deficit may worsen again in the coming years. [1] This view is based broadly on the following considerations:

- The recent improvement in the United States export performance came about as a result of the lagged effects of the depreciation of the dollar relative to other major currencies which started in 1985. In December 1988 the real effective exchange rate of the dollar stood at 26 per cent below the average 1985 level. However, this rate has since risen and had regained about 4.5 per cent by March 1989. Thus, with the effects of the depreciation fading, United States exports are likely to lose much of their recent momentum.
- While cost differentials currently favour United States industry, even at existing exchange rates, and thus would tend to induce output to shift toward the United States and away from countries with comparative cost disadvantages, available data fail to show any perceptible movement in this direction. In particular, recent investment-intention surveys suggested the continued strength of investment trends in major trading partners, while the United States trend appeared much weaker than expected.
- Given the large trade deficit ($122 billion in 1980), unless exports expand much faster than imports, the deficit is bound to widen again in absolute terms. For example, if exports ($325 billion in 1988) and imports ($447 billion) both increase by half, the gap will widen to $183 billion (from $122 billion), even though remaining unchanged relative to the value of exports (37.5 per cent). It is unlikely that the large export-import growth differentials observed in 1988 can be maintained in the years to come, considering that the rates of domestic demand growth in the United States and in its major trading partners may not differ to any marked degree. [2] Furthermore, import demand into the debtor developing countries, many of whom are major export outlets for United States industry, is expected to remain very subdued in view of their continued heavy debt service burdens.
- Because of its swelling external debt, interest payments will add significantly to the United States' payments deficits. Because of these payments, net investment income, which amounted to over $20 billion in 1987, was negligible in 1988, and on present trends will be a substantial negative item in the balance of payments in the years to come.

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1 See also section B below on the outlook for the world economy in 1989-1990 and also P. Hooper, "Exchange rates and United States external adjustment in the short run and the long run", *Brookings Discussion Papers in International Economics 65* (Washington, D.C.: Brookings Institution, October 1988) and W.R. Cline, *American Trade Adjustment: The Global Impact* (Washington, D.C.: Institute for International Economics, March 1989.

2 For the outlook concerning demand and output in the developed market economy countries see section B below.

There are, however, indications that the rise in labour costs in the United States has been accelerating in recent months. Recent rapid increases in output have been accompanied by substantial employment gains. Unemployment fell from 6.1 per cent in 1987 to 5.3 per cent toward the end of 1988, and wage increases have been larger. For example, compensation per employee in the business sector was 6.3 per cent higher in 1988 than in the previous year, as compared with 4.4 per cent in 1987. Consequently, unit labour costs rose 4.4 per cent, which is more than 1 percentage point higher than the 1987 rate (3.2 per cent). The rise in unit labour costs was much greater than in other developed market-economy countries, an outcome not unrelated to the country's relatively slower gains in productivity during the year. Much of the wage acceleration in recent months took place, however, in the service sector. In manufacturing hourly earnings rose by only 2.6 per cent in 1988, compared with 4.5 per cent in Japan and 5 per cent in EEC. Furthermore, given its relatively high productivity growth, the pressure of labour costs in the United States manufacturing sector should continue to be relatively light.

On the whole, pressure on prices was not, until very recently, a major concern in most Western European countries. An important exception in recent months has been the United

Table 6

DEVELOPED MARKET-ECONOMY COUNTRIES: PRIVATE CONSUMPTION DEFLATORS

(Per cent, seasonally adjusted annual rates)

			1988				
Country	*1976-1985*	*1987*	*Year*	*Change* [a]	*First half*	*Second half*	*Change* [a]
Canada	7.6	3.7	3.7	-0.0	3.4	3.6	-0.2
United States	6.6	4.5	4.2	-0.3	3.7	4.8	+1.2
Japan	3.9	-0.1	0.0	+0.1	-1.1	1.3	+2.4
Federal Republic of Germany	3.9	0.6	1.3	+0.7	1.6	1.6	+0.0
France	10.0	3.1	2.7	-0.4	2.5	3.2	+0.7
United Kingdom	9.8	3.8	5.0	+1.2	5.1	5.9	+0.8
Italy	15.1	5.1	5.0	-0.1	5.1	4.8	-0.3
Other DMECs	11.0	5.7	6.6	+0.9	6.6	7.2	-0.6
All DMECs	7.5	3.3	3.4	0.1	3.1	4.1	1.0

Source: OECD secretariat.
a Change in 1988 from previous year or half-year, in percentage points.

Kingdom, where prices have been rising faster than in other major Western European countries (see table 7). With output increasing rapidly, unemployment in that country declined steadily and by early 1989 stood at 7 per cent, against 11 per cent in 1986. At the same time, wage increases began to accelerate; compensation per employee in the business sector increased 8 per cent in 1988 (compared with 5.2 per cent in 1987) and the slowdown in productivity growth led to a sharp increase in unit labour costs.[13] Higher profit margins also contributed to accelerated inflation in recent months.[14] As a result of these forces, retail prices rose by about 7.5 per cent (at an annual rate) in early 1989, compared with an average increase of only 3.3 per cent in 1988.[15] It should be noted, however, that the retail price index is heavily influenced by changes in mortgage rates; the rise in mortgage rates in the first half of 1988 added almost 2 percentage points to the index. Thus, in the short run monetary measures designed to reduce inflationary pressures contributed to a rise in the cost of living. Even allowing for this, the index rose significantly faster than in the previous year.

In other Western European economies there was a risk that those with relatively high shares of trade in total output and which have recently experienced significant depreciations of their currencies could be exposed to imported inflation should their currencies weaken further. In particular, after many years of virtual price stability, inflation in the Federal Republic of Germany was approaching the 3 per cent mark in early 1989, reflecting currency depreciation and also the increase in indirect taxes which came into effect during the early part of the year.[16]

Interest rates in the developed market-economy countries will probably remain high

13 Growth of productivity in manufacturing slowed down to 5.6 per cent in 1988 from 6.7 per cent in 1987. See National Institute of Economic and Social Research, *National Institute Economic Review*, No. 128, May 1989, p. 14.

14 See OECD, *Economic Outlook*, No. 45, June 1989, p. 86.

15 See *The Economist*, 18 February 1989, p. 69.

16 In real effective terms the deutsche mark stood in March 1989 at about 5.5 per cent below the average 1987 level.

17 Short-term rates in the United States rose to 8.7 per cent in April 1989 from 6 per cent in the first quarter of 1988; in the same period, rates in the Federal Republic of Germany rose from 3.4 per cent to 6.4 per cent, while those in

Table 7

DEVELOPED MARKET-ECONOMY COUNTRIES: GNP/GDP DEFLATORS

(Per cent, seasonally adjusted annual rates)

			1988				
Country	1976-1985	1987	Year	Change [a]	First half	Second half	Change [a]
Canada	7.0	4.3	4.2	-0.1	4.2	4.6	+0.4
United States	6.5	3.3	3.4	0.1	2.9	5.0	+2.1
Japan	2.9	-0.2	0.4	+0.6	0.0	1.3	+1.3
Federal Republic of Germany	3.6	2.1	1.5	-0.6	1.8	1.7	-0.1
France	9.6	2.9	3.2	+0.3	3.2	3.4	+0.2
United Kingdom	10.3	4.8	6.6	+1.8	5.9	8.8	+2.9
Italy	15.4	6.1	5.9	-0.2	6.0	5.8	-0.2
Other DMECs	10.4	6.1	7.3	+1.2	7.9	7.4	-0.5
All DMECs	7.1	3.2	3.6	0.4	3.4	4.5	1.1

Source: OECD secretariat.
a Change in 1988 from previous year or half-year, in percentage points.

until the authorities are assured that price pressures are being contained.[17] Indeed, interest rates have been prominent in the panoply of policy instruments used in efforts to avoid a new round of inflation. They reduce domestic demand and also tend to raise the exchange rate, thereby reducing import prices in domestic currency terms, with consequent positive effects on the domestic price levels.[18]

The latest available data have not assuaged the continued concern of policy makers over inflationary pressures, but neither do they indicate any worsening of the situation. In April 1989 the consumer price index in the OECD countries was estimated to have been 5 per cent higher than a year earlier, not significantly different from the corresponding situation in March. Disparities in inflation rates among countries remained large (see table 8). Among the major countries the rate accelerated in Japan due to the introduction of a general consumption tax. The price level has tended to stabilize of late in Canada, the United States and the United Kingdom but showed some acceleration in the other major countries.

the United Kingdom rose from 8.3 per cent to 12.2 per cent. In Japan, however, short-term rates remained relatively low (4.2 per cent) in April 1989, up slightly from 3.8 per cent in the first quarter of 1988. See OECD, *Main Economic Indicators*, January and June 1989.

18 However, import prices will not be reduced if all countries raise interest rates in concert, since this will leave the pattern of exchange rates, and thus of relative prices in international trade, unchanged. Changes in national interest rates would also induce movements of capital seeking higher returns and, in the process, exert downward pressures on low-yielding currencies.

Table 8

DEVELOPED MARKET-ECONOMY COUNTRIES: CONSUMER PRICE INDICES

(Percentage change) [a]

	1987	1988	1988					1989			
	Year	Year	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Canada	4.3	4.0	4.0	4.1	4.2	4.1	4.0	4.3	4.6	4.6	4.6
United States	3.7	4.0	4.0	4.2	4.2	4.2	4.4	4.7	4.8	5.0	5.1
Japan	0.3	0.5	0.6	0.5	1.0	1.1	0.9	0.9	0.7	0.9	2.4
France	3.1	2.6	2.8	3.0	3.0	3.0	3.1	3.3	3.4	3.4	3.6
Fed. Rep. of Germany	0.2	1.2	1.2	1.4	1.3	1.6	1.6	2.6	2.6	2.7	3.0
Italy	4.8	5.0	5.0	5.0	4.9	4.8	5.1	5.4	5.5	5.9	6.7
United Kingdom	4.2	4.9	5.7	5.9	6.4	6.4	6.8	7.5	7.8	7.9	8.0
All DMECs	3.3	3.9	3.9	4.0	4.2	4.3	4.4	4.7	4.8	4.9	5.0

Source: OECD, *Main Economic Indicators*, various issues.
a Change over corresponding month (or average) of the previous year.

B. Prospects for 1989-1990

Growth in the world economy in 1989-1990 can be expected to slow down, most markedly in North America, but also in other developed market-economy countries and in the developing countries of Asia and Latin America. The process of adjustment of external imbalances of the major industrial countries which had been taking place up to mid-1988 slowed markedly in the second half and appears now to have come to a halt, reflecting the appreciation of the dollar in the first half of 1989 and more vigorous growth in the United States economy. Partial reversal of these two factors in the period ahead may restore the process of adjustment, but the pace will be modest. Inflation will continue to be a preoccupation in some countries.

Little improvement can be foreseen in the external environment facing developing countries. World trade is expected to increase more slowly in response to the slackening of growth in developed market-economy countries, but interest rates are not likely to decline significantly. The prices of most primary commodities are expected to weaken relative to those of manufactures, while minerals and petroleum prices will remain relatively firm.

1. *Developing countries*

The most troubling aspect of the outlook for the near future is the unlikelihood of any significant improvement in growth performance in Africa and Latin America over the low rates achieved in 1988. Indeed the outturn for 1989 is expected to be even poorer.

As regards Africa, real GDP growth in 1989-1990 is expected to average roughly the same rate as in 1988, although as usual much will depend on agriculture, and in particular on weather conditions. In any case, the good harvests of 1988 in some countries are not likely to be repeated. Export earnings will continue to be highly dependent on the evolution

Table 9

WORLD CURRENT ACCOUNT BALANCES, 1986-1988, AND FORECASTS FOR 1989 AND 1990

(Billions of dollars)

Country group	*1986*	*1987*	*1988*	*1989*	*1990*
	Actual		*Estimated*	*Forecasts*	
Developed market-economy countries	12.9	-12.7	12.7	-7.0	5.1
of which:					
North America	-132.4	-149.6	-131.7	-129.0	-122.6
Western Europe	66.4	54.7	43.9	17.4	13.8
Pacific developed	78.9	82.2	100.5	104.5	113.9
Socialist countries of Eastern Europe	10.0	4.5	2.6	1.8	1.9
Socialist countries of Asia	-7.3	0.1	-2.1	-0.8	-1.1
Developing countries	-41.2	-9.8	-28.0	-21.8	-20.5
of which:					
Latin America	-22.2	-17.0	-17.0	-12.8	-12.7
Africa	-14.8	-10.9	-22.9	-24.2	-26.1
Asia	-5.4	16.4	10.2	13.3	16.0
Statistical discrepancy	-25.7	-17.8	-14.8	-27.8	-14.5
Memo item:					
Least developed countries	-8.2	-9.3	-10.6	-12.2	-13.7

Source: UNCTAD secretariat calculations, based on national and international sources for 1986-1988 and SIGMA for forecasts.

of commodity prices. In general, the outlook for earnings from the export of tropical beverages is cloudy, whereas prospects for mineral prices appear brighter. For a number of mineral-producing countries, higher export volumes also appear likely, as also for some producers of energy.

In Latin America prospects will continue to be dominated by the inability of most countries to reconcile price stability, growth and debt service. For some countries, including oil exporters, firm export prices will help the balance of payments. In most countries difficulties still continue to flow from the high net transfer they are obliged to make abroad and the consequences for investment and imports. In some countries, for example Bolivia and Mexico, considerable success has recently been achieved in controlling inflation. The challenge in the period ahead is to transform this success into a more rapid and sustainable expansion of the economy. Experience to date does not suggest that successful privatization, liberalization and budgetary reform lead automatically to a resumption of vigorous growth. In other countries, i.e., Argentina and Brazil, mastering inflation is a prerequisite for better growth performance. In both cases, but in particular in Argentina, external debt is a major stumbling block to improved domestic performance, a point that is elaborated on in chapter IV. The implementation of the Brady initiative, discussed in chapter II, is not expected to affect the external cash flow of the region in 1989; its impact in 1990 remains to be seen.

In Asia some slowing of growth from the high rates experienced in 1988 is to be expected. In East Asia a generally less vigorous expansion of world trade, and policy shifts designed to base expansion more on domestic demand

Table 10

WORLD TRADE VOLUMES, 1986-1988, AND FORECASTS FOR 1989 AND 1990

(Percentage change)

Country group	1986	1987	1988	1989	1990
	Actual		*Estimated*	*Forecasts*	
World					
Exports	5.6	5.2	9.4	6.1	6.5
Imports	5.4	6.5	9.2	6.5	6.0
Developed market-economy countries					
Exports	2.1	5.8	8.0	7.2	6.7
Imports	7.7	6.4	9.1	6.9	6.0
of which:					
North America					
Exports	2.0	11.0	18.2	9.0	7.1
Imports	10.1	3.3	8.1	5.1	4.4
Western Europe					
Exports	2.5	4.8	5.8	6.2	6.1
Imports	6.3	8.5	8.2	7.1	6.4
Pacific developed					
Exports	0.4	2.2	4.5	8.7	8.8
Imports	8.7	7.4	16.2	10.3	6.9
Socialist countries of Eastern Europe					
Exports	7.3	-2.0	5.6	5.4	6.4
Imports	5.1	3.4	4.9	5.6	5.1
Socialist countries of Asia					
Exports	10.2	14.6	15.9	2.8	4.5
Imports	-5.6	21.4	11.2	5.5	7.1
Developing countries					
Exports	15.4	5.5	13.5	4.2	6.2
Imports	-1.0	7.1	10.9	5.2	6.2
of which:					
Latin America					
Exports	-2.1	0.8	11.4	3.2	5.6
Imports	-1.2	-2.9	5.4	1.4	3.5
Africa					
Exports	9.6	-2.7	9.1	-0.8	5.8
Imports	-3.7	-6.5	-1.4	2.5	6.4
Asia					
Exports	24.1	8.7	15.2	5.4	6.4
Imports	-0.6	13.2	16.1	7.1	7.0
Memo item:					
Least developed countries					
Exports	7.9	18.3	-5.7	0.4	6.1
Imports	-0.0	4.2	-0.1	3.7	6.7

Source: UNCTAD secretariat calculations, based on national and international sources for 1986-1988 and SIGMA for forecasts.

Table 11

CURRENT ACCOUNT DEFICIT OF DEVELOPING COUNTRIES: [a] SOURCES OF FINANCING IN 1986-1988 AND FORECASTS FOR 1989 AND 1990

(Billions of dollars)

Item	1986 Actual	1987 Actual.	1988 Estimated	1989 Forecasts	1990 Forecasts
Current-account balance	-36.0	-10.3	-28.7	-26.2	-25.6
Source of financing:					
Increase in official reserves	17.7	43.8	15.9	26.1	32.6
Total net capital flows	53.7	54.2	44.7	52.3	58.2
Official bilateral flows [b]					
Grants [c]	12.9	13.1	14.7	15.6	16.6
Medium- and long-term loans	21.9	26.7	23.2	22.4	19.8
Private flows	-2.2	-3.9	8.5	12.7	17.9
Direct investment	8.3	9.7	20.3 [d]	11.7	12.8
Private borrowing	-10.5	-13.6	-11.8	1.0	5.1
Other capital, unrecorded flows, errors and omissions	21.1	18.3	-1.7	1.6	3.9

Source: UNCTAD secretariat calculations, based on international sources.

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

b Including flows from multilateral institutions.

c Excluding technical assistance.

d Including a preliminary estimate of the debt-to-equity swaps for Latin America.

growth, are factors which will account for the slowdown. High investment, and in particular foreign direct investment, will continue to fuel growth; in some countries the need for complementary supporting increases in investment by the public sector is increasingly being recognized. In South Asia economic performance in some countries continues to be influenced by natural calamities and prospects overall are for some slowing of growth. In West Asia an improved outlook for oil prices may underpin some acceleration in the overall pace of output growth.

2. *China*

The outlook in China is particulary difficult to assess. Rapid expansion had already triggered measures in 1988 to cool an economy in danger of overheating and by early 1989 there were some signs that these were having the desired effect. A lower growth of output in 1989-1990 was therefore to be expected; it is as yet too soon to assess the impact that recent internal unrest may have on the economy.

3. *Developed market-economy countries*

Recent developments have led to periodic downward revisions in forecasts for the developed market-economy countries. For example, the first half of 1989 was marked by a significant rise in short-term interest rates as monetary authorities reacted to fears of mounting inflationary pressures. The tightening of monetary policy which started in the summer of 1988 in the United States was followed by successive increases in the discount rate in the Federal Republic of Germany on account of

Table 12

DEVELOPING COUNTRIES: DEBT OUTSTANDING, 1986-1988, AND FORECASTS FOR 1989 AND 1990

(Billions of dollars) [a]

	1986	*1987*	*1988*	*1989*	*1990*
	Actual		*Estimated*	*Forecasts*	
All developing countries [b]	1008.8	1116.0	1123.4	1148.1	1177.4
of which:					
Latin America	459.8	491.0	487.1	491.0	494.9
Africa	217.7	254.1	266.5	283.3	301.7
Asia	331.3	370.9	369.8	373.8	380.8
Memo item:					
Least developed countries	56.5	66.2	71.0	77.6	85.3

Source: UNCTAD secretariat calculations, based on national and international sources for 1986-1988 and SIGMA for forecasts.

a Beginning of year.

b Excluding oil-dominant economies (see footnote *a* to table 11) and developing countries of Europe.

concern over the effects on the price level of the weakening of the deutsche mark. In the United Kingdom short-term interest rates reached 14 per cent in May 1989, up from 10 per cent only one year earlier, a move designed to curb buoyant domestic demand. The monetary authorities of other countries also allowed interest rates to creep upward in order to maintain existing differentials and thus their exchange rate stability. In Japan the discount rate, which was at a historically low 2.5 per cent, was raised to 3.25 per cent at the end of May to support the yen and to stem imported inflation. If recent trends indicating a reversal of the appreciation of the dollar which took place in the first half of 1989 are confirmed in the coming months, the risk of imported inflation should diminish both in Japan and in many Western European countries having a high share of trade in total output.

At present it seems that the tightening of monetary policy has forestalled the danger of inflation in the United States. The faster rise of consumer prices in the first four months of 1989 is attributable mainly to the surge in food prices, for which the annual rate of increase accelerated from 5.6 per cent in January to 6.5 per cent in April.[19] In the United Kingdom inflation seems to be more deeply rooted and was running at an annual rate of about 8.3 per cent in May 1989. Capacity utilization in manufacturing industry reached 94 per cent in 1988, which was much higher than during previous cyclical peaks, and wages have risen substantially both in that country and in some Nordic countries as the labour supply tightened. Persistently high unemployment rates in other Western European countries have had, up to now, a moderating influence on wage increases.

As the real economy started to react to the tightening of monetary policy, demand growth in the major developed market economies began to level off. In addition, the boom in investment which fuelled last year's surge in economic activity is expected to subside as a result of the rise in interest rates, although an offsetting factor is the continued rise in profits; business confidence remains high, particulary in Western Europe, where much is expected from the establishment of a unified market in EEC in 1992.

None the less, because of the expectation of a significant slackening of demand growth, particularly in North America, the balance of concern of the monetary authorities has shifted toward moderating this movement. Consequently, unless there is a resurgence of inflationary pressures or an unexpected widening of current account deficits, a further rise in inter-

[19] See also subsection 2(c) above.

est rates does not appear likely in the period ahead.

As noted above (see subsection 2(c)), the pace of adjustment in external imbalances, and especially of the large United States deficit, slowed down perceptibly during the second half of 1988. The sizeable reduction in the United States deficit during the first half of 1988 took place amid an expansion of world trade (over 9 per cent in volume for the year as a whole) that was the highest rate on record for the 1980s. But while the United States has been able to regain part of its market share lost in the first half of the decade, the effects of the improved competitiveness stemming from the depreciation of the dollar during 1985-1987 appear to have worked themselves out. Furthermore, the dollar has broadly stabilized since then and even appreciated in the first half of 1989 against the yen and the main European currencies in response to the widening of interest rate differentials in its favour. In addition, as noted above, economic activity is expected to slow down in both 1988 and 1990, leading to a moderation of import demand growth in most developed market economies. Thus, under present policies the current account deficit of the United States, on the one hand, may hardly improve, while surpluses of the Federal Republic of Germany and of Japan, on the other, are expected to increase again in 1989-1990; the trade balances of the smaller Western European economies should also deteriorate. Among the EEC countries only Denmark, the Federal Republic of Germany, Ireland and the Netherlands had trade surpluses in 1988.

4. *Socialist countries of Eastern Europe*

The 1989 economic targets of the socialist countries of Eastern Europe have been set on the assumption that the 1988 growth rates will be maintained or even accelerated. Taking into account existing trends, further positive qualitative changes in the economies of the socialist countries can be expected. For a number of them the main distinctive feature of 1989 lies in a major social reorientation of their economies, underpinned by enhanced dynamism and large-scale structural shifts. In particular, substantial progress is expected in consumer goods production. The performance of countries undertaking major reforms will be influenced by factors relating to the new economic mechanisms, e.g. farm reform, a more decentralized management of industry, price reform, direct access of enterprises to the foreign markets, etc.

Growth prospects vary among the countries. Continuing dynamic growth is expected in Bulgaria, the German Democratic Republic and the Soviet Union. Romania envisages a return to high growth rates. Moderate growth is forecast for Czechoslovakia, with a stabilization of the investment rate prior to implementation of economic reform in the 1990s. In Poland growth rates are also forecast to be moderate, though increasing slightly, with a recovery in the next two years from the economic crisis of the beginning of 1980s. In Hungary no growth of the economy is expected; official policy aims at the continued improvement of market mechanisms, with a view to creating conditions for stabilization and dynamic development over the medium term.

Foreign trade prospects of the region should be viewed in both their short- and medium-term aspects. The short-term outlook is heavily influenced by the export structure of these countries which, to a large extent, is still heavily weighted by raw materials. Given the depressed prices in this sector, the most probable outcome is one of stagnation or a slight increase of export revenues for the socialist countries of Eastern Europe as a whole, with export volumes remaining unchanged. Some changes on the import side can be expected. Foreign trade reforms and also structural adjustment in Hungary, and in particular the Soviet Union, could result in a significant increase in imports, especially of consumer goods and high-technology equipment. On the other hand, a persistence of the recent rise in the dollar and in interest rates could limit the increase.

Over the medium term, export prospects look more promising. Serious efforts aimed at extending a competitive system to export activities and stimulation of foreign participation in business activities, including joint ventures, will be one of the supportive factors for the region's exports as well as for import expansion.

C. Longer-term prospects

1. *Introduction*

In some quarters there is a feeling that the recent strong growth performance of the developed market economies and of many Asian economies is evidence that the world economy is on the verge of a more dynamic rate of economic progress which will continue until at least the end of the 1990s. Certainly, there are a number of reasons for guarded optimism in the medium term: there have been important improvements in labour productivity, particularly in Western Europe (see table 13), and the establishment of a unified market in 1992 within EEC could reinforce that progress; continuing advances in micro-electronics and information systems provide further potential for major productivity increases on a worldwide basis; and in spite of large distortions and imbalances in the world economy, international economic co-operation has not broken down. Indeed, some would argue that it has improved in recent years.

Be that as it may, there are important aspects of current trends in the world economy which could result in the 1990s showing little improvement over the present decade. Of central importance is the lack of progress to date in solving the debt problems of many developing countries in a manner conducive to growth. The continued deterioration of economic and social conditions in Africa is an increasing threat to the stability of the region. The escalating external debt of the United States, stemming from its budget and trade deficits, is likely to mean continued high real rates of interest, with the possibility of major financial disruptions.

Shifting demographic patterns in the developed market economies are also likely to have a significant impact in the 1990s, as the growth of the working-age population continues to decline in many cases. While labour force participation rates are projected to continue to increase modestly, they are not likely to offset completely the impact of the slower growth of the working-age population in all cases. Further, the strong growth of the United States economy in recent years was achieved to a significant extent through unexpectedly large increases in participation rates that could not easily be maintained in the 1990s, given current high levels of participation. The United States is also likely to provide less stimulus to the world economy over the next few years via import growth in view of the pressures to reduce its large and persistent trade and current-account deficits.

2. *Implications for the 1990s of current trends: a baseline scenario*[20]

On balance, current trends, behavioural relations and policy patterns do not indicate that world economic performance in the 1990s will improve significantly over that of the 1980s in the absence of major policy shifts or other unexpected events. It should be underlined that this conclusion is relatively insensitive to small changes in the underlying assumptions. In the absence of major new policy initiatives or significant changes in the nature of international financial and trade linkages, the baseline scenario indicates that the average annual growth of world output would be about 3 per cent, or much the same as is likely for the 1980s as a whole (see table 14), but below that achieved in the second half of that decade.

Demographic changes will be an important factor determining growth in the developed market economies over the medium to long term. The growth of the population of working age is slowing down significantly in the developed market-economy countries. In North America it is projected at about 0.9 per cent per annum in the 1990s, as against 1.7 per cent in the present decade. Corresponding projections for Western Europe are 0.8 per cent and 0.3 per

[20] The scenario described in this subsection has been produced with the aid of the UNCTAD secretariat's system for interlinked global modelling and analysis (SIGMA).

Table 13

LABOUR FORCE PRODUCTIVITY IN DEVELOPED MARKET-ECONOMY COUNTRIES

Actual and projected rates of growth

(Annual average percentage change)

Country or country group	1980-1985	1985-1990	1980-1985	1985-1990	1990-2000
	Unadjusted [a]		*Adjusted* [b]		*Adjusted* [c]
Canada	1.1	1.4	1.7	0.7	1.2
United States	1.3	1.5	1.3	1.1	1.2
Japan	2.8	3.0	2.9	3.0	3.0
France	1.0	2.2	1.9	2.3	2.1
Federal Republic of Germany	0.7	2.1	1.8	2.0	1.9
Italy	0.6	2.1	1.1	2.6	1.8
United Kingdom	1.0	2.7	2.3	1.9	2.1
Other EEC	0.4	1.9	1.9	1.4	1.6
Other DMECs	1.3	0.5	1.7	0.4	1.0

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

a Unadjusted for unemployment rates.

b Adjusted for unemployment rates.

c Projection based on the average of adjusted growth in labour productivity for the 1980s.

cent, respectively, and for other developed market-economy countries 1.2 per cent and 0.6 per cent. For certain major economies, such as Japan and the Federal Republic of Germany, the projected declines are even sharper. Nevertheless, these declines will be partially offset by projected increases in participation rates. As a result, the economically active population of the developed market economies is projected to grow at 0.8 per cent per annum in the 1990s, as compared to 1.0 per cent in the present decade. Assuming a constant trend for productivity, these economies can be expected to grow by about 2.5 per cent in the 1990s, compared to about 2.7 per cent in the 1980s.

Greater uncertainty surrounds the projections for the socialist countries of Eastern Europe. Several of them are currently engaged in major reform processes, the success or failure of which will largely determine future performance. The baseline scenario indicates some acceleration of growth for the region but this is due to a projected acceleration in the rate of growth of the working-age population in the period 1995-2000. A successful implementation of *perestroika* could significantly improve on projected performance.

While the overall growth of the world economy shows little change in the 1990s, as compared with the 1980s, projected patterns for the developing countries are both complex and diverse. For the developing countries as a whole the slight recovery of the second half of the 1980s is maintained in the first half of the 1990s and strengthened further in the latter half. Their baseline growth would be some 3.5 per cent in the 1990s, compared with about 2.4 per cent in the 1980s. Nevertheless, the diversity of experience which has marked developing countries' economic performance in the 1980s is carried over into the 1990s.

For Latin America the baseline scenario assumes that there will be no new net private bank lending in the 1990s while interest payments will continue to be met. On this basis the region as a whole maintains its general performance of 1985-1990 over the beginning of the 1990s and shows a slight, but measurable, acceleration of growth in the latter part of the decade. Given the assumption of no new

Table 14

WORLD OUTPUT SINCE 1980 AND PROJECTIONS FOR THE 1990s

(Percentage change)

Country group	1980-1985 Actual	1985-1990 Estimated [a]	1990-1995 Projections	1995-2000 Projections
World	2.6	3.4	2.9	3.1
Developed market-economy countries	2.4	3.1	2.4	2.5
of which:				
North America	2.9	3.1	2.2	2.5
Western Europe	1.5	2.7	2.1	2.2
Pacific developed	3.6	4.0	3.6	3.3
Socialist countries of Eastern Europe	3.4	3.8	3.8	4.0
Socialist countries of Asia	10.1	8.3	6.5	6.0
Developing countries	1.9	3.3	3.4	3.7
of which:				
Latin America	0.8	2.0	2.3	3.0
of which:				
Eurocurrency borrowers [b]	0.6	2.1	2.3	3.1
Others	1.7	1.2	2.2	2.3
Africa	1.0	2.1	1.4	1.7
of which:				
Eurocurrency borrowers [b]	-0.0	1.9	0.5	0.6
Least developed	0.8	2.7	3.0	2.7
Others	3.8	2.3	1.7	2.1
Asia	2.9	4.6	4.6	4.5
of which:				
Oil-dominant [c]	-5.0	-0.1	2.5	2.5
Eurocurrency borrowers [b]	5.1	7.2	6.4	5.8
Least developed	4.3	3.2	2.7	2.6
Others	5.3	4.5	4.0	4.1
Memo item:				
All least developed countries	2.3	2.8	2.9	2.7

Source: UNCTAD secretariat calculations, based on national and international sources for 1980-1989 and SIGMA for forecasts.

a 1985-1987 are actual (see table 1), 1988 are estimates and 1989-1990 are forecasts. For annual figures see table 1.

b Countries with cumulative borrowings in the Eurocurrency markets exceeding $2.7 billion, representing at least 1.5 per cent of Eurocurrency credits to developing countries over the period 1979-1983.

c See footnote *a* to table 11.

net lending, the stock of debt and related interest payments declines as a percentage of the value of exports. As a consequence, at the margin, resources are gradually freed to allow for some increase in the rate of domestic investment. Technically, the scenario illustrates that Latin America could begin to grow out of its debt problem, but both the pace and the extent of the progress are minimal. There would be several years more in which no significant increase in per capita consumption could be achieved, while unemployment would continue to grow. The possible social and political consequences of such a situation are such

Table 15

DEBT SERVICE AND CURRENT ACCOUNT BALANCES OF DEVELOPING COUNTRIES: ESTIMATES FOR 1990 AND PROJECTIONS UP TO 2000

(Ratios to exports of goods and services in per cent)

	1988	*1990*	*1995*	*2000*
	Estimated	*Forecasts*	*Projections*	
All developing countries				
Interest payments	8.9	8.0	5.3	3.6
Debt	136.6	118.7	82.2	59.9
Current account balance	-4.1	-2.4	-2.3	-2.5
Latin America				
Interest payments	23.3	21.5	14.1	8.8
Debt	299.0	261.8	170.0	105.2
Current account balance	-11.5	-7.5	-3.7	-6.6
Eurocurrency borrowers [a]				
Interest payments	27.0	24.0	15.5	8.9
Debt	333.7	278.7	176.4	104.5
Current account balance	-6.1	-1.2	-2.3	-6.3
Others				
Interest payments	11.5	13.4	9.7	6.3
Debt	189.8	208.1	150.1	107.3
Current account balance	-28.5	-27.4	-7.9	-7.5
Africa				
Interest payments	18.6	21.4	17.9	15.1
Debt	389.2	394.1	320.1	282.9
Current account balance	-35.3	-35.5	-27.9	-27.3
Eurocurrency borrowers [a]				
Interest payments	22.1	25.7	25.5	24.9
Debt	351.3	359.2	344.5	341.4
Current account balance	-14.1	-13.6	-16.0	-19.5
Least developed countries				
Interest payments	14.3	17.1	10.9	5.6
Debt	468.7	532.8	412.1	370.0
Current account balance	-80.3	-101.2	-77.0	-69.3
Other countries				
Interest payments	18.1	20.5	16.6	14.0
Debt	388.1	380.0	292.0	245.9
Current account balance	-34.2	-31.2	-21.9	-20.9
Asia				
Interest payments	3.4	2.6	1.6	1.2
Debt	57.2	46.5	33.0	25.5
Current account balance	1.9	2.9	1.0	1.1
Eurocurrency borrowers [a]				
Interest payments	3.4	2.2	1.0	0.6
Debt	46.2	31.2	17.7	11.1
Current account balance	9.5	10.0	4.9	3.9
Least developed countries				
Interest payments	11.7	14.2	11.4	8.9
Debt	563.3	596.5	498.0	448.8
Current account balance	-83.6	-88.2	-62.5	-55.1
Other countries				
Interest payments	4.9	4.7	3.6	2.8
Debt	98.6	95.4	72.4	56.8
Current account balance	-10.2	-11.7	-6.3	-5.2

Source: UNCTAD secretariat calculations, based on national and international sources for 1988 and SIGMA for other years.

a See footnote ***a*** to table 11.

Table 16

COMPOSITION OF THE DEBT OF DEVELOPING COUNTRIES IN 1988, FORECASTS FOR 1990 AND PROJECTIONS UP TO 2000

(Percentage shares of total debt)

	1988 Estimated	1990 Forecasts	1995 Projections	2000 Projections
All developing countries				
Private (medium- and long-term)	49.0	47.1	39.6	30.4
Short-term	16.3	16.1	19.8	23.3
ODA	17.0	18.9	24.2	28.9
Other official	17.7	17.9	16.4	17.4
	100.0	100.0	100.0	100.0
Eurocurrency borrowers [a]				
Private (medium- and long-term)	61.3	58.1	51.0	39.3
Short-term	15.6	16.4	22.6	29.7
ODA	5.4	6.2	7.8	9.3
Other official	17.7	19.3	18.6	21.7
	100.0	100.0	100.0	100.0
Least developed countries				
Private (medium- and long-term)	17.0	19.9	9.2	3.6
Short-term	7.6	7.6	11.2	11.2
ODA	62.5	62.6	73.7	81.5
Other official	12.9	9.9	5.9	3.7
	100.0	100.0	100.0	100.0
Other developing countries				
Private (medium- and long-term)	36.2	39.3	34.8	28.6
Short-term	11.7	10.8	12.4	15.2
ODA	31.1	30.7	35.6	39.4
Other official	21.0	19.2	17.2	16.8
	100.0	100.0	100.0	100.0

Source: UNCTAD secretariat calculations, based on national and international sources for 1988 and SIGMA for other years.

a See footnote *a* to table 11.

that the projection may not prove to be realistic.

For Africa the scenario offers little hope of any significant improvement, with all three sub-regions showing a continued decline in per capita GDP, averaging 1.5 per cent. Although there are considerable differences among the subregions, so far as most of Africa is concerned it is most unlikely that even the current inadequate level of political and social stability in the region can be maintained in the face of this further decline in per capita income.

In a continuation of the patterns established in the 1980s, Asia should continue to outperform the rest of the world in the 1990s under the baseline scenario. Indeed, the region as a whole performs somewhat better in the 1990s than in the current decade. However, the improvement is largely due to the considerably stronger performance of oil-dominant economies, which benefit from the relatively firm petroleum prices incorporated in the baseline scenario. The so-called Eurocurrency group of countries continues to be the strongest performer, although its rate of growth declines over the period, partly as a consequence of less dynamic growth of the developed market economies and partly due to increasingly important internal constraints (see section A). The least

developed countries of Asia continue to be relatively unaffected by the pace of world economic activity and to carry on with the generally low performance registered over the period 1985-1990. Political and climatic forces will continue to be dominant elements in the foreseeable future. The rest of Asia appears to resist the slowdown in world economic activity to a considerable degree. While its rate of growth does drop by half a point between 1985-1990 and 1990-1995, there is a slight acceleration in the latter half of the decade.

In summary, the baseline scenario presents a picture where there is little expectation of development progress in Latin America, Africa or the least developed countries of Asia. While other Asian developing countries continue to perform relatively well, the prospects for most other developing countries are dismal. Indeed, for much of the developing world they are so bleak under the baseline scenario that the results call into question a basic assumption of the exercise, namely, that there will be no fundamental change in the way in which domestic and international economic policies are established and applied. ■

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INTERNATIONAL FINANCING FROM THE CAPITAL MARKETS, PAYMENTS AND DEBT

A. Some overall trends

International capital markets during the 1980s have been notable for the difference between their overall dynamism, on the one hand, and the contraction in their role as a source of financing for developing countries, on the other. The dynamism is evident not only from the scale of bank lending and issues of securities to all borrowers but also from the pace of financial innovation. By contrast, for the great majority of developing countries, after 1982 net lending by banks first dwindled to levels far below those of the period preceding the outbreak of the debt crisis, and more recently has dried up or even become negative in many cases. Borrowing from private sources by developing countries in forms other than bank loans during this period has also been small.

According to one recent listing of financial innovations,[21] there has been a sharp acceleration during the 1980s, the number introduced during 1980-1986 being almost 2.5 times that during 1957-1979. Recent financial innovations have served various objectives, such as the facilitation of risk transfer (for example, in the case of financial futures and options), liquidity enhancement, and increases in the supply of credit and equity financing (for example, through the mobilization of new categories of collateral for borrowing or the tapping of new sources of funds). These innovations have benefited primarily participants in the international capital markets from the private sector, although the financial instruments in question have also been deployed by the governments and public enterprises of OECD countries (in their international borrowing). As regards developing countries, financial innovation has been manifest mainly in techniques for reducing their external debt or exchanging it for other financial instruments. The mainstream of recent financial innovations has had a much more limited impact on governments and other economic actors from these countries. Thus, for example, developing countries' share of underwritten Euronote facilities during 1984-1988 was less than 10 per cent, and their share of non-underwritten facilities during 1985-1988 was below 2 per cent. Several causes have doubtless contributed to the small role of developing countries in the markets for the new financial instruments, including controls and regulations in their domestic capital markets (probably the most important factor for countries with unimpaired creditworthiness), costs and other problems associated with establishing the required networks of communications and computer facilities and, for countries experiencing difficulties over debt service, shortages of foreign exchange.

After a year of slow growth in 1987, total borrowing from the international capital markets expanded rapidly in 1988. The main contributions to this expansion were the continued growth of syndicated lending by banks and the return of new issues of international bonds to

21 J. Walmsley, *The New Financial Instruments* (New York, etc.: John Wiley and Sons, 1988), pp. 4-6.

approximately their peak of 1986 after a decline in 1987. However, more than one quarter of the syndicated lending was used to finance corporate mergers and acquisitions, a sharp rise in comparison with a figure of less than 10 per cent in 1988. Moreover, borrowing by developing countries did not share in the increases of either bond issues or syndicated lending.

In the case of the first of these categories of borrowing, the share of developing countries has remained at about 2 per cent since 1986. The fall in this share since the second half of the 1970s, when it was much higher, in some years exceeding 10 per cent, reflects partly a reduction in the number of developing countries having recourse to this form of financing due to impaired creditworthiness, and partly the unwillingness of developing countries with more favourable external payments positions to increase their borrowing in line with the substantial overall rise in international bond issues. The small share of developing countries in new syndicated loans was accompanied by the continuation of the post-1981 decline in the growth of the overall net lending to these countries of banks in the BIS reporting area which is shown in table 17. Indeed, in 1988 such net lending was negative not only for developing countries as a whole but also for most of the groupings shown in the table. This fall reflects most importantly the determination of international banks to reduce their exposure to developing countries not only through reductions in the pace of lending but also through various market-related mechanisms such as debt-equity conversions. Banks' efforts to reduce their exposure have been directed primarily towards developing countries with debt-servicing difficulties. However, the recent behaviour of bank lending also reflects low levels of demand on the part of certain Asian countries, some of which have taken advantage of their strong external payments positions to make repayments to banks.

A reversal of the factors (discussed at greater length in section B) which have led banks to restrict their exposure to developing countries does not seem imminent. Among the influences likely to be important in this context are the greater attention of banks to risk management, the levels of provisioning likely to be associated with any new loans to countries experiencing difficulties over debt service, and pressures on banks to increase their capital in relation to their total assets. These influences are mutually interdependent since, for example, the market value of a bank's equity reflects, *inter alia*, the riskiness of its assets and charges on its profits due to loss provisions.

Since the mid-1970s there has been an increase among banks in their awareness of many of the dimensions of financial risk, accompanied by a substantial development of their techniques for managing it. Important reasons for this increased awareness are the greater volatility during much of the period of variables such as interest rates, exchange rates, certain categories of bank liabilities and the prices of financial assets, and the proliferation of non-performing loans (which have been a significant source of downward pressure on the values of many banks' equity). Banks' response to these phenomena have included the financial innovations designed to facilitate risk transfer mentioned above and the curtailment of their involvement in lending and other activities with low profitability likely to be unfavourably regarded by equity investors. Lending to developing countries is one of the activities affected by this curtailment. Indeed, in the case of those borrowers against their exposure to which most banks have established greatly increased loss provisions since early 1987, new lending must generally also carry the cost of provisioning at the same level, involving an equivalent charge on banks' profits.

The heightened emphasis on profitability and concern with their equity values among banks has received an additional fillip from pressures on them to increase capital in relation to their assets. The main recent manifestation of these pressures is the agreement of the central-bank governors of the Group of Ten countries (the Basle Agreement of July 1988) to endorse principles concerning the international convergence of capital measurement and capital standards. These principles (described in more detail in annex 2) set target figures for the ratio of capital to a risk-weighted sum of assets and off-balance-sheet exposures, culminating in a level of 8 per cent in 1992. For many of the major international banks attainment of these targets will require increases in their capital. Among the ways of achieving such increases are higher profits and new issues of equity, neither of which can easily be reconciled with new lending to highly indebted developing countries, for the reasons explained above.

Net flows of export credits were on a declining trend during 1980-1987. As shown in annex table 1, by 1985 net flows to most regions of medium-term and long-term credits had fallen by more than 80 per cent from their 1980 levels, and in 1986-1987 such flows were widely negative. Moreover, changes in total export credits (including those at short term), when adjusted for the effects of movements of exchange rates, were negative for approximately 50 per cent of developing countries in the four half-year periods during 1986-1988

Table 17

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA [a] VIS-À-VIS DEVELOPING COUNTRIES, 1982-1988

Area	Average 1980-1981	1982	1983	1984	1985	1986	1987	1988	Stock at end-1988
	Percentage rate of increase [b]								$ billion
Developing countries [c]	17.8	7.6	5.2	0.7	4.9	4.2	6.4	-4.2	512 [d]
Major oil exporters	16.2	8.1	8.6	-1.1	2.8	2.5	7.5	-2.3	218
Others	18.5	7.2	2.8	2.1	6.4	5.5	5.7	-5.5	294 [d]
By region:									
Latin America: Total	22.2	6.1	3.1	0.1	3.0	0.8	1.5	-5.3	246
Major oil exporters [e]	25.3	4.7	3.8	-2.7	3.0	-0.9	1.3	-5.8	101
Africa: [f] Total	10.9	9.8	1.6	-4.4	14.8	10.3	8.8	-8.4	55
Major oil exporters [g]	9.5	17.1	4.5	-6.4	19.9	18.0	10.7	-7.0	28
West Asia: [f] Total	3.9	9.9	20.0	3.2	0.0	4.6	16.7	3.5	84
Major oil exporters [h]	2.7	10.8	23.5	3.2	-3.7	0.4	14.7	4.2	68
South and South-East Asia: [i] Total	18.5	13.1	7.9	3.3	8.3	6.4	11.0	-4.3	116
Major oil exporters [j]	3.8	35.9	19.2	3.9	7.7	10.6	14.1	0.5	19
Europe [k]	18.0	-5.8	-2.0	-1.3	7.6	-2.1	-0.4	-9.5	9
Memo item:									
All borrowers: Total [l]	18.0	9.0	4.0	3.2	19.1	27.0	28.5	6.9	4485

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

a Including certain offshore branches of United States banks.
b Based on data for end-December.
c Excluding offshore banking centres, i.e.: in Latin America: Barbados, Bahamas, Bermuda, Netherlands Antilles, Cayman Islands and Panama; in Africa: Liberia; in West Asia: Lebanon; in South and South-East Asia: Hong Kong and Singapore.
d Including a small amount not shown under the regions.
e Ecuador, Mexico, Trinidad and Tobago and Venezuela.
f Libyan Arab Jamahiriya is included in West Asia up to 1982 (since it could not be separated from this area in the BIS series). Since 1983, it is included in Africa.
g Algeria, Angola, Congo, Gabon, Nigeria and (since 1983) Libyan Arab Jamahiriya.
h Bahrain, Iran (Islamic Republic of), Iraq, Kuwait, Libyan Arab Jamahiriya (up to 1982), Oman, Qatar, Saudi Arabia, Syrian Arab Republic and United Arab Emirates.
i Including Oceania.
j Brunei Darussalam and Indonesia.
k Malta and Yugoslavia.
l Including multilateral financial institutions.

specified in table 18. In all the regions shown the proportions of countries experiencing declines are substantial, those for Africa and West Asia consistently exceeding the average for all developing countries.[22] Recent estimates for 1988 as a whole indicate that the total net flow of export credits from DAC members to developing countries at current prices was positive for the first time since 1985, although at $2.6 billion its level was still less than 25 per cent of that during 1980-1982.[23] This rise was accompanied by an increase in 1988 of almost SDR 3

[22] Annex table 1 also shows the recent decline in medium-term and long-term supplier credits to public agencies and to private parties with a guarantee from a public agency in developing countries.

[23] "Financial resources for developing countries: 1988 and recent trends", *OECD Press Release*, 22 June 1989. Unlike

Table 18

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

(Number of countries) [b]

	1986 (2nd half)	*1987 (1st half)*	*1987 (2nd half)*	*1988 (1st half)*
All developing countries	49	50	45	56
Africa	56	56	52	58
Latin America	42	39	33	47
West Asia	53	60	67	80
South and South-East Asia	48	52	41	55

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 effects of movements of exchange rates.

b As a percentage of the total number of developing countries (in each region or grouping) for which figures are available.

billion in gross borrowing by all countries in the form of export credits with an original maturity of more than five years, much of which was accounted for by developing countries classified as relatively poor under the OECD Arrangement on Guidelines for Officially Supported Export Credits (the OECD Consensus).[24] However, a single year's lending is not a sufficient basis for forecasting a new and more buoyant trend for export credits to developing countries, especially since the data presented in section C below point to the continuation for most such countries of a restrictive stance on the part of major export credit agencies (ECAs) as regards the provision of official insurance cover for private export credits.

Recent movements in export credit financing have resulted from factors on both the demand and the supply sides, and from their interaction. For the majority of developing countries the main influences have been demand for certain categories of their exports, higher interest rates than those typically prevalent in the second half of the 1970s (as illustrated in annex table 2), and other factors associated with impaired creditworthiness and external financial stringency. Thus, for example, low levels of world demand for mineral commodities have led to reduced investment in new mining projects in developing countries, the financing of which is often a source of demand for export credits. External financial stringency and impaired creditworthiness have depressed export credits through the interaction of demand and supply. When a country's balance of payments position deteriorates, as part of a process discussed in more detail in section C, the increased risks associated with financing and payments arrangements for its imports lead to the imposition by ECAs of higher costs and more restrictive conditions on their insurance cover for private export credits[25] (thus accentuating the very external financial stringency which is the source of these increased risks). The effects on export credits of such actions on the supply side are added to reductions in demand resulting from deflationary measures

the figures for net flows of total export credits used for table 18, those in this press release are not adjusted for the effects of movements of exchange rates.

24 "Officially supported OECD long-term export credits expanded sharply in 1988", *OECD Press Release*, 24 April 1989. The totals in this press release (which refer to lending by the 22 member countries of the OECD Consensus) cannot be directly compared with the data used to estimate net flows of medium-term and long-term export credits in annex table 1, since the latter refer to loans with an original maturity of more than one year.

25 The connection described here between external financial stringency and the availability of insurance cover does not help to explain recent movements of official export credits which are in the form of direct official lending. Although such credits reflect political considerations more frequently than private ones, their movements too are influenced by other factors described in this paragraph, such as reductions in imports resulting from deflation.

taken in response to unfavourable changes in the balance of payments. During the 1980s such measures have led to widespread reduction of gross investment in developing countries,[26] and thus to lower imports of capital goods, which are the main sources of demand for medium-term and long-term export credits.[27] It has also been argued that demand for export credits on the part of developing countries with unimpaired creditworthiness as well as those experiencing external financial stringency has contracted in response to the increased attractiveness of alternative financing and payments arrangements as market rates of interest decreased in relation to the minimum rates under the OECD Consensus.[28]

The low level of net borrowing by most developing countries from the capital markets is related to the continuing absence of a sustained improvement in their debt position since 1982 (as shown by the indicators in table 19). This absence reflects to a significant degree the uneven incidence and limited extent of recent favourable changes in external conditions. Thus, for example, the recovery of developing countries' exports in 1987-1988 has been heavily concentrated in South and South East Asia, those of Africa remaining in 1988 more than 30 per cent, and those of Latin America more than 15 per cent, below their levels of 1981. Moreover, only in 1986 did the fall in LIBOR for dollar deposits (illustrated in annex table 2) bring rates down to those prevailing before 1979, and minimum rates of interest on export credits under the OECD Consensus (which have also declined) are still substantially above those of the second half of the 1970s.

As shown in table 19, the ratio of debt to exports fell in 1988 for all net debtors and for the group of highly indebted countries (the so-called Baker 15), but to levels still higher than those of 1982-1985. That for sub-Saharan Africa continued to rise.[29] Both net debtor countries as a whole and the highly indebted countries have experienced favourable trends in their ratios of interest payments to exports since 1984, but sub-Saharan Africa has not benefited from a similar movement, its ratio increasing sharply in 1988. The declines in interest payments during 1985-1987[30] for all three groups in the table were accompanied by a continuing stagnation of net disbursements of new financing, and thus by the prevalence of low or negative net financial transfers. The downward trend in major international interest rates has been reversed since the second half of 1988, and it should be recalled that each rise of one percentage point in these rates increases developing countries' annual interest obligations on their outstanding debt to banks alone by some $5-6 billion.

The lack of progress evident from such debt indicators, continuing strains in debtor-creditor relations, and the highly unfavourable impact of the debt overhang on economic performance and living standards in developing countries gave fresh impetus in 1988 to alternative approaches to solving the debt problem. Prominent among such proposals was the provision of debt relief through reductions in the stock of debt or in interest payments. At the Toronto summit in June 1988 these ideas were reflected in the acceptance by major creditor countries of a plan for providing relief on the official debt of the poorest developing countries which allowed creditors during reschedulings to choose among the options of concessional interest rates, the extension of repayment periods, partial write-off of debt-service obligations, or a combination of the three types of relief. Progress in implementing this plan is discussed in section C below. Acceptance by creditor governments of the need for a broader and more rapid approach to debt relief in the case of bank debt has been slower in coming. However, a reduction of bank debt and the interest payments thereon is the central feature of the initiative launched by the United States Secretary of the Treasury in March 1989. The modalities decided upon for implementing this initiative are evaluated in the next section.

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26 The scale of reduction is indicated in the case of a sample of countries in Latin America by the negative cumulative growth rate of 3.1 per cent for the volume of gross investment during 1981-1987, and in the case of sub-Saharan Africa by the fall in gross investment as a proportion of GDP from 21 per cent in 1981 to 11-12 per cent in 1984-1985 and 16 per cent in 1987.

27 The revival in 1988 of gross export credit lending with an original maturity of more than five years (which was mentioned above) is no doubt associated with the financing of capital goods, and may be due in part to the liberalization of ECAs' practices as regards the availability of official credit insurance to countries rescheduling their official debts (discussed in section C.3 below).

28 The movements of market rates of interest in relation to those of the OECD Consensus are exemplified in annex table 2 by LIBOR for dollar deposits of selected maturities.

29 Alternative debt-to-exports and interest-payments-to-exports ratios are also shown in table 19 to illustrate the impact on net debtor developing countries debt indicators of declines in the average prices of their exports since 1981.

30 After decreasing in 1985-1986 interest payments actually rose in 1987 for countries in sub-Saharan Africa, but to a level substantially below that of 1985. Their exports declined in each year during 1985-1987.

Table 19

SELECTED INDICATORS OF EXTERNAL DEBT POSITIONS OF NET DEBTOR DEVELOPING COUNTRIES, [a] 1981-1988

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
	Ratio of debt [b] to exports of goods and services (per cent)							
All net debtor countries [a]								
Actual	152.1	181.2	199.7	192.5	215.0	249.7	246.9	216.1
In 1981 export prices	152.1	169.8	170.0	165.5	181.8	188.3	194.9	178.7
Highly indebted countries [c]								
Actual	211.3	266.0	297.2	276.8	291.0	353.6	351.2	311.0
In 1981 export prices	211.3	244.8	247.8	233.7	238.1	259.5	278.7	249.7
Sub-Saharan Africa								
Actual	130.5	176.2	216.9	206.0	229.9	320.0	392.3	418.5
In 1981 export prices	130.5	155.1	160.6	167.5	188.1	231.1	277.7	286.3
	Ratio of interest payments [d] to exports of goods and services (per cent)							
All net debtor countries [a]								
Actual	16.0	18.3	15.8	16.3	16.0	16.0	14.2	13.3
In 1981 export prices	16.0	17.1	13.5	14.0	13.5	12.0	11.3	11.0
Highly indebted countries [c]								
Actual	26.8	32.6	27.2	27.3	25.7	25.8	22.4	22.4
In 1981 export prices	26.8	30.0	22.7	23.0	21.0	19.0	17.8	17.9
Sub-Saharan Africa								
Actual	9.4	11.0	11.9	13.1	12.6	11.3	12.5	14.5
In 1981 export prices	9.4	9.7	8.8	10.6	10.3	8.2	8.8	9.9
	Net financial transfers [e] ($ billion)							
All net debtor countries [a]	27.7	6.8	-42.1	-32.6	-39.4	-49.5	-32.6	-44.8 [f]
Highly indebted countries [c]	19.6	-6.9	-49.0	-38.0	-38.9	-46.2	-18.9	-42.5 [f]
Sub-Saharan Africa	4.7	3.5	4.6	0.3	-2.2	-0.1	1.9	2.1 [f]

Source: Total debt figures for 1981-1987 were taken from World Bank, *World Debt Tables. External Debt of Developing Countries 1988-89 Edition* (Washington, D.C., 1988), and those for 1988 were estimated on the basis of IMF, *World Economic Outlook* (Washington, D.C., April 1989); interest payments on long-term debt during 1981-1987 were taken from World Bank, *op. cit.*, those on short-term debt during 1981-1987 are estimates of the UNCTAD secretariat, and total interest payments in 1988 were estimated on the basis of IMF, *op. cit.*; exports of goods and services in current prices are data of the UNCTAD secretariat; exports of goods and services in 1981 prices are extrapolations of 1981 figures on the basis of data of the UNCTAD secretariat for export volumes. Net financial transfers: transfers associated with long-term debt for 1981-1987 are based on figures in World Bank, *op. cit.*, while those associated with short-term debt are estimates of the UNCTAD secretariat; figures for 1988 are estimates of the UNCTAD secretariat based on IMF, *op. cit.*

a All developing countries and territories other than Islamic Republic of Iran, Kuwait, Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia, Taiwan Province of China, and United Arab Emirates.

b Total short-term and long-term debt other than outstanding credit from IMF.

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

d Interest on short-term and long-term debt other than outstanding credit from IMF.

e Disbursements of, minus repayments of principal and interest on, short-term and long-term debt (other than outstanding credit from IMF).

f Preliminary estimates.

B. Bank lending to developing countries

1. Recent debt restructuring agreements

There were few debt restructuring agreements negotiated between developing country debtors and commercial banks during 1988 and the first quarter of 1989. Brazil, Malawi and Yugoslavia finalized agreements reached in principle earlier in the year, while Côte d'Ivoire, Nigeria and Trinidad and Tobago reached agreement in principle. In addition, Chile and Uruguay signed agreements with their creditor banks to amend earlier restructuring packages, and Congo, Gambia and Guinea finalized agreements concluded in principle in 1986-1987. The total bank debt restructured amounted to $76.5 billion, of which $61 billion was accounted for by Brazil alone.[31]

The terms on rescheduled debt have been tending to improve. The average maturity on restructured debt has increased. The average for debt restructured in 1984-1986 was 10 years, whereas it was 18 years for debt restructured in the first three quarters of 1988. Moreover, the average grace period has risen, from four years in 1985-1986 and five years in 1987 to eight years in 1988. Interest rate margins have also been reduced. The record low of 13/16 over LIBOR obtained by Mexico in 1986 has been extended to other debtors such as Brazil, Chile, Ecuador and Venezuela. The average margin for all agreements was 1 per cent for 1987 and 0.8 per cent for 1988, compared to 1.3-1.5 per cent in 1985-1986. The improvement in the terms of restructuring agreements for bank debt, however, remained largely restricted to large debtor countries. For smaller ones (such as Gambia, Malawi and Trinidad and Tobago) maturities have remained short, and the spreads high.

A more notable feature of recent agreements is the paucity of new concerted lending. Since 1987 only four agreements (those with Argentina in April 1987, Ecuador in November 1987, Côte d'Ivoire in April 1988, and Brazil in June 1988) have included such lending. The amounts agreed to in 1987 totalled a mere $2.4 billion, rising to $5.7 billion in 1988, but almost all of this latter figure ($5.2 billion) was accounted for by Brazil alone. The lower level of concerted lending is indicative of the increasing difficulties of assembling new money packages.

In the early years of the debt crisis, the high exposure rate of the major creditor banks gave them a common interest in supplying new money. Moreover, these banks were in a position to oblige other creditors with low exposure rates to participate pro rata. Over time, however, the position of the larger banks has changed and creditors have become increasingly differentiated.[32] All have succeeded, though to a varying extent, in reducing their developing country exposure relative to capital and, more recently, in building reserves against eventual loan losses. Differences in prudential regulation and disclosure requirements, tax and accounting treatment, etc., have also served to fragment the creditors. As "free riders" have become the rule rather than the exception, the process of concerted lending has come to a virtual halt. In essence, it has survived only with respect to very large debtors, and even then in a much reduced form.

Many banks have responded to the pressures on them to supply resources by searching for alternatives to new money, a search which has given rise to the so-called "market-based menu" approach. The menu offers a variety of instruments and devices tuned to the specific interests and constraints of commercial banks,

[31] IMF, *International Capital Markets, Developments and Prospects* (Washington, D.C., April 1989), tables A34 and A36.

[32] Divergences among the larger banks are manifested by the reactions to the United States Citicorp decision to make loan-loss reserves in 1987, and to the Morgan Guaranty Bank exchange deal organized for Mexican debt. As one observer put it, "Increasingly, relations among America's major banks appear to be dominated less by thoughts of preserving industry solidarity than by sentiments of *sauve qui peut*". Benjamin Cohen, "Developing country debt: a middle way", *Essays in International Finance No. 178* (Princeton, New Jersey: Princeton University, May 1989), p. 22.

such as onlending and relending facilities,[33] debt-equity conversion mechanisms, exchange offers with collateralization,[34] debt buy-backs, and exit instruments (an example of the last being exit bonds).[35]

Recent agreements have incorporated many of these items. Exit bonds were included for the first time in the 1987 Argentine rescheduling, but the option was not taken up by most banks. The 1988 Brazilian agreement represents the most fully-fledged "menu" package, with a very wide range of options that includes, in particular, an expanded debt-equity conversion scheme, "relending" and "onlending" facilities, debt-for-debt-exchange and exit bonds. The latter have been particularly successful: about 100 banks subscribed to more than $1 billion of exit bonds.[36]

These options are attractive to creditor banks for a number of reasons. Exit bonds have seniority of status and are easily tradeable but, most importantly, they exempt banks from participation in future concerted lending packages; for banks in a position to take the resulting accounting losses, these benefits outweigh the cost of providing discounts. The attractiveness of debt-equity swaps lies in the fact that the discount applied by the central bank in the debtor country is lower than the market discount; banks can therefore exchange loans of doubtful value for often undervalued real assets without incurring a stiff penalty. They also serve to increase demand in the secondary market, increasing the room for manoeuvre for banks willing to sell loans through that channel. Onlending and relending operations allow creditor banks to exceed the legal limits on loans to a single borrower, to charge higher fees and spreads, to fund their subsidiaries in debtor countries, to enhance their role in the allocation of domestic credits, and to establish business relations with certain firms. Moreover, relendable loans fetch a higher price in secondary markets since the transnational corporations which purchase them can use them in their debtor countries for their borrowing and lending operations. Thus, not only does the funding take place at a preferential exchange rate, but also the holder of the claim on the debtor country can use the full domestic currency value of that claim through its subsidiary.

However, some of the items in the menu may create problems for debtors. As demonstrated in chapter IV, section B.3 below, when undertaken on a large scale, relending and onlending and debt-equity swaps can lead to an overexpansion of the supply of money and credit. Moreover, "round-tripping"[37] can result, with unfavourable effects on the debtor's foreign exchange reserves and exchange rate. These factors have led some countries to suspend special debt-equity swap programmes established under creditor pressure. In Mexico, suspension occurred in November 1987. In Brazil, where a debt conversion programme through auction had been established in February 1988,[38] the authorities slowed down the pace of conversion in early 1989, and eventually stopped auctioning debt.[39]

By early 1989, three of the agreements including concerted new lending since 1987 had broken down: the Argentine agreement had completely collapsed and the country was accumulating large arrears; Ecuador had suspended its agreement because the banks had not subscribed the amounts of new money agreed; and the agreement with Côte d'Ivoire had not been implemented.[40] Moreover, the Brazilian agreement was already facing difficulties. By January 1989, Brazil was trying to modify the relending and debt-equity swap

33 Concerning such facilities see definition in chap. IV, box 10.

34 Under exchange offers with collateralization debt is exchanged for an alternative financial asset whose service is guaranteed by collateral specially established for this purpose.

35 Exit bonds are long-term bonds, usually with low interest rates, that allow banks to avoid participating in future concerted lending packages since such bonds are not included in the base exposure that usually determines new money contributions.

36 The interest rate on these bonds (6 per cent, compared with 4 per cent for Argentina, for instance), as well as the possibility of exchanging them at par into indexed cruzado-denominated Brazilian Government debt, is said to have contributed to making them attractive.

37 "Round-tripping" consists of financial operations entailing capital movements into and out of a debtor country designed to take advantage of differences between the prices of its currency in the foreign exchange markets and the price available to those purchasing its debt in the secondary market and taking advantage of the discounts available under its debt-equity conversion mechanism.

38 In terms of the volume of transactions, the debt-to-equity swap programme had been considered as rather successful. In the 12-month period until January 1989, 10 formal debt conversion auctions took place in Brazil, in which about $3.6 billion were swapped. In addition to these formal debt conversions, informal conversions (outside the government programmes) have also been rapidly spreading.

39 The Government said that the suspension of auctions was temporary but to date there has been no resumption.

40 Implementation was stalled because of the halting after only one month of interest payments which were scheduled to resume under an agreement that also provided for the consolidation and refinancing of interest arrears.

programmes contained in the agreement, and the flow of new money had become blocked because of a disagreement with the World Bank. However, by April 1989 most of the $600 million agreed upon had been received, and negotiations had begun on the release of the next tranche scheduled. Banks subsequently suspended the disbursement of further new loans, owing to the country's failure to meet IMF targets on inflation and government spending.[41]

Chart 1

CHANGES IN THE CLAIMS OF BANKS IN THE BIS REPORTING AREA ON HIGHLY INDEBTED COUNTRIES [a]

(Percentage)

Source: As for table 17.

a Based on year-end data. For the 15 highly indebted countries see table 19.

2. *Trends in lending and exposure*

In 1988, for the first time since the beginning of the debt crisis, bank claims on developing countries registered an absolute decline of 4 per cent (see table 17). As noted in section A, this decline was mostly due to a reduction of new lending to developing countries and to the adoption by banks of a more decisive and open strategy to reduce their exposure to troubled debtors. The decline in bank claims on the 15 highly indebted countries over the period 1982-1987 has been particularly marked; after barely any growth in 1987, bank claims on these countries declined in absolute terms in 1988 (for the second time since 1982), registering a decrease of 6.7 per cent (see chart 1).

The level of new bank lending to developing countries continued to decline in 1988. Gross flows of such lending, including managed loans, fell to $15.3 billion, from $20.1 billion in 1987. The annual average for 1986-1988 was $15.7 billion, compared to one of $27.5 billion for 1983-1984. Bank lending to Latin America, most African countries, as well as a number of oil producers in West Asia, continued to be restricted by considerations of creditworthiness. Hence, whereas at the time of the Baker plan commercial banks were expected to provide $20 billion in net lending to the most heavily indebted countries over the three-year period 1986-1988, according to World Bank estimates net medium-term and long-term loans by banks (to public entities or carrying a public guarantee) averaged only about $5 billion per annum over that period, mostly to a few large debtors.

On the other hand, banks' efforts to reduce their portfolios of developing country loans have been gathering momentum in the last 18 months. Between 1983 and 1988, about $27 billion of developing country debt is estimated to have been retired through debt reduction practices, including corporate restructurings, buy-backs, debt-equity swaps and debt conversion into collateralized securities. United States banks have played the leading role in this process. Their exposure to developing countries has continuously decreased since 1983, the cumulative decrease over the five years up to December 1988 reaching 35 per cent.[42] Since the capital of United States banks rose by 70 per cent between 1983 and 1988, their exposure ratio (the ratio of claims on developing countries to capital) has improved even more dramatically (see annex table 3); it was cut by two thirds from a peak of 196 per cent in 1981 to 64 per cent at end-1988, a level below that registered in 1977, the first year for which such data were collected.

The trend has been most marked among the smaller United States banks, whose claims on developing countries had fallen 50 per cent by 1988, but a similar trend has also characterized the exposure of large banks. Thus, for example, the nine largest United States banks have also reduced their claims more than 20 per cent since 1983, much of the reduction coming in the last 18 months (see box 5). Moreover, in the last nine months of 1988 the 13 largest United States banks decreased their claims on developing countries by almost 10 per cent. Improved financial positions are one reason for

[41] The World Bank also suspended disbursement of fresh loans.

[42] United States Federal Financial Institutions Examination Council, *Country Exposure Lending Survey. Statistical Release*, various issues.

Box 5

REDUCTION OF DEVELOPING COUNTRY EXPOSURE IN SOME OF THE 14 LARGEST UNITED STATES BANKS

Bank	*Rank in US* [1]	*Initial exposure*	*Action taken*
Citicorp	1	Had the highest developing country exposure ($14.6 billion in June 1987)	Reduced its exposure to developing countries by about 17 per cent between June 1987 and September 1988 through debt sales, swaps and other transactions; and is reported to aim at a $5 billion reduction (more than 30 per cent) over 5 years.
Chase Manhattan Corp.	2	$8.74 billion total exposure to developing countries in June 1987	Is reported to have reduced its medium and long-term exposure to developing countries by about 13 per cent during 1988.
BankAmerica Corp.	3	$10.35 billion exposure to developing countries in June 1987	Reduced its exposure by 13 per cent between June 1987 and September 1988.
JP Morgan	5	$5.4 billion exposure to developing countries in June 1987	Reduced its exposure by 15 per cent during 1988.
Security Pacific Corp.	6	$1.7 billion exposure to developing countries by end-1987	Having reduced its exposure by 70 per cent, the bank said in April 1989 that it had accomplished its objective as regards its exposure to developing countries.
First Interstate Bancorp.	9	$1.4 billion at end-1987	Reduced its developing country loans by 38 per cent during 1988.
Wells Fargo	10	$1.8 billion medium and long-term loan exposure at end-1987	Reduced its troubled (medium and long-term) loans to developing countries by almost two thirds by autumn 1988.
First Chicago Corp.	11	About $3 billion exposure at end-1987	Reduced its exposure to troubled developing countries by about 30 per cent during 1988.
Bank of Boston	12	$1.4 billion exposure to developing countries in June 1987	Reduced its exposure by 29 per cent between June 1987 and September 1988.
Continental Bank Corp. [2]	14	$2.3 billion exposure at end-1987	Reduced its exposure by 18 per cent during 1988.

1 Ranked by assets according to *The Banker*, July 1988.
2 Name changed from Continental Illinois Corporation to Continental Bank Corporation in December 1988.

the increased interest in debt reduction. The widespread move to establish loan-loss provisions has significantly increased the ability of banks to sell loans at a discount (and to resist pressure for new lending). Moreover, United States banks' profits have risen by 17 per cent, to reach a record level of $25.3 billion in 1988. Over the last five to six years the claims on developing countries of banks from other major creditor countries (France, Switzerland and the United Kingdom) also declined overall.[43]

The banks' intense interest in portfolio adjustments caused activity in the secondary loan market to surge in 1988. Prices had remained relatively stable in the first half of 1988 (following the slide observed in the second half of 1987), but registered spectacular declines in the last part of that year, especially in respect of most of the highly indebted countries. For instance, during 1988 the price of claims on Argentina fell by 35 per cent (to 22 cents on the dollar), on Côte d'Ivoire by 38 per cent (to 25 cents), on Ecuador by 65 per cent (to 13 cents) and on Venezuela by 30 per cent (to 41 cents).[44] Between mid-1987 and end-1988 the average price of the debt of the highly indebted developing countries fell from 54 cents on the dollar to 35 cents. In early 1989 trading volume also dropped due to the suspension of the Brazilian debt-equity swap programme, growing worries as to a moratorium on interest payments by Brazil and Venezuela, and electoral and political uncertainties in the main Latin American debtor countries. Depressed demand conditions lowered both prices and trading volumes.

Debt buy-backs and debt-equity swaps have been the two main mechanisms of developing country debt reduction. Data on buy-backs are still poor; it is estimated, however, that between $8 and $10 billion of debt has been retired through buy-backs since the onset of the debt crisis. Most of it has been undertaken by companies, but public and publicly-guaranteed debt to banks has been reduced by $299 million in Bolivia (47 per cent of the country's debt to banks) and by $300 million in Chile (2 per cent of its debt to banks). As regards debt-equity swaps, the cumulative debt reduction through such mechanisms reached almost $13 billion for the 1983-1988 period.[45] In the debt-for-collaterized-securities conversion category, the only notable experience to date is the Mexican debt-for-bond swap organized in 1988. The reduction achieved amounted to $1.1 billion, a disappointing result for some observers. Another technique, which has received considerable publicity since it was first employed in 1987, is debt-for-nature swaps. This technique, experience of which is reviewed in box 6, seems capable of being a useful tool of conservation policy but has had a very limited effect in reducing outstanding debt.

Thus, the overall amount of debt reduction has been small. The $27 billion decrease through market-related mechanisms that has been achieved over the past six years amounts to merely 10 per cent of the total bank debt of the 15 so-called Baker countries in 1983. The scale of debt-equity swaps was, as already explained, circumscribed by their potentially disruptive macroeconomic consequences. On the other hand, the scope for buy-backs and debt conversions was limited by the shortage of foreign exchange.

3. *Impediments to new lending*

It is doubtful whether the decline in new bank lending observed throughout the period of the Baker plan can be reversed. In the new competitive and regulatory environment that prevails, banks are more averse to risk, and especially developing country risk, than at the outbreak of the debt crisis. By and large, they see reduction of their level of exposure as offering a more certain outcome than trying to improve the quality of their exposure by adding to it ("defensive lending"). This is clearly the case for those banks which have managed to reduce their exposure and to set aside sizeable loan-loss provisions, and which are able to absorb the book-keeping losses from selling (or swapping) loans at a discount. But, those creditors whose exposure still remains high, or which have not yet been able to make substantial loan-loss provisions (or both), and which therefore show less interest in debt reduction, are also extremely reluctant to keep adding to their exposure. Such banks can be expected to participate (albeit reluctantly) in concerted lending only for big debtors, and only when, and to the extent that, the alternative is a dis-

[43] The assets of banks in France, Switzerland and the United Kindom are measured in their respective home currencies. Banks in the Federal Republic of Germany, however, registered some increase during the same period. Little information is readily available for Japanese banks; there are indications, however, that they have continued to lend to some developing countries, especially in Asia.

[44] Data from Salomon Brothers, as quoted in World Bank, *Financial Flows to Developing Countries. Quarterly Review*, December 1988.

[45] Morgan Guaranty Trust Co., *World Financial Markets*, December 1988.

Box 6

DEBT-FOR-NATURE SWAPS

How they work

Debt-for-nature swaps are one among a variety of swap techniques. In a swap, a third party buys debt from a creditor at a discount, or, occasionally, receives it as a gift. The debtor then redeems this debt, not in the foreign exchange in which the original debt was denominated, but in claims on local currency. In debt-for-nature swaps, conservation groups use debt they have acquired to support nature conservation in the debtor country. An incentive to such swaps was added by the United States Treasury in November 1987 when it ruled that lenders may deduct for tax puposes the full face value of developing country debt donated to fund charitable activites in debtor nations. Debt-for-nature swaps so far have mostly been financed by American partners.

The cases [1]

The first debt-for-nature swap dates from the middle of 1987. ***Bolivia*** reached an agreement with Conservation International (CI), a United States non-governmental organization whereby CI purchased $650,000 of Bolivia's commercial debt for $100,000 donated by a United States foundation, and cancelled it. In exchange for CI's redemption of this debt, the Bolivian Government agreed to strengthen the legal protection of an existing reserve and to increase to 1.2 million hectares the protected area of Amazonian forest around it. Furthermore, a $250,000 fund in local currency, consisting of $100,000 in pesos from the Bolivian Government and $150,000 in pesos contributed by USAID from its local currency PL480 funds, was established to manage the reserve and its additional buffer zones.

At the end of 1987, the United States World Wildlife Fund (WWF-US) concluded a debt-for-nature swap programme with ***Ecuador***. The scheme had first been proposed by Roque Sevilla, President of Fundación Natura, a private conservation organization in Ecuador. Under the agreement, WWF-US can purchase from United States banks up to a face value of $10 million of Ecuador's external debt. In December 1987, $1 million of debt was purchased for $354,000, and in April 1989 $9 million were purchased for $1.08 million. The face value of this debt is converted - at the overvalued official exchange rate - into local currency bonds to be held by Fundación Natura. The interest on the bonds - over 30 per cent per year - is used to finance a variety of conservation projects, including national park management, training for park personnel and environmental education. At maturity, after nine years, what remains of the principal of the bonds after inflation is destined to become an endownment for Fundación Natura. The agreement was extended in April 1989.

The Government of ***Costa Rica*** established a debt-for-nature programme in 1987, creating a Natural Resources Conservation Fund using specially issued bonds to support the effort. Costa Rican debt was directly donated, or purchased on the secondary market, for about 17 cents on the dollar, with funds donated for the purpose. Costa Rica exchanged this debt for bonds at 75 per cent of its face value. These bonds, with a maturity of up to six years, carry an average of 25 per cent interest. The interest income is allocated to projects agreed between the donors and the Ministry of Natural Resources to expand, manage and protect national parks. A ceiling of $5.4 million on the value of swaps for this purpose was set. Donor pledges reached this amount in early 1988, and an expansion of the programme is being planned. The Costa Rica programme is unique in that it includes contributions from outside the United States.

The Government of the *Philippines*, a local conservation organization and WWF-US signed an agreement in June 1988 covering up to $2 million in face value of debt, purchased at a discount on the secondary market. The Central Bank will credit the full amount of the debt to a local currency account managed by the local conservation organization. The projects funded by this debt swap include management plans, buffer zones and infrastructure for national parks. They will also support research, environmental education and training, as well as help the Government repress illegal trading and exploitation of wildlife resources. The funds cannot be used to pay non-Philippine consultants.

Debt-for-nature swaps also seem to have inspired other measures, such as the Midland Bank's decision in December 1988 to donate all of its Sudanese debt to UNICEF. In June 1989, Hambros and the Deutsche Bank similarly converted about £3 million (sterling) of Sudanese debt into a local currency sum. UNICEF arranged with the Sudanese Government for these contributions to support a health, water and reforestation scheme.

DEBT-FOR-NATURE SWAPS

Evaluation

The face value of third world debt withdrawn by debt-for-nature swaps is certainly well under $100 million. Compared to the total debt of developing countries, the amount may seem negligible, but it is additional to other flows. Conservation groups would not have mobilized these sums if the debtor countries had not provided the opportunity to use them for this specific purpose. Besides, although the amounts concerned may be small relative to total debt, their contribution to conservation may be large; for example, the interest on the local bonds issued in the first Ecuadorian swap doubled what the country had previously budgeted for its national parks.

There are special advantages to conservation organizations from swaps. Firstly, many conservation organizations are more interested in raising funds to meet current expenditure than in constituting an endownment capital. Consequently, the threat of high inflation rates eating into the capital value of local currency bonds is not an insuperable deterrent where interest payments to support year-by-year operations in the short term are high enough. Secondly, conservation organizations have a wide range of activities in debtor countries that require nothing but local currency. This distinguishes debt-for-nature swaps from debt-for-equity swaps, for instance, since expenditures under the latter often require additional outlays of foreign exchange.

A debt-for-nature swap involves numerous actors. As with any economic transaction, a successful deal is one in which every actor receives some benefit and the balance of advantages is perceived as equitable by all. Such swaps appeal to donor organizations in so far as they are more cost-effective than conventional funding methods. WWF-US, which is the leader in this field, is conscious that the success of these swaps essentially depends on effective conservation organizations in the debtor countries, and is thus anxious to ensure the recipient's autonomy. Conservation work also draws on scarce local resources like teachers and scientists. If it were not for the offer of debt relief, the government of the debtor country might not have chosen to allocate these resources to its national parks. Since the authorities of the debtor country must agree to make the local currency available for the swap, the government can ensure that national development priorities are respected. This power, combined with the donors' willingness to respect the limited absorptive capacity of local conservation organizations, ensures that debt-for-nature swaps will remain small. In this context it should be emphasized that, whereas any swap releases additional local currency into the economy, debt-for-nature swaps are too small to cause inflationary increases in national money supplies.

Even though donor organizations insist on working with local conservation organizations, the danger of new, environmental conditionality remains. If problems in this area are to be avoided, there must be similarity of views between the conservation organizations in the debtor country and those of the donor organization. While debt-for-nature swaps can meet conservation objectives, they do not necessarily meet the requirements of sustainable development. As a spokesman for the United Kingdom Overseas Development Administration put it, to put a ring fence around the tropical forests is not an answer to the aspirations of millions of poor people around the world. [2] A number of arguments have been adduced against these swaps. One developing country, refusing to engage in debt-for-nature swaps, has stated bluntly that tropical forests are not private museums for the amusement of developed nations, scientists, and tourists. [3] The developed countries can see tropical forests as a sink for the carbon dioxide they produce. To persuade developing countries to preserve their forests is a cheap alternative to reducing carbon dioxide emissions, and it shifts the burden of adjustment. Conservationists in the United States explicitly state that tropical forests provide a cornucopia of vital and valuable raw materials. As a result of biotechnology, the genetic resources of the tropical forests are acquiring a market value, but nature reserves perpetuate the idea of free access to them. Debt-for-nature swaps can also be regarded as a highly inadequate exercise in damage limitation. The urgent need for foreign exchange to service debt has certainly put direct and indirect pressure on forests in developing countries on a scale far greater than can be compensated for by the declaration of nature reserves or the strengthening of national parks departments. Debt-for-nature swaps are a small dressing on this deep wound.

continuation of debt servicing. They are not likely to finance growth, unless the debtor refuses to continue servicing its debt otherwise, or to provide new money to debtors too small to pose a serious threat to their own positions. This situation also implies that potential lenders will resist providing fresh funds if these are to be used for debt reduction.

Regulatory pressures also run counter to increased lending. In order to comply with the 1988 Basle Agreement on capital adequacy (described in annex 2), many banks will need to raise their capital ratios, which they can do by limiting the expansion of their assets or by raising more capital (or both). Loans to troubled debtors are naturally viewed as poor-quality assets; under the new guidelines such borrowers, except for those in the OECD area and Saudi Arabia, have been weighted as high risks. The aggregate requirement for additional capital by the 12 largest or so United States banks, for instance, has been estimated at between $5 and $15 billion.[46] Part of it will come from retained earnings, but part will probably also have to come from capital markets. As already noted, for banks with high developing country exposure, equity issues will be particularly difficult.

Moreover, the cost of new lending to developing countries has been raised by the higher level of provisioning now prevalent. Following the 1987 round of reserve increases, banks that previously maintained reserve ratios on their developing country loans of about 5 per cent now carry provisions of 30-35 per cent. This figure has tended to become a minimum standard of bank provisioning on loans to developing countries. Furthermore, under the Basle Agreement, general loan-loss reserves will become part of Tier 2 or supplemental capital (while in the United States, for instance, such reserves were formerly treated as part of primary capital). Such reserves will be taken into account only up to a limit of 1.25 per cent of total risk-based assets. Any reserves exceeding this limit will remain as idle resources, and will thus be costly.

It is not only bank managers and regulators' perceptions of risk that militate against increasing exposure. Equity markets have been penalizing the share prices of banks with high exposure, and rewarding banks which take steps to reduce it. Low equity prices make it more costly for banks to increase their capital; they also make bank managers more vulnerable to hostile take-over bids. Depositors, too, are wary of highly-exposed banks. These factors provide additional reasons for banks to resist new lending that is not "credit-enhanced".[47]

The fact that most banks are eager to meet the new opportunities for growth and profit opening up in the newly-liberalized financial markets of developed countries, and that such opportunities are of greater concern to them than the debt of developing countries, suggests a marked shift in the strategic interests of the banking community. In the United States and Japan, for instance, deregulation of the financial sector is giving banks access to new lines of business. In Western Europe many banks are attracted by the competitive challenge that the integration of national banking markets in 1992 in EEC represents.

In any event, highly exposed banks have lost the power to force others to join in concerted lending. The increased fragmentation of the banking community has widened the scope for "free riding", and has reinforced the myopia evident both during the rapid expansion of bank lending and after the outbreak of debt crisis. The more individualistic and self-protective approach by banks makes it extremely difficult for them collectively to take positive initiatives. The resulting impasse can only be overcome by assertive action by public authorities.

