UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1992

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of the
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Contents

Page

Chapter III

Chapter IV

Part Two

FINANCE AND ECONOMIC EXPANSION

Chapter I

Page

Part Three

POLICY REFORM IN DEVELOPING COUNTRIES

Page

Chapter II

List of text tables

List of boxes and charts

Explanatory notes

Classification by country or commodity group

The classification of countries used in this Report generally follows that of the UNCTAD *Handbook of International Trade and Development Statistics 1991.*[1] It has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

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

Generally speaking, sub-groupings within geographical regions and analytical groupings (e.g. Major petroleum exporters, Major exporters of manufactures and Least developed countries (LDCs)) are those used in the UNCTAD *Handbook of International Trade and Development Statistics 1991.* References to "Latin America" in the text or tables include the Caribbean countries.

The term "economies in transition" or similar terminology refers to the countries of Central and Eastern Europe (Albania, Bulgaria, Czechoslovakia, Hungary, Poland and Romania) and the former USSR (comprising the Baltic republics, the Commonwealth of Independent States (CIS) and Georgia).

Unless otherwise stated, the classification by commodity group used in this Report follows generally that employed in the *Handbook of International Trade and Development Statistics 1991.*

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 1991* refers to *Trade and Development Report, 1991* (United Nations publication, Sales No. E.91.II.D.15).

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.

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

A dash (-) indicates that the amount is nil or negligible.

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

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

1 United Nations publication, Sales No. E/F.91.II.D.11.

Abbreviations

ADR	American Depository Receipt
AIDS	acquired immune deficiency syndrome
ASEAN	Association of South-East Asian Nations
BIS	Bank for International Settlements
CD	certificate of deposit
CEPAL	Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe)
CIS	Commonwealth of Independent States
c.i.f.	cost, insurance and freight
CMEA	Council for Mutual Economic Assistance
DMEC	developed market-economy country
ECA	Economic Commission for Africa
ECAs	export credit agencies
ECE	Economic Commission for Europe
ECGD	Export Credits Guarantee Department (United Kingdom)
ECLAC	Economic Commission for Latin America and the Caribbean
ECU	European currency unit
EEC	European Economic Community
EFTA	European Free Trade Association
EMS	European Monetary System
ESAF	Enhanced Structural Adjustment Facility (IMF)
ESCAP	Economic and Social Commission for Asia and the Pacific
ESCWA	Economic and Social Commission for Western Asia
EXIM	Export-Import Bank (United States)
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
f.o.b.	free on board
FSLIC	Federal Savings and Loan Insurance Corporation
FY	fiscal year
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	generalized system of preferences
IDA	International Development Association
ILO	International Labour Organisation
IMF	International Monetary Fund
LDC	least developed country
LIBOR	London Inter-Bank Offered Rate
mb/d	million barrels per day
MERCOSUR	Southern Cone Common Market
NPV	net present value

NAFTA	North American Free Trade Agreement (Canada-United States-Mexico)
NMP	net material product
NTB	non-tariff barrier
NTM	non-tariff measure
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PE	public enterprise
QR	quantitative restriction
R and D	research and development
S&Ls	Savings and Loan Associations
SDR	special drawing right
SIGMA	System for Interlinked Global Modelling and Analysis
SITC	Standard International Trade Classification (revision 1)
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNU	United Nations University
VAT	value added tax
VER	voluntary export restraint
WHO	World Health Organization
WIDER	World Institute for Development Economics Research

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OVERVIEW
by the
Secretary-General of UNCTAD

The world economy has been suffering its most severe recession since the Second World War. Production has fallen in the United States and flattened in Japan. Western Europe is stagnating: the boost provided by German unification has petered out, while high interest rates remain. Growth has picked up in Latin America, but remains slow there and in other developing regions, other than parts of Asia. Central and Eastern Europe are suffering a precipitous fall in living standards; the transition process is proving much more painful than anticipated. Overall, signs of improvement are scant.

The unexpected severity of the global recession reflects the presence of debt deflation in a number of industrialized economies - a process not experienced since the Great Depression. Household and business expenditures are being reduced, the flow of credit is shrinking, and confidence is being eroded. Econometric forecasts, by taking little or no account of the domestic debt overhang, have tended to paint an over-optimistic picture.

A private sector weighed down by debt and high long-term interest rates will not generate stability or growth unaided. Governments must resume their responsibilities, by acting to foster a return to financial stability and to stimulate the level of economic activity. No single country can solve the macroeconomic problem on its own: the situation demands improved coordination.

Without a swift policy response, cumulative forces may be unleashed, damaging all countries. World economic recovery is especially important for developing countries, for without sustained export growth further bouts of instability can be expected, including an intensification of threats to democratic institutions in countries where these have been established or re-established only recently.

Many developing countries, as well as countries in transition, have unilaterally undertaken a fundamental change of direction towards greater openness in trade. For them to succeed in pursuing outward-oriented strategies, developed countries need to follow suit by relaxing their own import restrictions. A successful conclusion to the Uruguay Round is therefore highly important.

Improved development performance will also require further policy effort at home. The need for reforms is inescapable, but these should be introduced thoughtfully, on the basis of fact, not fiction.

Patterns of economic performance

The disparate experiences of countries during the recent past reflects in large part circumstances particular to them. In Central and Eastern Europe (including the former USSR) the difficulties inherent in introducing viable market and State mechanisms *ab initio* to replace the now defunct system of command and control have taken a severe toll. This manifests itself in different ways from country to country, but the general picture is one of sharp declines in industrial output, shortfalls in agricultural production, disruption of trade flows, external financial strains, and, especially in the former Soviet Union, fiscal imbalances. Some countries in this region are still at a relatively early stage in the process of reform, whereas others are fully engaged in the process of transformation to a market economy. For both groups further drops in output are in the offing, though for a few countries prospects appear to be brighter and, hopefully, reform will soon produce some positive economic growth.

In a number of Latin American countries, inflation has come under greater control, creditworthiness continues to improve, and external finance, including foreign direct investment, is increasingly available. This has produced for the first time in many years a positive net transfer of resources into the region. However, these resources have only partially been translated into new investments; they have mostly been directed to short-term uses and portfolio investment. In some of the largest economies of the region the investment/GDP ratio is still very depressed.

African countries continue to labour under the difficulties of putting in place and maintaining reforms in the face of poor export earnings. Where efforts at reform have been pursued rigorously and external conditions have been favourable, growth performance has improved. But commodity prices declined by 11 per cent in 1991, and for two commodities that are important for Africa - coffee and cocoa - prices are currently at their lowest level in 17 years. The result has been a 5 per cent contraction in the value of exports and a squeezing of the external accounts, with all the usual consequences for growth. Besides, a number of countries are suffering from severe drought.

In West Asia, the aftermath of the war in the Persian Gulf was the determining factor. In those countries with ample financial resources, reconstruction efforts have led to dynamic expansion, whereas in those with financial constraints, the pace of recovery from the consequences of the conflict has been much slower. In the rest of developing Asia, the quality of domestic policy has been a key factor. Economies that have pursued growth-oriented policies for some time have continued to do well, although their very success is sometimes generating bottlenecks, particularly in economic and social infrastructure, that is slowing the pace of advance. Other countries have registered both weak effort in the area of policy-making and poor growth performance.

A notable feature of the recent past has been the ability of some developing countries to accelerate growth or maintain relatively high growth rates in the face of recession in the industrial world. This resilience has helped shore up world activity: the volume of imports of Latin American and Asian developing countries rose by 10 per cent and 15 per cent, respectively, at a time when imports of industrial countries were growing by only 1.5 per cent. However, these countries will not be able swim against the tide for long. Especially in Latin America, weakness in export markets risks cutting off the positive dynamics currently prevailing, and the sluggishness of commodity prices remains a serious drag on a large number of countries. Greater buoyancy at the centre - i.e. the industrial countries - will thus be critical to the world economy as a whole.

The undercurrent of debt deflation

If the 1980s were dominated by the debt crisis in the developing world, the 1990s have started under the shadow of one in the developed.

At the same time that debtor developing countries started to work their way out of their difficulties, firms, households, financial institutions, and Governments in a number of developed economies began to increase their indebtedness to record levels. In the United States, government debt increased as taxes were cut in the hope that increased growth rates would lift total government revenues; takeover bids for firms were made with borrowed funds in the expectation that the capital gains would be more than enough to pay off the loans; households stepped up their borrowing, thinking that incomes would rise sufficiently to allow them to repay; and savings and loans institutions, followed by banks, borrowed funds in order to invest in higher yield (and more risky) assets to offset the costs of financial market deregulation. The premise was that the steady expansion and asset price inflation of the 1980s would persist and continue to sustain a rising burden of debt.

Thus, when the expansion came to a halt in mid-1989, all sectors found themselves overcommitted. The cyclical fall-off in demand was therefore aggravated not only by the war in the Persian Gulf, but also by a shift of behaviour away from accumulating debt towards repaying it. This change was especially marked in the United States, the United Kingdom, and a number of smaller developed countries. The slowdown spread to continental Western Europe as Germany curtailed government expenditures related to the reunification of the country. It also hit Japan, which encountered problems of unprecedented gravity in the financial sector.

Behind the difficulties faced by many countries was a surge in bank lending for the purchase of commercial property. In the United States and the United Kingdom, for instance, this had gone so far as to cause a massive oversupply, followed by a sharp fall in prices. In Japan, where property is often used as collateral for stock market operations, property and stock prices had been lifted in a speculative bubble. Monetary policy was then tightened, triggering falls in asset prices steep enough to threaten the solvency of both the investment companies and the banks that had funded them. In all three countries, banks have experienced losses on their property loans and are sharply restricting lending for this purpose. Firms unable to find finance as a result are being forced to sell, driving down the market prices of the assets held by the banks still further. Households are also under pressure: much of their borrowing from banks has been backed by their primary residence, and their incomes have risen little or have even declined.

Typically recessions, by reducing profits, diminish the main source of finance for business investment. For expenditures to recover, banks must be willing and able to extend loans. Otherwise, the recovery may be aborted and the economy will at best move in fits and starts, with each expansion bumping up against a financial constraint.

The imminent introduction of the BIS capital adequacy requirements (which oblige many banks to raise the ratio of bank capital to risk-weighted assets) and increased pressure from bank supervisors have provided further impetus to banks in the United States and elsewhere to reduce the pace of their lending and to change the composition of their assets in favour of those with lower risk weighting. As banks have become altogether more prudent, they have sharply reduced the funds available to firms to expand out of the recession.

This process corresponds closely to a "debt deflation" - a process whereby a decline in banks' willingness and ability to lend forces debtors to curtail operations or resort to distress sales of inventories or other assets, which in turn lowers incomes and asset prices further and thus prolongs the recession. The present recession is the first in the postwar period in which debt deflation has played a crucial role.

The global economy thus appears to be at an impasse, with the private sector in most major economies unable to take the lead in reigniting growth. This is precisely the context in which it is most apt to adopt Keynesian policies of raising government spending in order to stimulate private consumption and investment demand, and thus make fuller use of productive capacities. Counter-cyclical fiscal policies have been used with positive results on countless occasions in the past. Nevertheless, because budget deficits have been high, fiscal expansion is being resisted even where it is most needed, that is in countries where the debt-deflationary undercurrent runs strongest. However, the cyclical component of the government deficit is larger than the structural. By promoting income growth, higher expenditures would probably reduce rather than increase deficits.

For recovery to be sustained, long-term interest rates need to fall and to be kept permanently low. Long-term rates are high even in the United States - roughly double historical averages for sustained expansion - despite repeated cuts in short-term interest rates, the reason being fears that the Federal Reserve Board's policy will lead to an increase in short-term rates once recovery gets under way.

Action is also needed to bring short-term interest rates in Western Europe down nearer the levels currently prevailing in the United States and Japan. Otherwise, the dollar or the yen, or both, could come under intense pressure and depress stock markets, particularly if expectations of recovery in the United States continue to be frustrated and if there is a continued slowdown in Japan. Besides, upward pressure on the deutche mark relative to the dollar and the yen could cause the German currency to strengthen against those of other members of the European Monetary System, forcing the latter to tighten monetary policy so as to prevent strains on the European Exchange Rate Mechanism becoming intolerable.

New policy initiatives are urgently required:

- Developed countries should increase demand and activity at home by increasing spending on social overheads and infrastructure - areas which have been badly neglected, particularly in the three largest economies suffering from debt deflation. Such spending would also improve productivity and contribute to structural improvement in economic peformance;
- They should enlarge their export markets by substantially strengthening the flow of long-term capital to developing countries and countries in transition, and by renewing SDR allocations. This would also accelerate growth in those countries;
- Now that price pressures are under control, the Federal Reserve Board should return to a policy of targeting the rate of interest, i.e. the policy it pursued before changing its procedures in 1979 to counteract a virulent inflation;
- Germany should lead the way in bringing down European rates to provide its partners with more scope for expansionary action.

Unless measures along these lines are taken, the global economy will continue to be at risk from the strong undercurrent of debt deflation, and suffer continued stagnation. Stronger global growth is needed if the developing countries are to achieve sustained expansion. 1980s thinking should not be allowed to stand in the way by producing another "lost decade".

International capital markets and debt

The external financing of developing countries has continued to be characterized by sharp contrasts.

Several countries of South and South-East Asia once again increased their borrowing in the form of both bank loans and bond issues. The recent revival of bond lending to certain Latin American countries also continued, now accompanied by substantially increased foreign investment. Argentina, one of the countries receiving increased inflows of external financing, reached agreement on a restructuring of its debts to its creditor banks only in early 1992, while for Brazil, another such country, a preliminary agreement was attained still more recently.

Yet it would be premature to conclude that the debt problems and external financial stringency of developing countries have been resolved. The increased bond lending to Latin American countries was not accompanied by a rise in bank lending. Moreover, the terms of the bond issues were onerous: they carried relatively high yield spreads over benchmark interest rates and were enhanced by techniques designed to reduce risks for investors. Although the turn-about in financial transfers to Latin America in 1991 was substantial, a large part was attracted by high interest rates, currency appreciation or both. These are forces which can discourage investment and damage industry by reducing competitiveness. Moreover, the recipient countries are highly vulnerable to sudden reversals of market sentiment. The surge in inflows can also create problems for macroeconomic management: to prevent inflation, the impact on the money supply needs to be sterilized by selling government securities, but this can lead to a mushrooming of domestic public debt at very high interest rates.

Furthermore, for the majority of borrowers from the developing world, access to external financing remains difficult and its costs high. Net lending by banks was negative in 1991 to all major developing regions other than South and South-East Asia, and preliminary estimates indicate a continuation of the negative net flows of medium- and long-term export credits to developing countries observed in 1990. Several developing countries are currently engaged in negotiations for the restructuring of their debts to banks. Moreover, in 1991, unfavourable changes in the costs and other terms of financing and payments arrangements for developing countries' imports outnumbered favourable ones. Adverse perceptions of creditworthiness are evident, for example, in the terms on official insurance for financing and payments arrangements available from the export credit agencies of two OECD countries.

Such perceptions have also depressed bank lending to the countries of Central and Eastern Europe, though this was partly offset by greater reliance on official or officially guaranteed financing. However, experience in this region was not uniform, and Hungary, for example, continued to be able to raise substantial sums through bond issues.

* * *

As regards official bilateral debt, the recent adoption by most Paris Club creditors of the "enhanced" Toronto terms for the poorest countries is welcome. This treatment, however, represents a substantial dilution of the proposed Trinidad terms. The latter are the right benchmark for debt reduction, though they would need to be buttressed by additional country-specific measures. The debt reduction that will result from the enhanced Toronto terms will be significantly smaller, and would eventually apply to the entire stock of eligible debt only after another series of repeated reschedulings. For many of the beneficiaries, debt burdens will still remain unsustainable. There is therefore need to further review the scale and modalities of debt reduction for the poorest countries, in order to remove their debt overhang once and for all.

* * *

The rapid globalization of finance that has occurred in the last two decades, spurred on by liberalization and deregulation, has given rise to the need for a framework for governance of international banking. Recognition of this need has been reflected in the efforts of the Basle Committee on Banking Supervision to strengthen and harmonize prudential supervision. One important outcome of its work was the 1988 agreement to establish a target level for banks' capital in relation to a risk-weighted sum of their assets and off-balance-sheet exposures. Others include statements on the respective responsibilities of supervisors in the parent and host countries of international banks, and appropriate prudential guidelines for different banking risks and money laundering. The Basle Committee has had an impact not only on Governments' regulation of banking but also on the internal controls employed by banks in their day-to-day business.

Nevertheless, various events, most recently the failure of the Bank of Credit and Commerce International (BCCI), have pointed to continuing weaknesses in the regulation of banks in some centres and to the impediments posed to supervisory cooperation by laws on banking secrecy. As a result, the Basle Committee has now produced new guidelines, which emphasize the supervisory responsibility of the authority in an international bank's parent country. In order to prevent key banking entities from escaping adequate supervision, the guidelines state that parent authorities should have the right to information on the international operations of banks under their supervision; on the other hand, supervisors in host countries should have the right not only to refuse market access to foreign banks but also to take restrictive measures against branches of such banks already on their territories, if they are not satisfied with the adequacy of the supervision of the parent banks in their home countries.

If the guidelines are adhered to, the market access of foreign banks and thus global financial liberalization will be more explicitly linked than before to the observance of adequate supervisory standards. This will result in a global improvement of prudential regulation.

Reforming trade policies

In an effort to benefit more fully from international specialization and more competition in the home market, many developing countries liberalized their trade in the late 1980s and early 1990s, generally as part of a more comprehensive programme of structural adjustment. The simultaneous adoption of liberal trade regimes by many developing countries makes it necessary for developed economies to open up their markets, too, if increased exports from the developing world are to be absorbed. Otherwise, efforts by developing countries to increase exports could depress the export prices of their raw materials and labour-intensive manufactures, which will continue to make up the bulk of their exports. But the trend towards greater openness in developing countries has been accompanied by more, not less, protectionism in developed ones. This shortcoming needs to be corrected in wrapping up the Uruguay Round.

Trade liberalization needs to be introduced with care. A sudden lifting of protection will cause irreversible losses of capital, labour skills and technological capabilities if, as is often the case, import-competing firms are unable to adapt rapidly. Strengthening the competitiveness of import substitutes takes time and resources, as does the expansion of export supply capabilities. Both processes typically involve a prolonged learning process.