4. Recent initiatives to reduce the debt burden

Over the past year, official thinking on the debt problem has undergone a turning point, with major creditor governments such as those of France, Japan and the United States putting forward proposals designed to enlarge the scale of debt (or debt service) reduction. The main practical outcome so far is that IMF and the World Bank have adopted new policy guidelines which will enable them to finance a variety of methods of debt or debt service reduction:

- Around 25 per cent of a country's drawings from IMF under standby or ex-

[46] BIS, *59th Annual Report of 1st April 1988 - 31st March 1989* (Basle, June 1989).

[47] Banks' desire for credit enhancement on new lending is reflected in a recent report of the Institute of International Finance, an organization grouping about 160 large international banks; "credit enhancement ... is a part of the new rationale needed for banks to stay in the process and the ingredient needed to lay the basis for long-term bankable business". *The Way Forward for Middle-Income Countries* (Washington, D.C.: Institute of International Finance, January 1989), p. 28.

tended arrangements can be set aside to support reduction of principal, as can around 25 per cent of its World Bank structural adjustment loans over a three-year period (10 per cent of total lending where lending is primarily for projects).[48]

- In addition, up to 40 per cent of a country's Fund quota, and up to 15 per cent of its overall three-year lending programme from the Bank, can be used for interest support.[49]

As a result, the two institutions together will in theory be able to extend around $20 billion to the highly indebted countries for debt and debt service reduction. A further $10 billion will be available in parallel lending from Japan.[50] The total pool is thus around $30 billion.

However, it is unlikely that actual use will approach this figure because of the restrictiveness of the guidelines. For one thing, countries unable or unwilling to accept Fund and Bank conditionality are not eligible to receive any of the resources. For another, access to resources under the interest-support guideline, which account for well over half the total pool, will require special justification, reflecting the strength of the country's medium-term programme. This could well mean that it would be restricted to countries which have succeeded in fulfilling policy conditions for several years; the same might also be true of the Japanese funds. Only a handful of countries are, however, able to meet such a test.

Moreover, for countries qualifying only under the principal-reduction guideline, borrowing for debt reduction will be at the expense of other borrowings: only funds available under the second will be additional to what would have been available otherwise (and, even then, only partly so). Such countries will also derive fewer benefits from the borrowing, since a dollar devoted to principal reduction will generally bring a smaller improvement to medium-term cash flow than one devoted to interest support.[51]

The restrictiveness of the guidelines regarding the extent and type of operations to be supported apparently stems from the concern of certain members of IMF and the World Bank to limit those institutions' own exposure to risk. Countries with "a solid track record" of market-oriented policy reform are deemed more creditworthy, and lending for debt retirement is viewed as being less risky than providing interest support.

However, there also exist debtor countries where macroeconomic equilibrium cannot be attained unless the net outflow of resources is first reduced. It is therefore important to ensure that countries are not denied debt relief because of poor performance when good performance is unattainable in the absence of such relief. Breaking the vicious circle of domestic disorder and external resource shortage requires conditionality to take fully into account the complex linkages among the external payments constraint, macroeconomic imbalances, growth performance and policy effort.[52]

The guidelines adopted by the Fund and Bank imply that these institutions will support debt and debt service reduction only when the discounts obtained are substantial. Large discounts will be obtainable only if all or most banks compete aggressively against each other. But if instead the main creditors agree among themselves to offer debt sales or exchange at modest discounts, such collusion could prevent an acceptable "market-based" solution, leaving the funds available largely unutilized - as in the Mexican defeasance scheme of 1988. Countervailing power capable of convincing all or most creditors to accept substantial discounts on significant amounts of outstanding claims will then be necessary. The recent decision of IMF no longer to insist that a member be current on its debts to banks before drawing on its resources could help, if it puts an end to the Fund's role as a debt collector and improves the bargaining position of debtors. But other steps will also be required to provide the assertive leadership needed to strengthen discipline and ensure that no creditor shirks its responsibility to contribute to a durable solution.

Even if the $30 billion were fully used and significant discounts obtained, debt burdens would still be reduced by only a modest margin. This can be illustrated by assuming that one half of the pool is used to reduce the debt to banks of the highly indebted countries through an exchange of debt at a discount of 40 per cent for an alternative financial instrument, whose

[48] Amounts set aside would be used for operations involving reduction of debt principal, such as buy-backs or exchanges.

[49] Additional lending could, for instance, be used to fund a special escrow account to guarantee interest payments on new bonds carrying either a lower face value (deep discount bonds) or a reduced interest rate (par-value, reduced-interest bonds), or a combination of the two, issued by the borrower in exchange for bank debt.

[50] Japan's initial pledge was for $4.5 billion, but this figure was raised to $10 billion in July 1989.

[51] For a detailed discussion of some recent experiences of debt retirement through buy-backs and debt defeasance schemes, see *World Economic Survey 1989* (United Nations publication, Sales No. E.89.II.C.1), pp. 71-73.

[52] See chap. IV below.

repayment is guaranteed by a 20-year zero-coupon bond with an interest rate of 8.3 per cent, and that the other half provides a two-year rolling guarantee on the interest payments on the alternative financial instrument. Interest payments would then fall by about $3.7 billion for these countries, i.e. about 15 per cent of their current obligations.[53] The reduction of principal would amount to less than 20 per cent of their medium and long-term debt to banks. On both counts, the reductions are much less than the minimum needed.[54]

Thus, while acceptance of the need for systematic resort to debt and debt service reduction represents significant and irreversible progress at the conceptual level, the innovations so far introduced are too small to constitute a viable solution to the debt crisis. Further action needs therefore to be taken. First, the role of creditor governments in bringing about debt reduction by private creditors, either by providing attractive inducements ("carrots") or imposing sanctions ("sticks") needs to be enlarged. Second, the problem of conditionality also needs to be fully addressed, taking into account the diminishing capacity of debtor countries to achieve, in the face of a massive net outflow of resources, the social and political consensus necessary for economic stability and growth.

A number of proposals designed to deal with some or all of these issues have recently been put forward. Among those emanating from creditor circles are the following:

- President Mitterrand of France, in his address to the United Nations General Assembly on 29 September 1988, proposed making a special allocation of SDRs to finance a special fund at IMF which would provide support for new securities issued in exchange for existing debts;
- The Independent Group on Financial Flows to Developing Countries, chaired by former Chancellor Helmut Schmidt of the Federal Republic of Germany, has proposed the establishment of a new facility sponsored by the World Bank and IMF, and funded by voluntary contributions from OECD countries, with Japan playing a major role.[55] The scale of parallel lending to support debt and debt service reduction could thus be enlarged. The Group has also suggested that the multilateral institutions should consider establishing an advisory group to review the general criteria used for establishing conditionality;
- A WIDER Study Group, chaired by Mr. J. Witteveen, former Managing Director of IMF, has proposed the establishment of a trust fund at IMF to provide additional resources for debt and debt service reduction. Its resources would come from voluntary contributions by surplus countries such as Japan and the Federal Republic of Germany, and could be suppplemented by loans from the agencies of surplus countries (such as the Export-Import Bank of Japan) directly to the borrowers, with part of the loan proceeds being deposited in the trust fund to serve as collateral.[56] Trust fund resources would carry policy conditions no more onerous than those on regular tranche drawings. The Fund would agree with the borrower on a debt-reduction programme which would provide a basis for negotiation between the borrower and creditor banks designed to obtain a comprehensive relief package;
- Prime Minister Gonzales of Spain has proposed the creation of a European Guarantee Fund (EGF) directed at the debt problems of middle-income developing countries.[57] Contributions would be provided by both EEC and other creditor countries. The debtor country would need to reach agreement with IMF on a three-year economic programme, and creditor banks would be obliged to accept the discounts considered appropriate by EGF;
- The Bank of Nova Scotia has proposed that interest rates be reduced by banks on a concerted basis. An insurance scheme would be established covering all or part of the remaining interest obligations in the form of a stand-by credit facility. This would be created and financed jointly by

53 An average interest rate of 10 per cent on the medium and long-term bank debt of these countries is assumed.

54 The reduction needed by the 'Baker 15' taken together has been calculated at 30 per cent of all their debt to commercial banks, which is equivalent to 36 per cent of their medium and long-term debt to commercial banks. See *TDR 1988*, part one, chap. IV.

55 *Facing one world. Report by an Independent Group on Financial Flows to Developing Countries*, Hamburg, 1 June 1989.

56 *Debt Reduction. Report of a Study Group of the World Institute for Development Economics Research (WIDER) on the Debt Problem of the Middle-Income Developing Countries* (WIDER, *Study Group Series No. 3*), Helsinki, May 1989.

57 "Elements of the Spanish proposal concerning the creation of a European Guarantee Fund (EGF) for operations to reduce the payment and level of the foreign debt of heavily indebted countries" (Annex II of the communiqué issued by the EC Heads of State and Government at the end of their meeting held in Madrid on 26-27 June 1989).

banks and the official sector (e.g. the international financial institutions).[58] Principal would be rescheduled on long maturities and repayment collateralized by hard-currency bonds. To avoid free riders, the relief would be negotiated on behalf of the banks collectively, and once agreement was reached with a substantial majority of creditors, the borrower would pay the lower interest rate to all of them; since the reductions would be pro rata, this would be legally permissible.

C. Other aspects of financing and payments in the trade of developing countries

1. *Introduction*

Trade may be financed by any of the various types of external financial inflow, private or official. Thus the supply of such financing is affected by flows of official development assistance and foreign direct investment as well as by types of lending and payments arrangements generally linked more closely to trade transactions.[59] A substantial part of international bank claims[60] as well as export credits come under the latter heading. Recent trends in flows of these categories of financing and in interest rates on them were discussed in sections A and B. However, private export credits carrying official insurance or guarantees are of further interest since changes in their costs and other terms provide a broad indication of the risks associated with the financing and payments of developing countries' imports and thus of their perceived creditworthiness. The following two subsections give a more detailed account of information concerning the availability of private export credits to developing countries, and of the outcomes of reschedulings of official debts (which include debts in the form of such credits).

As a result of its adverse effects for a very large number of developing countries on the costs of export credits and other traditional financing and payments arrangements for their imports, the debt crisis has generated increased attention to possible alternatives. Two of these are countertrade and regional clearing and payments arrangements. Interest in countertrade rose to great heights during the years immediately following the outbreak of the debt crisis, but more recently has subsided somewhat. Possible reasons for this, as well as recent trends in the use of countertrade by developing countries, are discussed in subsection 4. Subsection 5 describes the impact on regional clearing and payments arrangements of the spread of external financial stringency, and their resulting failure to reduce the vulnerability of their members' trade to shortages of convertible currencies.

2. *Recent trends in the costs and other terms of export credits and similar arrangements*

As noted in section A, the fall since the early 1980s in net flows of export credits to developing countries (at least two thirds of which were private credits carrying official insurance or guarantees) is due to factors on both the demand and the supply side. Among the latter are not only interest rates, determined either by conditions in the capital markets or by the OECD Consensus, but also other terms and charges associated with official insurance and guarantees for private export credits. The latter

[58] "Notes on implementation of debt service reduction", by Peter J. Nicholson, Senior Vice-President, The Bank of Nova Scotia (mimeo, Toronto, May 1989).

[59] The close relationship between trade financing and payments arrangements is clear from the definition of the former often used, which includes all the various facilities made available to traders to bridge the gap between buyers who require time before paying and sellers who need to be paid on or before the shipment of goods.

[60] The bank claims constituting the external assets which are reported to BIS and shown in table 17 above include credits directly related to trade transactions as well as various other items, such as international securities. However, some types of trade-related lending such as supplier's credits, are classified as domestic rather than external assets by some reporting countries. (BIS, *Guide to the BIS Statistics on International Banking* (Basle, February 1988), pp. 14-16).

Table 20

EXPORT CREDIT INSURANCE: SELECTED FEATURES OF TERMS AVAILABLE TO A SAMPLE OF DEVELOPING COUNTRIES DURING RECENT YEARS

(Number of instances [a] in which specified terms were applied)

A. Terms [b] on insurance cover (from EXIM and ECGD)

	Normal cover		No cover		Restrictive conditions	
Region/period	*Short-term*	*Medium- and long-term*	*Short-term*	*Medium- and long-term*	*Short-term*	*Medium- and long-term*
Africa						
Late 1986/early 1987	6	4	14	18	50	48
Late 1988/early 1989	9	8	18	21	43	41
Latin America						
Early 1987	7	7	5	8	40	37
Late 1988	7	7	6	9	39	36
Asia and Oceania						
Early 1987	16	14	5	5	27	29
Early 1989	16	16	3	3	29	29

B. Changes in terms [c] on insurance cover between the two periods

	More favourable terms [c]	*Less favourable terms* [c]
Africa	8 [d]	8 [d]
Latin America	2	4
Asia and Oceania	2	0

Source: *A:* Exporters' guides in *Euromoney Trade Finance Report* and *Trade Finance*, various issues; *B:* estimated from the data used for A.

a Each country for which information is available corresponds to two instances, one for the terms available to it from EXIM and one for those available from ECGD.

b Short-term credits for the purpose of insurance cover from ECGD denote those with maturities up to 180 days, and for the purpose of insurance cover from EXIM have the same meaning, except in the case of certain equipment goods and bulk agricultural commodities, when they may also denote credits with maturities up to 360 days. Normal cover applies when cover is available to a borrower subject to no restrictive conditions. Such conditions include surcharges and restrictions on the availability of insurance cover, and reflect the perceived riskiness of the provision of financing to the borrowing country in question (or in certain cases other considerations). Their number and stringency vary. For some borrowing countries cover is not available on any terms.

c Changes in terms refer only to cases in which there is a shift in a country's classification between the categories of part A of the table, namely "normal cover", "no cover" and "restrictive conditions". The change in terms may refer only to short-term cover, only to medium- and long-term cover, or to both.

d There was also one country for which a favourable change in the terms for long-term credits from one of the two agencies was accompanied by an unfavourable change in the terms for short-term credits.

include insurance premia, the proportion and size of the credit for which cover is available, the size of the limit on the amount of financing below which the exporter can exercise discretion in granting credit, the length of the period after the occurrence of non-payment before claims are met (the claims-waiting period), and the types of security required. Insurance premia tend to be raised, and other terms to be made more restrictive, for a debtor country as ECAs perceive an increase in the risk of non-payment. Eventually such an increase generally leads ECAs to suspend the availability of cover altogether. It should be noted that in financing and payments arrangements for trade that are not covered by official insurance or guarantees, greater risks of non-payment have analogous effects. For example,

the charges on payments mechanisms such as letters of credit and the premia on private credit insurance tend to rise. Arrangements without official insurance also become very difficult or impossible to obtain, if the risks of non-payment are great enough.

Thus, when access to, and the cost of, financing and payments arrangements are being considered for debtor countries experiencing external financial stringency, there is a need to go beyond the relevant rates of interest and to take account also of the other costs and terms. Tables 20 and 21 illustrate the continuing pressures on the terms of export credit insurance for developing countries resulting from the debt crisis. Table 20 indicates the prevalence of restrictive terms on the insurance cover for payments and financing arrangements available from two major ECAs, namely the Export-Import Bank of the United States and the Export Credits Guarantee Department of the United Kingdom, while table 21 points to the extent of the losses on their insurance activities incurred by the great majority of ECAs in developed market-economy countries during the 1980s. The information on which table 20 is based is of a largely qualitative character. Furthermore, the category "restrictive conditions" includes a wide variety of sets of terms, which vary considerably among countries in their stringency. In certain cases, in particular a number of those in which insurance cover was completely unavailable, the policies of the two agencies appear to have reflected broader political considerations rather than the risks of non-payment. Nevertheless, subject to these qualifications, the figures in part A of the table give an idea of the continuing extent of restrictive conditions on export credit insurance cover, especially in Africa and in Latin America, the two regions most seriously affected by the debt crisis. Moreover part B shows how limited have been the shifts since 1986 between the categories of conditions in part A. Of particular note is the increase for Africa in the number of instances in which cover was completely unavailable, amounting in late 1988/early 1989 to about one quarter of the total in respect of cover for short-term financing and payments arrangements, and to 30 per cent in respect of medium-term and long-term arrangements. The position as regards the terms on private insurance (which is not shown in the table) closely parallels that for official insurance.[61] Moreover, significant shifts in the terms available from the private market seem to have been even less common than for official insurance, no favourable changes being registered between the periods shown in table 20.

The financial positions of the ECAs covered in table 21 are of interest for various reasons. The frequency of cases in which claims under the agencies' insurance activities exceeded premium income and recoveries is another illustration of how widespread since the early 1980s have been disruptions of financing and payments due to external financial stringency among developing countries. As the table shows, the proportion of ECAs making losses rose to a peak as part of the immediate aftermath of the outbreak of the debt crisis. Since then it has fallen somewhat, although loss-makers have continued to represent at least two thirds of the sample and the losses have often been large. The extent of these losses is itself a source of pressure for higher charges and other more restrictive terms, since export credit agencies are generally required to be self-supporting on their commercial operations over the medium term.

3. *Rescheduling of official debts*

As a recent UNCTAD report noted,[62] "the pervasiveness of debt problems is such that debt rescheduling, once an isolated, one-off mechanism designed to overcome a temporary debt-servicing problem, has now become an established feature of the financial system." This statement holds both for the debts of developing countries to banks (discussed in previous section) and for their official debts in the form of officially insured or guaranteed private export credits and direct lending from bilateral official sources. The modalities and terms of official debt reschedulings now play an important role in determining the availability and costs of trade financing for developing countries - not only those which have traditionally been more dependent on export credits but also for others whose access to alternative types of external financing from private sources has recently been curtailed.

The number of reschedulings of official debts in 1988, at 15, was still well above pre-1982 levels, and the decline from the aver-

61 Information concerning the terms on insurance for financing and payments from the private market is available from the same source used for table 20, namely the exporter's guides to different regions in *Euromoney Trade Finance Report* and *Trade Finance*.

62 "Review of the implementation of the guidelines contained in Board resolution 222(XXI)" - report by the UNCTAD secretariat (TD/B/1167), para. 57.

Table 21

PROPORTION OF EXPORT CREDIT AGENCIES IN SELECTED DEVELOPED MARKET-ECONOMY COUNTRIES THAT INCURRED LOSSES [a] ON INSURANCE ACTIVITIES, 1981-1987

(Percentage)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*
Proportion:	50	60	85	70	65	70	71

Source: 1981: D. Bown, D. Mills and M. Knight, *The Euromoney Guide to Export Finance* (London: Euromoney Publications, 1986), Part I; 1982-1986: ed. M. Knight, J. Ball and A. Inglis-Taylor, *The Guide to Export Finance 1988* (London: Euromoney Publications, 1988), Part I; and 1987: S. Ware, "Agency review. ECAs on the run - though the pace is slow", *Trade Finance*, December 1988.

a Losses occur when claims exceed the sum of premium income and recoveries (adjusted in some cases for the inclusion of other factors). The number of loss-making agencies is expressed as a proportion of the total number of agencies for which data were available (20 in 1982-1986, 18 in 1981, and 17 in 1987).

age figure of more than 17 during 1983-1987 should not be interpreted as indicating a significant lessening of pressures for official debt relief. Rather, it reflected delays in the negotiation of new adjustment programmes supported by IMF which are a precondition for meetings of the Paris Club. During the first half of 1989 the pace of rescheduling accelerated, no less than 15 meetings of the Paris Club taking place during this period.

Rescheduling agreements for developing countries' official debts since 1987 have been characterized by tendencies towards a dichotomy of debtors, under which certain low-income countries in sub-Saharan Africa have benefited from a much more extensive liberalization of terms than have debtors outside this category. The dichotomy became evident in 1987 in such indicators as the maturities of rescheduled debts. Reflecting the terms agreed for the region's low-income countries from May of that year, the maturities for rescheduling debtor countries of sub-Saharan Africa averaged 18 years in 1987, the figure for other rescheduling developing countries being only 9.8 years. The dichotomy was given additional impetus by the agreement at the Toronto summit in June 1988 "on a framework of comparability that allows official creditors to choose [in rescheduling official debts of the poorest developing countries] among concessional rates usually on shorter maturities, longer repayment periods at commercial rates, partial write-offs of debt-service obligations during the consolidation period, or a combination of these options". Since October 1988, 13 developing countries have already benefited from the arrangements to implement this agreement worked out by the Paris Club. However, as is clear from the more detailed account provided in box 7, these arrangements appear highly restrictive as regards debtor countries' eligibility for the rescheduling options. Moreover, the Toronto measures have brought only modest relief to beneficiary countries, because their scope is limited, and the degree of concessionality is not commensurate with the beneficiaries' overall debt-servicing capacity.

Surveys by IMF since 1985[63] have indicated a series of shifts during recent years in the practices of ECAs in a number of developed market-economy countries concerning the maintenance and restoration of official insurance cover in the context of reschedulings. The 1986 survey found that most of the agencies were prepared to restore official insurance cover once the bilateral agreement implementing a Paris Club rescheduling had been concluded with the debtor, so long as obligations under the agreement were being met. This willingness, which was conditional on a com-

63 E.H. Brau and C. Puckahtikom, "Export credit cover policies and payments difficulties", *Occasional Paper No. 37* (Washington, D.C.: IMF, August 1985); E. Brau, K.B. Dillon, C. Puckahtikom and M. Xafa, *Export Credits, Developments and Prospects* (Washington, D.C.: IMF, July 1986); and K.B. Dillon, L. Duran-Downing and M. Xafa, *Officially Supported Export Credits, Developments and Prospects* (Washington, D.C.: IMF, February 1988).

Box 7

TORONTO OPTIONS FOR RESCHEDULING OFFICIAL DEBT OF LOW-INCOME COUNTRIES

Implementation so far

The Toronto summit in June 1988 led to the adoption of the following menu of options to be chosen by creditor countries in rescheduling the official bilateral debt of low-income countries within the framework of the Paris Club:

(A) *Partial write-offs:* one third of the debt service due during the consolidation period is cancelled and the remaining two thirds rescheduled at market interest rates, with a maturity of 14 years, including 8 years of grace;

(B) *Longer repayment periods:* debt service due during the consolidation period is rescheduled at market interest rates, with a maturity of 25 years, including 14 years of grace;

(C) *Concessional interest rates:* the consolidated debt service is rescheduled at market interest rates reduced by 3.5 percentage points or 50 per cent, whichever is less, and with a maturity of 14 years, including 8 years of grace.

Rescheduling agreements which have so far benefited from the Toronto terms have shown that, for non-concessional debt owed to OECD countries, option A was applied to about 35 per cent of the consolidated debt (by two countries), option B to 30 per cent (by four countries), and option C to 35 per cent (by ten countries). For official development assistance (ODA) debt, it has been agreed that the maturity will be as in option B, and the interest rate at least as low as the original rate, regardless of the option chosen. An increasing number of donor countries have applied more generous measures to ODA loans by converting them into grants for many low-income countries, in line with Trade and Development Board resolution 165 (S-IX). Most recently, the French Government has announced its intention to cancel $2.5 billion equivalent of ODA debt owed by 35 IDA-eligible African countries. The United States has decided to write off up to $1.3 billion of ODA loans made to sub-Saharan African countries implementing adjustment programmes. Among official creditors other than those regularly participating in the Paris Club, the USSR has indicated its readiness to grant debt write-offs or 100-year moratoria to least developed countries.

Evaluation

The Toronto Summit marked a major advance in the stance of official creditors with regard to non-concessional debt owed by poorer debtors. However, the implementation of the Toronto measures has shown a number of important shortcomings, especially with regard to eligibility criteria, scope, degree and timing of concessionality, and additionality.

Eligibility. By June 1989, 13 sub-Saharan African countries (Benin, Central African Republic, Equatorial Guinea, Guinea, Madagascar, Mali, Mauritania, Niger, Senegal, Togo, Uganda, United Republic of Tanzania and Zaire), all of them included in the World Bank's Special Programme of Assistance (SPA), had benefited from the Toronto measures. Countries eligible for the SPA are those sub-Saharan countries which receive only IDA funds, have a debt service ratio of at least 30 per cent, and are undertaking internationally approved adjustment programmes. Although there are no formal eligibility criteria for the Toronto measures, creditors have in practice denied the benefits of such measures to IDA-eligible, debt-distressed countries, such as Nigeria, Guyana and Bolivia, which are not, however, SPA countries. Guyana has nevertheless benefited from a long maturity of 20 years.

Scope. Paris Club creditors account for only about one third of total debt service obligations of the 13 beneficiary countries. Consequently, the amounts to which the Toronto terms can be applied are small relative to total debt service. For these countries, options A and C will generate cash-flow benefits during the grace period in the form of savings on interest payments, which are estimated to amount at most to about $25 million (excluding arrears) annually, or roughly 30 per cent of interest payments under previous Paris Club terms. However, these savings are less than 2 per cent of their total debt service payments (including those related to other official bilateral debt as well as private and multilateral debt) falling due in 1989, after rescheduling of Paris Club debt. This points to the need for (a) other official creditors (such as socialist countries of Eastern Europe and OPEC countries) to consider adopting comparable measures to alleviate the debt burden of debt-distressed countries; and (b) bolder action which should involve not only bilateral debt but also multilateral and commercial debt. Another limitation is that previously rescheduled debt, arrears and late interest are not fully consolidated in some cases, while short-term debt and servicing of debt contracted after the cut-off date are excluded from the rescheduling. For one country, for example, the 1981 cut-off date was maintained, with the result that close to half of its Paris Club debt did not benefit from the Toronto measures. This underlines the necessity of widening the coverage of rescheduling to 100 per cent of Paris Club obligations. The increase in concessional debt relief that would result from bringing forward the cut-off date would by far outweigh any possible negative impact on new export credits. Most poorer countries would, in fact, be able to attract and afford only highly concessional flows for many years to come.

Box 7 (concluded)

TORONTO OPTIONS FOR RESCHEDULING OFFICIAL DEBT OF LOW-INCOME COUNTRIES

Concessionality. While the Toronto measures have introduced concessionality into the terms of rescheduling official and officially guaranteed export credits, the concessionality involved is generally not commensurate with the overall debt servicing capacity of beneficiary countries. The grant element differs as between the options. At a discount rate of 7 per cent (that used in the OECD Consensus definition of concessionality for mixed export credits), options A and C introduce a grant element of 33 per cent and 27 per cent, respectively, while option B carries no concessionality. For the 13 beneficiary countries, the overall grant element was, on average, 21 per cent. At a discount rate of 10 per cent (that used by the Development Assistance Committee of OECD for the definition of concessional loans), the overall grant element is about 39 per cent, as compared to 23 per cent under previous rescheduling terms. Despite this improvement in concessionality, debt service payments that would have to be met by several poorer countries after the application of the Toronto measures would still be three or four times higher than the cash payments these countries have been able to make in recent years. The overall degree of concessionality of the Toronto options - as well as their short- and medium-term cash flow benefits - could be increased by abandoning option B. However, this would not be sufficient to match the 65 per cent average grant element of 1987 loan commitments from official sources to low-income African countries, a target official creditors could consider in order to ensure that the debt service ratio does not exceed 25 per cent, as called for by the SPA. Moreover, the Toronto consensus should not deter more generous treatment at the bilateral level, so that the specific problems of individual debtor countries can be more adequately addressed.

Timing. Only debt service payments falling due during the consolidation period - typically of 12-15 months - benefit from the Toronto terms, so that the process will inevitably need to be repeated. Ideally, the Toronto measures should be applied to the entire stock of debt outstanding, in order to bring about a once-and-for-all debt or debt service reduction. Alternatively, Paris Club creditors should consider the possibility of rescheduling debt service due during a three-year period, in line with the programme periods under the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) of IMF. Conditionality would be maintained if each year's debt relief was conditional on continued performance under a SAF/ESAF programme.

Additionality. Some creditors are financing the cost of debt relief by transferring funds from their aid budgets to their ECAs. This practice should be avoided in order to maximize the additionality of the Toronto measures. Such additionality would be better monitored with a closer co-ordination between the Paris Club and donors' groups. This has become more urgent since, with the implementation of the Toronto initiative, the Paris Club has been empowered to extend concessional assistance.

mitment by the debtor not to seek a change in its cut-off date[64] under its Paris Club agreements, represented a change from the usual earlier practice whereby suspension of cover was continued until the agency was satisfied that the debtor's creditworthiness had been fully restored. But this change in policy was likely to result in only a small improvement in the availability of cover for the many developing countries undergoing a series of reschedulings (often on an approximately annual basis), since bilateral agreements are typically not concluded until about six to nine months after a meeting of the Paris Club. The 1988 survey indicates that agencies are now more willing to continue to make cover available up to a Paris Club meeting and during subsequent negotiations leading to a bilateral agreement, so long as the country in question has a good record in implementing previous rescheduling agreements and proceeding with its adjustment strategy.

This shift does not affect countries undertaking their first reschedulings, towards

[64] The cut-off date is the date before which debt must have been incurred, if it is to be eligible for rescheduling. Creditors are reluctant to accept changes in the cut-off date for subsequent reschedulings since they would entail the inclusion in renegotiations of export credits granted since the initial rescheduling. A major objective of the maintenance of cut-off dates is to encourage new lending to rescheduling countries.

which export credit agencies are still likely to pursue more restrictive policies. Moreover, insistence on maintenance of a fixed cut-off date is unlikely to lead to a revival of the flow of export credits to low-income countries experiencing severe difficulties over debt service. Greater benefits would accrue to such countries if the cut-off date was advanced in such a way that a higher proportion of their debt service obligations was covered by rescheduling.

There have also been other steps in addition to those already mentioned in the direction of liberalized terms in recent reschedulings.[65] For instance, there had already been a marked increase during 1986-1987 in the number of agreements in which the proportion of principal and interest rescheduled was in the range of 90-100 per cent, and in all but two of the agreements during 1988 the proportion was 100 per cent. This development is equivalent to the acceptance in official reschedulings that most or all of the interest due during consolidation periods should be capitalized. However, there has been little movement as regards two major features of official reschedulings, namely the length of consolidation periods and the procedures for setting interest rates on rescheduled debts.

Consolidation periods are still concentrated in the range of 12 to 18 months and thus fall far short of the average figures in rescheduling agreements for developing countries' debts to banks.[66] The resulting tendency for repeated reschedulings can be exemplified from the renegotiations of 1988: of the 15 countries involved only two had not had reschedulings since 1984, while four had already had as many as three reschedulings and one as many as four. The adverse impact of repeated reschedulings at relatively short intervals has no doubt been mitigated by the changed practices as regards the maintenance of official insurance cover described above. However, such a series of reschedulings imposes high costs in terms of the human resources in a debtor country tied up in debt management, and complicates its longer-term economic planning. It is also likely to impede the reduction of perceived risks associated with, and thus the costs of, a debtor's international financing and payments arrangements. Indeed, the frequency of serial reschedulings probably helps to explain the limited incidence of improvements in the terms of export credit insurance in table 20. Most recently, however, following the failure of earlier multi-year rescheduling agreements (MYRAs), there has been a return to MYRAs for the Philippines and Mexico, in line with their extended arrangements with IMF.

Interest rates for restructured debt service payments are determined in the bilateral negotiations between creditor and debtor following the agreements at the Paris Club. Although information on the resulting rates on export credit loans is not generally available, they appear typically to be set at market levels. A consequence of this practice is that the subsidy element in rates of interest on original loans is not necessarily renewed when export credits are rescheduled, so that, for example, the new rates in such cases may well be higher than those for export credits under the OECD Consensus shown in annex table 2.

The effects of policy changes concerning reschedulings of official debts and the provision of official insurance cover may be overridden by other factors, so that assessment is difficult. For example, the 1988 survey by IMF mentioned above comprises the evolution of cover policies towards a sample of debtor countries, and provides a number of examples of liberalization.[67] Moreover, according to the source used to characterize the situation as regards insurance cover in table 20, the Export-Import Bank of the United States has recently pursued liberal cover policies in the case of certain sub-Saharan African countries through the period before and after reschedulings of official debts. Such liberalization may have contributed to the recent rise in export credit lending at long maturities to certain low-income developing countries reported in section A. However, the absence of widespread improvements in the terms available from ECAs indicated by table 20 suggests that the effects in practice of the shifts in the direction of more liberal policies towards countries rescheduling their export credit debt are still tending to be offset by the remaining unfavourable features of the rescheduling process described above and by other adverse influences on the perceived riskiness of debtor developing countries' financing and payments arrangements.

65 For a fuller discussion of these steps see TD/B/1167 (*op. cit.*).

66 The average consolidation period in rescheduling agreements for developing countries' debt to banks was already 2.8 years in 1984-1986 and rose to 4 years in 1987 and 5.8 years in the first nine months of 1988. As of June 1989 only four rescheduling agreements had consolidation periods exceeding two years, that of Ecuador in April 1985, that of Côte d'Ivoire in June 1986, and those of the Philippines and Mexico in May 1989. An extended consolidation, initially covering 12 months but with a possible extension of 10.5 months, was agreed for Yugoslavia in May 1986.

67 Dillon, Duran-Downing and Xafa, *op. cit.*, appendix.

4. Countertrade

Despite the interest in countertrade generated by its expansion during the 1980s, lack of precise information still surrounds key aspects of the phenomenon, including its overall importance in world trade, the extent to which its growth has recently slowed, and its costs and benefits in practice. The difficulty of estimating the extent of countertrade stems from various causes, amongst them the absence of a clear consensus as to the transactions which should be classified under this heading.[68] The definitional problems which hamper measurement are related to a more general lack of information concerning contractual and certain other arrangements associated with trade transactions. For example, it is not known how common were different forms of formal and informal reciprocity[69] in such transactions before the 1980s. As a result, it is impossible to be sure how sharp a break with previous practices the different forms of countertrade of the 1980s represent, and how great was the base level of transactions sharing characteristics with countertrade from which the recent expansion started.

Plausible estimates of the importance of countertrade in the trade between different regions indicate a range of 10 per cent to rather more than 15 per cent for the likely share of countertrade in world trade during the mid-1980s. Significantly higher shares characterized trade with the socialist countries of Eastern Europe and the mutual trade of developing countries. There are also indications that more recently the expansion of the first half of the 1980s may have slowed.

The most systematic available evidence for a recent slowing of the growth of countertrade is that in a recent survey of a sample of countertrade deals involving developing countries during 1980-1987.[70] In the case of the deals which can be dated, the number rose from 18 in 1980 to a peak of 304 in 1985 before falling to 270 in 1986 and 272 in 1987. This series must be treated with caution as an indicator of the trend in the value or volume of trade in the form of countertrade. The units are deals or agreements varying in value from less than $0.25 million to more than $1 billion, and the resulting trade often takes place over periods substantially in excess of a year. Moreover, there is no way of evaluating the representativeness of the sample. It should also be noted that there is significant variation in the experience of different regions. Thus, for three of the seven developing-country regions specified in the survey there was no downturn in new deals in 1986-1987.[71] Nevertheless, the overall slowdown since 1985 is consistent with other qualitative information. For example, there are indications that the experience of the 1980s has made possible a learning process which has caused certain developing countries to reassess their involvement in the costlier forms of countertrade, in particular counterpurchase. Moreover, recognition of the costs and uncertainties involved in countertrade seems to have led to a reduction in the number of firms engaged in and promoting it.

Both the effects and prospects of countertrade are a source of continuing debate. Proponents of one of the views in this debate acknowledge the role of the deterioration of the international economic environment in the expansion of countertrade but tend to emphasize exclusively its harmful aspects. These include the high costs of countertrade transactions in comparison with those of conventional methods of financing and payments, and the distortional effects which countertrade may have on resource allocation. These points doubtless outweigh other considerations in a number of cases. However, proponents tend to ignore the extent to which both the prices and the availability of conventional financing and payments arrangements are adversely affected by the increased risk of non-payment for countries with debt-servicing difficulties.[72] Moreover, generalizations concerning distortional real effects need to be treated with caution in

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68 Some categories of countertrade present no difficulties of classification. These include barter (the exchange of goods without the medium of cash payments), counterpurchase (linked trade transactions in which the goods delivered in both directions are not closely related), and switching (the practice of switching to third parties the obligation to settle imbalances in clearing accounts associated with bilateral payments agreements). There is less of a consensus as to which transactions coming under the heading of industrial co-operation should be classified as countertrade. Industrial co-operation covers agreements intended to produce benefits to the importing country in such forms as technology transfers, joint ventures and subcontracting, and includes buy-back and offset arrangements generally classified as countertrade.

69 Reciprocity entails commitments made by Party A as a condition for making a sale to B. A common such commitment is an agreement to make a purchase from B.

70 S.F. Jones and A. Jagoe, *Third World Countertrade. Analysis of 1,350 Deals Involving Developing Countries, 1980-1987* (Newbury, England: Produce Studies, 1988).

71 The regions in question are a group of countries and territories in West Asia, a group in South and South-East Asia, and sub-Saharan Africa.

72 Owing to increased risks of non-payment due to debt-servicing difficulties, a country may face increased costs not only

circumstances characterized by many other divergences from a theoretically optimal pattern of resource allocation, such as excess capacity and excess supplies of exportable goods in one or both of the countries engaging in countertrade.

An alternative way of looking at countertrade in the 1980s is to place it in a longer-term perspective concerning contractual arrangements in international financing and trade. As indicated above, various types of formal and informal reciprocity have long been a feature of many kinds of international and domestic transaction. For example, arrangements similar to buy-back (under which sellers of capital goods and technology commit themselves to buy output from the resulting investment) were used for the financing of investment in mining projects by the celebrated capitalist, Jacob Fugger the Rich (1459-1525). Reciprocity may have a one-off character (as in some types of countertrade transaction). It can also take the form of longer-term contractual or informal commitments between buyers and sellers. Such commitments may have anti-competitive effects, which is why in some countries they are subject to restrictions or prohibition under antitrust policies. However, recent literature[73] has drawn attention to benefits in the form of reductions in certain business risks which may result from reciprocity. These arguments may often apply to various types of countertrade, especially those under the heading of industrial co-operation which serve as vehicles for transactions involving international trade in investment goods and technological services, where there are potential benefits from longer-term business relationships between suppliers and customers.

In this longer perspective the rapid expansion of countertrade during the first half of the 1980s can be viewed as largely a response to pressures associated with unfavourable conditions in the international markets for goods and money. The pressures included excess capacity and excess supplies of exportable goods in developed and developing countries, the external financial stringency widespread among the latter and the resulting disruption of traditional financing and payments arrangements for their imports, and uncertainties concerning access to markets. The variants of countertrade used in response to these pressures mostly consisted of, or were related to, techniques already tried, and several had long been common in trade with socialist countries. The growth of countertrade made possible a process of trial and error which demonstrated that the costs of certain countertrade transactions may often exceed their benefits.[74] Nevertheless, the pressures and incentives to engage in countertrade persist, especially its utility to developing countries as a marketing tool for non-traditional exports and the adverse effects of external financial stringency on the cost and availability of traditional financing and payments arrangements. The learning process is likely to have provided indications as to how countertrade can best be used for these and other purposes. It is thus reasonable to expect continuing recourse to countertrade on a substantial scale by developing countries, though the shares in total countertrade of different types of transaction and of different regions may well change in comparison with those which have characterized the 1980s so far.

5. *Regional clearing and payments arrangements of developing countries*

Among the noteworthy manifestations of the strains affecting developing countries' financing and payments are recent disruptions of the functioning of certain regional clearing and payments arrangements. Intended, *inter alia*, to lessen the dependence of members' mutual trade on availability of convertible currencies, these arrangements have none the less failed in most cases to escape the adverse impact of the spread of external payments difficulties among developing countries during the 1980s.

The clearing mechanisms of these arrangements make possible reductions in the use of foreign exchange reserves in international transactions among members, only outstanding residual credits and debits being settled according to agreed frequencies in convertible currencies. Use of the mechanisms is voluntary, and the proportion of members' mutual trade that is cleared through them varies considerably both among arrangements and, for individual

in importing but also in exporting if sales of the products it exports require financing of the supplier. (P. Moore, "Adding sugar and spice to country risk", *Trade Finance*, October 1988, pp. 47-48.)

[73] See, for example, S. Borner, *Internationalization of Industry. An Assessment in the Light of a Small Open Economy (Switzerland)* (Berlin, etc.: Springer-Verlag, 1986), pp. 19-22, and O.E. Williamson, *The Economic Institutions of Capitalism Firms, Markets, Relational Contracting* (New York: The Free Press, 1985), pp. 32-35.

[74] For example, there is evidence of disillusionment in certain developing countries with policies entailing the mandatory use of counterpurchase for certain categories of trade.

arrangements, over time. For example, in the mid-1980s about 30 per cent of members' intra-group imports were cleared through the Asian Clearing Union, while at the beginning of the 1980s the corresponding proportions for the ALADI Payments and Reciprocal Credit System, the Central American Clearing House and the CARICOM Multilateral Clearing Facility were 80 per cent or higher. The Central American Clearing House exemplifies the degree to which this proportion may change substantially during a relatively short period; the value of transactions cleared contracted (as part of a process discussed in more detail below) from a figure equivalent to more than 100 per cent of members' imports from each other in 1980-1981 to 6 per cent of the grouping's trade in 1987.[75]

Large arrears began to affect certain clearing and payments arrangements in the early 1980s. The spread of shortages of foreign exchange played the key role in this process. Not only did such shortages hinder the settlement of clearing balances but they also provoked tendencies among some member countries to divert their exports away from other members to third markets in order to increase earnings of convertible currencies for purposes such as servicing external debts.[76] As early as 1983 the CARICOM Multilateral Clearing Facility had to be suspended when credit limits under the agreement were exceeded and one member country was unable to meet large accumulated arrears. The emergence of strains in the functioning of clearing and payments arrangements has been evident in such phenomena as declines in the value of transactions cleared and the high proportions of such transactions settled in foreign exchange.

Thus, for example, the recent limited recourse of member countries to clearing through the West African Clearing House, where there have been large unsettled balances, has been accompanied since 1985 by the settlement in foreign exchange of more than 85 per cent of total cleared transactions. A more detailed illustration of the disruptive effects of the accumulation of arrears can be given for the Central American Clearing House. As already mentioned, at the beginning of the 1980s, transactions cleared through this arrangement amounted to about 100 per cent of members' mutual trade. However, by the end of 1985 large imbalances in this trade (which amounted to 28 per cent and 61 per cent of their intra-group exports in 1985 for the two surplus countries, and 54 per cent, 59 per cent and 62 per cent of their intra-group imports for the three deficit countries) were accompanied by unsettled obligations on cleared transactions of $689 million.[77] These phenomena were associated with a fall to 70 per cent in the proportion of members' mutual trade consisting of cleared transactions. In 1986-1987 mutual trade fell short of the level of 1985 but there was also some reducton in intra-group imbalances. One of the two surpluses had disappeared by 1987, while the second was still in the range of 45 - 50 per cent of the country's intra-group exports. The deficits of the three other countries by this date amounted to 36 per cent, 48 per cent and 50 per cent of their intra-group imports. Accumulated debit balances had risen to $721 million, while cleared transactions amounted to only 6 per cent of members' mutual trade and the arrangement's continued functioning was based on a set of bilateral agreements.[78]

Some clearing and payments arrangements are supported by mechanisms designed to provide financing to members beyond the short-term credit lines available as a result of the delays before outstanding debit balances have to be settled. But such financing has been too small to make more than a limited contribution to alleviating the difficulties of clearing and payments arrangements disrupted by imbalances in members' mutual trade and the associated arrears. In view of the potential efficiency of these arrangements, there is widespread interest in ideas for reviving those whose operations have recently been seriously disrupted or suspended, as well as in alternative regional schemes for financing and payments. Among the ideas floated in this context is the use of aid monies to settle such arrears, one example of a recent initiative of this kind being the provision of a sum to restore the liquidity of the Central American Clearing House under the United Nations Special Plan of Economic Co-operation for Central America.■

75 Inter-American Development Bank, *Economic and Social Progress in Latin America, 1988 Report* (Washington, D.C.: 1986), p. 85.

76 See, for example, "Review of developments in the area of trade and monetary and financial co-operation among developing countries" - report by the UNCTAD secretariat (TD/B/C.7/92), para 42.

77 Inter-American Development Bank, *Economic and Social Progress in Latin America, 1986 Report* (Washington, D.C.: 1986), pp. 64-65; and *ibid, 1987 Report* (Washington, D.C., 1987), p. 75.

78 *Economic and Social Progress in Latin America, 1988 Report (op. cit.)*, pp. 84-85.

TRENDS AND ISSUES IN INTERNATIONAL TRADE

A. Recent developments

1. The volume of trade

The volume of world trade expanded by over 9 per cent in 1988. This was well above the annual rate of 3 per cent which had so far prevailed in the 1980s. Buoyant economic activity in the developed market-economy countries, particularly as regards investment, and strong growth in several developing countries of South-East Asia, were important factors contributing to their strong expansion. However, with key economies shifting towards policies of greater demand restraint, some deceleration of this recent high growth in the volume of trade is probably now under way.

Exports from the developed market economies rose by some 7 per cent in 1988, compared with 5.8 per cent in 1987 (see table 22). Reflecting the widespread investment boom in these countries, demand for capital goods was particularly strong; indeed, some two thirds of the absolute increase in world trade during 1988 consisted of exports of capital goods from these countries. The import markets for capital goods which expanded fastest were those of Japan, the South-East Asian developing economies exporters of manufactures and the countries of Western Europe. Thanks to the accelerated growth of demand in other developed market-economy countries and the earlier realignment of the dollar exchange rate, the United States experienced a strong recovery in its exports; over 1988 as a whole, the volume of exports was almost one quarter greater than in the preceding year. United States exports, however, appear to have lost much of their momentum in the second half of 1988.[79] In contrast, in Japan - where total imports rose by some 16 per cent in 1988 - there was only a modest expansion of exports in 1988; after two years of quasi-stagnation, exports of manufactures were some 4 per cent higher in 1988. Most other developed market economies experienced a rapid acceleration of exports in 1988.

Exports from developing countries increased by some 13 per cent in volume in 1988. While the exporters of manufactures fared best, primary commodity exporters also benefited from the enhanced demand - though there were some important exceptions. Compared with other regions, Africa was handicapped by the product composition of its exports. The non-oil-exporting Asian and Latin American countries generally benefited from the buoyant trading environment, particularly with respect to manufactures.

In general, the exporters of manufactures continued to perform better than most other developing countries. Trade in consumer durables, in particular, benefited from the rising trend of private consumption in many developed market economies. A few developing countries were also able to take advantage of the strong demand for producer goods. Indeed, the share of developing country exports in the markets for machinery and equipment - albeit still very low - has been rising since the

[79] This has put in jeopardy the process of adjustment in the trade deficit (see chap. I, sect. A).

Table 22

EXPORT VOLUME GROWTH IN DEVELOPED MARKET-ECONOMY COUNTRIES AND DEVELOPING COUNTRIES

(Percentage)

	1980-1985	1986	1987	1988
	(Average annual increase)	(Increase over previous year)		
Developed market-economy countries	3.4	2.5	5.8	7.0
Developing countries	-1.4	15.1	5.6	13.3
Major oil exporters [a]	-9.1	25.8	-7.7	15.3
Major exporters of manufactures [b]	9.6	6.3	20.8	17.2
Other developing countries	4.1	9.0	9.0	2.1
of which in:				
Latin America	0.8	3.8	-4.6	-1.0
Africa	0.4	11.8	12.3	-4.7
West Asia	18.7	1.3	18.8	2.1
Other Asia	6.7	13.0	14.1	7.9

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

a Algeria, Angola, Bahrain, Brunei Darussalam, Congo, Ecuador, Gabon, Indonesia, Iran (Islamic Republic of), Iraq, Kuwait, Libyan Arab Jamahiriya, Mexico, Nigeria, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, Trinidad and Tobago, United Arab Emirates, Venezuela.

b Argentina, Brazil, Hong Kong, Republic of Korea, Singapore, Taiwan Province of China, Yugoslavia.

mid-1980s, and rose even more strongly in 1988. Gains in the exports of manufactures were very large for a number of countries in South-East Asia and in Latin America. A growth in export volume of around 17 per cent was experienced by both Argentina and Brazil, largely on account of manufactures, although higher commodity exports - especially in Argentina - also contributed. Mexico has also been achieving a rapid growth in exports of manufactures. The South-East Asian exporters of manufactures were particularly favoured by the external environment, notably by the strongly rising import demand of Japan. Indeed, a significant shift has taken place since 1986 in the relative importance of the Japanese and United States markets for their exports (see chart 2). Further, intra-trade in the region has been rising strongly. In recent years, such exports from both the established exporters of manufactures (Hong Kong, Republic of Korea, Singapore and Taiwan Province of China) and newer exporters (Indonesia, Malaysia and Thailand) have risen rapidly.

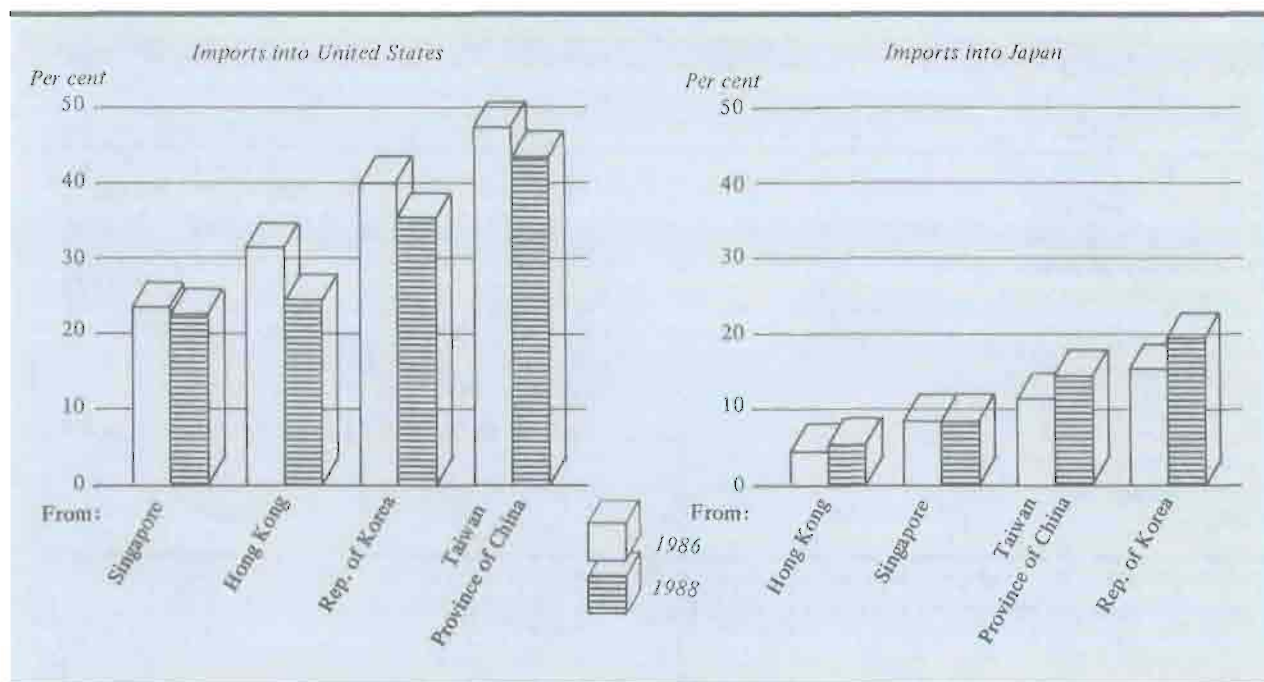
2. Developments in international prices

Enhanced world demand for industrial materials has resulted in higher export earnings for producers of ores and metals, as well as of some agricultural raw materials; prices of minerals and non-ferrous metals rose by over 34 per cent in 1988 in dollar terms (see table 23). There were, of course, wide variations in price changes for individual commodities. For example, prices for iron ore, lead and tin rose very little (see annex table 4). Producers of temperate zone foodstuffs also fared relatively well, on account of drought in the United States, which induced a sharp rise in grain prices. In contrast, prices of tropical beverages, which are of particular interest to African

Chart 2

DISTRIBUTION AMONG EAST ASIAN DEVELOPING COUNTRIES OF THEIR EXPORTS OF MANUFACTURES TO THE UNITED STATES AND TO JAPAN IN 1986 AND 1988

(Percentage)



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

countries, failed to improve because of continued oversupply.

For the oil-exporting developing countries, exports rose by some 15 per cent in volume in 1988, thus recouping the losses sustained since 1981. But because of the sharp fall in the price of oil, the purchasing power of their exports declined by almost 7 per cent. Oil market conditions continued to be affected by excess supply. Although prices rose significantly in the first quarter of 1989, they had already settled back somewhat by mid-year, and further declines were expected.

Owing largely to somewhat higher inflation in the developed market economies and the continued depreciation of the dollar with respect to other major currencies, prices for manufactures exported by the developed market economies, expressed in dollars, moved up by about 6 per cent. This was a much smaller increase than the 14 per cent recorded in 1987, basically because the dollar depreciated much less than in that year.

The tendency towards further increases in international prices of manufactures appears to be continuing in 1989. It is against this trend that the recent improvements in some primary commodity prices, which represent no more than a partial recovery from the sharp declines experienced earlier in the decade, should be assessed. Since 1980, non-oil primary commodity prices have, on average, declined by some 10 per cent in current dollars, while prices of manufactures exported by developed market-economy countries have risen by about 25 per cent (see table 23).

Developments in world commodity markets have affected countries and regions differently, because of differences in the composition of commodity exports. In 1988 and 1989, the improvement in the prices of some foodstuffs such as wheat, maize and sugar brought greater benefits to developed than to developing countries. Among developing countries, the major beneficiaries were Latin American countries while, as already noted, exports from African countries are largely made up of commodities for which prices either rose little or actually declined.

Table 23

THE EVOLUTION OF INTERNATIONAL PRICES SINCE THE MID-1980s

	1986	*1987*	*1988*			*1989*
	Year	*Year*	*Year*	*Third quarter*	*Fourth quarter*	*First quarter*
Price index of all non-oil commodities (1979-1981 = 100)	79	76	90	89	92	93
Food	62	66	83	88	84	83
Tropical beverages	110	72	73	69	73	77
Vegetable oilseeds and oils	51	60	78	86	78	76
Argicultural raw materials	77	96	104	103	103	104
Minerals and metals	71	82	110	105	122	122
Unit value index of fuel imports of DMECs (1980 = 100)	55	59	53	50	50	...
Unit value index of manufactured exports of DMECs (1980 = 100)	103	116	123	118	125	...

Source: UNCTAD, *Monthly Commodity Price Bulletin*; United Nations, *Monthly Bulletin of Statistics*.
Note: Price indices are derived from data in dollar terms.

3. *Developing countries as markets for manufactures*

For producers in developed economies, markets in developing countries generally improved in 1988. Thanks to higher foreign exchange earnings, the imports of developing countries made a substantial contribution to economic activity in the developed market economies. Information on the volume of trade in manufactures is not available. However, data in value terms can serve as a first approximation, by applying to such data unit value indices of manufactures exported by the developed market economies, which provide a proxy for price movements of manufactures generally. Exports of manufactures from these latter countries to the developing countries increased in value by some 16.6 per cent in 1988, somewhat greater than in 1987 (see table 24). As the unit value of these exports rose more slowly in 1988, the gain in the volume of exports was perhaps more than 10 per cent. The exports of developed market economies rose particularly strongly to East Asian developing countries, advancing by perhaps almost 30 per cent in volume. The decline in export volume to other developing regions appears to have ceased, and this turn-around provided a fillip to world trade and output.

Of course, import behaviour differed markedly from country to country in each region. In Latin America, Mexico accounted for over 90 per cent of the increase in the value of total imports (most of which were of manufactures) in 1988. In nine countries of the region, imports continued to decline and in only three did their volume expand by more than 5 per cent.[80] One reason for continued depressed levels of imports in many developing countries is their persistent burden of debt service. In particular, the volume of imports into sub-Saharan Africa in 1988 was only two thirds that of 1980 and in Latin America only three quarters. In West Asia, import volumes have been stagnant over the last three years, after having declined steadily in 1982-1985.

[80] Economic Commission for Latin America and the Caribbean, *Preliminary Overview of the Latin American Economy, 1988* (Santiago, 3 January 1989).

Table 24

DEVELOPED MARKET-ECONOMY COUNTRIES: REGIONAL DISTRIBUTION OF EXPORTS OF MANUFACTURES AND GROWTH IN THEIR TOTAL VALUE, 1980-1988

(Percentage)

Exports to:	Distribution		Rate of growth			
	1980	1987	1980-1985 average	1986	1987	1988 [a]
World [b]	100.0	100.0	1.5	16.1	15.4	17.3
Developing countries	36.7	27.0	-3.1	8.7	14.1	16.6
of which:						
Africa	7.5	3.6	-7.3	-0.4	1.9	8.6
Latin America	9.4	6.1	-5.6	12.5	11.8	15.5
West Asia	8.5	4.6	-3.4	-8.7	0.8	7.1
South Asia	1.4	1.6	4.0	22.3	7.1	5.8
East Asia [c]	8.7	10.2	1.6	19.9	30.7	34.8
of which:						
Major exporters [d]	5.5	7.8	3.9	23.9	33.9	37.1
Memo item:						
Rate of change in index of unit value of manufactured exports of DMECs			-2.7	16.1	13.9	6.0

Source: UNCTAD secretariat calculations, based on data (in current dollars) of the United Nations Statistical Office.
a Preliminary estimates, based on data for the first three quarters.
b Excluding intra-EEC trade.
c Including developing countries in Oceania.
d Hong Kong, Republic of Korea, Singapore and Taiwan Province of China.

4. Export performance, import penetration and protectionism

During the 1980s, developing countries have gradually increased their share in the markets for manufactures of the industrial countries (see chart 3) and continued to do so in 1988. The strongest performers have been the more industrialized countries of South-East Asia and, to a lesser extent, of Latin America (see table 25).

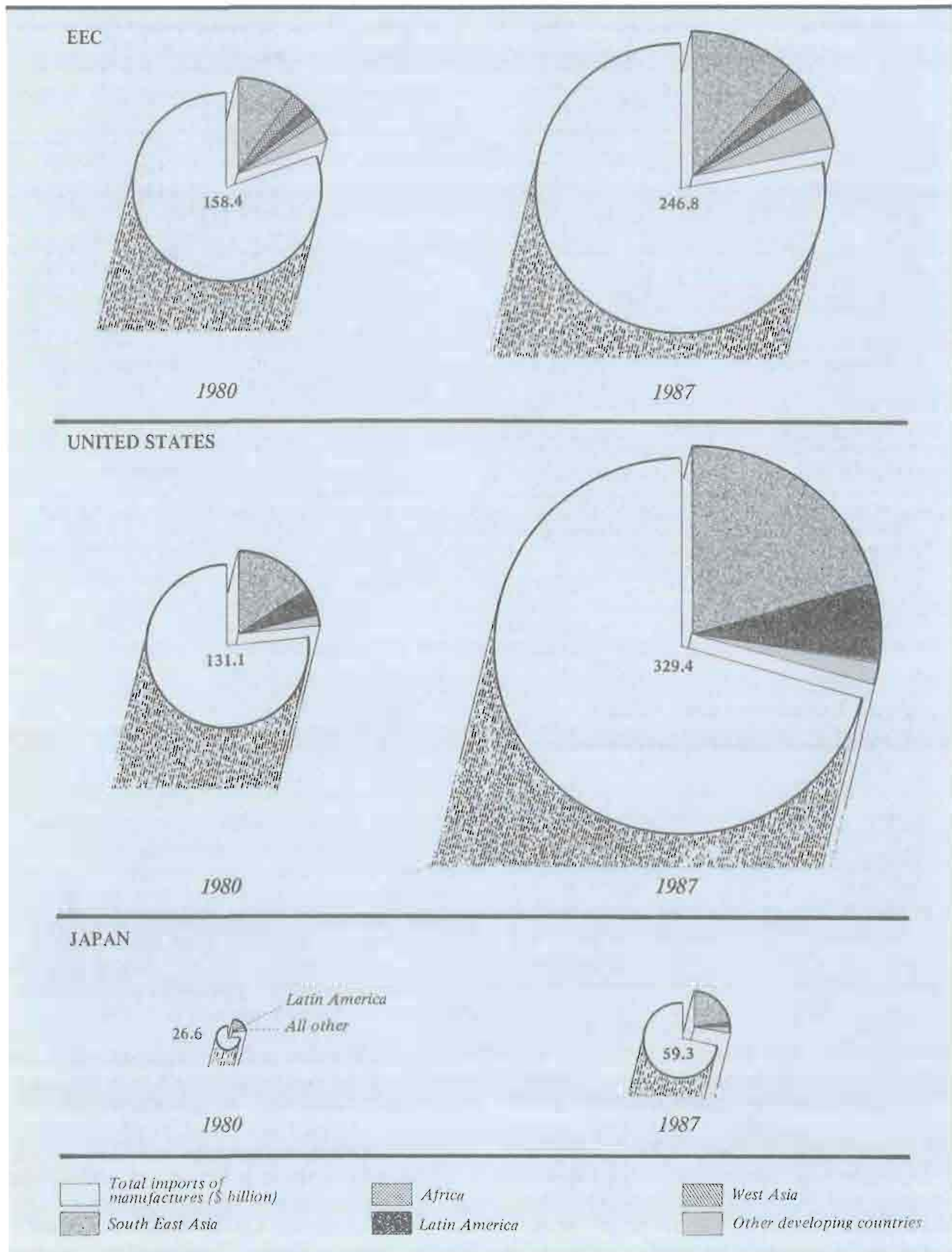
Imports of manufactures into all major groups of developed market-economy countries have expanded vigourously. As a proportion of apparent consumption of manufactures, imports from developing countries have risen strongly in the United States, EEC and Japan. In fact, much of the increase that has taken place since 1985 in those countries' import penetration ratios for manufactures (imports as a share of apparent consumption) has been due to imports from developing countries (see chart 4). The increase in the ratio has been particularly strong in Japan, where the share of imports from developing countries in total consumption of manufactures rose by one half from 1986 to 1988. In 1987 and 1988, the sharp rise in the yen and buoyant domestic demand - for both consumption and investment - accounted for the significant increase in imports in general, but the increase was particularly strong for imports from developing countries, especially those in South-East Asia, partly because of the relocation of production by Japanese corporations from their home base to affiliates in that region.

The increase in the imports of manufactures from developing countries into the developed market-economy countries has also been fairly broad-based in respect of product composition. While the most dynamic export sectors have been those producing capital goods, some consumer goods exports, even those facing high non-tariff trade barriers, have also expanded significantly. An analysis of the product composition of the increase in imports

Chart 3

SHARE OF DEVELOPING COUNTRIES IN THE IMPORTS OF MANUFACTURES OF EEC, UNITED STATES AND JAPAN, 1980 AND 1987

(Percentage)



Source: UNCTAD secretariat.

Table 25

DEVELOPED MARKET-ECONOMY COUNTRIES: GROWTH OF THE VALUE OF IMPORTS OF MANUFACTURES BY REGION, 1980-1988

(Percentage)

Imports from:	*1980-1985 average*	*1986*	*1987*	*1988* [a]
		All developed market-economy countries		
World [b]	2.8	26.3	20.1	17.3
Developing countries	8.7	22.6	32.7	24.2
Latin America	12.8	7.7	24.9	27.9
Major East Asian exporters [c]	9.6	26.5	34.2	16.2
ASEAN [d]	10.1	17.3	39.5	34.7
		United States		
World	14.9	14.8	9.5	7.0
Developing countries	17.0	14.9	25.2	15.6
Latin America	17.7	8.0	23.4	24.6
Major East Asian exporters	17.4	18.2	25.0	3.5
ASEAN [d]	13.8	9.4	31.1	21.9
		EEC		
World [b]	-1.3	31.7	26.4	23.9
Developing countries	-1.6	37.8	40.5	26.3
Latin America	0.5	10.2	30.3	30.9
Major East Asian exporters [c]	-3.7	52.2	48.2	28.8
ASEAN [d]	6.2	29.3	45.1	37.7
		Japan		
World	6.0	35.7	22.7	40.5
Developing countries	6.0	32.0	52.7	58.9
Latin America	9.0	9.0	0.3	62.7
Major East Asian exporters [c]	6.0	35.1	60.0	53.2
ASEAN [d]	5.5	29.1	71.0	74.2
Memo item: Rate of change in index of unit value of manufactured exports of DMECs	-2.7	16.1	13.9	6.0

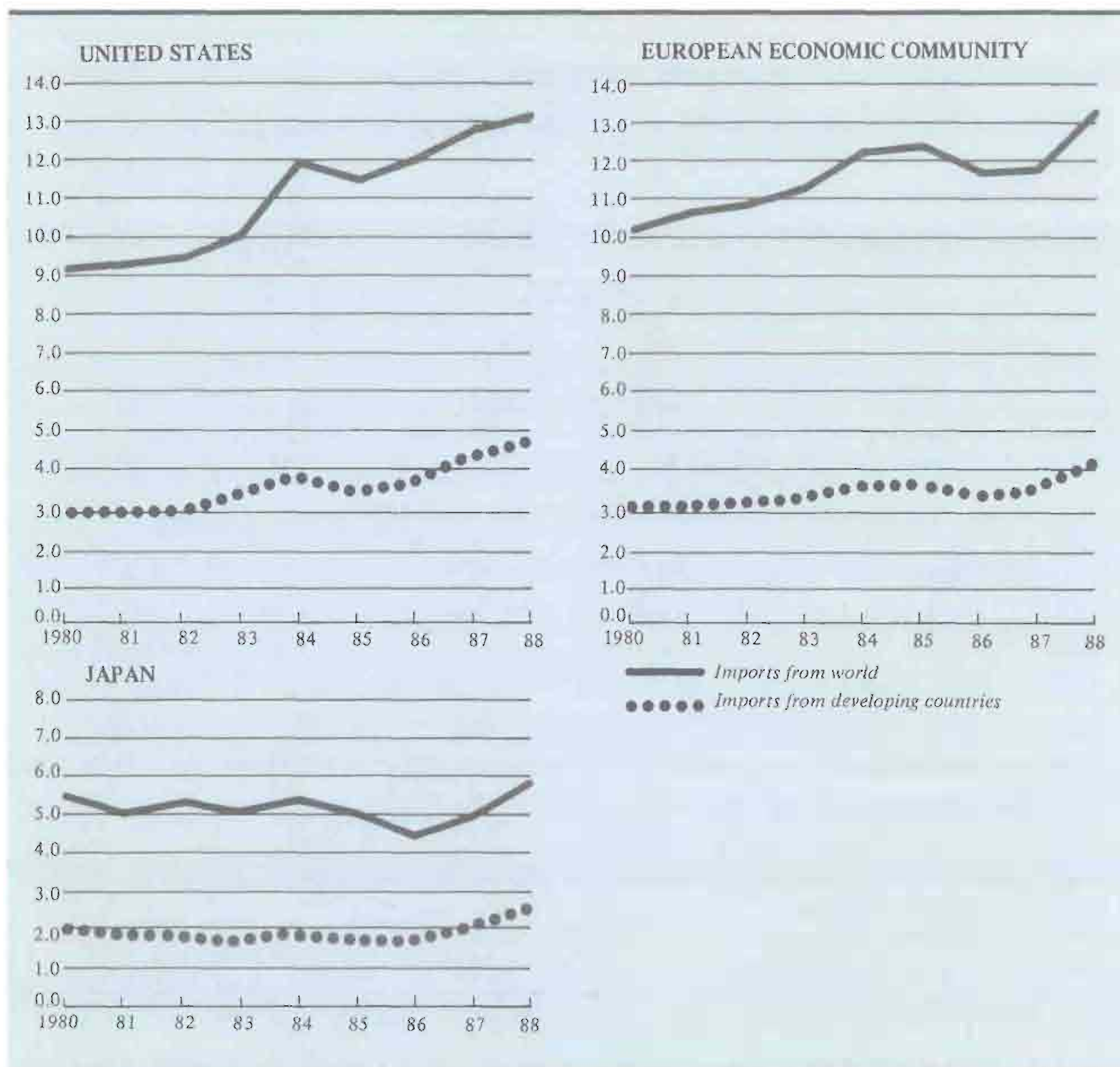
Source: UNCTAD secretariat calculations, based on data (in current dollars) of the United Nations Statistical Office.
a Preliminary estimates based on data for the first three quarters.
b Excluding the intra-trade of EEC.
c Hong Kong, Republic of Korea, Singapore and Taiwan Province of China.
d Excluding Singapore and Brunei Darussalam.

of manufactures from developing countries in the period 1985-1987 shows that over 40 per cent took place in engineering products, which, by and large, are less affected by non-tariff barriers than other types of goods (see table 26). Much of the dynamism of world trade has been in these products, and the more industrialized exporters of manufactures among the developing countries have gradually shifted the composition of their exports towards these products. If in the future market access for such products is seriously impeded, there will be higher costs and a loss of international competitiveness for user firms. While the imposition of non-tariff measures in this sector cannot be ruled out (as, for example, in the case of semi-conductors), user industries for which exports are important, or which compete against imports in their domestic market, may be expected to oppose them resolutely.

Chart 4

IMPORT PENETRATION RATIOS FOR MANUFACTURES IN EEC AND THE UNITED STATES, 1980-1988

(Percentage of apparent consumption)



Source: UNCTAD secretariat.

About 25 per cent of the increase in imports of manufactures from developing countries in 1985-1987 was in textiles and clothing. The increase in demand for these products in the developed market economies has been strong and, were it not for the stringent ceilings set by the Multi-Fibre Arrangement (MFA) and other restrictive measures, imports from developing countries would have risen considerably faster.

Whatever the immediate causes of the continued growth of textile and clothing exports from developing countries, high trade barriers have been unable to prevent them from increasing their shares in world production and trade. In other sectors, trade restraints have been considerably more effective in checking imports from developing countries. A case in point is iron and steel, which accounted for only 1 per cent of the increase in imports from developing countries in 1985-1987. In the

Table 26

DEVELOPED MARKET-ECONOMY COUNTRIES: INCREMENT IN THE VALUE OF IMPORTS OF MANUFACTURES FROM DEVELOPING COUNTRIES, BY PRODUCT GROUP, FROM 1981 TO 1984 AND FROM 1985 TO 1987

(Percentage of total increment)

	1981-1984	*1985-1987*			
	All DMECs	*All DMECs*	*United States*	*EEC*	*Japan*
Total increment ($ billion)	30.5	64.2	29.0	22.7	8.6
Share of product group					
Chemicals	5.7	3.3	-0.1	4.5	9.3
Textiles	2.1	5.3	2.8	7.4	4.2
Clothing	14.3	19.5	14.9	23.8	22.0
Iron and steel	4.9	1.3	-0.1	0.8	6.6
Other semi-manufactures	4.6	9.5	5.6	9.4	17.8
Other consumer goods	15.6	18.6	21.2	16.4	19.1
Engineering products [a]	52.8	42.5	55.7	37.7	20.9
Total	100.0	100.0	100.0	100.0	100.0

Source: GATT, *International Trade, 1987-88*, Vol. II, Geneva, 1989, tables AB1, AB2, AB5, AB8 and AB9.

a Machinery, office and telecommunications equipment, motor vehicles and transportation equipment, and household appliances.

United States, steel imports from developing countries actually declined in absolute terms in that period, as a result of quotas and voluntary export restraints. In this sector, producers in some of the more industrialized developing countries have also become competitive in international markets. However, severe excess capacity in the industrial countries has prompted the imposition of non-tariff measures which have effectively prevented a shift in production and exports towards the developing countries commensurate with the latter's increased competitiveness.

Prospects for developing country exports of manufactures are probably brightest in Japan. As a result of the rise in the yen and a shift in economic policy from reliance on exports to an emphasis on the domestic market as the major source of demand expansion, the behaviour of imports appears to be undergoing substantial modification. Imports of manufactures into Japan could indeed continue to grow strongly in the future, especially if official policy continues to emphasize growth in domestic demand. The country's large current-account surplus suggests that there is ample scope for such an increase. Some developing countries, particularly those in South-East Asia with which Japan has strong and growing economic ties, should be well placed to take advantage of further increases in Japanese imports.

Imports of manufactures into Western Europe and the United States from developing countries could well continue to rise faster than their total imports. However, much will depend on whether protectionist pressures, which have recently gathered force, can be held in check, and on whether non-tariff barriers now in place can be dismantled. The next section of this chapter deals with this issue. It reviews trade policies in the developed market-economy countries and their implications for the evolution of the open multilateral system and for the exports of developing countries.

B. The drift towards greater protection: trade policies and the new trade legislation of the developed market-economy countries

Despite assertions from both North America and Western Europe of undiminished support for the open, multilateral trading system, resort to protectionist measures, which has been evident since the mid 1970s, has intensified during the current decade. Two recent legislative measures of major importance have done much to generate fresh concern about the protectionist drift in trade policies. The first is the United States Omnibus Trade Expansion and Competitiveness Act of 1988 and the second is the Single European Act adopted by the member States of EEC in 1986. A striking feature of the former is that it requires the United States Administration to negotiate bilaterally for improved market access and, if unsuccessful, to restrict foreign access to its markets. The latter sets the aim of unifying the internal markets of EEC countries by 1992, raising fears that this may lead to the emergence of a more exclusive trading area.

To some observers, the outlook appears even more ominous. Alongside the Single European Act they cite other developments, such as the creation of the United States-Canada Free Trade area and the growth of trade between Japan and South-East Asian countries; they fear that in consequence the world trading system may be fragmenting into three major trading blocs.

1. The new legislation

How large an effect the new legislation will have on international trade is far from certain, since many decisions have yet to be taken. However, decisions are bound to be influenced by the prevailing climate of opinion, which is an uneasy mixture of protectionist and open trade attitudes.[81] On balance, a drift away from GATT disciplines - and especially increasing resort to bilaterally applied non-tariff measures such as voluntary export restraints - appears to have been gaining ground. More recently, in the 1980s, an added weapon of protection - formally consistent with GATT - has been found in national machinery for the imposition of anti-dumping and countervailing duties; the machinery has increasingly been used in a restrictive way to penalize imports.[82] It is against this background that recent legislation has to be considered.

(a) United States Omnibus Trade Expansion and Competitiveness Act of 1988

Having been passed very recently, the Act reflects current attitudes and compromises in the United States with regard to trade policy. It amends previous trade legislation relating to a range of issues, including the escape clause and the anti-dumping and countervailing duty clauses. However, its most innovative thrust has been on measures to gain greater market access abroad as well as improved protection of intellectual property rights.

For trade in manufactures, the most critical clauses in the Act are those relating to unfair trade practices. In some respects, they do no more than reaffirm the provisions of earlier legislation dating back to 1974. The Administration continues to be bound, for instance, to investigate practices of trading partners that violate United States rights under trade agreements or treaties and to take retaliatory action if the trading partner does not desist from such

81 See *TDR 1988*, especially the review of trade policies in the Overview.

82 There has been a remarkable increase in the number of anti-dumping and countervailing duty cases investigated in the developed market economies; in EEC, around 300 cases were investigated between 1980 and 1987, while in the United States the number was some 700. There is also an accumulating body of evidence to indicate that the machinery is often being used for protectionist ends. See Jagdish Bhagwati, *Protectionism* (Cambridge, Ma., MIT Press, 1988), especially pp. 48-53.

practices. More active use of such legislation had, in fact, begun to be made in recent years. In this vein, quite a number of cases of "unfair trading practices" have been pursued with trading partners in the last few years, and several have involved industrially more advanced developing countries in both Asia and Latin America.

However, the new Act goes further than previous legislation. It gives the United States Trade Representative (USTR) discretionary powers to investigate and to take retaliatory action in instances of "unreasonable trade practices", whether or not they violate any legal rights of the United States.[83] Since such practices are defined as any practices which are "unfair or inequitable", the door has been opened for United States producers to press their claims for access to markets abroad or for protection at home on the basis of an almost indeterminate range of charges. Further, Congressional surveillance of the trade policy decisions of the Administration has been considerably tightened in the new Act. Most dramatically, the USTR is obliged to draw up a priority list of countries engaging in unfair trading practices and to enter into negotiations with these countries in order to bring about elimination of these practices over a three-year period.[84]

This approach carries the high risk of generating unintended consequences, giving further impetus to protectionism, and weakening the multilateral system. As a result of pressure from the United States, a trading partner of that country may make concessions which give preferential access to United States exports; and these exports, rather than displacing domestic products, may replace exports from third countries, thereby breaching the principle of non-discrimination and possibly provoking a trade conflict with the affected third countries. Furthermore, the trading partner may prefer to risk retaliatory action rather than make unilateral concessions. After all, unilateral concessions granted on any scale offend the whole idea of reciprocity underlying multilateral trade negotiations, where each country broadly balances concessions granted with those received. Should any action be taken by the United States, the new Act could become a cloak for the introduction of additional protectionist measures.

The strongly assertive thrust of the new trade legislation reflects in large part a frustration with the intractibility of the huge United States trade deficit. In a popular view which has carried considerable weight in the formulation of the recent legislation, the difficulty allegedly lies in the unfair trading practices of the trading partners of the United States, especially when these practices are contrasted with the relative ease with which foreign producers can sell in the United States market. However, the belief that a more aggressive trade policy will eliminate the large and persistent United States trade deficit is very largely mistaken. Greater protection of the home market or efforts to force United States exports on trade partners would have complex repercussions, and it is not at all clear that these policies would, in the end, result in a sizeable reduction in the trade deficit. Much would depend on the impact of the changes in exports and imports on domestic demand and on the exchange rate for the dollar, both of which would have indirect effects on trade flows themselves. The causes of the trade deficit are macroeconomic, and a lasting solution to the problem must be sought in appropriate changes in macroeconomic policies in the United States and in its trading partners, as well as in concerted action at the international level. Unilateral action by the United States would only invite retaliation and worsen the international trading environment.[85]

A more sophisticated view of the trade deficit holds that it is symptomatic of a loss in technological leadership by the United States. Other developed countries, particularly Japan, have been gaining a competitive advantage in the "frontier" industries, and in the view of some observers this has been due to some extent to trade policies. Since market access on a global scale is deemed important for economies of scale and for "learning" in these industries, it is alleged that the ease of foreign access to the United States market and the difficulty of United States access to foreign markets have placed United States industry at a disadvan-

[83] Congress placed the authority directly with the USTR, and not with the President as head of the Executive Branch, apparently because it believed that the President would be more restrained by general foreign policy considerations than would the USTR, who is assigned specific trade responsibilities.

[84] On 26 May 1989, the United States cited three countries as unfair traders: Japan, for erecting trade barriers in super computers, telecommunications satellites and wood products; Brazil, for its import licensing policies and high tariffs; and India, for its trade-related foreign direct investment regulations and for restrictions on United States insurance companies. Eight countries were placed on a "priority watch list" and 17 on a "watch list" for their policies relating to intellectual property rights. These latter countries included EEC members (Italy, Greece, Spain and Portugal). See *Financial Times*, 26 May, 27-28 May, and 30 May 1989, and *The Economist*, 3-9 June 1989, p. 48.

[85] For a discussion of policies to correct the trade deficit, see chap. I, sects. A.1(b) and A.3.

tage. For many, this issue goes beyond the immediate question of the trade deficit, since the new information-processing industries are the key to present and future growth throughout the national economy. Whatever the theoretical merits of these propositions, the advantage gained by resort to aggressive trade policies could be easily lost, if competing countries retaliate and this sets off successive rounds of "tit-for-tat" actions.[86] Furthermore, the wider consequences for the preservation of the basic norms that underpin the international trading system would be extremely adverse.

(b) *The Single European Act of the European Communities*

One of the principal aims of the Single European Act is completion of the single, internal market by 1992. (See box 8 for a summary of the Act.) While the regime of a common external tariff and zero internal tariffs has been long established and there has been considerable progress in the harmonization of numerous laws and regulations relating to economic and social activities, many administrative, legal and technical obstacles to the free movement of goods and services remain; and policies concerning such matters as public procurement, industrial subsidies or restrictive business practices also continue to fragment markets.

The general intent of the Single European Act is to create conditions throughout the Community which will ensure that all the enterprises of member countries compete on a more equal footing. The belief is that the present fragmentation of markets, by restricting competition, results in the inefficient use of existing productive resources, prevents the full exploitation of economies of scale and slows down the rate of innovation. The programme is seen as a way of attacking some of the chronic economic problems that have beset EEC countries for many years - high levels of unemployment, low rates of economic growth and loss of technological competitiveness.

On the assumption of no change in its external trade policies, faster economic growth within the Community would have beneficial consequences for its trading partners throughout the world, including developing countries. However, it is an open question how significant the reforms would be for economic growth, especially when it is considered that access to Community-wide markets for most domestic industries in EEC countries has not been seriously constricted under the present regime.[87]

The programme of reforms affecting the internal movement of goods and services will inevitably necessitate changes in EEC commercial policy and practices which are likely to affect in one way or another trade with third countries in most goods and services. The critical question for third countries is whether the effect of such changes will be to make the EEC market a more open one or whether, on the contrary, the market will become more protected.

For developing countries as a whole, the most important single set of changes will be those that arise from the virtual elimination - or at any rate, simplification - of customs procedures at internal border posts within the Community. If implemented as proposed, the changes will mean that individual member countries will no longer be able to maintain their own national restrictions on imports from extra-Community sources, since they will no longer be able to monitor and control such imports when they reach the domestic market by way of other Community member countries. For developing countries, the most important national import restrictions are the quotas fixed under the MFA or other textile arrangements. But there are also the various voluntary export restraints and orderly marketing arrangements which could be maintained under the new regime only if they, too, are brought into conformity at the level of the Community.

The case of the MFA can be taken as illustrative of the kinds of considerations that are likely to bear on the outcome of bringing into conformity arrangements for quantitative restrictions in the EEC market. Under the MFA, EEC member countries have at present an extensive network of bilaterally negotiated national quotas limiting their imports of clothing and textiles from developing countries. In the earlier years of the MFA - and of its predecessors - "market disruption" was considered to be the rationale for restricting increases in imports from "low wage" countries. This was later transformed into a seemingly similar, but in practice different, notion of "cumulative market disruption", which has led to a system of quotas based on "acceptable levels of market pene-

[86] For a discussion, see Paul Krugman (ed.), *Strategic Trade Policy and the New International Economics* (Cambridge, Ma., *The MIT Press*, 1986).

[87] The Commission of the European Communities has estimated that "static" gains - i.e. those arising from more efficient utilization of existing productive resources - could raise GNP by some 2 1/2 to 6 per cent. See Commission of the European Communities, *The Economics of 1992* (Brussels, 1988).

Box 8

THE SINGLE EUROPEAN ACT

In 1985, the heads of Government of the European Communities committed themselves to a group of reforms which were set forth in the Single European Act. The Act addresses itself to political, economic and institutional changes. It introduced an important change in decision-making within the Communities by substituting majority voting for unanimity in most decisions within the legislative process. It provides that member States shall endeavour together to formulate and implement a European foreign policy. Further, the Act contains provisions for closer co-operation in monetary matters, social policy, the environment, and research and technological development.

However, the element in the Act which is of most immediate interest to third countries is the programme for a single market, the intent of which is further to reduce the fragmentation of EEC markets. A main element of the programme is directed towards the removal of administrative, legal or technical barriers to the movement of goods and services, persons and capital; these include such matters as the adoption of common health, safety and other consumer protection standards for goods and services, the reduction or simplification of border controls on the movement of goods or persons, and the harmonization of national regulations concerning banking, insurance and the provision of professional services. Another significant element in the programme is the creation of a more open competitive market for firms within the Community in the public procurement programmes of the individual member States. Several other measures, such as tighter rules on national subsidies to enterprises, more vigorous action against restrictive business practices and enforcement of intellectual property rights, are also designed to promote more open and fairer competition within the Community.

Implementation of the programme entails agreement by member States on a host of specific measures. Considerable progress has been made on a range of measures, but there are large areas of disagreement that remain to be settled. The simplification of border controls, for example, is interlocked with that of harmonization of indirect taxes, and member States have different views on the desirability of fiscal harmonization.

tration", a largely political norm with little economic content. The rates of growth of imports allowed for under the Arrangement have been progressively reduced.

If and when Community quotas come to be substituted for national quotas, the question likely to be posed is what constitutes the "acceptable level of market penetration" at the Community-wide level. At present, there are significant variations among EEC member States in levels of market penetration by developing countries (see chart 5). If Community quotas were set at levels corresponding to the sum of current national quotas, countries with below-average levels of market penetration would be exposed to intensified competition from imports, and might exert pressure for a reduction of the Community quota. The same situation may arise for other products subject to quantitative restrictions, though these are generally exercised through voluntary export restraints and orderly marketing arrangements.

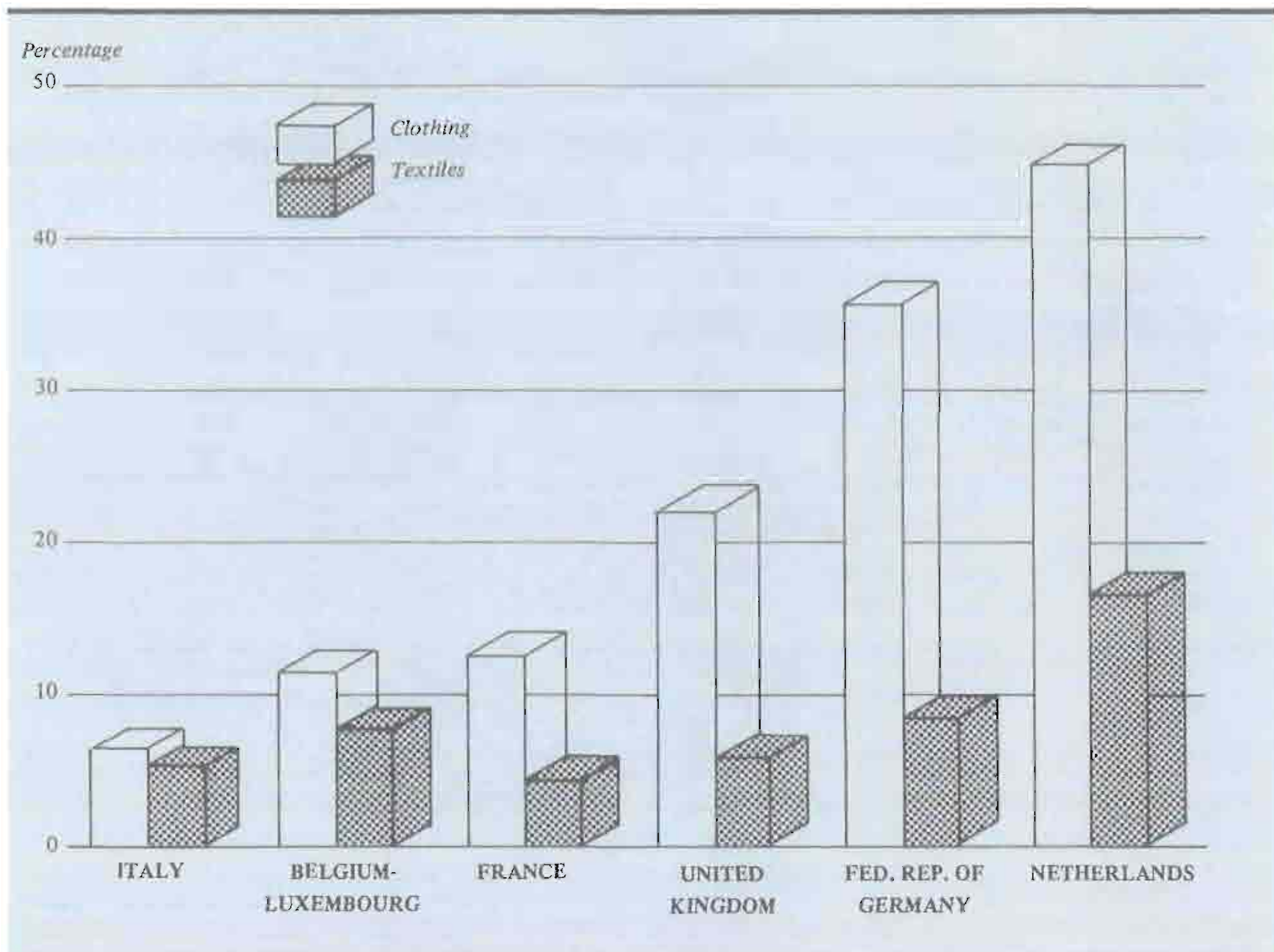
Abandonment of the restrictions would be the sure way of making the 1992 programme consistent with the pursuit of a more open external trade policy; in view of the large funds at the disposal of the Community for assisting industrial restructuring, it is a course which should be feasible. Moreover, such an outcome would be consistent with the objectives of the Uruguay Round of multilateral trade negotiations and, therefore, cannot be ruled out. But in the absence of deliberate decisions to this effect - which would probably have to be taken at the highest political level - implementation of the programme for a single market may risk providing a further impetus to the protectionist drift.

2. *Are tripolar trading blocs emerging?*

Several developments of the last two to three years have caused a number of observers to express the fear that the multilateral trading system may be fragmenting into three large trading blocs. A principal source of these fears is the programme for a single EEC market discussed above and the concern that the current

Chart 5

IMPORTS OF CLOTHING AND TEXTILES BY SELECTED EEC COUNTRIES FROM DEVELOPING COUNTRIES, AS A PROPORTION OF APPARENT CONSUMPTION, 1985



Source: UNCTAD secretariat calculations, based on data of EEC.

drift towards increased protection may permeate the decisions being made in implementation of the programme. But developments in other areas are also cited, such as the regional trading agreements negotiated by the United States and the upsurge of trade between Japan and the South-East Asian developing countries. However, the significance of these developments has to be interpreted with care. At present, there appears to be more shadow than substance in the fears of emerging trading blocs, although the commitment to a multilateral approach to trade policy has certainly eroded.

EEC has, of course, long had special trading relationships with a number of other countries both within and outside Western Europe. It is linked in a free-trade arrangement with the countries of the European Free Trade Association (EFTA), and it has similar arrangements with certain other countries, such as Turkey, Yugoslavia and Israel.[88] For these countries, the programme for a single market raises the question of whether they should seek closer integration with EEC - a matter now under discussion by EFTA members. A closer integration of EFTA countries with a single EEC market would certainly strengthen the existing arrangements in Western Europe, but it would not be grounds for descrying the emergence of a new trading bloc. The case could only be made out if Western Europe were to

[88] EEC also accords preferential access to its markets - in varying degrees and for varying ranges of products - to some Mediterranean developing countries, to ACP countries, and to developing countries at large under the generalised system of preferences. These preferential trading arrangements cannot be regarded as contributing to the formation of a trading bloc since they are subject to varying restrictions and are mostly non-reciprocal; preferential access to EEC markets is granted in return for most-favoured-nation treatment in the markets of the partner countries.

become a more exclusive trading area through the unchecked drift towards greater protection.

Such concern has indeed been frequently expressed in the United States, and the recently signed United States-Canada Free Trade Agreement - as well as official statements about possible negotiation of comparable arrangements with Mexico and other countries - could be interpreted as defensive action which might lay the foundation of a North American trading bloc. However, that would again be taking the event out of context, mainly because there was already free trade between Canada and the United States for over 70 per cent of their traded goods. From the point of view of international trade relations, what is significant about the Agreement is not that it enlarged the scope of a free-trade area in North America, but - as in EEC - that this enlargement is taking place in a climate of intensifying protection.

The dynamic economies of East Asia - Japan and the newly industrializing economies of the region - are seen as the third element in the tripolar trading world. Certainly, these are the fastest-growing exporting economies in the world and in the last two or three years the most dynamic component of their total trade has been their trade which each other. Part of the explanation for this simply lies in the proximity of these economies to each other. In addition, several developing economies in the region have pursued policies to encourage exports and foreign direct investment, policies which Japan has supported. Exchange rate movements have also helped; while the yen has risen strongly against the dollar, the currencies of other East Asian economies have appreciated much more modestly. Their exports have become more competitive in the Japanese market, and Japanese firms have also been outsourcing more production in these economies. Under the influence of rising trade surpluses and external pressures from their major trading partners in Western Europe and North America, trade policies in these countries have been moving towards the greater opening of their markets, and it cannot be said that the protectionist drift elsewhere has provoked any defensive response towards the formation of a trading bloc.

3. Outlook

The trade policies of both EEC and the United States are at a difficult and dangerous juncture as opposing forces struggle for ascendency. On the hopeful side is the fact that the mid-term review of the Uruguay Round has been completed, and that the negotiating phase has now begun. If the negotiations were to result in an effective standstill and rollback of non-tariff measures, the incorporation of agricultural trade and textiles into GATT and the restoration of an adequate multilateral safeguards discipline, developing countries could look forward to a more promising international trading environment in the 1990s. The other side of the coin is that the recently enacted legislation of both EEC and the United States could easily become powerful instruments of protection. If implementation of the legislation confirms this tendency - as may be feared from actions taken so far - the prospects for strengthening and extending the multilateral trading system in accordance with GATT will be dim. Much therefore depends on how Governments respond to protectionist demands at home.

Over the years, Governments have frequently acquiesced in demands for protection - or, more recently, in demands for assisting exporters in access to foreign markets - often on the grounds that it represents a political compromise which has served to ward off an open trading policy from heavier attack. Such pragmatism, however, involves risks when policy-makers themselves appear less convinced of the national advantage to be derived from an open trade policy, the more so since trade policy abounds in specious arguments which are widely used to throw a cloak of national legitimacy over the advancement of sectoral interests. In facing up to protectionist pressures, there is in the end no alternative to clear assertion of where national, as distinct from sectoral, interests lie.

There are also multilateral dimensions to the successful management of domestic protectionist demands. Underlying some of the domestic tensions caused by trade are the significant disparities in performance between North America and Western Europe, on the one hand, and the East Asian countries - particularly Japan - on the other. The former are faced with a series of adjustments dictated by the need to accommodate themselves to the high rates of growth in output and exports and in the pace of technological change in the latter. In this situation, Japan can be particularly helpful in demonstrating its support for the open, multilateral system, especially by reducing its formal non-tariff measures and by ensuring that internal practices do not neutralize the effects of its relatively low trade barriers.

The greatest present danger to the open, multilateral system, however, comes from the failure of macroeconomic policies - as yet -

substantially to reduce the huge trade imbalances that exist among the developed market economies. The trade deficit of the United States is being used to legitimize sectoral pressures for protection or for increased market shares abroad; and the new trade legislation provides for the unilateral use of retaliatory measures which, if taken, would fly in the face of GATT rules and procedures for the multilateral settlement of disputes. An aggressive trade policy is being urged on the grounds that it will help to shrink the trade deficit, but the reality is that it will at best have only a marginal effect on the deficit. At the same time, if pursued without restraint, it could provoke a rash of counteractions that would damage the present trading regime and discredit the Uruguay Round. Only further adjustments in macroeconomic policies in the United States, as well as in its main trading partners, can reduce the trade imbalances. An effective combination of macroeconomic policies is thus essential if the open, multilateral system is to be preserved and strengthened.■

MACROECONOMIC DISORDER IN DEVELOPING COUNTRIES

A large number of developing countries, at all levels of development, have been suffering from increasing and persistent macroeconomic disorder in the 1980s, reflected in some or all of the following features: high and often fluctuating rates of inflation; growing capacity underutilization and unemployment; reduced and unstable growth; large and persistent public sector deficits; rapid expansion of the money supply and domestic credit, but demonetization in real terms; high and unsustainable nominal and real rates of interest; sharp currency depreciations and fluctuating nominal and real exchange rates; an unsustainable stock of external, and in some countries internal, debt; large private holdings of foreign exchange assets at home and abroad; and balance of payments constraints incompatible with growth and stability.

The increased domestic instability and imbalances emerged as countries sought to adjust to a drastically worsened external environment. It has been increasingly recognized that the adjustment process has not been compatible with growth, and there is now broad consensus on the need for debt reduction. It is, however, less appreciated that the process has also been incompatible with macroeconomic stability. Many countries have accommodated the swing in external variables such as the terms of trade, interest rates and financing. But they have also witnessed a greatly enhanced degree of disorder on many fronts, despite countervailing efforts through various kinds of policies, both orthodox and heterodox. This chapter examines the origin of increased macroeconomic disorder in developing countries, and assesses how far sustained macroeconomic stabilization is possible without a significant improvement of external conditions and easing of payments constraints.

A. Payments adjustment, deflation and inflation

1. *Inflation and growth*

The two important indicators for determining whether there is macroeconomic disorder in developing countries are inflation and growth. Developed market-economy countries have enjoyed, on average, faster growth and lower inflation since 1982 than they did in the 1970s and early 1980s. By contrast, developing countries have generally registered not only lower growth, but also higher inflation. For the sample of developing countries in annex table 5, the average drop in the growth rate amounted to about 3 per cent per annum. The largest drop was in the highly indebted countries,[89] exceeding 5 per cent per annum in Bolivia, Brazil, Cote d'Ivoire, Ecuador, Nigeria and Philippines. In such countries the cumulative loss of output since 1982 amounted to

[89] The term "highly indebted countries" in this chapter refers to a group selected on the basis of the availability of data relevant to its analysis, and differs, for example, from its use in chap II, where it refers to the so-called Baker 15. This group consists of Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay and Venezuela.

more than one quarter of the present level of income.

Another important characteristic of growth in developing countries in the 1980s has been its increased instability. While the economies of some countries have remained permanently depressed (e.g. Bolivia and Jamaica), in others there have been considerable ups and downs; the growth instability indicator rose for 19 of the 29 countries included in the table. In a few countries this reflected a tendency of growth rates to rise in recent years compared to 1982-1983 (e.g. Ghana and, to a lesser extent, Chile). In most others, however, there have been considerable downward movements. In some low-income countries this was partly due to drought, but in many debt-troubled countries where growth became much more unstable, it reflected a stop-and-go process: attempts to push growth were often frustrated by the payments constraint, necessitating a new round of retrenchment (e.g. Argentina, Brazil, Côte d'Ivoire, Mexico, Morocco, Nigeria, Peru and Venezuela).

Annex table 5 provides a comparison of inflation in a number of developing countries over three distinctly different periods: 1966-1972, which was a period of relatively low inflation worldwide; 1973-1982, when prices rose worldwide by some 12 per cent per annum; and the most recent period of adjustment to reduced availability of external finance and falling real commodity prices. In a large number of developing countries, including in particular the majority of debt-troubled countries, inflation rates in the 1980s have been higher in comparison not only to the 1960s but also to the 1970s. For the highly indebted countries, the average rate of inflation was 90 per cent per annum during 1983-1988, compared to less than 40 per cent during the 1970s, and 15 per cent during the 1960s. Of the 16 highly indebted countries included in the table, 15 experienced higher inflation in the 1980s than in the 1960s, and only one (Chile) succeeded in reducing inflation considerably compared to the 1970s. In a number of countries (e.g. Argentina, Bolivia, Brazil, Mexico, Peru and Zaire) the increase in inflation was particularly marked, in some cases turning into hyperinflation during certain periods. Almost every country where inflation is or has been a major problem is debt troubled.

Again, the increase in the average rate of inflation has been accompanied by larger fluctuations of inflation rates; this is particularly true in countries which have experienced an average annual rate of inflation of 30 per cent or more.[90] This too reflects not so much a steady trend as a stop-and-go process. Indeed, a number of countries (e.g. Argentina, Brazil, Ghana, Mexico, Nigeria and Zaire) succeeded in bringing down inflation considerably for a while, only to face a new and sometimes stronger upsurge thereafter.

Most of the countries which experienced drastic declines in growth and increased price instability have also suffered from other types of macroeconomic disorder; this will be examined below. Underlying this widespread disorder were three characteristics, which were shared by these countries in varying degrees:

- A sharp decline in external resource transfers since the early 1980s, owing, on the one hand, to worsened terms of trade and sharply increased interest rates, and, on the other hand, to cuts in new lending. In many countries net financial transfers (net capital inflows minus interest payments) have turned sharply negative;
- Collapse of growth as a result of deflationary adjustment to the loss of real revenues. This, in combination with the swing in external transfers, has resulted in drastic declines in resources available for domestic distribution and use (i.e. domestic absorption) in per capita terms, making it impossible to maintain absolute levels of incomes of the various classes and groups;
- Large swings in key relative prices. In the course of adjustment currencies have been devalued in order to raise profits in sectors producing tradeable goods and services relative to wages and to profits in non-tradeable goods sectors; the internal terms of trade between agriculture and industry have undergone drastic changes; and domestic interest rates have increased sharply, resulting in sizeable internal income transfers from debtors to rentiers. The consequent tension and conflicts that have arisen over income distribution have both threatened social peace and seriously impaired the ability of governments to govern.

[90] Higher instability, as measured by standard deviation in annex table 5, does not always indicate that variations relative to the mean are also greater. But it has to be kept in mind that the absolute size of the swing in inflation rates has an important bearing on other economically relevant variables (e.g. real interest and exchange rates) and, hence, on the degree of uncertainty under which policy and business decisions have to be taken.

2. *Per capita resource availability*

As documented extensively in previous issues of *TDR*, and shown in annex table 6, there has been a massive swing in resource availability since the early 1980s. For the majority of developing countries the terms of trade in 1986-1987 were much lower than in 1980-1981, due to the collapse of prices of commodities (including oil) relative to manufactures. The cumulative cost of the decline in terms of trade (and hence in the volume of resources available for domestic distribution and use) was, on average, about 6 per cent of GDP, and over 10 per cent in many countries - that is, about two years' output growth in good times and the entire output growth between 1980 and 1988 in a large number of countries.

Resource loss in debt-troubled countries through the swing in net financial transfers since the early 1980s amounted, on average, to about 4.5 per cent of GDP. About one half of these countries turned from being net recipients to being net providers of financial resources. Most of the others continued to be net recipients, but at much lower levels than before.

These losses have necessitated a substantial adjustment of trade volumes. In most cases export volumes have been raised considerably, but the scale of adjustment required has made it impossible to avoid drastic import cuts; the widespread co-existence of increased export volumes and reduced import volumes was unprecedented. Consequently, per capita domestic production either stagnated or declined between 1980-1981 and 1986-1987 and in many countries the absolute level of real domestic ouput fell.

The upshot was that the volume of resources available for domestic distribution and use declined drastically in a large number of countries. In no less than 10 countries in annex table 6, the decline reached or exceeded 20 per cent. In countries where per capita resource availability stagnated, it represented a substantial swing from the trend in the 1970s when per capita domestic absorption was rising at a rapid pace (e.g. 3 per cent per annum in Brazil).

Although per capita consumption declined considerably in a number of countries, it was investment that bore the brunt of the burden of adjusment. Domestic savings (GDP minus consumption) fell a little in many countries, but national savings (domestic savings minus net factor payments abroad) declined very sharply as interest payments escalated. This, together with the cut in lending levels, was the main factor depressing the pace of capital accumulation. Concerted lending by banks, which was designed to keep countries current on interest payments, registered as an increase in foreign savings (net capital inflows) as conventionally defined, but it did not constitute a net transfer of resources, and hence did not contribute to capital accumulation.

For the group of countries in annex table 6, per capita real investment declined, on average, by 25 per cent between 1980-1981 and 1986-1987, and by more than 50 per cent in many. In most countries fixed capital formation as a proportion of GDP fell by more than five percentage points (see chapter V, table 43). However, in real terms the decline was, in general, much greater, since the prices of imported investment goods relative to those of other components of GDP rose because of worsening terms of trade and currency depreciations. Consequently, each percentage point of current GDP spent on fixed capital investment represented a lower rate of capital accumulation in real terms. In some countries (e.g. Chile, Jamaica, Mexico, Philippines and United Republic of Tanzania) the difference between the investment ratio in current and in constant prices was as much as 2 per cent of GDP (GNP) or even more (e.g. Bolivia, Brazil, Côte d'Ivoire, Ghana, Kenya, Nigeria and Peru).

3. *Swings in key relative prices*

In most developing countries there have been sharp swings in key domestic relative prices during the 1980s, due in part to policy responses to increased payments difficulties and in part to changes in world market prices. Since these relative prices are an important determinant of the way income is distributed among various classes and groups, in a situation where total resource availability also declined, the redistribution of incomes meant a drastic fall in absolute income levels for certain groups and classes. This often met with stiff reactions of various kinds, and generated, among other things, strong inflationary pressures.

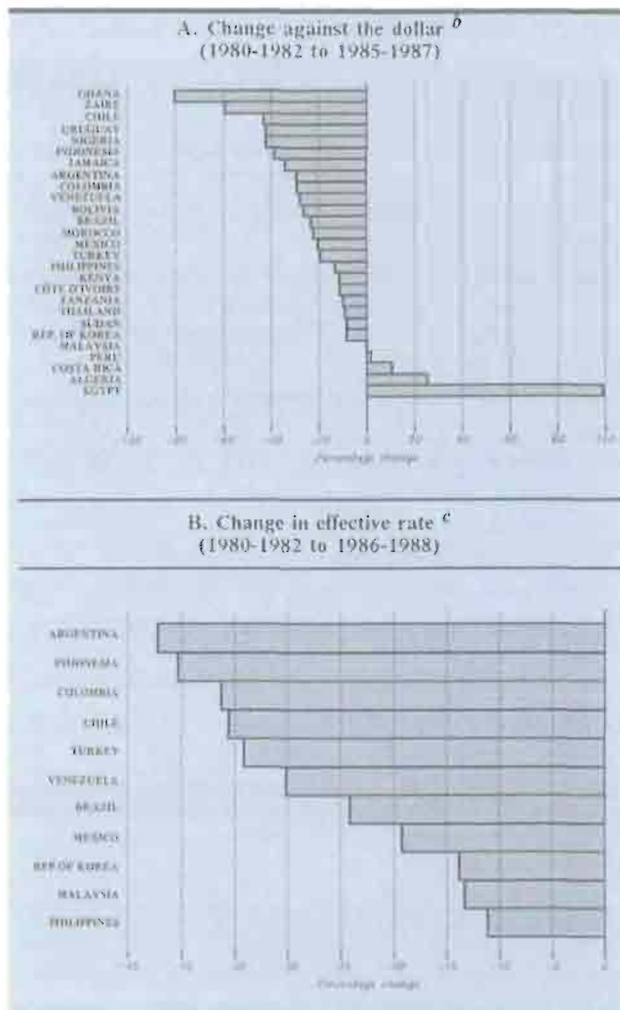
There has been a widespread resort to currency devaluation in an effort to raise international competitiveness, and profits and, hence, output in export- and import-substitution sectors, to reduce imports, and to transfer resources away from, and demand into, non-tradeable goods and services. Such an outcome required, *inter alia*, increases in the prices of tradeables relative to wages and non-tradeables, and, hence, transfers of income

from wages to profits and from non-tradeables to tradeables. Where currency depreciations also led a to further worsening of the terms of trade (as exporters bid down prices in world markets), the decline in real wages and the shrinking of the non-tradeable goods sectors represented partly a domestic redistribution and partly a loss of national income.

Chart 6

CHANGES IN REAL EXCHANGE RATES IN SELECTED DEVELOPING COUNTRIES

(Percentage) [a]



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics*; and Morgan Guaranty Trust Company, *World Financial Markets* (various issues).

a A negative change indicates a depreciation.

b Based on the United States wholesale price index and domestic consumer price index for the developing countries.

c Trade-weighted average value against the currencies of the country's principal trading partners, adjusted for relative price changes in manufacturing.

Evidence suggests that many developing countries have attained substantial changes in these relative prices since the early 1980s, often after devaluing several times in order to keep ahead of inflation. Charts 6 and 7 give three different measures of real exchange rate movements for a number of selected developing countries. The real exchange rate against the dollar (part A of chart 6) is an approximate measure of the relative prices of tradeables with non-tradeables. With the exception of a few countries, the rate fell considerably, indicating a sharp rise in the prices of tradeables relative to non-tradeables. In some countries the rate of depreciation was extremely large, exceeding 50 per cent and even 75 per cent.

A second measure is the real effective exchange rate (shown in part B of chart 6), which compares prices of manufactures in domestic markets with those in export markets in terms of a trade-weighted basket of currencies. A fall in this index thus represents increased competitiveness in manufactures in world markets. Since this requires that the rise in the domestic cost of production of manufactures should be below the rate of depreciation of the nominal exchange rate, it implies a decline in the cost of labour and other domestic inputs in terms of foreign currency. In most countries such declines were sizeable, as indicated by large changes in real effective exchange rates.

A final measure of the real exchange rate movements is changes in the ratio of wages in manufacturing relative to those in the nominal exchange rate, corrected for changes in the dollar prices of tradeables (chart 7). Because wages are an important component of domestic costs, this index is a measure of changes in the ability of domestic producers to sell in world markets and to compete with imports. It combines the distributional and competitive aspects of exchange rates. A rise in wages in real dollars indicates loss of competitiveness unless it is accompanied by a commensurate increase in labour productivity. On the other hand, a decline in wages in real dollars represents a deterioration in the purchasing power of wage earners over traded goods. However, if such a decline is also associated with a fall in labour productivity, its effectiveness in raising international competiveness is diminished.

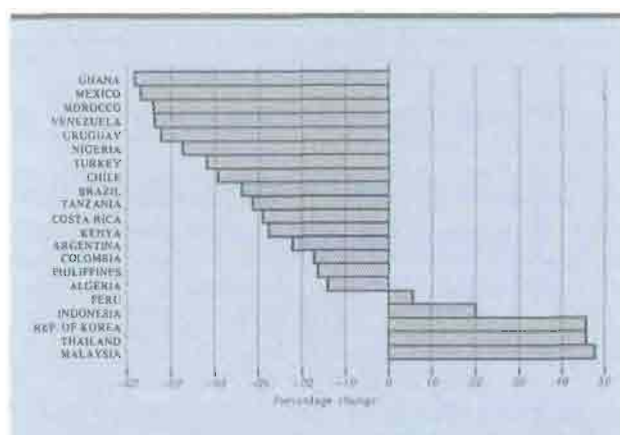
In three quarters of the countries for which the data are available (chart 7), there were sharp declines in the real purchasing power of wages in manufacturing in terms of the dollar. The international competitiveness of producers of manufactures did not, however, always improve as much, because of falls in labour productivity (real output per employee). The available evidence suggests that productivity in manufacturing fell in some countries (e.g. Algeria, Ghana, Kenya, Morocco and United Republic of Tanzania); nevertheless, competitiveness increased considerably because

declines in real wages were relatively steeper. In others (Argentina, Chile, Colombia, Mexico, Philippines, Turkey, Uruguay, and Venezuela) labour productivity increased while real wages declined, implying considerable improvements in competitiveness. Among the countries where real wages (in dollars) increased, most experienced faster growth in labour productivity (Indonesia, Malaysia, Republic of Korea and Thailand), improving competitiveness. In only a few countries (e.g. Peru), did labour productivity drop while wages increased. Thus, in most cases, exchange rates fell enough to raise the competitiveness of manufacturing.

Chart 7

REAL WAGES IN MANUFACTURING [a] IN SELECTED DEVELOPING COUNTRIES, 1980-1987 [b]

(Percentage change over the period)



Source: UNCTAD secretariat calculations, based on ILO, *Year Book of Labour Statistics*; IMF, *International Financial Statistics*; World Bank, *World Tables* (various issues).

a Index of nominal wages (or earnings per employee) deflated by the nominal exchange rate against the dollar and the United States wholesale price index.

b Except for Algeria, Brazil, Ghana, Indonesia, Malaysia, Morocco, Nigeria, Turkey, United Republic of Tanzania and Uruguay (1980-1985), Thailand (1980-1986) and the Philippines (1983-1987).

Payments adjustment also led to disparate movements of real wages in different sectors. While such movements are often determined rather by underlying sectoral trends in productivity, the available data suggest that the process of payments adjustment has been a major factor in the 1980s. In almost all countries in table 27, real wages in manufacturing performed much better than in transport, communications and construction, on the one hand, and in agriculture, on the other. Of these three sectors, manufacturing and agriculture typically produce tradeable goods, whereas the output of the third sector is largely non-tradeable. Devaluations improve the relative ability to pay higher wages in tradeable goods sectors compared to non-tradeables; this was probably the most important reason why real wages in manufacturing rose relative to transport, communications and construction. On the other hand, changes in domestic prices of commodities relative to manufactures would have disparate effects on incomes in the manufacturing and agricultural sectors. Indeed, there is a close correlation between changes in relative prices and movements of wage differentials between these sectors; in all countries where domestic agricultural prices fell in relative terms, real agricultural wages either declined more than in manufacturing or rose less.

The relationship between domestic agricultural and manufacturing prices is influenced by a variety of factors, including changes in world markets, the extent to which domestic agricultural prices are decoupled from world prices through pricing policy (including subsidies), the degree of tradeability of goods produced by these sectors and exchange rate policies. In most countries the fall in world agricultural prices has been mirrored by sharp declines in domestic agricultural prices relative to manufacturing (chart 8). In some countries the fall was limited by government pricing policies. But in some poorer countries, agricultural prices were raised considerably in order to stimulate export production - a factor that also contributed to the fall in commodity prices in world markets. In certain cases prices in agriculture moved much more favourably against industry as a whole than against the manufacturing sector. This was particularly true for major oil exporters after 1985, on account of the effect of the sharp fall in oil prices on industrial costs. There can be little doubt that such major price swings altered the relative positions of various classes and groups in agriculture and industry.

Another key price change has been in the real domestic rate of interest. In most countries domestic real interest rates stood at much higher levels in recent years than at the beginning of the decade, with increases exceeding 15 percentage points in a number of countries (chart 9). In most cases this was not so much because inflation slowed down as because nominal rates were raised sharply relative to the rate of inflation. Many governments found this necessary to check shifts into foreign currency assets in domestic markets (i.e. currency substitution) and capital flight in the face of increased world interest rates, currency depreciations and increased political risk of holding domestic currency assets.

Table 27

REAL WAGES BY SECTOR IN SELECTED DEVELOPING COUNTRIES IN THE 1980s

(Percentage change between the years indicated)

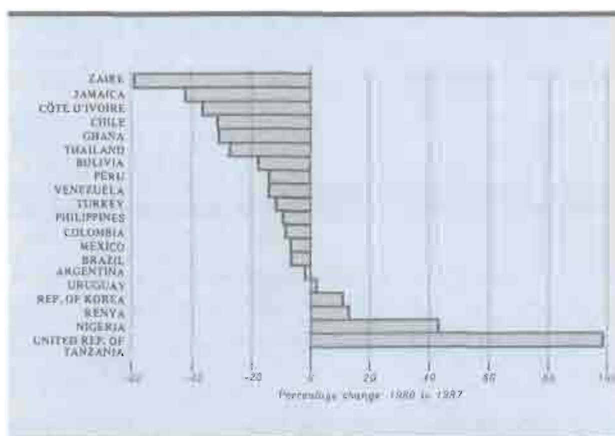
Country	*Period*	*Manufacturing*	*Transport, communications and construction*	*Agriculture*
Chile	(1982-1987)	-8.2	-17.2	-37.3
Ghana	(1980-1985)	4.3	-26.0	-5.5
Kenya	(1980-1987)	-10.5	-23.7	-10.6
Mexico	(1980-1985)	-16.4	-22.8	-27.9
Rep. of Korea	(1980-1987)	50.0	25.3	14.9
Uruguay	(1984-1987)	15.5	16.4	6.8

Source: UNCTAD secretariat estimates, based on ILO, *Year Book of Labour Statistics*; and IMF, *International Financial Statistics* (various issues).

Chart 8

CHANGES IN THE DOMESTIC TERMS OF TRADE BETWEEN AGRICULTURE AND MANUFACTURING [a] FROM 1980 TO 1987 [b] IN SELECTED DEVELOPING COUNTRIES

(Percentage points)



Source: UNCTAD secretariat calculations, based on World Bank, *World Tables* (various issues).

a Including mining and construction for Côte d'Ivoire and Uruguay.

b Except for Brazil, Ghana and Peru (1980-1985), Chile (1980-1983) and Mexico (1980-1984).

Increases in real interest rates resulted in a substantial transfer of income from domestic debtors to rentiers. The former often included not only the public sector, but also small and medium-size corporations, and small and self-employed producers in agriculture, services and industry. Since the financial liabilities of these sectors normally exceed considerably their financial assets, they have to allocate a higher proportion of their real incomes to domestic debt servicing. In many countries higher real interest rates have brought about an internal transfer of 2 - 5 per cent of GDP.

4. *Income distribution, inflation and social conflict*

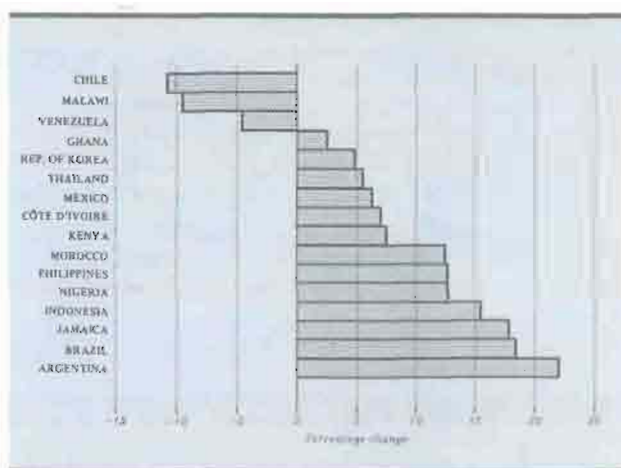
The changes in the level and distribution of income discussed in the preceding sub-sections have not brought about a smooth and orderly adaptation to external shocks, but, rather, an unceasing process of disequilibrium and instability. Inflation has intensified and persisted because of conflicts over the distribution of the burden of resource transfers abroad, the recessionary character of the adjustment, and the changes in relative prices and incomes sought to generate and retain foreign exchange. In other words, resource transfers abroad and payments adjustment have been a cause, and not just a consequence, of macroeconomic imbalances. Disruption of macroeconomic stability by external supply shocks is not unique to developing countries; it was also the experience of the OECD countries in the 1970s, although on a much smaller scale (see box 9). This is the main reason why the problem of developing countries today has proved so difficult both to analyse and to tackle.

There can be little doubt that important differences exist among developing countries regarding growth and macroeconomic stability. It is true that almost every developing country suffering from persistent macroeconomic instability has not only incurred significant terms of trade and financial shocks but also experienced a drastic decline in growth. However, not every developing country that incurred such shocks has had the same experience regarding growth and macroeconomic stability. A small number of countries in East and South-East Asia successfully absorbed such shocks, and reversed the initial decline in economic activity, restoring a satisfactory rate of growth with price stability. On the other hand, a number of low-income countries in Asia and Africa have not been able to restore growth, but the degree of price instability in these countries has remained relatively moderate.

Chart 9

MOVEMENTS OF REAL INTEREST RATES [a] IN SELECTED DEVELOPING COUNTRIES

(Annual average percentage swing between 1979-1981 and 1986-1988)



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics*; Morgan Guaranty Trust Company, *World Financial Markets*; various national sources.

a The nominal rates underlying the calculations are: three-month treasury bill rate for Brazil, Ghana, Malawi, Morocco, Philippines, Thailand; one-month treasury bill rate for Jamaica; six-month deposit rate for Côte d'Ivoire, Indonesia, Kenya; three-month deposit rate for Nigeria, Republic of Korea, Venezuela; one-month deposit rate for Argentina, Chile, Mexico. The real interest rates have been derived by adjusting nominal rates per annum for the annualized rise in the consumer price index during the maturity of the instrument.

Policy differences have no doubt played an important role. However, it would be extremely simplistic to explain the persistent macroeconomic disorder in a large number of developing countries in terms of a pathology in policy-making. For one thing, policy makers do not enjoy the same degree of autonomy and discretion everywhere; they are subject, to varying extents, to social and political constraints that are closely related to institutional arrangements and the strength of political and social organizations. Thus, for certain policies to be effectively applied, certain institutions and organizations would need to be reformed, and, in some cases, suppressed. But since such institutional arrangements are deep-seated reflections of a country's history, such changes may be very difficult to undertake, and attempts to do so may prove disruptive and counterproductive. In any event, the relationship between policies and performance is not strictly linear, since much depends on the "initial conditions" as regards the social, political and economic environment. Indeed, under some conditions, the relationship can be non-existent or even perverse.

For many developing countries the success of adjustment in the 1980s has depended on their ability to initiate an export-led growth following an initial period of austerity to accommodate the external shocks; exports generate the foreign exchange needed to raise imports, and growth provides additional domestic resources for consumption and investment, thus, alleviating conflicts over income distribution. However, economic structure and social and political institutions have played an important role in determining whether there is scope for such a process. Where the scope has been absent, "chaotic" or "explosive" results have often followed.

Countries with a large tradeable goods sector, substantial industrial capacity and a production pattern similar to that of their major trading partners find it is easier to raise export earnings: since currency depreciation affects a large proportion of output, the degree of real devaluation and decline in real wages needed will be modest. If significant wage resistance does not develop, the required change in relative prices can be achieved without triggering a devaluation-price-wage-devaluation spiral. Moreover, if the overall rate of investment can be prevented from falling too much, the relative price swings will lead to substantial capacity expansion in tradeable goods sectors. As export-led growth picks up, inflation can be reduced and real wages raised without eroding competitiveness. Such has been the experience of, for instance, the Republic of Korea where, after a sharp initial drop in GDP, domestic absorption and investment, and a rise in inflation during 1980-1981, growth picked up based on exports, and inflation was brought under control.

Box 9

RESOURCE LOSSES, SOCIAL CONFLICTS AND INFLATION: A COMPARISON OF OECD COUNTRIES IN THE 1970s AND DEVELOPING COUNTRIES IN THE 1980s

Stagflation in OECD countries during the 1970s and early 1980s is often attributed to the terms of trade losses and the consequent conflicts over income distribution brought about by oil price rises. In the immediate aftermath of the first oil price rise in 1973, the OECD secretariat put the problem in the following terms: "It is evident that our countries are suffering from a psychological shock, with adverse effects on business and consumer confidence ... The most serious aspect is the very strong momentum which inflation has attained, propelled by the interaction between wage and price increases and by the efforts of various groups in the society to improve, maintain or restore their relative positions ... if real growth is adversely affected, conflicts over the distribution of available incomes may increase."[1] As inflation accelerated, the OECD secretariat warned: "There is a danger ... that high rates of inflation will be kept going by a wage/price spiral, as different groups within the community struggle to offset the large changes in relative prices ... at this point the inflation switched from being an essentially exogeneous phenomenon ... to a basically endogeneous phenomenon."[2]

The policy challenge was onerous, "probably unprecedented outside time of war. And since governments are having to rely on peace-time, rather than war-time, responses from their constituents, the effects are proving particularly hard to absorb ... It is beyond argument that governments are today faced with policy dilemmas which will severely tax their ability to obtain domestic and international consensus on the priorities to be observed ... The challenge to economic policy is to find ways of slowing down inflation and resuming economic growth at the same time. Reliance on restrictive demand management alone would not be enough to check inflation sufficiently in many OECD countries; nor would it be politically feasible to continue such policies indefinitely."[3]

Similar conflicts and policy dilemmas also emerged after the second oil price rise in the late 1970s. In both episodes cumulative terms of trade losses in the OECD area as a whole amounted to about 2 per cent of GDP (see table below). The average rate of inflation increased by two-and-a-half times during the first episode, and two thirds during the second, and the OECD economies experienced two long and deep recessions. Reduced growth and increased unemployment in the early 1980s served to reverse the earlier terms of trade losses by exerting downward pressure on commodity prices. This greatly helped to bring inflation under control in the major OECD countries, allowing profits to be restored without putting pressure on prices and wages.[4]

Resource losses: OECD in the 1970s and the highly indebted developing countries in the 1980s

	Highly indebted countries	*Total OECD*	
	1980-1981 to 1986-1987	*1973 to 1975*	*1979 to 1982*
Change in per capita GDP (per cent)	-9.8	-1.2	0.2
Change in per capita domestic absorption (per cent)	-17.8	-2.5	-1.0
Terms of trade losses (per cent of GDP in 1980-1981)	-5.1	-2.1	-2.0
Swing in the trade balance (per cent of GDP in 1980-1981)[a]	4.2	-1.1	-0.6

Source: UNCTAD secretariat calculations.

[a] A positive figure indicates a decline in net external transfers.

RESOURCE LOSSES, SOCIAL CONFLICTS AND INFLATION: A COMPARISON OF OECD COUNTRIES IN THE 1970s AND DEVELOPING COUNTRIES IN THE 1980s

A comparison of this experience with that of debt-troubled developing countries in the 1980s shows that:

- Income transfers from developing countries due to terms of trade and interest rate shocks, have been four times the terms of trade losses by OECD countries as a proportion of GDP;
- These losses have also been more enduring; the ability of developing countries to reverse resource losses by their own action has been much more limited. By contrast, the rise in inflation in OECD helped to restore terms of trade by its impact on export prices, while the recession served to depress import prices;
- The capacity of developing countries to adjust has been much more limited, since resource losses also meant shortage of foreign exchange on which domestic production and investment crucially depended; thus, trade deficits had to be reduced through deflation and import cuts. By contrast, in OECD (as in many oil-importing countries in the 1970s) higher oil prices meant increased spending on imports, and the consequent trade deficits were financed through capital markets;
- The declines in per capita GDP and domestic absorption in developing countries have been much greater. Despite this the surge in inflation (by three times between 1980-1981 and 1987-1988) was comparable in relative terms to that in OECD during the first oil price rise.

1 *Economic Outlook*, No. 14, Dec. 1973, pp. 5-9.
2 *Ibid.*, No. 15, July 1974, pp. 5, 27.
3 *Ibid.*, No. 16, Dec. 1974, pp. 5, 10.
4 *TDR 1987*, part one, chap. 2, sect. B.

The scope for such an adjustment is extremely limited in countries where the export sector is heavily concentrated on a few primary commodities. In those where the export structure is more diversified and includes also manufactured goods, but the foreign trade sector is small, it will be difficult to adjust the trade balance primarily through exports; imports may need to be reduced through substantial cuts in domestic demand, particularly investment. Unless the initial rate of investment is very high, the drop in capital accumulation will limit the ability to generate exports and growth over time. In that case, it may be impossible to raise exports without further depressing demand and growth. Moreover, the currency will need to depreciate much more, intensifying conflicts over income distribution. Such conflicts will be especially sharp where income inequalities are initially already wide and political mobilization along functional lines is highly developed. Real devaluations will then require repeated nominal devaluations and, hence, accelerated inflation. Unless mark-ups in industry are highly flexible, the normal prescription to combat inflation, namely, demand restraint, will reduce output and employment rather than inflation. It will also worsen the terms of trade of agriculture with industry since agricultural prices tend to be more sensitive to demand. Social and political tension will thus sharpen further. It might be possible to attain price stability for a while through drastic deflation or social consensus, but it will not last long if growth is not restored. Attempts to do so by expanding demand are frustrated by the external payments constraint; a new round of payments adjustment will be needed, involving cuts in domestic absorption and currency devaluation, undermining price stability. The extreme difficulty of reconciling growth and stability without a reduction of resource transfers abroad is clearly demonstrated by the experience of a number of countries in the western hemisphere.

The extent of conflict over income shares and of wage resistance depends on the institutional structure of the labour market and the role played by labour organizations in political decision-making through their formal or informal relations with political parties and organizations. The institutional structure includes such elements as trade unions, collective bargaining, established rules and procedures governing job security, unemployment compensation, cost-of-living adjustment, minimum wages, etc., and differs considerably from

country to country.[91] For instance, rates of unionization of the labour force are much higher in some countries (e.g. Brazil, Chile, Colombia, Mexico, Philippines and Venezuela) than in others (e.g. Indonesia, Malaysia, Republic of Korea and Thailand, as well as many low-income countries). In many countries with a low degree of unionization the right to strike is not recognized or is subject to prior authorization from the government. Labour militancy and the number of working days lost per employee in labour disputes have been typically much greater in Latin America than in Asia and Africa. Similarly, many countries with strong trade union movements have legislation regarding minimum wages and mandatory cost-of-living adjustments, and wage setting is usually at the industry or regional level, often with direct government involvement, whereas in others such legislation is absent or ineffective and wage setting is much more segmented. Similarly, the degree of concentration of the working population in large urban areas is, in general, much greater in the former group of countries, which tends to increase popular political mobilization and limits the ability of governments to localize and isolate resistance and conflicts.

Social conflicts in countries with large, concentrated and politically mobile working populations can only be managed through continuous growth in employment and consumption. External borrowing in the past helped alleviate, or postpone, such conflicts by raising growth above what was possible with domestic resources alone. By the same token, the debt problem has served to aggravate such conflicts in the 1980s. Growth also allowed inflation, although high, to be kept relatively stable, and indexation mechanisms served to reduce its impact. However, as growth collapsed and conflict over income distribution intensified, changes in relative prices and income distribution could only be attained in the context of accelerated inflation.

The scope and effects of policies were also subject to social and political constraints in countries without strong labour movements. Indeed, even in countries where the populace does not have political leverage, concern with its well-being often figures prominently in the design of policies. Thus, in some countries where the poor are located mainly in rural areas, reduction of inflation is often a political necessity.[92]

The financial sphere was also an arena of conflicts over income distribution. Rentiers were able to influence financial policies where the degree of financial openness was greater. The extent of exchange controls is one determinant of openness, but there are also others, such as the importance of tourism and workers' remittances in total foreign exchange earnings, the presence of transnational corporations in financial and non-financial activities (which can transfer funds in and out of the country with greater ease) and the physical proximity to hard-currency areas. These factors facilitate the establishment of an efficient and well-organized informal (i.e. the so-called "curb") market in foreign currency and, hence, access of residents to foreign currency assets. Curb markets increase the scope for currency substitution and capital flight, giving the rentier class greater bargaining strength. They also tend to amplify instability arising from payments difficulties, and to restrict the ability of governments to control interest and exchange rates. In these respects too there are considerable differences among developing countries. For instance, it has been argued that the financial system in the majority of the developing countries in the western hemisphere has been relatively more open and capable of generating autonomous disturbances than in many countries in Asia and Africa.[93]

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91 A detailed comparative analysis is given in Tariq Banuri and Edward J. Amadeo, *The Importance of Institutions and History in Development Policy: A Comparison of Macroeconomic Experience in Asia and Latin America* (WIDER, Helsinki, June 1987).

92 For the evidence, based on a number of case studies, on the importance of "social matrix" in circumscribing policies see Lance Taylor, *Varieties of Stabilization Experience: Towards Sensible Macroeconomics in the Third World*, (WIDER, Helsinki, 1987).

93 For evidence and comparison see Banuri and Amadeo, *op. cit.*, and Taylor, *op. cit.*

B. Fiscal and monetary management

Payments crises and inflation in developing countries are generally attributed to excessive fiscal deficits and the consequent monetary expansion. While this proposition may be valid under certain circumstances, it does not tally with the events in the 1980s. First, as is now well known, the payments crisis was triggered by the sharp changes in the terms of terms of trade and interest rates in the early 1980s and aggravated by cutbacks in lending, and these shocks endured much longer than expected; the debt burden is still present and the terms of trade of debtor countries remain depressed. Second, as already discussed, the acceleration of inflation has been the outcome of massive transfers abroad and of the exchange rate changes which have been a major component of the process of payments adjustment. Third, persistent and large fiscal deficits and rapid monetary expansion have been the effects, even more than the causes, of payments crises and inflation. This last issue is the subject matter of this section.

Most analyses of the payments adjustment in developing countries in the 1980s have emphasized the balance of payments consequences of external shocks and the payments aspect of the transfer of resources abroad. Much less attention has been given to the incidence of these shocks on the finances of the public sector and the consequences for it of payments adjustment. As is shown in this section, not only has the burden of external shocks fallen disproportionately on the public sector, but also the measures taken to deal with external payments and stagflation have aggravated fiscal imbalances. The reconciliation of different policy objectives has not proved possible without entering into a number of serious trade-offs, and fiscal and monetary aggregates have been strongly influenced by factors beyond the control of governments. In combination with social and political constraints on policy decisions, this explains the fiscal and monetary disorder in many debtor countries.

The external shocks exerted a direct influence on the public sector accounts primarily through two channels:

- Since a very large proportion of external debt is serviced by the public sector, the rise in interest payments added considerably to public sector deficits, whereas cutbacks in lending created a domestic financing problem. In many countries the external transfer problem became also a budgetary transfer problem. Resistance by the private sector to making such transfers was evident in a struggle between the private and public sectors over domestic resources. In particular, a trade-off emerged between export and fiscal performance in countries undergoing adjustment through private sector export expansion, in so far as increased export earnings had to be used for debt service and hence transferred abroad by the public sector;
- The collapse of commodity prices reduced government revenues from exports because of declines in export taxes and public sector export earnings, especially in oil-exporting countries.

Trade adjustment and measures taken to deal with external imbalances have impinged directly on fiscal balances in a number of ways:

- Reduced imports by the private sector have added to budget deficits, particularly where tariffs and other import charges were an important source of government revenue;
- Reductions in tariffs have also reduced government revenues, since they could not be translated into higher imports because of foreign exchange shortages. For the same reason, additional government revenues generated were small where quantitative restrictions on imports were replaced by tariffs;
- In most countries currency depreciations added to budget deficits by raising the domestic currency value of debt servicing and the cost of imports for public investment. Although they also raised government revenues from trade, this effect was not generally strong enough to offset their expenditure-raising effects;
- Resort to many of the voluntary debt-conversion facilities has tended to aggra-

vate the domestic transfer problem, while bringing little benefit in terms of foreign exchange availability. If undertaken on a large scale, it could necessitate increases in the monetary base, thereby undermining monetary control and exchange rate stability.

Public sector deficits have also been swollen by the effects of slower economic activity and accelerated inflation:

- Tax revenues from large incomes and profits, and transactions in domestic goods and services, have fallen or stagnated along with economic activity;
- Accelerated inflation has reduced real tax revenues due to collection lags and tax deductibility of corporate interest payments;
- Cuts in public spending, in particular investment, have had deficit-enlarging as well as deficit-reducing effects. They have reduced public sector revenues both directly by their effects on earnings from public capital assets and indirectly through their contractionary effect. Investment cuts have also reduced the scope for increasing efficiency in public enterprises, necessitating sharp increases in the prices of public sector goods in order to reduce deficits, with attendant consequences for price stability;
- The increased riskiness of public debt, in combination with real depreciations of the domestic currency, have necessitated sharp increases in real interest rates on domestic debt in order to check capital flight, while the acceleration of inflation has pushed nominal rates to very high levels. Consequently, the need to finance deficits domestically when external financing was reduced gave rise to an unprecedented pace of domestic debt accumulation; government deficits (as conventionally measured) started to move almost one-to-one with the rate of inflation as interest rates kept pace with the latter.

Fiscal adjustment in the 1980s has thus had to take place under extremely adverse circumstances characterized by various trade-offs and endogenous influences beyond the control of governments. Nevertheless, public sector deficits in many debtor countries have been brought down from the very high levels they reached during the early 1980s as a result of external shocks, to the levels of the late 1970s. This experience will be examined first, followed by an account of various influences summarized above.

1. *Fiscal and monetary experience*

(a) *External shocks and fiscal balances: 1979-1982*

Because of data shortcomings it is not always possible to give a precise description of the evolution of the financial position of the public sector, including all levels of government and public enterprises. Table 28 gives deficits of the consolidated central government budget (i.e. the traditional concept of "budget deficits"), whereas table 29 gives some estimates of deficits for the public sector as a whole, and also shows (for a smaller number of countries) central bank losses as a source of monetary expansion.[94] Deficits of the public sector - i.e. the public sector borrowing requirement (PSBR) - are typically greater than that of the central government budget because of deficits of state and municipal governments and, particularly, public enterprises, which hold an important place in many developing countries. Nevertheless, there is a close correspondence between their movements; central government deficits are directly influenced by the financial position of other parts of the public sector through transfers from the budget. For instance, an increase in interest payments on external debt or a decline in borrowing abroad by public enterprises often entails greater transfers, raising the deficit of the central government.

With the exception of a very few countries, the central budget was in deficit during the late 1970s. However, in most countries the deficits were relatively moderate, barely reaching 3 per cent of GDP. For the highly indebted countries included in table 28, budget deficits were, on average, less than 2 per cent of GDP, and primary deficits (i.e. deficits excluding interest payments) were almost nil, whereas some low-income countries had sizeable deficits stemming largely from development expenditures financed with external resources. The

[94] In these tables, and in a number of other tables and charts in this chapter where changes (swings) in a given period are indicated, the comparison is always of one period (usually a biennium) with another. For example, 1978-1979 (or 1978-79), refers to an average of the two years 1978 and 1979. Where an average of fiscal years is compared with one for calendar years (e.g. budget deficits as a proportion of GDP) the fiscal year is that which overlaps to the greatest extent with the calendar year.

Table 28

BUDGET DEFICITS [a] IN SELECTED DEVELOPING COUNTRIES

(Percentage of GDP)

Country	Total balance			Primary balance		
	1978-1979	1981-1982	1986-1987	1978-1979	1981-1982	1986-1987
Argentina	-2.9	-7.8	-5.6	-0.9	-3.8	-3.4
Bolivia	-2.8	-10.4	-2.8	-2.5	-3.5	..
Brazil	-1.1	-2.5	-12.8 [b]	0.9	0.1	-1.2 [b]
Chile	2.4	0.8	1.0	3.8	1.3	3.0
Colombia	-0.1	-3.9	-1.3	0.3	-3.1	0.0
Costa Rica	-5.9	-1.9	-2.7	-4.2	-0.3	-0.1
Ecuador	-0.9	-4.6	-3.4	1.0	-1.0	1.1
Ghana	-9.6	-7.1	0.3	-7.6	-5.2	2.0
Indonesia	-2.6	-1.9	-2.2	-1.5	-1.0	0.6
Jamaica	-12.8	-14.9	-1.4 [b]	..	-6.8	9.0 [b]
Kenya	-5.6	-7.8	-6.5	-3.9	-4.9	-1.9
Malawi	-8.8	-9.7	-7.3 [b]	-6.7	-5.2	-1.1 [b]
Mexico	-3.0	-11.1	-10.5	-1.4	-7.6	3.3
Morocco	-10.1	-12.8	-8.8 [b]	-8.1	-9.1	-3.1 [b]
Nigeria	-1.6	-7.4	-5.4	-0.4	-5.2	1.2
Peru	0.7	-3.5	-4.7	4.0	0.1	-2.7
Philippines	-0.7	-4.1	-4.0	0.1	-3.2	0.4
United Rep. of Tanzania	-11.7	-7.2 [c]	-5.5 [d]	-10.4	-5.1 [c]	-3.5 [d]
Uruguay	-0.3	-5.3	-1.4	0.4	-4.6	0.2
Venezuela	-1.1	-2.9	-0.6	0.3	-0.8	3.0
Zaire	-7.9	-10.1	-7.2	-5.7	-6.2	-2.5

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

a Consolidated central government. The primary deficit equals the total deficit less interest payments. A minus sign indicates a deficit.

b 1986.

c 1981.

d 1985.

PSBR, on the other hand, was much greater, reaching or exceeding 10 per cent of GDP in a number of countries. While this was partly due to operating losses of public enterprises, it reflected, in large part, the excess of investment over savings which was financed by borrowing from abroad. In some countries which subsequently experienced debt crisis, the PSBR was at sustainable levels before the onset of the recession and the jump in world interest rates.

After the shocks, however, budget deficits shot up almost everywhere in a matter of a couple of years. In the highly indebted countries, they increased more than threefold, reaching, on average, 6 per cent of GDP; interest payments as a proportion of GDP almost doubled, and primary deficits rose to reach 3 per cent of GDP. This was also true for the PSBR, particularly for some major debtors (e.g. Argentina and Mexico), where the increase was due, in large part, to mounting interest payments. An important part of these deficits was financed by borrowing from abroad, thereby accelerating the pace of debt accumulation.

While budget deficits were raised initially by the combined effects of the slowdown in economic activity and sharp increases in interest payments, the cutback in commercial lending after 1982 aggravated the problem, increasing the need for fiscal adjustment. The decline or reversal of financial transfers had to be accommodated through fiscal action because so much of the external debt was serviced by the public sector.

Moreover, concern with the disruptive effects of increased debt servicing led many governments to assume greater responsibility by socializing private sectors' external liabilities and collectivizing the transfer burden. This happened in a number of Latin American countries, where the private sector had free ac-

Table 29

PUBLIC SECTOR DEFICITS AND CENTRAL BANK LOSSES IN SELECTED DEVELOPING COUNTRIES

(Percentage of GDP)

Country	PSBR [a]			Primary deficit			Central bank losses		
	1978-1979	1981-1982	1986-1987	1978-1979	1981-1982	1986-1987	1978-1979	1981-1982	1986-1987
Argentina	-6.5	-14.3	-4.5	-3.4	-5.4	-2.0	-3.5 [b]	-5.0	-1.8
Bolivia	-9.1 [b]	-11.8	-6.8	..	..	..	..	..	..
Brazil	..	-14.2	-10.8 [c]	..	-1.9	0.5 [c]	..	..	..
Chile	4.8 [d]	-1.3	-1.8 [c]	6.0	-0.9	0.6 [c]	1.0 [b]	-0.5 [e]	-9.5
Colombia	-0.2	-5.6	-1.1	0.8	-4.1	2.8	..	..	..
Costa Rica	-10.6	-11.2	-1.0	..	..	..	..	..	-3.4
Côte d'Ivoire	-8.7	-12.3	-3.6 [f]	-6.2	-6.2	6.3 [f]	..	..	..
Ecuador	-2.8	-6.7	-2.5 [c]	-1.0	-3.1	2.0 [c]	..	..	..
Jamaica	-13.8	-15.4	0.1	..	..	..	..	-0.4	-5.6
Malawi	-11.7 [b]	-14.0	-7.5 [g]	-9.7 [b]	-10.4	-2.1 [g]	..	..	..
Mexico	-7.4 [d]	-15.5	-15.9	-4.0 [d]	-8.9	3.6	..	..	..
Morocco	-10.7	-12.8	-4.0	..	..	1.8 [c]	..	..	..
Peru	-3.9	-7.0	-5.7	-0.8	-2.5	-2.8	..	..	..
Philippines	..	-7.0	-1.5	..	-6.1	5.1	..	..	-2.2
Uruguay	0.5 [b]	-6.1 [e]	-1.3	..	..	..	0.0	-8.3 [e]	-4.6
Venezuela	-4.8	-5.3	-6.1 [c]	-3.4	-0.5	-0.9 [c]	..	..	..

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

a PSBR: public sector borrowing requirement. Includes all government and public enterprises; excludes central bank losses. A positive sign indicates a negative PSBR or a primary budget surplus or central bank gain.
b 1980.
c 1986.
d 1979.
e 1982.
f 1984.
g 1985.

cess to external finance without prior government approval and government guarantee, on the assumption that private firms could be expected to assess carefully the costs and benefits of domestic and foreign debt. This assumption proved incorrect, resulting in overborrowing by the private sector. In such countries the subsequent socialization of private sector liabilities raised the debt burden of the public sector by 15 - 20 per cent. Assumption of financial losses of private firms and banks, and exchange rate guarantees and preferential exchange rates given to private debtors, explain a large part of central bank losses in a number of countries where such actions were taken (e.g. Argentina, Chile, Costa Rica, Philippines and Uruguay). In Chile, for instance, these losses amounted to almost 10 per cent of GDP during 1986-1987; when added to PSBR, they raised public sector deficits in that country to the levels of the high-deficit countries of the region. Other factors were also important in some countries (e.g. Jamaica and Venezuela). Delays in import transfers because of foreign exchange shortages entailed losses for central banks when the currency depreciated. In certain countries interest payments on bank reserves were not covered by interest received from rediscounts and lending to the public sector. Losses were also incurred from foreign exchange interventions.

The decline in net transfers has exceeded, on average, 4 per cent of GDP - a large figure in view of the fact that the budget generally did not exceed 20 per cent of GDP. Some estimates of the fiscal burden are given in table

95 Due to data problems, the estimates in table 30 are based on net transfers related to public and publicly-guaranteed debt rather than debt serviced by the central government (and the central bank which, for the purpose of the analysis here, needs to be consolidated with the central government). This may give rise to underestimation rather than

Table 30

FISCAL ADJUSTMENT NECESSITATED BY SWINGS IN FINANCIAL FLOWS, FROM 1981-1982 TO 1986-1987 IN SELECTED DEVELOPING COUNTRIES [a]

(Percentage)

Country	Swing in net transfer as a proportion of: Real revenue [b] (1)	Swing in net transfer as a proportion of: Real expenditure [c] (2)	Deficit-enlarging effect of swing in net interest payments as a proportion of real revenue [b] (3)
Argentina	29.6	22.0	22.4
Bolivia	-48.7	-28.5	-50.8
Brazil	10.1	9.8	-0.3
Chile	5.6	5.9	7.8
Colombia	15.1	13.9	10.7
Costa Rica	49.6	55.3	13.3
Côte d'Ivoire	30.0	30.5	2.3
Ecuador	-20.8	-19.5	3.9
Egypt	10.6	9.6	0.9
Ghana	-70.0	-33.0	8.9
Indonesia	12.9	7.3	9.7
Jamaica	51.4	38.1	12.1
Kenya	3.7	2.9	3.2
Malawi	-5.2	-3.4	-4.5
Mexico	19.6	12.7	1.4
Morocco	18.4	14.1	1.5
Nigeria	14.1	21.8	-1.8
Peru	1.6	1.6	-7.4
Philippines	36.5	29.2	17.1
Sudan	72.3	49.2	-3.0
Tunisia	8.7	10.2	4.0
United Rep. of Tanzania	18.2	12.1	0.0
Uruguay	13.3	11.3	5.2
Venezuela	9.2	9.0	1.2
Zaire	-2.1	-1.3	1.2

Source: UNCTAD secretariat calculations, based on World Bank, *World Debt Tables 1988-89 Edition*; IMF, *International Financial Statistics*, various issues; IMF, *Government Finance Statistics Yearbook*, various issues; national sources.

a A negative sign indicates a positive swing and a deficit-reducing effect, respectively.
b Excluding grants.
c Domestic spending (i.e. excluding interest payments abroad).

30.[95] This is measured, first, in terms of percentage increases in real government revenues needed to accommodate the swing in net transfers between 1981-1982 and 1986-1987 without resorting to cuts in real government domestic spending (i.e. total real government spending minus interest payments abroad), an expansion of the monetary base or an increase in domestic borrowing. In very few countries (only Bolivia, Ecuador, Ghana, Malawi and Zaire) net transfers were, on average, less negative or more positive in 1986-1987 than in 1981-1982, whereas in most the average rate of increase needed was 21.5 per cent for this roughly half of a decade, or 4 per cent per annum. For some countries the figure was as high as 10 per cent per annum, and not necessarily for the highly indebted commercial borrowers. Indeed, a number of official borrowers (e.g. Costa Rica, Jamaica, Sudan and United Republic of Tanzania) needed higher increases in real government revenues, at an average rate

overestimation of the fiscal burden, since swings in, rather than absolute levels of, net transfers are used. Governments in debtor countries today service a much greater proportion not only of total debt but also of public and publicly-guaranteed debt.

of about 5 per cent per annum. In these countries declines in net transfers (in terms of GDP) were comparable to those in the highly indebted countries, but the dependence of the public sector on external resources was higher both because of closer links between the budget and external financial flows and because of the greater share of external finance in the budget.

An alternative measure of the fiscal burden is the percentage cut in real government domestic spending needed, in the absence of revenue increases, to accommodate the swings in resource transfers without resorting to money creation or increased domestic borrowing (column 2 of table 30). The size of the cut averages 18 per cent in countries with reduced or reversed transfers; in per capita terms it comes to almost one third. Here, too, the required reduction is greater for official borrowers. Avoiding cuts in public investment would have, on average, required doubling the government savings rate (expressed as a proportion of revenues), cutting per capita current spending by around 40 per cent, or cutting current non-interest spending by almost 50 per cent.

Swings in net financial transfers to the public sector have affected government finances in two ways. Increased interest payments abroad have raised budget deficits, and cuts in lending have created a need for increased domestic financing of these deficits. Experience has varied in these respects. In most countries shown in table 30 interest payments abroad rose, adding to budget deficits (column 3). The rate of increase in real government revenue needed to offset the rise in interest payments abroad between 1981-1982 and 1986-1987 was particularly large in some countries even though much of the deficit-enlarging effects of interest payments had already occurred during the late 1970s and early 1980s as a result of sharp increases in world interest rates. In most countries where interest payments abroad rose (Costa Rica, Côte d'Ivoire, Ecuador, Egypt, Jamaica, Kenya, Mexico, Philippines, Tunisia, Uruguay and Venezuela) net external borrowing (the difference between columns 1 and 3) also declined. In others (Argentina, Chile, Colombia, Ghana and Indonesia) net capital inflows increased, but, except in Ghana, not enough to offset mounting interest payments. Some 20-25 per cent of external interest payments in recent years by some highly indebted countries has been covered by bank lending designed to keep governments current on interest payments. This added to recorded budget deficits by about 2 per cent of GDP, without, however, altering the size of net transfers. On the other hand, in a number of low-income countries (Bolivia, Malawi, Sudan and United Republic of Tanzania) interest payments were smaller in 1986-1987 than in 1981-1982 as a result of official debt relief, helping to reduce budget deficits. However, as net capital inflows in some of these countries declined much faster, the need for governments to cut domestic spending or raise resources through taxation, through an increase in the money supply or through domestic borrowing was no less than that in the highly indebted countries with increased interest payments.

(b) Fiscal adjustment in the 1980s

The extent of the fiscal adjustment that was actually made varied from one country to another, but almost everywhere budget deficits and the PSBR were lower in 1986-1987 than in 1981-1982. In the highly indebted countries, taken as a group, the decline in budget deficits was moderate, but the PSBR was reduced to 4.5 per cent of GDP. More importantly, the primary deficit of the central budget was cut from more than 3 per cent of GDP in 1981-1982 and brought to a surplus, giving a swing of 4 per cent of GDP; for the public sector as a whole the swing was even greater (5 per cent). In a number of countries the extent of adjustment in the primary deficit was 10 per cent of GDP or more (e.g. Côte d'Ivoire, Jamaica, Malawi, Mexico and Philippines). Indeed, in the majority of the debt-troubled countries the primary budget was in surplus during 1986-1987 for both the central government and the public sector as a whole.

Table 31 describes the fiscal adjustment since the early 1980s. Although there are significant variations among countries, a number of common features can be observed. First of all, fiscal adjustment involved mainly spending cuts rather than revenue increases. In a small number of countries where revenues rose, this was largely due to increased prices of public sector goods and services, as well as to the sale of public assets (which are typically included among revenues), rather than to increases in tax revenues. Indeed, with a few exceptions, tax revenues declined or were constant. Interest payments rose almost everywhere, except in Argentina and Peru, where domestic and external interest payments, respectively, were reduced. Primary spending was cut almost everywhere, with cuts exceeding 5 per cent of GDP in half of the countries. Such cuts occurred even in countries where revenues increased. There were widespread cuts in current non-interest expenditures, including public administration, social spending and transfers. However, the burden fell primarily on capital

Table 31

FISCAL ADJUSTMENT FROM 1981-1982 TO 1986-1987 IN SELECTED DEVELOPING COUNTRIES

(Change as a percentage of GDP)

Country	Fiscal component					
	Total revenue [a]	*Tax revenue*	*Total expenditure*	*Interest payments*	*Current non-interest expenditure*	*Capital expenditure*
Public sector [b]						
Argentina	3.1	2.3	-6.7	-6.4	0.9	-1.2
Bolivia [c]	4.5	5.4	-5.0	..	..	-3.0
Brazil [d]	-2.7	-3.4	10.6	17.6	-4.8	-2.2
Chile [e]	1.3	-0.6	1.8	2.0	-2.7	2.5
Colombia	-4.4	1.0	-8.9	2.4	-11.8	0.5
Costa Rica	7.2	0.3	-3.0	..	..	-2.7
Côte d'Ivoire [f]	2.0	-2.3	-6.7	3.8	-2.6	-7.9
Ecuador [e]	-0.7	0.4	-4.9	0.9	-2.9	-2.9
Malawi [d]	0.1	0.1	-6.4	1.8	-1.0	-7.2 [g]
Mexico	5.0	0.6	4.1	10.6	-1.3	-5.2
Peru	-10.5	-3.0	-11.8	-1.6	-6.8	-3.4
Philippines	0.0	0.7	-5.5	5.7	-7.1	-4.1
Uruguay [e]	0.5	0.4	-4.3	..	..	-2.1
Venezuela [e]	-4.0	-2.5 [h]	-3.2	0.4	-1.4	-2.2
Central government						
Ghana	8.7	7.2	1.3	-0.2	0.8	0.7
Indonesia	-1.9	-3.4	-1.6	1.9	0.0	-3.5
Jamaica	3.5	..	-10.0	2.3	-7.4	-4.9
Kenya	-0.7	-1.9	-2.0	1.7	-1.5	-2.2
Morocco	-2.3	0.6	-6.3	2.0	-3.0	-5.3
Nigeria	2.1	..	0.1	4.4	-0.3	-4.0
Zaire	-7.0	-5.4	-9.9	0.8	-7.4	-3.3

Source: UNCTAD secretariat calculations, based on international and national sources.
a Including grants.
b Excluding the central bank.
c Total revenues and expenditures exclude state economic enterprises.
d Change between 1981-1982 and 1985.
e Change between 1981-1982 and 1986.
f Change between 1981-1982 and 1984.
g Development expenditures.
h Non-oil taxes.

spending, which was more than halved in a number of countries.

Efforts at fiscal adjustment in many developing countries compare favourably with those in the major OECD countries during the same period. There can be little doubt that the need for adjustment was also much greater. However, fiscal adjustment in developing countries has had to be undertaken under extremely unfavourable circumstances compared to the major OECD countries. In the major seven OECD countries, average budget deficits in 1986-1987 were lower by only 1.5 per cent of GDP than in the highly indebted countries taken together. Cuts in budget deficits between 1981-1982 and 1986-1987 barely reached 0.5 per cent of GDP even in countries such as the United Kingdom, where reducing the deficit was the primary goal of fiscal policy.

(c) Financing of deficits

The PSBR in most highly indebted countries was thus reduced to the levels of the late 1970s. In 1986-1987 it was higher, on average, by only one half of a percentage point of GDP than in 1978-1979, whereas interest payments were higher by 3 percentage points; about two thirds of the latter was due to increased interest payments abroad. However, adjustment in the primary budget was not enough to accommodate the swing in net transfers. Because of cut-backs in external lending, the PSBR had to be financed in domestic markets. This, in combination with increased central bank losses, was the main cause of increased monetary expansion and, in some countries, domestic indebtedness of the public sector.

Table 32 shows the central bank financing of public sector (or central government) deficits, as well as changes in the monetary base. Central bank claims on the public sector include lending to finance the deficits of the government and public enterprises and correspond to the conventional concept of "inflationary financing".[96] These figures also include the central bank losses of some countries that were indicated in table 29. For these latter countries, they thus correspond to the concept of "net domestic credit creation for the public sector", defined as the monetary base less net foreign assets and discounted obligations of the private sector, a concept based on a consolidation of the public sector and the central bank.

It should be noted that there is no one-to-one correspondence between increases in central bank claims on the public sector and monetary expansion. An increase in central bank lending to the public sector or in central bank losses may be offset by a decline in the discounted obligations of the private sector or an increase in reserve requirements of the banking system. In such cases the rate of monetary expansion will be unchanged, and the public sector will have been financed at the expense of the private sector.[97] Similarly, an increase in credit creation for the public sector can result in a loss of foreign exchange reserves or may be covered by external borrowing by the central bank without giving rise to an additional expansion of the monetary base.[98]

Indeed, these factors explain large differences between credit creation for the public sector and the pace of monetary expansion in some countries. For instance in Chile public sector deficits (including central bank losses) exceeded 15 per cent of GDP in 1985, and were financed through central bank credit creation for the public sector. However, in the same year the monetary base expanded by less than 1 per cent of GDP. The difference was explained partly by the decline in central bank credits for the private sector (about 2 percentage points of GDP) and a loss of foreign exchange reserves (another 2 percentage points), but largely by a sharp increase (about 8 percentage points of GDP) in foreign liabilities of the central bank, which was also reflected in positive net flows and net transfers from abroad in that year. Although in some other countries too external borrowing by the central bank prevented sharp increases in net credits to the public sector from being translated into increased monetary expansion, this experience was quite atypical in view of the reduced lending by banks and the persistent negative transfers experienced by the large majority of the debtor countries. Thus, in most countries central bank financing of public sector deficits went hand-in-hand with monetary expansion.

In most countries there is a close correlation between the evolution of public sector deficits and borrowing from the central bank. During the late 1970s, borrowing was small, barely exceeding 2 per cent of GDP in the highly indebted countries (where it averaged about 1 per cent of GDP during 1978-1979). With the increase in deficits, borrowing from central banks in those countries rose, reaching

[96] Increases in central bank claims on the public sector may exceed the PSBR if repayment of domestic and external debt by the public sector exceeds new gross borrowing at home and abroad.

[97] There are also other complications which sever the link between the PSBR and the monetary base. If the public sector borrows from commercial banks in order to avoid money creation by requiring them to hold government securities, and banks, in turn, borrow from the central bank, then the balance sheet of the central bank will show that the expansion of the monetary base is caused by increased claims of the central bank on the private, rather than the public, sector.

[98] A complication arises when the currency is devalued. If the central bank is a net debtor vis-à-vis the rest of the world, devaluation will raise the domestic currency value of foreign exchange liabilities. These valuation differences can affect the central balance sheet in many ways. If the foreign exchange was originally lent to the private sector without an exchange rate guarantee, the increase in the domestic currency value of the central bank's foreign exchange liabilities will be matched by an increase in central bank claims on the private sector, with no consequences for the credit expansion to the public sector. If there is an exchange rate guarantee and/or the debt is public, then the valuation difference will be matched by a decline in the net worth of the central bank and/or an increase in claims on the public sector. Credit creation for the public sector will have risen without any rise in the monetary base. The counterpart will be the rise in the domestic currency value of external debt.

Table 32

CENTRAL BANK FINANCING OF BUDGET DEFICITS IN SELECTED DEVELOPING COUNTRIES AND CHANGES IN THE MONETARY BASE

(Per cent of GDP) [a]

Country	Central bank claims on the public sector [b]			Monetary base		
	1978-1979	1981-1982	1986-1987	1978-1979	1981-1982	1986-1987
Argentina	5.5	10.5	5.9 [c]	6.6	15.4	2.4 [c]
Bolivia	3.2	9.5	-1.7	1.2	6.4	1.3
Brazil	2.3 [d]	-0.1	2.2 [e]	2.6	2.0	3.0
Chile	1.6	-1.3	15.1 [e]	3.0	-1.2	0.2 [e]
Colombia	-1.2	1.1	-0.4 [c]	3.6	2.1	0.1 [c]
Costa Rica	4.9 [d]	6.1	6.7	2.6	6.9	-0.5
Côte d'Ivoire	1.2	1.5	-0.1 [c]	1.8	0.2	0.5 [c]
Ecuador	-1.2	0.2	1.7	2.2	0.8	2.3
Ghana	6.3	4.3	9.8	6.4	3.0	3.0
Indonesia	1.0	-2.1	0.7	1.3	0.6	1.2
Jamaica	9.8	7.4	0.3	1.1	-0.7	2.8
Kenya	2.3	4.7	2.2	1.3	1.0	2.0
Malawi	2.5	5.8	3.5	-1.6	1.3	5.6
Mexico	3.2	9.0	3.0	4.0	8.2	3.4
Morocco	1.8	2.6	-2.5 [c]	2.2	1.4	2.9 [c]
Nigeria	0.5	6.0	2.6	0.5	0.3	1.1
Peru	2.9	2.8	2.5 [c]	6.0	5.4	5.8 [c]
Philippines	0.4	1.7	3.8	1.5	0.4	1.5
Uruguay	0.6	11.8	4.9	3.3	1.3	4.4
Venezuela	-1.1	0.9	-0.4	1.3	1.7	-0.2
Zaire	8.1	9.5	13.7 [c]	2.9	7.4	6.0 [c]

Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* (various issues); and table 29.

a Average annual change in each two-year period.

b Figures relate to the entire public sector for Brazil, Costa Rica, Ecuador, Ghana, Indonesia, Malawi, Peru and Philippines and to the central government budget for other countries. They include central bank losses for Argentina, Chile, Costa Rica, Jamaica, Philippines and Uruguay (see table 29).

c 1986.

d 1979.

e 1985.

3 per cent in the early 1980s. This was less than the increase in deficits as the latter were financed partly by increased borrowing from abroad, and, in some countries, by domestic borrowing. By 1986-1987, central bank financing was reduced along with public sector deficits, and both fell back to the levels of the late 1970s. Since, however, net external borrowing by the public sector was considerably smaller, the financing of public sector deficits with domestic debt rose, on average, by as much as the decline in external borrowing. But since, on the other hand, interest payments abroad also increased during that period, a greater portion of central bank financing was due to interest payments in recent years than in the late 1970s. Without such an increase in interest payments, the same amount of central bank financing (as a proportion of GDP) could have meant less domestic debt financing; or, the same amount of domestic debt financing could have been associated with reduced central bank financing.

There were, however, considerable differences in the domestic financing of public sector deficits. In the majority of countries the central bank financed an important proportion of the PSBR (or the deficits of the central government). In many others, however, domestic borrowing from commercial banks and the non-bank private sector, through the issuance of government paper, was equally and even more important. Indeed, the 1980s have witnessed a substantial accumulation of domestic

debt in a number of developing countries. This experience is unprecedented and closely related to the debt crisis. On the one hand, while cutbacks in lending forced governments to shift the financing of deficits to domestic markets, increased interest payments abroad made it very difficult to reduce the PSBR despite drastic cuts in spending. On the other hand, the acceleration of inflation and the rise in interest rates threatened to set off a dynamic process of domestic debt explosion whereby higher interest rates fed into a larger public deficit which in turn resulted in still higher debt and deficits through higher interest payments (see section 3 below). For instance, in Brazil and Mexico interest payments on domestic debt became the most important component of the PSBR, reaching or exceeding 15 per cent of GDP in recent years. During the early 1980s domestic debt was about 10 per cent of GDP in both countries; it rose rapidly, exceeding 20 per cent in Brazil and 40 per cent in Mexico during 1986-1987. In these latter years domestic debts of the public sector in these countries were as much as three quarters of their external debts.[99] Similarly, in a number of other countries public sector borrowing from commercial banks and the non-bank private sector rose rapidly, resulting in domestic interest payments in the order of 3-5 per cent of GDP (e.g. Jamaica, Kenya, Nigeria and Philippines).

2. *Payments adjustment and fiscal balances*

(a) *Conflict and consistency between payments adjustment and fiscal balances*

The preceding sections have shown that while declines in net transfers and in the terms of trade have been accommodated by cuts in import volumes and/or export expansion, in many developing countries the fiscal counterpart of this adjustment has not been attained. Fiscal adjustment has relied primarily on investment cuts, and monetary expansion and domestic debt accumulation remained excessive. Indeed, in some countries fiscal balances have deteriorated by more than the swing in external transfers by the public sector. This section and the following ones examine why.

The fiscal challenge has depended on a number of factors, including the respective role of import cuts and export expansion in trade adjustment and the public sector's involvement in export activities. Generating trade surpluses (or reducing trade deficits) itself generally required restrictive fiscal measures and cuts in public and private imports. However, while cuts in public sector investment and imports helped generate foreign exchange, stagflation, adjustment in key prices and import cuts by the private sector had an adverse impact on the balance between government revenues and spending. The domestic currency equivalent of increased trade surpluses, therefore, remained largely in the private sector, and had to be transferred to the public sector through increased taxation if further cuts in primary spending or increases in monetary expansion and domestic borrowing were to be avoided.

Where trade surpluses were generated primarily through import cuts, income transfers from the private sector were needed in order to meet debt servicing, whether or not there was public ownership in export sectors. But, to the extent that the trade balance improved on account of export expansion, the public sector's role as an exporter was a major determinant of the ease or difficulty of servicing external debt without adding to domestic fiscal imbalances. In countries where public ownership in export sectors was important and such exports were expanding, governments could at least partly cover the increased net transfers abroad without having either to tax the private sector or to lower public domestic spending. However, payments adjustment involved many problems on the fiscal front where export expansion was generated by the private sector, since the foreign currency needed to make transfers abroad had to be obtained from the private sector in order to effect the corresponding transfers abroad. Where government policies succeeded in raising net private sector exports but failed to prevent the private sector from translating additional export earnings into domestic absorption, and withdraw these resources for debt servicing, cuts in government domestic spending or increased monetary expansion or domestic borrowing were inevitable. In other words, there was a trade-off between export and fiscal performance in countries undergoing adjustment through private sector export expansion in so far as increased export earnings had to be transferred abroad by the public sector.

[99] See H. Reisen, "Public Debt. North and South", Conference Paper prepared for the World Bank Symposium "Dealing with the Debt Crisis", 26-27 January 1989, OECD, Development Centre, January 1989, Paris.

An increase in export receipts - for instance through a rise in prices for commodity exports - that enlarges import capacity will improve the fiscal balance whether or not the public sector is an exporter. Where it is, fiscal revenues will rise immediately, as commodity earnings rise, and will rise again as imports and economic activity increase. In economies where the increased export revenues accrue to the private sector, fiscal revenues will rise immediately to the extent that such receipts are taxed, and, as in the previous case, as imports and economic activity increase.

However, for troubled debtors, terms of trade gains do not translate automatically into increased imports and economic activity. Such countries have tended to find the supply of foreign loans reduced on the grounds that "new money" requirements have been lowered by the terms of trade gain. In that case imports and economic activity are kept in check, and the governments forgo the increased revenues that would otherwise be forthcoming. Especially difficult fiscal problems occur where the terms of trade gain accrues to private exporters (though not if it accrues to the public sector). The government will have to take restrictive measures to prevent imports from increasing and to offset the deterioration of its own balance stemming from the cut in foreign lending. If it is unable to accomplish the latter by taxing away the entire windfall accruing to exporters, other segments of society will have to bear a high tax burden if the government is to avoid deficit financing. Governments will naturally find that an extremely difficult undertaking in the face of rising export earnings.

Thus, if private creditors succeed in keeping the level of new lending to the bare minimum needed to avert non-payment, and if at the same time the availability of credit is made highly conditional on fiscal performance, an improvement in the terms of trade can, instead of bringing relief, exacerbate distributional conflicts and accentuate macroeconomic disorder.

Terms of trade losses can also create fiscal problems even when the burden initially falls entirely on the private sector, since restrictive government action will typically be required to ensure that import volumes are cut and/or export volumes raised sufficiently to make up for the terms of trade loss. However, the fiscal problem will be much more serious where the public sector is the exporter, in which case the decline in commodity prices is reflected immediately in increased budget deficits. With a higher proportion of public sector export revenues absorbed by debt servicing, the government is then unable to maintain domestic spending without additional taxation, money creation or domestic borrowing.

(b) Trade policy, trade taxes and government revenues

Trade shocks and adjustment exert an important influence on fiscal balances because taxes on international trade and transactions are an important source of government revenues - indeed more than income taxes in many developing countries - reaching, on average, 5 per cent of GDP and more than a quarter of total tax revenues. Most of such revenues come from import duties, but export taxes are also important in countries exporting agricultural commodities. Trade taxes are typically more important in low-income countries, where they often reach 8 per cent of GDP.

It is generally recognized that fiscal stance is an important determinant of the trade balance, but it is less well appreciated that changes in the trade balance themselves exert a powerful and direct impact on government revenues. Indeed, not only is there a strong, positive correlation between trade and fiscal cycles, but also the former often lead the latter, with government revenues generally falling after a worsening of the trade balance.[100]

Government revenues from trade taxes are determined by (a) the volume and prices of imports and exports (or, simply, the trade performance); (b) tax rates on traded goods (or, the degree of trade liberalization); (c) the real exchange rate (or, the real value of the trade tax base in terms of domestic currency). These are not independent of each other; not only is trade performance influenced by tax rates and the real rate of exchange, but also, in the design of trade policies tax and exchange rates are often considered together.