The experience of successful developing country exporters in recent decades puts into question the simplistic view that any form of protection is inimical to export success. Although rapid export growth has often been a crucial element of good economic performance, there is no automatic link between the trade regime and export growth. Some countries with rapid export growth have, indeed, had fairly liberal trade regimes - but others have not. Inward and outward orientation should be looked at as complementary, not incompatible. Most successful exporters have managed to combine elements of both export promotion and protection. Typically they have gone through a phase of import substitution before breaking into international markets. Many of them gradually converted previously inward-oriented industries into outward-oriented ones, while maintaining some degree of protection, and have introduced across-the-board import liberalization only after, sometimes well after, the upturn of exports. This suggests that trade reform should follow a sequence in which protection is reduced substantially first on inputs used by export sectors, and on other goods only after export supply capabilities have been built up.

Country experiences in the 1980s also indicate that export success involved one or more of the following: (a) management of the exchange rate and the use of export subsidies in the early stages of export growth; (b) the establishment of export processing zones; (c) active industrial policies to support the learning process, especially where new products and markets are involved. If necessary, targeted incentives and infant industry protection should be provided for strictly limited periods. Moreover, intervention to ensure the availability of financing in the amounts and on the terms required will also generally be necessary.

The experience of developing countries in the 1980s suggests that trade liberalization can be destabilizing when the economy lacks enough foreign exchange to finance an adequate level of imports, because it may need to be accompanied by very sharp devaluations. On the other hand, combining trade and other structural reform policies with macroeconomic stabilization in large reform packages can overload policy and inflate the costs of adjustment. A phased approach, whereby macroeconomic stabilization comes first and structural reforms are implemented in a gradual sequence thereafter, often stands a better chance of success.

Country experiences, both old and recent, also indicate that liberalization of international capital flows heightens the potential for macroeconomic instability. Since such flows are inherently volatile, some control over them is a necessary part of the Government's array of policy instruments.

Reforming public enterprises

In many developing countries, the public sector is in severe crisis, in many cases radical reform often being needed. There are various options for reform, principally restructuring, privatization and liquidation. No single answer is applicable everywhere, for the extent and nature of the remedy called for depends on how the performance record of a public enterprise is judged against the objectives set for it. Privatization is often desirable and feasible, but many enterprises will inevitably remain under public ownership. The question is how to restructure them to obtain maximum efficiency.

Public enterprises have been important in many countries, both developed and developing, notwithstanding differences of political regime and philosophy. They have often played a strategic role in industrialization. In many cases they were established because private entrepreneurs lacked sufficient capital or incentive to undertake investments of benefit to the economy as a whole, or to avoid the establishment of a private monopoly. Other reasons included distributional and allocative considerations, or a desire to provide essential consumption goods and intermediate inputs at low prices, or the need to raise government revenue in the face of an ineffective tax system.

However, in practice public enterprises have often been made to pursue goals having little or no connection with the original rationale, and many have been allowed to continue even when the reason for their existence no longer held. This has significantly impaired their performance. But public enterprises are not always poor performers. Besides, judgement of their performance is not a simple matter: measures such as deficits, borrowing requirements and profits can be misleading when a firm's financial results fail to provide an accurate gauge of the costs and benefits to society. A number of different measures reflecting the objectives being pursued by the public enterprise should be considered before passing judgement.

That said, it remains clear that public enterprises performed especially poorly in the 1980s. They were hard hit by the sharp swings that took place in international interest rates, terms of trade and commodity prices, and in net foreign lending. Many bankrupt private firms became public enterprises as a result of rescue operations. Moreover, adjustment policies frequently improved balance sheets by reducing expenditures critical for improved long-term performance. However, bad management has also plagued public enterprises, owing to the lack of effective systems of ownership, control, and budgeting, political pressures, and corruption. The problems of bad management are often exacerbated by the absence of competition in the public enterprises' product markets.

Long-term corporate planning is especially important for public, as well as private, enterprises in developing and the formerly socialist countries because of the costs and time involved in "learning by doing". In these economies, public ownership can sometimes be the only way to ensure that the budget constraint is sufficiently flexible for this purpose. However, it needs to be combined with a strict discipline on management to perform well. Greater competition generally brings efficiency gains, though in some lines of production a proliferation of enterprises can result in a considerable loss of scale economies. But public enterprise reform is not synonymous with abandoning every kind of government intervention. The approach followed by many successful countries has been to integrate competition policies into a broader industrial policy.

In many cases, public enterprises need to be relieved from some of the tasks they have been allocated. The crucial question for the Government then is whether to abandon these tasks altogether - as is often advised - or to pursue them using other instruments. If non-commercial objectives continue to be assigned to the enterprise, the costs should be financed separately and transparently. The Government should not interfere in the management's operational decisions, but the autonomy it grants must be matched with rewards and penalties that are closely linked to performance. Preferential financial treatment may be warranted for enterprises operating in carefully selected priority areas, but should not be given simply because the enterprise is publicly owned.

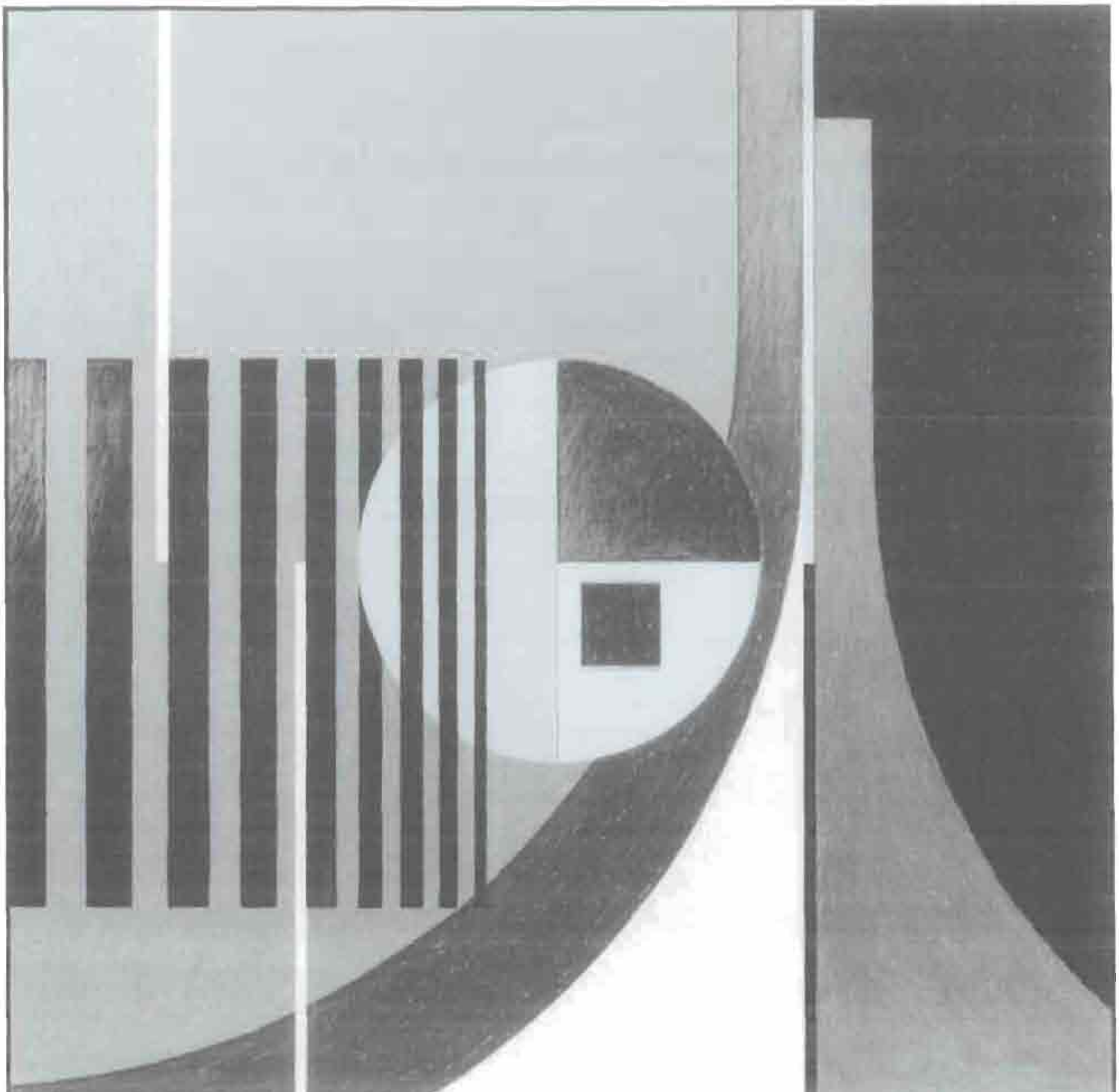
The pricing and employment policies of public enterprises often need to be thoroughly reviewed. In general, taxes and direct subsidies provide a better way to achieve distributional objectives than controls over prices of their outputs, but they can overburden a country's administrative capabilities. The employment policy of public enterprises also often needs to be changed, for it is typically one of the principal causes of poor performance. In principle, overmanning should be stopped; and if income support is needed, it should be given through institutions designed to provide social benefits. Deviations from this rule should take place only in the context of clearly formulated employment policies.

However, no guidelines will guarantee greater efficiency in the presence of clientelism and political irregularities. In many developing - and, for that matter, developed countries as well - public enterprises have been expected to favour certain interest groups through their employment and pricing policies. Thus, political reform can be a prerequisite for effective enterprise reform.

The reform of public enterprises under programmes of structural adjustment and privatization has frequently been aimed not at obtaining a sustained improvement in efficiency but simply at improving short-term financial results and reducing the size of the public sector. Thus, the measures recommended here, which take account of both efficiency considerations and the social dimension, will often require a change of perspective.

K.K.S Dadzie

CURRENT SITUATION AND PROSPECTS FOR THE WORLD ECONOMY



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Chapter I

THE GENERAL OUTLOOK

The world economy is in a period of uncoordinated, disparate and overall weak growth, with little prospect of a vigorous recovery in the near future (see table 1). In a continuation of trends which became increasingly evident in 1989 and 1990, world economic activity weakened further in 1991, with output estimated to have been roughly unchanged from the previous year, but with the volume of international trade having expanded modestly. The current outlook is for a very weak recovery in 1992, with the pace of economic activity unlikely to equal even the relatively poor showing of 1990. Furthermore, there is little probability of an early return to the growth rates of the 1980s. Nevertheless, the performance and prospects of the various economic groupings and regions remain very different.

While production stagnated in 1991, world trade volumes are estimated to have grown by about 3 per cent, and the value of world trade by less than 2 per cent. International primary commodity prices in dollar terms fell across the board, with the exception of non-fuel minerals, and those of manufactures stagnated. Export performance was strongest in developing countries, where volumes expanded by 8 per cent, compared to slightly more than 3 per cent for the developed economies. In contrast, the volume of exports from Central and Eastern Europe and the former USSR fell by an estimated 15 per cent and imports by 20 per cent, in reflection of the overall grave economic situation of many of those countries. In 1992, world export volumes are expected to pick up slightly, partly in response to the weak recovery in the developed market economies.

Performance in developing countries was somewhat better than expected in 1991, with aggregate GDP growing by about 3 per cent. Most countries of East Asia continued to outperform the rest of the world economy and are likely to continue to do so for some time, albeit at relatively lower rates of growth. In Latin America there were positive growth rates of per capita GDP for the first time since 1987, an accomplishment which should be repeated in 1992. African per capita GDP continued its slow absolute decline in 1991, with little prospect of any early significant reversal. The countries of Central and Eastern Europe and the former USSR are, in many cases, struggling to transform their economic and social structures in the context of severe economic depression and in the face of economic and social problems of reconstruction on a scale normally limited to the aftermath of major disasters. The developed market economies themselves are performing with different degrees of effectiveness and, on balance, are likely to grow at slightly lower rates over the medium term than in the 1980s. Countries members of EEC have the firmest grounds for moderate optimism in the medium term, although the evolution of the Community is open to some uncertainty in the light of recent events.

Some of the key problems facing the world economy are structural in nature, and specific to particular country groups or regions. The clearest example is, of course, that of the countries of Central and Eastern Europe, where new political, economic and social institutions are having to be built to replace the former ones. Institution building in EEC will also be important to its economic future. Other developed economies, such as the United States and the United Kingdom, face major tasks of rebuilding deteriorated infrastructures in the light of difficult fiscal constraints. In Asia, growth in many of the newly industrialized economies will increasingly be constrained by environmental deterioration and too little investment in infrastructure. In contrast, the process of development has scarcely been launched in Africa. In all regions problems stemming from demographic changes and pressures require urgent attention. In sum, measures to put the world economy on a balanced and sustainable path of development require not only macroeconomic policy coordination, but also approaches which are carefully tailored to the

Table 1

WORLD OUTPUT, 1980-1991, AND FORECASTS FOR 1992 AND 1993

(Percentage change) [a]

Country group	1980-1990	1990	1991	1992	1993
	Actual		Estimated	Forecasts	
World	2.9	1.9	-	1.5	3.0
Developed market-economy countries	2.8	2.2	0.5	1.5	3.0
of which:					
North America	2.9	1.0	-0.8	1.7	2.9
Western Europe	2.3	2.2	0.2	1.1	2.8
Other	3.9	4.8	3.6	2.0	3.4
Central and Eastern Europe and former USSR	2.0	-4.5	-15.4	-10.3	-5.0
Developing countries	2.6	3.2	3.2	4.7	4.9
of which in:					
America	1.3	0.3	3.0	3.2	3.4
Africa	1.9	2.1	3.1	3.8	3.8
Asia	3.8	5.3	3.6	6.1	6.1
China	8.8	5.2	7.0	8.0	7.5
Memo item:					
Least developed countries	2.8	2.1	0.2	3.4	3.4

Source: UNCTAD secretariat calculations, based on national and international sources, and SIGMA for forecasts
a Annual average or change over previous year

specific needs of individual countries and regions while at the same time being mutually supportive and taking account of global interdependence. The ability of individual countries and regions to cope with their disparate problems nevertheless would be significantly enhanced by a strong and stable international trading and financing environment.

In the following chapter a review of recent developments and likely trends in international trade, commodity and financial markets is presented. Developments and prospects by economic grouping and geographic region are reviewed in chapter III, and in chapter IV the longer-term implications of current economic trends are examined.■

Chapter II

INTERNATIONAL MARKETS

A. World trade

1. Recent developments

The deceleration of world trade expansion that began in 1989 continued throughout 1991. The 3 per cent growth in the volume of world trade in 1991 (see table 2) was the smallest since 1983. The recession in North America and the United Kingdom, weakening investment trends in Japan and the economic slowdown in Western Europe all served to dampen demand for tradeable goods. A further contributing factor was the sharp output contraction in Central and Eastern Europe and the former USSR. Indeed, the slowdown in the pace of world economic activity has been more pronounced and longer lasting than originally expected. Preliminary data indicate that slackening trade growth was evident in all major sectors. In particular, the quantum index of manufactures exported from developed market-economy countries increased by less than 2 per cent in 1991, as against almost 5 per cent in 1990, while imports of fuel into those countries fell by 1 per cent, compared with an increase of almost 3 per cent in 1990.

There were, none the less, some countervailing forces which prevented a sharper slowdown in world trade. Despite generally less favourable export markets outside the region, East Asian countries continued to grow rapidly and buoyant domestic activity bolstered imports. In addition, increasing intra-regional trade and the continued inflow of foreign direct investment were important factors. Import demand was also strong in the Persian Gulf area, on account of reconstruction in some economies. The economic recovery in some Latin American countries provided a further boost to world demand. Another significant factor was the unification process in Germany, which substantially raised import demand.

In value terms, world exports grew by less than 2 per cent in 1991, down sharply from 13 per cent in the previous year. Thus, smaller volume growth was accompanied by declining export prices, owing to relatively stable supply conditions in the face of sluggish demand. The appreciation of the dollar also pushed down export price indices expressed in dollars. Petroleum prices plunged by over 17 per cent and there was an overall decline of almost 6 per cent in the price of non-fuel primary commodities and metals (see table 3). The small increase (2 per cent) in the value of manufactures exported by developed economies was entirely due to volume, since export unit values were unchanged from the 1990 level. These price movements resulted in a considerable deterioration in the average terms of trade of developing countries, affecting most severely the major petroleum exporters and other commodity-dependent countries in Latin America and Africa. Thus, West Asia suffered a loss of almost 12 per cent in its terms of trade, while developing America and Africa registered declines of 6 per cent and more than 8 per cent, respectively.

As far as the pattern of world trade is concerned, the volume of exports of developed market economies as a group increased by slightly more than 3 per cent in 1991, compared

Table 2

WORLD TRADE VOLUMES, 1980-1991, AND FORECASTS FOR 1992 AND 1993

(Percentage change) [a]

Country group	1980-1990	1990	1991	1992	1993
	Actual		Estimated	Forecasts	
World [b]	4.3	4.5	3.2	5.2	6.2
Developed market-economy countries					
Exports	4.4	5.1	3.3	5.0	6.4
Imports	4.9	4.4	1.8	4.5	6 4
Central and Eastern Europe and former USSR					
Exports	0.9	-10 0	-15.0	-7.6	-1.5
Imports	1.5	-5 0	-20.0	-7.7	1.1
Developing countries					
Exports	3.7	4.0	7.5	6.4	5.3
Imports	3.9	11.6	11.6	8.4	7.8
of which in:					
America					
Exports	4.8	5.4	1.5	-0.9	6.4
Imports	-0.3	8.1	10.3	5.3	4.4
Africa					
Exports	-0.7	-1.2	3.8	1.7	1.2
Imports	-1.5	9.6	-5.2	1.1	2.6
Asia					
Exports	4.3	4.4	9.9	8.8	5.5
Imports	6.5	12.8	14.2	9.9	9.1
China					
Exports	11.5	14.0	15.3	9.5	5 6
Imports	11.8	-12.5	20.4	19.1	12.8
Memo item:					
Least developed countries					
Exports	-0.3	-7.5	10.2	1.3	5.6
Imports	-0.0	2.7	-3.3	1.4	3.4

Source: UNCTAD secretariat calculations, based on national and international sources, and SIGMA for forecasts.
a Annual average or change over previous year.
b Average of world exports and imports.

with over 5 per cent in 1990, while the volume of imports grew by less than 2 per cent, against over 4 per cent in 1990. Export expansion slowed in virtually all the major industrialized countries in volume terms. However, in the United States, it remained fairly brisk, and at over 6 per cent was about double the world average. With exports amounting to more than $400 billion, the United States was the leading exporter in 1991, with highly competitive prices enabling it to achieve important market gains. The volume of imports, on the other hand, fell slightly, owing to depressed domestic demand, resulting in a marked improvement in the trade balance. Since there were also large official transfers from the United States' coalition partners in the Gulf war, the current account deficit shrank to less than $9 billion in 1991, compared with over $92 billion in 1990.