Given the tax and exchange rates, increases in imports and exports both generate higher government revenues. Thus, the trade balance adjustment (i.e. reduction in trade deficits or enlargement of trade surpluses) necessitated by a deterioration in the terms of trade and external financial flows will improve fiscal balances if it raises the levels of both exports and imports, but not if it is accomplished through import cuts. Government revenues will be adversely affected even if import cuts are

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[100] See Ke-young Chu, "External Shocks and Fiscal Adjustment in Developing Countries: Experiences During 1962-82", unpublished manuscript (WP/87/48), IMF, Washington, D.C., 1987.

accompanied by some increases in export earnings, since tax rates are typically much higher for imports than exports. On the other hand, declines in commodity prices will result in considerable revenue losses for governments in countries where export taxes are important.

Trade liberalization can significantly alter the fiscal balance. If import quotas and quantitative restrictions are eliminated, and replaced by tariffs, government revenues will rise even if imports are reduced, but tariff reductions will lower government revenues, especially if the level of imports is being reduced. Moreover, the increased import demand resulting from tariff reductions will have to be counteracted by deflation and currency devaluations. A real devaluation will help raise real government revenues, but it may not sufficiently make up for the revenue loss through reduced imports and tariffs; moreover, it will give rise to other fiscal problems (see below). Similarly, cuts in export taxes will lower government revenues unless export earnings rise by more than the rate at which the tax is cut, which is generally not the case in developing countries.

Finally, real devaluations raise the trade tax base by increasing domestic currency values of imports and exports. This direct effect will be examined in the following subsection. However, since devaluations also affect trade, their overall impact depends on how exports and imports respond. The real value of export taxes will be greater when the currency depreciates in real terms, even if exports valued in foreign currency stay constant. But if the import bill in foreign currency is reduced, the share of import taxes in GDP will rise only if the real value of imports in domestic currency rises. Otherwise, real depreciations will cause real revenue losses for governments, unless the export response is especially strong, since tax rates are higher for imports. The available evidence does not permit firm generalization in this respect, but it would seem that the overall impact of real depreciations on government tax revenues from trade is positive.

Tables 33 and 34 describe the effects of changes in tax rates and trade volumes and prices on revenues from trade taxes. The implicit average effective tax rates (columns 1 and 2) are measured as percentages of the import bill or export earnings in current prices and valued at current exchange rates. Columns 3 and 4 give shares of trade taxes in GDP at constant real exchange rates;[101] the difference between these two columns reflects changes both in implicit average effective tax rates and in the value of imports and exports. It should be noted that since trade performance is also affected by tax and exchange rate changes, these figures incorporate the indirect effects of trade measures and currency depreciations.

Changes in the implicit average effective tax rate measured in this way reflect changes not only in tariffs and other trade restrictions, but also in the composition of trade, in particular of imports. The composition of imports, in turn, may change not only due to differential changes in tariff rates, but also to different price (exchange rate) and income elasticities of different categories of imports. Even when imports have to be cut greatly, the most essential imports tend to be maintained. In low-income countries such imports include food and intermediate goods, which generally carry low or no tariffs. Thus, when imports are cut by, *inter alia*, raising tariffs on non-essential goods, the implicit average effective tax rate may nevertheless decline if such imports fall considerably. This may also happen even when quantitative restrictions are replaced by tariffs. On the other hand, when demand for investment falls, the decline in capital goods imports with low tariffs may be so steep as to raise the implicit average tax rates even if there is an overall tariff reduction. Consequently, recorded changes in the implicit average tax rate may underestimate the extent of the tariff reduction that has taken place. By the same token, when tariffs on certain goods are initially prohibitive, a reduction can register as an increase in the implicit average effective tax rate if the share of such goods in total imports rises rapidly, as has been the case in some countries (e.g. Chile).

Table 33 shows that the implicit average tax rate on imports has varied substantially among countries, ranging from 5 per cent to 25 per cent. On average, there was a moderate decline between 1980-1981 and 1985-1986. There was a fall in the majority of the highly indebted countries, which amounted to or exceeded 5 percentage points in Bolivia, Côte d'Ivoire, Morocco, Nigeria and Uruguay, largely because of tariff reductions (see tables 40 and 41 in the next chapter). In most countries where the implicit average tax rate fell, quantitative restrictions had been reduced considerably and replaced by tariffs during the 1970s, which, in combination with growing imports, helped raise government revenues from

[101] The real exchange rate in this context is defined differently than in chart 6 since the purpose here is to measure the real purchasing power of each unit of domestic currency vis-à-vis the dollar, in which trade figures are expressed. It is thus measured as domestic currency per dollar, corrected by the GDP deflator (hence, disregarding the increase in US wholesale prices).

Table 33

IMPORT TAXES IN SELECTED DEVELOPING COUNTRIES, 1980-1981 AND 1985-1986

(Percentage)

Country	*Implicit average effective tax rate* [a]		*Import taxes as a proportion of GDP*	
	1980-1981	*1985-1986*	*1980-1981*	*1985-1986* [b]
	(1)	*(2)*	*(3)*	*(4)*
Argentina	19.5	16.3	1.4	0.5
Bolivia	16.4	9.5 [c]	2.3	1.0 [c]
Brazil	6.6	7.0	0.6	0.3
Chile	7.4	12.2 [d]	1.5	1.4 [d]
Colombia	11.0	17.1 [d]	1.6	1.6 [d]
Côte d'Ivoire	25.0 [e]	20.0 [f]	7.2 [e]	3.0 [f]
Ecuador	18.2	24.3 [f]	2.9	2.7 [f]
Ghana	13.6	16.5 [d]	0.8	0.6 [d]
Indonesia	4.8	4.5 [d]	1.0	0.6 [d]
Kenya	13.1	13.3	4.4	2.6
Malawi	13.9	15.3	4.4	2.9
Mexico	10.6	8.7 [d]	1.1	0.5 [d]
Morocco	18.8	12.1	4.9	2.4
Nigeria	16.2 [g]	11.1 [d]	3.3 [g]	1.1 [d]
Peru	19.0	23.7	2.8	2.4
Philippines	11.9	12.3	2.7	1.9
United Rep. of Tanzania	7.4	8.5 [f]	1.7	1.5 [f]
Uruguay	19.4	15.6	3.0	1.3
Venezuela	9.4	10.7	1.6	1.4
Zaire	25.9	21.1	2.9	2.0

Source: UNCTAD secretariat estimates, based on IMF, *Government Financial Statistics Yearbook*, various issues, and *International Financial Statistics*, various issues.

a Import taxes divided by import bill.
b Expressed in terms of data in constant 1980-1981 prices and exchange rates.
c 1984.
d 1985-1987.
e 1980.
f 1985.
g 1978.

import taxes. In the 1980s, tariff reductions have been a more prominent feature of trade liberalization, particularly in countries with externally supported adjustment programmes. In some of these countries, particularly at lower levels of income, trade liberalization in the 1980s involved, in large part, replacement of quantitative restrictions by tariffs, helping to offset the adverse effect of import cuts on government revenues (see section A in the next chapter).[102]

For the countries in table 33 as a whole, the combined effects of import cuts and changes in implicit average effective tax rates lowered government revenues from import taxes by 1 per cent of GDP between 1980-1981

[102] The average tariff rates given in the next chapter (see tables 41-43) differ from the implicit average effective rates used here; they are, indeed, much higher. This is partly because the latter take into account import composition. On the other hand, there are significant exemptions from tariffs which reduce the implicit average effective tax rates. According to some estimates for a sample of countries, such exemptions amount to almost half of total imports. See V. Tanzi, "Quantitative Characteristics of the Tax System of Developing Countries", in D. Newberry and N. Stern (eds), *The Theory of Taxation for Developing Countries* (Oxford University Press, 1987), p. 233. Changes in the distribution of imports among importers with different degrees of exemption also affect the movement of the implicit average effective tax rate over time.

Table 34

EXPORT TAXES IN SELECTED DEVELOPING COUNTRIES, 1980-1981 AND 1985-1986

(Percentage)

Country	*Implicit average effective tax rate* [a]		*Export taxes as a proportion of GDP* [b]	
	1980-1981	*1985-1986*	*1980-1981*	*1985-1986*
	(1)	*(2)*	*(3)*	*(4)*
Argentina	2.6	13.8	0.2	0.8
Brazil	3.9	1.2	0.3	0.1
Colombia	6.6	1.0 [c]	0.7	0.1 [c]
Côte d'Ivoire	7.7 [d]	6.1 [e]	2.3 [d]	1.6 [e]
Ecuador	3.0	0.9 [e]	0.6	0.2 [e]
Ghana	16.8	22.7 [c]	1.2	0.8 [c]
Indonesia	1.6	1.5 [c]	0.4	0.2 [c]
Kenya	1.0	3.7	0.2	0.5
Mexico	39.6	0.3 [c]	3.1	0.0 [c]
Morocco	2.2	1.3	0.3	0.1
Peru	9.7	3.4	1.6	0.5
United Rep. of Tanzania	7.6	0.3 [e]	0.8	0.0 [e]
Zaire	6.3	5.8	1.5	0.9

Source: UNCTAD secretariat calculations, based on IMF, *Government Financial Statistics Yearbook*, vol. XII, 1988; and IMF, *International Financial Statistics* (various issues).

a Export taxes divided by export earnings.
b Expressed in terms of data in constant 1980-1981 prices and exchange rates.
c 1985-1987.
d 1980.
e 1985.

and 1985-1986. This represents an average decline of more than 6 percentage points in the share of import duties in total government revenues, with a decline of 10 points or more in a number of countries (e.g. Côte d'Ivoire, Ecuador, Malawi, Morocco and Nigeria). These effects were also negative for a large majority of the countries largely because of imports cuts, and the revenue losses were particularly heavy where import taxes were high. In some countries (e.g. Argentina, Bolivia, Côte d'Ivoire, Morocco, Nigeria, Uruguay and Zaire) average tax rates also fell, contributing further to the decline in government revenues. In others revenue losses were relatively small, either because tax rates were low (Brazil, Indonesia, United Republic of Tanzania and Venezuela) or because they rose (Chile, Colombia, Ecuador and Peru).

Declines in the implicit average effective tax rates were much more pronounced for exports, exceeding, on average, 3.5 percentage points (see table 34). Export taxes were raised in a few commodity-exporting countries, but eliminated or reduced in many others, and together with poor export performance this reduced the average share of export taxes in GDP (at constant prices and exchange rates). The entire adverse effects of lower export earnings on government revenues were due to declines in commodity prices in world markets. Indeed, if the 1980-1981 price levels had been maintained, government revenues from export taxes during 1985-1986 would have been higher by between 0.4 and 0.8 per cent of GDP in a number of countries (e.g. Argentina, Côte d'Ivoire, Ghana and Zaire).

The evidence thus suggests that, in general, trade policies, import cuts and commodity price declines in the 1980s had adverse fiscal consequences by lowering trade taxes as a proportion of GDP, at a cost to governments, on average, of 1.5 per cent of GDP. Import cuts played a major role almost everywhere, but cuts in tax rates on trade were also important in a number of countries. While it is possible that, in the long run, tariff reductions may benefit output and growth by stimulating efficiency

and competitiveness, with a consequent increase in government revenues from income taxes, such benefits can only be reaped if imports expand, which has generally not been possible in the 1980s because of the debt constraint. It is therefore not surprising that many governments in developing countries have been reluctant to lower tariffs despite strong pressures from the international community.

(c) Currency depreciation and fiscal balances

While real currency depreciations may help improve trade performance, their overall impact on the fiscal balance may be negative. Devaluations can reduce government revenue by intensifying inflation and/or lowering activity; this will be discussed in a broader context below. They will also have direct effects via changes in trade taxes, the real purchasing power of financial flows and real spending on tradeable goods.

As noted above, currency devaluations affect trade taxes positively by raising the real tax base. These direct effects are shown in table 35. These figures, however, do not include the effects on government revenues from public sector exports, which, as will be seen below, are an important determinant of fiscal balances in oil-exporting developing countries.

Currency depreciations exerted a significant positive influence on fiscal balances in a number of countries where trade taxes were an important source of revenue. However, with very few exceptions, they could offset only part of the revenue losses stemming from declines in tax rates, import volumes and commodity prices. Consequently, the share of trade tax revenues in GDP (at current prices and exchange rates) fell between 1980-1981 and 1985-1986 in three quarters of the countries in table 35, with declines exceeding 1 percentage point of GDP in some countries (e.g. Bolivia, Côte d'Ivoire, Mexico, Morocco, Nigeria, Peru and United Republic of Tanzania).

Real depreciations redistribute domestic income in favour of export sectors (except to the extent they lead to a deterioration in the terms of trade) while raising the real burden of interest payments abroad. The domestic currency value of interest payments rises in real terms when the rate of depreciation exceeds the rise in the overall price level, even if nominal government revenues keep up with prices. Since every dollar of interest payments absorbs a greater amount of real revenue, governments face a need to tax the private sector if they are to maintain the real level of domestic spending without enlarging the real budget deficit. Table 36 shows the magnitude of the rise in the real domestic currency value of net transfers and of interest payments on public and publicly-guaranteed debt during 1985-1987 as a result of real depreciations after 1980-1981, expressed as a proportion of GDP.[103] The figures demonstrate that, in most countries, the real cost of interest payments and, hence, public sector deficits (including central bank losses), would have been substantially lower if governments had been able to acquire the foreign exchange needed to make interest payments abroad without real depreciations.

In a few countries the domestic currency actually appreciated in real terms, but in most, the real burden of interest payments increased, and particularly so in the most highly indebted countries, where it reached or exceeded 1 per cent of GDP both because of the depreciations and also because of the high share of interest payments in GDP. The burden was also heavy for some low-income countries, which had to allocate an even greater proportion of GDP to interest payments abroad because of sharp devaluations. In many countries in both groups (e.g. Argentina, Chile, Ghana, Nigeria and Zaire) the domestic currency value of interest payments in real terms rose by more than 40 per cent.

The impact of exchange rate changes depended also on the level of net borrowing from abroad by the public sector. Where this exceeded interest payments (i.e. where net external transfers to the public sector were positive), devaluations improved the fiscal position, allowing governments either to reduce monetary financing and domestic borrowing or to raise spending without additional domestic financing. Although the data do not always allow the net transfer position of the public sector to be calculated precisely, they do nevertheless suggest that in many low-income countries (where the link between the budget and external financial flows is very close), net borrowing from abroad during recent years has exceeded interest payments by the public sector. In some such countries (e.g. Bolivia, Ecuador, Ghana and Malawi) real depreciations served to improve fiscal balances; however, the benefits were partly offset where external borrowing necessitated provision of counterpart funds. On the other hand, others with positive net transfers from abroad

[103] Here, too, real exchange rates are measured as described in footnote 101.

Table 35

CURRENCY DEPRECIATIONS AND THEIR EFFECT ON GOVERNMENT REVENUES FROM TRADE TAXES IN SELECTED DEVELOPING COUNTRIES, 1980-1981 TO 1985-1986

(Percentage of GDP)

Country	*Effect of depreciation on trade tax revenues* [a]	*Trade taxes at current real exchange rates*	
	1980-1981 to 1985-1986	*1980-1981*	*1985-1986*
Argentina	1.1	1.6	2.4
Bolivia	-0.3 [b]	2.3	0.7 [b]
Brazil	0.1	0.9	0.5
Chile	1.2 [c]	1.5	2.6 [c]
Colombia	0.4 [c]	2.3	2.1 [c]
Côte d'Ivoire	3.0 [d]	9.5	7.6
Ecuador	-0.3 [d]	3.5	2.6 [d]
Ghana	3.9 [c]	2.0	5.3 [c]
Indonesia	0.3 [c]	1.4	1.1 [c]
Kenya	0.6	4.6	3.7
Malawi	0.7	4.4	3.6
Mexico	0.3 [c]	4.2	0.8 [c]
Morocco	1.2	5.2	3.7
Nigeria	0.5 [c]	3.3 [e]	1.6 [c]
Peru	0.1	4.4	3.0
Philippines	0.2	2.7	2.1
United Rep. of Tanzania	-0.3 [d]	2.5	1.3 [d]
Uruguay	0.8	3.0	2.1
Venezuela	0.5 [c]	1.6	1.8 [c]
Zaire	3.1	4.4	6.0

Source: As for tables 33 and 34.

a The difference between trade tax revenues in 1985-1986 at current and constant (1980-1981) real exchange rates (see tables 29 and 30).
b 1984.
c 1985-1987.
d 1985.
e 1978.

(e.g. Egypt) allowed real appreciations which served to depress the real domestic currency value of such transfers.

Where governments make net transfers abroad, currency appreciations help the fiscal balance. However, this may not be compatible with payments adjustment. Indeed, the evidence suggests that barely any country has been able to combine net transfers with currency appreciation because of the need to devalue in order to improve the trade balance. In those countries with negative net transfers, currency depreciations necessitated the mobilization, on average, of an additional 0.5 per cent of GDP by governments to finance the net transfer.

Currency depreciation affects public finances in two ways by raising the real domestic currency value of government spending on tradeable goods. First, it raises the cost of intermediate goods imported by public enterprises, and hence adds to public sector deficits when these enterprises produce primarily for the domestic market. Second, and more importantly, it raises the cost of public sector investment, which has a high import content (generally about one third in countries at relatively high levels of development, but exceeding one half in low-income countries,[104] though

[104] See *TDR 1988*, pp. 113, 118.

Table 36

EFFECTS OF CURRENCY DEPRECIATION ON NET TRANSFERS AND INTEREST PAYMENTS IN SELECTED DEVELOPING COUNTRIES IN THE PERIOD FROM 1980-1981 TO 1985-1987 [a]

(Percentage of GDP)

Country	*Net transfers*	*Interest payments*	*Country*	*Net transfers*	*Interest payments*
Argentina	0.7	2.0	Malawi	-0.2	0.4
Bolivia	-0.1	0.1	Mexico	0.9	1.5
Brazil	0.2	0.2	Morocco	-0.1	1.2
Chile	0.9	2.9	Nigeria	0.3	0.8
Colombia	0.0	0.3	Peru	0.0	-0.1
Costa Rica	-0.5	-0.7	Philippines	0.1	0.3
Côte d'Ivoire	0.5	0.8	Sudan	0.0	0.1
Ecuador	-0.1	0.5	Tunisia	0.1	0.4
Egypt	0.1	-0.9	United Rep. of		
Ghana	-2.2	0.6	Tanzania	-0.3	0.1
Indonesia	0.1	0.7	Uruguay	0.9	1.5
Jamaica	0.7	1.4	Venezuela	1.0	0.6
Kenya	0.1	0.4	Zaire	0.0	1.5

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

a Change in the real value of average net transfers and interest payments as a result of changes in the real value of the national currency between 1980-1981 and 1985-1987. A negative sign indicates a net decline in transfers or interest payments abroad expressed in terms of GDP in the base period.

varying according to sector). Table 37 gives some estimates of the effect of real depreciation on the real domestic currency requirement of public investment via real import costs in selected developing countries, based on rather conservative assumptions regarding the import component of public sector investment (20 per cent for Brazil and Mexico, 40 per cent for low-income countries, and 30 per cent for the remaining countries). The table shows, for the volume of investment actually made in 1985-1986, by how much (in terms of GDP) spending and public sector deficits would have been lower if the 1980-1981 real exchange rates had been maintained.[105] Despite drastic cuts in public investment, the additional resource needs were on average as much as 0.6 per cent of GDP. However, there were significant differences among countries, depending on the level of investment, rate of real depreciation of the currency, and the (assumed) import components of public investment; the cost reached as much as 1 per cent of GDP in a number of countries. If, instead, the 1980-1981 volume of investment had been maintained, in many countries the cost of currency depreciations would have risen to twice the levels shown in table 37. That table also shows the rates at which public sector investment could have been raised above the levels actually achieved if the real cost of capital goods imports had remained at the 1980-1981 levels - an amount that ranged from 2 per cent to 30 per cent and averaged 10 per cent.

A number of conclusions emerge when these various effects are put together. If a government derives most of its revenues from the non-traded goods sector while spending heavily on traded goods and debt servicing -

[105] These figures do not take into account the effects of increases in the prices of domestically produced tradeable capital goods brought about by currency depreciations, relative to other components of GDP. This latter effect may indeed be only partly compensated by increases in real government revenues from such activities.

Table 37

ESTIMATED INCREASES IN THE REAL COST OF PUBLIC INVESTMENT IN 1985-1986 DUE TO CURRENCY DEPRECIATIONS IN SELECTED DEVELOPING COUNTRIES SINCE 1980-1981 [a]

	Increase as a percentage of:			*Increase as a percentage of:*	
Country	*GDP*	*Public investment*	*Country*	*GDP*	*Public investment*
Argentina [b]	1.0	13.2	Kenya	0.3	5.8
Bolivia [b]	0.1	1.5	Malawi	0.7	7.2
Brazil	0.2	3.5	Mexico	0.4	6.6
Chile	1.0	13.2	Morocco	0.7	9.5
Colombia [b]	0.4	3.9	Nigeria [b]	1.1	16.2
Côte d'Ivoire	0.7	11.2	Philippines	0.1	3.0
Ecuador	0.1	2.0	Uruguay	0.4	11.5
Ghana [b]	0.7	29.2	Venezuela	0.6	4.1
Indonesia [b]	0.7	7.8	Zaire	0.9	20.7
Jamaica [b]	0.3	4.8			

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

a Increase in the real domestic currency cost of public sector investment due to the effect of real depreciations on real import costs.

b 1985-1987.

more precisely, if the share of net transfers abroad plus imports of capital goods and intermediate products by the public sector in GDP exceeds the share of government export revenues and trade taxes - real depreciations worsen the fiscal balance. Evidence suggests that this is generally the case, except where public ownership in the export sector and trade taxes are important, where net transfers abroad are small (or there is a net transfer from abroad), and where public investment does not loom large. Indeed, in many highly indebted countries total government revenues from international trade are barely 2 per cent of GDP, whereas the share of interest payments abroad plus the import component of public investment comes to more than 6 per cent, implying that a real depreciation of 10 per cent will raise the budget deficit by about 0.5 per cent of GDP. In fact, in many such countries the rate of depreciation since the early 1980s has exceeded 30 per cent. It may therefore be concluded that "realistic" exchange rate policies have been an important factor behind "fiscal laxity".

(d) Overall effects of trade and trade measures on budget deficits

Table 38 brings together the various influences exerted by changes in trade tax revenues and related trade measures on fiscal deficits already discussed. The trade effect describes changes in government revenues from import duties and export taxes due to changes in tax rates and in import and export volumes and prices. The depreciation effect is the sum total of the effects of changes in the real value of currency on trade taxes, interest payments abroad by the public sector and the import cost of public investment. These figures do not include the effects of changes in government revenues from oil and non-oil commodities directly exported by the public sector. Estimates for a number of such countries for which data are available are given in table 39. In that table the trade effect describes changes in revenues from direct export earnings (at constant real exchange rates) as a result of changes in export volume and prices, while the depreciation effect gives increases in the real domestic currency value of these revenues as a result of

Table 38

EFFECTS IN 1985-1986 OF CHANGES IN TRADE TAX REVENUES AND OF CURRENCY DEPRECIATIONS SINCE 1980-1981 IN SELECTED DEVELOPING COUNTRIES [a]

(Percentage of budget deficit)

	Increase in deficit due to:		
Country	Trade effect [b]	Currency depreciation effect [c]	Total effect
Argentina	6.0	32.0	38.0
Brazil	4.2	3.4	7.6
Chile [d]	2.1	127.3	129.4
Colombia [d]	33.3	16.7	50.0
Côte d'Ivoire [e]	153.1	12.5	165.6
Ecuador [d]	37.5	10.0	47.5
Ghana [d]	100.0	-433.3	-333.3
Indonesia [d]	31.6	57.9	89.5
Kenya	27.8	1.9	29.6
Malawi	16.6	5.6	22.1
Mexico [d]	35.9	15.5	51.4
Morocco	32.1	7.2	39.2
Nigeria [f]	92.3	13.5	55.8
Peru	46.4	3.6	50.0
Philippines	23.6	2.9	26.5
United Rep. of Tanzania [g]	24.4	0.0	24.4
Uruguay	88.9	16.6	105.5
Venezuela [d]	8.3	50.0	58.3
Zaire	34.9	-9.3	25.6

Source: Tables 33-37.

a A negative sign indicates a decrease in the deficit.

b Effects of changes in trade taxes due to changes in implicit average effective tax rates, trade volumes and prices from 1986.

c Effect of currency depreciation in real terms on trade taxes (tables 33 and 34), interest payments abroad by the public sector (table 36 adjusted for the estimated shares of the public sector in total interest payments on public and publicly-guaranteed debt), and import cost of public investment (as defined in table 37).

d 1985-1987.

e 1984.

f Effects since 1978.

g 1985.

real depreciations.[106] Due to data shortcomings, estimates had to be made for certain items, such as the proportion of total interest payments on public and publicly-guaranteed debt made directly by the public sector, the import component of public investment, and direct export earnings of the public sector. However, since the assumptions underlying these estimates are rather conservative and the estimates broadly consistent with the underlying tendencies in fiscal balances, the figures in tables 38 and 39 would not appear to exaggerate the fiscal effects.

Revenue losses from trade taxes due to the combination of import cuts, declines in export prices and tariff reductions enlarged the budget deficit in all the countries in table 38; on average the enlargement was about 40 per cent of the deficit actually incurred by these countries in recent years. In a few countries the effects were minimal. In some such countries (e.g. Brazil) trade taxes were not an important

[106] In most countries government revenues from public sector exports are derived as taxes from State enterprises. Where such taxes could not be identified, estimates have been made on the basis of export earnings.

source of revenue for governments, which also implies that an externally induced improvement in trade (e.g. a growth of export markets or improved terms of trade) can add little to tax revenues from trade. In Argentina, on the other hand, where trade taxes are more important, the adverse effects of import cuts and the decline in average tariff rates (which together accounted for 20 per cent of the budget deficit) were partly offset by higher tax rates on exports. Thus, although the overall trade effect in recent years on budget deficits has been small, an improvement in export prices will substantially contribute to a reduction of the deficit through higher export tax revenues. Furthermore it would permit the financing of a higher level of imports, resulting in an increase in import tax revenues. (However, if net foreign borrowing is reduced proportionately, an acute fiscal problem can nevertheless occur for reasons already explained.) In the remaining countries, the combined effects of import cuts, declines in effective tax rates and export prices accounted for an important part of budget deficits, reaching or exceeding one third in Colombia, Indonesia, Kenya, Mexico, Nigeria, Peru and Zaire, and corresponding to the entire deficit in Côte d'Ivoire, Ghana and Uruguay.

In most countries in table 38 the positive effects of depreciations on trade tax revenues were weaker than their effects on real government spending, and especially so in Argentina, Chile and Indonesia, where depreciations and/or changes in public sector investment were much larger than some other comparable countries (e.g. Brazil and the Philippines). On the other hand, in many low-income countries the adverse effects of currency depreciations remained small because of the importance of trade taxes relative to interest payments abroad; indeed, in some of these countries (e.g. Ghana and Zaire) currency depreciations raised tax revenues relative to government spending.

Except for Ghana, the combined effects of currency depreciations and changes in trade taxes on budget deficits were adverse (table 38). For the highly indebted countries included in the table, they amounted to about two thirds of the average budget deficit incurred during 1985-1986, in six countries for about one half, and in another three for more than the entire deficit.

The effect of changes in export earnings on fiscal balances during the 1980s differed considerably in countries where public sector exports are important. In Chile revenues from copper exports, which averaged more than 10 per cent of GDP (at current prices and exchange rates), exceeded interest payments abroad by a substantial margin. Although copper prices fell sharply between 1980 and 1986, the decline in foreign exchange earnings was relatively moderate thanks to increased export volumes. A sharp recovery in copper prices in 1987 (to about 30 per cent above the 1986 level) raised export earnings significantly in domestic currency terms, helping to produce a small budget surplus for the first time since 1981. Thus, between 1980-1981 and 1985-1987 the fall in copper earnings (at constant prices and exchange rates) had a small impact on the budget (as may be seen from the first column of table 39). Moreover, the sharp depreciation of the currency during that period served to increase copper export revenues in terms of domestic currency; indeed, the revenues rose more than the real value of interest payments abroad and the import cost of public investment. Consequently, the contribution of copper exports to the budget exceeded by a wide margin the combined adverse effects of trade taxes and currency depreciations shown in the final column of table 38.

Changes in public sector export earnings had a less favourable, and often adverse, impact on budgets in other countries with an important public export sector. In Mexico oil export revenues during 1982-1985 were, on average, higher than in 1980-1981 largely because of increased volumes, but only by just about enough to cover higher interest payments abroad. However, the price collapse of 1986 brought oil revenues below interest payments. Consequently, the sharp devaluation of the peso, while restoring the share of oil revenues in GDP (at current prices and exchange rates) increased the budget deficit by about 5 per cent of GDP in that year. Despite a partial price recovery in 1987, declines in oil revenues, import cuts, tariff reductions and currency depreciations have together accounted for more than one half of the budget deficits in recent years.

Falling government revenues from oil were particularly serious in Indonesia, Nigeria and Venezuela. While this was primarily due to the collapse of oil prices in 1986, in these countries export volumes in 1985-1987 were also lower than in 1980-1981. Currency depreciations served to offset only part of these public revenue losses. Thus, the combination of oil, trade and depreciation effects accounted for more than the entire budget deficits in these countries.

Table 39

FISCAL EFFECTS OF CHANGES IN COMMODITY EXPORT EARNINGS OF THE PUBLIC SECTOR IN SELECTED DEVELOPING COUNTRIES IN 1985-1987 [a]

(Percentage of budget deficits)

Country	Increase in deficit due to: Trade effect [b]	Currency depreciation effect [c]	Total effect
Chile	9.1	-372.7	-363.6
Ecuador [d]	31.3	-12.5	19.0
Indonesia	431.6	-136.5	294.7
Mexico	12.6	-37.9	-25.3
Nigeria	203.8	-109.6	94.2
Venezuela	708.3	-308.3	400.0

Source: UNCTAD secretariat calculations.

a A negative sign indicates a decrease in the deficit. Export earnings consist of copper for Chile and oil for the other countries.

b Decline in export revenues at constant real exchange rates between 1980-1981 and 1985-1987 as a proportion of budget deficits in the latter period.

c Effects of real currency depreciations between 1980-1981 and 1985-1987 on real export revenues, expressed as a proportion of budget deficits in the latter period.

d 1985-1986.

3. Macroeconomic consequences of market-based menu operations

The contribution of various facilities of the market-based menu (see box 10)-to foreign exchange availability is not very clear. More importantly, these facilities require generation of resources in debtor countries, particularly by the public sector, which is not often possible without further deflation and/or price instability, and recourse to such mechanisms has consequently so far been limited.

The macroeconomic implications of debt conversion depend on a number of factors. Conversion of private debt into private equity has no fiscal impact; nor does it have a monetary impact if the central bank does not lend to the debtor. Lending will not be necessary if conversion involves purchase of equity capital by the investor in the indebted firm. But if conversion includes private debt with exchange rate guarantees, its immediate impact on monetary expansion can be important since currency depreciations will oblige the central bank to provide additional funding.

If public debt is exchanged against equity capital in existing public enterprises in the context of a privatization programme, it also has no fiscal or monetary repercussions; debt will have been disccharged by the sale of public assets. If, on the other hand, conversion involves new investment, it is equivalent to deficit spending, except that the public sector will not own the financial assets. Indeed, the fiscal and monetary impact would be the same as for the conversion of public debt into private equity and the public sector would accordingly need to generate resources to finance the conversion.

Debt conversions reduce interest payments by the public sector over time. However, if they are financed by privatizing profitable public enterprises, the former public revenues from those enterprises will be lost. If, on the other hand, the initial monetary expansion is offset by issuing government paper, external debt will have been translated into domestic debt, exerting pressure on interest rates. Since in many debtor countries domestic debt carries higher real interest rates than external debt, this can lead to a deterioration of the fiscal balance. Preferential exchange rates given to holders of debt aggravate monetary and fiscal problems,

Box 10

MARKET-BASED MENU OPERATIONS

The market-based menu includes various debt conversion schemes as well as a number of devices for restructuring and reallocating the existing stock of debt. Most debt restructuring agreements in recent years have included provisions allowing the conversion of external debt into equity investment in debtor countries. Typically, debt purchased in secondary markets is presented to the central bank of the country concerned for redemption in local currency, to be used for equity investment. Different agreements stipulate different restrictions regarding the type of debt eligible for conversion, the sector in which equity investment can be made, the form of equity investment (direct or portfolio investment), and the eligibility of residents as well as non-residents.

In many countries conversions are made through an auction system, and central banks often charge small conversion fees. However, the discount that central banks obtain is usually of the order of 5-15 per cent of the face value of debt. Since market discounts are considerably greater, investors enjoy a large exchange rate premium.

In recent years there has been a rapid growth in the so-called informal conversions and debt-peso swaps. In informal conversions, private firms repurchase their debt in secondary markets, whereas in debt-peso swaps third-party residents purchase their own country's debt and present it to the central bank for conversion. In some cases (e.g. Chile) the proceeds of debt-peso conversions do not have to be invested, operators can choose to be paid in domestic currency or debt payable in domestic currency. In others (e.g. Philippines) residents are eligible for the same debt conversion schemes as are open to non-resident investors. Since the purpose is often to bring back flight capital, such schemes also include some form of amnesty. In some countries residents are also allowed to buy foreign exchange in the parallel market to repurchase debt in secondary markets, with a benefit to the operator which depends on the difference between the secondary market discount on debt and the parallel market premium. If, for instance, the secondary market discount is 50 per cent, there will be an incentive for informal conversion so long as the parallel market exchange rate (domestic currency per dollar) is less than twice the official exchange rate, a situation that prevails in most debtor countries.

Other mechanisms with significant macroeconomic consequences are relending and onlending, which have become important elements of recent restructuring and new-money agreements (e.g. Argentina, Brazil, Bolivia, Chile, Morocco, Philippines and Venezuela). These mechanisms, in essence, allow creditor banks to reallocate their claims among various sectors in the debtor country. The creditor bank owns a deposit account (in foreign currency) at the central bank of the debtor country for its claims on the original borrowers, and the amounts that fall due are relent to other borrowers in that country. The new borrower uses the loan in domestic currency, but its debt and debt service are denominated in foreign currency. Thus, net transfers abroad are not affected, but an internal transfer is made from the original to the new borrower. Onlending works essentially in the same way, except that it involves new loans from the creditor banks; the original borrower of this loan, usually the public sector, transfers the proceeds to a new borrower in the private sector.

since they raise the redemption cost in domestic currency.

Debt conversion can easily become a source of financial instability, given the size of the external debt compared to that of money and credit markets. In many debt-troubled countries today, the ratio of external debt to GDP is around 60 per cent, whereas the monetary base is less than 5 per cent of GDP. Thus, if every year 2 per cent of the outstanding stock of debt is converted, the monetary base can expand by 30 per cent per annum. Sterilization of this through the issue of government paper can raise domestic debt by 5 - 10 per cent per annum, that is, much faster than GDP growth. There can be little doubt that a 2 per cent annual average cut in external debt is too small to make a dent in the debt problem; but, in many countries, a 30 per cent annual increase in the monetary base is large enough to greatly exacerbate financial instability.

Persistent arbitrage opportunities provided by informal conversions and debt-peso swaps, in combination with an amnesty in respect of flight capital, can encourage recycling of discounted debt (round-tripping), and thereby accelerate net transfers abroad. Moreover, there is an incentive to under-invoice ex-

ports and/or over-invoice imports. Thus, such conversions tend to put pressure on exchange rates, reduce foreign exchange reserves and divert foreign currency from imports.

So far these various conversion schemes have been used in different degrees in different countries. Due to data shortcomings it is difficult to assess their scale. In Brazil, where firms are allowed to buy dollars in the parallel market, such conversions during 1988 probably exceeded $7 billion, equivalent to about two thirds of foreign exchange reserves and to more than the entire monetary base. They were also an important reason for the persistence of a substantial parallel market premium over the official exchange rate, despite a sizeable trade surplus. In the June 1988 financial package, more than $60 billion of Brazil's bank debt was restructured into a deposit account in the central bank, all eligible for conversion. According to World Bank estimates, $28 billion of this amount could have a monetary impact; converting 5 per cent of this latter amount in one year could increase the monetary base by about 30 per cent. Argentina, in its April 1987 package, limited conversion to less than $2 billion over five years in order to avoid excessive monetary expansion, and required matching funds in dollars to prevent round-tripping (although the requirement was somewhat reduced subsequently). In Mexico, the inability to offset the monetary impact of conversions led to a temporary suspension of the scheme at the end of 1987. In Chile, where conversion has been more important, a large proportion of swaps (about two thirds) has involved private debt of financial and non-financial companies. The monetary impact of debt conversion has been offset through long-term bond issues by the public sector at relatively low real interest rates. However, debt-peso swaps have proved so popular that the Government has had to limit the amount in its monthly auctions.

"Relending" and "onlending" after a certain size can also give rise to important macroeconomic problems. First, if residents are allowed to purchase relendable loans in secondary markets, the pace of external transfers may accelerate, putting pressure on exchange rates in the ways discussed above. Second, the increasing role of international banks in domestic financial markets tends to reduce the autonomy of monetary authorities in the allocation of credit. But, more importantly, there may result a rapid expansion of the monetary base and domestic credits. When the original borrower is the public sector and the new borrower is the private sector, relending would give rise to a budgetary transfer problem. Similarly, onlending allocates new money to the private sector, while old debt is serviced by the public sector.

These factors explain the reluctance of many governments to agree to such operations as part of debt rescheduling deals. Nevertheless, the rights that creditor banks have acquired for the use of their central bank deposits for these operations are far from negligible. For instance, in Brazil the actual amounts of onlending/relending reached $8 billion in 1984, declining to about $2 billion in 1987. Because of data shortcomings regarding the source and allocation of such loans, it is difficult to assess their contribution to monetary expansion, but it is significant that the actual amounts of onlending/relending during 1984-1985 exceeded the entire monetary base in that country. In its June 1988 financial package Brazil agreed to a minimum relending quota of $1.5 billion per annum to the private sector during 1989-1990. At current real exchange rates, this can lead to an expansion of 30 per cent in the monetary base, and a sizeable increase in domestic credits. While these may be rather small compared to the recent pace of money and credit expansion, they can give rise to significant problems during disinflation. Indeed, in order to control the money supply the Central Bank has recently slowed down disbursement of cruzados for such operations as demand from foreign creditors exceeded double the ceiling.

Under the present crisis conditions in debt-troubled countries, there is a serious danger that many of the mechanisms of the market-based menu can become an additional source of financial instability and capital flight. They open up new prospects for arbitrage, speculation and windfall profits for a handful of operators in creditor and debtor countries whose interests lie in the persistence of the crisis. Given the extent of macroeconomic disorder, it is not easy to design an appropriate mix of policies to deal with their destabilizing influences. Even if the benefits of such mechanisms in terms of external transfers were beyond doubt, they may only be obtained at the cost of increased financial instability and austerity, conflicting with the prime objective of debt reduction.

4. Stagflation and government revenues

The preceeding sections have demonstrated that in order to avoid cuts in spending or increases in budget deficits, governments in debtor countries have had to seek considerable

increases in revenues from taxes on income, profits and domestic goods and services, as well as from public enterprises. They have had to do so to accommodate not only the swing in net external transfers, but also the deficit-enlarging effects of import cuts, commodity price declines, tariff reductions and currency depreciations. For the highly indebted countries the required increase in real revenue was, on average, more than 5 per cent per annum; even this rate of increase implies a decline in per capita domestic spending and is in any event extremely difficult to attain when GDP is contracting or growing very slowly.

This difficulty is partly related to political and social constraints on policy decisions and implementation. Since debt is serviced and domestic absorption reduced through the budget, governments become the arbiter of the distribution of the burden among various classes. Since governments accord high priority to the preservation of their authority and of social peace, the ways in which such transfers are made and conflicts handled are not necessarily those most conducive to macroeconomic stability.

Resource transfers abroad inevitably reduce social welfare. If they are made through higher savings, current consumption is reduced without adding to growth potential. If investment is cut, future consumption is reduced without a corresponding increase in current consumption, but this solution is generally politically easier. Similarly, whether budgetary resources are generated by higher taxes or by printing money may have no bearing on aggregate social welfare losses from the transfers abroad, but the latter option often avoids direct confrontation with certain classes and groups, and allows a different pattern of losses to be imposed than would otherwise be possible.

These political and social considerations, and concern to avoid the disruptive effects of various measures, have been a major constraint on fiscal adjustment in many countries. Raising the revenues of public enterprises in an orderly way would have required not only reducing public employment over time but also updating technology and restructuring. However, the scope for improving efficiency has been reduced by cuts in investment, and to reduce employment in the public sector has proved a very difficult undertaking for many governments, particularly since economic activity was depressed and real wages were falling. In Brazil, for instance, plans were made in early 1989 to release some 80,000 civil servants whose jobs were not protected by the Constitution. The number was large enough to trigger a strong reaction, but the potential saving was the equivalent of no more than a few days' interest payments abroad.

In the absence of efficiency-induced improvements in the financial position of public enterprises, governments have had to rely on increases in public sector prices and the reduction or elimination of subsidies. In the face of strong political opposition and social unrest such decisions have sometimes had to be reversed. Moreover, even steep increases in public sector prices were not always enough to bring lasting relief, as they often triggered generalized price increases, necessitating further adjustment and thereby undermining price stability. It is not therefore self-evident that price adjustment was always a better way of dealing with public sector deficits and inflation than a simple financing of the deficits by the central bank.

Above all, however, many governments have been unable or unwilling to implement the tax reforms needed for an orderly adjustment. Increased emphasis on private initiative in the process of adjustment and the risk of capital flight were important reasons why part of the burden was not shifted to the higher income groups. The need to raise net after-tax returns on domestic financial assets in order to retain money at home has often led governments to tax lightly the income from such assets, especially since flight capital was often granted tax exemption in the recipient countries, for instance, under the "non-resident alien" status in the United States. Government bonds have often been accorded tax-free status to raise their return vis-à-vis foreign exchange assets. The consequence has been considerable losses of public revenue since incomes from such sources have tended to grow much faster than other forms of income, reaching or exceeding 15 per cent of GDP in some countries. Taxes on private incomes, profits and capital gains have continued to remain remarkably low, barely exceeding 3 per cent of GDP in most debtor countries. In some countries the private corporate tax bill has been less than investment and export subsidies directly received by the sector.

The economic crisis has encouraged activities to be shifted to the "underground economy", and the dismal state of public finances has often provided justification for the "ethics of tax evasion" which governments have not been able to cope with during day-to-day crisis management. Dealing effectively with the underground economy and tax evasion would have called for substantial increases in spending on public administration and law enforcement.

Cuts in public spending themselves reduced government revenues not only by reducing the scope for increasing the efficiency of public enterprises, but also through various linkages between the public and private sectors. In the first place, private sector output responds positively to public spending in areas that directly affect profitability in the sector, such as transport and communications and education. Failure to maintain such infrastructure at an adequate level can result in major bottlenecks in the private economy, reducing profitability, output and the tax base. Secondly, cuts in public spending reduce aggregate demand and production unless offset by increased private spending. Private investment may increase if the public spending cuts are accompanied by lower interest rates, but not necessarily so. There is growing evidence that in many developing countries (e.g. Argentina, Brazil, Côte d'Ivoire, Egypt, Mexico and Turkey) there are strong complementarities between public and private investment due to supply-side linkages.[107] In such cases, the contractionary effect of public investment cuts will be magnified, with adverse consequences for public revenues. Indeed, it has been increasingly emphasized that the "fiscal constraint" arising from governments' inability to raise revenues and, hence, investment has become an important factor in reducing the growth prospects of a number of debtor countries.[108]

Accelerating inflation has also tended to reduce real tax revenues. Two effects were particularly important: tax treatment of interest payments by the private (particularly corporate) sector and lags in the collection of taxes. In many developing countries, interest payments by the corporate sector are deducted from taxable income. Under conditions of rapid inflation, the consequence is that the government is effectively retiring private debt, since a very large proportion of interest payments is the counterpart of declines in the real value of debt. Moreover, the effective real cost of debt to private corporations falls, and the effective rate of subsidy rises, with the rate of inflation (see box 11). Therefore, as inflation accelerates, government losses increase, whereas corporations are encouraged to resort to debt rather than equity finance, which, in turn, puts pressure on interest rates; indeed, as shown in the box, the real effective cost of debt to corporations can become negative even at moderate rates of inflation.

These losses have not been fully recuperated by taxing interest incomes. First, the withholding tax rates on interest earnings have been kept low, for reasons already explained. Second, an important part of interest payments by the corporate sector in some countries accrues to foreign creditors who cannot be taxed; deduction of such interest payments from taxable incomes effectively meant that the public sector was servicing an important part of the private external debt. Moreover, the burden rose with real depreciations of the currency and increases in world interest rates. Finally, in some countries (e.g. in Mexico until the recent tax reform) this tax treatment, in combination with tax exemptions granted to flight capital in the recipient countries, encouraged lenders to shift their wealth abroad, and then to recycle it as loans to enterprises under their control, thereby avoiding taxes on interest income while deducting such payments from their taxable income.[109]

In countries with progressive income taxation, the tax elasticity (as measured by the increase in tax revenues, without discretionary tax changes, relative to incomes on which such taxes are levied) tends to exceed unity. When taxes are also withheld at the source, an acceleration of inflation can raise real tax revenues. This so-called "fiscal drag" was particularly evident in the OECD countries in the mid-1970s.

In developing countries, on the other hand, tax elasticity is generally low and collection lags much longer. Consequently, when inflation accelerates, real tax revenues tend to fall. For instance, a three-month collection lag implies a decline of about 14 per cent in the real value of tax receipts where monthly inflation is 5 per cent, and up to 40 per cent if it is 20 per cent. In many developing countries *ad valorem* taxes are adjusted with long lags due to legislative procedures and/or administrative delays. For other types of taxes, some countries have introduced indexation (e.g. Brazil) or advanced payments (e.g. Peru), but these do not always fully protect the real value of tax revenues when inflation is accelerating. In most developing countries taxes withheld at

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107 Such evidence has been presented in, *inter alia*, a number of country studies by WIDER (see Lance Taylor, *op. cit.*, pp. 43-44).

108 See, for example, D.D. Carneiro and R.L.F. Werneck, "External debt, economic growth and fiscal adjustment", *Discussion Paper*, No. 202, Department of Economics, Catholic University of Rio de Janeiro, August 1988; and N. Eyzaguirre, "Ahorro e inversion bajo restriccion externa y fiscal. El caso de Chile 1982-1987", CEPAL, IC/IN.65, 17 January 1989.

109 See V. Tanzi, "The Impact of Macroeconomic Policies on the Level of Taxation (and on the Fiscal Balance) in Developing Countries" (unpublished manuscript), IMF (WP/88/95), October 1988, p. 20.

Box 11

FISCAL EFFECTS OF TAX DEDUCTIBILITY OF CORPORATE INTEREST PAYMENTS WITH HIGH INFLATION

If the nominal lending rate of interest on domestic debt is **i** per cent, the rate of inflation **p** per cent and the corporate tax rate **t** per cent, the real rate of interest received by lenders will be $r = (i-p)/(1+p)$. When all interest payments by corporations are deductible from taxable income, the real effective rate they pay will be given by $c = (i(1-t)-p)/(1+p)$, whereas the difference between **r** and **c** will, in effect, be paid by the government: $s = r - c = it/(1+p)$. Given **r** and **t**, the effective real cost of debt to corporations (**c**) falls and the effective subsidy (**s**) rises with the rate of inflation. Moreover, even if **r** is positive, the effective real cost to corporations will be negative whenever $t(i-p)/i$. In such a case the government not only subsidises interest payments but also effectively makes a capital transfer to private debtors. If, for instance, $t = 30$ per cent and $r = 5$ per cent, this will be the case when the rate of inflation is greater than 13 per cent. If, for these values of **r** and **t**, the rate of inflation is 10 per cent, of the 5 per cent real rate of interest, 0.8 per cent ($=c$) will be paid by the corporate sector and 4.2 per cent ($=s$) by the government. If net corporate domestic debt is 15 per cent of GDP, the revenue loss for the government will be about 0.6 per cent of GDP. If, on the other hand, inflation rises to 100 per cent while **r** and **t** remain unchanged, then the effective real cost of debt to the corporate sector becomes negative ($c = -11.5$ per cent) and the revenue loss to the government rises to 2.5 per cent of GDP.

To the extent that recipients of interest from the corporate sector are taxed, these losses may be recuperated. It can be easily shown that if these incomes are taxed at the same rate as the corporate tax rate, then the offset will be full. Otherwise, effective taxes on interest income will be negative, and the more so the higher the rate of inflation.

If the external corporate debt in dollar terms is D^*, world interest rates i^* and the exchange rate (domestic currency per dollar) **x**, then the revenue loss to the government as a proportion of GDP is given by $(xD^*/pY)i^*t$, where **p** is the GDP deflator and **Y** is real GDP. This loss will increase when world interest rates rise or **x** increases relative to **p** (i.e. the currency depreciates in real terms). In the highly indebted countries, the ratio of external private debt to GDP can be estimated to be of the order of 12 per cent. With $t = 30$ per cent and $i^* = 10$ per cent, revenue losses to governments can be as much as 0.4 per cent of GDP. Unlike the domestic private debt, these losses cannot be recuperated by taxing the creditors.

the source generally account for a small proportion of total taxes, and indirect taxes and taxes on corporate profits and non-wage incomes are often assessed at some interval of time before they are collected. This not only reduces real tax revenues, but also may distort income distribution, since it is taxes on earned incomes which are typically withheld at the source. The redistribution of income from wages to profits itself also tends to lower government revenues because profits have not only greater scope for tax evasion but also a longer collection lag.

Since tax revenues are influenced by a host of factors, including discretionary tax changes, modification of tax collection mechanisms and tax evasion, it is difficult to assess precisely the impact of inflation on tax revenues in developing countries. Nevertheless, available evidence suggests that in countries where collection lags were long, tax buoyancy (a concept relating percentage changes in taxes to percentage changes in GDP, without adjusting for discretionary changes in tax rates) tended to move inversely with inflation. In Bolivia, for instance, total tax revenue collapsed as inflation accelerated sharply, dropping to 1 per cent of GDP in 1985; it rose rapidly during disinflation, reaching almost 7 per cent of GDP in 1987, helped also by a tax reform. In Peru, where advance payments did not protect the real value of taxes (because they were based on the previous year's tax liability), there was a sustained drop in tax revenues from income, profits, and domestic goods and services during the first half of the 1980s when inflation accelerated; there was a short-lived recovery in 1986 as inflation was halved, followed by declines in the last two years when it accelerated again. Similarly, in Zaire tax revenues fell by 3 percentage points of GDP during 1985-1987 when the rate of inflation quadrupled. By contrast, tax buoyancy in the Philippines rose rapidly during 1984-1987 as inflation came down sharply.

5. *Inflation and government debt*

Inflation also added substantially to budget deficits and the PSBR (as conventionally defined) by raising interest payments on domestic debt. As nominal interest rates rise with inflation, the inflation component of debt service increases, and an increasing proportion of these payments represents the decline in the real value of debt - i.e. inflation forces governments to retire real domestic debt at an accelerated pace, although almost always by contracting new debt. This effect is captured by the measure of ***operational*** or inflation-adjusted deficits, which include only real interest payments in addition to primary deficits.[110] In Mexico during 1986-1987 the conventional PSBR was close to 16 per cent of GDP but the operational budget was balanced; nominal interest payments were about 20 per cent of GDP, but only 4 percentage points of these were real interest payments, and they were covered by a primary surplus. In Brazil the operational deficits in 1987 (about 5.5 per cent of GDP) were much lower than the conventional PSBR. Indeed, in that country the PSBR tended to follow inflation, as a large proportion of public debt was indexed, but operational deficits remained relatively stable. When inflation doubled between 1981-1982 and 1984-1985, the PSBR (as a proportion of GDP) also almost doubled, whereas operational deficits actually fell. During the period of the Cruzado Plan in 1986, the PSBR was halved as inflation dropped considerably, but operational deficits changed little.

The significance of the measure of operational deficits as a guide to fiscal management depends largely on the behaviour of the holders of public debt. The nominal part of interest payments by the public sector does not affect its real debt; nor would it affect the real wealth of holders of government debt if these payments were entirely saved. But if they are treated as part of disposable income, and hence consumed - as seems to be the case in some developing countries[111] - an increase in inflation and nominal interest payments on public debt will result in a decline in real private savings. In order to maintain aggregate savings, it will then be necessary to reduce the PSBR by cutting current primary spending. Moreover, operational deficits may not indicate the size of the PSBR when there is no inflation; when inflation slows down, the real rate of interest may rise considerably, as it happened, for instance, in Mexico during 1988.[112] The PSBR is, therefore, not altogether irrelevant as an indicator of the state of fiscal balance. But, if too much emphasis is placed on it, the result may be deflationary overkill.

Even though an important part of interest payments did not add to real public debt, there was a massive increase in domestic debt relative to GDP. This was partly because primary deficits in earlier years and net external transfers had not been covered by government revenues and central bank financing. However, sharp increases in real interest rates also played a major role.

As government paper was competing mainly with foreign exchange assets, real interest rates were governed by expectations regarding the currency as well as the perceived risk of government debt. Commitments by governments to service external debt made it necessary for them to pay higher interest rates on domestic debt to overcome fears that such commitments would be honoured by taxing domestic assets or even defaulting on domestic debt. Moreover, where the currency was expected to depreciate, the real rate of return on government domestic debt had to be raised accordingly. This was broadly the experience of Brazil, where the real rate of interest after 1981 exceeded, on average, 15 per cent; the Constituent Assembly recently imposed a 12 per cent ceiling. In Mexico, the peso depreciated sharply in the free market in 1982, when there was a *de facto* partial default on domestic Mexodollar public debt, and the Government converted this debt into pesos at an exchange rate well below the free market rate. The overshooting of the real exchange rate allowed real interest rates to be kept at very low levels during the subsequent two or three years when, indeed, the free market exchange rate rose. After 1984, the currency started to depreciate in real terms and real interest rates rose rapidly, reaching 15 per cent at the end of 1986 and much higher levels during the recent period of disinflation.[113]

In general, when the real rate of interest on domestic debt exceeds the real growth rate,

110 In this context the real interest rate on external debt is given by the foreign rate of interest plus the real rate of depreciation of the currency.

111 See Y. Akyuz, "Financial system and policies in Turkey in the 1980s", UNCTAD, *Discussion Paper*, No. 25, February 1989; and *TDR 1987*, part one, chap. II. sect. C.2.

112 See R. Dornbusch, "Mexico: stabilization, debt and growth", *Economic Policy*, No. 7, October 1988, pp. 234-283.

113 For the Mexican experience see A. Ize and G. Ortiz, "Fiscal Rigidities, Public Debt and Capital Flight", *IMF Staff Papers*, vol. 34, No. 2, June 1987, pp. 324-328; and R. Dornbusch, *op. cit.*

domestic debt rises relative to GDP even if the rest of the budget is balanced (i.e. non-interest spending plus net transfers abroad are covered by government revenues). The debtor countries are, therefore, confronted with a serious dilemma. On the one hand, the payments crisis requires real interest rates to be kept high in order to prevent currency substitution and capital flight, while on the other it inhibits growth. Avoiding a domestic debt explosion then requires generation of surpluses in the rest of the budget. Since real interest rates on external debt also exceed the real growth rate (and the more so, the more rapid the rate of real depreciation), tax revenues must rise; otherwise, generating surpluses in the rest of the budget will require further cuts in investment, which will reduce output growth and the tax base. However, it is not possible to keep allocating an ever-increasing proportion of tax revenues to servicing foreign and domestic debt (see box 12).

The scope for reducing the real value of domestic debt and debt service by taking advantage of an unexpected burst in inflation and by monetization of debt is severly limited by the fact that most government debt instruments are extremely short-term. For instance, in Brazil interest rates on much of the government debt (such as LBCs (Central Bank bills) and LFTs (Treasury financing bills)) reflect the average overnight rate. Thus, any increase in inflation and, hence, short-term interest rates, will enlarge fiscal deficits. Moreover, the stock of domestic debt in Brazil and Mexico is about 10 times the monetary base, implying that a large-scale monetization can be very destructive, by accelerating flight from the currency. Indeed, it was the concern over such disruption that gave rise to increased domestic debt financing in the first place.

Given that there is no easy solution, the question arises as to what extent debt explosion (both domestic and foreign) can be avoided by generating and maintaining a primary surplus while keeping domestic real interest rates at sufficiently high levels to stem capital flight. This would require reduction of the external debt burden, a relatively high rate of growth of GDP and a substantial reduction in inflation. In these respects some recent calculations for Brazil and Mexico are very illuminating.[114] They show that if real interest rates on external debt are reduced to 7 per cent (a reduction of about 20 per cent in interest payments on the outstanding stock of debt), inflation reduced to 5 per cent, the need for real devaluations for payments purposes eliminated, and the GDP growth rate kept at relatively high levels (5 per cent for Brazil and 4 per cent for Mexico), debt explosion can be avoided at a rate of a primary surplus of 2.1 per cent of GDP in Brazil and 5.1 per cent in Mexico. The Mexican primary surplus is currently greater, whereas Brazil would need an adjustment of about 3 per cent of GDP. Maintaining or attaining these figures while raising public investment from its presently depressed levels would not be a very difficult task if other conditions were fulfilled - i.e. if fiscal adjustment took place under conditions where the external constraint is lifted and stability and growth secured.

C. Stabilization policies

Thus far efforts to stabilize the economies of debt-troubled developing countries and to eliminate macroeconomic disorder have not had much success, whether they have been pursued through orthodox policies based on monetary and fiscal retrenchment or on heterodox policies based on prices and income measures; a number of countries have recently joined the group experiencing three-digit inflation. This failure is closely related to the extent and the nature of the disorder. In the prevailing circumstances, it is extremely difficult to design a feasible set of policy instruments that could simultaneously attain policy objectives regarding debt service, growth and stability.

The extent of disorder differs from country to country. However, a number of common features are present:

- The acceleration of inflation has reflected, in large part, increased incompatibility of income claims - as in the OECD economies during the 1970s. The incompatibility was first triggered by the supply shocks

[114] See Reisen, *op. cit.*, tables 9 and 10.

Box 12

KEYNES ON DEBT AND INFLATION

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

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

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

(worsened terms of trade and reversal of financial transfers), and then aggravated by sharp devaluations and the collapse of growth;

- The pace of the acceleration has depended on the intensity of conflicts and the institutional mechanisms accommodating income claims. In countries where conflicts were especially tense and incomes rigidly indexed, inflation became self-perpetuating; yesterday's inflation set a minimum to nominal income claims today, and attempts to raise real incomes tended to accelerate inflation further. Past inflationary shocks were thus perpetuated by indexation and inertia, and magnified by persistent efforts of various classes and groups to restore their pre-shock real incomes;
- There can be little doubt that inflation cannot accelerate indefinitely without monetary accommodation, and that monetary expansion is often the counterpart of fiscal deficits. Nevertheless, budget deficits and monetary aggregates in the 1980s have been largely endogeneous and passive, rather than assuming an autonomous, independent and leading role in inflation; indeed, considerable efforts have been made to reduce fiscal deficits, as witnessed by the drastic cuts made in real primary spending;
- The persistence of large fiscal deficits has reflected difficulties of reconciling increased debt burden with resistance to increased taxation and to public expenditure cuts. Moreover, refusal to accommodate the rise in prices by monetary expansion often served to depress activity and incomes, making reconciliation of income claims especially difficult;
- In most countries there has not been a one-to-one correspondence between the rate of inflation and the size of the public sector deficit as a proportion of GDP (the latter being a measure of resources claimed by the public sector over and above its revenues), even allowing for the fact that inflation itself tended to enlarge the deficit. In some countries inflation actually fell as deficits, including central bank losses, widened (e.g. Chile), whereas in many others the reverse situation applied. Similarly, there was no systematic relationship between inflation and seignorage (as measured by increases in the monetary base as a percentage of GDP) in as much as the same amount of resources thus mobilized was associated with very diverse annual rates of inflation (e.g. in Argentina 150 per cent in one year and 700 per cent in another; in Brazil 50 per cent and 150 per cent; and in Mexico 25 per cent and 100 per cent);
- More importantly, no systematic relationship appears to exist between inflation, on the one hand, and the ratio of the public sector deficit to GDP, on the other (see chart 10). Public sector deficits of similar size in different countries have co-existed with widely differing inflation rates. Countries such as Argentina, Bolivia, Jamaica, Kenya, Nigeria, Peru, United Republic of Tanzania, Uruguay and Venezuela had public sector deficits of the order of 5-6 per cent of GDP in recent years, but inflation rates ranging from 5 per cent to several hundred per cent per annum. Again, public sector deficits were similar in Brazil and Chile, but inflation rates were widely different. Similarly, there is a very weak correlation between rates of inflation, on the one hand, and financing of public sector deficits from the central bank and the increase of the monetary base (as a percentage of GDP), on the other. These results suggest that the dynamics of inflation have differed substantially, depending on the degree of conflict over income distribution and the extent to which income claims have been accommodated and translated into faster price increases.

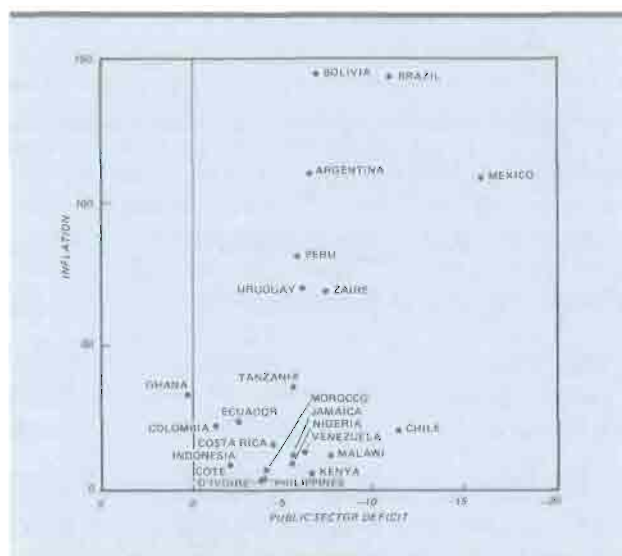
Stabilization in debt-troubled developing countries calls for reconciliation of income claims, including a reduction of public sector deficits. Persistently high deficits, whether financed by an increase in the money supply or an unsustainable pace of domestic debt accumulation, reflect incompatibility of the claims made by various groups (such as public employees, rentiers, foreign creditors, recipients of government subsidies and beneficiaries of public goods) with the income transfers that the private sector is willing to make to the public sector through taxation. If this incompatibility is allowed to persist while a consensus is sought over prices and wages in the private economy, the monetary expansion necessitated by the budget deficit can undermine the efforts to moderate prices and wages, particularly when imports cannot be increased. Any attempt to reduce inflation by arriving at a generally acceptable pattern of income distribution must therefore include a consensus over fiscal measures and identify the sectors and social categories that will be most affected by fiscal consolidation.

The neglect of the distributional aspect of fiscal deficits and inflation perhaps explains why orthodox policies relying solely on budget cuts and monetary restraint have been unable to contain inflation permanently. Indeed, evi-

dence from the experience of many Latin American countries shows that such policies have been able to reduce inflation only temporarily and at the expense of sharp increases in unemployment and a drastic worsening of income distribution - and that the effects often exacerbated social tension, and eventually resulted in faster inflation.[115] Lack of a broad social consensus over wages, prices and fiscal consolidation made it impossible, in view of the strong political and social opposition, to reduce inflation permanently via demand restraint and unemployment.

Chart 10

INFLATION AND THE PUBLIC SECTOR DEFICIT IN SELECTED DEVELOPING COUNTRIES, 1986-1987



Source: IMF, *International Financial Statistics*, and tables 28 and 29.

Note: The public sector deficit refers to the public sector borrowing requirement plus central bank losses as reported in table 28, except for Ghana, Indonesia, Kenya, Nigeria, United Republic of Tanzania and Zaire, where it refers to the consolidated central government budget.

Heterodox policies have sought to deal directly with the distributional aspect of inflation by using prices and income policies. However, they, too, have generally been unsuccessful in reconciling income claims. One version, which is sometimes called "populist heterodoxy",[116] has relied on policies which stand in sharp contrast to orthodoxy: control was extended over prices and exchange rates rather than wages, while government spending, aggregate demand and employment were increased rather than reduced. Such policies, combined with a unilateral restriction on external interest payments, underlined the Inti Plan in Peru in 1985. The plan was applied after a period of drastic decline in export prices (by more than one third between 1980 and 1984), devastating climatic instability, explosive inflation and massive wage cutting. At first the programme was successful, reducing inflation sharply, and raising growth primarily on the base of consumption, employment and real wages. However, the compatibility of income claims was not really assured. Wage increases exceeded the rise in per capita income, inflation was kept low thanks to controls and subsidies on public sector prices, and there were widespread interest and exchange rate subsidies. The budget effectively absorbed such claims, and as long as there were sufficient foreign exchange reserves domestic borrowing or money creation could be avoided. However, the decline in reserves, together with mounting deficits, necessitated sharp adjustments in public sector prices and the exchange rate, so that by the end of 1987 growth had slown down and inflation accelerated, exceeding an annual rate of 1,000 per cent in 1988.

By contrast, heterodox policies pursued in Argentina (the June 1985 Austral Plan) and Brazil (the February 1986 Cruzado Plan) did not seek to alter income distribution in any essential way. It appears that their main premise was that inflation was primarily inertial, reflecting a struggle by the various classes simply to *maintain* their real incomes. Therefore, absent new supply shocks (such as a worsening of the terms of trade or real depreciations), the rate of inflation would remain stable at whatever level it had happened to reach. Thus, a generalized freeze on prices and wages (after appropriate initial adjustments) would be broadly neutral regarding income distribution, and this would simultaneously allow each group to attain its goal of preventing a fall in its living standards and avoid the negative effects of orthodox policies on overall output and employment.

These programmes had various common features. A shock treatment, rather than a gradualist approach was adopted. An important component was a monetary reform involving a new currency, which was deemed necessary not only to reduce inflationary expectations but also to provide a basis (with the aid of a conversion table or *tablita*) for revision of non-indexed contracts carrying a large

[115] See M. Pastor, "The Effects of IMF Programmes in the Third World: Debate and Evidence from Latin America", *World Development*, February 1987.

[116] See E.A. Cardoso, "Hyperinflation in Latin America", *Challenge*, Jan.-Feb. 1989, and R. Dornbusch, "Peru on the Brink", *Ibid.*, Nov.-Dec. 1988.

margin of inflationary adjustment based on expectations, thereby preventing sizeable capital gains and losses when inflation ceased abruptly. A price freeze was introduced in Brazil for an indefinite period, whereas Argentina announced that it would gradually relax price controls. Wages were frozen in both countries after some initial adjustment, and exchange rates fixed against the dollar (in Argentina after a devaluation). Financial instruments were partly de-indexed; in particular, Brazil suspended indexation of government bonds. In both countries fiscal consolidation was planned as an important part of the stabilization programme. The Austral Plan, in particular, explicity recognized that the prices and incomes policies were complementary to the management of aggregate demand. The Government undertook not to finance the public sector by printing money; deficits were to be financed by external borrowing. However, the agreement with IMF provided finance for less than one third of the PSBR (about 2.5 per cent of GDP) and public sector prices were consequently raised considerably before the freeze.

After an initial success (which was much shorter-lived in Brazil than Argentina) these programmes (and the subsequent attempts, such as the Brazilian "Bresser Plan" in June 1987 and the "Spring Plan" in Argentina in August 1987) failed to attain their objectives. The most important reason is that inflation was not purely inertial, but a reflection of a continuing struggle by different population groups to attain income levels that were not mutually compatible. The plans did not reflect negotiated income policies based on a consensus regarding income distribution and the extent to which the income of the public sector needed to be raised and its current expenditure reduced; indeed, such negotiations were absent even after the plans were launched.

Moreover, the disinflation itself was not neutral in its income distribution effects. From the very beginning the Cruzado Plan granted an 8 per cent real wage bonus (16 per cent for low-income workers at the minimum wage) over and above the inflation adjustment. Besides, in some industrial sectors (e.g. automobiles in Brazil) prices were frozen at levels which gave rise to excess demand and to revenue losses for firms. But the main problem was the inability to control prices in sectors with flexible prices, such as dairy products, meat, clothing and fruit and vegetables. As demand was expanding rapidly, particularly in Brazil, prices of these goods, as well as real earnings in the informal sector and of the self-employed, started to rise at the expense of incomes in the sectors where controls were effective. Demand buoyancy was partly due to disinflation itself; the abrupt halt to inflation raised the real value of wealth and reduced forced savings, thereby adding to aggregate demand, including consumption. Moreover, consumers hastened their purchases in the expectation that prices would be higher in the future. In these circumstances, importing more "flexi-price" goods could have helped prevent redistribution at the expense of the sectors where price controls were effective, but the payments constraint had already been tightened due to increased demand, particularly in Brazil, where exports were diverted to domestic markets. In Argentina the terms of trade worsened sharply in the middle of the Austral Plan (a decline of about 20 per cent between 1984 and 1986), which no doubt had a major impact on the success of the plan.

The tendency of "flexi-prices" to rise presented a major dilemma because, in the absence of import expansion, the rise could only be checked through demand restraint, involving primarily fiscal tightening. Despite original intentions, these plans, particularly in Brazil, were not backed by comprehensive, effective, and negotiated schemes for budget consolidation capable of enhancing the role of fiscal policy in demand management. However, contrary to a widespread impression, the fiscal stance cannot be said to have been expansionary during these episodes; in Argentina the PSBR was more than halved between 1984 and 1985 (whether or not central bank losses are included) and stabilized therafter, whereas in Brazil operational deficits fell from 3.5 per cent of GDP in 1985 to 2.6 per cent in 1986; they rose only after the Plan collapsed. But in Brazil, demand management was needed because the economy was being overheated by the impact on aggregate demand of disinflation and the initial wage increases. On the contrary, monetary policy was much looser than was necessary to meet the increased demand for real balances (which typically takes place under disinflation); interest rates fell considerably, encouraging stocking. Thus, whereas the Cruzado Plan sought to reduce inflation without depressing output and employment, it resulted in a rapid rate of growth, which reached 8.5 per cent in 1986. This combination of fast growth and disinflation could not be sustained, and stagflation followed; first inflation picked up, and then growth collapsed as the trade surplus was raised to meet debt-servicing obligations.

These experiences demonstrate that it is very difficult to reduce inflation permanently without reconciling competing income claims. A consensus needs to be established and maintained over prices and wages, as well as over

the ways and means of reducing fiscal imbalances, promoting the budget from the status of a shock-absorber to an effective instrument of demand management. Such a consensus is hard to forge when a substantial portion of output is transferred abroad, and when output growth is constrained by the balance of payments. Indeed, a massive inward transfer of resources was a major factor in Israel's success with similar policies launched at about the same time as in Argentina (July 1985). That programme was combined with a considerable increase in official unrequited transfers, almost doubling the level of 1984 and exceeding $4 billion; the increase amounted to about 8 per cent of GDP and was broadly maintained in subsequent years. It also played a major role in fiscal consolidation, which in other respects was similar to that of Argentina. Budget deficits were reduced to around 5 per cent of GDP (or about the same level as in Argentina) and the annual inflation rate fell from about 500 per cent in 1984-1985 to about 20 per cent in 1987-1988, while the growth of GDP accelerated from 3.5 per cent in 1985 to 6 per cent in 1987. Evidence based on the work of the IMF staff suggests that the episodes of high and accelerating inflation that preceeded the heterodox attempts at stabilization in Argentina, Brazil and Israel resulted from large nominal exchange rate changes designed to deal with external payments, and monetary policy was simply accommodating.[117] It should thus come as no surprise that the policies succeeded only where adequate external financing removed the need for real depreciations of the exchange rate, and where the degree of conflict over income distribution was perhaps much less.

D. Some policy implications

There can be little doubt that the economies of many debt-troubled countries need stabilization which would involve a considerable drop in inflation; moderation of public sector deficits; reduction in the pace of public domestic debt accumulation; substantial slowdown in monetary expansion; reduction and stabilization of real interest rates; stabilization of real exchange rates; and lessening of the degree of currency substitution and capital flight. But it is essential that stability be attained without pushing these economies into deeper recession; for not only is growth an important objective in its own right, but without it, the chances of attaining macroeconomic stability may be very small.

Many developing countries are currently making renewed efforts with various combinations of orthodox and heterodox measures. However, their success will depend on their ability to lift growth, without which the incompatibility of income claims will remain. As shown in *TDR 1988*, lifting growth would require, *inter alia*, a substantial reduction in the debt burden.

The need for debt reduction has now been generally recognized by the international community but implementation involves a number of problems. The analysis above has demonstrated that in a number of countries, restoring stability, order and confidence, and eliminating uncertainties and imbalances, will take some time even if a substantial amount of debt relief is provided and even if, at the same time, appropriate domestic policies are pursued by the debtor countries themselves. This is because the crisis has been allowed to persist for so long; the cumulative damage is too deep-rooted to be undone swiftly. It would therefore be unrealistic, and even counterproductive, to require debtor countries to eliminate internal imbalances before they become eligible for debt reduction, just as it would be to expect a swift return of stable conditions within a short time. The difficulty of attaining stability after a prolonged period of turbulance is demonstrated by the experience of the major OECD economies themselves. Even when the external environment had improved, it took those countries almost half a decade to restore macroeconomic order - and even then with only partial success.

[117] See N. Liviatan, "Inflation and Stabilization in Israel. Conceptual Issues and Interpretations of Developments", unpublished manuscript, IMF (WP/86/10), 1986; and P. Montiel, "Empirical Analysis of High-Inflation Episodes in Argentina, Brazil and Israel", unpublished manuscript, IMF (WP/88/68), 1988.

Debt reduction can have two positive effects that tend to be mutually reinforcing over time in reconciling income claims and eliminating disorder: it will immediately release resources for domestic use and, more importantly, it will allow growth to be restored. However, various elements of the current macroeconomic disorder will disappear only gradually, as the present negative impulses give way to the positive ones that are introduced.

Debt reduction will lower interest payments by the public sector, and so help to reduce budget deficits. However, since private investment needs the support of public investment (in infrastructure and related areas), the latter will need to be raised if debt reduction is to bring about faster growth, especially in the tradeable goods sectors. This means that fiscal adjustment will need to be based on growth. A full fiscal consolidation will therefore take several years to attain. However, it is essential that current spending be kept under control and serious efforts made to raise the share of government revenues in GDP as the latter grows.

In countries where inflation is at three-digit levels and accelerating, negotiated prices and incomes policies will be needed, complemented by demand management, in order to attain a sharp drop in inflation. In some of these countries such policies have already been tried and failed, in part because of the paucity of resources. Their credibility could, however, be restored by a debt reduction, provided that it is sufficiently large to improve perceptions, and is accompanied by greater social cohesion.

Stability in real exchange rates can only be attained as the need to resort to currency devaluations is reduced through an increase in the capacity to produce tradeable goods, which in turn requires new investment. Domestic real interest rates could then be reduced without triggering currency substitution and capital flight, since successive real devaluations would no longer be expected as a matter of course. Lower domestic real interest rates, faster GDP growth and a smaller PSBR could gradually reduce public debt relative to GDP; a reduced level of external debt would thus be translated into a lower domestic debt ratio. The resulting restoration of stability, growth and confidence would also encourage the repatriation of flight capital.

In *TDR 1988* it was pointed out that debt relief was not a "quick fix" and that substantial policy efforts would also be required. It is equally true that debt reduction will not put an end to disorder immediately; the process of stabilization could indeed be lengthy. So far the approach based on "stabilization first, growth later" has yielded only meagre results on either front. A debt strategy that seeks to restore macroeconomic order in the context of growth may thus be a more viable option than the sequence "stabilization - debt reduction - growth" that appears to underlie current official thinking.■

Chapter V

TRADE POLICY REFORM AND EXPORT PERFORMANCE IN DEVELOPING COUNTRIES IN THE 1980s

The main objectives of this chapter are to evaluate trade policy changes in developing countries in the 1980s and to assess the influence which such changes may have had on export performance and on growth. In addition, it examines the conditions with regard to market access which are necessary if developing countries are to step up their reliance on foreign trade to promote growth.

Prompted mainly by intense foreign exchange scarcities, in the course of the 1980s a large number of developing countries introduced trade policy reforms designed to increase exports and to improve their international competitiveness. These changes, which varied in intensity from country to country, involved a combination of reductions in non-tariff import barriers, reductions in the level and dispersion of tariffs, currency devaluation[118] and greater reliance on the exchange rate as a balance of payments equilibrating mechanism, and the introduction or strengthening of export promotion measures.

Partly as a consequence of these policies, in most countries real exports tended to rise relative to real GDP. However, in many cases the shift in resources towards the production of tradeable goods did not take place in a context of economic growth. Usually because of the burden of servicing external debt, the ratio of imports to GDP failed to rise *pari passu* with the ratio of exports to GDP. A fall in investment, brought about by import compression, was widespread. Thus, the response of economies to more open trade policies in terms of aggregate economic growth and of underlying adjustments in the structure of production has often been weak. In many countries, the expansion of exports took place not through larger investment but primarily through a shift of output away from domestic markets, which were depressed by demand management policies designed to generate trade surpluses.

Trade policy reforms have sometimes also been defeated by internal imbalances. Real currency depreciation, often the result of an explicit policy, has been unexpectedly sharp in many countries, owing mainly to the acute scarcity of foreign exchange. Since the exchange rate is a key link in the inflationary spiral, real depreciation has often been achieved only through very large nominal devaluations, which have led to accelerated inflation. In these circumstances, the shift towards higher relative prices for tradeable goods brought about by the real devaluations has been viewed as temporary, thus undermining their effectiveness in encouraging the desired reallocation of resources, particularly for investment. Currency depreciation and foreign exchange scarcity have consequently been locked into a kind of vicious circle: the scarcity has led to depreciation, which, in the context of domestic uncertainties as to relative prices, has failed to induce higher export earnings; in turn, the continuing foreign exchange crisis has resulted in further currency depreciation. High inflation has made real exchange rate stability difficult to attain, and exchange rate instability has discouraged investment in tradeables.

There were significant exceptions to this general pattern, most of which were in South-East Asia. Several countries in this region were able to increase and diversify their exports substantially in a context of rising domestic output and to allow higher imports in support of new investment in both the tradeable goods and the domestic sectors. With output rising vigorously, they tended to enjoy greater price stability, and their real exchange rates were accordingly steadier. The greater stability in relative prices - of both domestic and foreign goods - encouraged investment in the desired

[118] In this chapter the term "devaluation" refers to a specific governmental decision concerning the exchange rate; the terms "appreciation" and "depreciation" refer to actual (*ex post*) exchange rate movements.

directions, with a feed-back to the growth of output and exports. Here the circle was not a vicious, but a virtuous, one. Thanks to rising imports and investment, the shift in resources sought through more open trade policies was achieved.

During the 1980s, strong export and output performance has gone hand-in-hand-with a variety of experiences as regards trade policies. Some countries which managed to sustain strong rates of output and export growth over the long term did indeed - in varying degrees - liberalize their import policies, without this signifying, however, any reversal in the policy of selective trade intervention which most of them had long pursued in support of industrialization.

Among other countries - where there was sometimes a more sweeping liberalization of import policies - there were as yet few clearly evident effects. Against a backdrop of severe domestic disequilibrium, stringent foreign exchange constraints and low investment, liberalization of import policies has had little perceptible effect in enhancing the efficiency of production or the pace of economic growth.

The adoption of export-oriented growth strategies, and the set of policies necessary to implement them, in a growing number of developing countries raises the issue of the coherence of trade policies in developing on the one hand and developed countries on the other. At the same time as policy makers in developing countries have become increasingly convinced of the beneficial effects of a greater participation in the international economy, uncertainties as regards the open trading system have grown.[119] If the growth rates of exports since the mid-1970s were maintained into the early 1990s, and if policy makers in the industrial countries were to respond to increases in import penetration much as they did in the past, pressures for trade restraints can be expected to rise significantly in a number of traditional manufacturing sectors. The new exporters of manufactures among the developing countries would be particularly affected, since they are most likely to enter world markets for manufactures precisely in these traditional sectors.

A. Major trade policy changes in developing countries

Most developing countries affected by the balance of payments and debt crisis reacted initially in a defensive manner by adjusting imports to foreign exchange availabilities. Thus the early 1980s saw frequent increases in tariffs and import surcharges, as well as the imposition or tightening of quantitative restrictions. Some countries resorted to multiple exchange rates and to foreign exchange restrictions. In a second stage, more comprehensive approaches have been tried which have aimed at improving the efficiency of the export and import-competing sectors, switching productive resources from the non-tradeable to the tradeable sectors, and compressing domestic demand. Thus, as regards trade policy, most countries reversed the policies adopted as an immediate response to the crisis.

Trade policy changes have varied widely. While some countries made sharp departures from the past, in other countries changes were more gradual. In spite of the diversity of responses, it can be said that most developing countries had adopted, or were edging toward, more liberal trade policies at the end of the 1980s than they had before the crisis of the early part of the decade. This was so in spite of the fact that most countries were still facing acute balance of payments difficulties.

This section concentrates on changes in tariffs, non-tariff measures, export promotion measures, and exchange rate policies. A sample of 32 countries was selected which are representative of the various trade policy approaches followed during the present decade. It comprises several countries which implemented major trade policy changes or which have maintained relatively low tariffs and few quantitative restrictions throughout the period, countries which significantly reduced tariffs and/or quantitative restrictions, and countries where changes in trade policy regime were not as pronounced. An attempt was also made to select countries at different levels of develop-

119 For recent developments in trade policies in the industrialized economies, see chap. III above, sect. B.

ment and with different structural characteristics.

It should be kept in mind that it is somewhat artificial to discuss each policy instrument separately. Individual policy instruments (including many in non-trade areas) interact to determine the structure of incentives available to producers. For example, in the presence of tariff protection export subsidies in a particular industry may be necessary in order to offset the stimulus to production for the home market. Similarly, the imposition of tariffs may render uncompetitive production for exports which have an important import content or use domestic inputs produced behind tariff walls. In such cases, tariff drawbacks and export subsidies may prove necessary. Where the requisite exchange rate realignments are difficult to implement (e.g. because they would fuel inflation), export subsidies may also help to offset the resulting disincentives for exporters. On the other hand, where devaluation is feasible it may ease the burden of lowering import barriers and many render export subsidies less necessary.

1. *Import policies*

A growing number of developing countries now have low tariffs and a low incidence of non-tariff measures (see table 40), in some cases (e.g. Bolivia, Côte d'Ivoire, Jamaica, Mexico, Republic of Korea, and Uruguay) after a period of fairly restrictive import measures. Others had already adopted such policy reforms earlier (e.g. Chile, Malaysia and Singapore).

Among the second group of countries in the sample, Costa Rica, Nigeria and Senegal also undertook major reforms of their quantitative import restrictions since 1985-1986, while maintaining high tariffs. Others (Mauritius, Sri Lanka, Thailand and Turkey) have followed this policy throughout the 1980s.[120] A third group of countries lowered their tariffs and/or relaxed their non-tariff measures on a wide range of products, but by the end of 1988 still maintained significant non-tariff measures of various kinds and, in some cases, fairly high tariffs. This is the case of Bangladesh, Brazil, Colombia, Ecuador, Ghana, Indonesia, Kenya, Morocco, Pakistan and Philippines (see table 41).

Another group of countries made less significant changes. These include some of the highly indebted countries (Argentina, Peru, Venezuela and Yugoslavia), as well as India, which has traditionally relied on tariffs as a tool of industrialization (see table 42).[121] In Argentina and Peru trade liberalization measures taken before 1980 were even reversed. Sierra Leone (as well as some other African countries not included in the sample) was forced to abandon its policies of greater openness by a surge of imports for which it could not find foreign finance. Most of these countries attempted to compensate for the implicit disincentive to exports by introducing or strengthening export promotion schemes, particularly tariff drawbacks for exporters.