The unification process in Germany led to the diversion of production to internal markets and a sharp rise in imports. Exports declined in volume by 2 per cent in 1991, in contrast to an import volume growth of more than 9 per cent. Thus, there was a swing from a traditional surplus on current account to a deficit of almost $20 billion. The increased import demand stimulated exports from other Western European countries, whose total exports grew in volume by around 3 per cent, whereas their total imports grew by less than 1 per cent.

Another noteworthy development was the doubling of the current account surplus of Japan from $36 billion in 1990 to $78 billion in 1991, representing around 2 per cent of its GDP in the latter year but nevertheless less than half of the peak ratio of 1986, when the surplus amounted to almost $95 billion. The large surplus in 1991 reflected the sluggish domestic economy, which included a volume import growth of only 1 per cent, against over 6.5 per cent in the previous year. At the same time, the strong demand for Japan's exports from developing countries in Asia and Latin America was sustained, so that the volume growth of total exports was over 3 per cent.

It was the developing countries which provided the major impetus to world trade in 1991; their volume of exports rose by 7.5 per cent and of imports by almost 12 per cent. The impressive performance of the leading exporters of manufactures in Asia[1] in the face of weak international demand reflected policies encouraging private initiative and an outward orientation of the economy, as well as generally cautious fiscal and monetary policies. From slightly less than 8 per cent in 1990, the volume of exports of these countries soared by almost 14 per cent in 1991, and they have been able to penetrate markets not only within the region but also outside it. Within the last decade they have doubled their share of world trade, from under 5 per cent of world exports in 1980 to more than 10 per cent in 1991. These countries have also been dynamic importers, increasing their share in world imports from about 5 per cent in 1980 to more than 10 per cent in 1991. Over the same period, China has likewise raised its market share and integrated into the world economy, with a rapid growth in both export and import volume, averaging around 12 per cent per year.

The resumption of growth in Latin America, in the wake of structural reforms and stabilization policies applied earlier in some countries, resulted in a volume growth of imports for the region as a whole of over 10 per cent in 1991. Although a number of other developing countries, notably in Africa, have also been implementing such policies, many of the commodity-dependent among them have been less successful, in large part because of depressed commodity export prices. For developing countries in Africa as a whole, the sharp fall in commodity prices (see section B) and consequent impairment of purchasing power resulted in a fall in the volume of imports by over 5 per cent.

In the Persian Gulf region expenditure on reconstruction by the countries most seriously affected by the recent hostilities maintained high import levels, despite the drop in export earnings resulting from the sharp fall in petroleum prices. Thus, in West Asia, although there was a 10 per cent decline in the value of exports, total imports increased by over 18 per cent in 1991.

The decision to move to hard currency payments for their mutual trade led to a virtual collapse of trade among member countries of the former CMEA. Rough estimates indicate that the export earnings of these countries plunged by 20 per cent in 1991, after a decline of about 8 per cent in the previous year. For imports, the situation was even more dramatic, as a shortage of convertible currency, accompanied by some hoarding in the former USSR, resulted in a contraction of imports of 23 per cent in value terms for the region as a whole and over 40 per cent in the former USSR.[2]

The collapse of trade among the countries of Central and Eastern Europe and the former USSR stimulated efforts to enlarge other markets, notably in Western Europe. Statistics of imports into Western Europe from European members of the former CMEA indicate a fairly rapid growth in value terms, of 10.5 per cent in 1991, with a consequent increase in their share of this market from 2.8 per cent in 1990 to 3.1 per cent. If the former USSR is excluded, the growth of imports was as much as almost 18 per cent. However, these efforts only compensated partially for the loss of traditional markets.

2. Short-term prospects

The outlook for world trade depends much on the extent and timing of the expected recovery in industrialized areas and the world

1 Hong Kong, Malaysia, Republic of Korea, Singapore, Taiwan Province of China and Thailand.

2 See GATT, "Council Overview of Developments in International Trade and the Trading System. Annual report by the Director General" (C/RM/OV/3 Rev. 1), Geneva, May 1992.

as a whole. A number of factors serve to explain the current uncertainty: the strong undercurrent of debt deflation, especially in Japan, United Kingdom and the United States; the slowdown in Germany continues and appears to be more persistent than predicted earlier; high interest rates in Western Europe are constraining growth in the area; and there are still no clear signs of a turnaround in Central and Eastern Europe and the former USSR, even in countries that have moved farthest on the road to market-oriented economies.

Import demand remains strong in East Asia, but in some countries rapid expansion has created capacity constraints and infrastructural bottlenecks. Labour shortages, increased inflation and growing environmental concerns are other factors that may constrain future growth. Moderate growth in imports is still expected in some countries in Latin America, while reconstruction in the Gulf region should continue to sustain high import levels.

Given all these trends, only a modest increase in world trade can be expected in 1992, of about 5 per cent in volume. Assuming a more favourable world economic outlook for 1993 an increase in world trade of around 6 per cent could prove possible.

Adding to the present uncertainty is the failure so far to conclude the Uruguay Round. Independently of these negotiations, a number of developing countries, as well as some Central and Eastern European countries, have recently liberalized their trade regimes. It should be stressed that increased access to export markets is a prerequisite for the successful transformation of the economies of the latter countries and their integration into the world economy, and in this respect a successful conclusion of the Uruguay Round is crucial.

B. World commodity prices

1. Recent developments

After a relatively strong performance in the previous year, primary commodity prices measured in dollar terms fell by 11 per cent in 1991, marking clearly the end of the boom of 1987-1989. Even the 1990 price increases do not appear very significant when compared to the substantial rise in that year of prices of internationally traded manufactures. The considerable difference in the behaviour of primary commodity export prices as between the developed market economies and the developing economies in 1990 and 1991, with prices in the latter having risen more in 1990 and fallen more in 1991, was primarily due to the large changes in petroleum prices over those two years and the greater importance of petroleum exports for the developing world.

The decline in prices in 1991 affected virtually all the major commodity groups and the majority of individual commodities (see table 3). Overall, food prices fell by around 3 per cent, dominated by a decline of 27 per cent in sugar prices. As a consequence, developing country food export prices were particularly hard hit. Among tropical beverages, world markets for coffee, cocoa and tea were characterized by persistent surpluses, with large accumulations of stocks in the case of coffee and cocoa. Real prices of tropical beverages fell by 52 per cent from the 1990 level, the largest drop of any non-fuel commodity group, and coffee and cocoa prices are currently at their lowest level in 17 years. Stocks of coffee accumulated steadily in both exporting and importing countries, and in particular in the latter, following the suspension in 1989 of export quotas under the International Coffee Agreement, 1983. Cocoa production has exceeded consumption for the last seven years, and stocks are currently well over half of world grindings. (However, it is expected that the 1991/92 crop will generate the first production deficit in eight years.)

Within the group of agricultural raw materials there were disparate movements in 1990 and 1991. In particular, prices of timber products, which were firm in 1990, moved more in line with the group average in 1991. In that year it was the falling prices of wool, woodpulp and softwood which accounted for the severe drop in the average export prices of agricultural raw materials of the developed market economies, while an easing of pressure on rubber prices, combined with stable cotton quotations, explains the smaller decline of export prices of developing countries.

Table 3

WORLD PRIMARY COMMODITY PRICES, 1981-1991, AND FORECASTS FOR 1992 AND 1993

(Percentage change) [a]

Commodity group	1980-1990	1990	1991	1992	1993
	Actual		Estimated	Forecasts	
Food	-1.3	1.1	-3.4	4.1	4.5
Agricultural non-food	-	2.0	-6.0	0.2	7.8
Minerals excluding fuels	1.9	20.4	3.8	-4.1	0.4
Fuels	-2.9	26.3	-15.4	-	8.5
Non-ferrous base metals	1.1	-9.7	-16.1	-2.1	15.8
Total	-1.8	12.7	-11.0	0.9	7.5
of which:					
Non-fuel primary commodities	-0.4	0.5	-5.7	1.4	6.9
Memo item:					
Unit value index of manufactured goods exported by developed market-economy countries	3.1	10.6	-	3.0	3.0

Source: UNCTAD secretariat calculations, based on national and international sources, and SIGMA for forecasts.
a Annual average or change over previous year.

Prices of minerals (other than fuel), alone among the principal commodity groups, continued to strengthen in 1991 following a strong increase in 1990; this was due to phosphate and iron ore prices, which appear to be peaking several years later than prices of other industrial raw materials. In contrast, prices of non-ferrous metals declined sharply in 1991 after a substantial fall in the previous year from the peak levels of 1989.

The fall in international prices of fuels in 1991 is explained largely by the behaviour of crude oil prices. After a sharp drop in oil prices in the first quarter of the year only a very limited recovery took place during the second half of 1991; on average, prices were some 17 per cent lower than in the previous year. A decline in output in the United States and disappointingly slow growth in the OECD countries as a whole led to an only marginal increase in demand while crude oil output continued to rise. The slow recovery and a mild winter also resulted in much lower demand for thermal coal than previously anticipated.[3]

2. Prospects

While developments in world commodity markets in 1992 are largely dependent on factors specific to individual commodities, the slow growth and weak recovery of the developed economies and the deepening depression in many countries of Central and Eastern Europe and the former USSR remain key sources of uncertainty. On balance, the slump in primary commodity prices which continued into 1992 may be expected to be followed by generally firming prices in the course of the

3 Because in developing countries exports of fuel other than petroleum are marginal (natural gas - the biggest item - accounts for about 1 per cent of their total fuel exports), the impact of crude oil prices on average export prices of fuel is greater than in developed market-economy countries. In the latter, oil exports represent only about half of total fuel exports (where coal and gas also bulk large).

Table 4

WORLD CURRENT ACCOUNT BALANCES, 1980-1991, AND FORECASTS FOR 1992 AND 1993

(Billions of dollars)

Country group	1980-1990 [a]	1990	1991	1992	1993
	Actual		Estimated	Forecasts	
Developed market-economy countries	-19.0	-46.1	11.1	-20.0	-30.0
Central and Eastern Europe and former USSR	0.2	-5.7	-14.2	-22.2	20.6
Developing countries	-29.9	-15.1	-94.1	-122.0	-115.6
of which in:					
America	-20.1	-11.7	-37.1	-48.0	-40.5
Africa	-15.4	-6.8	-22.4	-27.2	-25.6
Asia	5.6	3.4	-34.6	-46.0	-49.5
China	-	11.9	11.9	9.5	7.3
Statistical discrepancy	-48.7	-55.0	-97.2	-154.7	-158.9
Memo item:					
Least developed countries	-10.1	-10.7	-16.3	-18.8	-18.8

Source: UNCTAD secretariat calculations, based on national and international sources, and SIGMA for forecasts.
a Annual average.

year and a moderate upturn in 1993. Thus, world export prices of primary commodities are expected to increase by about 1 per cent in 1992, after a fall of some 11 per cent in the previous year. If petroleum is excluded, prices are forecast to increase marginally, after a fall in the previous year by 6 per cent. Expectations are for an across-the-board increase in commodity prices in 1993 - 9 per cent for fuels and 7 per cent for other commodities.

Prices of food in 1992 should prove firmer than those of other commodity groups, supported by increased demand for cereals in many countries of Central and Eastern Europe and the former USSR as well as of sub-Saharan Africa and by emerging supply shortages for cocoa after a long period of surpluses. Among agricultural raw materials cotton prices are expected to decrease sharply due to record world production and moderating consumption in 1992, although there may be a partial recovery in 1993.

Prospects for prices of mineral raw materials are mixed; after a relatively strong rise in 1991, they are declining. Since they normally respond only with a substantial time lag to any recovery in industrial production, they are likely to rise only slightly on average in 1993. Similarly, prices of non-ferrous metals are expected to rise, albeit sharply, in 1993 after declines in 1992. However, a moderating factor may be a possible recovery of exports of this commodity group from the former USSR. Prospects for tin prices appear particularly promising if production cutbacks continue. Petroleum prices may be constrained by a potential increase in production from new capacity and by disagreements in OPEC on production quotas. The expected increase in oil prices in 1993 of 9 per cent would barely bring nominal prices back to the average recorded for 1991.

Table 5

SOURCES OF FINANCING OF THE CURRENT ACCOUNT [a] OF DEVELOPING COUNTRIES, 1980-1991, AND FORECASTS FOR 1992 AND 1993

(Billions of dollars)

Item	1980-1990 [b]	1990	1991	1992	1993
	Actual		Estimated	Forecasts	
Current account balance	-45.6	-36.5	-21.8	-13.5	-14.6
Source of financing:					
Use of official reserves	-13.3	-35.5	-38.9	-20.0	-14 5
Total net capital flows	58.9	71.0	60.7	33.5	29.1
Official flows	38.0	17.8	47.6	43.2	36.7
Grants [c]	13.8	28.5	18.8	19.3	20.3
Medium- and long-term loans	24.2	-10.7	28.8	23.9	16.4
Private flows	2.7	12.0	7.5	21.1	28.7
Direct investment	14.9	18.7	22.1	23.0	24.2
Private borrowing	-12.2	-6.7	-14.6	-1.9	4 5
Other capital, unrecorded flows, errors and omissions	18.2	41.2	5.6	-30.8	-36.3

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

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

b Annual average.

c Excluding technical assistance.

C. Financial flows

As discussed in more detail in Part Two, chapter I, below, borrowing from the international capital markets in 1991 showed a more disparate pattern than in recent years. Financing in the OECD area was influenced by recession and increased concern over credit quality. Moreover, in the case of lending by banks the restraining impact of these factors was accentuated by their efforts to attain the 1992 target level of capital in relation to assets prescribed by the Basle Agreement on the International Convergence of Capital Measurement and Capital Standards. The influence of this deadline was particularly important for Japanese banks, the capital levels of which were severely affected by the decline in domestic equity prices in 1991 and which were responsible for a large part of the year's decline in international interbank lending. Certain measures of international bank lending to OECD entities (such as the exposure to such entities of banks in the BIS reporting area) actually contracted. Unlike international bank lending, external bond issues by OECD entities expanded substantially in 1991, but there was a decline in those issued by lower-rated corporate borrowers.

The external financing of developing countries was characterized by sharp contrasts. Several countries of South and South-East Asia increased their borrowing in the form of both bank loans and bond issues. Moreover, the recent revival of bond lending to certain Latin American countries continued and was accompanied by substantially increased foreign

Table 6

OUTSTANDING DEBT OF DEVELOPING COUNTRIES [a] BY REGION, 1989-1991, AND FORECASTS FOR 1992 AND 1993

(Billions of dollars) [b]

Region	1989	1990	1991	1992	1993
	Actual		Estimated	Forecasts	
All developing countries	867.7	817.1	853.4	897.4	918.3
of which in:					
America	367.7	332.7	336.2	345.2	345 2
Africa	228.6	210.5	218.1	226.3	228.2
Asia	271.4	273.9	299.1	325.9	345.1
Memo item:					
Least developed countries	93.0	87.8	95 1	104.6	109 6

Source: UNCTAD secretariat calculations, based on national and international sources, and SIGMA for forecasts Data relate to medium and long-term debt.

a Excluding oil-dominant countries (see note *a* to table 5) and developing countries of Europe.

b End of year

investment. Yet it would still be premature to conclude that the problems associated with the external debts of this group of countries and consequent external financial stringency have been definitively resolved. Increased bond lending was not accompanied by a corresponding rise in bank lending. Moreover, the bond issues carried relatively high yield spreads over benchmark interest rates and were enhanced by techniques designed to reduce risks for investors. Argentina, one of the countries receiving increased inflows of external financing, reached agreement on a restructuring of its debts to its creditor banks only in early 1992, whilst another, Brazil, was still, at the time of writing, engaged in long-drawn-out negotiations. Although the turnabout in financial transfers to these Latin American countries in 1991 was substantial, a large part was of a short-term, speculative character, so that recipient countries' external financial positions remain vulnerable to sudden reversals of market sentiment.

This recent experience of the countries in South and South-East Asia and Latin America is not typical of that of the majority of borrowers from the developing world. Import demand in most of these countries continues to be restrained by their unfavourable external payments positions, and their access to external financing remains difficult and its costs high. Net lending by banks in the BIS reporting area was negative in 1991 to all major developing regions other than South and South-East Asia, and preliminary estimates indicate a continuation of the negative net flows of medium- and long-term export credits to developing countries observed in 1990. Several developing countries are currently engaged in negotiations for the restructuring of their debts to the banks. Moreover, data on the costs for developing countries' imports show unfavourable changes outnumbering favourable ones in 1991.

Adverse perceptions of creditworthiness (evident, for example, in the terms on official insurance for financing and payments arrangements available from the export credit agencies of two OECD countries) have also depressed bank lending to the countries of Central and Eastern Europe, though this was partly offset by greater reliance on official or officially guaranteed financing. With regard to countries of this region also experience was not uniform, Hungary, for example, continuing to raise substantial sums through bond issues.■

Chapter III

REGIONAL PERFORMANCE AND SHORT-TERM PROSPECTS

A. Developing countries

1. *Latin America*

In 1991 per capita GDP in Latin America rose for the first time since 1987. In contrast to the closing years of the 1980s, when vigorous export expansion failed to spark a concomitant improvement in GDP growth, the resumption of growth in 1991 took place in spite of reduced export purchasing power. While the earlier failure to grow was due in part to internal economic disequilibria engendered by the debt crisis, in 1991 import capacity of the region was considerably enhanced as a result of lower debt service payments, on account of lower interest rates, and of substantial net capital inflows. In addition, lower debt payments provided direct relief to budgets and indirectly benefited the economy at large. In many countries, resumed growth was also accompanied by markedly smaller increases in the price level. This general improvement of the Latin American economy lends support to the thesis that the stabilization efforts being pursued in many countries have finally started to bear fruit. In some instances the turnabout has been no less than spectacular. Be that as it may, the fact remains that large sections of the population, particularly those with low incomes, continue to suffer the consequences of the long crisis; in most countries unemployment remains high and in some cases has aggravated political and social tensions.