Perhaps the most significant feature of trade policy reform during the 1980s has been the reduced resort to non-tariff measures, in particular in their most restrictive forms (discretionary licensing, quotas and prohibitions). Even if account is taken only of the years 1985-1988, several countries (Côte d'Ivoire, Ghana, Kenya, Mexico, Nigeria, Republic of Korea, Senegal, Sri Lanka and Turkey) reduced the frequency of quantitative restrictions by at least one third. About one half of all countries in the sample have by now reached a relatively low frequency of application of such quantitative restrictions (less than 15 per cent). Some of them (e.g. Republic of Korea and Turkey) had already progressed in this respect during the first half of the 1980s.

There have also been some significant shifts between the various types of quantitative restrictions imposed: import prohibitions have been reduced or even eliminated completely in some countries such as Colombia, Ecuador, Pakistan, and, more recently, India. Furthermore, the application of various other non-tariff measures has also been reduced or relaxed on average by several countries. On the other hand, foreign exchange restrictions remain frequent in several countries (including those adopting more liberal trade policies).

Changes in the levels of tariffs and equivalent import charges since 1985 have been less pronounced than changes in non-tariff measures. Only a few countries have reduced significantly and at the same time both tariffs and non-tariff measures, among which are

120 Although Mauritius has relatively high tariffs on imports (which, to some extent, encourages import substitution), exporters in the rapidly growing export processing zone enjoy access to foreign inputs at world prices. Production and exports in the zone represent a significant and growing proportion of GDP, and this sector of the Mauritian economy is in a free-trade situation.

121 In 1989, Venezuela introduced major trade policy changes, which included a tariff reform, a liberalization of a substantial part of non-tariff measures and, in conjunction with the unification of exchange rates, a major devaluation.

Table 40

IMPORT CHARGES AND NON-TARIFF MEASURES IN DEVELOPING COUNTRIES WHERE THEY WERE LOW IN 1988 [a]

(Percentage)

	Import charges [c]		*Quantitative restrictions* [d]	
Country [b]	*1988*	*1985*	*1988*	*1985*
Countries with major policy changes in the 1980s				
Bolivia (August 1985)	20	20	1	20
Côte d'Ivoire (November 1984)	25	26	7	12
Jamaica (August 1985)	..	17	..	6
Mexico (1985)	16	34	12	19
Republic of Korea (1980-1987)	25	26	9	12
Uruguay (January 1983)	29	32	1	1
Countries with low tariffs and non-tariff measures since the early 1980s				
Chile	17	35	0.2	1
Malaysia	14	14	5	4
Singapore	0.3	0.3	15	10

Source: UNCTAD secretariat calculations, based on communications from member States.

a Countries with a frequency of application of quantitative restrictions of less than 15 per cent and average levels of import charges exceeding 30 per cent.

b The dates in brackets indicate levels (or periods) of major policy reforms.

c Tariffs and equivalent import charges (unweighted averages for all products) as a percentage of the value of imports.

d Discretionary licensing, quotas and import prohibitions (unweighted frequency of application by tariff line in per cent).

Ghana, Mexico and Morocco (before 1985) and, to a lesser extent, Brazil, Colombia, Senegal and Uruguay.

There were also some cases of tariff increases. For example, Côte d'Ivoire, India and the Republic of Korea raised tariffs selectively in certain industries in compensation for the reduction or removal of non-tariff measures. However, average tariff levels have not increased in these countries. Persistent balance of payments pressure, foreign exchange shortages and budgetary problems motivated new increases in import charges by Nigeria, Peru and Sierra Leone. In Pakistan, the increase in average import charges was partly the result of a shift from non-tariff measures to tariffs.

Some important qualitative changes have taken place, as certain developing countries undertook comprehensive reforms of their tariff structures. Bolivia introduced a linear tariff of 20 per cent as a general rate (now reduced to 17 per cent), while applying a 10 per cent rate on capital goods. Chile also has had a general linear tariff rate during the entire period under review. The member States of the Central American Common Market rationalized their common external tariff by setting a ceiling on effective protection of consumer goods, increasing protection for intermediate and capital goods (in particular those produced in the sub-region), and applying a set of economic criteria to the tariff negotiations among themselves. Colombia, Ghana, Mexico, Morocco, Pakistan and Senegal also reduced their highest tariff rates and simplified their tariff structures.

For purposes of analysing the structure of incentives and how it has evolved over time, it is necessary to examine information on effective rates of protection (ERPs).[122] Unfortu-

[122] The effective rate of protection is equivalent to the nominal rate of protection adjusted to take into account the protection afforded to inputs. Therefore, it measures the protection accorded to value added in different industries.

Table 41

IMPORT CHARGES AND NON-TARIFF MEASURES IN DEVELOPING COUNTRIES WITH SIGNIFICANT CHANGES IN THEIR LEVEL IN THE 1980s BUT WHERE THEY REMAIN RELATIVELY IMPORTANT

(Percentage)

	Import charges		*Quantitative restrictions*	
Country	*1988*	*1985*	*1988*	*1985*
Countries with substantially relaxed non-tariff measures but retaining high tariffs [a]				
Costa Rica	62	92	1	1
Mauritius	56	..	..	..
Nigeria (September 1986)	63	37	8	92
Senegal	34	40	6	15
Sri Lanka	41	43	9	13
Thailand	43	41	..	13
Turkey	40	43	3	10
Countries with important remaining non-tariff measures [b]				
Bangladesh	82	..	49	..
Brazil	42	81	16	34
Colombia	48	83	74	96
Ecuador	49	50	27	38
Ghana (October 1986)	36	33	45	100
Indonesia	18	20	92	..
Kenya	41	40	44	67
Morocco	36	35	26	31
Pakistan	98	88	26	80
Philippines	33	38	43	53

Source: As for table 40 (see that table for the definition of "import charges" and "quantitative restrictions").

a Countries with a frequency of application of quantitative restrictions of less than 15 per cent and average levels of import charges exceeding 30 per cent.

b Countries with a frequency of application of quantitative restrictions exceeding 15 per cent.

nately, these are available for very few countries, and in most cases only for one point in time. Although information on changes in ERPs during the 1980s is not available, there is indirect evidence that the dispersion of tariffs across sectors may have declined in those countries where the average tariff rate fell, which would have brought about a fall in ERPs in those countries. This, of course, also applies to those countries which deliberately reduced the dispersion of tariff rates across sectors (e.g. Bolivia and Chile).

The general lowering of tariffs and non-tariff barriers noted above did not lead to an abandonment of past policies of selective trade intervention in support of industrialization. Even Singapore, which has very low tariffs, singled out chemicals and electrical products for support. Since the 1960s, the Republic of Korea has encouraged both import substitution and export promotion in individual sectors through a variety of policies, including export incentives and import restrictions. These incentives have discriminated among sectors, and have varied over time; and they have tended to be roughly equivalent as between production for domestic and for foreign markets.[123] During the 1980s, the Republic of Korea concentrated

[123] See H. Pack and L.R. Westphal, "Industrial Strategy and Technological Change: Theory vs. Reality", *Journal of Development Economics*, vol. 22 (1986).

Table 42

IMPORT CHARGES AND QUANTITATIVE RESTRICTIONS IN DEVELOPING COUNTRIES WHERE REDUCTIONS THEREIN HAVE BEEN RELATIVELY SMALL

(Percentage)

	Import charges		*Quantitative restrictions*	
Country	*1988*	*1985*	*1988*	*1985*
Argentina	26	28	31	50
India	99	..	73	..
Peru	66	54	53	50
Sierra Leone	41	26	100	0
Venezuela	33	30	18	17
Yugoslavia	12	12	32	28

Source: As for table 40 (see that table for the definition of "import charges" and "quantitative restrictions").

its remaining quantitative restrictions on the automotive sector and electrical equipment, industries which also figure prominently in its recent export successes. Of course, the efficacy of selective intervention has varied widely from country to country; but it is also true that the vast majority of the successful exporters and industrializers (during the current decade and in the long term) have practised policies of selective intervention rather than neutrality of incentives.

Several countries have attempted to rationalize their policies of selective intervention, in particular to correct the bias against exports in their trade and industrialization policies. Recently, countries such as India, Indonesia and Pakistan liberalized imports of industrial supplies and capital goods either generally or, at least, in favour of export industries. This liberalization is likely to improve the competitive position of user industries, particularly in export markets.

Actual levels of protection afforded by tariffs may in fact be lower than those suggested by the figures shown in tables 40 through 42. In practically all countries, effective duty collection tends to run, on average, at around 30-50 per cent of tariff rates (if the latter are expressed as a percentage of import value).[124] This is due to the special treatment given to government imports, preferential duty concessions, and the like. On the other hand, protection to domestic industries is sometimes increased by means other than tariffs and non-tariff measures, such as preferential government procurement, investment licensing which limits domestic competition, and other measures limiting access to domestic markets.

2. Exchange rate arrangements

Exchange rate policies became more flexible during the 1980s. In countries pegging to a major currency or to a basket of currencies, nominal exchange rates have been adjusted more frequently than before. In some countries, exchange rates have been left, to varying degrees, to be determined by market forces. A few countries introduced foreign exchange auctions, while either full or managed floating was used by some others. However, balance of payments difficulties led some countries to adopt foreign exchange controls, and resort to multiple exchanges rates increased. Among the countries in the sample, in 1988 eight applied

[124] For an analysis of the evolution of effective tariff collections as a percentage of imports, see chap. IV above, sect. B.

multiple exchange rates for commercial purposes, compared to four in 1982.

Generally, the trend in real effective exchange rates[125] has been towards substantial currency depreciations, regardless of the exchange rate arrangements in force in different countries (see chart 11 and annex table 7). Depreciations have been particularly large in highly indebted countries and in those whose currencies had appreciated strongly in the early to mid-1980s (Argentina, Bolivia, Brazil, Chile, Ghana, Mexico, Nigeria, Pakistan, Sierra Leone, Venezuela and Uruguay). In most countries, the disappearance of capital inflows, large debt-service obligations and terms-of-trade shocks were powerful forces making for real depreciation.

Few countries have achieved real exchange rate stability. One measure of such stability is the standard deviation of the annual rate of change of the real effective exchange rate (see chart 11 and annex table 7). This indicator measures the extent to which annual changes have deviated from the average rate of change for the period in question. For example, if a given currency depreciated or appreciated at a constant annual rate in real effective terms, the standard deviation would be zero. The standard deviation was 10 per cent or less in 14 countries out of the 32 countries in the sample.

Several of these 14 countries with relatively low exchange rate instability were in South-East Asia (Indonesia, Republic of Korea, Malaysia, Singapore, Sri Lanka and Thailand). All 14 countries avoided sharp real appreciations, and several (including Indonesia, Mauritius, Morocco, Pakistan and Turkey) adopted policies of steadily depreciating their currency in real terms. In most of the 14 countries, the maintenance of a stable real exchange rate was facilitated by relatively low inflation. In most other countries of the sample, real exchange rate stability has proven an elusive goal, as has price stability generally.[126] Strong fluctuations in major currencies have also made the preservation of real exchange rate stability difficult for most developing countries.

3. *Export promotion policies*

Most developing countries increased their emphasis on export promotion during the 1980s as a means of earning foreign exchange, in particular from non-traditional products. Overall policy reforms and exchange rate depreciations also made major contributions to correcting relative export prices and improving export earnings.

While some developing countries (e.g. Brazil, Mexico and Republic of Korea) already had in place elaborate export promotion systems in the 1970s, a number of others followed suit by substantially improving and enlarging the scope of their export promotion instruments. Since the early 1980s, many countries have adopted measures geared to the promotion of exports. These include preferential export financing, fiscal and investment incentives, and the setting up of new export processing zones. The adoption of export promotion measures has been widespread, encompassing relatively export-oriented countries (e.g. Malaysia and Thailand), as well as some more inward-looking ones (Argentina, Colombia, India and Peru). In yet other cases, the introduction of export promotion measures was part and parcel of an effort to re-orient the economy toward export markets, after substantial import substitution had been achieved (as in Indonesia, Morocco and Turkey). These policies, however, did not always yield the desired results, particularly when exchange rates were unfavourable to exports and fluctuated over time.[127]

In many cases, export incentives were used to compensate exporters for the adverse effects on competitiveness of protection granted to domestic inputs, of tariffs or non-tariff measures on imported inputs, and of exchange controls and currency overvaluation. A growing number of countries are now using duty drawback and tax rebate schemes for exporters (see box 13 for the experience of Malaysia and Thailand in this respect). In some of these countries, devaluation and import liberalization have permitted a simplification and reduction of these incentives. Some countries have also extended duty drawbacks, tax rebates, and pre-shipment financing to firms providing inputs to industrial exporters.

[125] The real effective exchange rate is a trade-weighted index measuring changes in exchange rates between the country in question and each of its major trading partners, taking into account differences in rates of inflation.

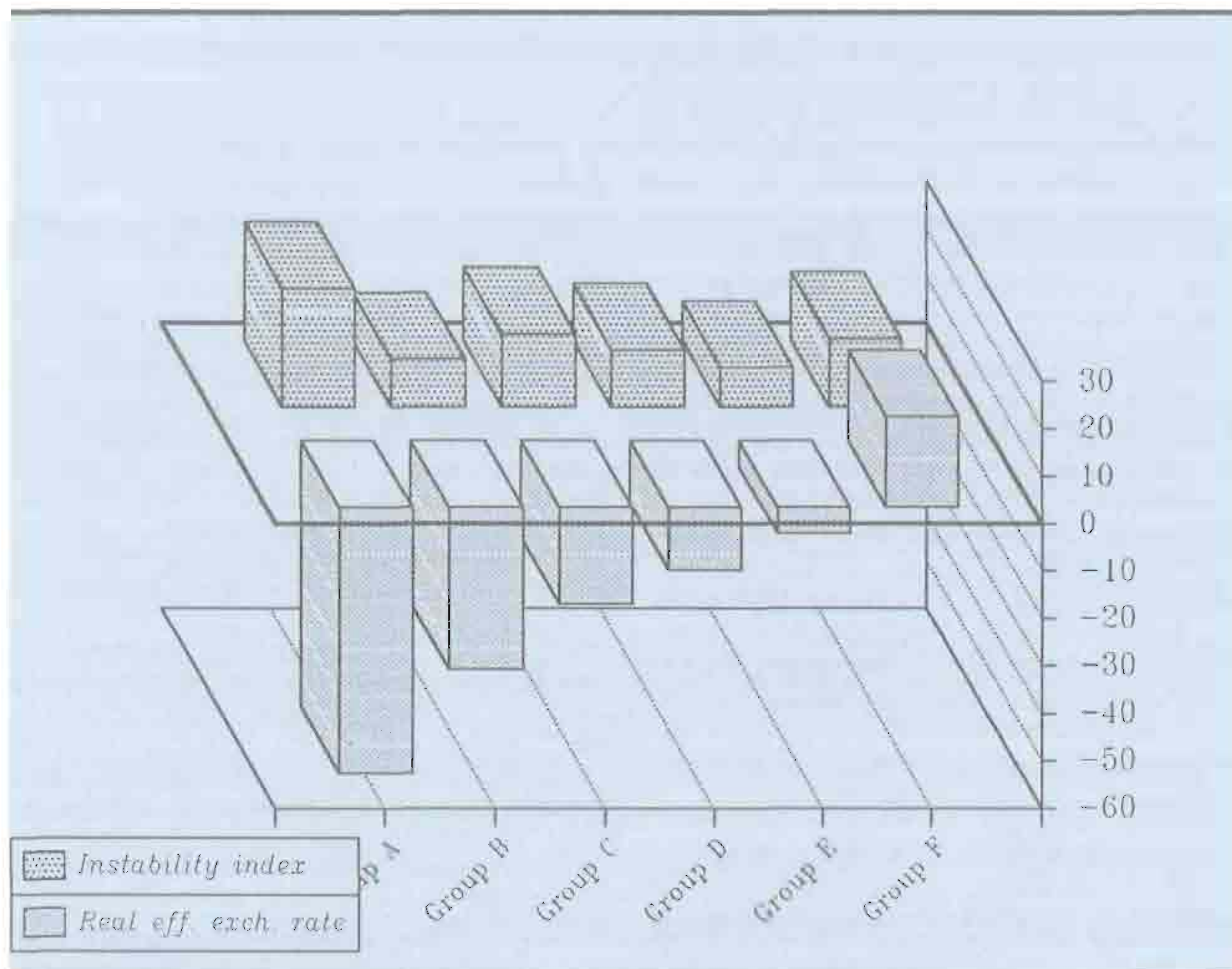
[126] Macroeconomic instability is the subject of chap. IV above.

[127] For the Latin American experience with export promotion policies, see "Politicas de promoción de exportaciones en algunos paises de America Latina", *Estudios e Informes de la CEPAL*, No. 55, Santiago, 1985.

Chart 11

SELECTED DEVELOPING COUNTRIES, GROUPED ACCORDING TO CHANGES IN THEIR REAL EFFECTIVE EXCHANGE RATE AND INSTABILITY INDEX, [a] 1980-1987

(Percentage)



Source: See annex table 7.

Note: The groups of countries are the following:

Group A: Countries whose depreciation was larger than 40 per cent: Argentina, Chile, Ecuador, Ghana, Mexico, Nigeria and Venezuela.

Group B: Countries whose depreciation varied between 30 per cent and 39 per cent: Colombia, Costa Rica, Indonesia, Jamaica, Morocco, Philippines, Turkey and Uruguay.

Group C: Countries whose depreciation varied between 20 per cent and 29 per cent: Bolivia, Kenya, Republic of Korea and Thailand.

Group D: Countries whose depreciation varied between 10 per cent and 19 per cent: Malaysia, Mauritius and Yugoslavia.

Group E: Countries whose depreciation was 9 per cent or less: Bangladesh, Brazil, Côte d'Ivoire and India.

Group F: Countries whose currency appreciated: Peru, Senegal, Sierra Leone, Singapore and Sri Lanka.

a The instability index is the standard deviation of the annual change in the real effective exchange rate.

During the 1980s, new export credit, pre-shipment financing and export credit guarantee schemes have been established by several developing countries, including Argentina, India, Indonesia, Peru and the Philippines; others, including Colombia, Pakistan, Turkey and Yugoslavia, improved their schemes' product coverage and interest rates. Preferential financing has become especially important to the more industrialized developing countries, whose export patterns are shifting towards engineering goods, the production of which requires larger

Box 13

TRADE POLICIES IN MALAYSIA AND THAILAND

Malaysia and Thailand have achieved above-average rates of growth of manufactures exports in the 1980s, and indeed over a longer period also. While several factors have contributed, trade policies have undoubtedly played a role.

Both countries rely on tariffs and other import charges to control imports. Tariffs vary, with low rates on essential goods and higher ones on non-essential or luxury goods. They also escalate with the degree of processing. Both countries have relied heavily on a case-by-case approach to tariff setting. Therefore, it is fair to characterize their trade regime as one of selective intervention, especially when import policies are considered in conjunction with export promotion measures. Quantitative restrictions have not been used often, mainly in recognition of their adverse impact on resource allocation, and tariffs are moderate in comparison to those of other developing countries.

Except for traditional primary commodity exports, there are no export taxes of note in either country; nor are export controls used.

In order to offset the stimulus to production for domestic markets that a system of tariff incentives for industry provides, export promotion measures now form an important part of the industrial incentive system in these two countries. Fiscal encouragements to exports include income tax concessions. Moreover, exporters are generally exempt from the various indirect taxes imposed on final products and on the inputs used for producing exports. Non-fiscal incentives (e.g., accessibility to credit guarantee schemes) have also been provided.

An important component of fiscal incentives to exporters consists of duty drawbacks on imported raw materials and components used in the production of exports. Exemptions from all import duties for projects located in export processing zones have been introduced. Producers located elsewhere benefit from deferred payments and tax credit schemes on duties on imported inputs.

Both countries have mechanisms designed to compensate for import duties and indirect taxes on locally produced inputs used by export industries. In this respect, Thailand's scheme is more comprehensive. In the case of Malaysia, sales of inputs to firms located in export processing zones are considered as exports and are accordingly eligible for duty drawback. In addition, these sales are also exempt from indirect taxation. However, exporting firms other than those located in export processing zones do not enjoy these benefits. In Thailand, on the other hand, the export incentive system permits rebates of duties on indirect imports used to produce raw materials and components bought by exporters.

and longer-term credits than are usually available from the private sector. Since several of those countries have had to reign in the expansion of credit in order to combat inflation, and interest rates are very high in real terms, special measures of this type have been necessary to assist the development of these new exports.[128]

[128] See also the report by the the UNCTAD secretariat "The financing of trade among developing countries" (TD/B/C.7/81).

B. Export performance and economic growth

1. *The record of the 1980s*

The evaluation of export performance is rendered difficult by the non-availability of indicators which would make it possible to disentangle the effect of policy effort from the influence of external factors. Export value cannot be used to gauge performance because it is affected by the behaviour of prices, over which exporting countries have little or no control. For example, the exporters of most primary commodities were adversely affected by the evolution of international prices in the period 1980-1987. Consequently, regardless of their efforts, the value of their exports rose little during this period. Nor is export volume exempt from shortcomings as an indicator of performance, since a country's exports may be heavily concentrated on a commodity the demand for which is declining in international markets. Such is the case, in recent years, of the large oil exporters (Indonesia, Mexico and Nigeria) in the sample of countries used in this chapter. Or a country may export to particular markets which are growing slowly. In these cases, economic policies, even when they succeed in encouraging exports, can be expected to have an impact on export volumes only in the longer term, and a period such as the one under review (1980-1987) is too short for a proper evaluation.

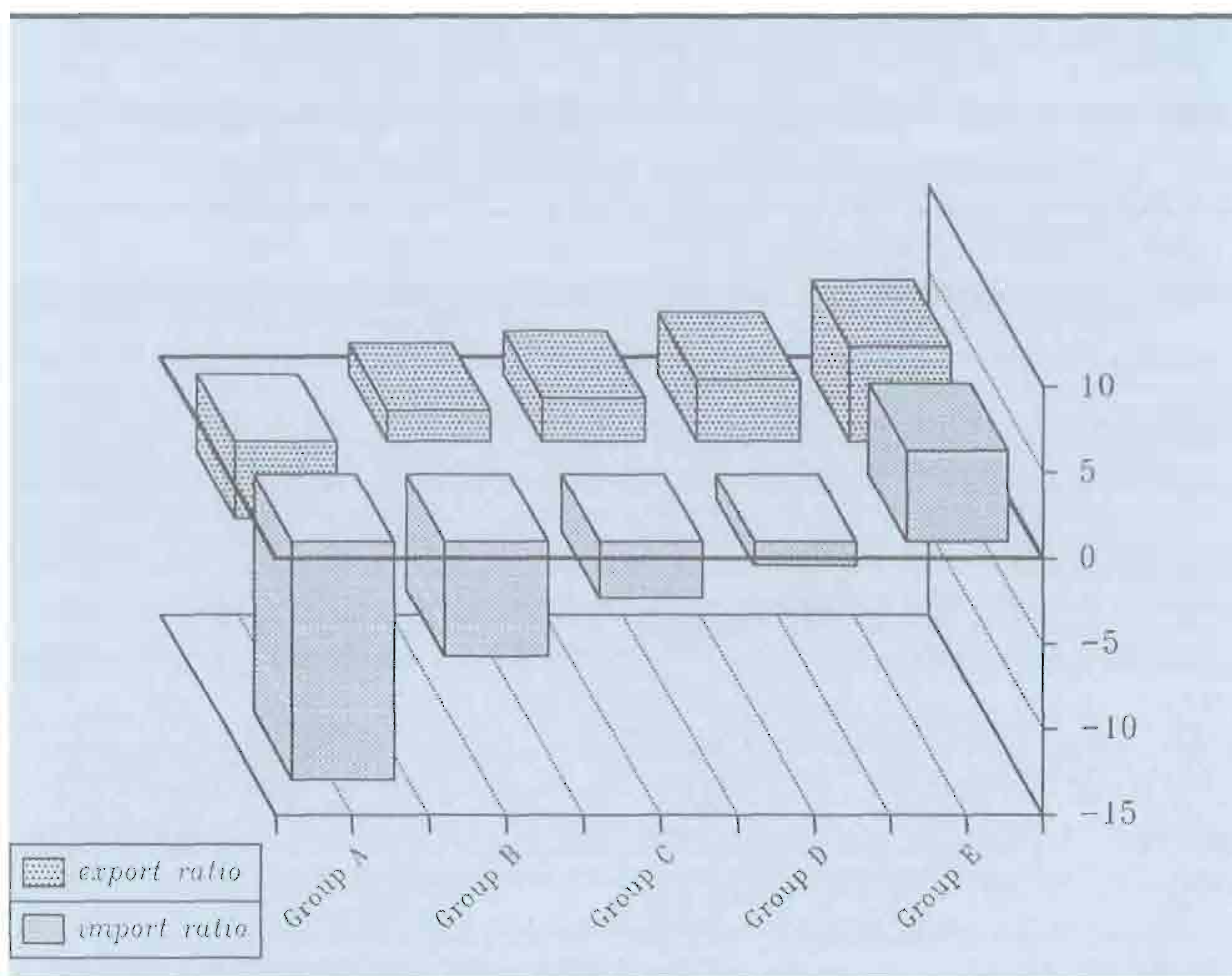
It should also be noted that favourable export performance is not necessarily synonymous with good overall economic performance. Some countries may succeed in increasing their export volume significantly, but only at the expense of production for the domestic market. Indeed, during the 1980s, this seems to have been the case in several countries. Furthermore, in such cases exports may be associated with lower welfare of the population, specially if export earnings are not used to increase imports. Moreover, the appropriateness of an export-oriented strategy of development will depend on a variety of factors, including the size of the economy; and if export growth is not accompanied by product and market diversification, it could increase the vulnerability of the economy to external shocks. It nevertheless remains true that export growth can be a vehicle for reaping economies of scale, improving competitiveness and, by way of the larger imports that it makes possible, acquiring foreign capital goods and technology.

For purposes of measuring the impact of exports on long-term development, several indicators are of interest. For example, the evolution of the purchasing power of exports gives an idea of the extent to which the economy is gaining command over foreign goods and resources. However, for purposes of gauging export performance, particularly through a country's own efforts, volume indicators are more appropriate. Two indicators of performance are used here: (1) the change in the ratio of exports to GDP, expressed in real terms; and (2) the growth in the volume of exports of manufactures. Both indicators should be considered only as approximate measures of performance, since both have serious deficiencies. The first shows the extent to which a country has been able to shift resources into the production of exportables, and has the advantage of being unaffected by the evolution of international prices. Its major defect has already been noted: the ease with which export volumes can be increased varies greatly from country to country. The second indicator is a proxy for the growth of non-traditional exports and export diversification. It is precisely on such exports that one can expect the impact of appropriate policies to be concentrated. It should not be forgotten, however, that non-traditional exports encompass a much broader spectrum than manufactures. Some countries in the sample have been able to increase non-traditional exports of agro-industrial goods (e.g. Chile, where export earnings from fruit and forestry products have, together, come to rival those from copper), in which case the second indicator does not capture the entire story with regard to export performance.

The two indicators do nevertheless reveal some useful information with regard to the relative export performance of the countries in the sample, and taken together with data for the performance of the economy as a whole, they yield some preliminary explanations of the factors which explain differences in export performance.

Chart 12

SELECTED DEVELOPING COUNTRIES, GROUPED ACCORDING TO CHANGES IN THE RATIO OF EXPORTS AND IMPORTS TO GDP FROM 1979-1981 TO 1985-1987



Source: See annex table 8.

Note: The groups of countries are the following:

Group A: Countries whose import ratio decreased more than 9 per cent: Côte d'Ivoire, Kenya, Nigeria, Senegal and Sierra Leone.

Group B. Countries whose import ratio decreased between 5 per cent and 9 per cent: Chile, Ecuador, Mexico, Morocco, Peru and Yugoslavia.

Group C: Countries whose import ratio decreased between 2 per cent and 5 per cent: Argentina, Bolivia, Brazil, Colombia, Costa Rica, Pakistan, Philippines, Thailand and Uruguay.

Group D: Countries whose import ratio decreased less than 2 per cent: Ghana, India, Indonesia, Malaysia, Mauritius, Republic of Korea and Venezuela.

Group E: Countries whose import ratio increased: Bangladesh, Sri Lanka and Turkey.

A fairly large number of developing countries have succeeded in increasing the production of exportables (see chart 12 and annex table 8). Of the 31 countries for which data were available, 18, or more than one half, show an increase in the ratio of exports to GDP (both expressed in constant 1980 prices) of two percentage points or more between 1979-1981 and 1985-1987. However, the developmental impact of these changes has been generally weak, mainly because imports have fallen as a share of GDP (again, when both numerator and denominator are in constant 1980 prices). In only three countries did the import ratio increase by more than two percentage points; while in 21 others it declined by more than two percentage points. The data available indicate that, in those countries where imports declined, all categories of imports, including capital goods, suffered. It is also of interest that the movements in the shares of imports and exports were correlated; thus, the decline in im-

ports limited the ability of countries to shift resources into exportables.

Rates of growth in the exports of manufactures in real terms are shown in table 43. These estimates should be considered approximate, since the deflators used and applied to values in current prices are of dubious quality. Moreover, in some cases the figures include some semi-processed raw materials, which could not be excluded.

The countries in the sample had widely differing growth rates of manufactures exports. In 11 the volume increase exceeded 10 per cent per annum, three of which have maintained export-oriented policies since before the 1980s (Malaysia, Republic of Korea and Thailand). The group also includes a number of countries that have made strong efforts to promote their manufactures exports and, if the recorded growth rates are any indication, have succeeded in doing so (e.g. Indonesia, Mauritius, Mexico, Morocco, Sri Lanka and Turkey). In some of these countries, the strong decline in their real effective exchange rates and a depressed domestic market increased the attraction of exports and significantly reduced the profitability of selling in the home market.

Several of the larger exporters of manufactures among developing countries, such as Argentina, Colombia, India and Yugoslavia, were not among the better performers during the 1980s. In all of these countries, with the exception of India, debt-related foreign exchange constraints and very unstable domestic conditions hindered efforts to increase investment in exportable goods.

2. *Exports, investment and output growth*

In order to determine the extent to which strong exports of manufactures were accompanied by the creation of new capacity for their production, it is desirable to examine statistics of investment in manufacturing. However, such data are generally not available for developing countries. Some inferences can be drawn by examining trends in investment in the economy as a whole, in output in the manufacturing sector, and in GDP. Accordingly, these indicators are also shown in table 43. Slow growth of exports of manufactures was generally accompanied by slow growth in investment, output of manufactures and GDP, and by a fall in the ratio of investment to GDP (in constant prices). The one exception is India, where exports of manufactures expanded relatively slowly, while investment and output growth were well above the sample average.

On the other hand, strong growth in manufactures exports has been generally accompanied by high rates of growth in investment, manufacturing output and/or GDP, and particularly so in Indonesia, Malaysia, Mauritius, Pakistan, Republic of Korea, Sri Lanka, and Thailand. These countries have in general been able to maintain their investment ratios (and even to raise them in some cases) or to increase their output of manufactures at a fast pace. Of course, domestic performance - whether measured by one or other of the three indicators - varied considerably from country to country, and the growth rates of the different indicators were not uniformly high in most countries. None the less, it would appear that export growth in these countries tended to accompany a broader-based process of structural transformation.

Other countries in the sample (Mexico, Morocco, Venezuela and, to a lesser extent, Brazil) combined a strong growth in manufactures exports with negligible growth in manufactures output and a falling investment ratio. In these countries, export growth may have been at the expense of production for the domestic market.[129] If and when their balance of payments situation eases, there could be pressures for an appreciation of the currency in real terms, which could discourage exports. At the same time, any strengthening of domestic demand could pull production from export markets back to the domestic market. Therefore, in those countries which have been unable to increase investment in manufacturing in recent years, export capabilities remain fragile and their strong export performance of recent years could easily come to an end.

3. *The role of trade policies*

Import liberalization is often advocated as being necessary in order to stimulate the growth of non-traditional exports. It is argued that producers will not seek out foreign markets while heavily protected domestic markets offer

[129] In the case of Mexico, where foreign investors have enlarged their export-oriented investments considerably since the early 1980s, investments for the domestic market have remained very depressed, and overall investment has declined sharply in absolute terms.

Table 43

SELECTED DEVELOPING COUNTRIES: GROWTH IN THE VOLUME OF EXPORTS OF MANUFACTURES AND CHANGES IN SOME EXPLANATORY VARIABLES, 1980-1987 [a]

(Percentage)

	Average annual growth (1980-1987)				GDI as per cent of GDP	
Country [b]	Exports of manufactures	Gross domestic investment (GDI)	Value added in manufacturing	GDP	1979-1981	1985-1987
Indonesia	43.9	11.3	7.5	3.8	30.9	33.5
Turkey	43.0	5.2	8.3	5.6	21.5	21.1
Mexico	23.8	-4.9	0.5	1.1	26.8	16.7
Venezuela	19.2	1.3	2.7	0.6	27.6	19.7
Malaysia	17.2	1.4	6.7	4.7	30.6	25.0
Rep. of Korea	15.0	10.0	10.9	8.7	33.3	32.7
Sri Lanka	15.5	-4.3	6.2	3.9	30.4	18.7
Morocco	14.5	-2.6	1.6	2.8	22.8	16.3
Mauritius	13.9	14.7	11.2	6.2	26.0	26.9
Thailand	13.7	4.1	6.1	5.7	27.0	23.2
Pakistan	12.8	7.2	9.1	6.8	17.9	18.3
Singapore	6.8	4.5	4.9	6.0	45.1	41.8
Brazil	5.9	-1.2	1.5	2.9	21.8	16.8
Senegal	5.3	2.0	5.2	3.7	15.5	13.7
Bangladesh	5.0	4.1	2.9	4.0	13.5	15.1
Philippines	4.7	-7.5	0.1	0.5	30.6	13.2
Chile	3.3	-2.8	1.3	1.5	20.5	15.1
India	3.1	4.0	8.3	4.9	24.2	22.9
Ghana [c]	3.0	2.4	-0.3	1.2	5.7	5.7
Costa Rica	3.0	0.1	1.4	1.4	22.9	20.3
Yugoslavia	1.8	-	1.5	0.9	40.8	37.1
Kenya	1.4	-0.2	4.4	3.5	27.2	19.5
Nigeria [c]	1.2	-8.4	1.0	-1.9	20.8	10.0
Uruguay	1.2	-8.0	-0.6	-2.0	16.8	8.1
Colombia	0.4	1.6	3.1	3.2	19.4	16.9
Bolivia [c]	-0.2	-13.7	-5.5	-1.6	15.5	4.7
Côte d'Ivoire	-1.3	-8.4	5.0	1.5	24.3	9.9
Peru	-3.0	2.2	3.0	2.3	26.9	19.9
Argentina	-3.7	-7.2	-0.7	-0.6	20.4	11.1
Jamaica	-5.5	-3.2	-2.2	-1.0	17.1	16.6
Sierra Leone	-6.6	-4.6	2.1	0.3	16.0	11.2
Ecuador [c]	-6.9	-3.3	0.8	1.1	24.3	17.0

Source: UNCTAD secretariat estimates, based on data of the United Nations Statistical Office and World Bank, *World Tables*.

a Growth rates and ratios are derived from data in constant 1980 prices.
b Ranked by growth of exports of manufactures.
c Exports of manufactures are less than 5 per cent of total exports.

them assured profits.[130] There is little to support this contention in the experience of the countries in the sample during the 1980s. The fact that the ranking of countries according to their rate of growth of exports of manufactures bears little relation to their ranking according to the extent to which they have liberalized their imports (see tables 40 through 42) suggests that import liberalization has not been an important ingredient in export performance. Of course, some countries which maintained high tariffs and/or significant non-tariff measures also recorded relatively sluggish growth in their exports of manufactures (e.g. Argentina, India, Peru and Yugoslavia). But rapid export growth was shared by countries having relatively low tariffs and few non-tariff measures or introducing significant liberalization programmes (e.g. Mexico, Mauritius and Malaysia), by those relying heavily on policies of selective intervention (Indonesia and Turkey), and by those with restrictive import policies (Venezuela).

Conversely, most of the countries that introduced drastic policy reforms during the 1980s or before were among those recording the most sluggish export growth rates (Bolivia, Chile, Côte d'Ivoire, Ghana, Jamaica, and Uruguay). Since several of these policy reform packages are fairly recent, it is too early to pass a final verdict on them. However, few of these countries are likely to improve their export performance or diversify their exports significantly in the medium term. In several of these countries, the conditions for rapid industrial development (which underpins strong growth of manufactures exports in the long term) have not been achieved. These conditions include the accretion of skills, the building of an appropriate economic and social infrastructure, and the achievement of economic and policy stability.

During the 1980s there have been some examples of import liberalization and strong export performance, but it would be far-fetched to assign causality to this correlation. For example, the Republic of Korea did gradually liberalize its imports in the course of the 1980s, mainly in order to increase the efficiency of its productive apparatus. As the economy becomes more complex, policies of targeting incentives at specific sectors become more difficult to implement without unforeseen adverse effects on other sectors. However, as noted above, the Republic of Korea did not abandon altogether its past policies of selective intervention; rather, it simplified and rationalized them.

Other successful exporters, such as Indonesia, Malaysia and Thailand, also used policies of selective intervention. While the overall degree of their restrictiveness of import policies varied, the protection of the domestic market tended to be moderate, particularly in comparison with other developing countries, and incentives to produce for the domestic market were roughly balanced by those to produce for export.

From the evidence for the countries in the sample, export incentives have been important to export performance. All countries recording high rates of growth of exports have had a strong and coherent set of export incentives. It would appear that the penetration of export markets is not an easy task, particularly for producers in developing countries who have very inadequate information on and access to foreign markets. Therefore, orienting domestic producers to foreign markets would seem to require special efforts. Duty drawback systems and other measures to provide domestic producers access to foreign inputs at world prices have been important factors in many countries. Practically all countries with strong export performance have instituted policies of this kind.

4. *Exchange rates and export performance*

It has been argued that the maintenance of a real exchange rate favourable to exporters is an important, albeit insufficient, condition for rapid export growth.[131] Exchange rates clearly influence the profitability of exporting; the predictability of incentives over time is also important to exporters, since the necessary investment will not be undertaken if potential exporters are uncertain about the future level of incentives, including the real exchange rate, regardless of how favourable they may be at any particular moment. While an appropriate exchange rate is undoubtedly important as a tool for stimulating sustained export growth, the experience of the 1980s shows that complementary policies are also required, especially if

[130] See C. Michalopoulos, "World Bank Program for Adjustment and Growth", in V. Corbo, M. Goldstein, and M. Khan (eds), *Growth-Oriented Adjustment Programs* (Washington, D.C., International Monetary Fund/World Bank, 1987), p. 45.

[131] See, for example, G.K. Helleiner, "Trade Strategy in Medium-Term Adjustment", paper presented at WIDER Conference on Medium-Term Strategies for Adjustment, Helsinki, 8-11 August 1988, p. 27.

export growth is to take place within a broader-based development process.

As already noted, during the 1980s in most countries in the sample the currency depreciated considerably in real terms, in some cases quite dramatically. This sometimes reflected a shift in policy in favour of export-led growth; however, in many countries the depreciation was fundamentally induced by severe foreign exchange scarcity. Such steep depreciations may have been unnecessarily large; moreover, they may have contributed to a perpetuation of exchange rate instability, since a reversal of the movement (a real appreciation) could be expected to take place if and when balance of payments stringencies eased.

It would be unrealistic to expect to find, on a cross-country basis, a simple correlation between exchange rate change or exchange rate stability (as measured, for example, by the standard deviation of exchange rate changes), on the one hand, and export growth, on the other. In the first place, the adequacy of the exchange rate in the early 1980s as an incentive to produce tradeables must have varied widely from country to country. Secondly, the response of exports to exchange rate changes can also be expected to vary considerably from one country to another. In countries with deep industrial structures, small real exchange rate changes may elicit relatively large export responses; by contrast, in countries with undiversified economies, changes in the rate may have little or no impact on exports. The responsiveness of exports to exchange rate changes may also depend on the existence of excess capacity and on the complementary use of other policies.[132] Finally, in countries experiencing strong inflation, even a real depreciation may not bring forth any additional investment and exports, because exporters may not believe that the depreciation will last.

It is none the less suggestive that the countries in the sample which experienced high exchange rate instability (Argentina, Bolivia, Ghana, Nigeria, Peru, Senegal, Sierra Leone and Yugoslavia) also recorded negative or below-average rates of growth of manufactures exports and, in most cases, a decline in their export/GDP ratios. At the other end of the spectrum, 11 out of the 14 countries with low exchange rate instability in the 1980s (i.e. with a standard deviation of the annual change in the real effective exchange rate of 10 per cent or less) recorded rates of growth of manufactures exports of 5 per cent or more (Bangladesh, Indonesia, Malaysia, Mauritius, Morocco, Pakistan, Republic of Korea, Singapore, Sri Lanka, Thailand and Turkey). In most of these countries, export/GDP ratios also rose. Several countries in this group also introduced policies of systematic real devaluation to stimulate the production of tradeable goods.

Several countries whose currencies depreciated in real terms performed poorly in exports. Eleven countries out of the sample of 32 recorded real depreciations of 30 per cent or more and, at the same time, appear in the bottom half of the ranking of countries according to the rate of growth of manufactures exports.[133] In fact, those where the depreciation in real terms was most pronounced (Argentina, Bolivia and Ghana) were also among those whose exports performed worst. These countries experienced not only sharp depreciations in 1980-1987 but also periods of sustained and strong appreciation - Bolivia and Ghana in or up to the early 1980s and Argentina in the late 1970s. This extreme instability was one of the elements behind lagging export growth. Bolivia and Ghana have relatively undiversified economies and a small manufacturing base, and they consequently need more than exchange rate signals to launch a sustained export drive. In all three countries, extreme domestic economic instability has militated against investment of any kind, be it for domestic or for foreign markets.

More generally, in most countries with severe inflation, a real depreciation of the currency did not stimulate exports, and it has only been achieved through accelerating inflation. Particularly where there is wage indexation and in highly import-dependent economies, a nominal depreciation has tended to fuel inflation, and domestic price inflation has quickly nullified the exchange rate adjustment. Under conditions of extreme price instability, price signals lose their effectiveness.

The diversity of experience with regard to the relationship between exchange rates and export growth suggests that there are other important factors responsible for export performance. It seems that a favourable and stable exchange rate is a necessary, but not a sufficient, condition for a sustained increase in the exports of manufactures or other non-

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132 Devaluation, even when it could improve international competitiveness, may be problematic in some countries for other reasons as well. In economies where imported inputs are a large component of industrial costs, devaluation may have a significant inflationary impact.

133 These countries are Argentina, Bolivia, Chile, Colombia, Costa Rica, Ecuador, Ghana, Jamaica, Kenya, Nigeria and Uruguay.

traditional goods. As already noted, fiscal and monetary incentives may be needed to orient domestic producers to complex and uncertain export markets. Furthermore, in undiversified economies, industrial policies are essential to bring about a process of industrialization which will, in the future, result in new exports.

5. *Exports and foreign direct investment*

Differences in export performance among the countries in the sample during the 1980s are due partly to the behaviour of foreign direct investment. Several of these countries have actively sought to attract foreign investors for their export-oriented industries. Countries such as Malaysia, Mauritius, Mexico, and Thailand have set up export processing zones or have instituted other measures designed to attract transnational corporations and smaller investors whose objective was to export. Indeed, a domestic environment conducive to exporting can be expected to stimulate greater exports from domestic and foreign companies alike.

However, variables beyond the control of the countries in question have also played a role. One of them has been the impact of the steep appreciation of the yen on the strategies and behaviour of Japanese transnational corporations. As part of their efforts to stay competitive in the Japanese and international markets, these corporations have engaged in outsourcing of labour-intensive consumer goods, inputs and segments of the production process to neighbouring, lower-wage (but politically and economically stable) countries. The beneficiaries have been the export-oriented economies of South-East Asia, particularly those which welcome foreign investment. Much of the output originating from such investment has been exported back to Japan, but some has also been destined to the investing corporations' markets in Western Europe and North America.[134]

Much of the export success in Mauritius is also due to investors from abroad, in this case from South-East Asia, largely in the clothing business. Part of the attraction of Mauritius lay in its preferential access to the EEC market and, until recently, unrestricted entry into the United States market (see box 14). Transnational corporations from the United States have played an important role in Mexico's strong export performance. Since 1983, a favourable real exchange rate and other incentives have induced some corporations to set up assembly operations in Mexico's fast-growing export processing zones (*maquiladoras*). Others, particularly affiliates of United States automotive companies, and encouraged by strong fiscal incentives, have used existing plant and equipment, or have even enlarged their facilities, to produce parts and components for the United States market.

The benefits which host countries derive from these investments depend on a variety of factors. Unless backward linkages to the rest of the economy are gradually developed, the benefits could be restricted to the employment that these investments provide, which, in some cases, such as those of Mauritius and Mexico, can be quite substantial.[135]

C. The coherence of trade policies in developed and developing countries

An important issue which has not received sufficient attention is whether the shift to greater reliance on export promotion strategies of economic development is consistent with the recent drift in trade policies in the developed market economies. In recent years, imports into the latter countries have risen more rapidly than aggregate output, not only as re-

[134] For an analysis of the impact of the appreciation of the yen on Japanese trade with and investment in developing countries, see H. Kohama and S. Urata, "The Impact of the Recent Yen Appreciation on the Japanese Economy", *The Developing Economies*, Vol. 26, No. 4 (December 1988).

[135] For a full discussion of these issues, see *Economic and Social Effects of Multinational Enterprises in Export Processing Zones*, Joint publication by the International Labour Organisation and the United Nations Centre on Transnational Corporations (Geneva, 1988).

Box 14

THE ROLE OF PRICE SIGNALS AND SUPPLY CAPABILITIES IN EXPORT PERFORMANCE: THE CASE OF MAURITIUS

If strong performance in non-traditional exports is desired by policy-makers, price signals must favour production for export. However, in order to be able to export, a country must build up the necessary supply capabilities, which is a difficult and lengthy process. Price signals are, by themselves, insufficient. Supply capabilities depend on the acquisition of human skills, the absorption of technology (most of which is imported), the development of an entrepreneurial class, and, in the case of manufactures, access to intangibles such as marketing outlets and product design.

Mauritius is a clear example of the interplay of these two sets of forces, having recorded sustained high rates of growth of manufactures exports since the early 1970s. Its performance in this respect during the 1980s places it near the top of the list of the countries in the sample selected for the analysis in this chapter. Indeed, Mauritius has succeeded in diversifying its economy and reducing substantially its dependence on exports of sugar. Most of its exports of manufactures come from industries established in the Export Processing Zone (EPZ), and consist mainly of garments. Foreign investors, mostly from Hong Kong and other parts of South East Asia, account for a high percentage of these exports. Joint ventures with Mauritian firms are common.

The high rates of growth of exports are explained by a combination of factors. Unlike primary commodities, exports of manufactures depend not only on price competitiveness but also on the export marketing capability of the industry. The latter includes, among other things, the capacity to assimilate the latest technological know-how and the ability to copy the latest product design and to target the product to potential export markets. Information is an essential ingredient in this respect, and most developing countries do not have ready access to the relevant information. Such information can be provided to individual producers by specialized industry-wide institutions (financed by the Government or local manufacturing firms). In the case of Mauritius, foreign direct investment became the major source of technical know-how and export marketing capability.

During the 1980s, a number of firms in South East Asia moved their production units from their home base to the EPZ of Mauritius in order to take advantage of its preferential access to the EEC market as well as of its, until then, unrestricted entry into the United States market. They were also attracted by the special conditions offered to producers in the EPZ. The international price competitiveness of manufacturing in the Mauritian EPZ was enhanced through a real effective devaluation of the Mauritian rupee. Raw materials and components were made available to exporting firms at world prices, and, perhaps more importantly, foreign firms were able to tap a significant pool of skilled low-wage labour.

In most respects, the experience of Mauritius is not typical of other sub-Saharan African countries and cannot be easily applied to them. Most African countries lack the physical and human infrastructure necessary for sustained growth in the manufacturing sector. Moreover, the success of Mauritius remains fragile, for two reasons. First, exports of manufactures are highly concentrated in the EPZ, which has relied heavily on foreign investment, and hence they are vulnerable to changes in the strategies of foreign investors. Second, exports are highly concentrated on garments, a sector which is very prone to trade restrictions in the main importing centres. Therefore, while Mauritius has so far enjoyed almost unrestricted access to its main markets, the situation could change in the future as a result of export success. The experience of Mauritius does illustrate, however, that the growth of exports of manufactures does not depend only on price incentives, but also on other policies aimed at overcoming deficiencies in export supply capability.

gards imports from all countries, but also, and in particular, as regards imports from developing countries.[136] At the same time, there has been increasing resort in the developed market economies to non-tariff measures in order to contain imports and slow down the process of

[136] See chap. III above, sect. A.

international structural adjustment.[137] The question, therefore, arises as to whether the rapid growth in imports of manufactures from developing countries characteristic of the past two decades or so will be sustained in the future. If more such countries succeed in expanding their exports to the industrial countries, the resulting increases in import penetration ratios could bring about an intensification of protectionism, which in turn could call into question the viability of the export-led strategy itself.

Roughly, two kinds of industries can be identified in terms of international trade relations: one kind, in which trade takes place along traditional comparative advantage lines and follows essentially an inter-industry pattern (with developing countries exporting to developed countries their labour-intensive manufactures); and the other, in which intra-industry trade predominates (with both developed and developing countries exporting different varieties of the same category of goods, or with exchanges taking place in the same goods at different stages of fabrication). In the first kind of industry, import competition in developed country markets has given rise to strong protectionist pressures; in the second, while protectionism has been far from absent, trade expansion has, on balance, favoured trade liberalization.

In some sectors, as imports increase as a proportion of domestic consumption, pressures for protection intensify. These industries have been growing at a slower pace in developed market economies than the manufacturing sector as a whole for quite some time. Although imports are not the only source of difficulty for domestic producers, competition from imports is often strong. In many instances, these industries suffer from problems of excess capacity and sectoral unemployment. In addition, a small or even negligible proportion of their output is exported; consequently intra-industry trade flows in these sectors are relatively small. In most cases, they produce consumer goods or industrial inputs used to manufacture final goods for the domestic market. Adjustment in these industries requires scrapping productive capacity, retraining the labour force and even physically relocating the unemployed. Non-tariff measures are concentrated in these industries, and the proportion of imports affected by such measures is particularly high.

There are other sectors where import penetration is also high, but where protectionist pressures are less strong than in the first group of industries. These sectors tend to be dynamic, in both production and trade. Intra-industry trade in these industries is important: the developed market-economy countries not only import a significant proportion of apparent consumption, but also export a certain proportion of output. Generally, large two-way flows of trade in the same industry are found mostly in capital goods. Industries producing intermediate and consumer goods characterized by high product differentiation and utilizing advanced technologies also have significant flows of intra-industry trade. Important characteristics of these industries are the predominance of economies of scale and the existence of product variety; in combination, these traits require the penetration of foreign markets for cost effectiveness and the import of some varieties to satisfy the needs or tastes of domestic users or consumers.[138]

In these latter, increasingly internationalized, export industries, competitiveness is a paramount consideration. Since trade barriers raise their domestic costs, they tend to be firmly resisted in some business quarters. Therefore, rising import penetration ratios tend to go hand-in-hand with larger dependence on exports; while higher import penetration ratios have, in some cases, led to the imposition of non-tariff barriers, the expansion of two-way trade in these industries has tended to favour trade liberalization.

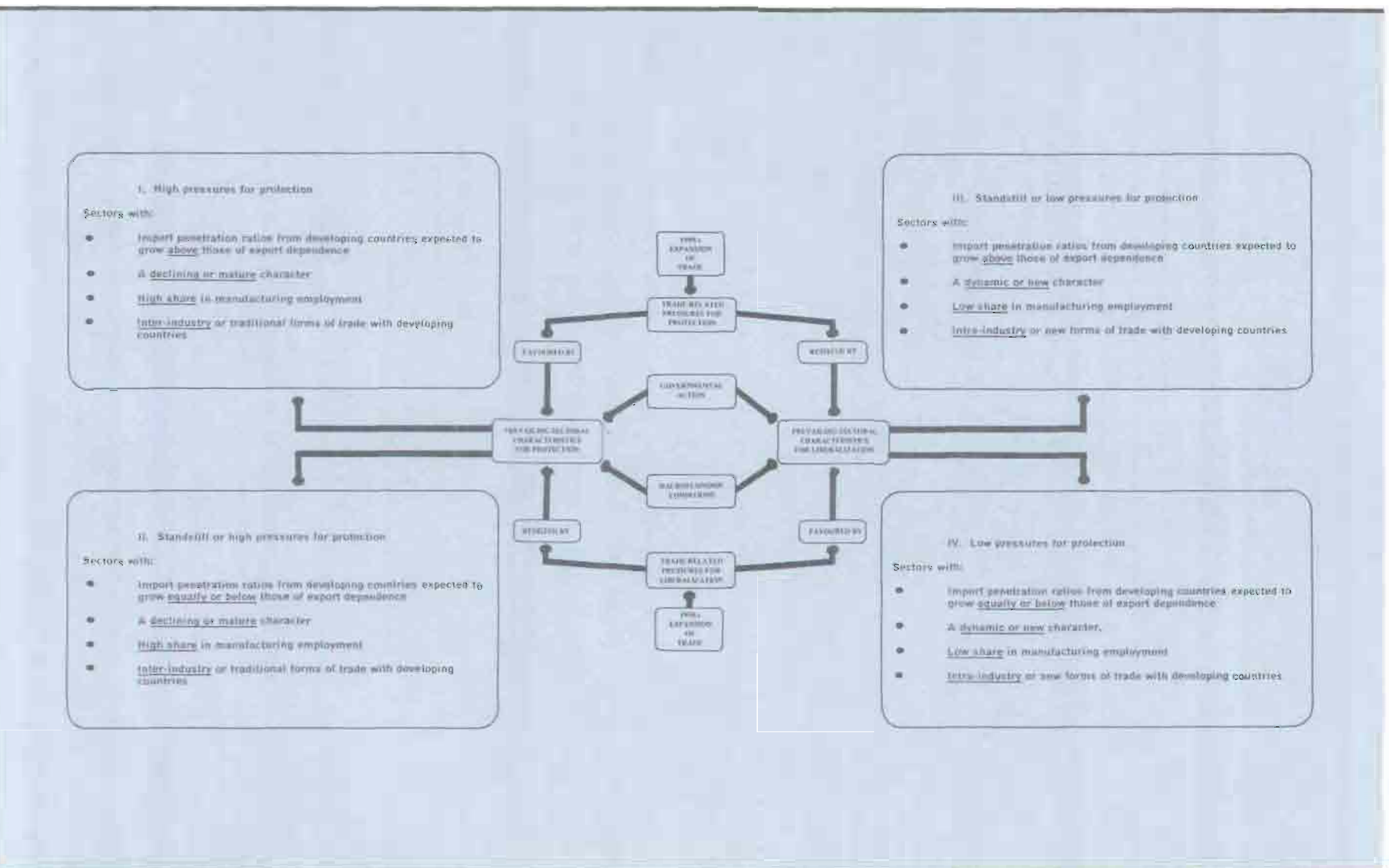
Although these more dynamic components of international trade are concentrated in trade among developed countries, intra-industry trade between the developed countries and some of the more industrialized exporters of manufactures among the developing countries has also been growing rapidly in the recent past. The latter are in the process of shifting their export structures away from the labour-intensive manufactures which face severe protectionist barriers and towards technologically more sophisticated goods, sectors in which intra-industry trade is an important and growing proportion of international trade.

137 For data on the incidence of the "new protectionism" and an analysis of its causes, see *TDR 1988*, part one, chap. III, sect. C.

138 See R.E. Falvey and H. Kierzkowski, "Product Quality, Intra-industry Trade and Imperfect Competition", in H. Kierzkowski (ed.), *Protection and Competition in International Trade* (New York, Basil Blackwell, 1987); D.Tussie, *The Less Developed Countries and the World Trading System, A Challenge to GATT* (London, Francis Pinter, 1987); and D. Grenaway and C. Milner, *The Economics of Intra-Industry Trade* (New York, Basil Blackwell, 1986), chap. VI.

Chart 13

PROJECTED PROTECTIONIST PRESSURES IN THE 1990s IN THE MANUFACTURING SECTORS OF DEVELOPED MARKET-ECONOMY COUNTRIES AS A RESULT OF THE EXPANSION OF TRADE WITH DEVELOPING COUNTRIES



Source: UNCTAD secretariat (see text).

In order to evaluate the likely effects on protectionist pressures of continued expansion of trade in manufactures in the medium term, a hypothetical projection exercise was carried out. The basic assumption made was that trade flows between developed and developing countries, and consumption and production in the developed countries, would continue to grow during 1989-1994 at roughly the same rates as since the mid-1970s. The implications for market access were studied with the aid of a simple political-economy model of protection in which the extent to which imports in a sector (at the four-digit ISIC level) are affected by non-tariff measures (the "trade coverage ratio") was made to depend on the import penetration ratio, the share of exports in total production (to reflect the relative importance of intra-industry trade in the sector), and changes in the share of the sector in total industrial value added over the preceding decade (to capture the relative dynamism of the industry).

The results for the United States and EEC were statistically satisfactory: for 1984 (the last year for which full information was available) the trade coverage ratio was positively correlated with the import penetration ratio, but was negatively related to the share of production exported. In addition, other things being equal, trade coverage ratios tended to be higher in sectors which had experienced relative declines than in those whose importance had increased over the preceding decade. The model is presented in flow-chart form in chart 13. Section B of annex 3 shows the main econometric results.[139]

The qualitative results of the projection exercise are shown in annex tables 9 and 10. In some sectors, imports from developing countries could continue to outstrip the growth in consumption and, if the behaviour of governments with regard to protection is unchanged, protectionist pressures can be expected to increase. This is the case not only of sectors where protectionist pressures are already strong (e.g. textiles and clothing) but also of some where non-tariff barriers are not yet significant but, on present trends in output and trade, pressures to increase protection could grow (e.g. footwear in the United States). In these sectors (Group I in annex tables 9 and 10), trade-related pressures for protection could outweigh trade-related pressures for trade liberalization, as exports from the importing developed countries are not projected to grow strongly.

In other sectors (Group II of the annex tables), while trade-related pressures for liberalization could outweigh those for protection, higher protection could none the less be the result of other forces such as large sectoral unemployment or the maturity of the industry. These domestic considerations could prevail over trade-related ones, for example in the iron and steel, sugar refining, and furniture industries.

There are a number of sectors where import penetration could grow more than export dependence. However, domestic pressures for protection could remain low, given the fact that output in these sectors (Group III of the annex tables) is projected to grow rapidly. Examples are some types of electrical machinery, office equipment and basic industrial chemicals. The outcome of the projection indicates either standstill or diminished protection.

Finally, there are sectors in which import penetration ratios could rise, but so would the share of production which is exported; therefore, one could expect pressures for protection to remain either unchanged or even to diminish, especially if such sectors are growing rapidly. This could be the case of several branches of the machinery industry (and components for machinery) and of industries producing chemicals or other sophisticated industrial inputs. In these sectors (Group IV of the annex tables), trade-related pressures could, on balance, favour trade liberalization rather than protection.

The extent to which the exports of manufactures of developing countries are presently concentrated on sectors which could experience greater protection (Groups I and II) or movements towards liberalization (Groups III and IV) in the 1990s can give a rough indication of the protectionist barriers they could encounter in increasing their exports to the developed countries in the 1990s. This information is presented in table 44 for broad categories of developing countries according to income level. If the composition of exports from each coun-

[139] The same issue has been explored in a simplified way in the past. In 1982, Cline studied the likely impact on import penetration ratios in the North of the generalization of the export growth in the four South-East Asian export-oriented economies to other developing countries. The results indicated that import penetration ratios would soon rise beyond a politically tolerable level. See William R. Cline, "Can the East Asian Model of Development be Generalized?", *World Development*, Vol. 10, No. 2 (1982). The novelty of the approach followed here is that considerably more sophisticated political-economy responses (at the sectoral level) are modelled and used in the projections.

Table 44

IMPACT OF HYPOTHETICAL CHANGES IN PROTECTIONIST RESPONSES IN THE UNITED STATES AND EEC ON EXPORTS OF DEVELOPING COUNTRIES IN THE 1990s

(Percentage)

	Share of 1985 imports in sectors:		*Share of 1985 imports in sectors which could experience in the 1990s:*	
	Under protection [a]	*Free*	*Higher protection*	*Lower protection*
Imports from:		*UNITED STATES*		
All developing countries	56	44	52	49
of which:				
By income level: [b]				
Low-income	67	33	75	25
Lower middle-income	53	47	64	36
Upper middle-income	57	43	48	52
By share of manufactures in GDP:				
Under 15 per cent	49	51	69	31
15 per cent and above	57	43	52	48
Imports from:		*EUROPEAN ECONOMIC COMMUNITY*		
All developing countries	80	20	61	39
of which:				
By income level: [b]				
Low-income	78	22	71	29
Lower middle-income	89	11	75	25
Upper middle-income	79	21	62	38
By share of manufactures in GDP:				
Under 15 per cent	73	27	65	35
15 per cent and above	83	17	69	31

Source: UNCTAD secretariat calculations (see text).

a A sector is considered under protection if in 1985 its trade coverage ratio was higher than 5 per cent and free of protection if the ratio was lower.

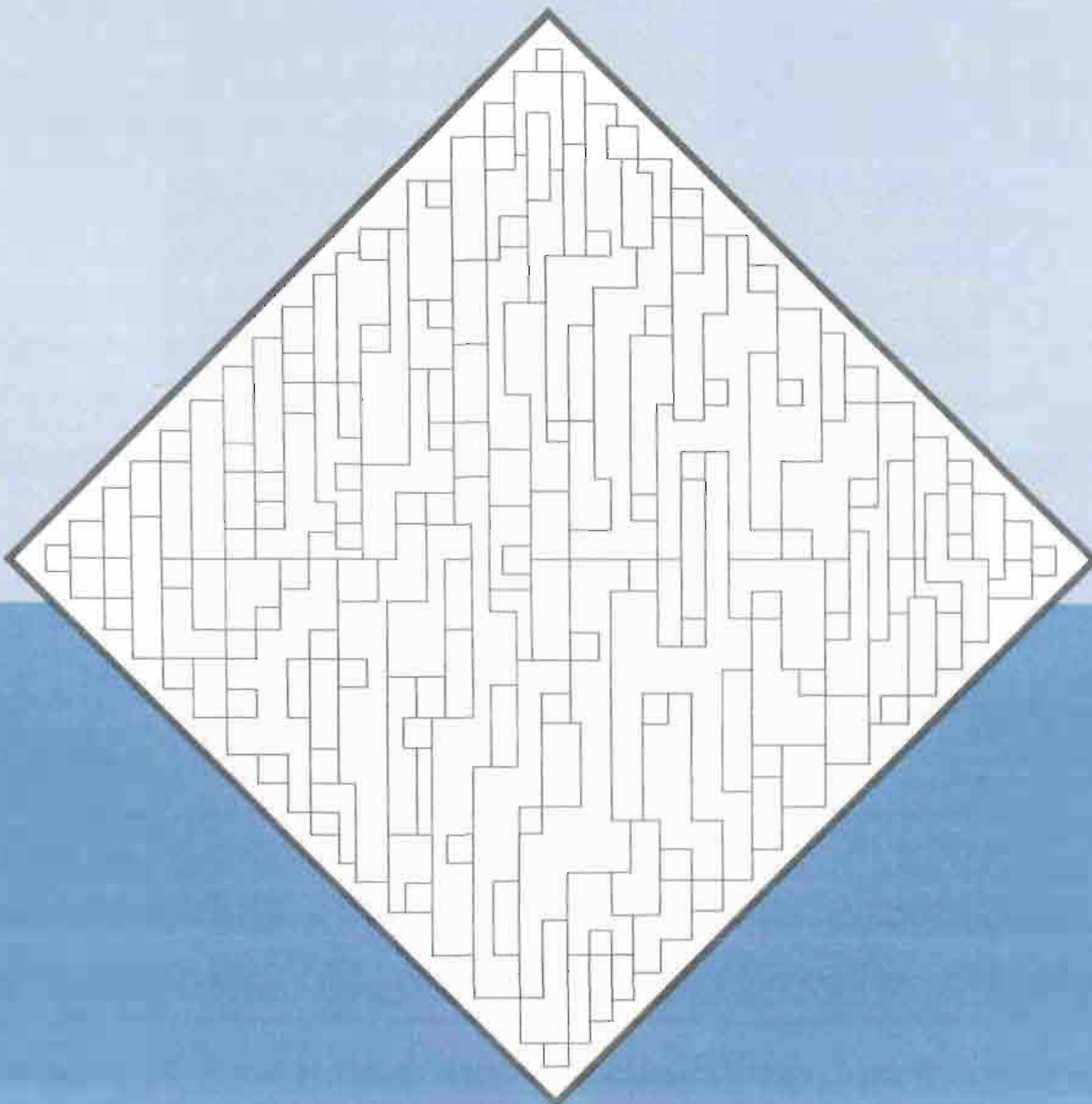
b In terms of GDP per capita. (Low-income: under $450; lower middle-income: $450-$1,800; upper middle-income: over $1,800.)

try group remains roughly unchanged, the higher-income countries could face marginally lower protectionism in the 1990s than they do at present, particularly in the United States, where imports of an intra-industry nature from those countries are most developed. This relatively favourable development with regard to market access would be aided by the fact that the export structures of these developing countries are changing in the direction of the less protected sectors. By contrast, the lower-income developing countries may well encounter greater difficulties of market access in the 1990s. It is also of interest to note that, even for the higher-income developing countries, the reduction of the share of exports to the developed countries facing high protectionist pressures is fairly small; therefore, these countries are still likely to encounter very

significant difficulties in exporting to foreign markets.

Of course, these findings are the result of projecting past trends into the future, on the assumption of unchanged policy responses. None the less, they are suggestive, and they indicate that protectionist forces may well continue to threaten the export success of developing countries. While protectionism will most probably not bring the export expansion to a halt, it may well diminish its dynamism significantly. This could affect particularly the newcomers to the international markets for manufactures, whose exports are heavily concentrated in sectors with restricted market access and where protectionist pressures could become even stronger. While the more industrially advanced developing countries have more room for manouvre, and are already in the process of diversifying their exports towards goods in which trade barriers are lower and are likely to decline, those countries too are likely to continue to be faced by non-tariff measures in the major markets. Therefore, it can be safely concluded that the adoption of export-oriented strategies of development by an increasing number of countries, if they are to succeed, will require strong political decisions in favour of open markets and a modification of the past approach with regard to trade policies in the developed countries.■

THE LEAST DEVELOPED COUNTRIES



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THE SPECIAL CHARACTERISTICS OF THE LDCs

A. Introduction

This chapter reviews the structural characteristics of the least developed countries which serve to differentiate them from other developing countries.[140]

These differences may be seen in the broad economic sphere, but also (and arguably more importantly) in the social, geographical and ecological spheres. The discussion which follows takes up each of these themes in turn.

B. Economic differences

The primary characteristics of the LDCs have been set out in the very definition of this group of countries: low levels of income, literacy and industrialization. Compared with other developing countries, the LDCs show striking differences in these indicators. Thus, per capita income in 1986 was but one quarter of that in the developing countries;[141] adult literacy rates were hardly greater than half those in the developing countries; and the share of manufacturing in total GDP was less than half that in the developing countries. These comparisons indicate very clearly the width of the gulf that separates the LDCs from the developing countries, not to speak of the developed world.

The gap is not limited to these three indicators. There are also those vital factors for the development of a country - the savings and

[140] The General Assembly has identified 42 countries as the least developed among the developing countries on the basis of their very low per capita income, very low literacy rate and low contribution of manufacturing industries to GDP. With a combined population of 340 million, these countries are: Afghanistan, Bangladesh, Benin, Bhutan, Botswana, Burkina Faso, Burundi, Cape Verde, Central African Republic, Chad, Comoros, Democratic Yemen, Djibouti, Equatorial Guinea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, Lao People's Democratic Republic, Lesotho, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar (formerly Burma), Nepal, Niger, Rwanda, Samoa, Sao Tome and Principe, Sierra Leone, Somalia, Sudan, Togo, Tuvalu, Uganda, United Republic of Tanzania, Vanuatu and Yemen.

[141] Comparative data are mainly taken from UNCTAD, *The Least Developed Countries - 1988 Report* (TD/B/1202) (United Nations publication, Sales No. E.89.II.D.3, 1989); and UNCTAD, *Handbook of International Trade and Development Statistics*, 1988 (United Nations publication, Sales No. E/F.88.II.D.11). The major indicators discussed are summarized in table 45 in the present chapter.

Table 45

SELECTED ECONOMIC AND SOCIAL INDICATORS FOR LDCs AND OTHER COUNTRY GROUPS

Indicator	*Year/ period*	*LDCs*	*All developing countries*	*Developed countries* [a]
A. Economic				
GDP per capita	1980	227	900	9838
(in 1986 dollars)	1986	221	884 [b]	11080 [b]
Annual growth of GDP per capita ($)	1980-1986	-0.7	-0.3	2.0
Share of investment	1980	19	25	22
in GDP (per cent)	1986	14	22	21
Exports per capita ($)	1980	26	255	1235 [c]
	1987	22	192	1631 [c]
Share of primary commodities	1980	69	19	19
in total exports (per cent)	1985	65	21	16
Imports per capita ($)	1980	51	209	1364 [c]
	1987	46	182	1701 [c]
Share of agriculture	1980	46	16	4
in GDP (per cent)	1986	46	18	3
Active population in agriculture	1980	77	59	8
(per cent of total population)	1987	73	56	6
Arable land and land under permanent crops (per cent	1980	6	10	12
of total area)	1986	7	11	12
Output per worker in	1980	339	660	10931
agriculture (in 1986 dollars)	1986	366	796	12043
Annual growth of per capita agricultural production (per cent)	1980-1987	-0.6	0.2	0.2
Share of manufacturing	1980	9	18	27
in GDP (per cent)	1986	9	21 [d]	24 [d]
Annual growth of per capita value added in manufacturing (per cent)	1980-1986	-2.1	-1.4	0.6

(For source and notes see end of table.)

investment rates. Whereas the investment rate for the developing countries was of the order of 22 per cent of GDP in 1986, it was no more than 14 per cent in the LDCs, only three fifths that level. The discrepancy in the savings rate was even greater, the average rate for the LDCs in the period 1980-1985 being only one quarter of the average for the developing countries.[142]

This low savings rate derives from the very low per capita income indicated above. Since a very large proportion of the LDC population lives at subsistence level, it is physically impossible for them to save more than a tiny fraction of their income.

At the sectoral level, the differences persist. Thus, the share of agriculture in LDCs' GDP is almost two and a half times greater than in the developing countries,[143] yet per capita agricultural production in the LDCs has been declining in the 1980s in contrast to the

[142] Investment was nevertheless able to proceed owing to the very significant inflows of foreign aid received by the LDCs.

[143] The differences are similarly marked for the other main sectors of economic activity. Thus, industry represents only

Table 45 (concluded)

SELECTED ECONOMIC AND SOCIAL INDICATORS FOR LDCs AND OTHER COUNTRY GROUPS

Indicator	*Year/ period*	*LDCs*	*All developing countries*	*Developed countries* [a]
B. Social				
Life expectancy at birth (years)	1980-1985 [e]	47	53	73
Infant mortality rate (per thousand)	1980-1985 [e]	132	100	18
Average daily calorie intake per capita	1979-1981	2032	2352	3308
	1984-1986	2048	2404	3361
Adult literacy rate (per cent)	1980	27	50	99
	1985	32	58	99
Primary school enrolment (per cent)	1980	57	84	101
	1986	55	87	103
Percentage of population with access to safe water	1980	30	45	99
	1985	34	53	99
Physicians per 100,000 of population	1980	8	36	182
	1984	11	45	204 [b]
Telephones per 1,000 of population	1980	2	21	537
	1986	3	29	603
Radio receivers per 1,000 of population	1980	60	111	1062
	1986	91	171	1185
Energy consumption per capita (kg of coal equivalent)	1980	54	459	6076
	1986	58	516	5853

Source: UNCTAD secretariat calculations, based on international and national sources.
a Developed market-economy countries.
b 1985.
c Including socialist countries of Eastern Europe.
d Based on a sample of countries for which data are available.
e Based on census data for the census year in the period 1980-1985 for the various countries.

slight growth recorded in the developing countries, and the same is true of per capita food production.[144] The failure of food production to match population growth has led the LDCs to import almost twice as much food, proportionately, as the developing countries. At the same time, the LDCs' export markets remain more closely tied to those countries with which they have traditional links than do those of the developing countries: LDC exports to EEC are twice as large, proportionately, as those of the developing countries, whereas the share of their exports to Japan and to North America in total LDC exports is less than half the comparable share of the developing countries. At the same time, the LDC market in developing countries is only two thirds as large, proportionately, as the intra-developing-country market.

The increasing *marginalization* of the LDC group in the world economy is evident from the evolution of its world export market share, which in 1987 was only a quarter as large as it had been two decades earlier. Moreover, this marginalization occurred even vis-à-vis other developing countries, whose export market share remained roughly stable over the same period (that of the major petroleum

12 per cent of GDP in the LDCs vs. 32 per cent in the other developing countries; for services, the shares are 39 and 45 per cent respectively.

[144] The difference is not accounted for by population growth, since although population in the LDCs is rising rapidly, its growth rate is only marginally higher than in the developing countries as a whole. However, the share of arable land under permanent crops is only two thirds as great in the LDCs as in the developing countries.

exporters declining slightly, from 7.1 per cent to 6.3 per cent, and that of the other developing countries rising slightly, from 13.0 per cent to 14.1 per cent). The relative decline of the LDCs is even more marked in the current decade, since the value of their exports in 1980-1988 grew at a rate that was less than a sixth that of the non-oil exporting developing countries. This result derives from the unfavourable evolution of the prices of the products - mainly primary commodities - exported by the LDCs, which declined at the rate of 1.7 per cent per annum over the 1980-1988 period, and from the more rapid growth of the volume of exports of the non-oil exporting developing countries, which more than tripled over this period.

The concentration of the LDCs' export structure is quite remarkable. Not only do the top ten exporters account for 67 per cent of total LDC exports (1986), as contrasted with the bottom ten, whose share is a meagre 2 per cent,[145] but these exports are, as indicated above, heavily concentrated on a very limited number of goods. In fact, whereas primary commodities account for 32.5 per cent of the total exports of the non-oil exporting developing countries (1986 data), they make up fully 65 per cent of the LDCs' exports.[146] This explains their extreme sensitivity to the fluctuations in the prices of primary commodities, fluctuations which are, it need hardly be said, entirely beyond their control, given their very small share of global primary commodity exports.

A further economic characteristic which distinguishes the LDCs from other developing countries is their extremely heavy dependence on imports of manufactured goods, which are hardly produced in their fledgling and fragile economies, and of food, which is not produced in sufficient quantities in many of them.[147] These two categories account for fully three quarters of LDCs' imports. Thus, the trade deficit of the non-oil exporting developing countries represents a much smaller share of imports than does that of the LDCs. Even in the early 1980s, when the former countries were running very substantial trade deficits in order to ward off the effects of the global recession, the deficit of the LDCs was proportionately more than twice as large; and more recently it has been running at rates five-to ten-fold that of the non-oil exporting developing countries.[148] Moreover, the stock of debt[149] of the LDCs, the servicing of which is affected by, and affects, the current account, amounts to three quarters of GDP in the LDCs as contrasted with about half in the developing countries as a whole. And even though much of the debt of the LDCs is contracted on concessional terms, the low level of their exports means that the burden of debt service in relation to export earnings is considerably higher (at about 32 per cent) than for the developing countries as a whole.

Factors related to the labour force also distinguish the LDCs from the other developing countries. Thus, the rate of population growth in the LDCs is faster than that of developing countries (2.6 per cent per annum, compared to 2.3 per cent per annum) and, as a result, the total dependency rate[150] is increasing (although at a lower level than in developing countries as a whole), while its growth indicates that it has tended to decrease in developing countries. A further labour force difference derives from the preponderance of the agricultural sector in the LDCs, where almost three quarters of the labour force finds employment, i.e. about 30 per cent more than in the developing countries. When workers in the mining and fisheries sectors are added, close to four fifths of the LDC labour force are seen to be employed in the primary, mainly subsistence, sector.

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145 Interestingly, this does not particularly distinguish the LDCs from other developing countries, for the share of the top quarter non-oil exporting developing countries in the total exports of this group (which corresponds proportionately to the top ten in the LDC group) is, at 68.4 per cent, slightly higher.

146 For 23 of the 42 LDCs for which data on export concentration were available, the Hirschmann index stood above 0.5 in the mid-1980s (by comparison, only one OECD country - Norway - had an index over half this value) and, of these, for 14 of the 19 LDCs for which 1970 data were available, that index had actually risen by the mid-1980s over its 1970 level - indicating still greater export concentration.

147 In 25 of the 36 LDCs for which FAO provides data, the cereals self-sufficiency ratio (defined as the ratio of total cereals production to total availabilities for domestic consumption of cereals) declined over the period 1970 to 1986. See *The Least Developed Countries - 1988 Report, op. cit.*, table 8.

148 It should be noted that the trade deficit for the LDCs has been remarkably stable as a share of imports over the current decade, at just over 50 per cent. The changes vis-à-vis the non-oil exporting developing countries arise because of the sharp reduction in the deficits of the latter countries.

149 Including short-term debt and IMF credit.

150 Defined as the ratio of the population aged 0 to 14, and 65 and over, to the population between 15 and 64 years of age inclusive.

C. Infrastructural and social differences

Nor are the striking differences between LDCs and the developing countries limited to purely economic indicators. Indeed, the indicators of social characteristics show an even greater divergence on many counts. For instance, the LDCs are significantly less urbanized than the developing countries. Their more rural nature is translated into such communications-related indicators as the number of telephones and radio receivers, the circulation of daily newspapers per thousand inhabitants and the number of post offices open to the public. It is equally to be seen in the energy consumption indicators which are significantly more weighted towards wood products than electricity, coal, oil or gas. Thus, whereas the average inhabitant of an LDC consumes nine times more wood products for energy purposes than the average developing country inhabitant, he uses hardly more than a tenth as much of the commercial sources of energy.

It should further be noted that a major structural characteristic of the economies of the LDCs is the exceedingly weak physical infrastructural base. The poor country-wide network of transport and communication linkages has helped to perpetuate an often stagnant dualistic economic structure. Development has tended to occur in a few monetized urban enclaves in relative isolation from the rural subsistence sector, where the overwhelming majority of the population and the natural development potential are located. Road vehicles, not being tied to a specific route, provide greater flexibility than do railways, a particularly vital characteristic for the LDCs where one of the major tasks is to provide accessibility to isolated communities and to exploit natural resource potential. Yet according to available data, 19 of the LDCs have a road network density of less than 60 km per 1000 km^2. This is significantly lower than the level of many other developing countries.

Moreover, there are several LDCs with no rail infrastructure whatsoever. In general, the railway network in LDCs is sparse, with extremely low density, and data for 18 LDCs indicate that eight of them have a railway network density of less than 2 km per 1000 km^2. Insufficiency of rolling stock and poor track superstructure and alignments are widespread and the facilities for maintaining them are inadequate. The handling facilities for containers and the marshalling facilities are equally inappropriately equipped. Skilled manpower is scarce at certain technical and management levels. Although many other developing countries face similar problems, these are sharply reinforced in the LDCs by their overall vulnerability, acute lack of financial resources and very limited operational ability to cope with the technological demands of modern railway management systems.

As regards air transport, most LDCs already have one international airport but the domestic aviation infrastructure is often lacking. Terminal facilities, including handling equipment, are also in many cases insufficient. The inadequate surface distribution systems, the low levels of traffic and the directional imbalance of freight flows impose severe constraints on the LDCs' ability to expand air-cargo capacity at economic rates. Available traffic data on 21 LDCs indicate that 14 of them recorded freight volumes of under 10,000 tonnes and seven of over that figure in 1986. Moreover, the upward trend observed in the expansion of air traffic volumes in many developed and developing countries in recent years is applicable to very few LDCs. During the period 1982-1986, the growth of traffic volumes either stagnated or declined sharply in several LDCs.

Nutrition and health-related measures also show a sharp cleavage between the LDCs and the developing countries. Thus, proportionately only half as many children in the LDCs have been immunized against diphtheria-pertussis-tetanus (DPT) as in the developing countries and the infant mortality rate is one quarter as high again. With regard to the availability of treatment for common diseases and injuries and of essential drugs at the first level of contact, i.e. local health care, the coverage rate in the LDCs in the mid-1980s was only two thirds that of the developing countries. LDCs are also less well endowed as regards the coverage rates of attendance during pregnancy and at childbirth.

Access to safe water is also considerably less widespread in the LDCs than in the developing countries. And the average daily calorie intake is 15 per cent lower in the LDCs than in the developing countries.

The educational situation repeats this depressing story: adult literacy rates in the LDCs are barely more than half those in the developing countries, and school enrolment ratios compared with those of the developing countries are only two thirds at primary level, one third at secondary level, and as little as one quarter at post-secondary level. In addition, LDCs devote only three quarters as much of their GDP to public educational expenditures as the developing countries.

Consequently, in 31 LDCs for which data are available, the number of illiterates aged 15 years and over was approximately 110 million in the early 1980s as compared to 95 million in the early 1970s,[151] so that during the past two decades the campaign to eradicate illiteracy may be said to have been more successful in spreading literacy than in ending illiteracy[152] in the LDCs.

Moreover, the situation as regards the quality of education is very serious in many LDCs. Studies carried out in Ethiopia, Guinea and the United Republic of Tanzania,[153] as well as evidence regarding other LDCs, show that the expansion of basic education has been accompanied by a lowering of standards, owing to poor physical conditions, the low level of teacher training and the lack of books and stationery. Cutbacks in education and teacher training budgets have been extensive in LDCs in the 1980s, and there are high repeater rates in the primary school system of many of these countries.[154]

Another social indicator which points to significant societal differences is the ratio of children (aged 0-14) and old people (aged 65 and over) to the total population; this measure is a fifth again as large in the LDCs as in the developing countries, implying a proportionately heavier burden on the working members of society.

D. Gender-related differences

Attention is increasingly being paid to the role of women in the process of development. Here, as elsewhere, there are striking differences between the LDCs and the developing countries as a whole.

Thus, even in the fundamental activity of child-bearing, major differences are to be found. The average total fertility rate of women in the LDCs is over half as high again as in the developing countries. Moreover, marriage and child-bearing occur earlier in the LDCs than in the developing countries: 45 per cent of all women between the ages of 15 and 19 years are already married in the LDCs as compared to only 39 per cent in the developing countries.[155] In addition, although marriage is increasingly being delayed in some parts of the developing world, patterns of early and arranged marriage have been slow to change in most LDCs. And only 10 per cent of LDC women use a contraceptive method as compared with 49 per cent for the developing countries.

[151] UNESCO, *Development of Education in the LDCs since 1970: A Statistical Study* (CSR-E-42) (Paris, January 1983), p. 5.

[152] P.H. Coombs, *The World Crisis in Education: The View from the Eighties* (Oxford University Press and New York, 1985), chap. 9, pp. 265-283.

[153] UNESCO, *Educafrica*, No. 11, 1984.

[154] In Bangladesh primary schools, only one in five students entering the system emerges literate. In Comoros, the educational reform to improve the quality of education carried out since 1985 has meant a reduction of enrolment in primary schools and a reduction in the number of teachers. In rural Mali, there are only six textbooks per hundred students, and seven out of twenty schools have no books at all. (See *The Least Developed Countries - 1988 Report, op. cit.*, p. 69).