(a) Trade and payments

Sluggish growth in world import demand and declining oil prices in the aftermath of the Gulf crisis led to an decline in export earnings for the region in 1991, generally affecting both oil and non-oil exporters. While oil exporters suffered relatively more from falling prices, the terms of trade of non-oil primary commodities exported from the region fell, in continuation of their long-term trend. Sharp declines in prices among the latter commodities affected metals, owing to sluggish growth in industrialized countries, and a number of foodstuffs, notably sugar, cocoa, and coffee, but prices of bananas and beef strengthened during 1991. All in all, the fall in the unit value of the region's exports, coupled with stagnating volumes, resulted in a significant fall in the purchasing power of exports from the 1990 level.

There were, however, wide differences among countries as regards both oil and non-oil exporters. Export performance was particularly favourable in Chile and Colombia, and to a lesser extent also in Brazil and Mexico. Among the oil exporters total export earnings were hit by the large drop in earnings from oil, which could not be fully offset by higher non-oil exports even in the most favourable cases, such as manufactures in Mexico. In Brazil, for example, the competitiveness of manufactured exports appears to have suffered from the lack of productive investment during the long crisis, with adverse effects on export performance.

The enhanced import capacity, noted above, in spite of declines in the purchasing power of exports, permitted a large volume increase in imports, of some 10 per cent. However, the bulk of the increase was accounted for by a handful of countries, notably Argentina, Mexico and Venezuela. In some countries, in contrast (which included Colombia, Costa Rica, Dominican Republic, Haiti and Honduras), imports actually declined. Where imports increased it reflected a rebuilding of depleted inventories, as in Venezuela, or buoyant domestic fixed investment, as in Mexico. In the particular case of Brazil, however, the relatively small increase in the volume of imports reflected mainly a reduced import bill for oil, due to depressed prices, rather than overall import compression. The increase in non-oil imports was relatively large, making up for shortages of domestically produced consumption goods. In some countries higher imports were facilitated by a continued pursuit of trade liberalization. The resulting substantial current account deficit of the region in 1991 was completely financed by sizeable inflows of capital which, in addition, permitted large accumulations of international reserves by a number of countries - notably Mexico, but also Argentina, Colombia and Venezuela. For the region as a whole, the net transfer of resources (i.e. net capital inflows less net payments of profits and interest) was positive for the first time since 1981. The swing exceeding $20 billion from 1990 to 1991 was mainly the result of larger capital inflows (about $18 billion higher than in 1990) but was reinforced by a decline in profit and interest payments (of some $5 billion). Among the larger economies, Brazil was an exception: the capital inflow declined, and in consequence there was a substantial increase in net transfers abroad. To the extent that these financial flows were a response to cyclical and speculative factors, rather than to confidence in the underlying strength of the economy, they can be expected to remain volatile. In this connection it should be recalled that the capital inflows consisted mainly of private non-debt creating capital, including much FDI (as in Argentina, Chile, Mexico and Venezuela), bond issues for countries such as Brazil, and short-term financial flows attracted by favourable domestic yield differentials. In addition, the net inflow was augmented on account of arrears in debt service.[4]

(b) The domestic economy

In spite of the estimated increase in GDP of about 3 per cent in 1991, a significant improvement over earlier years, per capita income in the region remained well below the level reached prior to the debt crisis. In general, and in contrast to previous experience, it was those countries that were most successful in containing inflation that had the highest real growth. On average, growth rates in 1991 were also the highest since the mid-1980s; however, the smaller countries of the region fared less well. It should be noted that Haiti, the only least developed country in this region, had an absolute decline in real output. For the region as a whole the increase in output was not sufficient to raise employment,and indeed, unemployment continued to rise in some countries, in particular in Brazil.

The resumption of growth resulted from factors as diverse as the growth experience itself. In those countries where inflation was most successfully combatted, as in Argentina and Peru, the purchasing power of wage earners rose considerably, leading to a significant expansion of demand. Confidence in greater stability also encouraged firms to implement longer-term investment strategies. Where inflation continued unabated, as in Brazil, growth also suffered. By the same token, where real wages did not rise, as in Colombia, domestic demand remained sluggish, in spite of higher exports. In Chile buoyant exports do appear to have made a sizeable contribution to growth, whereas in Brazil the export sector seems to have lost much of its competitiveness due to the protracted crisis and consequent arrears of productive investment. Growth in a few large countries benefited directly from autonomous expenditures (e.g. by the public sector in Venezuela), or from strong investment demand which attracted foreign direct investment and a repatriation of flight capital (as in Mexico).

In contrast to previous years, the rise in the price level was relatively moderate in many countries in 1991. The estimated average increase for the region of some 200 per cent was considerably lower than the average of over 1,000 per cent in 1990. Progress was particularly marked in countries which had suffered from chronic high inflation and had undertaken stabilization programmes, which included re-

4 See also, in this connection, Part Two, annex II.

forms in the fields of exchange rate management, monetary, and fiscal policies. Price increases abated particularly in Argentina, Nicaragua, and Peru toward the end of the year, much of the progress in Argentina being due to the enactment of the "convertibility" law establishing a fixed exchange rate for the dollar and allowing the Central Bank to issue local currency only when backed by a corresponding inflow of dollars into its own vaults. Progress was also discernible elsewhere in the region, thanks to continuing efforts to balance budgets. In many cases, large cuts in expenditure, both current and capital, were made and recourse was also had to sales of fixed assets. The privatization of public enterprises had the added benefit of attracting foreign investment, while in many countries trade liberalization contributed to raising domestic supply. In some, however, inflationary pressures were far from being contained, notably in Brazil.

(c) Prospects

Recent developments point to an improvement in prospects for the region. In some countries, relatively rapid expansion is possible, notably in Argentina, where it would relieve the budgetary situation. Elsewhere, stimulus should be provided from recent upturns in investment, such as in the oil sector in Venezuela. In Chile, the improved balance of payments, due in part to capital inflows, should permit an increase in imports and ease inflationary pressures, while the upturn in investment that started towards the end of 1991 seems set to continue. Investment may also expand faster than in 1991 in Mexico, if the Government is not obliged to rein back on planned public investment to restrain the economy. Thus, overall growth of the Mexican economy may match the target of about 4 per cent, in spite of a tight monetary policy designed to control inflation. Elsewhere non-cyclical factors may dampen growth. Most notably, the expiration of Bolivia's natural gas export contract with Argentina, a major source of Government receipts, may create fiscal difficulties. In the region as a whole, a continuation of the current economic climate will depend crucially on the continued success of stabilization programmes, especially as regards adjustment. With sustained confidence in the economies, capital inflows, including the return of flight capital, can be expected to continue, thus underpinning the necessary investment for growth. In such conditions growth in 1992 could exceed that of 1991 (about 3 per cent). Nevertheless, considerably higher growth rates would be needed to ease the unemployment problem, and there is also the risk that even these moderate growth rates may give rise to renewed inflationary pressures.

2. Africa

(a) Recent developments

African economic performance was modest in 1991, falling well short of population growth in the region and also below forecast rates in several of the larger countries. The overall trade balance of the region worsened, reflecting mainly a stable value of exports, although imports rose less markedly than in previous years. There was considerable variation among countries; imports were constrained in some countries while in others they were facilitated by trade liberalization. Despite substantial lower interest payments, due to various debt refinancing programmes, the payments deficit of the region further widened. Key economic indicators continued to show declining trends in many African countries, particularly where political uncertainties exercised a generally depressing effect on the economy.

In the oil-producing countries, economic activity in the course of the year swung sharply and the average annual growth over 1990 was only 1 per cent. It is estimated that total export earnings by the seven major African oil producers were $5.5 billion below 1990, a year in which they had generally benefited from the Gulf crisis and thus been able to increase public expenditure and revitalize the economy. The situation changed halfway through 1991, when the fallback of petroleum prices and the resultant widening of the current account deficits obliged them to implement restrictive economic policies. Nevertheless, the petrochemicals sector continued to expand in some countries, although at a slower rate.

The largest of the African oil-producing countries - Nigeria - was particularly hard hit in 1991, recording its lowest growth since 1988 as a direct consequence of a smaller increase in petroleum exports, traditionally a major driving force of the economy. The volatile international oil market and generally lower oil prices obliged the Government to restrict public spending, which had expanded in the first half of 1991, as well as domestic demand and imports. Nevertheless, imports increased in volume, almost wiping out the 1990 record payments surplus. In addition, Nigeria continues to be faced with heavy debt obligations.

On average, the countries of North Africa grew at a rate of 2.5 per cent, ranging from 1.0 per cent in Egypt to 4.0 per cent in Morocco, where important progress in diversification and integration into the world market has been achieved. Most countries of the subregion reaped record harvests in 1991, owing to favourable weather. However, nearly all countries continued to suffer from high levels of inflation.

Despite serious domestic difficulties exacerbated by severe external payments problems, growth resumed in Algeria (after a contraction of the economy in 1990), owing to a recovery in agricultural output and stronger performance in the hydrocarbon sector. A reduction in imports, facilitated by the good harvest, helped to maintain a large trade surplus, despite a decline in export earnings.

Growth in Egypt, in the midst of implementing a programme of economic reforms, was relatively slow in 1991. Although consumption was constrained by measures to combat high inflation and investment demand was weak, a growth rate of 1.0 per cent was achieved, primarily as the result of an upturn in invisible receipts in the latter part of the year. In spite of additional aid and some debt relief in 1991, the weak payments situation persisted, mainly because of the larger trade deficit due primarily to increased imports.

The economies of sub-Saharan Africa (excluding Nigeria) grew by only 1.6 per cent in 1991, so that per capita real income once again declined. As in previous years, this result was largely attributable to the continuing weakness of most commodity prices, in particular for tropical products. Nevertheless, in some countries, structural adjustment programmes underpinned an above-average performance, as in several Central and Western African countries, particularly with respect to agriculture. The examples of Ghana and Uganda, though very different, show the potential of such programmes. Since the initiation of the programme in the latter country in 1986, GDP growth has averaged 6 per cent annually and inflation has been reduced from three-digit rates to about 35 per cent in 1991. Among the measures taken were the abolition of inefficient parastatals, the introduction of a new investment code and privatization. Estimated GDP growth in 1991 exceeded the 4 per cent target, owing to generally favourable weather, increased public investment and higher mining output.

The economic performance of the least developed countries of Africa is difficult to assess because of a paucity of reliable data. Apart from Sudan, where the economy is in a state of virtual collapse as a result of the continuing civil war, African LDCs performed generally better in 1991 than in the previous year, partly because of better weather which in many cases (Burkina Faso, Niger and Mali, among others) produced record crops. On the other hand, prevailing weak mineral and other non-oil commodity prices resulted in sharply reduced export earnings for many countries, and the payments and the overall economic situation for this group of countries remains precarious.

(b) Prospects

The short-term prospects for the African region are for some improvement over the current situation. Overall, GDP growth is expected to exceed 3 per cent in 1992 and possibly somewhat more in subsequent years. However, the external position is unlikely to improve substantially: export earnings in 1992 will be virtually stable, in view of the only slight increase expected in world primary commodity prices, and the value of imports is likely to grow by more than 5 per cent. Due to various debt restructuring agreements concluded in 1991, debt servicing obligations are expected to ease somewhat, but nevertheless the external indebtedness of African countries is a major burden for them.

In North Africa higher growth rates are expected in Tunisia, Morocco and Egypt. In the latter country, some of the benefits of economic reforms should begin to accrue, generating a return to GDP growth and a general improvement in the external accounts. The projected widening of the trade balance, as a result of trade liberalization, is likely to be offset by a further recovery in invisibles, mainly in tourist receipts. Price reforms are expected to stimulate the production of cash crops as well as private investment. In Algeria, domestic difficulties in introducing structural reforms are likely to compound the present economic problems facing the country, and in addition debt servicing in 1992 will be particularly burdensome.

Short-term prospects for sub-Saharan Africa depend much on the political situation in some countries and on weather conditions.

Southern Africa has been hit by the worst drought in decades, with disastrous harvests in, among others, Zambia, Zimbabwe, Malawi and Namibia. Every country south of the twelfth parallel will be bound to increase imports of food. Further north, the weather appears to have been more favourable, but nevertheless food supply difficulties that have arisen for a number of reasons will persist in Ethiopia, Liberia and Sierra Leone. With no recovery expected in mineral prices (see chapter II above), further contraction of the economies of African mineral producers is likely occur.

Growth in the least developed countries is forecast to be slightly over 3 per cent. Higher growth is expected in the United Republic of Tanzania, Uganda and some other countries implementing structural reforms. In addition, projected stable amounts of external aid will have a positive impact. Total exports are forecast to fall by about 10 percentage points in volume, on the assumption that primary commodity prices rise only slightly above the average 1991 level.

Further progress to reduce budget deficits, liberalize prices and reactivate structural reforms are required in most African countries. The privatization process, which has started in many of them, needs to be supported by adequate legislative and administrative measures, including the further elaboration of viable mechanisms. However, the main problem for virtually all countries of the region is to ensure financial stability and diversify away from dependence on the export of one or two primary commodities.

3. West Asia

(a) Recent developments

The economies of many West Asian countries suffered, to varying extents, from the consequences of the Gulf war, which not only caused widespread damage, but also cost thousands of lives. Furthermore, in certain areas the environmental damage inflicted was enormous. The war has created millions of refugees and displaced persons; it also severely disrupted international trade and finance, brought tourism in the region to a halt, and weakened the region's banking system. Private transfers by nationals working abroad, an important source of foreign exchange for some countries, declined sharply, and will remain relatively low in 1992. The displacement or repatriation of expatriate workers exacerbated the unemployment situation therein and in general strained the countries' resources. Shortages of basic consumer goods became acute, and rationing was introduced in some countries. In others, funds were diverted to new purchases of arms and large sums committed for combat operations in anticipation of a wider conflict, resulting in a sharp worsening of budget and payments deficits. Inflation accelerated rapidly in many countries. The decline in the average crude oil price by 17.0 per cent in 1991, which was mainly attributable to weak demand in industrial countries and the relatively mild winter in the northern hemisphere, compounded an already difficult economic situation.

The Saudi Arabian economy, which grew by 10 per cent in 1991, benefited from a sharp increase in oil production, undertaken to make up for the temporary absence of Iraq and Kuwait from the world oil market. Increases in Gulf-related defence expenditures necessitated government borrowing and large-scale bond sales, but the impact on the balance of payments was considerably softened by the repatriation of private capital. Oil production in Kuwait, in spite of extensive damage to the oilfields, reached 0.5 mb/d by the end of 1991, but this was well below the 1989 average of 1.8 mb/d. Losses to petroleum reserves were less than feared, some spilled oil has been recovered, and exports of refined products have been resumed. After the hostilities, with the private sector still in disarray, household incomes were directly supported by the Government's insistence on considerable welfare expenditures. Foreign assets were substantially liquidated both to meet these expenditures and to help finance the current account deficit, estimated at $17 billion for 1991, as compared with a surplus of about $4.8 billion in 1990.

Iraq also suffered extensive infrastructural damage as a result of the military conflict. GDP is estimated to have fallen by at least 60 per cent in 1991 on this account and also because of the United Nations embargo. Widespread shortages of imported industrial raw materials and spare parts resulted in the shutdown of much industrial plant, and in spite of the much greater attention given to agriculture, food shortages and a scarcity of other goods caused a spiralling inflation. Industrial activity was largely limited to the production and refining of limited quantities of oil, mostly for domestic consumption. After the cessation of hostilities there were continuing financial problems, shortages of construction materials, and erratic supplies of electricity, all of which slowed down the reconstruction of the economy. Iraq's trade and payments transactions with the rest of the world have been reduced to a bare minimum by the United Nations embargo.

As a result of substantial reconstruction efforts following eight years of war, the economy of the Islamic Republic of Iran recovered in 1990, when GDP grew by 10.3 per cent, followed by a further 6 per cent in 1991. Output rose in almost all sectors, and there was a substantial increase in export revenues from oil and natural gas, as a result of which there was an improvement in both public sector finances and the balance of payments. Growth in the Syrian Arab Republic was apparently not so much affected by the Gulf crisis, and came to about 5 per cent, owing to increased crude oil production and a good cotton crop. As a part of the market-oriented liberalization programme, agriculture continued to be given priority and new banking facilities were offered to private investors. Despite financial constraints, the Government increased growth-oriented expenditures through borrowing.

Jordan, a net oil importer, though hard hit by the Gulf crisis, has already embarked on economic recovery. GDP declined by only about 0.5 per cent in 1991, compared with a contraction of over 5 per cent in the previous year. Emergency aid flows and financial assets of expatriates returning home helped to prevent a still larger fall in domestic demand, and there was a modest rise in construction and in retail sales. In Yemen, the return of expatriates doubled the unemployment rate to over 30 per cent in 1991, and further exacerbated the already serious social and economic problems of a country plagued with growing budget and current account deficits, accelerating inflation and a heavy burden of debt. The loss of workers' remittances represented some 20 per cent of Yemen's normal hard currency earnings. An effort to increase oil exports was frustrated by a rapid growth of domestic fuel consumption and by technical production difficulties arising from an over-abundance of gas in the oil fields.

(b) Prospects

The recovery which has been in evidence since the second half of 1991 should be strengthened in a number of countries of the region as oil exports and reconstruction gather momentum. With enhanced exports by some oil producers, current account deficits will decline substantially. In Kuwait, output is expected to recover rapidly, to a probable level of 1.0 mb/d for 1992, or one third below its pre-war quota. Massive government spending for reconstruction, combined with buoyant consumption stimulated by high disposable income, will ensure the dynamism of the economy. The adjustment of the Saudi Arabian economy to lower levels of oil production will result in slower overall growth than the previous two years. Projected increases in imports and in budget expenditures may require renewed recourse to external borrowing, although capital inflows, including the return of private capital, are expected to finance the bulk of the current account deficit. Economic prospects for Iraq are more uncertain, in view of the continuing United Nations embargo and various economic and political difficulties both within the country and in its relations with the outside world.

Prospects in the Islamic Republic of Iran are for continued rapid growth, as the country further liberalizes foreign trade. The Government is focusing on extensive market-oriented policy reforms, including a relaxation of controls on foreign capital inflows. In addition, exports of manufactured goods and agricultural products are gradually gaining importance relative to oil. Bahrain is also pursuing policies to promote competition, wholly foreign-owned companies now being allowed to operate in the country. Sustained economic expansion in the Syrian Arab Republic is expected to come mainly from hydrocarbon production, which is becoming increasingly important as new deposits of oil are found. Investment in manufacturing is to be stimulated by the grant of incentives. In addition, the country will receive assistance from the new development fund which is to be established by the Gulf Cooperation Council.[5] However, short-term inflationary pressures are likely to emerge as a consequence of the gradual removal of price controls and food subsidies. As regards Jordan and Yemen, the impact of trade and budget deficits, together with reduced aid and continuing low levels of private remittances, will continue to weigh heavily on economic performance. Social conditions may be eased through an improvement in the investment climate and in consequent employment opportunities. However, the recovery of tourism is likely to take longer.

5 For information on the proposed fund see *Middle East Economic Survey*, 29 April 1991.

4. South Asia

(a) Recent developments

For many developing countries of South Asia, 1991 was a difficult year owing to a widespread contraction of demand in both domestic and foreign markets, tight domestic policy, foreign exchange crises and serious balance of payments deficits. The domestic demand contraction resulted from sweeping stabilization measures aimed at curbing high import levels, credit expansion and persistent unsustainable fiscal deficits. Depressed export demand, due in large part to a slowdown in world trade and events in the former Soviet Union, contributed to a widening of trade deficits. Various setbacks, ranging from the consequences of the Gulf war, to social and political unrest, a fall in private remittances from abroad and in receipts from tourism, as well as natural disasters, resulted in unprecedented shocks to some countries. The temporary loss of confidence arising from these factors damaged their international credit ratings and made commercial borrowing difficult. Corrective measures became essential to restore confidence, maintain balance of payments equilibrium and ensure debt servicing. To this end, new strategies were put in place, including exchange rate and fiscal adjustment and structural reforms in the areas of trade, industry and finance. Fiscal adjustment was supported by a restrictive monetary policy aimed at reducing aggregate demand. In respect of industry, steps towards wide-ranging liberalization and deregulation of the economy were undertaken in order to enhance the overall efficiency and competitiveness of domestic firms, and to stimulate exports. In particular, financial reforms have been pursued with a view to encouraging domestic saving, attracting capital from nationals resident abroad and improving the investment climate for both domestic and foreign investors.

The average growth rate in South Asia during 1991 was almost one half that achieved in 1990. Growth slowed down in Bangladesh, India, Myanmar and Sri Lanka, while in Bhutan, Nepal and Pakistan it accelerated. A 3.6 per cent growth in 1991 in Bangladesh was achieved despite serious social strains, in particular labour unrest which led to the holding of democratic elections, and despite also severely devastating cyclones which upset the country's production base. Output in agriculture increased (by 2 per cent), an outcome that was made possible by the Government's input distribution programme aimed at streamlining the distribution and sale of agricultural inputs to farmers. GDP growth in India, which rose annually by 6.0 per cent during the period 1985-1990, slowed down sharply from 5.0 per cent in 1990 to about 2 per cent in 1991. Rising uncertainties associated with the political situation and persistent fiscal imbalances, accentuated by the Gulf crisis, intensified strains on an already weak balance of payments position. Agricultural output stagnated owing to bad weather, while industrial growth, particularly in manufacturing, slowed down sharply as a result of tight credit policy, high interest rates and import compression imposed by a severe shortage of foreign exchange and the burden of external indebtedness. To cope with these difficulties, the Government took wide-ranging deregulation measures, including the reform of public sector enterprises, a 23.0 per cent devaluation of the currency, and the grant of greater autonomy to commercial banks. The current account deficit in 1991 is estimated to be considerably lower than in the previous year. The liberalization programme in Myanmar, initiated in 1989, has so far made rather slow progress owing to lack of financial resources. Economic growth remained modest and was slightly lower than the 4.0 per cent attained in 1990, owing to crop damage caused by floods. The economy of Sri Lanka continued to improve with the reduction of civil unrest and a positive response of the private sector to the Government's reform programme. The slower growth of GDP, from 6.2 per cent in 1990 to 4.8 per cent, was due mainly to a relatively poor performance by agriculture.

Bhutan's economy, which is predominantly agricultural, improved slightly in 1991, and was hampered by slow growth in the industrial sector. A new approach to economic development has been made in Nepal since May 1991, when the newly elected Government promoted private initiatives and investment. The non-agricultural sector revived sharply under the impulse of construction and manufacturing activities, and substantial export gains were achieved. Aided by structural reforms pursued by the Government, Pakistan was the fastest-growing economy in South Asia (6.5 per cent in 1991, compared with 5.3 per cent in the previous year), with strong increases in agricultural output and in export sectors (despite a sharp shortfall in raw cotton exports).

Inflation increased somewhat in 1991 (with the exception of Bangladesh and Sri Lanka), partly as a result of transitional effects of the reform process undertaken by countries of the subregion, which generally provoked short-term price increases. In Pakistan, the consumer price index rose by 11.8 per cent in 1991, compared with 9.0 per cent the previous year, due in part to adjustments in domestic energy prices. Tight monetary policies are being pursued, with the prime objective of preserving export competitiveness, and also reducing the balance of payments deficit. Tax reforms have been implemented, including the broadening of the tax base.

(b) Prospects

The economic outlook in many countries of South Asia depends not only on the foreign environment, but also on domestic factors, such as political stability, weather conditions, domestic demand and, more particularly, the impact and speed of various policy reforms to restructure the economy. Though the new situations may require a period of adaptation, and unforeseen constraints may cause some delay, sustained favourable results are expected over the medium term. For the immediate future the outlook is brighter, as the subregion adjusts to earlier shocks. Since much industrial input is derived from agriculture, FDI in agriculture-related industries would help expand exports and thereby contribute to higher GDP growth. Further reforms in industrial policy are necessary, such as an 'exit' policy, which would allow non-viable enterprises to close down more easily.

As a result of industrial reforms recently initiated in Bangladesh, as well as of measures taken to reduce the budget deficit, manufacturing output can be expected to pick up. GDP growth is expected to recover rapidly from the low level of 1991. It should also be higher in India, despite tight fiscal policies and balance of payments constraints which are likely to continue until new financial flows resume substantially and barriers to foreign investment are lowered. Industrial production should nevertheless expand as import restraints on raw materials and essential goods are relaxed. Exports are likely to improve as the rise in input costs slows down. The private sector is likely to respond to business opportunities more readily than before, and have a greater impact on manufacturing output. As a result of its recent trade and transit agreement with neighbouring India, Bhutan should have a broader scope for the production of export-oriented crops, while reforms undertaken since 1989 to encourage privatization should gain momentum and contribute to higher GDP growth. In Sri Lanka, agriculture is unlikely to recover from the prolonged drought of 1991. The benefits anticipated from recent moves towards privatization in manufacturing may not fully materialize because of shortages of hydroelectric power. Growth in Myanmar is expected to be moderate, and will be hampered by the shortage of power and raw materials for industry. Medium-term prospects in Nepal are encouraging, following measures taken for a gradual devaluation of the currency and the lowering of import tariffs aimed at promoting manufacturing and increasing exports. However, the growth rate in 1992 will be low owing to crop damage. Pakistan should be able to sustain relatively high GDP and export growth over the medium term as privatization and deregulation take place, in favour of the manufacturing sector. Firms can be expected to respond strongly to these reforms, including fiscal incentives for private investment. However, fiscal discipline and expansion of the tax base are necessary if the budget deficit is to be reduced. Since much will depend on greater social stability, the Government is planning for a social action programme to improve the status of the poor.

5. South-East Asia

(a) Recent developments

The economies of South-East Asia, which had experienced the fastest growth rates in developing Asia during 1989 and 1990, have been able to continue their expansion in 1991, albeit at a slower rate than in the preceding two years, including a reasonably satisfactory export performance. The success was in part due to close ties with Japan and neighbouring newly industrializing economies, and to continued flows of foreign direct investment which have helped to improve labour productivity and productive capacity. Relatively high consumer demand, combined with substantial public investment, compensated somewhat for a slowdown in private investment. Private investment flagged not only because of world trading conditions, but also because of various internal factors, namely infrastructure bottlenecks, capacity constraints in the domestic capital goods sector, natural disasters, and tight fiscal and monetary policies designed to contain pressures on the price level and the balance of payments. In order to maintain a sustainable rate of expansion, some Governments have taken measures to encourage domestic saving and private investment.

In Indonesia, growth in 1991 is estimated to have been 6.6 per cent, compared with a rise of 7.4 per cent the previous year, in part due to a very modest growth in agricultural output because of a long drought. Unlike previous years, the export sector outpaced domestic demand as the engine of growth. The rise in real private consumption, which was almost 10 per cent in 1990, declined to 4 per cent in 1991. Policies of demand restraint, together with tighter controls on borrowing abroad, brought some relief to imports, and slowed the growth of investment, including construction. Although export prices weakened, particularly for oil, exports rose in value by 13 per cent, while imports rose by 17 per cent, a considerable reduction compared with the excessive growth of 33 per cent in the previous year. The current account deficit also widened, owing to a continued rise in the deficit on services account. Malaysia continued to be one of the fastest-growing economies in the region, with a growth rate of GDP of 8.6 per cent in 1991 that was induced both by domestic demand and by exports. In the Philippines, on the other hand, there was an actual decline of GDP (of 1.0 per cent) for the first time since 1985, owing to a number of unfavourable factors, including a string of natural disasters that struck the country. Stabilization measures taken by the Government to control the budget and trade deficits slowed down the economy further. The general climate of uncertainty, combined with an imposition of an import levy, weakened domestic demand and resulted in a 14 per cent contraction in real gross capital formation, particularly in construction. Various signs of improvement and of mild recovery were observed towards the end of 1991, and a moderate resumption of growth in the near term is expected. After a rapid growth during the previous four years (averaging 11.2 per cent), GDP in Thailand rose by 7.7 per cent in 1991, reflecting a cooling off of the economy and a move towards a more sustainable growth path. With the easing of demand pressures in most sectors, the rate of inflation was moderated and import growth declined.

Both the Lao People's Democratic Republic and Viet Nam have adjusted flexibly to the abrupt cessation of economic arrangements among the former CMEA countries and have been able to achieve growth of around 4 per cent in 1991. Their relative slowdown was due mainly to low agricultural output caused by bad weather, while the industrial sector continued to improve. Market-oriented policy reforms which have been undertaken in these two countries, and which require further consolidation, include fiscal and monetary policies, measures of privatization, and introduction of a new foreign investment code. In response, there has been a rapid increase in the number of joint ventures in Viet Nam, particularly in oil and gas exploration. Exports have enjoyed the benefit of low labour costs and exporting firms receive special tax treatment. Reorganization of State-owned enterprises has led to a substantial increase of industrial output, while new labour incentives have enhanced productivity. Faster response to the reforms has been hampered by persistent inflation, which is a major cause of concern in Viet Nam, partly because of the difficulty in financing the budget deficit. However, there are innumerable possibilities of cooperation with other countries in the further development of the economy, as more licences for investment projects are approved.

(b) Prospects

The outlook in many countries of the subregion depends, in part, on certain external factors such as the outcome of the Uruguay Round, the volume of world trade, and the level of oil and other commodity prices. The stimulus from world export demand is likely to remain relatively weak. Governments will continue to be concerned with payments deficits and with inflation, and consequently can be expected to continue pursuing the prudent fiscal and monetary policies which many of them have implemented since mid-1990, though perhaps with some easing. Conditions influencing domestic demand will remain favourable, although growth of consumption and investment will probably be somewhat less than the high rates of previous years. A smaller increase in FDI, together with diminished growth in Japan, will dampen the growth of intra-regional trade in spite of productivity gains in industry. The ASEAN countries are likely to remain on the high growth path of the last several years, though at a marginally lower rate than in 1991.

In Indonesia, non-oil manufactured exports will continue to grow at their strong trend rate, assisted by new production capacities coming on stream as a result of substantial past investments. Stagnation of imports should prevent any major widening of the current account deficit, while the postponement of investment plans may have consequences for heavy industry and the expansion of infrastructure in the longer term. On the other hand, the recent announcement that 100 per cent foreign ownership in new companies will be allowed should provide some further stimulus to the manufacturing sector. Growth should continue in Malaysia, although at a slower rate, and will continue to be driven by firm domestic demand. Public expenditures will be concentrated on improving infrastructure and will make up for some slackening of foreign capital inflows associated with joint ventures. Major imports of technology equipment are envisaged for improved efficiency and competitiveness. Recovery in the Philippines will be supported by progress under the current stabilization programme, rehabilitation of areas devastated by natural disasters and probably also by greater FDI as a result of new legislation. However, the Government will need to pursue reforms in a climate of social stability and of business confidence, and to overcome power shortages that have proved so disruptive. In Thailand, GDP growth will come mainly from an increase in exports (particularly electronics and electrical goods) due to tax reform measures implemented to enhance efficiency. However, the recent introduction of VAT, and the current political situation, may discourage the early implementation of planned investment by the private sector. Foreign exchange and other earnings from tourism will continue to be below the levels attained in 1990. Private savings will be mobilized through various fiscal and money market reforms, so as to narrow the savings-investment gap.

In certain countries, the services sector is projected to grow faster than in 1991 as tourism recovers and financial services expand to meet the growth of trade and investment. However, in some cases tourism flows may be affected by health risks associated with AIDS; likewise, labour productivity in enterprises may also be affected (see also the next chapter). While FDI and domestic private investment will be generally supported by recovery in foreign markets, structural supply constraints will be an impediment in some countries.

The potential for strong growth in the Lao People's Democratic Republic and Viet Nam, where important progress in the direction of a market economy has already been made, is considerable. Stable fiscal and monetary policies, together with measures to control inflation, will favour investment and stimulate greater FDI from neighbouring and Western European countries. Trade facilitation measures and adequate external financial assistance would help speed up growth prospects, but if more private foreign investment is to be attracted it will be important to remedy the deficiencies in basic social and physical infrastructure.

6. East Asia

(a) Recent developments

Despite the slowdown in the world economy, the East Asian economies continued to expand rapidly during 1991, supported by strong domestic and, to a lesser extent, export demand. Flexible production structures and supportive industrial policies enabled these countries to diversify exports and achieve larger market shares and so make up for relatively weak demand from the developed countries. A substantial increase in intra-regional trade also provided some stimulus. As business confidence improved, investment ratios rose and import demand remained firm, underpinned by a rapid growth of public investment in infrastructure.

In the Republic of Korea, there was a moderate slackening of growth, to 8.4 per cent in 1991, but because of earlier strong domestic demand and a surge of imports there was a payments deficit of $8.8 billion, compared with one of $2.2 billion in 1990. Sharp wage increases (due to labour shortage), as well as the sharp rise in the value of real estate and other capital assets, stimulated the expansion of private consumption. Inflation, which accelerated to 9.7 per cent, became a source of concern. Growth in Hong Kong and in Taiwan Province of China improved to 3.9 per cent in 1991 from 3.0 per cent in 1990 and to 7.3 per cent from 5.1 per cent, respectively. The announcement of construction plans for a new airport has strengthened confidence and given a fillip to domestic demand in Hong Kong, while close ties with neighbouring buoyant Guandong (China) fuelled re-exports, the share of which in Hong Kong's total exports reached 69 per cent in 1991, compared with 45 per cent in 1985. Growth in Taiwan Province of China was helped largely by high investment in infrastructure and a rise in exports. An improvement in the business climate prompted a further growth of private investment. However, much of it was financed by large inflows of short-term capital (due to the interest rate differential with the United States), which increased pressure for an appreciation of the domestic currency against the United States dollar. On the other hand, the slowdown in Singapore to 6.7 per cent, from 8.3 per cent in 1990, can be attributed mainly to sluggish non-oil exports, particularly computers, and some decline in financial services.

1991 was a very difficult year for Mongolia, owing to drastic disruptions of trade and payments arrangements and a sharp decline in financial assistance from the former CMEA countries. Serious shortages of raw materials and spare parts for machinery, as well as of consumer goods, including fuel and food (due to an unusually cold winter after heavy rains which severely damaged crops), compounded a difficult economic situation. The loss of its traditional export markets and the shortage of foreign exchange considerably hampered imports, resulting in the closure of enterprises and massive unemployment and accelerated inflation. GDP may well have declined by as much as 16 per cent in 1991.

In many countries, government expenditures on social and infrastructure projects have contributed to economic growth and will also strengthen the base for long-term structural change. In particular, Taiwan Province of China launched a massive $300 billion Six-Year Development Plan, which will finance public facilities, including highways and mass transit systems, with emphasis on environmental protection and on improving the quality of life. In Singapore, residential construction, mainly by the public sector, was the driving force of the industrial sector during 1991.

(b) Prospects

Rapid development in southern China, together with a number of large-scale infrastructure projects and some modest recovery in the United States, will contribute to strengthening export and GDP growth. Structural adjustment measures that have been carried out for some time in Hong Kong and Taiwan Province of China should begin to bear fruit. However, in certain countries labour shortage and environmental concerns have been a cause of delay in project implementation.

Signs of overheating in the Republic of Korea may induce a tightening of policy to curb private consumption and government expenditure. Tighter credit may result in lower business investment. But government attempts to moderate the rise in wages may help to improve the competitiveness of exports and thus reduce the trade deficit. Hong Kong will benefit from strong exports for outward processing in China and an expected increase in domestic demand. Prospects in Taiwan Province of China are for higher growth owing to sharply increased public expenditures and a rise in consumer spending as a result of higher disposable incomes. As the incremental value of imports is likely to exceed that of exports the trade surplus should decline. Because of strong domestic demand for investment, foreign investment in neighbouring countries is likely to rise more slowly. Singapore's prospects will be hampered by a slower rise in labour productivity in the manufacturing sector, but increased construction work, combined with an expected larger volume of tourism, particularly from Asia, will help to sustain the overall rate of activity.