[155] In Guinea and Niger, this figure rises to over 80 per cent, while in Bangladesh 90 per cent of women aged 20 to 24 have been married before the age of 18, and two thirds have already become mothers by that age. All data and findings in this section are drawn from a paper prepared for the UNCTAD secretariat by Ruth Dixon-Mueller entitled "Women and development in the LDCs: Assessment and proposals for action", 15 May 1989.

Although infant mortality rates have declined in both LDCs and developing countries, the LDC rates remain 32 per cent higher than those in the developing countries and the maternal mortality rates 20 per cent higher. Moreover, with an average life expectancy at birth of 48 years, the life span of women in the LDCs is fully eight years shorter than that of their counterparts in the developing countries.

Differences appear also in literacy rates. Whereas in the developing countries, about one half of the women and about two thirds of the men are literate, in the LDCs fewer than one quarter of the women and about half of the men are literate, the proportion being much lower for women than for men. Thus, not only are women in the LDCs much less likely to be literate than women in the developing countries, but the gender gap is wider in the LDCs. This is due in part to the fact that girls in the LDCs are only half as likely to attend primary schools as girls in the developing countries and only two thirds as likely as boys from the LDCs to do so. These differences persist in the secondary and tertiary levels of education, becoming, indeed, even more pronounced (girls in LDCs having an enrolment rate of 9 per cent at secondary level and 0.7 per cent at tertiary level, as compared with 31 per cent and 4.6 per cent in the developing countries).

Finally, some economic data may be presented. Thus, as is to be expected in countries in which three quarters of the population live in rural areas, in most LDCs about four out of every five economically active women are employed in the primary sector. In 1980, 79 per cent worked in agriculture, 8 per cent more than in the developing countries. Correspondingly, the share of women workers in the non-agricultural labour force in the LDCs is, at one quarter, slightly smaller than that in the developing countries.

E. Geographical differences

Fifteen of the LDCs are land-locked and nine are small, remote island countries. These geographical characteristics constitute an additional development constraint.

1. Land-locked countries[156]

The land-locked LDCs, though located at or near the centre of their continents, are on the periphery of the world economy and thus have limited access to international trade. This hampers their access to the major markets for primary products and to the primary sources of industrial goods. More than one third of the 42 LDCs are land-locked and these constitute three quarters of the 20 land-locked developing countries. Land-lockedness is therefore a peculiarly LDC phenomenon. Furthermore, most of the land-locked developing countries are situated in the African region where, as indicated in the next section, natural disasters have crippled economies that are already highly vulnerable. Land-locked LDCs and their transit neighbours have therefore not only had a limited capacity to expand the network of transit corridor systems but have also failed to maintain existing facilities, a difficult enough proposition given that the port nearest to the capital city or major commercial centre of, for example, Afghanistan, Burkina Faso, Burundi, the Central African Republic, Chad, Mali, Niger and Uganda is at least 1,000 kilometres away.[157] Their exports and imports thus entail travel over long distances, often involving 40 to 60 days, through the territories of their transit neighbours, over which they have, of course, no control.

This situation has rendered many of the land-locked developing countries highly vulner-

156 For a more comprehensive discussion of these issues see, "Report of the *Ad Hoc* Group of Experts to Study Ways and Means of Improving Transit-Transport Infrastructure and Services for Land-locked Developing Countries" (TD/B/1002) (1984); "Progress in the implementation of specific action related to the particular needs and problems of the land-locked developing countries" (A/42/537) (1987); "Land-locked developing countries: their characteristics and special development problems" (UNCTAD/ST/LDC/5 and Corr. 1), report prepared at the request of the UNCTAD secretariat by David M. Nowlan, 1985.

157 Among the non-LDC land-locked developing countries, only for Mongolia and Zambia are these distances as great or greater (see A/42/537, *op. cit.*, table 1, for the actual distances).

able to disruptions of transit routes resulting from technical breakdowns, natural disasters, labour disputes, political upheavals in their coastal neighbours or international conflicts. The emergence of monopolies - with their high transit cost implications - is an additional risk of heavy dependence on one outlet. Once again, this characteristic is peculiar to the LDCs: the non-LDC land-locked countries have in every case at least three alternative routes to ports, and are therefore much less vulnerable.[158]

Additional freight costs, lengthier transport times and unpredictable transport risks have several effects: they narrow the range of primary commodity exports and thereby decrease the total volume of exports, reduce the degree of processing before export, raise the proportion of imports from regional suppliers and increase the instability of export earnings. Since each of the land-locked LDCs has only a small share of the world market for any particular export commodity, it cannot influence world prices. Consequently, the value of its exports at the border is determined by subtracting expected transport costs (transport time, risks of delay, risks of damage and expected foreign exchange fluctuations) from the expected world market price. Similarly, the value of imports at each country's border is determined by adding transport costs to factory-gate prices in the country of production. In particular, the double penalty of lower export prices and higher import prices retards the commercialization of peasant agriculture, as the monetary returns from producing export crops are lower and the costs of consumer goods that are imported or manufactured locally using imported inputs are higher. It also weakens the land-locked LDCs' relative capacity for development by limiting their capability to import the necessary capital goods and production inputs more than in the case of other developing countries.

Although the added difficulties of being land-locked permeate every aspect of the development process, their impact on the evolution of external trade is particularly severe with respect to export development since such difficulties limit the range of potential exports and markets in which goods can be competitively and profitably traded. The land-locked countries' import bills are also very high, owing to high transport costs. The combination of these factors can evidently have a significantly adverse effect on the terms of trade of such countries.

2. *Island LDCs*

The most basic characteristic of island LDCs (ILDCs) is their smallness. Indeed, the non-island LDC country with the smallest land area (which happens to be the Gambia: 11,295 km^2) is more than five times larger than all but two of the nine island LDCs.

The very small land area of many of them tends to limit their agricultural potential, and is associated with water supply constraints. Similarly, the small land area - as well as the geological formation - of most ILDCs implies that they have limited mining potential. (The lack of natural resources of ILDCs should, however, be qualified by the potential afforded by the vast Exclusive Economic Zones which many of them have acquired under the Convention on the Law of the Sea.)

Proneness to natural disasters, owing to both meteorological and geological hazards, is another characteristic of ILDCs. Tropical cyclones are a particularly frequent and damaging type of disaster in island LDCs. Many islands are also subject to earthquakes and volcanic eruptions. Mention should also be made of the likely effects on islands of the expected global climatic changes known as the "greenhouse effect".[159]

Transport and communications are the most obvious aspect in which islands differ from continental countries. The fact that islands cannot connect with the road or rail network or with the water and electricity distribution system of a neighbouring country makes delivery more expensive than in most continental countries, however small. Furthermore, most ILDCs are archipelagoes, which suffer from additional transport and communi-

[158] For example, the main corridor linking Rwanda to the port of Mombasa in Kenya was disrupted on several occasions following political unrest in Uganda during the late 1970s and early 1980s. Rwanda was compelled for some considerable time to airlift part of its cargo to and from Mombasa. More recently, Rwanda began using a new corridor via Lake Victoria to Mombasa. Although it is a high-cost road/water/rail route, whose physical infrastructure is underdeveloped, it is a vital "insurance route".

[159] It is being predicted with increasing confidence that in the next 30 to 50 years the mean surface temperature of the globe will increase by 1.5°C to 4.5°C. One of the consequences of this will be a rise in the sea level, through thermal expansion, by 20-140 cm. This will affect all coastal areas, destroying human habitat and vital infrastructure, but would be particularly catastrophic for the small low-lying islands, some of which could disappear altogether. An increase in water temperature would also widen the cyclone belt and produce more violent cyclones.

cation constraints. This problem is particularly acute in the many scattered small ILDCs (for example, Maldives, Kiribati) and makes their national economic and social integration particularly difficult.[160]

Island LDCs must hold larger stocks of a wide range of goods, including such essentials as foodstuffs, fuel and spare parts, than most areas with easier and more immediate access to supplies, and must allow for longer delivery periods. These stocks, as well as time spent in transit, involve economic costs. In fact, small islands, being final destinations and irreversible markets from which goods, once delivered, cannot economically be shipped out, often suffer from shortages, since only minimum quantities for which there is an assured market are ordered from overseas.

The small economic size of most ILDCs means that they have reduced opportunities to take advantage of economies of scale, given indivisibilities in certain sectors. This tends to lead to high unit costs in social and physical infrastructure, so that these countries have to devote a greater share of their financial and human resources to providing basic infrastructure and services than larger countries and thus suffer from an unavoidable cost disadvantage in international competition and in promoting their development.

Another effect of smallness and of the critical minimum size for many economic activities is specialization in just a few export lines. This is apparent in the relatively high merchandise concentration indices in the ILDCs: the average number of products exported by them in 1985 was ten (excluding Haiti, for which the number was 56, given the proximity of the United States market) as compared with 22 for the LDCs as a whole, 104 for a lower-middle-income developing country such as Kenya and 173 for Singapore.

F. Environmental differences

A further characteristic of the LDCs, which it is difficult to quantify in the present state of data-gathering, is their environmental fragility. Because of its ramifications and implications, environmental degradation in LDCs, should it continue, can in fact not only compromise but even nullify the LDCs' development efforts. This phenomenon has multiple manifestations which are inter-related: steady deterioration of the earth's natural environment, drought and its sequels and other natural disasters. Land misuse and overuse, which is a characteristic of the economically weak LDCs, and constitutes the inevitable response of a very poor rural population trying to cope with its subsistence needs, causes continuing environmental degradation in these countries. Thus, declining fertility and soil erosion lead to lower agricultural productivity, which forces a growing population to clear forest and to extend cultivation into marginal lands as a means of meeting food needs, which in turn reduces agricultural productivity, and so on. Deforestation is exacerbated further by the heavy dependence on fuelwood in many LDCs. Fuelwood demand is, for example, estimated to be 2.5 times the sustainable yield in Ethiopia and twice the yield in Sudan.[161]

Drought has been an environmental phenomenon of particular concern to many LDCs in recent years. Although the LDCs account for only half of the African countries, drought is reported to affect nearly three quarters of them, i.e. 27. Surveys carried out in the West African region (including Burkina Faso, Mali and Niger) indicate that average rainfall has diminished considerably over the past 15 years as compared with the period 1934-1984.[162] Indeed, the fear has been expressed by environmental experts that drought episodes in Africa - and disproportionately in the LDCs - might in the future occur as often as every three

[160] An idea of the cost of the territorial discontinuity of archipelagoes may be obtained from the cost of completion of the 3.4 km causeway between Betio (Kiribati's main commercial centre) and Bairiki (the main administrative centre), opened in June 1987, which was more than $A 10 million (about $US 6.7 million), a figure of the order of one fifth of the country's GNP.

[161] Lester R. Brown *et al.*, *State of the World 1986 - A Worldwatch Institute Report* (New York and London, Norton, 1986), p. 24.

[162] *West Africa* (London, 30 May 1988), p. 968.

years.[163] Tragically, given the fragile environment of the LDCs, even improved rainfall in the aftermath of a drought episode has adverse side effects in some of them. Thus, in Africa, good rains since late 1985 provided exceptionally favourable breeding conditions for grasshoppers and locusts. Finally, it should be noted that, although drought is a natural phenomenon due to various climatic and meteorological factors, there is evidence that it may be induced by man-made devegetation.[164] A study commissioned by WMO and UNEP concludes that the interaction of naturally-recurring drought with the prevalent land-use practices of the LDCs can result in desertification.[165]

Environmental deterioration in the LDCs has been compounded by floods, cyclones, seismic disasters, civil strife and mass population movements. On the basis of long-term information (1960-1981) on the number of disasters and people killed, 15 LDCs have been identified by UNDRO as among the vulnerable and disaster-prone countries.[166] Of these, Bangladesh is by far the most disaster-prone, suffering 80 per cent of all the disaster-induced deaths recorded in the LDCs during 1960-1981. Disaster mortality tends to be higher the lower the income of the country affected.[167]■

163 *Marchés tropicaux et méditerranéens* (Paris, 28 August 1987), p. 2289.

164 See "Countries stricken by desertification and drought", report of the Secretary-General of the United Nations (A/41/346; E/1986/96) (9 June 1986), paras. 12-13.

165 Kenneth Hare, *Climate and desertification: a revised analysis*, World Climate Programme (WCP-44) (January 1983), pp. (ix) and 102.

166 UNDRO, *Disaster prevention and mitigation*, vol. 12 (1986), table 3.

167 UNDRO asserts that certain patterns emerge from the analysis of the effects of natural disasters: "the amount of damage and lives lost usually bears a close relationship to the prevailing level of economic development. The smallest and the poorest countries are affected most severely by natural disasters, and the poorest and most disadvantaged members of a disaster affected community are likely to experience the most serious consequences" (*ibid.*, p. 6).

STRUCTURAL ADJUSTMENT PROGRAMMES IN THE LDCs

A. Introduction

Chapter I has enumerated a number of characteristics that set the LDCs apart from other developing countries, and that make their economies much more fragile and vulnerable to external shocks, as well as to a limited range of policy choices. In the light of these characteristics, and in order to assist the LDCs to transform their economies towards self-sustained development and enable them to provide at least internationally accepted minimum standards of living for all their citizens, the international comunity established at Paris, in 1981, the Substantial New Programme of Action for the 1980s for the Least Developed Countries (SNPA), which entered into force just as the global recession of the 1980s was taking hold. In consequence, during the 1980s, the LDCs have been faced with the challenge of both carrying out the structural transformation of their domestic economies, and of dealing with a mounting debt burden and growing payments difficulties. These objectives have been pursued against a background of shrinking foreign-exchange receipts due to slackening world demand, depressed commodity markets, growing protectionist pressures, insufficient expansion of concessional financial flows, and the virtual stoppage of commercial bank lending. To attain these two objectives, major policy reforms, in the context of structural adjustment programmes, have been launched in LDCs, aimed essentially at improving the efficiency of resource use and allocation, enhancing the contribution of the various sectors to GDP, strengthening the physical infrastructure, and improving institutional capabilities in the field of development planning and policy. Table 46 summarizes the measures which have been adopted.

The present chapter draws heavily on the UNCTAD secretariat's work programmes for the least developed countries and in particular on *The Least Developed Countries - 1988 Report*, which has just been published.[168] The chapter uses these materials to consider the characteristics of structural adjustment programmes and provide instances of the measures adopted and the extent of their application among LDCs. This is necessarily a generalized treatment covering a wide range of countries. In order to obtain greater insight into the functioning and impact of structural adjustment programmes in the LDCs, chapter III presents an overview of experience in eight of them.

[168] TD/B/1202, *op. cit.*

Table 46

MAIN MEASURES TAKEN IN THE CONTEXT OF IMF-SUPPORTED ADJUSTMENT PROGRAMMES IN SELECTED LDCs

Country	*Depreciation and/or exchange rate flexibility*	*Reducing govt. expen-diture*	*Improving tax collection /new revenue*	*Tightening monetary and credit policies*	*Introducing flexible interest rate policy*	*Expanding role of private sector (including privatization of parastatals)*	*Improving efficiency of public enterprises*	*Liberalizing pricing and marketing of goods*	*Stimulating agricultural production*	*Promoting export diversification*
Bangladesh	X	X	X	X	X (implied)	X	X	X		X
Central African Rep.		X	X (implied)				X		X	
Gambia	X	X	X	X	X	X	X	X	X	X
Haiti		X	X				X	X		X
Malawi	X	X	X	X				X		
Mali		X	X			X	X	X	X	
Niger		X	X	X		X	X	X	X (implied)	X (implied)
Sierra Leone	X	X		X	X		X	X	X	
Somalia	X	X		X	X	X	X	X	X	X
Sudan	X	X	X	X				X	X	
Togo		X	X	X		X	X	X	X	
Uganda	X	X	X		X (implied)		X	X	X	X

Source: UNCTAD, *The Least Developed Countries - 1988 Report, op. cit.*, table 1.

B. Improving the efficiency of resource use and allocation

LDCs operate under severe resource constraints and need to overcome persistent external disequilibrium. Accordingly, the mobilization and efficient use of available resources has become a priority policy objective for these countries. The policy reforms undertaken include external sector adjustments, demand-management measures, mobilization of domestic savings and of human resources, promoting the role of the private sector, and improving the efficiency of public enterprises. A number of LDCs have carried out reforms in this regard in the context of upper-tranche stabilization programmes agreed upon with IMF; several of them are studied in detail in later sections of this report. Other LDCs have put in place programmes of a similar nature but outside the framework of formal IMF agreements; one such country (Botswana) is the subject of a case study for this report.

During the period from mid-1981 to June 1989, 27 LDCs[169] implemented stabilization programmes negotiated with IMF and, for that purpose, received support through stand-by arrangements (typically of 12-24 months' duration) and/or the recently established IMF Structural Adjustment Facility and Enhanced Structural Adjustment Facility (see annex 4). Case studies on seven of these countries appear in chapter IV below. The programmes have been increasingly supported by complementary long-term credits granted by the World Bank[170] and by regional development banks (see annex 4).

1. External sector policies

Exchange rate devaluation has been one of the key elements, if not a precondition, of the adjustment programmes negotiated with IMF, as a means both of enhancing the international competitiveness of locally produced goods and of encouraging import substitution. In conjunction with exchange rate devaluation, quantitative restrictions have tended to be replaced by customs duties; concomitantly, the marketing of exportable commodities has been liberalized so as to allow local producers to respond more directly to the stimulus of world market signals.

The number of LDCs whose currency depreciated in real terms with respect to the United States dollar increased from two in the period 1970-1975 to 31 in 1980-1985. Of these LDCs, nine are members of the CFA zone. Some of the devaluations recently carried out have been of a sweeping nature.[171] And in some countries an auction system for the allocation of foreign exchange has been established which determines the foreign exchange rate according to supply and demand conditions reigning in the market for foreign exchange at particular times. Whether these measures, a standard part of adjustment programmes, are the most appropriate ones to be taken in economies as fragile and weak as those of the LDCs is the subject of box 15, which considers a recent study examining the short-run effects of devaluation in poor economies; the conclusions reached there cast some doubt on the effective-

[169] Twenty-two LDCs have launched adjustment programmes supported by stand-by and/or extended arrangements entered into with IMF: Bangladesh, Burundi, Central African Republic, Ethiopia, Equatorial Guinea, Gambia, Guinea, Haiti, Lao People's Democratic Republic, Malawi, Mali, Mauritania, Myanmar, Nepal, Niger, Samoa, Sierra Leone, Somalia, Sudan, Togo, Uganda, and the United Republic of Tanzania. Of these, 17 have also secured credits from the Structural Adjustment Facility or the Enhanced Structural Adjustment Facility of IMF. In addition, five LDCs (Benin, Chad, Guinea-Bissau, Lesotho and Mozambique) have secured credits from the Structural Adjustment Facility but have not entered into stand-by arrangements during the period in question.

[170] Twenty of the 27 LDCs have received World Bank adjustment loans and credits. In addition, Sao Tome and Principe, while still negotiating a credit from IMF, embarked in June 1987 on a structural adjustment programme supported by World Bank credits and Burkina Faso received a sector adjustment credit in 1985.

[171] Examples include Sierra Leone (floating of the leone since 1986, entailing an 85 per cent depreciation); Sudan (44 per cent in 1987); the United Republic of Tanzania (68 per cent in 1986); Guinea-Bissau (60 per cent in 1987); the Gambia (53 per cent in 1986); and Sao Tome and Principe (55 per cent in 1987). In Guinea, the replacement of the syli by the Guinean franc, undertaken in January 1986, was tantamount to a drastic 94 per cent devaluation.

Box 15

DEVALUATION, INFLATION AND GROWTH

Devaluation is one of the central policy prescriptions of the adjustment programmes designed by IMF and the World Bank and implemented by the LDCs in an effort to improve the balance of payments and the allocation of resources within the country. Numerous studies have been made of the impact of devaluation on inflation and short-run output growth, some showing positive, others negative, effects. In a recent study, [1] it is argued that an important reason for these mixed results is that previous studies did not explicitly recognize the possibility of varying effects of devaluation on countries at different stages of development. Taking an approach similar to that argued in this report, the article contends that one should expect a stronger effect from devaluation and inflation on short-run output growth in the low-income developing countries than in richer developing countries, [2] for the same basic reasons as suggested in this report: their comparatively small and inefficient financial markets, their poor resource bases, their low agricultural productivity, the limited scale of foreign investments in them, the relatively sluggish response of the economy to stimuli, their heavy debt-servicing burden, and their weak currencies. Moreover, it is argued, the effect of devaluation on output growth in the short to medium term in the low-income countries is likely to be negative because of these economies' dependence on imported raw materials and other inputs.

The analysis undertaken is based on a model in which the rate of growth of GDP in the selected developing countries is related to proportionate changes in the real value of foreign currency, unanticipated changes in the inflation rate, and the rate of growth of real GDP in the industrialized countries (the latter to test for the effect of cyclical disturbances in these economies on output growth in the developing countries). The sample, based on data from 1960 to 1985, was split into two equal groups of ten low-income and ten "upper middle" income countries, the former containing seven LDCs (plus Zaire, Kenya and Ghana). It is thus very close to a test for the effect of devaluation and inflation on LDCs, in comparison to richer developing countries.

The empirical results of the study show that, whereas the effect of devaluation on output growth in the upper-middle-income countries is mixed (negative in the first year, but positive in the other years with the long-run effect very small - a 10 per cent devaluation causing output to decline by 0.4 per cent), the effect in the LDCs is consistently negative, and much stronger (the long-run effect of a 10 per cent devaluation being a full 6 per cent decline in output). In addition, the effects of devaluation on the growth of exports, imports and foreign direct investment respectively were studied. It was found that devaluation in the LDCs had neither a significant positive effect on exports or foreign direct investment, nor a significant negative effect on imports. This provides strong support for the view, put forward in this report, that the fragile economic structure of the LDCs creates particularly difficult problems for the design of structural adjustment programmes.

Effects on GDP growth in the LDCs of devaluation, inflation and the business cycle [a]

(Regression coefficients)

Dependent variable	Explanatory variable			
	Change in real exchange rate	*Same, lagged one period*	*Unanticipated inflation*	*Business cycle*
GDP	-.373*	-.227*	.311	.349*
Exports	.093	.099		
Imports	-.104	-.125		
Foreign direct investment	.084	.118		

Source: G.I. Nwanna, *op. cit.*, tables 1 (p. 335) and B (p. 342).

Note: * = statistically significant at 5 per cent level or better.

[a] These results relate to a sample of ten low-income countries, of which seven are LDCs: Bangladesh, Ethiopia, Togo, Sierra Leone, Malawi, Sudan and United Republic of Tanzania. The remaining three countries are: Zaire, Kenya and Ghana.

1 G.I. Nwanna, "Devaluation, unanticipated inflation and output growth: A comparative aggregate analysis", *Economia Internazionale*, vol. XL, No. 4 (Nov. 1987), pp. 329-343.

2 These are identified as having per capita incomes of between $1,500 and $6,000.

ness of devaluations in this context (see also box 16).

2. Demand-management measures

As part of the package of structural reforms to deal with their unsustainable levels of external and fiscal imbalances as well as high rates of inflation, a large number of LDCs have had to implement demand-management measures aimed at reducing public expenditure, increasing public revenue and containing credit and monetary expansion. In this regard, a major role has been played by privatization, the subject of box 17.

3. Mobilization of domestic savings

Although domestic savings represent only a modest share of total investment for most LDCs, many LDCs have introduced policies to encourage the growth of domestic savings by households and by Governments. They have also introduced measures to reduce capital flight, though it is recognized that a sound, growing domestic economy and a realistic exchange rate are the best ingredients for discouraging such outflows.

In most LDCs, the tax base is rather narrow, and taxes on imports and sales and excise taxes on a very limited range of consumer items provide the bulk of tax revenues. Many LDCs have, therefore, in the context of their adjustment programmes, made efforts to make the tax system simpler and more broadly based, to reduce tax leakages by streamlining the tax administration and by reinforcing customs departments,[172] and to reduce the dependence of government revenue on import taxes. To increase non-tax revenues, which derive mainly from earnings of public enterprises and revenue from services provided by the Government, several LDCs have instituted programmes focused on improvement, privatization and liquidation, where appropriate, of public and parastatal enterprises, and on fees and prices of public sector goods and services as well as on recruitment policies. Efforts have also been made to limit recurrent expenditures by streamlining administrative services, by introducing user participation in the cost of social services, particularly health services, and, in several cases, by rescheduling external debt.

4. Foreign direct investment

Faced with a very limited savings capacity, a mounting debt-service burden, slow growth and even stagnation of export earnings and concessional flows, as well as with the virtual collapse of commercial bank lending, LDCs have been turning towards foreign direct investment as a means of securing financial resources for their economic development and structural transformation. Many LDCs have thus undertaken a reform of their investment codes, or are in the process of doing so, with a view to encouraging the establishment of foreign enterprises and to allowing the employment of foreign manpower. A number of LDC Governments are also providing a variety of production incentives to attract foreign investment, such as the liberalization of profit repatriation rules, the offer of tax holidays, and the granting of special foreign exchange and tax privileges to enclave assembly operations for exports.

However, despite some positive developments in this field, LDCs have in general not been successful in attracting foreign direct investment: in the period 1980-1985, direct investment flows from the DAC member countries to the LDCs amounted to only $516 million (less than $65 million on an average per year).

5. Improving the efficiency of public sector enterprises

The budgetary and economic impact of the losses suffered by public sector enterprises (PSEs) in many LDCs has impelled their governments to undertake, in the context of their structural development programmes, thorough reviews of these PSEs with a view to selecting one or more of the following options: (a) increasing operational efficiency by way of management reforms and greater operational autonomy, including pricing policy ("streamlining"); (b) privatization; and (c) liquidation.

172 A serious problem arises from the reduction in tax revenue ensuing from import-compressing measures. Lower imports not only affect the volume of import taxes but also have negative consequences for investment in productive capacities, thus adding losses in income, either as taxes or as non-tax revenues, to the direct losses in import duties.

Box 16

DESIGNING STRUCTURAL ADJUSTMENT PROGRAMMES

Much of the controversy regarding structural adjustment programmes in the LDCs turns around the timing, dosage and mix of policies to promote growth with adjustment, the need for and basic structure of such programmes and the instruments employed not being disputed. That the usual IMF-supported stabilization programmes are often excessively deflationary is widely recognized. It is therefore of interest to note that an IMF staff member has recently published a paper which examines the question of how to improve the design of adjustment programmes so as to avoid excessive inflation and to provide for some growth, especially in circumstances where net capital inflows are limited and the currency is being depreciated. [1]

Chand notes that the basic model employed by IMF to solve for the permitted amount of credit expansion consistent with a given balance of payments target focuses exclusively on the balance of payments and assumes that the level of output is somehow fixed outside the model. This creates the potential for an inconsistency between the assured growth rate and the BOP target; this in turn means that certain of the "performance criteria" employed by IMF, in particular with regard to monetary growth, might not be realized, leading to the suspension of IMF funding. Since this is a fundamental defect of the IMF model, and not of the LDC economy, it is vastly more reasonable to adjust the model accordingly than to adjust the economy. Chand undertakes to do this by modifying the model to allow for endogenously-determined nominal income and capacity growth.

When this is done, the result is quite striking. First, the "adjusted" model reflects the impact on an LDC economy of an external shock much better than the standard IMF model. And, secondly, the extended model shows clearly that adjustment programmes alternative to the "orthodox" IMF programmes do a much better job of achieving "adjustment with growth". As regards the "quality" of the model, when a shock combining three serious effects on an LDC economy (10 per cent decline in export earnings (e.g. from a price fall), doubling in external debt service charges (e.g. from an interest rate increase), and the complete cessation of net capital inflows (e.g. from repayments to IMF and/or World Bank) is imposed, the standard IMF model shows no response at all - it is as though the shock had not occurred: aggregate demand is, according to the model, unaffected; so too is the demand for money and the permissible credit expansion, and no exchange rate adjustment is required. Yet clearly this is unrealistic. The "adjusted" model, however, shows a decline in real growth, a deterioration in the balance of payments and the need for exchange rate adjustment (or import controls), as would be expected.

Since the "adjusted" model is clearly a better representation of what happens in an LDC economy when external shocks are imposed than is the standard IMF model, it is of interest to see how it would deal with various proposed adjustment programmes. Chand examines two such programmes which have the same balance of payments, real growth, government revenue and inflation targets. The "orthodox" programme restricts domestic money demand expansion and imposes import liberalization immediately. The result is that the BOP worsens significantly relative to its target, and nominal and real GDP fall well short of target; the inflation target is, however, reached (see table below). By contrast, the alternative programme does not restrict money demand so tightly, and reduces the degree of import liberalization by phasing it over a longer period. The result is that *all* targets are met, only the budget deficit showing a (very slight) deterioration by comparison with the outcome of the "orthodox" programme.

The problems affecting the PSEs in LDCs, as in many other developing countries, have been largely rooted in management structures and objectives that were both lax and lacking in productive orientation.

Firstly, the payroll was bloated by the hiring of excessive and frequently unqualified staff, a policy which was pursued as a way of overcoming unemployment pressures. Secondly, under-pricing of the final output or service was often imposed on PSEs as a means of relieving inflationary pressures and avoiding consumer discontent. Thirdly, to the extent that PSEs enjoyed single-channel importation or export marketing rights - coupled with privileged access to scarce foreign exchange, often at significantly overvalued exchange rates for the domestic currency - they were able to offset their losses. However, for most PSEs such offsets were not feasible.

DESIGNING STRUCTURAL ADJUSTMENT PROGRAMMES

These results suggest strongly that there could be a very considerable payoff in terms of the welfare of the people of the LDCs to a thorough-going search on the part of the IFIs for improved adjustment policies.

Models of the adjustment process

(Percentage change)

Variable	*Initial equilibrium*	*Shock effects without adjustment ("adjusted" model)*	*Target*	*Adjustment programmes*	
				Orthodox programme	*Alternative programme*
BOP (reserves)	0.0	-3.7	-1.5	-3.3	-1.5
Nominal income	15.0	6.7	15.0	6.2	15.0
Real income	4.6	-3.3	4.6	-3.5	4.6
Inflation	10.0	10.0	10.0	10.0	10.0
Budget deficit	-2.9	-3.5	n.a.	-2.5	-2.6
Money demand	3.0	1.3	n.a.	1.2	3.4

Source: Chand, *op. cit.*, table 2.

1 S.K. Chand, "Toward a growth-oriented model of financial programming", *World Development*, vol. 17, No.4 (April 1989), pp. 473-490.

Such factors have led to repeated and growing operational deficits in many LDCs' PSEs and to a lack of incentive for investment and modernization. The drain on public finances caused by the current losses suffered by PSEs has not generally been compensated by higher growth impulses in that sector or by relief on the balance of payments side. In four LDCs analysed by the World Bank[173] (Myanmar, United Republic of Tanzania, Bangladesh and Nepal), the share of value added by PSEs represents only a small fraction of their share of national investment, while PSEs have accounted for a growing share of all developing countries' external debt, a trend that is also likely to apply to the LDCs among them. To the extent that PSEs have accumulated large amounts of debt, they are unlikely to be privatized unless such debt is largely or wholly written off before privatization or transformation into joint ventures takes place. The write-offs would have budgetary implications which, in the short term, would contradict the deficit-reducing policies concurrently pursued by the governments. Privatization by way of foreign-controlled enterprises - frequently the only viable bidders - presents obvious political problems when the PSE concerned is viewed as occupying a sensitive position in the national economy, either by virtue of the essential nature of the output provided or the service rendered or on account of the negative employment effect that full or partial privatization usually implies. Furthermore, some of the early privatizations involving purchases by foreign interests rapidly became a political embarrassment to the governments concerned.

While it remains true that local private investment interests and entrepreneurs are often not available or are not ready to respond to privatization opportunities in LDCs, it is also true that the supporting finance made available internationally and/or bilaterally to LDC governments endeavouring to reform and

[173] *World Development Report 1988* (New York, Oxford University Press, for the World Bank), 1988, pp. 2 and 3.

Box 17

PRIVATIZATION OF PSEs

In Africa, Togo is regarded as a pioneer in the policy of privatization of PSEs, instituted in 1985. Since then, the Government has offered various other parastatals for sale, lease or joint venture to foreign investors. Such divestiture has been achieved in the case of the country's only steel mill, its oil refinery, a dairy and two textile mills. In Guinea-Bissau, whose economy was once almost completely controlled by the public sector, 90 per cent of the outlets of two leading retail chains had been privatized by the end of 1986; since then, all foreign trade monopolies except for cereals have been abolished. In Malawi, a wide range of price and tariff adjustments were undertaken in 1987 alongside the decision to divest the Agricultural Development and Marketing Corporation of all its holdings in other companies and agricultural estates. Even the country's only nominally private-dominated corporation, Press Holdings, has also been restructured under World Bank guidance. Similarly, Lesotho's National Development Corporation is pursuing a policy of divestiture of viable PSEs. Burundi set up a national service in charge of overseeing the reform of the PSEs called for in the country's structural adjustment programme, which consist of the usual three-pronged approach (rehabilitation, privatization or liquidation).

In Equatorial Guinea's reform programme, both foreign and local capital are buying out PSEs in the fields of air and sea transport, banking, agriculture and forestry. Guinea's commitment to the privatization of PSEs has already resulted in the sale of two agro-industrial units (quinine and tea), a printing shop and a soft-drink plant; further sales are planned of larger PSEs, such as a textile complex, a brewery and the national fuel board. Of its 54 PSEs, Niger has earmarked 5 for liquidation, 16 for privatization, 5 others for retention but under private management, and 10 for restructuring. In Chad, Cotontchad, the marketing board of the country's major export staple, began a major cost-cutting exercise in 1986, involving a salary freeze along with a 50 per cent personnel cut, a ceiling on the volume of purchases equal to the 1985 level, the removal of subsidies on cotton-growers' inputs, the closing of one half of the country's cotton gins and the introduction of stricter management procedures. In Mali, the restructuring has perhaps shown the most vivid quantifiable results: after 15 years of deficit, the PSEs yielded a CFAF 2 billion ($6.7 million) surplus in 1987. The liquidation in 1988 of the trading firm SOMIEX, the single largest deficit producer, should further improve the country's record in this regard. Conversely, joint ventures have been successful in attracting new financing, promoting exports, achieving higher productivity, and, it is claimed, maintaining employment.

In the Pacific LDCs, the improvement of PSEs' efficiency has also become a central objective of government policy. Thus, in Kiribati, where subsidies to PSEs absorbed as much as 6 per cent of GDP in 1986, the Government is imposing stricter controls on PSE budgets and has introduced more flexible pricing policies. In Samoa, the Government set profitability targets for PSEs as from 1988 to ensure termination of budgetary subsidies for current operations. Moreover, the Government is studying the possibility of establishing a holding company, which would assume responsibility for all PSEs with a view to streamlining their management or implementing the Government's divestment of its interests.

rehabilitate their PSEs has often been pitched at modest levels compared with the task at hand.

6. *Impact of the measures to improve the efficiency of resource use and allocation*

It is difficult to ascertain on objective grounds the actual impact of the national measures described in this section, which have been taken with a view to improving the efficiency of resource use and allocation in the context of the adjustment programmes, both those negotiated with IMF and those carried out outside the IMF framework. Indeed, the issue of the effectiveness of adjustment programmes has become the subject of a vigorous debate, including among international institutions. Thus, a recent joint report by the World Bank and UNDP[174] on sub-Saharan Africa concluded that "domestic difficulties, in-

[174] *Africa, Adjustment and Growth in the 1980s*, World Bank/UNDP (Washington, D.C., 1989).

cluding structural rigidities and institutional weakness, as well as poor policies, have limited the ability of sub-Saharan Africa to adjust from the exceptionally good years of the late 1970s and early 1980s" (p. 2), but that nevertheless "the evidence of the past three years leaves room for optimism" (p. 3) as regards countries following Bank/Fund prescribed adjustment programmes. By contrast, the Economic Commission for Africa[175] argues that "all indicators are to the effect that structural adjustment programmes are not achieving their objectives" in Africa and that this has given rise to "frustrations on all sides", primarily because "the performance indicators of these programmes do not correspond to Africa's basic development objectives".[176]

No attempt is made in the present study to adjudicate this debate but, in assessing the effectiveness of these stabilization programmes, it is useful to note that empirical evidence indicates that the performance of the 12 LDCs[177] which have had consecutive programmes throughout most of the 1980s does not differ significantly from that of the LDCs as a whole. Only three of them registered a higher average annual rate of growth in 1980-1987 than that of the LDCs as a whole (2.3 per cent), and only two improved their growth performance in 1980-1987 as compared to the 1970s. On the other hand, as regards the current account deficit, its value as a proportion of the value of exports of goods decreased markedly or steadily in two thirds of them. Inflation rates were in turn reduced significantly between the 1970s and the 1980s in half of these LDCs, whereas they increased noticeably in the other half.

The above data do not suggest any consistent relation between the existence of adjustment programmes on the one hand, and economic performance in terms of growth rates and improvement in current account and in inflation rates on the other hand, and leave open the question of the adequacy of these programmes for the LDCs. To the extent that the new measures ensure greater efficiency in the management of resources and redress price and inter-sectoral distortions, they are likely to have beneficial effects upon the level of output in LDCs and upon the capacity of these countries to overcome present external and fiscal disequilibria. Nevertheless, as the first generation of adjustment programmes reaches completion, it is becoming apparent that these programmes, as currently defined, could bring about undesired effects, particularly in terms of high social costs and of weakening the LDCs' ability to achieve long-term economic development. Since, however, it is extremely difficult to go beyond this broad observation on the basis of aggregated data, the next chapter is devoted to a detailed review of the specific experiences of eight LDCs in the context of structural adjustment programmes, so that more pointed conclusions can be drawn.■

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175 United Nations Economic Commission for Africa, *African Alternative Framework to Structural Adjustment Programmes for Socio-Economic Recovery and Transformation* (E/ECA/CM.15/6/Rev. 3) (April 1989), p. 24.

176 Indeed, it needs to be asked against which framework such programmes should be evaluated. Against the performance of the adjusting countries in the previous period? On this score it can be argued that the programmes had to be adopted precisely because the economic conditions (internal and/or external) were no longer the same as in the previous period, and that previous policies were no longer tenable; performance may therefore differ from one period to another, not so much because of differences in the effectiveness of policies but rather because of differences in economic conditions. Furthermore, any effects observed have to be attributed carefully to the recession or the adjustment process itself. Or again, should such programmes be evaluated against the performance of LDCs that have not adopted adjustment programmes? It can be argued that these LDCs have not had to implement such programmes precisely because they were facing less adverse conditions, or simply because their policies already contained the kind of measures that are embodied in the typical adjustment package: again, performance may therefore vary because of differences in economic conditions or because adjustment measures have been in operation for a longer time in these other LDCs than in those that have formulated adjustment programmes.

177 Namely, Bangladesh, Central African Republic, Gambia, Haiti, Malawi, Mali, Niger, Sierra Leone, Somalia, Sudan, Togo and Uganda.

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OVERVIEW: EXPERIENCE OF EIGHT LEAST DEVELOPED COUNTRIES

A. Introduction

This overview is based on the experiences of eight least developed countries[178] with adjustment over the past decade. Of the eight LDCs for which detailed assessments are made, only one (*Botswana*) adjusted its economy without recourse to the IMF and structural (or sectoral) adjustment programmes with the World Bank and was able to maintain its economic and social progress, helped by the recovery of the diamond market after the early 1980s. Some initiated an adjustment process (e.g. *United Republic of Tanzania*) of their own design and later adopted IMF/World Bank programmes. In other countries, their first stabilization programmes did not succeed (in Bangladesh's case, an Extended Fund Facility was withdrawn by IMF in 1983) and they had to restart the process. The adoption of stabilization and adjustment programmes (either structural or sectoral) with the Fund and the Bank during the 1980s reflects the now predominant pattern among adjusting LDCs.

The focus of the analysis will therefore be on the adjustment phase. In making judgements and drawing conclusions about the impact of adjustment on the development paths specific to LDCs, however, two caveats must be added. Firstly, since adjustment follows a period of global recession around the period 1979-1982 which was accompanied by the debt overhang, care must be taken when attributing findings to the adjustment process alone. Although the counterfactual ("without adjustment") can never be completely known or perfectly constructed, the prior existence of a recessionary period (and its sequels) is a reality. Secondly, the adjustment process is relatively recent. In many cases, the substantial adjustment programmes started only in 1986 (Bangladesh, Nepal and Niger effectively and the United Republic of Tanzania under its formal programme); Lesotho's did not begin until 1988. A three-year period, or less, is thus rather a short time in which to identify and trace the results of the adjustment process. While the effects of some stabilization efforts can be captured and observed, most economic and social effects involving structural change and transformation can only be seen over longer periods probably even than those experienced by countries like Malawi (which began structural adjustment programmes in 1981) or Sudan (1983 onwards).[179]

Difficulties with the time-scale have already been acknowledged, *inter alia*, by the World Bank in its ten-year review of

[178] Bangladesh, Botswana, Lesotho, Malawi, Nepal, Niger, Sudan and United Republic of Tanzania. These reviews were undertaken by consultants at the request of the UNCTAD secretariat. Those for Botswana, Lesotho, Malawi, Niger and United Republic of Tanzania were carried out by the Overseas Development Institute, London, under the supervision of Adrian Hewitt, and for Bangladesh and Nepal by Mr. Abdus Samad, of the Ministry of Planning of Bangladesh. The review for Sudan was prepared by Mr. K. Kohli, former Chief Economist of the Asian Development Bank.

[179] Both Malawi and Sudan already had IMF programmes in earlier years.

adjustment lending,[180] which admits that adjustment is a longer process than was originally anticipated. Reform packages, however, are beginning to pay greater attention to the time needed to take effect; they are also being seen in a much broader context as regards the scope of their impact. Not only are short-term stabilization programmes viewed as the prelude to structural adjustment, but the latter process itself is recognized as having to encompass social and distributional questions as well as targeting key macroeconomic aggregates. For instance, another recent World Bank report,[181] while recognizing that economically strained countries and their policy-based lenders experienced a general preoccupation with macroeconomic imbalance and the debt crisis that often overshadowed poverty concerns, now asserts that given the time and effort required to turn deeply troubled economies round, it would be normally, politically and economically unacceptable to wait for resumed growth alone to reduce poverty.

Attention has increasingly been drawn to the fact that certain adjustment policies - devaluation, price decontrol and budgetary cuts affecting social services - may adversely affect particular poverty-stricken groups which, without compensatory programmes, have no access to the potential benefits of economic reform. Moreover, the early adjustment programmes are now viewed as having neglected the impact on the poor. Thus, adjustment now encompasses policies that supplement demand-management and growth-oriented approaches with clearly defined poverty reduction elements both within the programme of adjustment and as compensatory measures. Such shifts in the application of adjustment policies are crucially important to LDCs, where large portions of the population live in absolute poverty,[182] and where evident symptoms of poverty - high infant mortality and disease, extensive malnourish- ment, widespread illiteracy and substantial unemployment - are prevalent. They are in line with the SNPA, which has structural transformation as a key element, and aims at providing adequate minimum standards for the poor: LDC populations are generally so poor that they cannot postpone progress on the latter in favour of more decisive action on the former.

Among the characteristics of LDCs are not only their massive poverty but also their extreme vulnerability to natural disasters. In the 1980s, under recession and in adjustment, it is essential to recognize that disasters - natural and man-made - were constantly occurring (and in many cases with greater frequency or severity). Most notable among the sample have been: drought in Niger, floods and cyclones in Bangladesh, and an earthquake in Nepal. In addition, civil strife in Sudan, an influx of refugees into Malawi, and transit and trade problems for Nepal imposed further constraints on their economies. No adjustment programme reviewed provided for such contingencies. However, a programme that makes no allowance for them is inappropriate.

In viewing the adjustment process and assessing its validity for the 1990s, it is also essential to recognize that the early 1980s saw major changes in the climate of international trade and finance as it affected developing countries as a whole and LDCs in particular, and that these changes conditioned the recessions which most LDCs then experienced. Major elements in these changes were:

- a fall in demand for, and hence world prices of, many raw materials, which depressed LDCs' export earnings and weakened their import and debt servicing capacities;
- increased protectionism, affecting exports and potential new exports of LDCs such as garments (Bangladesh);
- major world payments imbalances - those of the rich countries far outstripping those of LDCs;
- increased world interest rates impinging on debt service;
- an inadequate volume of ODA flows and insufficient debt relief to these countries;
- a strengthening of the conditions attached to aid;
- a contraction of commercial bank lending and private foreign investment.

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180 *Adjustment Lending : An Evaluation of Ten Years of Experience,* World Bank Country Economics Dept. (Washington, D.C., 1989).

181 World Bank, *Strengthening Efforts to Reduce Poverty (1989).*

182 The study of Bangladesh - the largest LDC in terms of population - finds 51 per cent of the population below the poverty line, and 60 per cent of the rural population in "absolute poverty".

B. Results of structural adjustment

1. Balance of payments management

(a) Devaluation

Devaluation is a common feature in LDCs' stabilization and adjustment programmes, but the sample shows a wide range of applications. In *Nepal*, devaluation of the rupee in November 1985 (by 15 per cent) preceded the stabilization programme as such, the currency being devalued as a prelude to agreement on an IMF stand-by in December 1985. In *Malawi* there was a tradition of active exchange rate management; the Government had kept the Malawi kwacha close to its trade-weighted parity, yet in the 1980s under adjustment programmes it introduced more severe devaluations. In *the United Republic of Tanzania*, while devaluations were applied during the 1982-1986 period, it was after 1986, under the IMF and World Bank-sponsored economic recovery programme, that much larger devaluations were carried out.

The case studies do not attribute much weight to the devaluations themselves in stimulating exports or avoiding inflation, but they certainly created some short-term hardships, not only in the urban areas. Economic difficulties, however, appear to have been somewhat eased owing to the support given by new resource inflows, in particular from international financial institutions. In the case of the United Republic of Tanzania, aid had been slowed down until it undertook to devalue the shilling substantially and reached an agreement with IMF.

There is yet more diversity in the sample of LDCs. *Bangladesh*, which had had a dual exchange rate since 1977, continued to maintain this under structural adjustment although the devaluation of the taka between 1984/1985 and 1987/1988 (by about 20 per cent) did succeed in narrowing the gap between the two, to about 5 per cent. Nevertheless, all exports and most non-aid imports have continued to use the secondary market. In *Sudan*, the current account improved with devaluation although debt service was made even more difficult. Lastly, *Niger* represents yet another kind of case. With a regional currency, the CFA franc, devaluation was not an available instrument. The Government had to resort instead to dampening aggregate demand and reducing public expenditure by other means which, however, proved to be equally harmful to the poorer sections of the population. *Botswana*, for its part, has proved to be an example of a monetary and foreign exchange system that worked well during the 1980s.

(b) Domestic demand management

Domestic demand restraint was commonly exercised through a number of policy instruments; however, budget cutbacks (or strict ceilings on the rate of growth of budgetary expenditure in nominal terms, usually in highly inflationary conditions) constituted the policy that had the most immediate primary and secondary effects. The case studies show that governments tended to make cuts fall disproportionately on the development budget rather than the recurrent budget; moreover, attempts to enhance fiscal revenue were much less successful than fulfilment of requirements to trim government spending. Examples of this phenomenon include *Bangladesh*, *Malawi*, *Nepal* and *Sudan* - though in Sudan's case the increased current expenditure is attributable, *inter alia*, to the civil strife.

This finding, however, has serious implications for the recovery process, and is a significant warning signal for LDCs. For it should not be assumed that recurrent government expenditure failed to be restrained because governments were unwilling or unable to shed or freeze civil service posts and to reduce the public wages and salaries bill. There is considerable evidence that they complied, quite fully, with requirements to disband, restructure or privatize inefficient or loss-making public corporations (*Malawi*, *Niger*, *Bangladesh*, *United Republic of Tanzania*, especially after 1986, and *Nepal*). Instead, a major component of the build-up of recurrent expenditures was the need

to keep debt service current: thus in many cases the recurrent costs of public services were being cut back in favour of redirecting tax revenues to service external debts. On top of this, new investment (the development budget) was being cut as a priority.

These factors are often more significant than the fact that overall public spending appeared to be sustained at relatively high levels in some LDCs, since the cutbacks were applied where LDCs aiming for minimum living standards and sustained recovery as a complement to the adjustment and transformation process could least afford them, *viz.* in the social services provision. Moreover, standards among those in absolute poverty could hardly be raised when cost-recovery schemes were being introduced or when subsidies that were essential to maintaining minimal nutritional standards were removed. Provision of health care, education, a safe water supply and sanitation, all with necessarily substantial public components, especially in LDCs, is now a feature of the design of newer structural adjustment programmes, and extra funds are being raised internationally to support complementary or compensatory programmes targeting the poor.

Secondly, there must be substantial concern over the economic recovery prospects of very poor nations whose development spending has been cut back as part of the adjustment process. This concern flows from the budgetary compression observed above, but not only from that. National funding of development projects in most LDCs is relatively insignificant compared with donor aid funding. But LDCs need to maintain a substantial level of infrastructural investment in order to avoid further deterioration of their already impoverished economies, to improve prospects for sustained development and to make provision for adequate maintenance and running costs. With domestic budgetary resources reduced and diverted elsewhere, the national contribution to both items has been inadequate under adjustment. Moreover, an even more important constraint has been the inadequacy of the supply of concessional aid and lending from abroad for new investments. As part of the adjustment process itself, new aid flows are being increasingly directed towards policy reform and thus used relatively less for capital investment. Moreover, the budgetary cutbacks, which have left inadequate provision for local counterpart funding of projects (as in Bangladesh), may mean that many of the aid commitments merely rest unused in an ever-growing project aid pipeline.

(c) *Export incentives*

In addition to strict domestic demand management, structural adjustment for LDCs has meant improving the incentives to export. The need to expand export revenues, apart from improving the import capacity, was justified by rising debt service requirements (and arrears): for most LDCs, the major part of the debt service was payable to government creditors and the international financial institutions themselves. In a case such as *Sudan*, however, debts service was on debts substantially incurred to commercial lenders (in the 1970s when Sudan's economic potential, especially as a food exporter to the Gulf region, attracted such lending). Since debt service due was already at approximately the level of Sudan's total commodity earnings, the export expansion task set in such circumstances was enormous, and was not achieved. As most LDCs are, like Sudan, endowed with only a relatively narrow range of primary commodities to export, the effects of agricultural and general export product diversification (which forms part of most of the structural adjustment programmes) have proved to be at best medium term, when successful. On the other hand, the stabilization measures, the devaluations and the programmes for reintroducing broader price incentive schemes for crops, have had more immediate effects in stimulating supply response as regards traditional commodities.

(d) *Price signals and commodity problems*

Where supply responses had become distorted and suppressed, the pricing measures referred to above did produce an effect, e.g. in the *United Republic of Tanzania* both pre-1986 and after the formal adjustment programme was introduced. However, in *Sudan* and *Malawi*, the structural adjustment programme did not adequately address the unfavourable bias against smallholders; in Sudan, emphasis remained placed on large-scale irrigated export agriculture, while in Malawi the tobacco estates continued to have preferential access to resources and to enjoy concessions.

Moreover, the price signals, which were meant to stimulate export volume and to provide the resources for sustained growth and transformation, proved to be an inadequate instrument in the case of a number of LDCs that faced unstable and falling commodity demand. This applies to tropical beverages, jute, leather, minerals and tobacco. While the "fallacy of

composition" arguments have by now applied with great force to cocoa producers, similar trends are already evident in the case of coffee exports (United Republic of Tanzania), jute (Bangladesh) and tobacco (Malawi). In the case of *Malawi*, too, price changes as between food and export commodities, and changes in fertilizer pricing policy, which also affected the mix between crops, caused havoc in the supply responses of farmers and eventually contributed to unaccustomed food supply difficulties. Similarly, many of *Niger's* adjustment problems are attributable to the collapse of uranium prices - a commodity which formerly supplied 80 per cent of exports and 41 per cent of government revenue. This distorted the whole productive economy and estate management, and so adjustment out of this dependence - a form of "Dutch disease"[183] - was clearly in order. However, the programme does not seem to have significantly restored Niger's growth or restructured the economy.

(e) Manufacturing export expansion

While LDCs are characterized, *inter alia*, by low levels of industrialization, this has not prevented some of them from diversifying into export of manufactures, and this (with services) should form part of any comprehensive adjustment package. The case studies of *Bangladesh* and *Nepal* show, however, that, while they did successfully expand non-traditional exports more rapidly than those of traditional commodities, investment in new capacity for the export of garments nevertheless confronted serious market access barriers, despite the GSP concessions which LDCs are supposed to enjoy and the almost infinitesimally small share of the world garment trade which they represented. Because of these continuing restrictions, this policy of export expansion and diversification has had only limited success.

(f) Labour migration

Many LDCs' stocks of human resources have been brought into play during the period of adjustment by being given a further export orientation in the form of service flows. In countries like Lesotho, Botswana, Sudan and Bangladesh, migrants' remittances are a significant non-merchandise flow, which has helped to reduce the debt service ratio. However, migrants' remittances, while a useful source of foreign exchange, are too vulnerable to be seriously contemplated as a means for a country to grow out of debt, and cannot be a basis for economic transformation. If export earnings are to be the locomotive of growth rather than a means to keep debt service current, they need to arise from product lines that reflect comparative advantages after investments in physical and human capital have taken place; these could be traditional exports, with enhanced efficiency in production, marketing and distribution, or new products.

(g) Import compression and investment implications

In nearly every case *imports* have been substantially cut back, adversely affecting investments (see table 47). The purpose of adjustment programmes has indeed been to permit a more market-oriented discrimination among different import items, and there is some evidence that this is beginning to happen as a result of liberalization. Only in *Nepal* have imports risen more rapidly than exports, and that was mainly in the early 1980s before adjustment programmes began. Given the modest results of import liberalization, it is questionable whether such a policy ought to be linked - as it often has been - to export liberalization in the case of LDCs. Their essential industries are so fragile that even the most basic infant industry arguments are not sufficient.

Of far greater concern than providing a market-based choice of imported inputs should be the overall level of import availability, and in nearly every case this was very depressed, compared not only with levels in the 1970s but with the start of the adjustment programmes. Given that LDCs were already operating at a very low level with essential imports comprising a large proportion of their total imports, the studies show that the continuing import compression predicated on the external stabilization approach to adjustment, and the absence of rapid economic recovery, have meant that al-

[183] This term refers to the decline in the Netherlands' export competitiveness which followed the discovery of the Groningen gas fields in the early 1970s. The decline is attributed to the appreciation of the real exchange rate which follows a rapid infusion of foreign exchange from a "new" export, and leads to a contraction of the traditional export sectors and inflation in the non-traded sectors. It should be noted that, in a recent paper (N.C. Benjamin *et al*, "The 'Dutch' disease in a developing country", *Journal of Development Economics*, vol. 30, No. 1 (1989), pp. 71-92), it has been argued that the standard "Dutch disease" results can be reversed in a developing country where there is imperfect substitutability between domestic and imported goods.

Table 47

EVOLUTION OF IMPORT VOLUME AND REAL INVESTMENT PER CAPITA IN SELECTED LDCs

(Annual average percentage change)

Country	Import volume		Investment	
	1970-1980	*1980-1987*	*1970-1980*	*1980-1987*
Bangladesh	0.0	2.6	2.1	0.8
Botswana	8.9	-2.0	2.9	-3.1
Lesotho	12.8	-5.7	19.6	1.7
Malawi	1.0	-8.3	0.6	-13.3
Nepal	2.1	4.4	14.7 [a]	4.3 [b]
Niger	10.4	-9.2	5.0	-17.4
Sudan	1.8	-10.7	5.1	-6.7
United Rep. of Tanzania	-2.8	-7.4	-0.5	-8.8
All LDCs	1.8	-2.2	2.9	-4.0
Memo item: Non-oil exporting developing countries	3.5	0.1	..	..

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1988*; World Bank data, and national sources.
a 1975-1980.
b 1980-1985.

ready poor countries have entered a low-level equilibrium trap, with their future growth constrained by low import capacity, a period of disinvestment and poor maintenance of capital, especially in terms of imported input requirements.

2. *Growth and structural transformation*

(a) Growth record

Adjustment programmes are implemented to restore economic growth as well as to move the external account into balance but there is as yet little evidence in the case of LDCs that the formal adjustment programmes are succeeding in achieving the first objective. As the earlier analysis indicated, most of the progress towards external balance has been achieved by the method of demand restraint and import compression. With export expansion proving more elusive and few new funds going into investment, it is not surprising that output recovery and growth is usually observed to have been at best modest. This applies to LDCs that have undertaken formal adjustment programmes over the last few years (*Niger*, the *United Republic of Tanzania* - despite some initial upturns - *Bangladesh* and *Nepal* - whose growth was better but well below long-run potential) and to those in a longer policy-based lending arrangement: *Malawi* appeared to be recovering in 1984 but GDP growth has been flagging since then; *Sudan's* record - though also influenced by non-economic factors - has been consistently worse.[184]

[184] Incidentally, it is in other countries *not* undertaking adjustment programmes that much more acceptable growth rates for LDCs can be observed. Available data show that some non-sample LDCs (*Maldives*, *Bhutan* and *Lao PDR*) without adjustment programmes (Lao PDR agreed to an IMF programme only in 1989) experienced high average

The performance of larger LDCs such as *Bangladesh*, despite export successes, seems to have been below potential. Its average GDP growth over the period 1979/1980 - 1987/1988 is calculated at 3.8 per cent (compared with a population growth of 2.2 per cent); no significant growth stimulus has yet arisen directly from the adjustment programme, though there are hopes that this will filter through as a result of increased efficiency in resource allocation and mobilization (including support from donors) in the 1990s. Similarly, *Nepal's* average growth rate of 4.9 per cent during the period 1980-1988 is only the equivalent of 2.2 per cent per head and has yet to rise as a result of the adjustment programme.

(b) Sectoral impact: the example of agriculture

Agriculture is, and will remain, the key sector determining the growth, employment absorption and recovery of the majority of the LDCs. Most of the structural transformation anticipated also has to occur in agriculture-based economies. Exceptions like *Lesotho* (where migrant labour is an important source of employment and foreign exchange flow) and *Niger* and *Botswana* (where mineral exports dominate foreign exchange earnings) do not negate this pattern, for rural production and employment opportunities still depend crucially on efficient agriculture in these countries, as does the satisfaction of local consumption needs.

Given that adjustment programmes have placed great emphasis on agricultural policy reforms (and even more on export-oriented agriculture), the record of success in LDCs so far seems rather modest, though their efforts have not been assisted by generally depressed international commodity prices. In *Sudan* the poor recovery of agriculture under adjustment policies is attributed to neglect, in policy reform also, of the less "modern" rainfed agriculture sector, which generated some two thirds of agricultural GDP, in favour of the large-scale irrigated sector (on which many of Sudan's debts were incurred in the late 1970s). Even in the sugar sector, the restructuring of four government sugar plants was less successful than the steady progress of one privately managed plant. Sudan's agricultural export potential and its recovery in exports have also been hampered by the fact that the products in which it could produce and trade at a comparative advantage - foodgrains, oilseeds and even cotton - are precisely those whose world prices are distorted as a result of agricultural subsidies in affluent countries.

Malawi seems to have produced one of the best results of adjustment in the agricultural sector. This is because, throughout the late 1960s and 1970s, before Malawi undertook its first adjustment programme, the Government had given priority to agriculture and had a long tradition of agricultural export promotion. Industry was not favoured over agriculture, nor was import substitution encouraged, and Malawi managed its exchange rate to benefit agricultural exporters when it undertook its first IMF programme in 1979, followed by three World Bank SALs. These focused on price reform in agriculture, the liberalization of marketing and the gradual restructuring and disbandment of agricultural parastatals. What they seem not to have addressed adequately was the crucial distortion that arose between estate and smallholder agriculture, to the latter's disadvantage. In fact the State sector, which already had the benefits of extensive land holdings, tax concessions and implicit subsidies via the banking system, and which was in many cases rather less efficient, benefited further from the devaluations and the continuation of cheap labour policies. Massive but irregular changes in the producer prices of smallholder crops, plus a plan under adjustment, which was eventually dropped, to withdraw fertilizer subsidies over a very short period, introduced completely new distortions into smallholder agriculture. Farmers responded first by switching into maize, producing a massive food surplus, which was not always exportable, and then into other crops, which contributed to domestic food shortages just at a time of refugee influx. Remoter farms went back to subsistence agriculture. Malawian farmers clearly responded to price signals, but the net result was not to strengthen the agricultural economy, nor yet to address the distortions between sectors within agriculture.

The *United Republic of Tanzania's* experience appears to give greater support to the maxim that agriculture-focused adjustment programmes are required, but the evidence is available only on the early impact. The structural adjustment programme of 1981-1984 was not a success, as the period was beset by three seasons of drought. Although government policy in those years did not favour major devaluations, which in the Government's view would not assist even export-directed

GDP growth rates in the 1980s: Maldives 12.0 per cent, Bhutan 6.3 per cent and Lao PDR 4.8 per cent (1980-1987 averages). See also "Review of economic and social development of the least developed countries in the ESCAP region in the 1980s and recommendations and proposals for the 1990s" (A/CONF. 147/DR/3/Add. 1) (3 March 1989).

agriculture, reforms in this direction were gradually introduced. The Economic Recovery Programme since 1986, in addition to devaluation, has operated mainly through producer price increases in the agricultural sector. Export crops have responded more consistently than domestic food crops, but neglect of key support sectors (fertilizer, seeds, technology, irrigation, extension) and linkages (processing and the domestic supply of inputs) indicates that price reforms alone will not produce sustained growth and recovery in agriculture, let alone structural change and transformation within the sector.

The early results of adjustment in *Bangladesh* and *Nepal* are also mixed as regards agriculture. Taking movement towards food security as a major SNPA goal, the studies found that during the period of adjustment Nepal had ceased to be a net food exporter while food self-sufficiency was still a very remote prospect for Bangladesh; nutritional standards instead have been falling in a country where agriculture (mostly rainfed) represents 50 per cent of GDP and employs 75 per cent of the population.

(c) Improving the public/private mix

Formal adjustment programmes have all aimed at reducing State intervention in the productive economy, and at releasing the forces of private entrepreneurship, whether at the level of the smallholder farmer or in the industrial domain. In so far as adjustment programmes have been designed on a common pattern, it is questionable whether the standard model of deregulation and privatization should necessarily apply to LDCs. If these countries are least developed, it is partly because they have so far proved unattractive to entrepreneurs and investors. This is not just an issue of foreign private investment and lending; LDCs also tend to lack a domestic entrepreneurial class, let alone local capital, to exploit any market opportunities that can be identified. For both reasons, it therefore appears that in LDCs public bodies often operate in productive sectors simply because without them no private entrepreneur would fill the vacuum. They also have a socio-economic role to play in, for example, the remoter areas which would be less attractive to firms with profit as the main objective, as well as the responsibility to provide longer-term investment support and the sort of social service provision that is itself a long-term investment in human capital. The argument that the public/private mix in LDCs ought to be different from that in other developing countries, and should be tailored to each LDCs' circumstances, is therefore persuasive.

Nevertheless, adjustment programmes have correctly identified inefficiencies in the public sectors of a number of the LDCs studied, and have taken action to reform, restructure, privatize or disband them. They have also required budget cutbacks in government expenditure. Private enterprise divestiture was a major programme in *Bangladesh's* adjustment. In *Malawi*, the adjustment programmes have only recently started to come to grips with two parastatal or near-parastatal institutions which, together, apart from introducing obvious inefficiencies into the resource allocation and mobilization process, had shifted the benefits of production, especially in agriculture, away from smallholders. On the other hand, the current share of public expenditure in GDP in countries like Bangladesh and Nepal (at 16 per cent and 20 per cent respectively) is well below the levels in the mature "mixed economies" of the OECD countries. It is indeed questionable whether the pruning of the public sector *per se* is desirable, especially as it is the vehicle for investments, future economic growth and structural transformation.

(d) Debt burdens

LDC debt burdens are an issue increasingly receiving international attention and action. Despite retroactive terms adjustment measures taken by developed countries pursuant to Trade and Development Board resolution 165 (S-IX), adopted over a decade ago, to address the issue of ODA bilateral debt, and improvements in rescheduling terms, notably by Paris Club creditors,[185] there remains ample scope for debt relief, including debt reduction and rescheduling (see table 48). If the LDCs' debt service had not risen so much absolutely (and also as a share of exports or total foreign revenues), their enforced focus on export expansion and import restriction in the first half of the 1980s, at the expense of domestic investment and recovery, would not have been required. In most of the sample countries it is the debts owed to the international financial institutions that now weigh most heavily.

Botswana, *Nepal* and *Lesotho* have kept their debt service ratios at manageable levels as compared to most LDCs. The situation of

[185] See section 5(d) below.

the other LDCs under review - most particularly Sudan, which is the largest debtor - call for urgent arrangements with main creditors, including commercial banks and IFIs.

3. *Social development*

(a) Distributional effects

Limited survey data in LDCs and developing countries as a whole means that there is very little hard evidence so far of the distributional effects of structural adjustment programmes. Data and findings generated by UNICEF have tended to concentrate on the consumption and welfare effects of adjustment (and the recession which preceded it) on the poor, while data on the income effect of the stimulus to production and resource mobilization arising from adjustment are much harder to trace, especially in the early years of adjustment. However, it is now recognized that most adjustment programmes are not distributionally neutral. If fully applied they tend to benefit the rural and productive agricultural population at the expense of urban dwellers. In practice, urban interests tend to introduce impediments to any such full application, the result being a new set of distortions.

In most LDCs, a large proportion of the population is rural, and already lives near to subsistence level. Some adverse results have been observed in the studies of adjustment. In *Bangladesh* structural adjustment may have skewed income distribution by reducing employment and earnings opportunities for low-income households and increasing the prices of basic goods. In *Niger* it has yet to benefit the rural smallholder majority. Bodies such as the World Bank and IMF which design and facilitate adjustment programmes now concede that without complementary or compensatory actions, or an in-built distributional element targeting the poor, adjustment can and does leave the poor worse off.

(b) Education, health and sanitation

The evidence on the social impact of adjustment on nutrition, education, health and sanitation is partial and scattered. Most of the findings may be just as well the result of the recession itself as of the failure of adjustment, and in the majority of cases it is premature to show social indicators. For example, although infant mortality changes year by year, and only a few years would be needed to assemble "with-adjustment" comparative data, child health standards and the quality of educational output (as opposed to changes in numbers enrolled) take much more time to observe and assess. Nevertheless, some important findings emerge from the case studies, the most solid observations being those based on government spending.

In *Bangladesh* for instance, government expenditure on health was stable and, on education, increased in the primary sector, but expenditure on sanitation declined. The more relevant indicators in this context are expenditures in terms of their shares in GDP. Under adjustment, Bangladesh experienced modest growth, which was just ahead of the population increase, so primary education growth represented an advance in absolute terms. This was also achieved in *Botswana* through a cautious policy of State spending. In either case, however, unlike some more developed countries, there was little prospect that the private sector would supply or compensate for any shortfall in social services that resulted.

Worryingly, the Bangladesh study also found lower nutritional standards under adjustment and little progress in the alleviation of poverty in general. In *Malawi*, which was already rather disadvantaged in respect of public provision of social services, it was only because the Government did not introduce new cost-recovery schemes in education and health that the impact of adjustment on the poor was not worse.

The eight studies unearthed little evidence that the rural landless and other underprivileged groups took advantage of the price signals introduced by adjustment to move into wage employment or to become entrepreneurs.

(c) Basic human needs in LDCs

Thus, the studies provide cause for concern that one of the key tenets of the SNPA, namely, to increase the provision of fully adequate and internationally accepted minimum standards for the poor, is not being satisfied under adjustment. This means that supplementary investment must be channelled towards the poor, but the objective could also be partly achieved through increasing general infrastructural investment in social services, transport and distribution. Although the latter

Table 48

EVOLUTION OF DEBT SERVICE RATIOS IN SELECTED LDCs

(Percentage of exports of goods and services)

Country	1980	1982		1986		1987	
	LT [a]	Total	LT [a]	Total	LT [a]	Total	LT [a]
Bangladesh	10	23	15	45	31	40	27
Botswana	5	10	9	5	5	4	4
Lesotho	2	3	3	5	5	5	5
Malawi	22	36	25	50	36	41	27
Nepal	5	8	4	10	10	9	9
Niger	14	39	37	49	44	49	40
Sudan	10	25	13	79	62	50	29
United Rep. of Tanzania	17	22	13	30	22	42 [b]	37 [b]
All LDCs	12	20	14	33	25	27	21
Memo item:							
Non-oil exporting developing countries	..	22	19	21	19	..	..

Source: UNCTAD, *Handbook of International Trade and Development Statistics,* 1987 and 1988 issues, and information provided by the OECD secretariat.

a Long-term debt only. Total debt includes short-term debt and use of IMF credit.

b Estimated.

would not of itself improve the distribution of income, as the poor are users of these services, increasingly so in the more remote areas, their needs would be partly addressed.

4. Special issues

(a) Regional factors

While LDCs in general are distinguished by their poverty, lack of industrialization and low adult literacy levels among a range of other factors, a number of them suffer from particular disadvantages which further condition the results of the adjustment process. One such issue is the regional factor. Some LDCs have very long borders with non-LDCs. The case studies show that a neighbouring economy can have a significant, though unanticipated, effect on the success or failure of an adjustment programme, yet the phenomenon is entirely or largely out of the control of the LDC itself.

In *Niger's* case, Nigeria's adjustment was a further factor for which Niger had to adjust, but adjustment programmes were not designed to accommodate this regional dimension. Both *Lesotho* and *Botswana* had appreciable levels of dependence on regional employment and income flows (migrant labour and remittances), as had *Sudan* with respect to the Gulf States. *Nepal* has had to accommodate disruption in its external trade due to the lapse of trade and transit treaties with India in 1989.

(b) Land-locked and remote LDCs

The regional factor and other factors (such as dependence on a major neighbouring economy) are also features of *land-locked* LDCs. But the clearest case of land-lockedness affecting adjustment is that of *Malawi.* The traditional direction of Malawi's import and export trade was via south-eastern ports, including Mozambique's ports of Beira and Nacala, and the initial country of transit for most of the traffic was Mozambique. Civil

strife there required Malawi to reroute the bulk of its export trade, increasing its c.i.f. costs and causing a deterioration in its export competitiveness. New transit transport routes had to be developed to the north and south-west and the costs of both the new investments and the additional charges on longer transit routes had to be absorbed during a period of adjustment; some of the post-1985 recession is clearly attributable to this. It is fortunate that, since independence, Malawi had begun to develop a road system in its northern region. Such investments are now contributing to the facilitation of rerouted transit traffic, but the northern transit route will take several years to become fully operational.

(c) Refugees

While some LDCs are themselves subject to internal conflicts that produce refugee flows, the impact of adjustment programmes is also crucially affected by the influx of refugees into LDCs. The case studies show examples of this in *Sudan* (over 1 million refugees from neighbouring countries) and *Malawi* (over half a million, the equivalent of one tenth of the national population). Such influxes of refugees present delicate political and social problems for the host government. Their presence places an added strain on the economies of adjusting countries. Since LDCs tend to be particularly vulnerable to such refugee flows as well as to natural calamities, allowances for this eventuality need to be made in the design of adjustment programmes, or at least their terms and conditions should be relaxed to cope with the consequences.

5. International issues

(a) Aid

International adjustment programmes include IFI financing (generally provided in tranches) as a quid pro quo for the rapid implementation of policy reform, often with co-financing from other donors (bilateral and multilateral). For most LDCs, this financing is on concessionary terms (IDA credits and IMF, SAF and ESAF drawings). As regards co-financing from other donors, the aid in question is not necessarily wholly additional.

Aid flows to LDCs rose from $7.5 billion in 1981 to $11.7 billion in 1987 and have been increasingly in the form of quick-disbursing programme assistance. Nevertheless, the extra aid resources directed to LDCs (especially in Africa) do not appear to have been sufficient to support their adjustment efforts. Furthermore, the share of grants in aid commitments and disbursements declined in countries pursuing adjustment programmes. In several cases scarcity of counterpart local currency has constrained aid absorption.

(b) Market access

LDCs have striven to liberalize their imports and exports as part of the adjustment process, even when infant industries might legitimately deserve protection, or regional trade development might favour special trading arrangements rather than complete liberalization. But the studies provide evidence that LDC exports were confronting protectionist barriers: *Bangladesh* garments have been facing quotas in the United States market; *Nepal's* textiles could not be exported freely to OECD markets, even with GSP concessions; while *Sudan's* actual and potential exports were of three commodities - foodgrains, edible oils and cotton - for which world markets were distorted as a result of restrictive trading practices on the part of developed countries.

(c) Compensatory finance

Given the vulnerability of LDCs owing to their dependence on commodity exports,[186] compensatory finance is a particularly relevant instrument in the short term. The APC countries can claim additional aid flows from the EEC under the Stabex scheme if a downward fluctuation in earnings is established for a particular commodity traded with the Community. Moreover, the EEC now allocates up to about Ecu 10 million per year under a companion scheme to LDCs that are not signatories of the Lomé Convention. In 1988, just over half the Ecu 19 million claims of *Bangladesh*, *Haiti* and *Nepal* was paid under this mechanism. But, in contrast, relatively few LDCs have made use

[186] For 23 of the 42 LDCs for which data on export concentration were available, the Hirschmann index stood above 0.5 in the mid-1980s (by comparison, only one OECD country - Norway - had an index over half this value), and of these, for 14 of the 19 LDCs for which 1970 data were available, the concentration index had actually risen - indicating still *greater* export concentration over its 1970 level by the mid-1980s.

of IMF's compensatory financing facility owing to its hard terms and its association with policy conditions. For the same reason, LDCs may not benefit from the new Compensatory and Contingency Financing Facility (CCFF), which includes a contingency allowance for rises in interest rates and natural disasters. In 1988, Switzerland unilaterally introduced an earnings stabilization scheme on bilateral trade from which LDCs will benefit.

(d) Debt relief

With the emergence of new schemes and proposals for debt relief, progress has been made for LDCs beyond that achieved a decade ago with the retroactive terms of adjustment (RTA) measures. In 1987, the Paris Club introduced significantly longer terms of repayment (up to 20 years) and an extension of the grace period, from which eight LDCs benefited. In 1988, renewed efforts to ease the debt burden of the poorest countries led to the agreement reached at the Toronto summit and implemented by all Paris Club creditors, involving three options in setting grace and repayment periods and interest rates.[187] Four LDCs have benefited from this "menu" approach in 1988 (see also box 7 in Part One, chapter II).

The scope of the "menu" approach, however, remains limited in so far as: (i) the option implying extension of repayment periods is not concessional; (ii) eligibility is in principle confined to low-income countries undertaking internationally agreed structural adjustment programmes (and thus does not apply to all LDCs); and (iii) the measures, instead of dealing with the overall stock of debt, affect only debt service due during the consolidation period and do not apply to loans contracted after the cut-off date.[188] Moreover, it should be noted that multilateral negotiations under the Paris Club do not include the OPEC members and socialist countries of Eastern Europe, which are important bilateral creditors for a number of LDCs.

A further important point in this context is that the Paris Club negotiations do not include multilateral creditors, to which LDCs owe a considerable part of their obligations.[189] Indeed, the only measure which has been taken to cope with LDCs' multilateral debt is the recent establishment by the World Bank of a reserve fund (to be financed out of repayments on IDA credits) to help pay the interest on past World Bank non-concessional loans on behalf of countries that are now eligible only for concessional IDA assistance. Five LDCs are currently eligible under this scheme.

(e) Policy conditionality

Finally, it is important to recall that, through their policy advice, multilateral institutions have come to exercise an important - even over-riding - influence on the economic policies of the majority of the LDCs, and that the adoption of Bank/Fund-designed structural adjustment programmes has in many cases become a precondition for securing fresh donor funding or debt relief.[190] The case study of the United Republic of Tanzania shows how bilateral aid is itself made conditional upon acceptance of a Bank-Fund programme - and its accompanying conditionality. An important issue affecting LDCs is therefore that of the conditionality attached to policy-based lending. The use of resources under certain facilities is subject to numerous and comprehensive prescriptions which preclude access by some LDCs because of the difficulties of complying with the conditions. Difficulties also arise from "inconsistent requirements of different creditors and

[187] These are:

(A) reducing moratorium interest rates on the whole rescheduled debt by 3.5 percentage points or by half, whichever is the less, with a 14-year repayment period, of which 8 years is the grace period;

(B) writing off one third of the debt service falling due in the consolidation period (principal and interest) and rescheduling the balance over 14 years, of which 8 years is the grace period, with moratorium interest charged at market rates;

(C) extending repayment periods for the whole rescheduled debt to 25 years, of which 14 years is the grace period, with moratorium interest charged at market rates.

[188] This is unchangeable and has become very distant for many countries after repeated reschedulings.

[189] At end-1986, service payments in respect of concessional and non-concessional debt to multilateral agencies (including use of IMF credit) are estimated to have reached $1.3 billion, exceeding one third of LDCs' total debt service payments.

[190] "Bilateral donors have relied on these institutions [IMF and the World Bank] for guidance as to the design and adequacy of such programmes and for management and advice in the supporting financial programming through the consultative group process and in the context of Paris Club operations". There was now "a recognition of the central role of the World Bank and the IMF in the whole process of policy-based lending". OECD, *Development Co-operation, 1987 Report* (Paris, 1988), p. 129.

multilateral institutions",[191] or what might be called onerous cross-conditionalities.[192] Conditionality attached to policy-based lending to the LDCs should rather be made more flexible, and better adapted to the special circumstances and requirements of these countries.

C. Conclusions

The review of LDC experience, as summarized above, provides a number of conclusions regarding the design and impact of structural adjustment programmes in the LDCs. These conclusions are set out below:

- Adjustment has begun relatively recently and in general has come after a period of major recession; thus evidence of firmly attributable effects will not become stronger until later.
- Meanwhile, even allowing for the fact that the initial changes of policy cause some unavoidable damage to vested interests but also to vulnerable groups, the adjustment programmes have so far produced mixed results and achieved, at best, limited success. The specific characteristics of individual LDCs were not always adequately taken into account in the design of these programmes, and external financial aid to these programmes remained insufficient.
- The reviews, however, also reflect a concern that adjustment for LDCs has too often focused on demand restraint measures, which have reduced already poor economies to operating at an even lower level of output.
- The strong emphasis given by adjustment programmes on redirecting resources from public bodies to private entrepreneurs is also called in question. The programmes need to take into account that LDCs in general have a very poorly developed entrepreneurial class and depend on public institutions to sustain both development and welfare provision.
- Devaluation, which is a common feature in LDCs' stabilization and adjustment programmes, appears to have produced little effect in stimulating exports.
- The reviews do not provide any firm indication that current adjustment strategies are building up the linkages required to assist in the long-run transformation of LDC economies. The adjustment strategies adopted, by focusing so strongly on short-term balance of payments management, may have neglected to develop the longer-run potentials of the national economy.
- There has also been neglect of the human resource potential in LDCs. Social services have suffered under adjustment, partly because of cuts in governments' development budgets and insufficient maintenance and operational support.
- The adjustment programmes have also failed to make provision for the flexibility to adapt - as the vulnerable LDCs must inevitably do - to unforeseen factors, be they internal, regional or global in origin, which are beyond the control of the LDCs.
- Additional financial resources directed to LDCs appear not to have been sufficient to support their adjustment efforts. Moreover, the share of grants in aid disbursement has declined and conditions attached to aid have become stringent.
- Adjustment programmes have not taken the problems of debt sufficiently into account in their design.
- Finally, in taking adjustment as a precondition for development, when in reality the former has concentrated on short-term payments equilibrium including debt service, the adjustment strategies have not, generally, succeeded in facilitating long-run development. The sort of changes that are required need additional resources, a longer time-frame and careful sequencing in policy implementation.■

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191 See Communiqué of the Intergovernmental Group of Twenty-Four to the Development Committee of the World Bank (24 Sept. 1988), para. 13.

192 For examples within and between the Bretton Woods institutions and their supporting governments acting as donors, see Sidney Dell, "The question of cross-conditionality", *World Development*, vol. 16, No. 5 (1988).

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EXPERIENCE OF INDIVIDUAL LEAST DEVELOPED COUNTRIES WITH ADJUSTMENT

This chapter reviews the adjustment programmes that have been implemented in seven LDCs and analyses their impact on the economies of those countries.[193]

A. Bangladesh

1. Introduction

Bangladesh is poorly endowed with natural resources: apart from fertile agricultural land, other exploitable resources are natural gas and fisheries. With a per capita income of about $170 in 1988, income and consumption levels in Bangladesh are some of the lowest among the LDCs. The production structure is undiversified and economic growth is largely determined by the performance of agriculture, which contributed 47 per cent of GDP and provided 71 per cent of employment in 1986. Agricultural output is dependent on the monsoon and is vulnerable to weather uncertainties. A series of natural calamities - drought, floods and cyclones - have wrought havoc in agriculture in recent years. The manufacturing industries (the share of which was 8 per cent of GDP in 1986) have performed poorly in the 1980s. Because of this sector's strong linkage with agriculture, the faltering performance of the latter has had adverse effects on manufacturing output by reducing the supply of raw materials and lowering rural incomes. Depressed international demand for jute goods and leather, and quota restrictions on exports of garments have resulted in lower capacity utilization in these industries.

The gross domestic savings rate of about 2 per cent (a national savings rate of 5 per cent) of GDP and the heavy dependence on foreign capital flows for financing investment are major structural constraints for Bangladesh's economy. More than one half of gross domestic investment is financed by foreign grants and loans from bilateral and multilateral sources. The country's export base is small (about 6 per cent of GDP) and undiversified. There is a high degree of concentration on a limited number of primary and semi-finished products which suffer from both supply inelasticity and income inelasticity in the importing countries. The earnings from traditional exports (jute, jute goods, tea and leather) stagnated in the 1980s.

The country faces an extremely difficult demographic situation: a population of 107.9 million in mid-1988 (82 per cent living in the rural areas) in a total area of 143,998 sq. km makes Bangladesh an extremely densely populated nation. The high rate of population growth has not only led to excessive pressure on limited arable land but also exacerbated the problems of poverty and unemployment.

[193] It draws, like chap. III, on the reviews prepared by consultants at the request of the UNCTAD secretariat (see footnote 178 of chap. III).

Growing landlessness and lack of employment opportunities in the rural areas have accelerated rural-urban migration. Poverty is widespread, nearly 51 per cent of the population are below the internationally-defined poverty line, with 60 per cent in the rural areas living in absolute poverty. Malnutrition is endemic, being particularly acute among children under 5 years of age and pregnant or lactating mothers. An underlying factor behind the massive poverty and low household incomes is the substantial overt and disguised unemployment of the labour force. About a third of the country's labour force was estimated to be unemployed in mid-1985 and since then job opportunities have fallen sharply behind the numbers of new entrants into the labour market. The social indicators, such as a life expectancy of 55 years, an infant mortality rate of 116 per thousand, a low level of human resource development, an adult literacy rate of 33 per cent, a high rate of dropouts from the school system and extremely low participation of girls in education, show that living standards are extremely unsatisfactory in Bangladesh. Most people are exposed to health risks (e.g. water-borne diseases) owing to limited access to safe drinking water and grossly inadequate sanitation facilities. Per capita energy consumption in Bangladesh is very low, and the bulk of it is supplied by the traditional fuels. The rural population's access to modern transport and communication facilities is still limited.