Mongolia is still in a difficult transition process to a market economy, and industrial output will continue to decline in 1992 because of shortages of raw materials and other imports and lack of transport facilities. While government expenditures continues to rise, receipts have been falling with the decline of GDP, and private savings have started to shrink. To speed up reforms and improve the environment for private enterprises, particularly those engaged in foreign trade, a number of measures have been taken, including the waiving of export licences for goods and adjustment of the exchange rate. Despite these efforts to stabilize the situation, Mongolia badly needs financial assistance from the international community to help replenish supplies of much-needed industrial raw materials and petroleum.

B. China

1. Recent developments

Following implementation of economic adjustment measures in 1989, GNP in China rose sharply in 1991, exceeding by 7.0 per cent that of the previous year. The performance was sustained by a strong increase in industrial production (14 per cent), large gains in manufactured exports, and an improvement in agricultural output, as well as by strong consumption expenditure. In spite of devastating summer floods that struck the northern part of China, and which reduced grain output (but only by 2.5 per cent), farmers have responded favourably to new production incentives, and total agricultural output rose 3.0 per cent, against 7.6 per cent in 1990. Industrial production, which started to pick up in mid-1990, expanded further in 1991 as a result of increased fixed investment, high retail sales (a volume increase of 10 per cent), and continued strong export demand. In order to raise the efficiency of State-owned enterprises, the Government has introduced a series of measures since September 1991, including a cut in corporation tax rates and an increase in the depreciation rate of fixed assets. More autonomous management skills, with simpler organizational structures, were introduced. For example, factory managers have been given control over wages and bonuses, allowing pay scales that reward individual effort and skill. Stockpiles of goods were reduced, new quality products developed, and overall enterprises losses slowed down. In 1990, State-owned enterprises accounted for only 55 per cent of total industrial production, compared with 78 per cent in 1979 (just prior to the economic reform process), while the share of joint ventures and private firms has progressively risen. Relative price stability was maintained (the consumer price index rose by only 2.9 per cent), though certain State-administered price increases were effected for some categories of raw materials and staple foods so as to stimulate their production and reduce the burden of subsidies on the budget.

In the foreign trade sector, imports rose in value by as much as 19 per cent, outpacing the export growth of 15 per cent, and giving rise to a reduced trade surplus of $7.9 billion in 1991. The rise in imports was a consequence of the growth of domestic demand, especially for machinery and raw materials, and the need to upgrade plant and equipment. Another factor was the preferential treatment accorded to foreign companies, such as lower tax rates, which induced rising capital inflows for joint ventures and associated increases in imports. The current balance on invisibles account, however, continued to improve, mainly owing to higher earnings from tourism, and foreign exchange reserves were augmented.

2. Prospects

The progress of reform in China is to be continued. New reforms will seek to expand the role of markets and diminish that of the State, so as to speed up changes and facilitate the incorporation of new production techniques. On-going reforms, such as those affecting prices and the economic organization of rural areas, together with the rural policy of family responsibility and profit incentives, are expected to provide a healthier foundation for economic expansion. More flexible policies will be extended to State-owned enterprises with the aim of increasing competitiveness and profitability, including the right of managers to appoint or dismiss staff. Firms will have easier access to investment, import-export rights, and will be allowed to retain a higher proportion of their foreign exchange earnings. At the same time, they will be more accountable for their performance. Capital inflows for more joint ventures and foreign technology acquisition are to be encouraged for quality and efficiency improvement. High technology development zones along the Pearl River Delta will be expanded. On the international front, the liberalization of the trade system has, in part, been supported by tariff cuts on a number of imported items since the beginning of 1992, while the abolition of all export subsidies will help improve relations with trading partners. Foreign banks are also gradually expanding services in the country. China has allowed the yuan to depreciate slowly in a 'managed float', in view of its intention to reactivate its membership of GATT, thus bringing the official exchange rate closer to the domestically used renminbi rate on swap markets, leading eventually to the adoption of a single exchange rate regime.

As for future prospects, agricultural output is likely to expand as result of a substantial increase in investment. A further rise in procurement prices of farm products is likely, with a view to stimulating production and to abolishing price controls on most agricultural commodities. In addition, markets for the trading of farm inputs and grain sales are being gradually introduced in lieu of State channels. Industrial production may rise less than in the previous year, due to adjustments taking place in industrial structure which will take some time to work their way through, and also because of shortages of energy and of transportation facilities. Urban unemployment may rise with the redeployment of workers in the process of rationalizing State sector industries. However, with rising real personal incomes and new job opportunities in rural areas, consumer expenditures should be maintained at a high level. There is a need for institutional mechanisms for securities markets, so as to allow potential borrowers to tap the huge amounts of bank deposits that have been accumulated for maintaining price stability. However, much will also depend on measures introduced to reduce the budget deficit.

Though trade frictions between China and some developed countries may hamper exports, continued buoyancy of joint ventures and coastal export-oriented firms should ensure an expansion of exports, but at a lower rate than in 1991. On the other hand, imports are expected to grow faster than exports as a result of tariff reductions, higher purchases of capital goods by both the private and the public sector, and the presence of a growing number of foreign companies that are investing in the economy. Consequently, the trade surplus will decline further, but this will probably be offset in part by higher invisible net receipts, especially from tourism. The marked improvement in the economy in 1991 is likely to be sustained over the next two years, with growth in 1992 projected at about 8 per cent.

In the coming years, a series of measures will be taken, including steps to increase investment in agriculture and to pursue rural reform so as to ensure stable growth of grain output. The aim is to raise agricultural output at an annual rate of 4 per cent during the period 1993-1996. Real investment in fixed assets is expected to increase moderately. Though some bottlenecks will probably hinder production in industries, emphasis will be laid on the contract responsibility system in management so as to expand output at around 11 per cent annually. As the establishment of coastal special economic zones and joint ventures has made a critical contribution to China's trade and foreign exchange earnings, further measures to encourage such activities and attract FDI are envisaged. As more enterprises become operational, the value of total exports is likely to increase at an annual average rate of 11 per cent. However, the need for more construction materials and other production inputs, as well as for technology equipment, will cause an annual expansion of imports of 14 per cent in value terms. Domestic demand pressure will cause the price level to rise around 7 per cent per annum. In view of the process of restructuring, the economy is projected to grow annually by 7-7.5 per cent in the medium term.

In April 1992, the Chinese Government gave the go-ahead to build the world's largest hydroelectric station at the Three Gorges dam on the Yangtze River. Though it will cost people their homes, on completion of the project, the benefits to be reaped are enormous, including improved flood control and irrigation, and abundant power which will help ease the shortage of energy.

C. Central and Eastern Europe and the former USSR

1. Recent developments

(a) Central and Eastern Europe

The recession of the economies of the region deepened dramatically in 1991. Output contracted further and there were continued internal and external imbalances. A major feature in most countries was a considerable decline in industrial output resulting from a number of factors, including the growing impact of stabilization policies and economic reforms, a concurrent painful transformation toward market-oriented economies, and the collapse of intra-regional trade. Although there was recession in all countries, there were important differences among them in its severity and prospects of economic recovery.

The economic performance of Hungary was controversial in 1991. On the one hand, the expected 4-5 per cent drop in GDP is estimated to have been in fact one of 7-8 per cent. Both industrial and agricultural output fell sharply. The recession in State-owned industry was the deepest since the beginning of structural reforms, mainly due to the collapse of trade within the former CMEA and the disruption of stable economic links with the former USSR, a number of enterprises being traditionally oriented to the latter market. On the other hand, the country recorded its healthiest ever balance of payments, with a record surplus on current account due to sharply reduced imports and substantially increased exports of services, primarily tourism. From the very beginning the newly emerging economic structures have concentrated on hard currency markets. Within two years there was a significant change in the direction of trade, with the industrialized countries becoming Hungary's principal trading partners. Inflation, though still high by European standards, remained under control. Despite some budget difficulties in the middle of the year, the Government recovered fiscal control and the budget deficit remained within manageable limits.

The economy of Poland experienced in 1991 a new phase of recession. A forecast steep decline of industrial output in the public sector was not accompanied by the expected increase in private sector activity, and agricultural output stagnated. As a result, GDP further contracted, by some 9 per cent. Contrary to expectations, investment demand, which was supposed to be a major driving force of the recovery, declined, owing to the continued pursuit of a tight fiscal and monetary policy and a resulting lack of confidence of potential investors. The current account balance worsened in 1991 mainly because the trade surplus was the smallest since 1982. After an impressive rise in 1990, exports declined, although the decline was less pronounced than predicted. The rapid growth of imports was fuelled by imports of consumer goods by the private sector. At the same time, last year Poland benefited from exceptional debt rescheduling and capitalization of interest (see Part Two below, chapter I, section II).

1991 was the first year of real structural change resulting from the programme of economic reforms in Czechoslovakia. As in the other countries of the region, the initial response was a substantial decline in production. According to the most recent estimates available, the fall in GDP in 1991 was some 16 per cent, while the decline in industrial production was even more pronounced, mainly because of a combination of unfavourable external factors, in particular the unexpectedly rapid disintegration of CMEA, the collapse of the Soviet economy, and the Gulf crisis. The immediate impact of the economic transformation has been an acceleration of inflation, stemming from the liberalization of prices at the beginning of 1991 as well as from the increases in the prices of imports from the former CMEA countries, rising unemployment, and a fall of per capita real income.

The contraction of the Bulgarian economy is estimated to have been around 23 per cent in 1991, affecting most seriously the construction sector and domestic trade. The role of the private sector in Bulgaria is still marginal. A major achievement of financial policy was the reduction of the current account deficit with convertible currency countries. Nevertheless, the external financial situation remains serious.

(b) The former USSR

Economic activity in the former Soviet Union was dominated by political events, which by the end of the year resulted in its disintegration and the creation by the majority of the former Soviet republics of the Commonwealth of Independent States (CIS). The dramatic fall in industrial output - estimated at 18 per cent - and the decline of agricultural output - the two traditional major driving forces of economic activity, were responsible for a fall of GDP by 17 per cent. The profound disruption of the financial system, a large budget deficit, and strong inflation, owing to the failure of administrative price reform, all of which was compounded by a number of social and ethnic conflicts, contributed to further economic decline. The fragmentation of the country and of its common economic space during the year was accompanied by a harsh breakdown of traditional economic links among the formely highly integrated constituent republics, which accelerated the economic collapse.

In 1991 the persisting shortage of convertible currencies continued to boost barter trade, and both exports and imports recorded a steep decline. In rouble terms total exports dropped by some 32 per cent, resulting mainly from a sharp decline in the value (and volume) of crude oil exports, the most important export product. The decline in imports was even more pronounced, particularly for imports from the former CMEA countries, and partly explains the collapse of Soviet industrial output in 1991. The composition of trade flows by region has completely changed in the last two years. As a result, after a trade deficit in the previous year, the combined trade balance of the former Soviet republics showed a large surplus in 1991.

2. Prospects

(a) Central and Eastern Europe

Short-term economic prospects for Central and Eastern Europe as a whole are moderately optimistic. Although output will continue to fall in almost all countries, the pace of contraction is likely to slow down. Exports are expected to expand further, as new opportunities in European markets replace the disrupted markets of the former USSR. Imports, fuelled by some growth of internal demand, are forecast to rise faster than exports, with a resultant deterioration of these countries' combined current account balance and the individual balances. Short-term forecasts inevitably involve a large element of uncertainty on account of the domestic political instability in some of the economies. Longer-term prospects are brighter. It is expected, that structural reforms and improved investment opportunities will restore positive growth rates to Poland and Hungary, and perhaps also Czechoslovakia, by the mid-1990s (and possibly as early as 1993 in Hungary). Because of the delays in implementing institutional reforms in Bulgaria and Romania, recovery in those countries is expected to take longer.

Hungary seems to have the best chance of overcoming the recession in the coming years: the most uncertain period of the transition has already passed; market institutions, including the necessary legal basis, have been created; tax, price and subsidy systems have been reformed; and privatization, after a period of cautious expectation, has accelerated. Exports are expected to continue their strong expansion, mainly to hard currency markets (but a return to the former Soviet markets is also possible). However, some worsening of the balance of payments may occur as a result of increasing demand for imported goods.

Poland has modified its economic strategy, which now aims at easing the rigours of market-oriented policies. The latter have brought about rising unemployment and declining living standards, especially in the State-owned industries. Emphasis has been switched from deflationary to anti-recessionary measures, with a focus on boosting exports and investment so as to stabilize the level of unemployment. A slow recovery of the Polish economy began in the first months of 1992 with an increase in exports, reflecting the rise in sales of industrial products. Nevertheless, an early return to positive growth rates seems unlikely.

In Bulgaria the Government's expectations of a rapid recovery rely on the expected inflow of foreign investment, privatization and the resulting increase in exports, and higher personal consumption. However, the country is still in the initial stages of the transition process and recovery in 1992 is unlikely.

(b) The former Soviet republics

The former Soviet republics, both members and non-members of the CIS, will continue their transition to market economies and integration into the world economy. However, the initial conditions of this process vary from one economy to another and largely depend on their size, the degree of integration into the former Soviet economy and their political and social stability. In the years to come these countries will face problems of economic transformation related to the freeing of prices, the re-establishment of budget discipline, introduction of national currencies, banking reforms and privatization. In the new economic climate created by the break-up of the Soviet Union, the former Soviet republics facing the greatest difficulties will be those which strongly depend on foreign trade and have large trade deficits - in particular the three Baltic states, Moldova and Belarus, which are relatively poorly endowed with natural resources and depend on the exchange of manufactured goods for energy and raw materials from the Russian Federation.

Economic relations with the Russian Federation, the largest of the former Soviet republics in terms of territory, population, and industrial and export potential, will, at least for the next few years, continue to influence the economic performance of individual countries that were formerly republics of the Soviet Union. The process of economic reforms in the Federation and its political, ethnic and social stability will influence the overall economic situation in this subregion as well. Since the beginning of 1992 the new Government has started to implement a large-scale programme of economic reforms, with emphasis on the liberalization of prices, of domestic and external trade, and of the foreign exchange regime, and on financial stabilization (consolidation of the budget, financial reform), as well as on privatization. Already the first results of this reform have provoked controversial reactions. Some beneficial impacts of the relatively strict application of the programme started to be felt in the first three months of its application: substantial consolidation of the budget has been achieved through cuts in military expenditure and subsidies and some increase in revenues ensured by the introduction of VAT. There has also been some recovery in exports. Also, the domestic market has started to be replenished at the higher prices. At the same time, the tight fiscal and monetary policy has provoked a continued fall in industrial output, albeit at a decreasing rate. As a result of foreign exchange liberalization, imports have risen sharply and the trade surplus has turned into a deficit. Real financial stabilization has not yet been achieved and structural changes have not yet been initiated. The planned transfer of State property into private hands is constantly delayed and the programme of large-scale privatization of over-monopolized industry is not yet finalized. The second stage of the programme involves the introduction of credit incentives to producers. Further steps in economic reform, involving rouble convertibility and external and internal liberalization, are expected to be taken during the second half of the year.

The Government's revised forecast for 1992 is for a 12 per cent fall in GDP and industrial output, and 13 per cent in the production of consumer goods (18 per cent for food). The fall of GDP is expected to continue until mid-1994, when recovery and a restoration of positive growth rates may be achieved.

D. Developed market-economy countries

1. Recent developments

Economic performance in the developed market economies over the past two years was characterized by drift and a slow erosion of momentum. 1991, with a growth of aggregate output of only a half of 1 per cent, proved to be somewhat worse than expected, although outright recession for the group as a whole was avoided. Nevertheless, in a number of countries, including the United States and the United Kingdom among the larger economies and Finland, Sweden and Switzerland among the smaller, GDP declined. Australia and New Zealand also underwent recession in 1991. With the exception of Germany, where GDP remained unchanged, the other developed economies experienced varying degrees of growth, led by Japan among the larger ones and Norway among the smaller. Generally, the slower expansion of aggregate demand was primarily due to weak private investment, with the principal exception of Germany.

Inflation rates have been on a downward trend and are generally lower than in the 1980s. Among the major countries only in Germany has the rate tended to increase; the rise in the consumer price index is currently about $4\frac{1}{2}$ per cent on an annual basis, as compared to $1\frac{1}{2}$ per cent over the last half of the 1980s. Unemployment rates clearly reflect the recent slowdown in economic activity in the developed economies. After last peaking at $8\frac{1}{2}$ per cent in 1983, the rate of unemployment fell slightly in every year up to 1990, but in 1991 increased to over 7 per cent, from 6.3 per cent in 1990.

In the United States, output declined by 0.7 per cent in 1991, reflecting the recession of the last quarter of 1990 and the first quarter of 1991, followed by a weak and faltering recovery in the rest of the year. The prolonged weakness of the United States economy was reflected in the decline of all major expenditure components. Historically low inflation rates have allowed considerable flexibility in monetary policy, but unemployment rates increased sharply in 1991 and currently stand at $7\frac{1}{2}$ per cent. The federal deficit was around $4\frac{1}{2}$ per cent of GDP and is expected to increase considerably. In Canada, there was likewise a fall in GDP, of $1\frac{1}{2}$ per cent in 1991, and unemployment increased sharply, currently standing at more than 11 per cent of the labour force.

Performance in Western Europe was mixed in 1991, with only the United Kingdom among the major economies having a decline in GDP, of almost 2.5 per cent. Although the German economy registered no growth, import demand relating to reconstruction needs played a significant role in supporting growth in the rest of Western Europe. France and Italy succeeded in maintaining positive rates of growth of about 1 per cent, while the rest of EEC did relatively well, growing on average by about 2 per cent. The region as a whole, while avoiding recession, grew at less than half of 1 per cent in 1991, after registering better than 2 per cent growth in 1990.

In almost all Western European countries inflation, as measured by the consumer price index, was brought down. The index for EEC as a whole fell by half a percentage point, to less than 5 per cent in 1991, in spite of accelerated inflation in Germany. The United Kingdom made considerable progress in bringing its rate of inflation into line with the EEC average. Unemployment, on the other hand, was generally higher in 1991, particularly in the United Kingdom, where it rose from slightly less than 6 per cent of the labour force in 1990 to more than 8 per cent in 1991 and now stands at $9\frac{1}{2}$ per cent.

Japan continued to expand at a relatively rapid rate in 1991, achieving a growth of GDP of $4\frac{1}{2}$ per cent with stable unemployment and a slight increase in the rate of inflation. In contrast, recession in both Australia and New Zealand caused sharp increases in unemployment, with rates currently at double-digit levels.