2. *Adjustment in the 1980s*

Soon after launching its Second Five-Year Plan (1980-1985), Bangladesh was forced to shift to adjustment for various reasons. The economy experienced a sharp decline in GDP growth, export shortfalls, a massive deterioration in the terms of trade (by over 30 per cent in 1980/81 and 1981/82) and declining flows of concessional assistance. Added to these were a series of natural disasters which compounded economic management difficulties. Faced with unsustainable budget and external deficits, Bangladesh embarked upon an adjustment programme in mid-1983. The adjustment package included measures for mobilization of domestic savings and reduction of public expenditures by the phasing out of subsidies and slashing of public investments. In agriculture, a medium-term food production plan was launched and land reforms introduced. Various incentives were instituted to promote export expansion. A decentralized administrative system was established to support rural development, and a number of studies were initiated in the energy, water resources, transport and financial sectors with a view to the development of appropriate sectoral policies.

In 1985/86, the authorities undertook a stablization programme under a stand-by arrangement with IMF. This was followed by negotiations for an IMF Structural Adjustment Facility (SAF) in 1986/87 for the period 1986/87 to 1988/89, which was later extended to 1989/90. The medium-term structural adjustment programme is aimed at improving real per capita income while lowering the rate of inflation and making significant progress towards balance of payments viability. The programme is also being supported by various sectoral and policy-based credits from IDA and ADB.

The policy package of the structural adjustment programme contains elements of demand management policies aimed at reducing current account and fiscal deficits as well as measures for strengthening the directly productive sectors through greater reliance on market mechanism. The emphasis is on expanding the role of the private sector in the domestic economy.

Over the past few years, the Bangladesh authorities have implemented a wide range of measures under the structural adjustment programme.

(a) Government revenues

In order to raise more revenue, significant fiscal measures have been introduced during the last three years. These measures include changes in the coverage and rates of existing taxes, the introduction of new taxes and improvements in the tax administration. Major import tariff reforms were implemented in 1987/88 and 1988/89 to eliminate discrimination against export industries. A system of tax rebates on imports of intermediate goods has been introduced. Cost recovery was implemented for public services in irrigation, electricity, transport, communications, education and health. Measures for improving the tax administration included the strengthening of the National Board of Revenue and establishment of Task Forces to tackle smuggling. The report of the World Bank-sponsored tax reform study is now under consideration by the authorities.

(b) Reduction of public expenditures

The Government has taken measures to restrict current expenditures by delaying salary adjustments of public servants, postponing new recruitment, and reducing subsidies and transfer payments. In the capital budget a variety of measures have been taken to improve efficiency in resource allocation. The most significant measures are: (a) a reduction in the projects portfolio in the public sector; (b) the introduction of a "core programming" system to protect priority projects against resources uncertainty; and (c) improvements in the project approval and implementation system. Increased allocations have also been provided for operational and maintenance outlays in priority sectors. In 1989, the World Bank completed a "Public Expenditure Review in Bangladesh", which is expected to serve as a framework for public resources management in the next plan period.

(c) Public enterprises

The authorities have taken measures to enhance the efficiency of the public enterprises and to put them on a sound financial footing through divestiture/rehabilitation, price adjustment and the introduction of a performance-monitoring system. Under the divestiture programme, a large number of industrial units in jute, textiles, chemicals, food, steel and engineering were sold to the private sector and, since 1986/87, 49 per cent of the shares of selected PEs have been offered for public subscription. Rehabilitation of retained public enterprises in jute, textiles, fertilizers, paper and newsprint, and power plants was completed. The capital structure of several PEs was improved by an infusion of capital and the conversion of debt into equity. Administered prices of sugar, paper, newsprint, fertilizers, gas, electricity, transport and petroleum products were raised to pass on increased costs to the consumers. By the end of 1987/88, a performance contract system was established in five enterprises.

(d) Monetary measures

Net credit to the Government and public enterprises was reduced, while bank credit to the Government fell by 2.4 per cent in 1986/87 and a further 1.7 per cent in 1987/88. The Bangladesh Bank has raised nominal interest rates to maintain the real interest rate at positive levels. It has restricted refinancing facilities for the commercial banks and shifted to qualitative methods of credit control. A number of private banks and insurance companies have been permitted to operate, and government-owned commercial banks have been denationalized in order to expand the role of the private sector in financial intermediation. Since 1986/87, a credit recovery plan has been launched for collecting overdue agricultural and industrial loans. The Grameen Bank[194] has expanded its lending to landless and marginal farmers.

(e) The exchange rate and external borrowing

Devaluation has been a key element of the stabilization/adjustment package negotiated with IMF. The taka, which is pegged to a basket of trade-weighted currencies, was depreciated about 20 per cent between 1984/85 and 1987/88. Progress has been made in narrowing the gap between the official exchange rate and the exchange rate in the secondary market (by November 1988 the premium in the secondary market over the official rate was reduced to 2 per cent from 6.5 per cent in 1986/87). In view of the growing debt service burden, the authorities have maintained strict limits on non-concessional borrowing (eg. loans carryng high interest rates and short maturities).

(f) Agriculture and food

In agriculture, steps were taken to expand the role of the private sector in inputs delivery, to reduce subsidies and to increase producers' incentives. Subsidies on fertilizers were withdrawn and on irrigation equipment reduced. Wholesale and retail trade in fertilizers are in the private sector and farmers can buy irrigation equipment individually or jointly. Procurement prices of various crops have been raised periodically to provide growers' incentives. Efforts have been made to strengthen linkages between agricultural research and extension. Food subsidies under public distribution have been substantially reduced, and subsidized food is now directed to the rural poor and the vulnerable groups. The Government is seeking to ensure food security by stabilizing consumer prices through open-market sales and the maintenance of a critical mini-

[194] See chap. II.

mum reserve stock of foodgrains. The programmes/projects for afforestation and development of fisheries and livestock are being implemented with donors' assistance.

(g) Industrial and trade policy

The New Industrial Policy announced in July 1986 envisages a leading role for the private sector in the country's industrial development. Sanctioning procedures are now greatly simplified. An Investment Board has been set up recently to approve all cases of foreign investment and provide support services to the sponsors. In order to improve access to intermediate inputs and capital goods, trade liberalization measures have been implemented. These measures include introduction of a passbook system, improved availability of foreign exchange, tariff reforms, etc. Bangladesh has also put into practice a number of incentive schemes for exporters, i.e. a cash subsidy to exporters under the Export Performance Benefit (EPB) Scheme, bonded warehouse facilities, duty drawback, export credit guaranteesa and the Export Processing Zone at Chittagong.

(h) Energy

Bangladesh has focused its energy policy on (i) development of natural gas reserves by drilling new wells and expanding the distribution network, (ii) exploration of oil and gas, (iii) energy conservation in industry, transport and other uses, and (iv) rural electrification. Public sector investment in gas production, power generation and fertilizer production have received priority. Prices of gas and electricity have been raised to generate more resources for investment in the energy sector. A plan of action for the restructuring of public sector agencies involved in gas and electricity is being implemented to improve their efficiency.

3. International support

The performance of the Government in the implementation of the Bank-Fund adjustment package was expected to serve as a catalyst to mobilize additional resources from bilateral donors and multilateral financing agencies . There is very little evidence that this has happened in Bangladesh. The trends of aid commitments show marked year-to-year variations and stagnation over a longer period. Within the aggregate trend, new commitments by bilateral donors, especially non-aid group sources, have declined. However, net disbursements in real terms have increased during the adjustment period. The composition and quality of the aid given have become more unfavourable for Bangladesh. The share of fast disbursing non-project aid (food and other commodities) fell sharply from 60 per cent in 1982/83 to 39 per cent in 1986/87. Given the country's limited capacity to provide matching local currency, the change in aid composition has worsened the problem of aid absorption. The quality of aid has also deteriorated following a decline in the share of grants associated with the increased conditionality of the policy-based lending programmes of multilateral financial institutions. The share of grants in total disbursements has declined from 53 per cént in 1979/80 to 43 per cent in 1988/89. Consequently, the country's indebtedness has increased. Bangladesh already has a very heavy debt service burden, and this trend will impair its future import capacity as the prospects for rapid export growth are not bright. The response of foreign private investment to various concessions and facilities extended by Bangladesh remains rather limited. The country has received very little international support in terms of either market access or compensation for export shortfalls. The quota restrictions on exports of ready-to-wear garments in major markets have hampered the growth of this promising industry.

4. Impact of the adjustment programme

In evaluating the impact of the adjustment programme, it is very difficult to distinguish the effectiveness of the programme from the impact of changes in external factors. Moreover, the adjustment programme is still in force and will not come to an end for some years. None the less, tentative observations can be made. The adjustment programme seems to have been more successful in reducing budget and current account deficits. By 1987/88, the budget deficit was reduced to 7.5 per cent of GDP from about 11 per cent in 1982/83, despite the disruptive effects of the floods in 1987 on the government budget. Similarly, the current account deficit was brought down from over 10 per cent to less than 6 per cent of GDP. This was achieved through compression of imports, and rapid growth of non-traditional exports and workers' remittances. Moreover, the inflation rate was reduced to around 10 per cent.

The growth of GDP averaged 3.8 per cent per year between 1979/80 and 1987/88, which was well below the programme target and the potential of the economy. In 1988/89, the growth rate of GDP has been less than the population growth rate, signifying a decline in per capita income. The reduction of public investment in agriculture and increased prices for fertilizers and irrigation equipment, coupled with restrictions on agricultural credit, have impeded agricultural growth. The progress made towards food self-sufficiency has been inadequate and imports of foodgrains rose sharply in recent years because of severe floods. The manufacturing industries have also performed poorly owing to depressed domestic and external demand.

Contrary to the programme target, gross domestic investment dropped drastically from 17 per cent of GDP in 1979/80 to 12 per cent in 1987/88. A falling revenue surplus (government savings) and restrictions on borrowing from the banking system lowered public sector investment, while the private sector failed to pick up the slack. The decline in net investment following the earmarking of resources for post-flood rehabilitation, and poor maintenance of capital, have diminished Bangladesh's future economic growth.

Despite a strong commitment on the part of the Government to improve the situation of the poor, the adjustment programme has contributed very little to furthering poverty alleviation and attaining human resource development targets. Unemployment has increased further in recent years. Per capita food availability fell to 448 grams per day in 1987/88 from 496 grams in 1984/85. Together with high prices, this has reduced the access of the poor to food supplies. In addition, the level of public expenditures on education, health and drinking water, which remained constant, has restricted the access of the poor to basic services.

In sum, the adjustment policies have not advanced Bangladesh's transition to self-sustained development over the longer term. The burden of adjustment has fallen more severely on the poor and disadvantaged households. Added to this the adjustment policies have produced misallocation effects such as deterioration of physical assets due to an inadequate maintenance budget, and a deceleration in the off-take of fertilizers and use of irrigation equipment following price adjustments and imposition of restrictions on agricultural credit. Contraction of public investment in infrastructure, especially irrigation and drainage facilities and human resource development, has also diminished the country's long-term development prospects.

5. *Conclusions*

In the case of Bangladesh, the adjustment programme is still being implemented and it is premature to come to firm conclusions about the success or failure of the programme. The Bank-Fund-supported adjustment programme has thus far produced mixed results. Nevertheless, the structural problems in Bangladesh are deep-seated and complex and can only be tackled by pursuing growth-oriented adjustment over a sufficiently long period. Moreover, the design and thrust of the Bank-Fund adjustment package suffer from several weaknesses. Firstly, the focus of the programme is on short-term external balance and demand management policies. Insufficient attention has been paid to domestic supply responses and investment in infrastructure and human resource development. Secondly, very little attention is given to the social consequences of the programme, especially the distribution effects. Thirdly, there is a strong bias towards privatization and reliance on market mechanism. Market imperfections are well known in a country like Bangladesh. Moreover, as in most LDCs, a dynamic entrepreneurial class is lacking. The responsibility of the public sector to provide long-term investment support, particularly for human resource and infrastructure development, should be recognized. The standard policy package, which has a better chance of success in organized economies, is unlikely to achieve the desired results in a disaster-prone, subsistence economy. Lastly, there is considerable rigidity in the time-frame for implementing the policy package. There should be flexibility in sequencing the implementation of various measures, and recognition, for example, that institutional reforms take time to design, legislate and administer.

B. Lesotho

1. *Introduction*

Lesotho is a small mountainous country completely encircled by South Africa. Its economy has few natural resources; only 13 per cent of the land is cultivable and there are no known significant mineral deposits apart from small quantities of diamonds.

The economy is heavily dependent upon remittances from the migrant labour force in South African gold and coal mines. Migrants' remittances amount to some 50 per cent of GNP and are the main source of income for over a third of all households. Agriculture is the primary source of income for a further third of households, in the form of either subsistence production or sales of food staples, wool and mohair.

The economy of Lesotho grew rapidly during the 1970s, with real GNP growth of 8 per cent per annum. Growth was based upon a substantial increase in the level of migrants' remittances, the development of diamond mining, and a high level of development assistance, allowing for a sizeable expansion of government services and employment. The industrial sector, however, remained small and its development was constrained by the small size of the domestic market and by the competition of tariff-free imports from neighbouring South Africa. During the 1980s, GNP growth slowed markedly, and real per capita income started to decline. The main causes of economic decline were the reversal of favourable factors from the previous decade and continuing economic dependence upon South Africa. Diamond mining on a commercial basis ceased in 1982, and from 1984 onwards the growth of migrant workers' remittances became sluggish. In addition, agricultural production fell as a result of prolonged drought between 1983 and 1986.

GDP growth has been more buoyant since the mid-1980s as a result of deficit-financed increases in government expenditure, but has been directed largely towards imported consumption goods or investments in transport and its accompanying infrastructure, and in livestock. Consequently, major imbalances started to appear in the economy. The government deficit rose to 12 per cent of GDP in 1985/86 and to 20 per cent by 1987/88, contrasting sharply with improvements in the fiscal position between 1982/83 and 1984/85.[195] The major factors contributing to the increased deficit were a significant rise in recurrent expenditure and stagnation of customs revenues (some 65 per cent of recurrent revenue) from the Southern African Customs Union between 1984/85 and 1987/88. Increased government borrowing from both domestic and foreign sources pushed the current account into deficit (9 per cent of GNP in 1987/88), and from 1986 onwards the absolute level of foreign reserves was in decline, falling to less than four weeks' import coverage by the end of 1988. Public foreign debt increased sharply over the 1985-1988 period as expenditure on loan-financed projects accelerated and the maloti depreciated against the dollar. The debt stock was, however, largely on concessional terms and the debt service ratio remained relatively low. The Lesotho Government increasingly relied upon funding from the domestic banking sector to finance expenditure.

During 1988, the advent of the $2 billion Highlands Water Project has brought considerable new activity to the capital, Maseru, although the economy has been slow to respond to the potential manufacturing linkages in the construction and building material industries. In 1987 and 1988, small export-oriented manufacturing businesses grew rapidly, mainly in the footwear and clothing sectors. Consequently merchandise exports more than doubled from 1986 to 1988.

Perhaps the most serious economic problem in Lesotho is that of unemployment. The annual addition of 20,000 entrants to the workforce compares with an estimated 3,000 new formal sector positions within Lesotho and a stagnant level of migrant mining employment. The relatively high investment level of over 18

[195] The government deficit fell from 59 million maloti in 1981/82 to M 17 million in 1984/85 before rising to M 161 million in 1987/88.

per cent of GNP (1985-1987 average), coupled with low growth of output and employment, suggests that significant changes will be required to set the economy on a path to self-sustained growth and development.

2. *The adjustment programme*

The Lesotho authorities realized that an adjustment programme, whether formally negotiated with an international institution or carried out alone, would have to respond to two distinct objectives:

- firstly, to increase the productive capacity of the domestic economy to confront the serious employment problem and simultaneously to reduce the vulnerability of the Lesotho economy to changes in neighbouring South Africa; and
- secondly, to address the emerging fiscal crisis and its resultant balance of payments problems by a combination of expenditure restraint and improved tax collection.

The Fourth Five-Year Plan 1986/87 - 1990/91 signified the realization of the economic problems that faced Lesotho, and proposed a number of measures to improve domestic productivity, i.e. the implementation of land reform with the introduction of leasehold forms of land tenure, the development of urban services and planning and the reorganization of government planning functions to allocate capital funds more effectively. To stimulate industrial production, an export-financing agency was announced to provide guaranteed loans to the private sector. However, the results of the first two years of the Plan were not up to expected levels and the Government, together with IMF and the World Bank, designed a new set of policy adjustment measures. A SAF agreement was concluded with IMF in June 1988 for the period 1988/89 - 1990/91 for the amount of SDR 10.6 million.

The adjustment programme supported by the SAF is a "standard" IMF adjustment package, albeit in a somewhat reduced form. Lesotho's economic dependence upon South Africa inhibits the use of the independent monetary and exchange rate policy which is frequently the centrepiece of an IMF adjustment programme. The standard prescription of currency devaluation is therefore rendered invalid as the maloti is fixed at par to the rand by arrangements in the Common Monetary Area agreement, and is arguably unnecessary given the sharp depreciation of the rand against major currencies from 1985 onwards.

Over the the three-year period, GDP was targeted to grow at an average of 4 per cent per annum (against population growth of 2.7 per cent per annum). Changes in fiscal policy were assigned a leading role in the adjustment programme. Revenues were programmed to rise from 40 per cent to 47 per cent of GDP over the programme period by the introduction of income taxes for migrant workers, increases in sales tax, cost recovery in health and education and increases in duties, fees and charges. A policy of restrained recurrent expenditure was advocated. Increases in grant-funded projects and a standstill in the contracting of new external non-concessional borrowing were also to contribute to a reduction in the overall government deficit from an estimated 20 per cent of GDP in 1987/88 to 4 per cent by 1990/91. The operating performance of public enterprises (mainly utilities) was intended to improve over the Plan period by means of tariff increases and better monitoring and evaluation. The major quantitative benchmarks for evaluating performance during the SAF were limits on total domestic credit from the banking system, in order to be consistent with a reduced current account deficit and increases in official reserves.

Sectoral policies articulated for the adjustment programme were built on the Fourth Five-Year Plan. Implementation of grazing fees was foreseen to reduce livestock pressure upon overgrazed communal land. In industry, support was enunciated for export-oriented industry without substantive policy changes apart from measures to attract foreign investment, which included the simplification of administrative procedures through the formation of a one-stop investment promotion unit. Although the debt stock as a proportion of GNP had doubled to 37 per cent over the five years up to 1987/88, projections of debt service in relation to government revenue did not indicate problems.

During the first year of the adjustment programme there was some slippage in its implementation, notably as regards fiscal and domestic credit targets. Annual credit targets were exceeded halfway through the financial year, while the overall annual government deficit was estimated to have remained unchanged at around 20 per cent of GDP. The standstill on contracting new non-concessional debt was not observed and new foreign commercial loans to the parastatal sector were guaranteed by the Government. However, performance on legislative reform and revenue-generating measures was far better.

Targets did not refer in great detail to the second and third years of the programme, although reference was made to implementation of migrants' income taxation and to civil service efficiency reforms. Migrant workers account for nearly 60 per cent of regular wage/salary earners and at present are not liable for income tax either in Lesotho or in South Africa.[196] As regards the civil service, although a recruitment freeze has been in place intermittently since 1981, the government establishment continued to grow slowly throughout the 1980s. With wages and salaries accounting for 50 to 60 per cent of government current expenditure, attempts at expenditure control could not have been accomplished without an eventual rationalization of employment numbers, particularly if real wages were to be raised to maintain and attract skilled personnel.

3. *Impact of the adjustment programme*

It would be premature and probably impossible to evaluate the magnitude and direction of impact of an adjustment programme after only one full year of operation. However, the central adjustment policies during 1988/89, which concentrated upon domestic credit restraint and, in particular, upon a reduction of the government deficit and indirectly the current account deficit, clearly have not been implemented.

Tax reform was in general carried through, and a significant improvement in the level of revenue was projected. However, improvements in expenditure control did not appear until towards the end of the fiscal year, by which time it was clear that the government borrowing targets could not be met. Delayed control of current expenditure also had undesirable side-effects as ministries found they could not meet staff costs and in certain cases had insufficient funds for essential supplies; for example, the budget for rural drugs was exhausted within six months and budgets for casual labour were exhausted in a similar period. The major causes of the budget over-run were weak expenditure control, combined with the implementation of a pre-agreed salary review at the same time as the adjustment programme.

However, positive results were also achieved during the first year of implementation of the adjustment programme, notably the growth in real GDP, which was larger than anticipated, and the mobilization of new donor funding. The financing needs for Lesotho's structural adjustment programme and development strategies were examined at a Round Table Conference held in December 1988. The intentions of financing expressed by the participants reportedly indicated that these requirements will be adequately covered in the immediate period ahead. In June 1989, IMF approved the second annual arrangement for Lesotho under the SAF.

C. Malawi

1. *Introduction*

Even prior to the initiation of adjustment programmes, Malawi pursued policies of agricultural export promotion and had relatively undistorted exchange rates. Structural adjustment did not involve any dramatic change in economic philosophy. Agricultural exports were instrumental in the initially impressive economic performance of the 1970s when Malawi was considered to be an example of what could be achieved by a small, resource-poor country through market-oriented policies and a a relatively efficient bureaucracy.[197]

By the end of the decade, however, exogenous shocks resulting from increases in oil prices and interest rates, combined with drought, falling prices of key agricultural exports, and escalating external transport costs due to the disruption of routes through Mozambique, exacerbated underlying struc-

[196] However, a small capitation fee is levied at border crossings on migrant workers.

[197] For discussion of the background to the adjustment programme in Malawi, see Kydd (1988).

tural weakness in the economy. Severe imbalances appeared in the economy, the balance of payments deteriorated, the budget deficit widened and borrowing increased.

A first stand-by arrangement and a Compensatory Financing Facility drawing was agreed with IMF in 1979, but were inadequate for the necessary major restructuring of the economy. In the early 1980s, therefore, the Government entered into negotiations with IMF and the World Bank for further stand-by and structural adjustment funds. A new IMF stand-by agreement came into operation in 1980 and the first structural adjustment loan (SAL) was agreed with the World Bank in 1981. Since then there has been an IMF Extended Financing Facility arrangement (1983) and two more structural adjustment loans (1983 and 1985). In recognition of the difficulties encountered in implementing macroeconomic reforms, the World Bank is currently experimenting with sectoral adjustment initiatives. A SDR50.6 million credit for a trade and industry sector adjustment was agreed in June 1988 and discussions with the Government concerning a possible agricultural sector credit were to open in early 1989. Malawi, in July 1988, became the first beneficiary of IMF's Enhanced Structural Adjustment Facility under an arrangement to the value of SDR55.8 million.

2. *The adjustment programme*

IMF support has been conditional throughout on fiscal and monetary restraint and currency depreciation. Initial lack of success in meeting balance of payments objectives, however, coupled with the deep-seated structural causes of disequilibrium, led to the negotiation of a series of more concessional structural adjustment loans from the World Bank.

Conditionality associated with these loans has varied. The first loan required only a commitment to raise charges made by parastatal enterprises and to decontrol prices and wages. The second was more stringent, requiring substantial increases in the producer prices of export commodities and some reform of the large-scale private sector. By 1984, the economy appeared to be recovering and the arrangements for the third loan departed from the previous format in that they included funding from bilateral donors. Conditionality was more relaxed and revolved around a concern to improve the performance of parastatals. In particular, there was pressure to raise the productivity of the estate sector and to improve the efficiency of agricultural marketing through, *inter alia*, the privatization of a number of the activities of the Agricultural Development and Marketing Corporation (ADMARC).[198] Emphasis was also placed on diversifying production, particularly of exports.

The economic recovery experienced in 1984 began to weaken after 1985, substantially as a consequence of the deteriorating situation in neighbouring Mozambique, which resulted in considerable increases in the freight costs associated with moving commodities in and out of the country. Consequently, the appropriateness of the objectives attached to previous loans was reassessed, and a sectoral adjustment credit for trade and industry was agreed with the World Bank in June 1988. This is oriented towards the liberalization of external trade, the promotion of domestic competition and support for small-scale industry. Negotiations are currently (1989) under way for an agricultural sector adjustment credit.[199]

The principal components of the programmes implemented by the Malawian Government include devaluation and reduction in government spending. The main vehicle for reducing the latter, however, has been through cut-backs in development, rather than in recurrent, expenditure. Moves to decontrol prices have been relatively slow, at least in the early stages of the programme, and efforts to promote export production within the agricultural sector have had to be tempered in response to consequent food deficits. Efforts to improve the efficiency of the quasi-public sector and to privatize parastatal activities have also met with some difficulties.

[198] ADMARC is the agricultural marketing parastatal, and the principal institution concerned in the move towards privatization.

[199] The implications of the reform programme in Malawi have been well documented. See, for example, Collier (1988); Kydd with Hewitt (1986); Kydd and Hewitt (1986); Kydd (1988); Winter (1984).

3. Impact and evaluation of recovery programmes

(a) External balance

Prior to the emphasis on structural adjustment, Malawi maintained its currency close to the market value. This has been an important facilitator of agricultural growth in the past, and has greatly simplified the task of implementing policy reforms since the ensuing periodic devaluations were a continuation of previous policies. The effectiveness of policy in this respect is reflected in the fact that, since 1980, changes in the nominal rate mirror those in the real effective rate of exchange.

Currency depreciation has been a central instrument in correcting the severe balance of payments deficit of the late 1970s. The deficit was reduced from over 22 per cent of GDP in 1980 to approximately 5 per cent in 1987. In 1984, the proportion fell to as low as 1 1/3 per cent. Also important in reducing the deficit has been the contraction in domestic demand leading to a fall in the demand for imports. It is the latter, rather than an improvement in export performance, which appears to have contributed most to reducing the current account deficit. The value of imports has fallen substantially since 1980 relative to GDP, while that of exports has shown no discernible trend.

One consequence of the stagnation in export earnings has been that the debt service ratio has also grown to substantial proportions. With no immediate prospect of an improvement in the export performance, particularly given the continuing and expensive re-routing of external trade, and with the debt burden still growing, the problem of debt servicing is likely to remain. Malawi has already rescheduled its external debt several times during the 1980s.

It is difficult to separate the extent to which this unfavourable situation is due to external influences, such as deteriorating terms of trade and the closing of the Beira corridor, or to the design of the early adjustment programmes. At the same time, it is apparent that early structural adjustment policies failed to address the underlying problems of the agricultural sector, particularly those stemming from past over-reliance on, and over-protection of, the estate sector. It is reasonable to conclude, therefore, that current debt service problems are attributable to both inclement external influences and the sequencing of adjustment-related reforms. In this respect it is noticeable that, since the introduction of SAL III, there has been a shift in emphasis towards more sector-specific reforms.

(b) Budget deficit and State corporations

The growth of government deficits to substantial levels in relation to GDP necessitated the mobilization of domestic revenue and more stringent control of public expenditure. The tax schedule was reorganized, many personal allowances were eliminated and marginal tax rates increased. The objective of increasing the proportion of revenue from taxes on incomes and company profits was not noticeably fulfilled, however. Attempts to control government expenditure met with some success, although reductions occurred primarily in development rather than recurrent expenditure, where the high salary component and the political implications of reducing the number of government employees raised apparent problems. The development budget was, to a great extent, financed by aid flows.

The objective was both to dampen and restructure demand, and this was only partially achieved. As a proportion of GDP, consumption changed little throughout the period, although there was some shift from government to private consumption. The main impact of austerity measures fell on investment, and particularly on private investment, with savings showing no particular trend. A related aim of the programme was to introduce greater control over monetary growth, and in particular over the rate of domestic credit expansion. This was largely unrealized apart from the initial reversal of trend over the early part of the decade. Although nominal interest rates have risen, except in 1985 they have remained negative in real terms. The rate of inflation fell in 1982 and 1985, but rose dramatically to 25 per cent in 1987.

Malawi's fiscal problems have been aggravated by the financial problems of the parastatals. These companies have not been able to service their debts and the Government, which guaranteed their foreign debt, incurred substantial costs in meeting their interest and amortization payments.

As a consequence of the conditions attached to SAL III, a two-pronged programme of institutional reform was drawn up. The first component related to the financial restructuring of ADMARC. Previous studies of Malawi's key development institutions, carried out under SALs I and II, had identified ADMARC's financial problems as being pri-

marily caused by over-investment in illiquid equity capital, over-diversification out of agricultural sector investments and poor performance of its chosen portfolio. Since mid-1987, in an effort to restore its financial viability, the Corporation has pursued a programme of asset rationalization with the aim of achieving a smaller, more profitable and less illiquid core portfolio.[200]

SAL III also included a complementary revision of crop trading operations, with the primary objective of increasing marketing efficiency through allowing private traders to compete with the Corporation. An improvement in ADMARC's financial position was to be achieved through reducing the number of its buying points, closing down the smallest 20 per cent. Private traders were to be allowed to operate under licence, and export licences were to be available at the discretion of the Ministry of Trade, Industry and Tourism. Private trader activities would be monitored through a licensing system.

From the beginning, the liberalization has been fraught with difficulty. Many of the problems are the result of inadequate planning and impact analysis and the lack of a clear concept of ADMARC's future role. At the same time, the problems do not provide a critique of liberalization *per se*; rather, they point to difficulties in implementation.

(c) *The agricultural sector*

The agricultural sector in Malawi is characterized by a clear-cut distinction between the large-scale estate sector and the smallholder sector. The former has, since the mid-1960s, enjoyed considerable subsidization and preferential access to resources and markets. It enjoys a legal monopoly in production of the superior types of tobacco, and a virtual monopoly of tea and sugar production. The expansion of the estate sector has been the linchpin of government agricultural policy since 1965. Although there are significant obstacles to change in this sector, it is recognized that the present low land utilization rates reflect a misallocation of resources.

The economic crisis of the early 1980s manifested itself within the agricultural sector in stagnating production, declining food security and falling agricultural export earnings, the latter caused by a deterioration in international terms of trade for Malawi's traditional export crops. The recovery programme therefore addressed the need for increased and diversified agricultural exports by means of producer price incentives and, for the estate sector, an export credit facility; the restructuring of ADMARC and the liberalization of domestic trade in agricultural commodities; and the removal of the fertilizer subsidy. There were also proposals, as part of SAL III, to review estate expansion, to provide an estate credit and extension service, and to review the land tenure system.

The impact of economic recovery programmes on the agricultural sector has been diverse. In the estate sector, the principal influence has been through devaluation and trade liberalization. Being primarily engaged in export crop production and responsible for their own marketing and input supplies, estate producers have benefited from higher producer prices in terms of domestic currency and more liberal access to foreign exchange and therefore imported inputs. They have also benefited from a continuation of the cheap labour policy previously pursued by the Government, which contributes greatly to Malawi's comparative advantage in export crop production. The sector is affected by management problems and low levels of productivity, however, and one of the principal stumbling-blocks for the reforms has been the limited extent to which these benefits have been reflected in output growth. Moreover, estate production has been liable for export taxes on an *ad valorem* basis for some time, and rates have recently been increased as part of the macroeconomic measures designed to reduce the size of the government deficit.

In the smallholder sector, because of ADMARC's dominant role in price setting and marketing activities, devaluation and external trade liberalization have had relatively little influence. These reforms inevitably affect policy decisions concerning producer price levels. ADMARC's other policy objectives, including the safeguarding of national food security and the protection of rural incomes, have not been notably successful and there is a serious deterioration in nutritional standards in most of the country.

The high price responsiveness of smallholder agriculture in Malawi is well documented, although it is usually manifest in changes in cropping pattern rather than increases in overall production. This is primarily due to resource constraints which limit the opportunities for raising productivity, either of land or of labour. The influence of relative price changes is therefore profound. In order to boost export earnings, under SAL II relative price shifts were initiated in favour of

[200] See Pryor (1987) for a review of ADMARC's functions.

smallholder cash crops such as cotton, groundnuts, pulses and burley tobacco. Because of the unacceptable decline in the production of food crops that ensued, however, this policy has since been reversed.

Relative changes in the price of inputs as well as of products have also occurred. With significant increases in the real price of fertilizers as a result of the SAL III Fertilizer Subsidy Removal Programme, fertilizer-using crops (maize) became much less profitable in comparison to unfertilized crops (groundnuts). This four-year programme was introduced in 1986, in line with the general move towards increased cost recovery. However, the programme has since been suspended indefinitely. At the same time, sharp increases in the landed costs of pesticides for tobacco and cotton added to production costs for these crops.

Reference must also be made to the liberalization of agricultural marketing in 1987, which cannot fail to have a substantial impact on smallholder markets. At present there is insufficient evidence on the nature of any resulting changes.[201] None the less, it is likely that the impact will be significant. In particular, liberalization will affect the regional distribution of product markets; less profitable remote locations have been abandoned by ADMARC and, since they have never been attractive to private traders, a marketing vacuum has occurred. It follows that an increase in subsistence production would be expected in these areas. This will influence both the regional distribution of income and, through the reduction in production of marketable surplus, national food security.

(d) Human capital and basic needs

Social services in general, and the health sector in particular, have historically received relatively low priority in Malawi, and social indicators are low. Current policies now give increasing attention to the social services sector. The elements of Malawi's structural adjustment programmes with a potential direct impact on the health service are those promoting reductions in the government budget deficit and cost recovery in the service provision. To date, the latter has not been implemented. Government development expenditure on health actually increased from 0.89 per cent of the total in 1979 to 2.98 per cent in 1987, while recurrent expenditure remained roughly constant as a proportion of the total. In fact, over the period 1979-1987, the latter increased as a proportion of GDP from 1.24 per cent to 1.60 per cent. It must be pointed out, however, that the overall government budget has been pruned as a result of macroeconomic reforms, so these proportions mask a decline in absolute expenditure. In addition, the real value of nominal expenditure per capita has been eroded by inflation.

Education was also given relatively low priority in the government budget in the past. Illiteracy rates remain high, particularly in the rural areas. During the adjustment period, development expenditure has been protected from budgetary cuts and teachers have been excluded from public sector employment cuts, although this may not have been enough to maintain facilities in the face of a rapidly growing school age population. Education's share of the recurrent budget declined from 12.7 per cent in 1979 to 9.3 per cent in 1987, although development expenditure increased from 6.1 per cent to 9.8 per cent over the same period. Given the historical neglect of the sector, coupled with the proposals to increase school fees as part of the cost recovery programme, it appears likely that the opportunity cost of primary education make this even less accessible to large sections of the population.

The central issue with regard to the provision of basic needs concerns the ability of households, particularly rural households, to achieve some measure of food security. For a large proportion of rural families, this is reflected in the extent to which off-farm activities provide them with adequate resources to purchase sufficient food. It is estimated that between 75 per cent and 95 per cent of rural households dependent on off-farm earnings are unable to acquire sufficient income for this purpose. As a result, Malawi's rural population has a poor average level of nutrition, and nutritional deficiency is a principal contributing cause of a dominant fraction of preventable mortality.

In so far as the recovery programme can be said to influence this situation, it should be noted that increases in the real price of maize, occurring at a time when traditional methods of family support are breaking down, and when the problem of inadequate alternative income-earning opportunities has not been addressed, can only add to the number of "at risk" households. In fact, while the incidence of seasonal malnutrition may be declining, permanent stunting, caused by inadequate food intake over a prolonged period, appears to be increasing.

201 See, nevertheless, Kandoole *et al* (1987).

(e) Public infrastructural investment and maintenance

A key platform of the post-Independence Government has been the uniform development of all three regions of the country and the removal of spatial imbalances through investment in transport infrastructure. Accordingly, the transport sector has traditionally received as much as 30 per cent of the government development budget. Funds have been used to extend the road network into the Northern Region and other previously isolated areas and to increase the proportion of tarred road. The relative importance of transport expenditure in the government budget has not changed significantly as a result of the economic reform programme, remaining at around 30 per cent of development expenditure, and 3 per cent of recurrent expenditure.[202]

Being an export-oriented, land-locked country, Malawi is heavily dependent on international trade, and cheap and reliable external transport links are consequently essential to the economy. The cutting of supply routes through Mozambique has disrupted Malawi's external trade and proved very expensive. Thus, the structural adjustment programme includes funding for the creation of a "Northern Corridor" route to the Tanzanian coast which will upgrade the Lake Malawi ports, improve the road system through northern Malawi to the United Republic of Tanzania and create bonded port facilities at Dar es Salaam. This route will not be completed for some years, however, and other investments in transport infrastructure will consequently be limited by the need to reduce development expenditure in line with the reduction in the budget deficit.

4. Conclusions

Malawi's economic reform programme has progressed through a number of discernible phases, each with its own key objectives. SAL I focused exclusively on the principal macroeconomic indicators, while later loans had broader objectives that recognized the importance of institutional support, and accordingly included provisions for sector policy reviews, export credit facilities, transport infrastructure and an estate extension service. Thus, it is apparent that there has been a gradual broadening of the reform programme objectives.

To a great extent, the problems that beset the Malawian economy at the outset of the adjustment process still remain, in spite of the fact that the environment for implementing such a package of measures has been relatively conducive, with little basic change of economic policy required and a central Government committed to it. Consequently, shortcomings in performance reflect weaknesses in package design and unfavourable external factors rather than implementational failures. GDP growth has faltered since 1985, monetary growth continues unabated, and the key external imbalance has not been brought under control.

There are considerable difficulties associated with attempting to attribute causality to events that have shaped the Malawian economic performance. It is realistic to assume, however, that external factors, particularly declining world commodity prices and higher transport costs due to disrupted international transport routes, have been highly significant in inhibiting Malawi's return to growth, as has the influx of refugees from Mozambique, exacerbating existing strains on scarce resources. Furthermore, major constraints arise from the poor natural resource endowment and the weak linkages between the largest sector, the small-scale agricultural sector and the wider economy. The limited achievements of policy and institutional reform must be viewed in the context of these deep-seated constraints to economic diversification.

Export industries, both primary and agro-processing (the latter accounting for two thirds of manufacturing industry), have clearly benefited from devaluation. At the same time, shortcomings in the adjustment approach adopted can be identified in a number of areas, such as the following:

- policies relating to private sector development;
- subsidy policy;
- policies to promote growth in the small-scale agricultural sector, e.g. in respect of credit and extension packages and land distribution;
- the pace of reform, which has tended to limit the potential benefits derived from the programme. For example, retail price de-control and foreign exchange allocation revision have proceeded more slowly than the implementation of demand management measures designed to promote private sector expansion. This de-coupling has limited the ability of the manufacturing sector to respond to the changing structure of incentives.

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202 Malawi Government, *Statement of Development Policies, 1986-96.*

Two sections of the population have experienced an unambiguous deterioration in their economic position during the adjustment period. The recovery programme stipulated the de-control of non-agricultural prices coupled with wage restraint. The objectives were to encourage private sector growth while maintaining a competitive export sector and control over the domestic wage bill. As a result the purchasing power of wage earners has been seriously eroded in real terms. In addition, many part-time farm households, lacking access to suitable support services and restricted in resource access, remain unable to produce the more remunerative commercial crops. They have consequently been faced by a deterioration in their food security position, as the combined purchasing power of their activities has declined in the context of a rising maize price.

D. Nepal

1. *Introduction*

Nepal, a land-locked country with a land area of 147,187 sq. km, is endowed with few natural resources. After more than three decades of development efforts, per capita income stood at $170 in 1988. About 94 per cent of the country's 18 million inhabitants in mid-1988 lived in the rural areas, with a significant number distributed sparsely in the inaccessible hills. Rapid population growth (2.7 per cent per annum) has resulted in a deteriorating land/man ratio, cultivation of sub-marginal land and over-exploitation of forest resources. Agriculture dominates the economy, providing 60 per cent of GDP, 90 per cent of employment and 75 per cent of exports. Traditional agriculture is primarily rainfed; irrigation facilities cover only 15 per cent of arable land and hence agricultural output is highly vulnerable to weather uncertainty. Supplies of fertilizers, seeds and pesticides are both irregular and expensive. Weak producers' incentives coupled with inadequate agricultural research and extension services are responsible for low productivity in agriculture. Manufacturing industry, dominated by small and cottage enterprises, contributes about 5 per cent of GDP and employs only about 4 per cent of the labour force. The small size of the domestic market, instability in the supply of raw materials and stiff competition from imports adversely affect capacity utilization in most industries.

Nepal's export base is small, consisting mainly of agricultural and semi-processed products with merchandise exports comprising 5 per cent of GDP (rice, pulses, jute, leather, handicrafts and, more recently, garments and handknotted woolen carpets). The country's dependence on imports for consumption, current production and investment is substantial. More than half its external trade is with its neighbour, India. The country shares a long and open border with India, is separated from sea routes, and is influenced in many respects by developments in the Indian economy. Gross fixed investment is around 19 per cent of GDP, of which a quarter is financed by foreign aid.

The country's difficult terrain, its land-locked status and meagre natural resource base have combined to make the task of improving the living standards of the Nepalese people an especially onerous one. About 43 per cent of the people are below the poverty line, with about 68 per cent in the hills and Terai regions living in absolute poverty. Lack of employment opportunities in the hills has accentuated out-migration in recent years. Malnutrition is widespread, particularly among children, and in general people are inadequately protected against disease. The low level of human resource development in Nepal is mirrored in low life expectancy (46 years), a high infant mortality rate (139 per 1000 live births) and an adult literacy rate of 26 per cent.

2. *The adjustment programme*

Nepal launched a stabilization/adjustment progamme in 1985, the background to this being the severe internal and external imbalances experienced by the country in the early 1980s. Real GDP growth rate fell from 8.3 per cent in 1980/81 to 3.8 per cent in 1981/82 and became negative in 1982/83. Severe drought followed by floods in the Terai regions reduced the agricultural surplus and the output of agro-based industries. Nepal's export

earnings suffered substantial shortfalls, receipts dropped to $115.4 million in 1981/82 and to $81.9 million in 1982/83 from $134.4 million in 1980/81. Against this, import payments rose sharply. Increased import payments, coupled with the deterioration in the terms of trade and falling tourist receipts, widened the current account deficit to 5 per cent of GDP in 1982/83 as compared to 1 per cent in 1980/81. In the absence of adequate concessional assistance, the current account deficit had to be financed by depleting international reserves, which came down to 2 months' imports in 1982/83 from 8 months' in 1980/81.

The budget deficit grew rapidly as revenue collection lagged behind expenditures, rising from 1.6 per cent in 1980/81 to 12.3 per cent of GDP in 1982/83, which was financed by borrowing from the banking system. Monetary expansion in the face of supply shortages accelerated the rate of inflation, which averaged 13 per cent during 1980/81 to 1982/83, significantly higher than the previous record. In view of the continued worsening of the internal and external imbalances, the Government adopted a stabilization programme in 1985. In November of that year, the Nepalese rupee was devalued by 14.6 per cent. The Government entered into a stand-by arrangement (SDR 18.65 million) with IMF on 23 December 1985 in support of the programme. A Structural Adjustment Loan (SDR 40.9 million) was negotiated with the World Bank in 1987, the programme period covering 1986/87 to 1990/91. This was aimed at providing complementary resources to suppport the stabilization programme and to stimulate growth and structural changes over the medium term. In 1987/88, the Government entered into an arrangement with IMF for a Structural Adjustment Facility (SDR 26.1 million) during the period 1987/88 - 1989/90. The World Bank approved a second Structural Adjustment Loan (SAL-2) for Nepal in June 1989 (SDR 46.2 million).

The structural adjustment programme has been aimed at sustaining a higher GDP growth rate over the medium term while curbing inflation and reducing the current account and fiscal deficits. To these ends, demand management policies were to be complemented by growth-oriented structural measures. These measures included:

- mobilization of domestic savings to support an increase in investment;
- financial reforms for improving efficiency in resource allocation;
- promotion of growth in agricultural production and preservation of forests;
- stimulation of non-agricultural growth through a more liberal industrial and trade regime;
- reform of public sector enterprises and parastatal bodies; and
- improvement of the implementation of development projects.

3. *Implementation of adjustment policies*

The authorities in Nepal have been vigorously pursuing the implementation of adjustment measures. The progress made thus far is summarized below.

(a) *Demand management measures*

(i) *Fiscal measures*

To raise fiscal revenues, the Government implemented a revenue mobilization programme, designed with IMF technical assistance, to widen the tàx base and rationalize the tax structure. Significant tax measures were introduced in the period 1985/86 - 1987/88. These included changes in the coverage and rates of existing taxes, the introduction of new taxes, the rationalization of tariff rates and improvements in tax administration. Emphasis was placed on taxing domestic output and income, and specific rates were converted into *ad valorem* rates to enhance tax elasticity. In 1988/89 budget measures were introducted to increase the share of direct taxes (maximum income tax rates were reduced, a new flat rate corporation tax was instituted, and changes were made in rates on urban houses and land). Major tariff reforms were introduced in 1987/88 and 1988/89 to eliminate discrimination against export industries and to provide more effective protection for domestic import-substituting industries. A system for auctioning commercial import licences was introduced, with the premium accruing to the exchequer. To improve the tax administration, the Government took steps to introduce a unified revenue service and to train tax officials. Specialized revenue units were set up for collection purposes in the Kathmandu area and for major companies and small taxpayers. To increase non-tax revenues, cost recovery measures were strengthened in irrigation, forestry, transport, electricity, telephones, education and health.

The Nepalese authorities adopted measures to contain the growth of recurrent budget expenditures by a salary freeze for public servants, restrictions on new recruitment and the reduction of subsidies. A 25 per cent salary increase was granted in 1988/89 after a three-year freeze. Nevertheless, increased outlays on transport operations and maintenance as well as on the health and education services, and growing debt service payments, exerted pressure on the revenue budget. The Government took several steps to improve project implementation and speed up the disbursement of project aid. A "core programme" covering about 70 per cent of the development budget was identified and programme budgeting procedures applied to all projects in agriculture, irrigation, forestry, power and transport. Measures were also taken to expand the authority of project managers over spending decisions and to set up monitoring units in the line ministries. An apex trouble-shooting unit was established in the Cabinet division to review implementation issues and resolve inter-agency problems.

In order to improve the financial performance of the public enterprises (there are 60 fully State-owned enterprises), the prices of sugar, paper, fertilizers, gas, electricity, transport and petroleum products were raised progressively. The enterprises were given autonomy in fixing prices and in management decisions. Limits on public enterprise borrowing from the banking system were established. Detailed action plans to revamp the Nepal Food Corporation, Agricultural Input Corporation, Oil Corporation and National Trading Limited were initiated. Furthermore, 45 industrial units were earmarked for closure or divestiture.

(ii) Monetary policy

Since 1985/86 net credit to the Government and the public enterprises was reduced and more credit provided to the private sector. The Nepal Rastra Bank maintained the real interest rate at positive levels to attract domestic savings into financial assets. From May 1986, the commercial banks were allowed to set interest rates freely. Two new foreign commercial banks were established in the adjustment period and the number of bank branches rose to 406 in 1986/87 from 241 in 1979/80. A credit recovery plan for collection of arrears on agricultural and industrial loans was launched, and the Government provided subsidies to public sector corporations to clear their overdue loans. A financial sector reform programme has been initiated recently, aimed at improving the management of commercial banks and establishing a secondary market in government securities.

(iii) External sector

The Nepalese rupee was devalued by 14.6 per cent in November 1985, and since May 1986 a flexible exchange rate pegged to a basket of currencies has been maintained. The rupee was depreciated by 27 per cent altogether between 1984/85 and 1987/88. In conjunction with devaluation, import liberalization measures were implemented (quantitative restrictions were replaced by an import tariff, and an open general licensing system introduced), and exporters were given incentives (tax rebates, duty drawback, bonded warehouse facilities) to respond to international market opportunities. In order to prevent any significant increase in debt service obligations, the authorities are keeping strict control over the contracting or guaranteeing of non-concessional borrowings.

(b) Sectoral policies

(i) Agriculture and forests

The reform measures in agriculture have focused on:

- improving production incentives;
- enhancing the availability and reliability of inputs;
- developing irrigation; and
- strengthening key institutions for research and extension.

The retail and wholesale distribution of fertilizers is now carried out by private dealers and co-operatives (Sajhas). Fertilizer subsidization is limited to sales in the isolated parts of the country by the Agricultural Inputs Corporation. In order to provide growers' incentives, procurement prices for paddy, sugarcane, cotton and tobacco were raised periodically. The practice of levy was eliminated. There is now no subsidy on public distribution of foodgrains in the Kathmandu area. Measures were also taken to improve the seed supply by encouraging greater private sector participation. A National Agricultural Research Co-ordination Committee was set up for co-ordinating agricultural research activities.

The deforestation problem has created serious environmental degradation. In order to

reverse the trend of deforestation, the Government imposed a ban on exports of timber and launched programmes for the reforestation of protected forests, afforestation with community participation and the resettlement of families who had encroached upon the forested hills. The Nepalese Government has also undertaken a number of projects to develop the country's vast hydropower potential in order to alleviate the shortage of fuelwood, particularly in the hill areas.

(ii) Manufacturing industries

The New Industrial Policy, announced in October 1987, is outward looking, providing incentives for exports as well as import substitution activities. The Government has assigned an expanded role to the private sector in industrial development by liberalizing investments and imports, and reforming tariffs.

Sanctioning procedures have been greatly simplified and trade liberalization measures introduced. A Pass Book system for importing industrial raw materials was introduced in 1986/1987. Industries with less than 20 per cent import requirements are now able to obtain industrial licences automatically. Moreover, an open general licensing system has been introduced for a large number of products.

The Government simplified the tariff structure in 1987/88 and introduced a uniform effective protection rate of 30 per cent for all industries. Tariff rates have been rationalized into three categories; 5-15 per cent for industrial raw materials according to the degree of processing, 20-30 per cent for consumer goods and 30-50 per cent for luxury goods imported from countries other than India. The authorities have offered various incentives for promoting the expansion of exports, especially of manufactured commodities, in recent years.

(iii) Energy

Nepal's energy development programme consists of: (i) the expansion of electricity generation capacities by harnessing its vast hydro-electric potential; (ii) the reforestation of protected forests and afforestation in the hill areas with community participation; (iii) the development of alternative sources of energy by installing biogas plants, and the sale of solar collectors and heaters, and; (iv) exploration for petroleum and coal with donor assistance.

In the Seventh Plan period, two major hydro-electric projects are scheduled to be commissioned. In addition, a number of small-sized power plants are being installed in the private sector. Prices of electricity and petroleum products have been increased to mobilize domestic resources. Steps are also being taken to reduce system loss in power distribution through technical improvements and the collection of payments on power bills due.

4. Impact of the adjustment programme

Nepal's output recovery and growth performance were better in the 1980s compared to previous decades, with real GDP growing by 4.9 per cent per annum between 1979/80 and 1987/88. However, GDP growth fluctuated widely, reflecting the fragile state of agriculture (agricultural output declined in 1982/83 and the growth rate was barely 1 per cent in 1986/87 owing to drought). In the 1980s, Nepal ceased to be a net exporter of foodgrains, and per capita domestic production of foodgrains declined between 1980 and 1987. Increased prices of fertilizers, seed and pesticide shortages, and ineffective support prices, coupled with insufficent investment in irrigation, were major constraints on agricultural productivity. Manufacturing industries performed relatively better, as value added increased by about 10 per cent per annum from a low base. New capacities in several import-substituting industries (cement, sugar, paper, synthetic textiles) and increased exports of garments and woolen carpets kept industrial output buoyant, while import liberalization and tariff reform assisted industrial growth and diversification.

The budget deficit averaged 10 per cent of GDP in the adjustment period as compared to 12 per cent in 1982/83. Contrary to the asumptions of the adjustment programme, gross fixed investment as a ratio of GDP has remained constant at 19 per cent over the adjustment period. In this period, the country's aid dependence increased, reflecting the limited achievements of the efforts to mobilize domestic savings. Furthermore, the demand management policies seem to have had little success in reducing the rate of inflation. Given the country's dependence on imports, the devaluation of 1985 was immediately transmitted into the price level and the inflation rate spiralled to 15.9 per cent in 1985/86, and little progress was made in bringing it down in subsequent years. The disruption of bilateral trade and transit routes with India after the lapse of the trade

and transit treaties between Nepal and India in March 1989 has aggravated the inflationary situation.

Little progress was made in reducing the current account deficit, which stayed at 5 per cent of GDP during the adjustment period. Import payments grew by an annual average rate of 20 per cent, with IMF and World Bank programme assistance, as compared to an export growth rate of 9 per cent between 1980/81 and 1987/88. Moreover, export receipts continued to remain highly unstable though non-traditional items (ready-made garments, woolen carpets, leather shoes) registered an impressive growth in recent years. The share of grants in aid disbursement dropped sharply from 60 per cent in 1979/80 to 32 per cent in 1987/88, and consequently Nepal's indebtedness increased in the 1980s. Debt service payments on medium- and long-term borrowings rose to 7.8 per cent of the export of goods and services in 1987/88 as compared to only 1.6 per cent in 1980/81.

The distributional impact of the adjustment measures is less clear. Poverty and malnutrition are widespread and persistent. Only 86 per cent of calorie requirements are currently supplied. Calorie deficiency is further complicated by protein and iodine deficiencies. Prices of foodgrains rose during the adjustment period as a result of an increase in producers' prices and the removal of the subsidy on public distribution. New employment opportunities lagged behind the growth of the labour force when there was already a backlog of unemployed. Despite the Basic Needs Programme, there has been very little increase in public expenditures on health, education or the water supply. The health services are short of drugs, essential supplies and health workers. A high dropout rate, low enrolment of girls and shortages of teachers and technical manpower are major weaknesses of the educational system. The Nepalese people living in the hills and rural areas have extremely limited access to safe drinking water as well as to transport and communication facilities.

5. *Conclusions*

The Nepalese Government seems to have made serious efforts to implement various reforms under the adjustment programme. These steps have enhanced the efficiency of resource allocation and use, and improved development planning and policy. The programme was more successful in reducing the budget deficit than in promoting stable growth or balance of payments viability. The continued high rate of inflation casts doubt on the effectiveness of devaluation and other demand management measures, given Nepal's heavy dependence on imports and its land-locked situation. The success of Nepal's outward-looking strategies is conditioned by the goodwill of its transit neighbours. The country's long-term agricultural development (for satisfying both basic needs and export development) the solution of energy shortages, and environmental protection would require major investments in irrigation, hydropower generation and distribution, and afforestation. Industrial growth and diversification will largely depend on raising the purchasing power of the Nepalese people and protecting domestic infant industries. The satisfaction of basic needs and human resource development will need increased budgetary expenditures on education, health and drinking water supplies. In view of the country's geographical disadvantages and lack of a domestic entrepreneurial class, it is questionable whether strong emphasis on privatization will support the country's long-term development and provide minimum standards for the poor.

E. Niger

1. *Introduction*

Niger is, in many ways, typical of countries of the Sahelian region of Africa: the economy is dominated by rainfed agriculture, with the resource base being reduced by soil erosion and the extension of cultivation and grazing into areas of low fertility, which facilitates the occurrence of drought. Population is rising rapidly and, in most years, outstripping increments to national output, particularly with respect to food. These two factors have led to an increasing reliance on food imports, both

concessionary and commercial. The manufacturing sector is in turn poorly developed; a substantial proportion of it, and of the "modern" industrial sector in general, is owned by the State and has sometimes been inadequately managed. At the same time, a unique influence on the Niger economy is provided by the uranium industry, which grew very rapidly during the latter half of the 1970s, and on which the economy has become very heavily dependent.

The background to the economic crisis that precipitated the adjustment programme is a reflection of the indeterminacy of international commodity markets, and the vagaries of climate. The early years of the 1970s witnessed prolonged and damaging droughts which, in turn, led to a steep decline in GDP, largely as a result of falling agricultural production. By the middle of the decade, the weather pattern became more favourable, engendering a recovery in agricultural output. In addition, the international demand for uranium rose significantly following the oil price increases and world interest in diversification of energy sources, leading to rising prices and expanding production. As a result, the economy experienced a period of rapid growth during the latter half of the decade, when public sector deficits and the level of imports rose substantially.

The development of the economy became uni-dimensional, however, with economic activity largely dependent on the mining sector. Eighty per cent of export earnings and 41 per cent of government revenue were in fact derived from uranium production. Consequently, the contribution of the "modern" sector to GDP grew from 27 per cent in 1975 to 36 per cent in 1980. The rapid increase in government revenues had its counterpart in a swift rise in investment, which attained 17 per cent of GDP by 1981-1983, two thirds of this being public sector investment. There was a concomitant increase in both the number and the activities of public sector enterprises, with parastatals accounting for 11 per cent of GDP and 50 per cent of public sector employment by 1980. At the same time, the continued difficulties encountered in attempts to raise agricultural output meant that rising domestic incomes were reflected in growing demand for food imports. These imports were primarily of rice and wheat, commodities not produced in Niger, and the consequent shift in consumption patterns added to the problems of import dependence experienced when the downturn in economic activity occurred.

Both the clemency of rainfall patterns and the buoyancy of international commodity markets proved to be short-lived, and the period of growth came to an abrupt end at the close of the 1970s, leaving the economy dangerously exposed, with an overstretched public sector, a large budget deficit and an increasing current account deficit. The magnitude of these problems was exacerbated by a severe drought in 1984, leading to a fall in food production of between 30 per cent and 40 per cent, the decimation of cattle numbers and a further deterioration in environmental conditions. A rapid escalation in cereal imports resulted. An additional disruption to economic activity was caused by the closing of the Nigerian border. This further impaired agricultural productivity, since 40 per cent of the country's population live in the Frontier Zone, agriculturally the most productive.

Thus, after a period of positive growth during the 1970s (1.5 per cent), GDP declined in three consecutive years, i.e. 1982-1984, including a 14.7 per cent decline in 1984 alone. The deterioration in the terms of trade following the decline in world demand for uranium is reflected in a fall in the 1980-based index to 63.5 in 1981 and to 60.6 in 1985. Production of uranium dropped by 22 per cent between 1981 and 1983, and gross investment declined from an average of 17 per cent of GDP in 1981-1983 to an average of 9 per cent in 1984-1986. In addition, by 1983 the current account deficit had grown to 9 per cent of GDP, and, although imports fell, the external debt rose to 55 per cent of GDP, with a debt service ratio of 33 per cent (from 22 per cent in 1980). The economic deterioration had a direct impact on the growth and performance of parastatal activity: by 1983, the losses of these enterprises had increased to 13 per cent of government revenue, and they were responsible for almost half the external debt, the latter underwritten by the Government.

2. *The adjustment programme*

Negotiations with IMF began in 1983. Four stand-by credits were negotiated between 1983 and 1987, followed by two Structural Adjustment Loans (covering the period November 1986 - November 1989) from the World Bank, and an Agricultural Sector Assistance Loan from USAID (March 1985 - August 1987). In addition, the Fund has approved a three-year arrangement equivalent to SDR50.6 million. IMF credits were conditional on the reduction of the budget deficit by dampening aggregate demand, and on a move towards external account equilibrium by a mixture of expenditure reduction and switching. As devaluation is not a national policy option (Niger is a member of

the CFA franc zone), the main emphasis fell on the former. In addition, there was a slowdown in government borrowing and more rigorous control over foreign loans. Fiscal revenue was increased, primarily through the introduction of indirect taxes. Recurrent spending was curbed and development spending reduced. Public sector wages were frozen and non-wage expenditures reduced. An important target was thus to achieve greater fiscal prudence through better management of public resources.

The first phase of the Structural Adjustment Programme (SAP) ran from 1986-1987 and involved a credit of SDR55 million. The second phase, from 1987-1988, with a credit of SDR61.4 million, was specifically aimed at public enterprise reform. An additional loan of $29 million from USAID covered the period from March 1985 to August 1987 and was designed to promote agricultural productivity. In many respects the objectives of IMF and SAP credits overlapped, although the latter maintained the additional and familiar objectives associated with longer-term supply-side reform of improved resource allocation, reduced parastatal activity and lower public sector employment.

The first Structural Adjustment Loan (SAL) aimed at facilitating the following measures:

- Restrictions on recurrent spending, with greater emphasis on goods and services and limitations on the salaries and wages component. In this respect, cost recovery measures were to be introduced in the parastatals;
- The establishment of a three-year investment programme over the period 1985/86-1987/88 favouring both productive sectors as well as the rehabilitation of the economic and social infrastructure; this programme was subject to annual reappraisal;
- Increased mobilization of fiscal resources, including the introduction of VAT from January 1986 and measures involving higher petrol taxes and customs duties for a range of products. In addition, a series of studies was launched to review the investment and commercial practices of public sector enterprises;
- The introduction of, or increase in, cost recovery measures, particularly with regard to education, health and irrigation;
- Improved management of the external debt. This included an undertaking not to contract debts at a rate of interest greater than 6 per cent, or with an amortization period of less than 12 years.

The second SAL was focused on the Programme of Adjustment for the Public Enterprise Sector (PASEP). This aimed at reducing the role of government in economic activity through privatization of public enterprises and incentives to the private sector, coupled with fostering greater efficiency within the remaining parastatals particularly through the promotion of competition.

Incentive policies aimed at the private sector involved a gradual liberalization of market prices covering a wide range of goods and services. The number of products subject to price control was reduced from 27 to 7, and prices of commodities still produced by the public sector were raised to cover costs, with the exception of petroleum. The private sector was encouraged to participate in all areas of economic activity hitherto subject to public sector monopoly. In this respect, restrictions on the formation of private companies were repealed. In addition, the administered price regime for imported products was simplified and product coverage reduced. In May 1987, the system of supplementary tariffs was dismantled.

In 1985, parastatals had been provided with a new legal status enabling them to determine their objectives and to clearly demarcate roles and responsibilities, thus clarifying previously cloudy, and therefore inhibitive, terms of reference. It was further decided, following the recommendations of reviews carried out prior to the second phase, to privatize, either totally or partially, 16 public enterprises, and to suspend the activities of four others, including the formal credit institution Caisse Nationale de Crédit Agricole (CNCA). Three were integrated within the Ministry of Animal Resources, and, of the remaining 25, ten were subject to a programme of restructuring. The latter enterprises were those responsible for 95 per cent of financial losses and 45 per cent of public sector production.

Initiatives influencing the rural sector stemmed both from USAID and the SAPs. They involved the following principal measures:

- The reorientation of investment programmes towards small-scale projects using local resources and promoting group participation. In addition, an emphasis on the vetting of projects, current and future, to avoid recurrent cost problems. Priorities were to be given to projects promoting the exploitation of comparative advantage, and the protection of the environment;
- The second area of reform involved cereal marketing policy. The parastatal hitherto responsible for cereal pricing and market-

ing, OPVN, had its role reduced through the liberalization of its marketing activities as early as 1984, i.e. prior to the USAID loan and SAPs. Marketing monopoly was further reduced by opening the importation of cereal imports to the private and co-operative sectors. The number of OPVN selling points were simultaneously reduced, as were the parastatal's stockholding activities. Official prices for the two main cereal staples, millet and sorghum, were abolished, and, in the case of domestic market saturation, cereal exports were liberalized. Only in certain zones, mainly pastoral, were the retail activities of OPVN permitted to continue;

- With regard to cost recovery measures, a programme to reduce or abolish subsidies was introduced. For example, subsidies on agricultural equipment were discontinued and those on fertilizers gradually reduced to a maximum of 15 per cent of the final price;
- Reform of the rural credit system was a further objective. Following the suspension of the CNCA, a new system of formal rural credit provision is under review;
- Co-operatives were promoted, particularly with regard to marketing, storage and input supply.

In other sectors, particularly those concerned with the provision of social services, the accent of the reforms was on cost recovery and expenditure limitation. In the health sector, para-medics, traditional medicine and the growth of rural sanitation were given priority, and limitations placed on hospital expenditure and the import of medicines. User charges were introduced for hospital treatment. Cost recovery measures were also introduced in education, together with an attempt to stimulate the development of private sector schools.

In general, the record of programme implementation in Niger is reasonably satisfactory, particularly with regard to reform of the public enterprise sector and liberalization of economic activity. Parastatal activity has been substantially reduced, cost recovery initiatives introduced, and the corresponding measures taken to encourage the private sector. Attempts to cut public spending have been only moderately successful, however.

3. *Impact and evaluation of recovery programmes*

After a strong decline in GDP during 1984, largely as a result of the drought, the economy recovered through agricultural expansion in 1985-1986, due to an improvement in rainfall patterns. This growth was insufficient, however, to return GDP to previous levels. Real GDP declined by 2.2 per cent during 1980-1986, as compared to a positive, 1.5 per cent, growth in the 1970s. To a large extent this was due to the continuing shocks experienced by the Niger economy, notably with regard to the depressed world uranium market.

(a) The external balance

The achievements of stabilization policy are illustrated by the reduction in the budget deficit from 7.1 per cent to 3.6 per cent between 1983 and 1986, and in the current account deficit from 9.7 per cent to 2.3 per cent. Inflation fell over the same period from 9.8 per cent per annum to 1.5 per cent. The sharp contraction in domestic demand consequent upon government deflationary measures, coupled with the decline in the mining sector and the impact of falling unofficial trading activities with neighbouring Nigeria, are the primary causes of these movements towards economic equilibrium. Official exports have not grown, and unofficial exports may well have declined in response to the rising value of the exchange rate vis-à-vis the Nigerian naira.

In fact, providing incentives to export production by using conventional adjustment measures is not a viable option in the case of Niger. The country is a member of the West African Monetary Union (UMOA), which has a common currency, the CFA franc, the latter being convertible at a fixed parity with the French franc. Consequently, independent currency devaluation is not possible. Even so, the official CFA rate fell against a basket of currencies over the 1981-1987 period, partly reflecting the depreciation of the French franc.

More possibilities for reform exist with regard to other factors influencing trade, particularly those associated with tariffs. In this respect, the tariff system remained intact until as recently as 1987 and increased in severity over the relevant period, although some liberalization has been introduced since that date. A system of quantitative controls is still maintained, however, and although export taxes were simplified in 1986 and measures were

taken to encourage re-exports, the efforts made so far to liberalize trade have been limited.

(b) Budget deficit and State corporations

The reorganization of government receipts and expenditure, a condition for IMF credits, undoubtedly achieved a degree of internal balance. Government borrowing and domestic credit expansion were also brought under control. With regard to revenues, these were raised through the imposition of indirect taxes and higher import taxes, while tax rates on income and profits remained unchanged. Thus, there was an increase in the regressivity of the tax system. This reorganization had other repercussions as well, being very unequal in sectoral impact, as discussed below. The deflationary impact of spending cuts also fell disproportionately on the various sectors of society.

With regard to the reorganization of public sector activity, 12 of the 16 proposed privatizations have been accomplished. The reduction of monopoly activity with regard to public sector marketing activities has proceeded expeditiously. Privatization, whether partial or total, coupled with measures to liberalize the market frameworks of the remaining parastatals, have undoubtedly contributed to an improvement in the competitive framework, although it is too early to judge the extent to which the public and private sectors have each responded to such initiatives. As noted above, the drain of parastatal losses on the government budget was removed by means of a special World Bank loan.

(c) The agricultural sector

The dominant influence on the agricultural and food sector in Niger has been, and remains, the rainfall pattern. Observations over the last decade and a half show price response to be very weak, with year to year fluctuations in output primarily determined by the extent of the rains. Marketed output has varied between 10 per cent and 20 per cent of total production, although unrecorded transactions at the village and the border levels may be much higher.

As noted above, food imports have expanded persistently since the droughts of the early 1970s, and food aid has grown as a proportion of these imports. This reliance on foods other than local millet or sorghum for staple cereal intake has created a dependence which is likely to prove hard to reduce. Certainly, none of the policy changes that have affected the rural sector appear, as yet, to have had any influence in this respect.

(d) Other productive sectors

In assessing the changes that have taken place in recent years, it is apparent that sectors have differed substantially in the way they have been able to respond to the prevailing economic climate. The rural sector, which includes both small-scale farmers and graziers, is predominantly undercapitalized and subject to the vagaries of the weather. Value added fell during the adjustment period, as did the sector's contribution to GDP. Within the urban sector, the "modern" sub-sector primarily produces non-tradeables such as buildings and public services (although some textiles and household utilities are also produced). Its record has been one of stagnation: a fall in value added followed by a slight recovery. Only in the urban informal sector has growth been unequivocal.

The "modern" or formal sector is significantly dependent on imports of intermediate goods from industrialized countries, which have increased in price as a result of the depreciation of the CFA franc against major world currencies. Part of the sector's output, on the other hand, is sold domestically (e.g. textiles, soap, household equipment) and competes directly with imports from Nigeria, which have fallen in price as a result of the relative appreciation of the CFA franc vis-à-vis the naira. The extent of this squeeze on profitability is demonstrated by comparing the parallel exchange rate of the naira with the official rate for industrial suppliers. The ratio fell by 63 per cent between 1981 and 1987. As regards the urban informal sector, its inputs are primarily of domestic origin, and not therefore subject to the same pressures as those of the "modern" sector. In addition, informal producers are better able to reduce costs in response to rising input prices, nominal wages being more inflexible in the formal sector and production more capital intensive.

(e) Human capital and basic needs

The principal impact of the structural adjustment programme in this respect has been through the reduction in public spending. Social spending on education and health care has fallen in real terms, but less than for other categories of spending. It is still too early to evaluate the impact of cost recovery measures in education and the change of emphasis in health

spending, or even the extent to which these policy changes have been implemented.

The main social consequences of the programme have been felt through changes in relative prices and revenues. In this respect, as discussed below, there has been a shift in relative incomes from rural to urban, and within the urban sector from formal sector incomes to those in the informal sector.

4. Conclusions

The overall implications of the adjustment programme are difficult to gauge, either for the economy as a whole, or for individual groups and sectors within the country. This is due, in part, to the recent nature of many of the policy initiatives, and the time it takes for structural measures to permeate through the economy. It should be remembered that the adjustment programme (i.e. as compared to stabilization) did not begin until 1986.

It must be said that the stabilization measures undertaken at the instance of the IMF have undoubtedly been instrumental in reducing the extent of the disequilibrium in both the external account and the government budget. In addition, the breakup of some public sector monopolies and general rehabilitation of the public sector, although still incomplete, present a more solid foundation for future growth. With regard to the long-term aims of the adjustment programme, such as renewed growth through an expansion of the private sector, it is apparent that, in the case of Niger, there are two powerful influences both of which are currently beyond governmental control, namely, the rainfall pattern and the limited price-responsiveness of the domestic economy.

The recent economic problems of Niger are similar to those besetting many small economies in that they stem, in part at least, from dependence for foreign exchange earnings on a single, highly unpredictable international market. The enormity of the task of export diversification in such a resource-poor country (with the exception of uranium), is compounded by the type of policy inhibitors discussed above. Hence the need for complementary measures to facilitate structural adjustment.

F. Sudan

1. Introduction

Sudan is the largest African country, with an area of 2.5 million square kilometres. With a population of 22.6 million (1986) it has a very low population density of only 9 persons per sq. km.

The Sudanese economy is essentially agrarian. Approximately 30 per cent of the land is cultivable and agriculture comprises the main source of income. It contributes about one third to total GDP and provides a livelihood for 70 per cent of the population. The share of the manufacturing sector in total GDP is only about 7 per cent while its share in total employment is about 4 per cent.

Domestic and external factors have contributed to the economic crisis in Sudan. In 1972, the Government embarked on a large-scale programme of public sector development, which included the nationalization of a large part of the productive and commercial sectors of the economy. With generous external assistance, public investment rose by nearly 50 per cent in real terms between 1972/73 and 1973/74, and doubled again the following year. Economic growth averaged approximately 10 per cent from 1973/74 to 1975/76.[203] A Six-Year Plan for Economic and Social Development was begun in 1978. The Plan provided for an investment of $7.4 billion to be financed almost equally from domestic and external resources. The average annual growth of GDP was projected at 7.5 per cent for this period. Agriculture was to grow at 6.5 per cent and industry at 9.5 per cent.

The increase in investment led to high aggregate demand and an increase in imports. After 1976, foreign aid declined, but expansionary government policies were contin-

[203] The fiscal year ends on 30 June.

ued through domestic borrowing. This contributed to high rates of inflation. The trade deficit, which had been a negligible 0.2 per cent of GDP in 1972-1973, grew to 8.0 per cent in 1977-1978. During this period, ambitious projects were launched. The economic climate worsened in 1978/79 as the budget deficit increased to 9.5 per cent of GDP. The debt situation had become a major concern with payment arrears accumulating rapidly, and inflation was already at 26 per cent in 1978/79. GDP declined by the record amount of 12. 9 per cent. The Government was therefore obliged to reassess its development strategy and policy objectives. Between 1978 and 1985, the Government implemented several stabilization and adjustment programmes supported by IMF and the World Bank.

2. *The adjustment programme*

In 1978, a stabilization and adjustment programme was formulated with the assistance of IMF and the World Bank, and included an agricultural rehabilitation programme. The principal elements of this programme were (1) to maintain GDP growth at 4 per cent per annum; (2) to reduce inflation from 26 per cent in 1978/79 to 10 per cent by 1981/82; (3) to reduce the current account deficit on the balance of payments from $451 million in 1978/79 to $400 million by 1981/82; (4) to eliminate approximately $200 million in external payment arrears and to improve debt management; (5) to restore output in the agricultural irrigated subsector and restructure its cost recovery system; (6) to introduce an Export Action Programme; (7) to prepare a realistic Three-Year Public Investment Programme; and (8) to increase government revenues to 18 per cent of GDP.

The Sudanese Government implemented several important policy measures in support of those targets. They included substantial and frequent adjustments in the exchange rate, increases in nominal interest rates, substantial price increases spread over the years for several commodities (petrol, sugar, wheat, cotton seed, cement) and reform of the price structure in the irrigation sub-sector.

However, despite these measures, the economic situation continued to deteriorate. Substantial divergences between proposed programme targets and actual performance led eventually to a deadlock with IMF in 1981. It took almost a year before the new IMF stand-by agreement of February 1982 was approved following the implementation of a comprehensive package of exchange rate, fiscal and credit policy measures. Later that year, the Government issued a comprehensive policy document,[204] which formed the basis for discussion at the World Bank Consultative Group Meeting in Paris in January 1983.

Three annual PPED documents were formulated (PPED I,II,III), each containing a Three-Year Public Investment Programme (TYPIP). The goals and proposed policy measures were basically the same in each one and were not substantially different from those of the previous adjustment programmes. The specific goals of the Government were to: (i) maintain per capita GDP; (ii) increase agricultural output by an annual average of 5 to 6 per cent; (iii) expand cotton exports by 7 per cent annually; and (iv) increase capacity utilization in the industrial sector.

In agriculture, the programme measures were confined to the irrigation sector with the object of increasing cotton production and improving the cost recovery system in the individual schemes. Rain-fed agriculture accounts for almost two thirds of the total contribution of agriculture to GDP, yet there were very few proposals for its rehabilitation or improvement under the adjustment programmes. A target of 5 to 6 per cent in total agricultural production was set, but there were no specific measures to ensure its achievement. In the industrial sector, the PPED stressed capacity utilization in the sugar and textile industries in which major investments were made. Textiles were given substantial relief in the form of subsidized raw cotton and debt relief. For the Public Non-Financial Enterprises (PNFES), efforts made under the adjustment and stabilization programme to improve performance included price increases and reduction or abolition of subsidies. The Government was also to privatize several enterprises and close those with persistent losses. This, however, was not carried out under the formal IMF and World Bank Agreement.

In the areas of demand management and resource mobilization, the objectives were to: (i) reduce the share of consumption in GDP by 4 per cent between 1981/82 and 1984/85; (ii) eliminate the current budgetary deficit by 1984/85; (iii) increase total government revenues to 16 per cent of GDP and tax revenues to 12 per cent of GDP by 1984/85; and (iv) reduce inflation to 10 per cent by 1984/85.

[204] "Prospects, Programmes and Economic Development, 1982/83 - 1984/85 (PPED)".

In the external sector, the major objectives of the PPED exercise were to: (i) reduce the current account deficit as a percentage of GDP; (ii) obtain sufficient capital assistance and debt relief to close the overall balance of payments gap; and (iii) prevent the re-emergence of external payment arrears.

3. *Performance since 1978*

(a) Budgetary situation

Despite the above measures, the economic situation continued to deteriorate. Under the stabilization and adjustment programmes, improved budgetary performance was projected through higher taxation and reduced current expenditure. In 1978/79 government revenue constituted 16.6 per cent of GDP and despite various measures it declined to 10.5 per cent in 1986/87. This was caused mainly by a shift in the composition of imports in favour of essential consumer goods which carry low duty rates. Tax collection capability has also deteriorated. Furthermore, non-tax revenue declined from 2.2 per cent of GDP in 1978/79 to 1 per cent in 1985/86. This was mainly due to a deterioration in the performance of public sector enterprises. In 1986/87, non-tax revenues rose sharply to 3.7 per cent of GDP as a result of improved collection of dividends and interest from public enterprises as well as fees and charges from the public. Government expenditure, which stood at 22.1 per cent of GDP in 1978/79, increased to as much as 26.6 per cent in 1984/85 and has since remained around 23.5 per cent. The increase in government expenditure resulted from a large government bureaucracy, the conflict in the south which is draining government resources and an increase in interest payments on foreign loans.

(b) Balance of payments situation

During the stabilization and adjustment programmes there was a decline in the current account balance and a temporary improvement in the overall external balance. The composition of exports has remained essentially unchanged. Export earnings consistently declined from a level of $795 million in 1981 to $445 million in 1985 (and to $266 million in 1987). Imports have been steadily reduced since 1981, with 1985 imports totalling $573 million. This represents 35 per cent of the total value of imports in 1981. Owing to the drastic reduction in imports, the trade deficit fell dramatically from $845 million in 1981 to $128 million in 1985.

(c) Agricultural production

In the agricultural sector, the rehabilitation programme was confined to the irrigation sub-sector, mainly to increase cotton production. There has been varied success in the agricultural sector. During the 1970s, cotton production dropped from 1.2 million bales to 0.6 million. This trend was reversed in the early 1980s when production exceeded one million bales during the period 1982/83-1984/85. This exceeded the IMF and World Bank target fixed under the adjustment programme. The increase was due to several factors including (i) rehabilitation of irrigated schemes; (ii) the introduction of individual accounts on the tenants; (iii) substantial increases in procurement prices; and (iv) increased cultivation of medium staple cotton with higher yields than traditional staple cotton.

(d) Industrial production

In the industrial sector, efforts to increase sugar production have been successful thanks to the joint venture Kenana sugar factory which became operational in 1980/81 and whose capacity utilization has steadily increased over the years. Capacity utilization in textiles, most of which is in the private sector, has remained low despite incentives such as concessional prices on cotton and cheap credit. In general, industrial productivity is low and heavily dependent on imports. Thus, the immediate task for the Government would be to improve the capacity utilization of viable industries, keeping in mind that (i) the industries should not be import dependent; and (ii) they should cater to the needs of the large majority of the population. The obvious choice on this basis would be industries that process agricultural goods and those which provide inputs for agriculture or are related to agricultural equipment and machinery. Such an industrial policy would contribute to a reduction in regional disparity and promote greater economic activity throughout the country, thereby lessening the excessive dependence on the capital, Khartoum, which currently accounts for 70 per cent to 80 per cent of total industry in the country.

4. Conclusions

In retrospect the stabilization and adjustment programmes implemented with the assistance of IMF and the World Bank during the period 1978-1985 did not succeed in any of their major objectives. The basic premise that devaluation would improve export performance, although the current account balance had declined due to the drastic reduction of imports, was unfulfilled. The period was marked by a vicious cycle of inflation and devaluation. The balance of payments situation remained adverse, and the Government could not pay most of the maturing loans and interest on past debt. The capitalization of unpaid repayment obligations and new borrowing led to increasing debt liability, with total debt amounting to $9.4 billion by the end of 1986. In 1985/86, the interest ($559 million) and the principal ($654 million) together were more than two and a half times total commodity export earnings in that year.

Between 1985 and 1988 the Government of Sudan was in continuous consultation with IMF and the World Bank with a view to preparing a structural adjustment programme taking into account previous experience. However, no agreement was reached and Sudan was declared ineligible for IMF facilities. Moreover, the net disbursements of aid to Sudan, which reached a peak in 1983, declined substantially in subsequent years. Contrary to expectations, the production structure of the country did not undergo any significant changes and the capacity of the country to finance future developments from its own resources deteriorated. Sudan is currently embarking on a new phase of development with the formulation of a Four-Year Programme for Salvation, Recovery and Development (1988/89-1991/92), and enhanced international support is needed to supplement and encourage national efforts for recovery.

G. United Republic of Tanzania

1. Introduction

The United Republic of Tanzania is poorly endowed with natural resources, less than 10 per cent of its land is under cultivation, and, except in the north and south-west, it has only one rainy season, which limits farmers to one planting, and annual variations in rainfall. It has some natural gas reserves, and minerals contribute less than 1 per cent of GDP.

Per capita GDP was around $270 in 1980. Output and exports were undiversified during the 1970s: agriculture contributed 40 per cent to 45 per cent of GDP and over 85 per cent of employment. Agricultural exports accounted for nearly 80 per cent of foreign exchange earnings from exports of goods and were dominated by coffee and cotton, which alone represented 36 per cent in 1980. In 1980, manufacturing contributed just 11 per cent of GDP, and most manufacturing output and exports were of processed agricultural products. For all these reasons, the economy was highly vulnerable to "external shocks", especially the prices of oil imports, and of coffee and cotton exports.

However, as the provision of basic needs was a priority, the country surpassed the LDC average for all social indicators except secondary school enrolment in 1975-1980. Its adult literacy rate was 79 per cent (1980) compared to an LDC average of 27 per cent.[205]

Between 1977 and 1981, the United Republic of Tanzania suffered a 30 per cent fall in its terms of trade; combined with drought and declining export prices and production, this led to economic collapse. Imports and manufacturing output fell, fiscal revenue dropped by 25 per cent, the Government increased borrowing from banks to make up for the shortfall, and money supply and inflation soared.[206]

Global recession continued to depress the economy in spite of efforts to adjust in 1982-1985. Demand for the country's main

[205] UNCTAD, *Least Developed Countries - 1987 Report*, tables 57B/C/D/E; on adult literacy, see World Bank, *World Development Report 1983* and UNESCO, *Statistical Yearbook* (1985 and 1986).

[206] For a further discussion see Green (1986), Ndulu (1987) and Stewart (1986).

exports fell, reducing export earnings, and the terms of trade deteriorated. By 1986, the economy improved owing partly to low oil prices in 1985-1987, and also to a temporary rise in coffee prices.

In 1982-1985, the country implemented its Structural Adjustment Programme (SAP) without IMF support, although negotiations with IMF proceeded throughout this period. After introducing many IMF-style measures in 1984-85, the Government negotiated with IMF in August 1986 an 18-month stand-by credit of SDR64.2 million, in support of the Economic Recovery Programme (ERP).[207] The World Bank provided a multi-sector rehabilitation credit in 1986, and in 1987 agreement was reached on a three-year arrangement under IMF's Structural Adjustment Facility.

2. *Adjustment programmes*

The two adjustment programmes, the SAP and the ERP, contained many similar elements. Both aimed at restoring balance in the current account and the budget, reducing inflation and restarting growth. Both relied on additional foreign exchange inflows to finance imports (preferably in the form of import support aid), which would boost capacity utilization, rehabilitate infrastructure and supply exporters with inputs. Both were intended to increase fiscal revenue and cut growth in expenditure, by limiting the agricultural marketing authorities' losses, reducing public sector employment and shelving some projects. Both aimed at restrictions on money supply by reducing government borrowing from banks to finance the budget deficit, and reduce inflation.

The SAP included several measures similar to those in the ERP, notably devaluation by 12 per cent in 1982, 20 per cent in 1983 and 37 per cent in 1984; real agricultural producer price rises in 1984 and 1985; and the ending of maize subsidies in 1984. However, several ERP measures were more dramatic: faster devaluation of the shilling, increases in agricultulral producer prices and lower growth in minimum wages; and cuts in money supply growth and the budget deficit. The ERP also contained additional measures: 75 per cent real rises in consumer prices of price-controlled goods; and of nominal interest rates.

Nevertheless devaluation was gradual under the ERP; consumer prices were not completely decontrolled; minimum wages were not frozen; user charges on social services were confined to secondary education; budgetary and monetary targets were softened; and reforms of parastatals were postponed, subject to study.