2. Prospects

The outlook for the developed economies is for some increase in growth for 1992, possibly reaching about 1.5 per cent for the year as a whole, with a somewhat broader recovery, approaching 3 per cent, for 1993. However, any forecast is necessarily tentative in view of the persistence of a number of constraints and uncertainties, in particular financial fragility (discussed in Part Two, chapter II of this Report).

In North America, current forecasts are for the United States to grow at about 1.5 per cent in 1992 and Canada at about 2 per cent. Sustained recovery could result in an average growth in North America of 3 per cent in 1993. However, current indications of the pace of recovery in the United States are mixed and there is renewed pressure on the Federal Reserve to further ease credit. The forthcoming presidential and congressional elections are contributing to the climate of uncertainty. Nevertheless, renewed growth in Western Europe in the latter part of 1992 and 1993 should provide a stimulus to export demand for the United States.

In Western Europe, expectations are of a generally weak expansion in 1992 of perhaps not more than 1.5 per cent. The recession in the United Kingdom should come to an end and growth should be resumed in Germany. Nevertheless, the current uncertainties revolving around the process of ratification of the Maastricht treaty are having an unsettling impact on business confidence. Overall growth for the region may be no more than 1.5 per cent, with France, Germany, Italy and the United Kingdom all expanding at about the same pace. Subject to the uncertainties mentioned above, expansion should be considerably more robust in 1993, with growth approaching 3 per cent.

In Japan, business confidence has been shaken by a number of financial scandals and a sharp decline in prices of real and financial assets. Continued high growth in Japan up to the latter part of 1991 had been a stabilizing factor in the world economy, but developments in more recent months have dampened expectations of rapid global recovery . Furthermore, while forecasts are for a return in Japan to more normal growth in 1993 of about 3.5 per cent, the medium-term outlook is for growth rates somewhat lower than those of the 1980s.■

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Chapter IV

DEVELOPMENT AND GROWTH: A LONG-TERM PERSPECTIVE

A. Introduction

The world economy is presently undergoing a profound transformation which reflects developments in terms of economic fundamentals at the national and international level, in official policies as well as in financial markets and institutions. Of obvious immediate and longer-term significance is the economic transformation that is under way in the transition economies of Central and Eastern Europe and the former USSR. Similarly, the conclusion of the North American Free Trade Agreement (NAFTA), the establishment of a European Economic Area (EEA) and similar arrangements in the Western hemisphere, as well as of a single EEC market and the enlargement of the Community, may well lead to important changes, directly and indirectly, in both the direction and the composition of world trade.

As noted in the previous chapter, the world economy stagnated in 1991, an outcome that was worse than initially foreseen, in particular for the transition economies. The developed world remains largely in recession as a consequence of continued weak recovery in the United States, Canada, United Kingdom and Australia and relatively slow growth in Germany and Japan. While there appears recently to have been an upturn in activity, particularly in North America, a broader, though still relatively modest, recovery is not yet in sight.

There is concern that the weak performance of the developed market-economy countries could lead to a prolonged recession, especially because of the reluctance of Governments to provide any important fiscal stimulus when budgets are already severely strained. Similarly, the relatively high interest rate in Germany has limited the options available to other Western European countries to ease monetary policy. Moreover, in some countries there is a fear that too fast an expansion will rekindle inflation. Also of concern is the final outcome of the Uruguay Round and the implications for world trade, as well as the possibility of a world credit crunch because of a weak savings performance relative to global investment demand.

The present chapter examines briefly the growth prospects of the major regions of the world, especially those of the developing countries, during the 1990s. To that end, the UNCTAD secretariat's System of Interlinked Global Modelling and Analysis (SIGMA)[6] has been used to generate a baseline scenario up to the year 2000. A baseline scenario, as the name implies, is normally carried out under the assumption that there are no significant changes in current trends, policy measures, or major behavioural relationships, and is intended to serve as a point of reference for evaluating situations where it is assumed that such changes will occur.

6 For a brief description of SIGMA, see *TDR 1990*, box 8.

B. Key assumptions of the baseline scenario

In continuation of the current trend, growth in labour productivity in developed market economies is assumed to be the same as in the 1980s. Consequently, a crucial factor in determining future output will be the growth of the labour force, which is itself the product of the growth of the working age population and the labour participation ratio.

For demographic reasons, growth in the working age population is slowing down significantly, but at varying rates, in developed market-economy countries. However, this factor is offset to some extent by the projected increase in participation rates. The outcome in terms of projected GDP growth for these countries as a group is 2.5 per cent per annum during the 1990s, as compared to 2.8 per cent in the 1980s.

In the area of international finance, no radical changes are assumed. Instead, recent donor performance (including that of multilateral institutions) is projected to continue on the same lines in the 1990s. For currently indebted countries, however, it is assumed that only limited private lending will be forthcoming, and that they will continue to honour their debt service obligations.

Bilateral trade flows by major SITC groups[7] in the projection period are derived on the basis of import-share matrices estimated for the relevant SITC groups at the end of the 1980s. These matrices are also used as weights applied to available export unit values to generate corresponding import unit values for individual countries or regions in the system. Export unit values, on the other hand, are computed by using appropriate weights applied to projected prices for a set of some 40 selected commodities.

It should be noted that projections for countries in Central and Eastern Europe and the former USSR pose a particular challenge. Not only is there a lack of reliable and accurate statistics, but also it is difficult to adopt a meaningful methodology when drastic changes are taking place. The decision, for example, to abolish the CMEA clearing arrangements and adopt fully convertible currencies as the basis for trade as from January 1991, taken in the absence not only of adequate foreign exchange reserves but also of the necessary mechanisms for trading in hard currency, resulted in a drastic reduction of intraregional trade, which traditionally accounted for 35-40 per cent of the region's total trade.

Furthermore, these countries continue to suffer from rising unemployment and inflation, major internal imbalances and widespread shortages, especially of consumer goods, and tight financial constraints. The task facing their economies is not just a matter of transition but one of overall transformation of an economic system with inappropriate production and distribution structures. The enormity of the task confronting them can be compared to that of an economy emerging from a major war that has to reallocate resources away from the defence sector to consumer and capital goods industries and exportables. For these countries, therefore, extraneous rates of income growth are imposed on the system.

C. Summary results of the baseline scenario

The results of the baseline scenario in terms of GDP growth are summarized in table 7 whereas table 8 presents selected financial indicators for developing countries on a regional basis. As can be seen from table 7, continuation of current trends and policies would not lead to significant improvements in performance in the 1990s over the 1980s, and differences in growth among regions and countries will continue to persist. Most of the projected growth in the 1990s would be in the second half of the decade, when the world economy is

7 The commodity group classification is: SITC 0+1, 2+4, 3, 7, and 5+6+8+9.

Table 7

WORLD OUTPUT GROWTH IN THE 1980s AND PROJECTIONS FOR THE 1990s

(Average annual rate in per cent)

Country group	*1980-1985*	*1985-1990*	*1990-1995*	*1995-2000*
World	2.6	3.2	2.2	3.4
Developed market-economy countries	2.4	3.2	2.1	2.8
of which:				
North America	2.9	3.0	1.8	2.5
Western Europe	1.6	2.9	1.9	2.8
Other	3.5	4.3	3.3	3.7
Central and Eastern Europe and former USSR	2.9	1.1	-5.5	3.0
Developing countries	1 9	3.4	4.1	4 3
of which in:				
America	1.1	1.8	3.2	3.3
of which:				
Eurocurrency borrowers [a]	1 0	1.8	3.3	3.4
Others	1.8	1.8	2.5	2.9
Africa	1.7	2.2	3.1	3.7
of which:				
Eurocurrency borrowers [a]	0.1	1.6	3.7	4.3
Least developed countries	1.3	2.2	2.4	3.1
Others	3.8	2.7	2.8	3.3
Asia	2.6	4.8	4.8	5.0
of which:				
Oil-dominant [b]	-5.3	0.2	2.4	3.6
Eurocurrency borrowers [a]	5.4	7.9	6.5	6.3
Least developed countries	4.4	2.2	3.0	3.1
Others	5.5	4.5	4.3	4.4
China	10.0	7.6	7.2	6.5
Memo item:				
Least developed countries	2.4	2.2	2.7	3.1

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

a 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.

b Iraq, Kuwait, Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia and United Arab Emirates.

projected to resume its historical trend following the recovery of developed market economies in the second half of 1992.

Prospects for developing countries are not particularly encouraging, in spite of the fact that a number of them were successful in pursuing structural adjustment and stabilization policies and registered significant improvements in income growth in 1991, as noted in the previous chapter. With population projected to grow at some 2.3 per cent per annum during the 1990s, per capita income for developing countries as a whole would increase by 1.8 per cent. Underlying the global figures are considerable regional variations. Indeed, most of the gain will be in Asia (a rise of 2.7 per cent).

For Latin America, prospects will continue to depend on success in dealing with the debt overhang. Although positive growth was resumed in a number of countries in 1991, in-

Table 8

RATIO OF DEBT, [a] INTEREST PAYMENTS AND CURRENT ACCOUNT BALANCES OF DEVELOPING COUNTRIES TO EXPORTS OF GOODS AND SERVICES IN 1990 AND PROJECTIONS FOR 1995 AND 2000

(Percentage)

Country group	*1990*	*1995*	*2000*
All developing countries			
Debt	94.4	91.1	53.4
Interest payments	10.1	8.3	4.3
Current account balance	-0.8	-6.8	-2.3
of which in:			
America			
Debt	191.6	161.5	87.8
Interest payments	17.3	15.6	7.6
Current account balance	-6.5	-14.2	-9.2
Eurocurrency borrowers [b]			
Debt	199.8	144.3	78.1
Interest payments	13.4	11.4	5.1
Current account balance	-1.2	-14.7	-10.9
Others			
Debt	164.0	220.9	121.4
Interest payments	30.1	29.9	16.4
Current account balance	-24.6	-12.8	-3.6
Africa			
Debt	231.5	188.3	103.9
Interest payments	16.1	13.1	6.0
Current account balance	-7.4	-7.9	5.1
Eurocurrency borrowers [b]			
Debt	182.8	90.7	22.6
Interest payments	15.9	8.7	2.3
Current account balance	22.7	19.2	47.2
Least developed countries			
Debt	418.1	429.8	322.9
Interest payments	20.7	23.5	14.3
Current account balance	-51.5	-47.9	-43.3
Others			
Debt	204.2	170.4	98.1
Interest payments	14.9	12.4	6.1
Current account balance	-11.8	-10.8	-9.0

For source and notes see end of table.

cluding Argentina and Peru, on average there was a stagnation of output and a decline in living standards, due largely to a relative decline in demand for the region's exports stemming from the economic slowdown in the industrial countries, depressed or declining commodity prices and deteriorating terms of trade. However, FDI and portfolio investment continued to rise, maintaining the trend in evidence since 1987. With further improvements in the ratios of both debt and interest payments to exports, per capita income is projected to rise at an annual rate of 1.4 per cent in the 1990s.

For African developing countries and the entire group of least developed countries, an-

Table 8 (concluded)

RATIO OF DEBT, [a] INTEREST PAYMENTS AND CURRENT ACCOUNT BALANCES OF DEVELOPING COUNTRIES TO EXPORTS OF GOODS AND SERVICES IN 1990 AND PROJECTIONS FOR 1995 AND 2000

(Percentage)

Country group	*1990*	*1995* [a]	*2000* [a]
Asia			
Debt	47.6	61.5	38.7
Interest payments	7.2	6.0	3.3
Current account balance	1.7	-4.9	-1.6
Eurocurrency borrowers [b]			
Debt	37.4	51.0	30.8
Interest payments	5.8	4.5	2.3
Current account balance	2.0	-2.0	0.0
Least developed countries			
Debt	508.1	533.4	403.9
Interest payments	28.9	26.6	16.4
Current account balance	-60.1	-56.6	-42.2
Others			
Debt	77.7	75.6	46.9
Interest payments	8.5	6.4	3.4
Current account balance	-9.7	-8.5	-6.9
Memo item:			
Least developed countries			
Debt	442.4	458.6	346.7
Interest payments	22.9	24.4	14.9
Current account balance	-53.8	-50.3	-43.0

Source: UNCTAD secretariat calculations, based on national and international sources, and SIGMA projections.
a Excluding short-term debt.
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.

nual GDP growth in the 1990s is projected at 3.4 per cent and 2.9 per cent respectively, as compared to 2.0 per cent and 2.3 per cent in the 1980s. Nevertheless, since population will grow annually by some 3.0 per cent, per capita income in LDCs will fail to rise in the 1990s.

D. Uncertainties surrounding long-term forecasts

The picture presented above for the 1990s, as stated previously, assumes that there are no major changes in current trends and policies. Should there be such changes which lead to an improvement in the international environment, especially as regards the prices of primary commodities, the prospects for developing countries could be quite different. There are, however, several major events currently taking place, the effects of which are still in the process of working themselves out. Accordingly, there are varying degrees of inherent uncertainty, including those associated with the outcome of the Uruguay Round, the exact timing and extent of more generalized recovery in the developed market-economy countries, individually and collectively, the effect of the worst drought in Africa in a decade on an already difficult food situation, and - last but not least - the economic transformation of the countries of Central and Eastern Europe and the former USSR. In the long run, uncertainties associated with changes in demographic structures and growing awareness of environmental and other issues related to sustainable development can also be expected to be important determinants.

For the transition economies in Europe, the dismantling of existing mechanisms and institutions without appropriate replacements poses serious obstacles to the proper functioning of markets, as does also a price structure that is far from reflecting the underlying costs of production. The limited availability of reliable and up-to-date statistics that are essential for proper decision-making and for the functioning of a market system is a further handicap. Furthermore, the emphasis given to market-economy operations has diverted attention from the need for a sufficient understanding by all concerned of how the former centrally planned economies worked, so that decisions are generally taken without reference to a coherent theory of transformation to a market system. As a consequence, there is a lack of consensus among policy makers on such issues as the priority and sequencing of reforms and the time likely to be required for completing the necessary adjustments.

The external financial requirements for integrating these countries into the world economy can be considerable, and to some extent can be judged by the experience of German unification, and it may be years before the benefits of the reforms are felt throughout the economies. However, the prospects for such financing on a commercial basis in the 1990s are not particularly encouraging, in view of the financial fragility prevailing in the developed world, particularly in the United States and Japan. There is a possibility that the world banking system, faced with shrinking capital bases, may take measures to adjust loan portfolios in ways that would result in a substantial decline in the global availability of credit. Should this be the case, the resulting deflationary impact may significantly weaken the recovery that is otherwise expected.

With regard specifically to development finance, there is increasing concern that ODA to Central and Eastern European countries and several of the new independent States of the former USSR will be at the expense of developing countries. On the other hand, the prospective scaling down of military expenditures may release additional resources for development finance.

For developing countries, a key factor in determining their growth prospects in the 1990s will be their access to international capital markets. Without greater access to major financial markets, developing countries would benefit from a reduction in the fiscal deficits of developed market economies only through the indirect effects of income and interest rate movements on trade flows.

Access to international capital markets by these countries, however, is likely to vary widely. Experience of the 1980s has shown that re-establishing creditworthiness can be a lengthy process. Long-term bond financing, which is currently available only to borrowers perceived to be among the best credit risks, is unlikely to be a major source of direct funding. For countries which do not enjoy the privilege that comes from having a good credit standing or ready access to major financial markets, official transfers and long-term credits, rather than private financial flows, will continue to be the primary source of external financing.

Availability of external financing has a direct impact on domestic investment in most developing countries in the midst of policy reforms and structural adjustment. Given the possibility of a credit shortage, developing countries may therefore find it necessary to undertake comprehensive measures, including fiscal, monetary and financing policies, designed to create stable domestic economic and financial markets in order to mobilize more fully their domestic resources and enhance productivity, as well as to improve their credit standing.

Of importance in the long run are changes in demographic structures. For the industrial countries, there are important implications associated with an aging population, or one characterized by an increasing dependency ratio.[8] The need for further saving declines with age. Accordingly, in an aging population consumption can be expected to rise faster than current income. Increases in the dependency ratio may also mean a smaller labour force, and thus a lower potential output. In addition, there will be obvious changes in the composition of government expenditure (as well as in its total share in GDP) with respect to education and medical care, as well as changes in the extent of transfer payments such as pensions. Since a country's current account position can be expressed as the difference between national saving and national investment, it is likely that

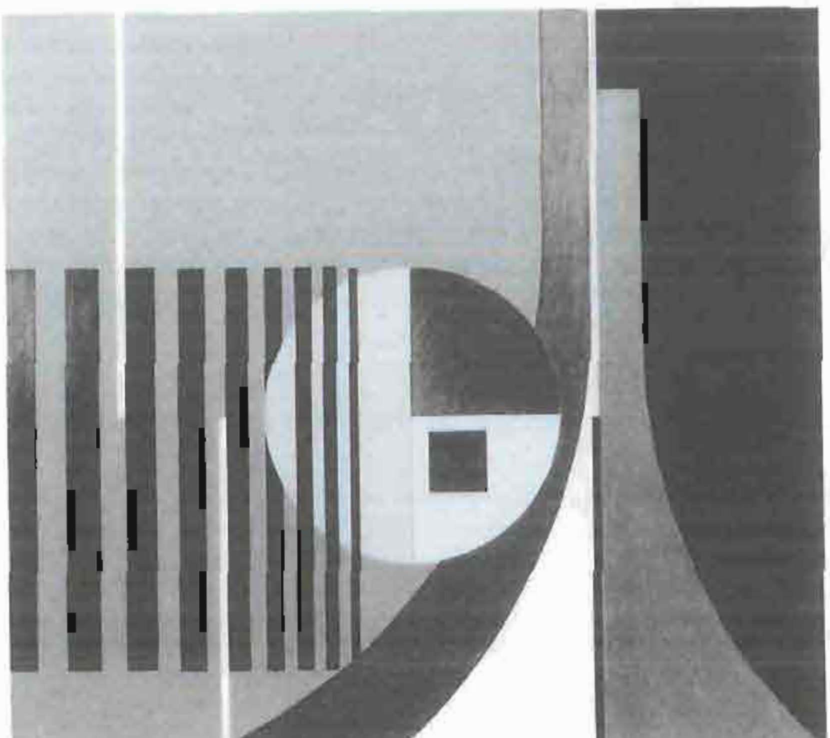
8 Those under 15 or over 65 years of age as a proportion of the population.

countries where population aging is most pronounced will tend to run current account deficits. In that event, the differences in the increase in the dependency ratio among the major industrial countries in the years to come could have important implications for global payments balance.