3. *The impact of programmes*

The SAP appears to have been ineffective in reducing the country's *current account* imbalance. It had two strategies for doing so: attracting additional (especially fast-disbursing) aid flows, and increasing agricultural exports. As discussed below, aid was not forthcoming without an IMF-agreed programme. Agricultural exports collapsed in 1985, owing to a fall in world prices and in coffee production. In spite of incentives, non-traditional exports also fell during 1981-1985, following shortages of imported inputs and spare parts. Import compression was resorted to in order to reduce the external imbalance, but was highly inappropriate given the "import strangulation" of the economy that already existed.

The ERP had three additional strategies: devaluation and incentive prices to increase agricultural exports, and debt rescheduling to reduce debt service. Devaluation was the main issue preventing an IMF agreement in 1982-1986.[208]

Agricultural exports, however, did not rise as expected. The lifting of International Coffee Organization coffee export quotas and higher prices pushed up exports in 1986, and record production helped cotton in 1987, but other crops were hindered by transport and processing problems, and the decline in world prices. There was some diversification as regards manufactures and other non-traditional exports, and a marked improvement in tourist revenues. Yet total exports remained below the levels reached in the years 1980 to 1982. Over the first two years of the ERP, exports fell short

[207] Two IMF programmes in 1979-1980 and the domestically-designed National Economic Survival Programme (NESP) of 1981 were too short-lived to have any major effect on the economy. For details on the NESP, see Green (1983). For more details on the 1979-1980 IMF programmes, see Ndulu (1987), pp.26-27; Biermann and Fontaine (1987); and Green (1983) and (1986) (p.43). The 1980 programme broke down after three months, owing to breaches of the targets for government borrowing from banks, and external payments arrears.

[208] See Green (1983), Jamal (1986), Malima (1984), Singh (1986).

of targets and imports had to be cut to meet the current account target.

The SAP relied on cuts in expenditure of 16 per cent between 1983 and 1985 (the original target was a cut of 22 per cent). Due to higher aid flows, the ERP was able to budget for higher real expenditure in each of its first two years, without raising the deficit, thus enabling greater investment to be made in all productive sectors.

Neither programme included large-scale measures to reform *parastatals*. Under the SAP there were marginal layoffs and improvements in auditing procedures until 1984-1985, when responsibility for purchasing agricultural produce was transferred from parastatals to co-operatives. Until 1988, the ERP continued the gradual liberalization of marketing and attempted to reduce agricultural marketing parastatal losses, but reform of industrial, mineral and financial parastatals was delayed.

Agriculture was the key sector in both programmes. The SAP relied on increasing inputs, improving marketing, payment and collection procedures and extension services; and raising budget expenditure on agriculture (from 13 per cent in FY1982/83 to 28 per cent in 1984/85). Producer price levels were maintained in real terms for food crops, and raised only marginally for export crops, reflecting a new emphasis on the latter. Inputs were given priority in foreign exchange allocation, but distribution problems reduced their availability. Export crops were, however, discouraged by appreciation of the real exchange rate, though export duties were removed during 1980-1984.[209] Co-operatives faced the same transport and input supply problems as parastatals and were unable to boost export supply.

The effects of the SAP on production are difficult to separate from those of drought in the 1981/82, 1982/83 and 1983/84 seasons. Subsequently more rain, real producer price increases, and improved availability of inputs brought higher maize production, substantially reducing food imports. By 1985/86, these factors (and advance notice of price rises for 1986/87) were beginning to increase marketed production of export crops, notably cloves, coffee and cotton. But the foreign exchange shortage hampered transport and processing, making export volumes insufficient to offset lower world market prices, and agricultural export earnings fell sharply.

The ERP has relied much more on producer price increases. The effects on production levels were mixed: 1986/87 saw record food production, enabling 60,000 tons of maize to be exported. However, in 1987/88 and 1988/89 maize and rice production fell by 10 per cent annually. Larger price rises in 1987/88 were outweighed by drought in some areas, which occurred again in 1988/89. Export crops responded more favourably, subject to input availability and collection/payment speed. However, price incentives have elicited a substantial supply response in individual crops only, not an aggregate response throughout the sector; and do not signify a consistent trend.

The ERP initially did not give priority to investment in fertilizers, seeds, technology, irrigation, replanting and extension. By 1988, aid was being channelled to increase fertilizer production; a World Bank loan for agricultural research is likely to improve seed and technology use; and sub-sector loans were boosting replanting. However, there had been no overhaul of extension services. Programmes to combat soil erosion and deforestation in order to maintain the cultivability of the land have also been a low priority. This is of great importance, since all these factors are crucial to the long-term growth of agriculture and of the economy as a whole.

Agriculture was also held back by the poor performance of manufacturing in producing inputs and processing farm products. Manufacturing output in real terms fell by 26 per cent between 1980 and 1986, and its contribution to GDP dropped by one third. Under the SAP, real output and capacity utilization fell in every year except 1984; by 1985 many industries had closed and capacity utilization was at only 20 per cent to 30 per cent. This decline was largely due to shortages of spare parts, fuel and capital equipment as a result of lower imports. In 1987, under the ERP, import allocations for intermediate goods rose dramatically: real output grew by 4.2 per cent (though the contribution to GDP continued to fall) and capacity utilization rose.

The impact of the programmes on *health and education* may be judged by the percentage of government expenditure, and by changes in social indicators. During the first two years of the SAP (1982-1984), expenditure was maintained at the levels of 1980/81, i.e., 11 per cent to 12 per cent for education and 4.5 per cent to 5 per cent for health, helped by the maintenance of aid to these sectors by donors. But in 1984-1986, expenditure on education fell to 7 per cent, and on health to 3.5 per cent. In

[209] See Addison (1986) and Stewart (1986).

the first year of the ERP, outlay on education fell to 6.4 per cent, and on health to 3.7 per cent. While actual figures for 1987/88 were not available, the overall budget estimate for social infrastructure dropped from 19.3 per cent to 14.6 per cent, indicating 33 per cent cuts in spending.[210]

Health and education indicators (such as the the under-five mortality rate, life expectancy, and adult literacy) have not yet reflected these spending cuts. But the infant mortality rate, which is more immediately sensitive to adjustment, appears to have risen. Other negative effects have been falls in primary and secondary school enrolment; these are due to declining expenditure on education, parents keeping children out of school to work on farms, and to enrolment and secondary school fees introduced as an ERP measure in 1987 and increased in 1988.[211]

Other *basic human needs* have suffered under adjustment programmes. Nutrition indicators, such as the percentage of infants with low birth-weight, or the percentage of malnourished children, have worsened in the 1980s, but the daily per capita calorie supply has improved. Access to safe drinking water has continued to rise each year, but at a slower rate than in the 1970s, and government expenditure devoted to water and housing has fallen in real terms. These indicators have varied with drought and food production, without any trend.

Infrastructural investment and maintenance suffered from both low import levels and local budgetary allocations for rehabilitation and maintenance under the SAP. Transport and communications deteriorated owing to lack of fuel and spare parts, undermining the distribution of inputs and collection of produce from rural areas. Industry faced frequent shortages of power and water supplies, as a result of drought and fuel scarcity.

The ERP brought about a substantial improvement in foreign exchange availability and an increase in development budget expenditure. Donors launched large new packages of aid for infrastructure: 55 per cent of the 1987 increase in aid commitments went to infrastructure, raising its share of commitments from 22 per cent in 1986 to 31 per cent in 1987. Road transport was the highest priority: a special consultative group meeting was held in December 1987, and pledged $350 million for trucks, spare parts and roads. Few effects were seen by 1988 - agricultural inputs and exports were still constrained by transport problems, but bottlenecks are expected to decline by 1990-1991. Much of the finance went into rehabilitating main roads, rather than building feeder roads for rural areas; funds were too scarce for both.

Neither the SAP nor the ERP achieved a balance between short-term stabilization and longer-term growth. The SAP introduced few sectoral reforms except in agricultural input distribution, produce collection and marketing, and parastatal auditing procedures, though these were main elements of the programme. The ERP had not undertaken any major reform of the industrial or financial sectors by 1989: both sectors were the subject of study and various action programmes being drawn up.

However in general, implementation of the ERP has proceeded relatively satisfactorily. GDP, which grew on average by less than one per cent during 1980-1985, experienced a growth of 3.8 per cent in 1986, 3.9 per cent in 1987 and 4 per cent in 1988. The Government has been successful in meeting its short-term fiscal targets containing the budget deficit and limiting net borrowing from the banking system.

An important reason for the greater success of the ERP in achieving its targets was its ability to attract more external finance. Under the SAP private and official capital inflows decreased. Bilateral and multilateral net ODA disbursements fell from $707 million in 1981 to $506 million in 1985, and net flows of all official capital fell to $569 million in 1985. The Government failed to achieve its aim of increasing the percentage of aid devoted to import support. In 1984-1986, many donors began to withhold aid until agreement had been reached with IMF. There were few signs of any private capital inflow, apart from small amounts under import licences.

In contrast, net disbursements of ODA increased substantially under ERP. ODA disbursements reached $690 million in 1987 and $888 million in 1988. However, disbursements were still well short of projected levels in 1986/87 and to a lesser extent in 1987/88. Among the aid announced in 1988 was $22 million from the World Bank and Sweden to refinance World Bank interest payments; the United Republic of Tanzania was one of eight sub-

210 See The Economist Intelligence Unit, *Country Profile* ...., 1988, based on Bank of the United Republic of Tanzania figures. The World Bank (*World Development Report 1988*) and UNICEF (*The State of the World's Children*, 1988 and 1989 editions) give slightly higher figures as estimates for 1985/86 and 1986/87, but the trend is similar.

211 See UNICEF, *op. cit.*, and World Bank, *op. cit.*, and EIU Country Reports (1988 and 1989).

Saharan countries to benefit from this initiative.

There is little evidence so far that the ERP has increased private flows. Foreign companies have, however shown interest in privatized management of hotels, tea estates and oil prospecting.

Under the SAP, debt service of about $550 million was paid between 1982 and 1985. The rest was allowed to fall into arrears in order to maintain import levels, and external payments arrears grew rapidly, from $100 million at end-1981 to $750 million at end-1985; as a result, premiums on trade credit grew by 40 per cent to 50 per cent. Between 1980 and 1988, OECD countries cancelled debts of over $500 million and waived $25 million of interest, and the United States allowed $25 million to be repaid in local currency.[212]

The ERP agreement with the IMF allowed Paris Club rescheduling: in 1986, the Paris Club rescheduled $1.1 billion (including $400 million in arrears) over ten years. In 1988, the United Republic of Tanzania became one of the LDCs to benefit from the Toronto agreement on new Paris Club terms.

4. Conclusions

Both the SAP and the ERP have illustrated that adjustment takes a longer time than they originally projected, and have failed to achieve many of their aims. The ERP's relatively greater success remains fragile: it is both vulnerable to drought and world commodity price trends, and dependent on large amounts of external aid and debt relief.

The ERP has relied so far largely on short-term measures, except in agriculture and infrastructure. Many of the harsher adjustment measures (budget cuts, price decontrol, agricultural marketing reforms) began already under the SAP.

The next stage of adjustment will be far more problematic. If the programme is to be genuinely appropriate to long-term growth and sustainable development of the country, it will have to tackle major structural problems. Foremost among these will be sustained agricultural supply increases, which will require large investment in fertilizer, seeds, oxen, tractors, feeder roads, irrigation and extension. The risk of environmental degradation must also be avoided.

Exports of traditional agricultural products are unlikely, without sustained world price increases, to solve the current account problem or to provide sustained growth independent of aid. For this reason, domestic food self-sufficiency and export diversification into non-traditional agricultural, industrial and mineral products, and tourism, will need more emphasis.

More broad-based reforms of the parastatals seem to be required. The top priority would appear to be agricultural marketing, but reorganization of industrial and financial sectors must follow.

Sustainable adjustment would also require more emphasis on health, education, other basic human needs and the social and distributional consequences of the programme. Without this, growing unemployment, a deterioration in human capital and a decline of living standards for the poorest in rural and urban areas cannot be avoided. Efforts to restrain population growth will also need to be strengthened.

The final requirement for sustained adjustment and growth will be further increases in debt relief, and in commitments and disbursements of aid, as increases in long-term private capital are unlikely, except in specific attractive sectors, at least over the short to medium term.■

[212] For debt service and cancellations see UNCTAD, *Least Developed Countries - 1988 Report*, *op.cit.* For external payment arrears, see Green (1986).

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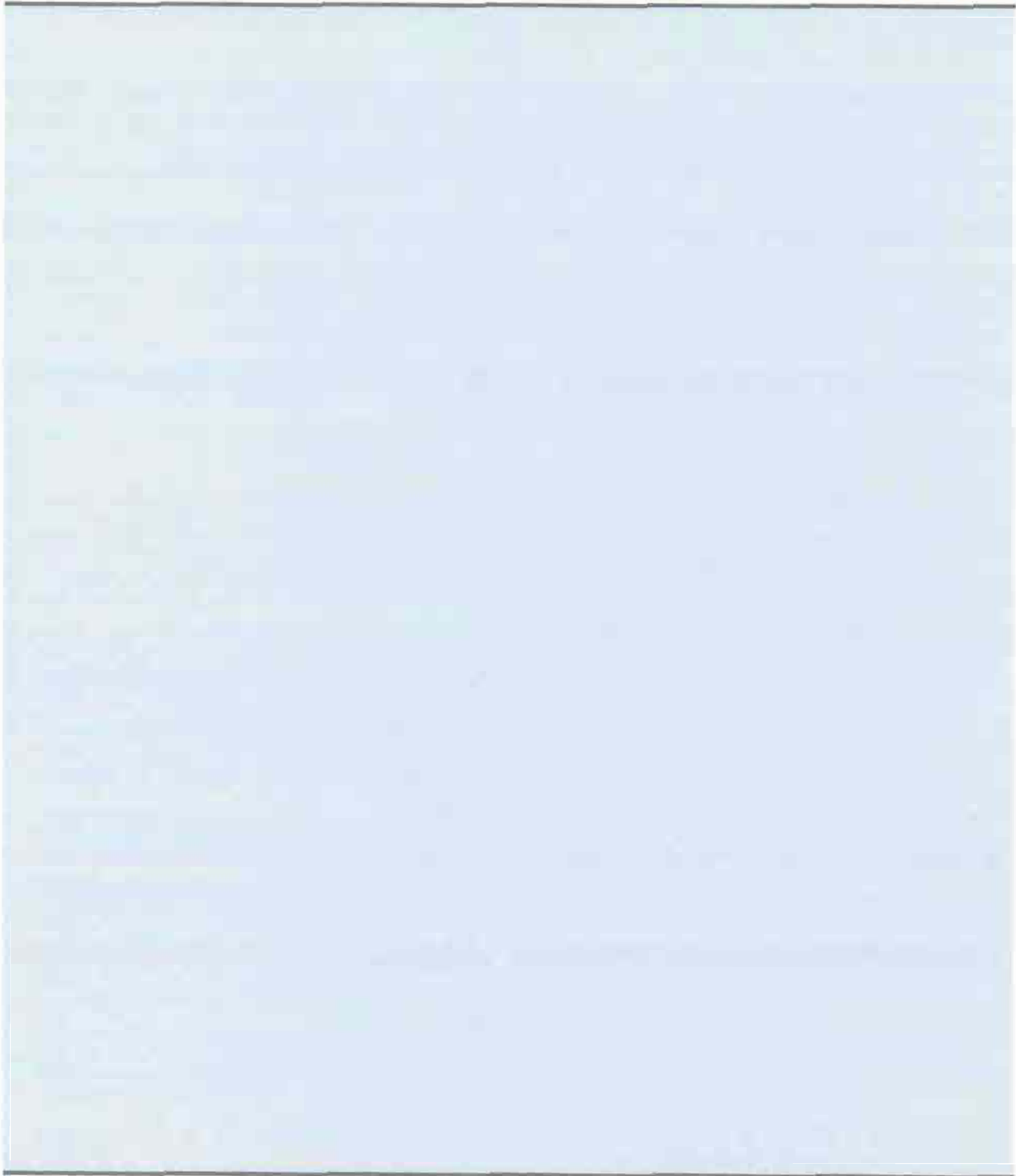

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THE SHORT-TERM OUTLOOK FOR COMMODITY PRICES

For the year 1989 as whole the prospects for primary commodities, excluding crude petroleum, are of a further rise in prices, although much smaller than in 1988. Since average prices of manufactures should rise even less, because of the appreciation of the dollar, there should thus be some improvement in the terms of trade of exporters of these commodities. Forecasts for the main commodity groups in 1989 as a whole and in 1990 are given in table A1. For agricultural commodities they naturally assume normal weather conditions.

Food prices are expected to increase by 6.6 per cent in 1989 - 9.6 per cent for cereals, 0.4 per cent for beverages and 12 per cent for sugar. FAO reports some recovery in world cereal production, which is forecast to be 7.9 per cent higher than the 1988 level. This output growth would, however, be insufficient to restore consumption to the trend value. Because of the previous year's drought, drawings on stocks were such that for the crop year 1989 a carry-over level of 17 per cent of consumption is forecast, which is barely the minimum necessary for world food security.[1] Thus, prices are expected to be significantly higher than in 1988. Likewise for sugar, the tight supply situation leads to high price expectations. In contrast, the prospects for beverages are not promising because of structural oversupply conditions. Thus, despite bad weather in Brazil, which affected the quality and volume of the coffee crop for the current season, world stocks are expected to increase further. The situation is even more serious for cocoa, with the prospect of sale of part of the ICCO buffer stock to finance storage costs.

Given normal weather, there will be a slight drop in the price of oilseeds, oils and fats, mainly attributable to soyabeans. In response to high prices, Brazil and Argentina have boosted the area under soyabean. Drought in Argentina severely reduced output, but this was more than outweighed by the bumper crop in Brazil. Because of low stocks, prices are expected to be significantly higher than in the mid-1980s.

The slowdown in world economic activity forecast for 1989 would have important implications for the prices of agricultural raw materials, minerals and non-ferrous base metals. However, because of tight supplies for some major commodities, price levels should remain firm. This is particularly the case for base metals, where prices are expected to remain far above production costs for some time in the future, despite weakening demand, although they may decline from the peak reached in 1988. For 1989 the price boom is expected to continue, notably for zinc and tin, but aluminium prices may fall significantly.

A relatively faster price increase is forecast for minerals, crude petroleum (10 per cent) and other minerals (15 per cent). Prices of crude petroleum rose sharply early in 1989, but began to decline in April, after the seasonal consumption peak. Price movements for the remainder of 1989 will naturally depend much on the ability of OPEC to ensure that members' production quotas are not exceeded.

For 1990, with further production increases and some stock-building, there could be an overall decline in the prices of non-oil primary commodities and base metals.■

1 FAO, *Food Outlook*, June 1989.

Table A1

WORLD EXPORT PRICES OF PRIMARY COMMODITIES AND NON-FERROUS BASE METALS

(Percentage increase over previous year)

	Actual		*Forecast*	
	1987	*1988*	*1989*	*1990*
Non-oil primary commodities	2.6	13.9	5.1	-3.1
Food	1.4	16.0	6.6	-6.5
of which:				
Cereals	-4.8	36.7	9.6	-5.9
Tropical beverages	-33.3	1.4	0.4	-6.7
Sugar	13.6	48.0	12.0	-12.0
Other agricultural products	14.7	15.1	1.6	-0.2
of which:				
Oilseeds, oils and fats	6.2	31.9	-2.0	-3.2
Agricultural raw materials	17.1	10.9	2.8	0.7
of which:				
Forest products	14.6	7.4	3.7	-3.2
Textile fibres	32.8	17.3	-0.4	4.8
Minerals	-11.1	0.0	15.0	4.7
Crude petroleum	29.0	-20.4	10.0	3.9
Non-ferrous base metals	24.3	49.4	1.2	-14.3
Memo item:				
Unit value of exports of manufactures of developed market economies	12.6	6.0	3.5	2.9

Source: UNCTAD secretariat calculations, based on national and international sources. Forecasts are based on prices of 39 commodities.

THE BASLE AGREEMENT OF JULY 1988 ON INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS

A. Background

In July 1988 the central bank governors of the Group of Ten countries and Luxembourg endorsed a document entitled "International Convergence of Capital Measurement and Capital Standards", which represents the culmination of efforts during recent years by the Committee on Banking Regulations and Supervisory Practices to secure international convergence of supervisory regulations governing the capital adequacy of international banks. This agreement (hereafter referred to as the Basle Agreement of July 1988) is a further stage in the development of a framework of international supervisory co-operation concerning banking activities. Previous important steps in the process included the Basle concordats of 1975 and 1983, which established principles covering the distribution between parent and host authorities of supervisory responsibilities over branches, subsidiaries and joint ventures[2] in international banking, and the exchange of information between such authorities.

These supervisory initiatives are a response to problems perceived as resulting from the rapid growth of international banking activites since the 1960s. Many of these problems are closely connected to tensions between the extent of parent authorities' responsibilities for supporting their banks' foreign branches, subsidiaries, and affiliates, on the one hand, and limits on their regulatory reach with respect to the operations of such units, on the other. Such tensions are particularly acute between major and offshore financial centres, since the latter aim to attract international banks through offering permissive regulatory climates, while also endeavouring to secure at least the implicit support of foreign parents and their central banks. As the author of a recent book on the regulation of international banking puts it, "within [such] a multi-jurisdictional regulatory regime there is an inbuilt tendency towards competitive deregulation".[3]

Moreover the greatly expanded international linkages between banks owing to their dependence on the inter-bank market and on other categories of inter-bank business have increased the risks of systemic damage originating in weaknesses which in the first instance affect only one part of the international banking system. As a result of the great volatility of international movements of funds, stresses within this system can develop and spread extremely rapidly. In such situations many banks (including those not directly affected by the shocks starting the crisis) may have to face sharply higher inter-bank interest rates as a re-

[2] Joint ventures in this context are defined as legally independent institutions incorporated in the country where their principal operations are conducted, and controlled by two or more parent institutions, most of which are usually foreign and not all of which are necessarily banks.

[3] R. Dale, *The Regulation of International Banking* (Cambridge: Woodhead-Faulkner, 1984), p. 172.

sult of "tiering" as well as the possible rationing of funds in, or even complete exclusion from, the inter-bank market.

Thus, an important part of the impetus behind efforts to improve international supervisory co-operation has been provided by awareness by national authorities of OECD countries of the vulnerability of their banking systems to disruptions resulting from activities over which they have no control. Efforts at improving supervisory co-operation are also due to realization of the need to ensure that international competition among banks takes place in a framework where no country's institutions are unduly favoured by particular features of national regulatory regimes, so that success in obtaining international banking business reflects differences in efficiency. Both of these concerns are evident in the statement in the Basle Agreement of July 1988 that its objectives "are, firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and secondly that the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks".[4]

The agreement was reached during a period which has witnessed large shifts in the relative importance of different banking activities. These shifts include declines for many major banks in the share of their income from international lending, and corresponding rises in that from fee-earning activities. The latter are associated with increases in banks' off-balance-sheet business, such as stand-by letters of credit, placing and underwriting commitments (for example, note issuance facilities (NIFs) and revolving underwriting facilities (RUFs)), various categories of swap agreements and options and forward contracts.[5] Although these instruments are not booked among banks' assets, none the less they leave banks with exposures to various types of risk not in principle different from those associated with on-balance-sheet business. Thus such instruments need to be taken into account by supervisory authorities in their measurement of the adequacy of banks' capital.

B. Salient features of the Agreement

The recommendations of the Basle Agreement of July 1988 are designed to ensure that banks observe uniform guidelines on capital adequacy which meet the prudential standards appropriate to the more deregulated environment now prevailing, and which take account of risks associated with banks' increased involvement in the fee-earning activities mentioned in the previous section. For this purpose they set an overall target figure for the ratio of capital to a risk-weighted sum of assets and off-balance-sheet exposures, while also specifying the eligible constituents of the numerator of this ratio.

The eligible constituents of capital are divided into two tiers. The first (core capital or Tier 1) is to include only permanent shareholders' equity (defined as issued and fully paid ordinary shares or common stock and perpetual non-cumulative preference shares) and disclosed reserves. Supplementary capital (Tier 2) may include undisclosed reserves, reserves resulting from the revaluation of certain assets (for example, securities) to a level above their historic cost, general provisions and general loan loss reserves, hybrid debt capital instruments combining certain characteristics of equity and debt, and subordinated term debt meeting certain conditions. At least one half of the value of the numerator of the capital ratio is to consist of items from Tier 1 or core capital.

Each of the assets in the denominator of the ratio is to be assigned to one of five risk categories, and to be given a weight according to the category's relative risk. For example, cash and certain claims on central governments and central banks in OECD countries are given

4 Committee on Banking Regulations and Supervisory Practices, "International Convergence of Capital Measurement and Capital Standards", July 1988, para. 3.

5 For descriptions of these financial instruments see Committee on Banking Regulations and Supervisory Practices, "The management of banks' off-balance-sheet exposures: a supervisory perspective" (Basle, March 1986).

a zero weight, while most types of lending to private entities and individuals are given a weight of 100 per cent. The credit equivalent of off-balance-sheet items other than foreign exchange and interest rate related contingencies is estimated through multiplication by a credit conversion factor. The item is then assigned to one of the five risk categories, and thus given a risk weight in the same way as on-balance-sheet items. For items related to exchange rates and interest rates (such as swaps, options and futures), the determination of credit equivalents is to be carried out by either of two specified methods for estimating the potential cost of replacing the associated cash flow in the event of default by the counterparty, account being taken of the residual maturity of the contract and of the volatility of its underlying rate.

The agreement sets 8 per cent as the common minimum standard for the capital ratios which international banks in the member countries of the Committee on Banking Regulations and Supervisory Practices will be expected to observe by the end of 1992. An interim minimum standard of 7.25 per cent is specified for the end of 1990.

C. Some aspects of the sequel of the Agreement

As noted earlier, the Basle Agreement of July 1988 is part of a larger process of developing a framework of international co-operation with respect to the supervision of banking activities. In December 1988 there followed agreement by the member countries of the Committee on Banking Regulations and Supervisory Practices on a "Statement of Principles" setting criteria for banks' conduct with the objective of preventing criminal use of their facilities for purposes such as money laundering. However, the agreements reached by this Committee so far still leave a substantial agenda for international supervisory co-operation. For example, the guidelines of the Basle Agreement of July 1988 are only a partial step towards establishing a more comprehensive framework for the assessment of capital adequacy, being directed primarily at credit risk and devoting little or no attention to other risks, such as interest rate, foreign exchange and liquidity risks.[6] Possible ways of extending supervisory co-operation to cover such risks are currently being studied. Other subjects of widespread concern in the context of supervisory co-operation include the adequacy of arrangements for the provision of financial support in response to disruptions threatening the stability of the international banking system, and the absence of internationally agreed standards as regards minimum capital levels, financial reporting, etc. for financial conglomerates whose activities comprise not only banking but also other financial services, such as securities trading. Problems under both of these headings are currently the subject of much attention among regulatory authorities at the national level. It can be expected that efforts to harmonize the resulting regulatory initiatives will constitute part of the future agenda of international supervisory co-operation.

Many of the eventual effects of the guidelines in the Basle Agreement of July 1988 are difficult to forecast, although banks in the countries in question are not generally thought to face major impediments to the achievement of the target levels of capital in relation to assets. The responses of banks to the Agreement are likely to differ among countries, and to be influenced by such circumstances as conditions in capital markets and the ways in which national supervisory authorities implement the guidelines (a matter concerning which they are accorded substantial flexibility).[7] Thus, for example, the attractiveness of new stock issues as part of efforts to meet the target capital ratio

6 Concerning the limited coverage of the Agreement see, for example, the remarks of Peter Cooke, Chairman of the Committee on Banking Regulations and Supervisory Practices, at the International Monetary Conference in Chicago (5 - 8 June 1988), reproduced in the *Bank for International Settlements Review* of 12 July 1988. Interest rate risk is the risk to a bank that its costs of funding may increase in relation to the return on its assets. Foreign exchange risk covers risks due to losses of various different kinds on a bank's foreign exchange operations. Liquidity risk is the risk that a bank may be unable to purchase its funding requirements at a reasonable price or, in extreme circumstances, at any price.

7 According to paragraph 51 of the Agreement, "Each country will decide the way in which the supervisory authorities will introduce and apply these recommendations in the light of their different legal structures and existing supervisory

will be affected by conditions in equity markets, owing to their impact on the valuation of banks' shares.

It is, however, widely agreed that, via the fillip given to increased attention to credit risks and to greater emphasis on profitability, the Agreement will help to discourage additional net lending by banks to developing countries other than in the form of export credits guaranteed or insured by the government of an OECD country. Except for loans with a residual maturity of up to one year made to other banks or carrying another bank's guarantee, such lending is assigned to the highest risk category, with a weight of 100 per cent. Moreover, bank managements can be expected to perceive a conflict between increased profitabilty and lending to borrowers in developing countries other than the minority whose perceived creditworthiness has been unaffected by the debt crisis. As explained in section A, the impact of this conflict is likely to be prohibitive in the case of borrowers, new loans which would generally have to carry a charge against profits consisting of loan loss provisions at the greatly increased levels prevalent since 1987.■

arrangements." Moreover (as specified in annex 2 of the Agreement) discretion is left to national authorities as to the risk weights to be assigned to certain banking claims.

EXPORT GROWTH IN DEVELOPING COUNTRIES AND THE POLITICAL ECONOMY OF PROTECTIONISM: ECONOMETRIC ANALYSIS

A. Factors contributing to export performance in developing countries

In theory, several factors affect export performance, the major ones being export supply capabilities, export prices, the size of production relative to the strength of domestic demand, and the demand potential for imports in partner countries.[8] A larger production capacity is assumed to increase output and thus the ability to supply export markets. Levels of domestic gross fixed capital formation (I) or, alternatively, of manufacturing output (MAN), or their shares in GDP, are generally used as proxies for a country's ability to export manufactures. Since export price series are not widely available, most studies use the exchange rate, suitably deflated, as a proxy. Currency depreciation is generally expected to make the production of exportables more attractive, relative to non-tradeables, and to increase foreign demand for locally produced goods. The strength of domestic demand is also often included as an explanatory variable. In the regressions reported below the domestic consumer price index (CPI) is used as a proxy for this variable, and the expectation is that a higher CPI is associated with lower exports. The aggregate demand of partner countries is generally used to reflect the ability of foreign markets to absorb a country's exports. Exports are expected to be positively correlated with the level of aggregate demand of partner countries.

The present analysis aims to assess the relative contribution of these various factors to the volume of exports of manufactures (X^{man}) of individual countries and to test empirically the above hypotheses for the period 1970-1987 for 20 developing countries (see table A2) having a significant industrial base. For this purpose, several specifications of the following equation were estimated, using ordinary least squares:

$$\log X_t^{man} = a + b \log S_{t-i} - c \log CPI_t - d \log RER_{t-j} + e \log Y_t^{oecd}$$

where S = I/GDP, MAN/GDP or MAN, RER is the real exchange rate for the United States dollar (equal to the nominal exchange rate deflated by consumer prices relative to wholesale prices in the United States), Y^{oecd} is real GDP in the OECD as a whole, and i and j are lag coefficients.[9]

8 See, for example, M. Khan and M. Knight, "Import Compression and Export Performance in Developing Countries", *Review of Economics and Statistics*, vol. 70, No. 2 (1988); and J. Riedel, C. Hall, and R. Grawe, "Determinants of Indian Export Performance in the 1970s", *Weltwirtschaftliches Archiv*, vol. 120, No. 1 (1984).

9 Sources for the series are the following: IMF, *International Financial Statistics*, for RER; OECD, *Statistical*

Table A2

ESTIMATION RESULTS OF THE BEST-FITTING EQUATION

Country	Parameter *S*	*CPI*	*RER*	*yoecd*	R^2	*D.W.*	*Specification*
Chile	2.84#	0.49	-0.66	-4.88	.950	3.36	0-3
Colombia	3.32	-0.96	1.32	5.05	.944	2.13	0-3
Costa Rica	0.66*	-0.12#	-0.40#	2.70	.913	2.28	0-1
Mexico	-2.78	0.02#	0.78	8.75	.946	1.06	0-3
Peru	1.63	-0.26	-3.20	10.82	.942	1.74	1-1
Uruguay	1.13	-0.25	-0.54	-1.40#	.940	1.62	0-1
Venezuela	4.10	-0.26#	-0.55	1.83**	.954	2.97	0-2
India	-0.38#	-0.94	-0.64#	4.36	.788	1.04	0-3
Indonesia	0.97	-	-1.13	7.23	.965	1.64	1-1
Malaysia	-0.92	3.67	-1.56	-1.38#	.978	1.79	2-1
Pakistan	3.69	-	0.29#	0.05#	.832	1.85	1-2
Philippines	0.93	-0.10#	0.47#	7.75	.990	2.66	1-1
Rep. of Korea	5.98	-	-0.85	2.94	.992	1.68	1-3
Singapore	4.77	1.34	-1.27	2.73	.982	1.79	1-3
Sri Lanka	-4.23	0.48#	1.05	6.94	.932	1.99	0-2
Thailand	0.85#	0.44#	-1.97#	3.48	.967	1.41	1-2
Turkey	-2.96	-	-2.01	5.89	.976	1.85	1-3
Yugoslavia	-0.43#	0.05#	0.57	1.83	.941	1.63	2-1
Mauritius	1.19	0.43#	0.44#	6.26	.962	1.71	1-1
Morocco	2.21	0.92	-0.55	2.03**	.981	1.43	0-3

Source: UNCTAD secretariat, based on official international sources.

Note: Unless otherwise indicated, coefficients are significant at the 95 per cent confidence interval or above; ** and * indicate a significance at, respectively, the 85 per cent and 90 per cent confidence level. # indicates that the coefficient is not statistically significant (less than 85 per cent). The estimation period for Chile and Malaysia has been limited to 1974-1987 and 1972-1987, respectively. In the specification, the first number shows the lag configuration: i=j=0 for 0, i=j=1 for 1, i=1 and j=2 for 2; the second number indicates the variables for which S stands: I/GDP for 1, MAN/GDP for 2, MAN for 3.

The estimation results are summarized in table A2 above. GDP in OECD countries, the proxy for the domestic ability to supply export markets, RER and the CPI are statistically significant and of the expected sign in, respectively, 14, 12, 10 and 3 of the sample countries. This indicates that economic expansion in the industrialized countries, domestic investment programmes, and exchange rate change have all been important in increasing the exports of manufactures of developing countries. The share of investment and the share of manufacturing in GDP, and the value of manufacturing output are best suited as proxies for the domestic ability to supply exports in respectively 6, 2 and 4 countries.

The relatively few countries for which RER is significant and of the expected sign deserve some explanation. Since it represents the exchange rate of the domestic currency for the dollar, it is a good proxy only for countries which trade essentially with or through the United States. This could explain why RER is not significant in India, Mauritius, Pakistan and Thailand and has the wrong sign in Yugoslavia; this does not, however, provide an explanation for the insignificance or the wrong

Yearbook, for Y^{oecd}; World Bank, *World Tables*, for X^{man}, CPI, GDP, I, and MAN. The values are all expressed in constant 1980 prices.

sign of RER in Costa Rica, Mexico, the Philippines or Sri Lanka. Furthermore, the elasticity of X^{man} relative to RER for Malaysia, Peru and Turkey is very high and implies that a 10 per cent real devaluation in these countries would be associated with an expansion of manufactures exports of between 15 and 30 per cent. This is hardly realistic and provides a further reason to interpret the results with caution.

The variety of institutional characteristics peculiar to each of the countries studied and the extreme simplicity of the specification used to explain their export performance are responsible for the relative weakness of the results reached, which can be regarded as no more than indicative. There is clearly scope for refinement in the approach, for example by making country case studies that take into account the particular factors which were relevant in each case for the industrialization process and the competitiveness of exports. A sectoral breakdown of investment, prices and wages would offer an ideal starting point for this purpose.

B. The political economy of protection: A model of the determinants of protection in North-South trade

A model of non-tariff forms of protection has been developed in the UNCTAD secretariat, using data from various international sources. The model estimates cross-section equations by the ordinary least squares method. The dependent variable for each of the three major developed country markets (United States, EEC and Japan) - the share of imports affected by non-tariff measures (the "trade coverage ratio", or TCR) - is expressed as a function of variables which proxy the demand for and the supply of protection. The variables on the demand side are import penetration, export dependence (or extent of intra-industry trade), and comparative advantage (labour productivity and changes therein). The supply-side variables considered are the importance of a sector (share in manufacturing production or labour force) and adjustment costs (changes in the share of employment or production and changes in import penetration). The most significant results for the United States and EEC are presented in table A3 below.

The demand for protection can be expected to be positively related to the level of import penetration (i.e. the share of imports in consumption) and negatively related to the extent to which exports (and, therefore, intra-industry trade) are important in a particular sector. Dynamic sectors or sectors where technical change is rapid (as reflected, for example, in high growth of labour productivity) are unlikely to lobby for protection against imports. On the supply side, sectors which loom large in total employment or where adjustment costs are high (for example, as a result of rapid increases in import penetration or where employment is declining) are more likely to be granted import relief than those which are less important as employers or which are not under a serious adjustment threat.

Results were best for the United States and EEC. The econometric results for Japan were poor, possibly reflecting the fact that Japanese imports of manufactures from developing countries are relatively small, and have therefore not been included in the table. For the United States and EEC, cross-section regression equations run for 1984 yielded coefficients which were statistically significant and of the expected sign.■

Table A3

DETERMINANTS OF TRADE COVERAGE RATIOS IN THE UNITED STATES, EEC AND JAPAN, 1984

(Ordinary least-squares estimation)

	United States		*EEC*	
	ISIC (4-digit) 81 sectors	*ISIC (3-digit) 26 sectors*	*ISIC (4-digit) 81 sectors*	*ISIC (3-digit) 26 sectors*
Constant	20.7*** (4.73)	-4.09 (-0.46)	16.9*** (3.01)	8.50 (1.15)
Demand for protection [a]				
IPR (import penetration)	1.68** (2.19)	5.82*** (2.68)	2.62*** (3.95)	2.71*** (4.05)
XOP (exports/output)	-1.76** (-2.06)		-1.48*** (-2.98)	-1.60** (-2.11)
Sector's comparative advantage:				
CHLPR (change in labour productivity)		0.90 (1.57)		
Supply of protection [b]				
Sector's political importance:				
SHEMP (share of manufacturing labour force)		9.98*** (5.08)		2.70** (2.16)
Sector's adjustment costs:				
CHEMP change in share of employment)		-33.8*** (-6.78)		-22.3*** (-2.71)
CHPRO (change in share of production)	-19.0*** (-3.31)		-22.4** (-2.20)	
CIP (change in import penetration)	-2.38** (-2.05)	-7.82** (-2.61)	-1.68** (-2.27)	
Others:				
SHPRO (share of production)		-7.88*** (-3.95)	5.14** (2.12)	

Source: UNCTAD secretariat, based on UNCTAD Data Base on Trade Measures and on official international data.

Note: Figures in parentheses are t values. Significance of regression coefficients is expressed by: *** at the 99 per cent level, ** at the 95 per cent level, * at the 90 per cent level.

a Explanatory variables are defined as follows: IPR: share of imports from developing countries in apparent consumption in 1984; XOP: ratio of exports to developing countries to the total value of production of the sector in 1984; LPROD: ratio of value added in constant 1980 prices to employment in 1984 (1985 for EEC); CHLPR: LPROD in 1984 (USA) or 1985 (EEC) less LPROD in 1975.

b Explanatory variables are defined as follows: SHEMP: share of sector in total industrial employment in 1984 (1985 for EEC); CHEMP: SHEMP in 1984 (for USA) or 1985 (EEC) less SHEMP, in 1975; SHPRO: share of sector in total industrial production in 1984; CHPRO: SHPRO in 1984 less SHPRO in 1975; CIP: IPR in 1984 less IPR in 1975.

ARRANGEMENTS IN SUPPORT OF STRUCTURAL ADJUSTMENT IN LDCs IN THE 1980s
(As of June 1989)

Amounts in SDR millions (unless otherwise indicated)

Country	IMF arrangements				World Bank loans and credits								
	Stand-by/Extended Facility		SAF/ESAF		Structural adjustment				Sector and other adjustment				
						Amount				Amount			
	Period	Amount	Period	Amount	Date of approval	IDA	African Facility [1]	Co-financing [2]	Date of approval	IDA	African Facility [1]	Co-financing [2]	Purpose
Bangladesh	July 1979- July 1980	85											
	Dec.1980- Dec.1983 [3]	800 [4]											
	March 1983- Aug. 1983	68.4											
	Dec. 1985- June 1987	180	Feb. 1987- Feb. 1990	201.3					June 1987	147.8			Industrial policy reform
Benin			June 1989- June 1992	21.9					May 1989	33.5			Private sector development
Burkina Faso									Feb. 1985	13.8		France/CCCE (3.2); Netherlands (2.1) F.R.of Germany/GTZ (2); France/FAC (1.7)	Fertilizers
Burundi	Aug. 1986- March 1988	21	Aug. 1986- Aug. 1989	29.9	May 1986	13.2	14.3	Japan (11); Switzerland (7.7);					
					June 1988	64 9		Japan (18.1); F.R.of Germany (6); Saudi Arabia (2.9)					
Central African Republic	Feb.1980- Feb.1981	4											
	April 1981- Dec. 1981	10.4 [5]											
	April 1983- April 1984	18 [6]											
	July 1984- July 1985	15											
	Sept.1985- March 1987	15 [7]			Sept.1986	12.3	14						
	June 1987- March 1988	8	June 1987- May 1990	21.3					July 1987	11 5		Saudi Arabia (2); Japan (6)	Cotton sector
					June 1988	28.9		ADF (25)					

ARRANGEMENTS IN SUPPORT OF STRUCTURAL ADJUSTMENT IN LDCs IN THE 1980s
(As of June 1989)

Amounts in SDR millions (unless otherwise indicated)

	IMF arrangements				World Bank loans and credits								
	Stand-by/Extended Facility		SAF/ ESAF		Structural adjustment				Sector and other adjustment				
						Amount				Amount			
Country	Period	Amount	Period	Amount	Date of approval	IDA	African Facility [1]	Co-financing [2]	Date of approval	IDA	African Facility [1]	Co-financing [2]	Purpose
Chad			Oct. 1987- Oct. 1990	21.4									
Ethiopia	May 1981- June 1982	67.5											
Equatorial Guinea	July 1980- June 1981	5.5											
	June 1985- June 1986	9.2 [8]											
			Dec. 1988- Dec. 1991	12.9									
Gambia	Nov. 1979- Nov. 1980	1.6											
	Feb. 1982- Feb. 1983	16.9											
	April 1984- July 1985 [10]	12.8 [9]											
	Sept. 1986- Oct. 1987	5.1	Sept. 1986- Sept. 1989	10.9	Aug. 1986	4.3	9.9	United Kingdom (4.5); African Development Fund (9)					
			Nov. 1988- Nov. 1991	20.5 (ESAF)	June 1989	17.9							
Guinea	Dec. 1982- Nov. 1983	25 [11]											
	Feb. 1986- March 1987	33 [12]			Feb. 1986	22.9	15.6	F.R. of Germany (9.4); Japan (27.8); France (26.7); Switzerland (4.8)					
	July 1987- Aug. 1988	11.6	July 1987- July 1990	40.5									
					June 1988	47.0		ADF (12); Japan (11.2)					

ARRANGEMENTS IN SUPPORT OF STRUCTURAL ADJUSTMENT IN LDCs IN THE 1980s
(As of June 1989)

Amounts in SDR millions (unless otherwise indicated)

	IMF arrangements				World Bank loans and credits								
	Stand-by/Extended Facility		SAF/ ESAF		Structural adjustment				Sector and other adjustment				
						Amount				Amount			
Country	Period	Amount	Period	Amount	Date of approval	IDA	African Facility [1]	Co-financing [2]	Date of approval	IDA	African Facility [1]	Co-financing [2]	Purpose
Guinea-Bissau									Dec.1984	10.1		Switzerland (Swf 4.5 mn.)	Economic recovery programme [13]
			Oct. 1987-Oct. 1990	5.3	May 1987	8	4	Switzerland (5.2); Saudi Arabia (3.2); African Development Fund (11.3); IFAD (5.3)					
					May 1989	18							
Haiti	Oct. 1978-Oct. 1981 [15]	32.2 [14]											
	Aug. 1982-Sept.1983	34.5											
	Nov. 1983-Sept. 1985	60 [16]											
			Dec.1986-Dec.1989	30.9					Mar.1987	32.8			Economic recovery
Lao People's Dem.Rep.	Aug. 1980-Aug. 1981	14											
Lesotho			June 1988-June 1991	10.6									
Malawi	Oct. 1979-Dec.1981 [17]	26.3											
	May 1980-March 1982	49.9 [18]			June 1981	36.7 [19]							
	Aug. 1982-	22											

ARRANGEMENTS IN SUPPORT OF STRUCTURAL ADJUSTMENT IN LDCs IN THE 1980s
(As of June 1989)

Amounts in SDR millions (unless otherwise indicated)

	IMF arrangements				World Bank loans and credits								
	Stand-by/Extended Facility		SAF/ESAF		Structural adjustment				Sector and other adjustment				
						Amount				Amount			
Country	Period	Amount	Period	Amount	Date of approval	IDA	African Facility [1]	Co-financing [2]	Date of approval	IDA	African Facility [1]	Co-financing [2]	Purpose
Malawi (continued)	Aug. 1983								Apr. 1983	4.6		IFAD (10.3)	Smallholder fertilizers
	Sept.1983-Sept.1986 [21]	81 [20]			Dec. 1983	51.9							
	March 1988-May 1989	13.0	July 1988-July 1991	55.8 (ESAF)	Dec. 1985	28.0	37.3	F.R. of Germany/KfW (6.4); Japan/OECF (22.6) United States/AID (15)					
					Jan. 1987		8.4	Japan (17.7); United Kingdom (7.5); F.R. of Germany (5)	June 1988	50.6		OECF (30) USAID (25) ADF (19.5) EEC (16)	Industrial and trade policy adjustment
Mali	May 1982-May 1983	30.4							June 1988	29.4		Japan (38.7) Saudi Arabia (5.9) ADF (45)	Public enterprise sector
	Dec. 1983-May 1985	40.5											
	Nov. 1985-March 1987	22.9 [22]											
	Aug. 1988-Oct. 1989	12.7	Aug. 1988-Aug. 1991	35.6									
Mauritania	July 1980-March 1982 [24]	29.7 [23]											
	June 1981-March 1982	25.8											
	April 1985-April 1986	12											
	April 1986-April 1987	12	Sept. 1986-Sept. 1989	23.7									
	May 1987-May 1988	10			June 1987	11.7	21.4	Saudi Arabia (4.8) F.R.of Germany (2.8)					
			May 1989-May 1992	50.9 (ESAF)									

ARRANGEMENTS IN SUPPORT OF STRUCTURAL ADJUSTMENT IN LDCs IN THE 1980s
(As of June 1989)

Amounts in SDR millions (unless otherwise indicated)

	IMF arrangements				World Bank loans and credits								
	Stand-by/Extended Facility		SAF/ ESAF		Structural adjustment				Sector and other adjustment				
						Amount				Amount			
Country	Period	Amount	Period	Amount	Date of approval	IDA	African Facility [1]	Co-financing [2]	Date of approval	IDA	African Facility [1]	Co-financing [2]	Purpose
Mozambique									May 1985	45.5			Economic rehabilitation programme I
			June 1987- June 1990	42.7					Aug. 1987	54.5	(18 6)	Switzerland (11.2)	Economic rehabilitation programme II
									May 1989	68.2			Economic rehabilitation programme III
Myanmar	June 1981- June 1982	27											
Nepal	Dec. 1985- April 1987	18.7	Oct. 1987- Oct. 1990	26.1	March 1987	40.9							
					June 1989	46.2							
Niger	Oct. 1983- Dec. 1984	18											
	Dec. 1984- Dec. 1985	16											
	Dec. 1985- Dec. 1986	13.5	Nov. 1986- Nov. 1989	21.4	Feb. 1986	18.3	36.6						
	Dec. 1986- Dec. 1987	10.1							June 1987	46	15.4		Public enterprise sector
			Dec. 1988- Dec. 1991	50.6 (ESAF)									
Rwanda	Oct. 1979- Oct. 1980	5 [25]											
Samoa	Aug. 1979- Aug. 1980	0.7 [25]											
	June 1983- June 1984	3.4											
	July 1984- July 1985	3.4											

ARRANGEMENTS IN SUPPORT OF STRUCTURAL ADJUSTMENT IN LDCs IN THE 1980s
(As of June 1989)

Amounts in SDR millions (unless otherwise indicated)

	IMF arrangements				World Bank loans and credits								
	Stand-by/Extended Facility		SAF/ ESAF		Structural adjustment				Sector and other adjustment				
						Amount				Amount			
Country	Period	Amount	Period	Amount	Date of approval	IDA	African Facility [1]	Co-financing [2]	Date of approval	IDA	African Facility [1]	Co-financing [2]	Purpose
Sao Tome and Principe					June 1987	3.1	2.3	African Development Fund (8.5)					
Sierra Leone	Nov. 1979-Nov. 1980	17											
	March 1981-Feb. 1984 [27]	186 [26]											
	Feb. 1984-Feb. 1985	50.2 [28]							June 1984	20.3		IFAD (5.4)	Agriculture
	Nov. 1986-Nov. 1987	23.2	Nov. 1986-Nov. 1989	40.5									
Somalia	Feb. 1980-Feb. 1981	11.5 [29]											
	July 1981-July 1982	43.1											
	July 1982-Jan. 1984	60											
	Feb. 1985-Sept. 1986	22 1											
	June 1987-Feb. 1989	33 2	June 1987-June 1990	30.9					June 1989	54.2			Agriculture
Sudan	May 1979-May 1982 [31]	427 [30]											
	Feb. 1982-Feb. 1983	198 [32]											
	Feb. 1983-March 1984	170							June 1983	46.4			Agriculture rehabilitation
	June 1984-June 1985	90 [33]											

ARRANGEMENTS IN SUPPORT OF STRUCTURAL ADJUSTMENT IN LDCs IN THE 1980s
(As of June 1989)

Amounts in SDR millions (unless otherwise indicated)

Country	IMF arrangements				World Bank loans and credits								
	Stand-by/Extended Facility		SAF/ ESAF		Structural adjustment				Sector and other adjustment				
						Amount				Amount			
Country	Period	Amount	Period	Amount	Date of approval	IDA	African Facility [1]	Co-financing [2]	Date of approval	IDA	African Facility [1]	Co-financing [2]	Purpose
Togo	June 1979- Dec. 1980	15 [34]											
	Feb. 1981- Feb. 1983	47.5 [35]											
	March 1983- April 1984	21.4			May 1983	36.9							
	May 1984- May 1985	19											
	May 1985- May 1986	15.4			May 1985	28.1							
					Aug. 1985		9.7						
	June 1986- April 1988	23.0											
	March 1988- April 1989	13.0	March 1988- March 1991	26.9	Mar. 1988	33.0		ADF (17.3); Japan (20.8)					
			June 1989- June 1992	46.1 (ESAF)									
Uganda	Jan. 1980- Dec. 1980	12.5											
	June 1981- June 1982	112.5											
	Aug. 1982- Aug. 1983	112.5							Feb. 1983	63.5		Italy/DCD (10)	Agriculture rehabilitation
	Sept. 1983- Sept. 1984	95 [36]											
									May 1984	47.2			Reconstruction
			June 1987- June 1990	69.7					Sept. 1987	50.9	18.8	United Kingdom/ODA (16)	Economic recovery
			April 1989- April 1992-	179.3 (ESAF)									

ARRANGEMENTS IN SUPPORT OF STRUCTURAL ADJUSTMENT IN LDCs IN THE 1980s (As of June 1989)

Amounts in SDR millions (unless otherwise indicated)

	IMF arrangements				World Bank loans and credits								
	Stand-by/Extended Facility		SAF/ESAF		Structural adjustment				Sector and other adjustment				
						Amount				Amount			
Country	Period	Amount	Period	Amount	Date of approval	IDA	African Facility [1]	Co-financing [2]	Date of approval	IDA	African Facility [1]	Co-financing [2]	Purpose
Un.-Rep. of Tanzania	Sept.1980-June 1982	179.6 [37]											
	Aug. 1986-Feb. 1988	64.2	Oct. 1987-Oct. 1990	74.9					Nov. 1986	41.3	38.2	F.R. of Germany (17.3); Switzerland (9.2); United Kingdom (7.3)	Multi-sector rehabilitation
									Jan.1988	22.5	(26.0)	Saudi Arabia (4)	Multi-sector rehabilitation

Source: Various issues of: IMF, *Annual Report* and *Survey*; World Bank, *Annual Report* and *World Bank News*.

1 Special Facility for sub-Saharan Africa; amounts in parenthesis are expressed in millions of dollars.
2 Including special joint financing and bilateral support; amounts in millions of dollar equivalents.
3 Extended Facility arrangement, cancelled as of June 1982.
4 SDR 580 mn. not purchased.
5 SDR 2.4 mn. not purchased.
6 SDR 13.5 mn. not purchased.
7 SDR 7.5 mn. not purchased.
8 SDR 3.8 mn. not purchased.
9 SDR 10.2 mn. not purchased.
10 Cancelled as of April 1985.
11 SDR 13.5 mn. not purchased.
12 SDR 6 mn. not purchased.
13 SDR Supported by IMF (SDR 1.88 mn. purchase in first credit tranche).
14 SDR 21.4 mn. not purchased.
15 Extended Facility arrangement.
16 SDR 39 mn. not purchased.
17 Cancelled as of May 1980; SDR 20.9 mn. not purchased.
18 SDR 9.9 mn. not purchased.
19 World Bank loan.
20 Original amount decreased from SDR 100 mn. SDR 24 mn. not purchased.
21 Extended Facility arrangement; cancelled as of August 1986.
22 SDR 6.6 mn. not purchased.
23 SDR 20.8 mn. not purchased.
24 Cancelled as of May 1981.
25 Not purchased.
26 Including an increase of SDR 22.3 mn. in June 1981. SDR 152 not purchased.
27 Extended Facility arrangement; cancelled as of April 1982.
28 SDR 31.2 mn. not purchased.
29 SDR 5.5 mn. not purchased.
30 SDR 5.5 mn. not purchased.
31 Extended Facility arrangement; cancelled as of February 1982; SDR 176 mn. not purchased.
32 SDR 128 mn. not purchased.
33 SDR 70 mn. not purchased.
34 SDR 1.75 mn. not purchased.
35 SDR 40.3 mn. not purchased.
36 SDR 30 mn. not purchased.
37 SDR 154.6 mn. not purchased.

STATISTICAL ANNEX

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Annex table 1

NET FLOW OF MEDIUM-TERM AND LONG-TERM EXPORT AND SUPPLIERS' CREDITS TO DEVELOPING COUNTRIES, 1980-1987

(Millions of dollars)

	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*
Net flow of medium-term and long-term export credits to:								
All developing countries								
Total	15907	11278	9211	7429	5476	871	-2967	-4839
Private	11303	9211	6542	4802	3728	1002	-1858	-2342
Africa								
Total	4641	3640	3277	3009	1070	635	-875	-2719
Private	4345	2934	2429	2499	717	541	-281	-2160
Latin America								
Total	4534	3442	1710	2243	855	-146	-716	-609
Private	3601	2695	894	1284	461	-240	-965	-787
West Asia								
Total	1692	589	1476	456	1622	260	-309	376
Private	1647	385	1324	523	1377	477	-226	362
South and South-East Asia								
Total	3093	3178	2665	1687	1869	198	-651	-2000
Private	2207	2797	1892	585	1196	333	-94	55
Net flow of medium-term and long-term suppliers' credits to:								
All developing countries	1079	1339	1288	2284	1424	722	546	219
Africa	696	1637	573	367	440	-47	-196	771
Latin America	122	76	673	1194	-36	313	223	169
West Asia	191	-127	-124	201	52	50	295	192
South and South-East Asia	77	-239	171	527	968	406	225	-912

Source: Net flow of medium-term and long-term export credits: estimates of the UNCTAD secretariat based on OECD figures. Net flow of medium-term and long-term suppliers' credits: estimates of the UNCTAD secretariat based on World Bank, *World Debt Tables. External Debt of Developing Countries 1988-89 Edition* (Washington, D.C., 1988).

SELECTED INTERNATIONAL INTEREST RATES

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

(Period averages in per cent per annum)

Year/period	*Maturity* 3-month	*Maturity* 6-month		*Maturity* 3-month	*Maturity* 6-month
1975-1978	6.86	7.36	1984	10.94	11.29
1979	12.09	12.15	1985	8.40	8.64
1980	14.19	14.03	1986	6.86	6.85
1981	16.87	16.72	1987	7.18	7.30
1982	13.29	13.60	1988	7.98	8.13
1983	9.72	9.93	1989 (1st quarter)	9.81	10.02

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

(Per cent)

	Maturity: 2 to 5 years			*Maturity: over 5 years*		
Rate as from:	*Group I*	*Group II*	*Group III*	*Group I*	*Group II*	*Group III*
July 1976	7.75	7.25	7.25	8.00	7.75	7.50
July 1980	8.50	8.00	7.50	8.75	8.50	7.75
November 1981	11.00	10.50	10.00	11.25	11.00	10.00
July 1982	12.15	10.85	10.00	12.40	11.35	10.00
October 1983	12.15	10.35	9.50	12.40	10.70	9.50
January 1984	12.15	10.35	9.50	12.40	10.70	9.50
July 1984	13.35	11.55	10.70	13.60	11.90	10.70
January 1985	12.00	10.70	9.85	12.25	11.20	9.85
January 1986	10.95	9.65	8.80	11.20	10.15	8.80
July 1986	9.55	8.25	7.40	9.80	8.75	7.40
January 1988	10.15	8.85	8.00	10.40	9.35	8.00
July 1988 [a]	..	9.15	8.30	..	9.66	8.30

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

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

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

Annex table 3

CLAIMS [a] OF UNITED STATES BANKS ON DEVELOPING COUNTRIES AS A PERCENTAGE OF THEIR CAPITAL, 1978-1988 [b]

Region/country	*1978*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
				All United States banks					
All developing countries [c]	148.1	196.0	186.5	168.7	141.2	114.1	95.7	79.1	64.4
Latin America	93.6	125.0	118.8	106.0	93.5	77.3	68.0	57.8	47.3
Africa	11.4	11.3	10.2	9.2	6.6	4.7	3.2	2.5	1.9
West Asia	15.3	12.0	9.8	10.3	7.8	5.8	4.6	3.1	2.6
South and South East Asia	24.5	43.4	44.5	40.4	31.0	24.2	18.2	14.3	11.3
Europe	3.3	4.3	3.2	2.8	2.3	2.1	1.7	1.4	1.3
15 highly indebted countries [d]	100.7	137.0	130.6	117.0	102.2	84.7	74.2	63.0	51.6
of which: [e]									
Brazil	28.4	30.3	31.1	27.2	26.9	22.4	20.3	17.2	15.1
Mexico	22.7	36.3	34.4	32.1	28.0	23.2	20.3	17.3	13.0
Argentina	5.8	14.0	12.1	11.1	9.1	8.3	7.8	7.1	5.9
Venezuela	15.9	16.8	15.9	13.7	11.4	9.3	7.5	6.2	5.6
Chile	3.2	9.5	8.3	7.5	6.9	5.9	5.4	4.5	3.4
Philippines	5.7	8.3	7.8	7.0	5.6	4.8	4.2	3.4	2.7
Colombia	3.5	5.0	5.2	4.5	3.3	2.4	1.9	1.6	1.5

	1982	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
				Nine largest banks			
All developing countries [c]	288.8	267.9	225.5	184.6	156.0	133.1	109.9
Latin America	176.5	162.9	146.4	124.2	110.1	97.0	86.6
Africa	19.3	17.4	12.2	8.7	6.0	4.8	3.7
West Asia	16.7	18.4	13.7	10.8	8.7	6.3	4.4
South and South East Asia	71.5	64.7	49.4	37.6	28.5	22.7	16.0
Europe	4.8	4.5	3.8	3.3	2.7	2.3	2.2
15 highly indebted countries [d]	196.8	181.6	161.5	137.0	125.5	109.8	91.8
of which: [e]							
Mexico	45.2	43.6	38.9	37.4	34.6	30.6	28.2
Brazil	48.8	43.6	44.2	32.7	28.9	26.0	21.3
Argentina	19.1	18.3	15.1	14.7	13.8	13.0	11.1
Venezuela	26.2	23.8	19.9	16.4	13.4	11.0	9.7
Chile	11.0	10.3	9.8	9.2	8.6	7.6	6.1
Philippines	13.1	11.5	9.6	8.4	7.7	6.2	4.9
Colombia	8.9	7.5	6.0	4.4	3.3	2.7	2.6

(For source and notes see end of table.)

Annex table 3 (concluded)

CLAIMS [a] OF UNITED STATES BANKS ON DEVELOPING COUNTRIES AS A PERCENTAGE OF THEIR CAPITAL, 1978-1988 [b]

Region/country	1982	1983	1984	1985	1986	1987	1988
			15 next largest banks				
All developing countries [c]	193.0	182.9	149.2	108.2	92.5	75.9	60.1
Latin America	124.0	117.0	97.5	71.3	64.4	55.5	39.6
Africa	6.9	7.6	5.7	3.4	2.1	1.6	1.3
West Asia	10.8	9.3	7.4	4.6	3.3	2.0	2.0
South and South East Asia	47.9	46.0	36.1	26.8	20.8	15.3	15.9
Europe	3.4	3.0	2.5	2.1	1.8	1.4	1.3
15 highly indebted countries [d]	136.6	127.7	105.9	78.5	70.4	60.3	43.9
of which: [e]							
Brazil	31.8	31.5	28.2	20.8	18.7	15.5	12.3
Mexico	37.5	35.3	29.3	22.7	20.7	17.7	10.8
Venezuela	15.2	13.4	10.8	7.9	6.6	6.2	5.2
Argentina	13.3	12.7	10.5	7.8	7.5	7.0	4.9
Chile	9.5	8.4	7.4	5.1	5.1	4.4	3.0
Philippines	8.1	6.7	6.0	5.1	4.2	3.5	2.9
Colombia	3.7	5.2	2.5	1.8	1.5	1.4	1.3
			All other reporting banks				
	1982	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
All developing countries [c]	78.2	67.2	55.2	46.8	37.7	28.9	20.6
Latin America	56.8	46.4	39.8	33.4	28.2	21.4	14.2
Africa	2.3	2.0	1.6	1.4	0.8	0.7	0.5
West Asia	2.6	3.1	2.2	1.4	1.2	0.6	1.0
South and South East Asia	15.1	14.5	10.6	9.6	6.8	5.7	4.6
Europe	1.4	1.2	1.0	0.9	0.7	0.5	0.4
15 highly indebted countries [d]	59.4	50.1	42.1	35.6	29.6	22.4	14.8
of which: [e]							
Mexico	21.8	19.5	16.5	13.9	11.7	8.9	5.5
Brazil	12.3	9.5	9.3	8.1	7.1	5.2	3.2
Venezuela	5.5	4.1	3.4	2.8	2.1	1.7	1.7
Argentina	4.3	3.4	2.6	2.2	2.0	1.6	1.1
Chile	4.9	4.2	3.7	3.0	2.3	1.7	1.0
Colombia	1.9	1.6	0.9	0.7	0.6	0.6	0.6
Philippines	1.9	2.6	1.3	1.1	0.9	0.7	0.4

Source: United States Federal Financial Institutions Examination Council, *Statistical Release*, various issues.

a Claims cover cross-border and non-local currency lending. The geographical distribution of claims is adjusted to reflect liabilities due to guarantees by non-residents of regions and countries.

b Situation at end-December.

c Excluding offshore banking countries overseas: Bahamas, Bahrain, Bermuda, Hong Kong, Lebanon, Liberia, Macao, Netherlands Antilles, Panama and Singapore.

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

e Ranked by the size of exposure in December 1988.

Annex table 4

INDICES OF MARKET PRICES [a] OF PRINCIPAL COMMODITIES EXPORTED BY DEVELOPING COUNTRIES

(1979-1981 = 100)

Commodity group/ commodity [b]	Annual average			Quarterly average				
				1988				1989
	1986	1987	1988	I	II	III	IV	I
Food	62	66	83	76	82	88	84	83
Wheat	67	67	85	75	80	90	96	101
Maize	62	60	75	65	67	88	77	81
Rice	50	55	72	72	72	73	72	67
Sugar	33	37	55	48	51	64	59	58
Beef	77	88	93	95	90	92	95	91
Bananas	109	102	122	117	145	111	117	127
Pepper	286	280	223	275	264	196	158	180
Soybean meal	74	81	107	89	107	116	114	111
Fish meal	71	84	119	105	122	129	122	101
Tropical beverages	110	72	73	76	73	69	73	77
Coffee	123	69	75	75	75	72	76	82
Cocoa	78	75	60	68	63	54	55	54
Tea	90	80	83	89	81	72	89	86
Vegetables oilseeds and oils [c]	51	60	78	72	77	86	78	76
Soybeans	71	73	103	87	103	117	106	106
Coconut oil	40	60	76	72	74	81	76	73
Palm oil	43	57	73	70	73	77	70	65
Agricultural raw materials	77	96	104	104	110	103	103	104
Cotton	71	89	95	94	92	86	98	102
Wool	80	109	151	139	162	155	150	141
Sisal	80	80	84	83	81	84	88	90
Jute	68	89	93	96	90	90	95	93
Rubber	63	79	92	88	103	96	80	86
Hides and skins	68	75	102	99	104	104	100	102
Tropical timber	95	116	123	124	126	118	126	123
Minerals and metals	71	82	110	103	112	105	122	122
Phosphate rock	81	72	83	83	83	83	83	97
Manganese ore	88	81	105	87	111	112	112	158
Iron ore	89	91	92	95	92	87	93	94
Aluminium	75	102	165	144	196	166	154	135
Copper	70	91	132	125	123	116	165	165
Lead	43	63	69	70	70	65	73	67
Zinc	91	102	160	117	154	165	203	240
Tin	37	45	47	45	45	48	48	52
Tungsten	33	34	39	38	40	38	41	42
Combined index	79	76	90	87	91	89	92	93

Source: UNCTAD, *Monthly Commodity Price Bulletin*, April 1989.

a Free market prices in terms of current dollars.

b For commodity price descriptions and weight in group totals, see source.

c This group also includes soybean oil, sunflower oil, groundnuts and oil, copra, palm kernels and oil, and linseed oil.

Annex table 5

GROWTH AND INFLATION IN SELECTED DEVELOPING COUNTRIES

	Real GDP growth per capita			*Inflation: increase in consumer prices*				
	Per cent per annum		*Instability index [a] (1971-1980=1)*	*Per cent per annum*			*Instability index [a] (1973-1982=1)*	
	1971-1980	*1981-1987*	*1981-1987*	*1966-1972*	*1973-1982*	*1983-1988*	*1966-1972*	*1983-1988*
Algeria	4.4	-3.3	0.92	4.3 [b]	10.0	8.4	0.46 [b]	0.62
Argentina	1.3	-2.4	1.61	26.4	140.8	311.4	0.15	2.05
Bolivia	2.0	-4.5	0.84	5.7	31.3	455.6	0.08	114.60
Brazil	6.0	0.5	1.54	23.3	54.7	237.8	0.30	6.67
Chile	0.8	0.1	1.00	31.4	105.1	21.8	0.11	0.03
Colombia	3.1	1.1	1.00	10.4	24.2	21.6	1.10	0.95
Costa Rica	2.9	-0.5	2.00	2.9	21.1	18.0	0.06	0.29
Côte d'Ivoire	2.7	-5.5	2.14	3.6	13.9	4.8 [c]	0.63	0.32 [c]
Ecuador	5.6	-1.7	0.65	5.9	14.3	35.9	0.44	3.47
Egypt	3.7	-0.1	1.35	2.9	11.4	17.7	0.63	0.90
Ghana	-1.2	-2.2	0.59	5.9	51.7	41.5	0.19	1.03
Indonesia	5.8	1.6	1.95	92.8	18.7	8.3	0.53	0.26
Jamaica	-1.7	-0.7	0.68	5.1	19.0	15.6	0.20	0.90
Kenya	1.9	0.2	0.98	2.3	14.3	8.6	0.50	0.80
Malawi	1.8	-1.4	0.73	5.5 [d]	10.4	19.5	0.71 [d]	1.73
Malaysia	5.0	1.8	1.15	1.7	7.0	1.9	0.40	0.33
Mexico	3.3	-0.7	2.20	3.9	23.9	91.1	0.09	2.04
Morocco	2.6	0.6	1.00	1.5	10.1	6.6	0.59	1.03
Nigeria	1.0	-7.2	1.03	6.6	16.4	21.1	0.84	2.10
Peru	0.9	-0.4	2.41	8.9	42.8	105.6 [c]	0.20	1.36 [c]
Philippines	3.5	-2.1	2.93	7.8	14.0	15.0	0.64	2.18
Rep. of Korea	6.4	7.1	0.53	12.5	16.6	3.5	0.22	0.20
Sudan	-1.0	-3.5	1.60	4.6	20.7	30.9 [c]	0.99	1.08
Thailand	4.3	3.6	0.63	2.6	11.0	2.5	0.28	0.16
Tunisia	4.7	0.4	0.74	3.2	7.6	7.4	0.54	0.39
United Republic of Tanzania	1.5	-3.5	0.54	9.8	18.2	31.7	0.57	0.39
Uruguay	2.4	-1.3	2.00	56.3	57.5	62.8	1.74	0.42
Venezuela	0.2	-2.2	1.16	2.0	10.4	15.9	0.21	1.77
Zaire	-1.5	-1.6	0.50	19.4	47.0	117.3	0.61	13.42
Median	2.6	-0.7	1.11	5.7	18.2	19.5	0.44	1.04
Mean [e]	2.5	-1.0	1.13	12.7	29.1	60.0	0.29	8.72
Dispersion [f]	0.9	2.8		1.5	1.0	1.7		
Memo items:								
Developed market economies	2.7	2.0	0.59	4.3	9.4	3.7	0.47	0.52
World [g]	1.7	0.9	0.60	5.2	12.5	11.1	0.33	1.16

Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* and various national sources.

a Standard deviation of annual rates of change.
b 1970-1972.
c 1983-1987.
d 1969-1972.
e Unweighted arithmetic average.
f Coefficient of variation of average annual rates across countries.
g Countries members of IMF.

Annex table 6

CHANGES IN RESOURCE AVAILABILITY FROM 1980-1981 TO 1986-1987 IN SELECTED DEVELOPING COUNTRIES

	Percentage change per capita			*Swing in resource transfer*
	GDP	*Fixed investment*	*Domestic absorption* [a]	*(Per cent of GDP)* [b]
Algeria	-32.0	-6.6	-14.9	-7.1
Argentina	-4.2	-52.5	-17.8	-5.7
Bolivia	-25.4	-70.6	-32.0	1.1
Brazil	5.8	-14.9	2.2	-3.9
Chile	-4.9	-20.3	-19.8	-12.6
Colombia	5.9	2.3	1.4	-7.9
Costa Rica	-8.2	-13.1	-5.0	-8.2
Côte d'Ivoire	-26.5	-64.6	-28.3	-20.2
Ecuador	-7.7	-34.5	-24.3	-5.9
Egypt	-3.5	6.9	4.5	-8.1
Ghana	-11.3	-12.3	-18.1	-0.6
Indonesia	5.2	-6.5	-1.7	-6.9
Jamaica	-7.0	-15.2	-5.2	-10.3
Kenya	2.7	-32.9	-16.6	-9.6
Malawi	-3.9	-55.7	-14.0	-7.7
Malaysia	9.9	-20.7	-36.0	-36.5
Mexico	-9.4	-43.1	-27.5	-13.4
Morocco	7.3	-20.7	0.8	-6.0
Nigeria	-38.2	-65.3	-42.6	-17.1
Peru	-5.8	-26.6	-11.6	-3.8
Philippines	-15.4	-59.5	-22.9	-11.1
Republic of Korea	50.5	69.6	40.0	-11.6
Sudan	-23.3	-14.1	-21.4	-6.5
Thailand	17.4	4.5	6.1	-12.8
Tunisia	-0.8	-29.8	-10.4	-10.0
United Rep. of Tanzania	-14.9	-42.6	-8.0	7.5
Uruguay	-10.1	-56.7	-18.5	-10.5
Venezuela	-13.1	-40.2	-33.0	-13.7
Zaire	-9.3	15.0	-21.8	-5.9

Source: UNCTAD secretariat calculations, based on World Bank, *World Debt Tables. External Debt of Developing Countries, 1988-89 Edition*, Washington, D.C., 1988; and UNCTAD, *Handbook of International Trade and Development Statistics, 1988.*

a Adjusted for changes in the terms of trade.

b Change in the resource balance plus terms of trade losses (gains) as a percentage of GDP in 1980-1981.

Annex table 7

REAL EFFECTIVE EXCHANGE RATES IN SELECTED DEVELOPING COUNTRIES, 1980-1987 [a]

(1980 = 100)

Country	1981	1982	1983	1984	1985	1986	1987	Standard deviation of annual percentage change
Argentina [b]	92	28	30	33	29	36	36	28
Bangladesh [b]	91	82	80	83	84	89	93	6
Bolivia	137	126	125	163	280	82	79	42
Brazil	121	128	104	104	100	94	95	11
Chile	118	107	87	85	69	58	54	12
Colombia	108	115	114	105	91	68	61	11
Costa Rica	63	72	83	82	81	73	66	16
Côte d'Ivoire	86	78	75	72	72	84	92	10
Ecuador	112	109	104	86	89	72	55	12
Ghana	222	278	187	72	52	30	23	58
India [b]	95	91	94	89	86	95	98	6
Indonesia [b]	102	105	84	80	78	74	61	8
Jamaica	107	111	104	73	64	69	68	12
Kenya	97	101	95	102	101	88	79	7
Malaysia	100	107	112	116	110	93	88	7
Mauritius [b]	90	81	78	70	67	80	82	10
Mexico	114	82	72	84	86	60	56	17
Morocco	91	90	84	79	74	71	68	2
Nigeria	111	114	134	185	166	91	29	34
Pakistan	113	104	100	102	96	79	70	10
Peru [b]	109	107	95	91	76	110	165	25
Philippines	103	107	90	89	98	76	70	11
Rep. of Korea	104	107	103	101	95	81	80	6
Senegal [b]	75	72	68	65	72	102	110	19
Sierra Leone	115	143	174	215	174	140	108	21
Singapore [b]	101	101	102	102	99	102	103	2
Sri Lanka [b]	98	95	94	98	98	110	109	5
Thailand	103	106	109	107	95	85	80	6
Turkey	98	84	81	77	78	65	62	6
Uruguay	112	117	72	69	67	66	64	15
Venezuela	112	121	110	94	90	75	54	13
Yugoslavia	90	81	61	56	55	76	84	19

Source: IMF, *International Financial Statistics.*

a Inflation-corrected trade-weighted index of units of foreign currency per unit of domestic currency. Hence an index below 100 indicates a depreciation of the domestic currency.

b Real exchange rate vis-à-vis the United States dollar only (nominal exchange rate, corrected by an index of domestic consumer prices relative to United States wholesale prices).

Annex table 8

EXPORTS AND IMPORTS IN SELECTED DEVELOPING COUNTRIES AS A SHARE OF GDP, 1979-1981 AND 1985-1987

(Percentage)

	Exports/GDP		*Imports/GDP*	
Country	*1979-1981*	*1985-1987*	*1979-1981*	*1985-1987*
Argentina	7.3	9.1	8.0	5.1
Bangladesh	5.8	6.3	16.5	17.0
Bolivia	22.7	21.7	20.5	18.4
Brazil	9.3	11.5	11.0	6.9
Chile	21.3	26.5	27.1	19.0
Colombia	15.4	17.0	15.1	12.6
Costa Rica	28.1	27.0	34.4	32.2
Côte d'Ivoire	33.0	32.1	38.0	22.9
Ecuador	25.8	29.0	23.9	18.0
Ghana	8.8	7.7	8.6	7.0
India	6.4	6.2	10.5	9.8
Indonesia	30.5	21.4	21.9	20.1
Jamaica	50.5	70.5	52.7	78.8
Kenya	27.8	27.6	36.1	23.2
Malaysia	56.8	71.3	53.0	52.4
Mauritius	47.3	56.5	58.4	57.0
Mexico	10.9	16.4	12.7	7.1
Morocco	18.5	19.7	31.3	25.2
Nigeria	22.9	12.1	17.7	8.1
Pakistan	12.4	14.5	22.4	17.6
Peru	22.8	20.3	21.7	15.4
Philippines	19.6	25.4	25.6	22.4
Rep. of Korea	33.2	42.4	41.4	39.7
Senegal	29.8	25.2	45.5	34.6
Sierra Leone	20.5	14.6	34.5	12.8
Sri Lanka	32.9	36.6	50.5	56.5
Thailand	24.2	30.1	30.1	26.7
Turkey	8.0	20.2	14.6	23.9
Uruguay	15.4	20.4	20.5	16.4
Venezuela	29.7	29.9	22.4	20.6
Yugoslavia	18.0	16.3	22.7	14.8

Source: UNCTAD secretariat calculations, based on data (in constant 1980 prices) in World Bank, *World Tables*.

UNITED STAT

POTENTIAL PROTECTIONIST PRESSURES, BY SECTOR, IN THE 1990s, AGAINST IMPORTS OF MANUFACTURES FROM DEVELOPING COUNTRIES

I. High pressures for protection

ISIC	Description
Sectors with high TCRs in 1985	
3220	Manufacture of wearing apparel (excluding footwear)
3320	Manufacture of furniture (excluding primarily metal)
3819	Fabrication of metal products (excluding machinery & equipment)
3233	Manufacture products of leather (excluding footwear)
3113	Canning & preserving fruits & vegetables
3559	Manufacture of rubber products n.e.c.
3551	Tyre & tube industries
3620	Glass & glass products ind.
3212	Manufacture of made-up textile goods
3214	Fabrication of tapestry & carpets
3692	Cement, lime and plaster
3813	Structural metal products
3902	Musical instruments
Sectors with low TCRs in 1985	
3240	Manufacture of footwear (excluding rubber & plastic)
3909	Manufacturing industries n.e.c.
3903	Sporting & athletic goods
3853	Watches and clocks
3833	Electrical appliances & housewares
3610	Pottery, china & earthware
3319	Manufacture of wood & cork prod.n.e.c.
3844	Motorcycles & bycicles

II. Standstill or high pressures for protection

ISIC	Description
Sectors with high TCRs in 1985	
3710	Iron & steel basic industries
3211	Spinning, weaving & finishing textiles
3118	Sugar factories & refineries
3111	Slaughtering, preparing or preserving meat
3219	Manufacture of textiles n.e.c.
3215	Cordage, rope & twine industries
3213	Knitting mills
3822	Agricultural machinery & equipment
3112	Manufacture of dairy products
3842	Railroad equipment
Sectors with low TCRs in 1985	
3116	Grain mill products
3115	Manufacture of vegetable or animal oils, fats

III. Standstill or low pressures for protection

ISIC	Description
Sectors with high TCRs in 1985	
3829	Machinery & equipment (excluding electrical) n.e.c.
3511	Basic industrial chemicals (excluding fertilizers)
3841	Shipbuilding & repairing
3513	Synthetic resins & plastic materials (excluding glass)
3114	Canning, preparing, preserving fish & crustacean
3691	Structural clay products
Sectors with low TCRs in 1985	
3560	Plastic products n.e.c.
3839	Electrical appliances & supplies n.e.c.
3831	Electrical industrial machinery & appliances
3901	Jewelery & related articles
3811	Cutlery, handtools & general hardware
3119	Manufacture of cocoa, chocolate and sugar confectionery
3852	Photographic & optical goods
3851	Professional scientific, measuring & control equipment n.e.c.
3823	Metal & woodworking machinery
3845	Aircraft
3824	Special industrial machinery and equipment (ex. 3823)
3812	Furniture & fixtures primarily of metal
3512	Fertilizers & pesticides

IV. Low pressures for protection

ISIC	Description
Sectors with high TCRs in 1985	
3832	Radio, tv, telecommunications equipment & apparatus
3529	Chemical products n.e.c.
Sectors with low TCRs in 1985	
3530	Petroleum refineries
3825	Office, computing & accounting machinery
3843	Motor vehicles
3720	Non-ferrous metal basic industries
3311	Sawmills, planing & other wood mills
3121	Manufacture of food products n.e.c.
3420	Printing, publishing & allied industries
3522	Drugs and medicines
3540	Miscellaneous products of petrochemical
3411	Manufacture of pulp, paper & paperboard
3231	Tanneries & leather finishing
3821	Engines & turbines

Source: UNCTAD secretariat, see part one, chap. III, sect. C.

Annex table 10

EUROPEAN ECONOMIC COMMUNITY

POTENTIAL PROTECTIONIST PRESSURES, BY SECTOR, IN THE 1990s, AGAINST IMPORTS OF MANUFACTURES FROM DEVELOPING COUNTRIES

I. High pressures for protection

ISIC	Description
	Sectors with high TCRs in 1985
3220	Manufacture of wearing apparel (excluding footwear)
3116	Grain mill products
3115	Manuf. of veget.and animal fats
3211	Spinning, weaving & finishing of textiles
3113	Canning & preserving fruits and vegetables
3901	Jewelry & related articles
3240	Manufacture of footwear (excluding rubber, plastic)
3233	Manufacture prods. leather (excluding footwear, apparel)
3841	Shipbuilding & repairing
3114	Canning, preparing & preserving fish and crustaceans
3839	Electrical apparatus & supplies n.e.c.
3212	Manufacture of made-up textile goods (excluding wearing apparel
3551	Tyres and tube industries
	* Sectors with low TCRs in 1985
3909	Manufacturing industries n.e.c.
3823	Metal & woodworking machinery

III. Standstill or low pressures for protection

ISIC	Description
	Sectors with high TCRs in 1985
3530	Petroleum refineries
3832	Radio, tv, telecommunications equipment & apparatus
3118	Sugar factories & refineries
3829	Machinery & equipment (excluding electrical) n.e.c.
3610	Pottery, china & earthware
3215	Cordage, rope & twine industries
3122	Manufacture of prepared animal feeds
	* Sectors with low TCRs in 1985
3511	Basic industrial chemicals
3825	Office, computing & accounting machinery
3845	Aircraft
3831	Electrical industrial machinery and apparatus
3513	Synthetic resines, plastic mat., man-made fibres (excl. glass)
3851	Professional, scientific, measuring and control equipment
3512	Fertilizers and pesticides
3811	Cutlery, handtools & general hardware
3903	Sporting & athletic goods
3821	Engines and turbines

II. Standstill or high pressures for protection

ISIC	Description
	Sectors with high TCRs in 1985
3311	Sawmills, planing & other woodmills
3111	Slaughtering, preparing & preserving meat
3710	Iron & steel basic industries
3214	Fabrication of tapestry and carpets
3819	Fabrication of metal products (excl. machinery & equipment)
3420	Printing & publishing & allied industries
3213	Knitting mills
3131	Distilling, rectifying & blending spirits
3132	Wine industries
3117	Manufacture of bakery products
3112	Manufacture of dairy products
3134	Soft drinks and carbonated waters industries.
	* Sectors with low TCRs in 1985
3320	Manufacture of furniture & fixtures (excl. primarily metal)

IV. Low pressures for protection

ISIC	Description
	Sectors with high TCRs in 1985
3720	Non-ferrous metals basic industries
3843	Motor vehicles
3560	Plastic products n.e.c.
3121	Manufacture of food products n.e.c.
3824	Special industrial machinery & equipment (ex.3823)
	* Sectors with low TCRs in 1985
3231	Tanneries and leather finishing
3411	Manufacture of pulp, paper and paperboard
3119	Manufacture of cocoa, chocolate & sugar confectionery
3852	Photographic & optical goods
3529	Chemical products n.e.c.
3522	Drugs and medicines
3559	Manufacture of rubber products n.e.c.

Source: UNCTAD secretariat, see part one, chap. III, sect. C.

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