The major democratic problem confronting most developing countries, on the other hand, is rapid population growth, which is a serious obstacle to the achievement of higher income growth and poverty alleviation. World population will increase at a record rate of nearly 100 million people a year during the 1990s, and almost all this growth will be in Africa, Asia and Latin America. Of a more varied and pervasive nature, is the impact of AIDS (acquired immune deficiency syndrome), the final and fatal stage of infection with the human immunodeficiency virus (HIV). First diagnosed in 1981, the disease has now reached global proportions. According to the latest estimates by WHO, some 9-11 million adults and about one million children have been infected with the virus, and over 80 per cent of them live in developing countries. The expectation is for a continued increase in HIV transmissions, particularly in developing countries. So far, the epidemic appears to have spread most rapidly in sub-Saharan Africa, which accounts for about two-thirds of the total number of HIV infections, but there are signs of its spreading to Asia, particularly in highly populated India and Thailand, and to some Latin American countries. Moreover, the presence of the virus in some rural areas is approaching that of urban districts, which has serious implications for developing economies heavily dependent on labour-intensive agriculture.

AIDS strikes young and economically productive adults, changing the size and quality of the labour force, and poses a serious threat to the further development of human capital. In contrast to developed countries, it strikes women in developing countries to almost the same extent as men, so that many newborn children are also at risk. For various reasons, epidemiologists and statisticians find the disease particularly difficult to model and hence its economic impact, both in the short term and in the longer run, is difficult to determine. While some direct costs, such as health care expenditures, are obvious and can be estimated, the indirect costs associated with loss of earnings, reduced productivity of the labour force, and losses from tourism, as well as those related to its social impact, are much more difficult to assess.

With respect to the sustainability of growth and development over the long run, there is a growing awareness of the linkages between economic activities and the environment. Increasing attention by the international community to environmental degradation, in such areas as soil erosion, desertification, air pollution, global warming, shrinking of the ozone layer, deforestation and pollution of the world's oceans, has led to a growing desire to ensure that economic policies also take environmental concerns into consideration. It is becoming increasingly difficult for Governments to ignore these linkages; the challenge (which was very much in the mind of participants in the recently held United Nations Conference on Environment and Development) is not only to minimize the possible adverse effects of macroeconomic policies on the environment but also to structure environmental policies so that they do not impair macroeconomic performance. The adoption or strengthening of measures to address environmental concerns could have significant macroeconomic implications, both in the short and in the long run, in terms of output, prices, employment, and fiscal balance, as well as for global payments equilibrium.■



FINANCE AND ECONOMIC EXPANSION

Finance remains one of the principal forces driving the world economy. The 1980s witnessed a sharp disparity in the availability of finance to developed countries on the one hand and developing countries on the other. For most of the latter severe financial constraints made it very difficult to adjust, while at the same time restoring investment and growth. By contrast, in the major industrialized countries many sectors enjoyed easy access to finance thanks to deregulation of interest rates and financial activity. Consequently, they were able to accumulate debt on a large scale and at very high interest rates, and to over-invest in some important sectors.

This legacy is now shaping events. The asset price inflation of the 1980s has been replaced by a "debt deflation", whose momentum has been quickened by the introduction of new rules by BIS (discussed in a special annex on the governance of international banking) designed to correct the imprudence of the 1980s. Meanwhile, developing countries are making new attempts to re-enter international capital markets. For most of them, the amounts available are inadequate, and their terms of re-entry are still onerous. A few are meeting with success, but the capital flows they are receiving are, to a considerable degree, not the most appropriate, being driven by short-term, speculative considerations.

Chapter I begins with a discussion of the recent trends in international lending to developing countries, and goes on to examine the external financial positions of these countries, using a number of debt indicators. It notes that the improvement in debt indicators, though fairly widespread, is not on a scale likely to have a major impact on perceptions of creditworthiness. It reviews recent debt restructuring agreements. It then examines bond issues by Latin American countries and non-debt creating flows to that region, and discusses the nature and effects of these flows (a subject further elaborated in another annex to the Part). The chapter concludes with a discussion of the costs and other terms of private export credits.

Chapter II focuses on the role of financial market conditions in the recent slowdown in economic activity in the major industrialized countries and the difficulties that their debt overhang in many sectors create for recovery. It starts with a description of current conditions in financial markets, noting that banks, which have been experiencing losses due to their bad loans, have been restricting their lending considerably in order to restructure their balance sheets. It examines the sources of current difficulties, including the deregulation of interest rates and internal and external financial transactions in the 1980s, the way monetary policy has been conducted in the major industrialized countries and the disuse of fiscal tools in macroeconomic management. The last section discusses the consequences of financial difficulties for recovery, and outlines what kinds of monetary and fiscal policies are needed.

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INTERNATIONAL CAPITAL MARKETS AND EXTERNAL DEBT

A. Recent trends in international lending

In 1991 the different major categories of borrowing from the international capital markets presented a more disparate picture than in recent years. As shown in table 9, issues of external bonds, which shared in the overall slowdown of international lending in 1990, recovered the dynamism which has characterized their growth during most years since the mid-1980s. On the other hand, as can also be seen from that table, as well as from table 10, lending by banks tended to contract in 1991. This movement was strongly influenced by international interbank lending, which fell in each of the first three quarters of the year.

The behaviour of international bank lending reflected on both the demand and supply sides the effects of the recession in the OECD area and the deterioration in the quality of loan collateral. As is analysed in the next chapter, the recession and, in some cases, longer-standing problems due to unfavourable economic outturns in particular sectors have coincided with attempts by banks to increase their ratio of capital to total assets with the approach of the 1992 deadline for achieving this ratio prescribed by the Basle Agreement on the International Convergence of Capital Measurement and Capital Standards (described in annex I). The influence of this deadline appears to have been especially important for Japanese banks, where capital levels were severely affected by the fall in domestic equity prices in 1991 and which were responsible for much of the year's declines in international interbank lending.[9] During recessions slowdowns in lending tend to be especially severe for lower-rated borrowers, since banks feel that they would not be able to achieve on such loans the higher returns which would be justified by greater credit risks. In the current situation this tendency has probably been reinforced by the provisions of the Basle Agreement which, for the purpose of calculating banks' required levels of capital, assigns relatively high risk weights to most categories of claim on the private sector and on Governments and other entities incorporated outside the OECD area.[10]

[9] Under the Basle Agreement 45 per cent of the difference between the value of banks' holdings of equities at historic cost and at market prices can be included in the supplementary elements qualifying as Tier 2 capital. For detail concerning the definition of capital under this Agreement see annex I to this Part, sect. B.4.

[10] Subject to variations in implementation at the national level the main features of the system of risk weights under the Basle Agreement are as follows: a weight of zero is attributed to cash, claims on central Governments and central banks denominated in national currency and funded in that currency, other claims on OECD central Governments and central banks, claims collateralized by cash or OECD-central Government securities or guaranteed by OECD central Governments; weights varying from zero to 50 per cent are attributed to claims on domestic public sector entities, excluding central Government, and loans guaranteed by such entities; a weight of 20 per cent is attributed to claims on multilateral development banks and claims guaranteed by, or collateralized by, securities issued by such banks, to claims on banks incorporated in the OECD area and to loans guaranteed by OECD-incorporated banks, to claims on banks incorporated outside the OECD area with a residual maturity of up to one year and loans with a residual maturity of up to one year guaranteed by such banks, to claims on non-domestic OECD public sector en-

Table 9

SELECTED CATEGORIES OF INTERNATIONAL FINANCING AND SHARES OF DEVELOPING AND CENTRAL AND EASTERN EUROPEAN COUNTRIES [a] THEREIN, 1984-1991

Category	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*
External bond offerings								
Total ($ billion)	109.5	167.8	227.1	180.8	227.1	255.7	229.9	297.6
Percentage share of:								
Dev'g countries	3.2	3.7	1.3	0.9	1.5	0.9	2.0	2.7
Central and Eastern Europe and former USSR	..	0.2	0.1	0.3	0.5	0.7	0.7	0.5
Syndicated credits								
Total ($ billion)	57.0	43.0	52.4	91.7	125.5	121.1	124.5	113.2
Percentage share of:								
Dev'g countries [b]	39.6 (20.2)	37.4 (20.9)	19.1 (19.1)	18.3 (7.9)	10.2 (6.1)	12.1 (12.1)	14.7 (12.3)	22.0 (21.9)
Central and Eastern Europe and former USSR	4.6	8.4	5.0	2.9	2.2	2.0	2.5	0.1
Committed borrowing facilities [c]								
Total ($ billion)	28.8	42.9	29.3	31.2	16.6	8.4	7.0	6.3
Percentage share of:								
Dev'g countries	21.5	4.7	8.5	4.2	7.8	10.7	30.0	32.0
Central and Eastern Europe and former USSR	..	..	..	..	..	..	..	..

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

a Including the former USSR.

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

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

The marked contrast in 1991 between the behaviour of international bank lending and issues of external bonds reflects the shift towards more widespread use of marketable securities as a vehicle for raising money from international capital markets. A fillip has been given to this trend by various recent innovations enhancing the attractiveness to investors of such

tities, excluding central Government, and loans guaranteed by such entities, and to cash items in process of collection; a weight of 50 per cent is attributed to loans fully secured by mortgages on residential property; and a weight of 100 per cent is attributed to claims on the private sector, to claims on banks incorporated outside the OECD area with a residual maturity of more than one year, to claims on central Governments outside the OECD area (except for those denominated and funded in national currency to which the zero weight specified above applies), to claims on commercial companies owned by the public sector, to capital instruments issued by other banks (unless deducted from capital), and to various other real and financial investments (for example, in premises, real estate and equipment).

securities. However, in spite of their rapid growth external bond issues, like bank loans, have recently been affected by concern over credit quality, such issues by lower-rated corporate borrowers being less frequent in 1991 than in recent previous years.[11]

These overall trends in the international capital markets were accompanied by increased borrowing by a number of developing countries in South and South-East Asia, and by a rise in lending in the form of external bond issues to a small group of Latin American countries, two of whose increased recourse to such issues in 1990 was discussed in last year's Report.[12] However, most developing countries continue to be faced with unfavourable perceptions of their creditworthiness, and lending to them remains depressed. The position was similar for most Central and Eastern European countries, though somewhat more favourable for Hungary and Czechoslovakia.

The concentration of lending in the form of external bonds to developing countries on only a few borrowers is indicated by the fact that 39 per cent of the issues by such countries included in table 9 were by four countries of South and South-East Asia (India, Indonesia, Malaysia and Republic of Korea) and 58 per cent by four countries of Latin America (Argentina, Brazil, Mexico and Venezuela). The same group of South and South-East Asian countries accounted for 34 per cent of the syndicated credits to developing countries covered by the table. Moreover, the increases in the claims of banks in the BIS reporting area on countries in South and South-East Asia (the only developing region in table 10 to which such banks reported a rise in their exposure) were also accounted for almost exclusively by the same four countries together with Taiwan Province of China. The rise in bond issues to the four Latin American countries was not accompanied by analogous movements for bank lending. New syndicated credits to them were small ($0.9 billion of the total in table 9).[13] Moreover, Mexico was the only member of the group to which banks in the BIS reporting area substantially increased their exposure in 1991 (by $6.3 billion). Indeed, these banks actually decreased their claims on Brazil by $4.2 billion in the second quarter of the year, a significant part of the reduction being due to the writing-off of loans as a result of their difficulties over reaching an agreement on the restructuring of the country's debt to them.[14] However, as discussed in section E below, some of the countries in this group did receive large inflows of new equity investment.

The failure of external financing in the form of bank lending and export credits to revive for the great majority of other developing countries is evident from tables 10, 11 and 12. In particular, the possible revival of export credits suggested by the rise in net medium- and long-term lending of this kind in 1989 and by the fall in the proportion of countries experiencing negative total net flows of such credits in the first half of 1990 has not been confirmed by figures for the subsequent period. The Persian Gulf crisis contributed to depressing levels of external financing from the capital markets after mid-1990, especially to countries of West Asia. Otherwise the main factors on the demand and supply sides influencing these levels appear to have been the same as in other recent years - low levels of spending on capital goods in many developing countries (imports of which are an important source of demand for export credits) and the unfavourable perceptions of creditworthiness already mentioned (concrete indicators of which are described in the discussion of the costs and other terms of private export credits in section G).

In view of the remarks above about the way in which risk weights assigned to different categories of banks' claims under the Basle Agreement may decrease lending by them to lower-rated borrowers, it may be asked whether

At the time when the Basle Agreement was negotiated, the Basle Committee on Banking Regulations and Supervisory Practices acknowledged the elements of arbitrariness in the Agreement's differentiation between OECD and non-OECD Governments, noting that it was none the less adopted in response to comments submitted by banks in its member countries as "the most practical and prudentially realistic approach" to specifying the group of countries for which claims on Governments and banks would be assigned the same risk weights as in the case of analogous domestic claims. See Committee on Banking Regulations and Supervisory Practices, *Report on International Developments in Banking Supervision*, No. 6 (Basle: BIS, September 1988), p. 14.

11 See OECD, *Financial Market Trends*, No. 51 (February 1992), p. 52,

12 See *TDR 1991*, Part One, chap. II, sect. B.3.

13 West Asia accounted for a large share of the borrowing in 1991 in the form of syndicated credits by developing countries other than those of South and South-East Asia. The greater part of this borrowing consisted of two loans, one of $4.5 billion to Saudi Arabia and one of $5.5 billion to Kuwait.

14 This writing-down by banks of the value on their balance sheets of their loans to Brazil was not matched by corresponding reductions of their claims in the renegotiation of the country's debt to them.

Table 10

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA [a] VIS-À-VIS DEVELOPING AND CENTRAL AND EASTERN EUROPEAN COUNTRIES, [b] 1984-1991

	1984	1985	1986	1987	1988	1989	1990	1991	Stock (end of 1991)
	Percentage rate of increase [c]								$ billion
All developing countries [d]	0.7	4.9	4.2	6.5	-2.6	-2.0	-0.3	0.2	512
Of which in:									
America	0.1	3.0	0.8	1.4	-3.0	-6.7	-10.6	-0.7	209
Africa [e]	-4.4	14.8	10.3	8.8	-7.6	-3.3	4.1	-9.2	51
West Asia [e]	3.2		4.6	17.0	3.9	10.1	4.6	-8.6	89
South and South-East Asia [f]	3.3	8.3	6.4	10.9	-3.5	0.8	17.3	12.8	156
Europe [g]	-1.3	7.6	-2.1	0.4	-9.7	-13.6	-2.5	-19.2	6
Central and Eastern Europe and former USSR	-1.4	25.9	18.7	17.3	3.4	12.2	-3.7	-2.4	92
Memo items:									
All borrowers: Total [h]	3.2	19.1	27.0	28.5	7.8	18.5	17.1	-0.5	6240
15 highly indebted countries [i]	21.5	2.8	2.9	1.6	-4.6	-7.8	-11.0	-2.4	224

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 Including the former USSR.

c Based on data for end-December.

d Excluding offshore banking centres, i.e. in Latin America: Barbados, Bahamas, Bermuda, Netherlands Antilles, Cayman Islands and Panama; in Africa: Liberia; in West Asia: Lebanon; in South and South-East Asia: Hong Kong and Singapore.

e Libyan Arab Jamahiriya is included in West Asia up to 1982 (since it could not be separated from this area in the BIS series). Since 1983, it is included in Africa.

f Including Oceania.

g Malta and Yugoslavia.

h Including multilateral financial institutions.

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

Table 11

PREVALENCE OF NEGATIVE NET FLOW OF TOTAL EXPORT CREDITS [a] TO DEVELOPING COUNTRIES, BY REGION

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

	1986	1987		1988		1989		1990		1991
	(2nd half)	(1st half)	(2nd half)	(1st half)	(2nd half)	(1st half)	(2nd half)	(1st half)	(2nd half)	(1st half)
All developing countries	49	50	47	43	42	35	45	33	39	56
Of which in:										
Africa	56	56	54	38	40	28	42	28	48	64
America	42	39	35	38	38	32	54	27	32	59
West Asia	53	60	67	60	53	50	43	36	36	71
South and South-East Asia [c]	48	52	38	45	45	45	41	48	34	28
Memo items: [d]										
Highly indebted countries [e]	5	8	10	9	10	5	7	5	3	9
Central and Eastern Europe and former USSR	3	5	5	4	6	3	4	4	3	-

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

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

b Excluding countries for which data are not available.

c Including Oceania.

d Number of countries.

e See note *i* to table 10.

these standards are not significantly reducing the availability of external financing to developing countries. This question cannot be answered precisely owing to the coincidence of the effects of the Basle Agreement with other factors adversely affecting banks' lending policies towards developing countries. Many of the more important of the latter factors antedate the Basle Agreement and result from longer-term trends in banks' behaviour (including those strongly influenced by the problems resulting from their exposure to developing countries after the outbreak of the debt crisis in 1982). The Basle Agreement is likely to become a clearly identifiable impediment to higher lending by banks to developing countries only in circumstances where other factors depressing such lending become less important and efforts to strengthen their capital positions continue to have a major impact on banks' behaviour.

In the case of the transition economies lending was depressed by the reluctance of commercial banks to extend any new credit unless official guarantees were provided. As a result, for example, the share of these countries in total borrowing in the form of syndicated credits in 1991 was very low (see table 9). The large financing requirements for these countries' imports were reflected in increasing reliance on export credits (see table 11). Their share in lending in the form of bonds remained fairly stable, largely due to an increase in issues by Hungary.

Table 12

NET FLOW OF MEDIUM-TERM AND LONG-TERM EXPORT CREDITS TO DEVELOPING COUNTRIES, 1984-1991

(Millions of dollars)

Net flows to:	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*
All developing countries								
Total	5407	552	-3308	-7053	-5037	3861	-326	-407 [a]
Private	3725	1006	-1985	-4279	-3480	4129	-1360	..
Of which in:								
Africa								
Total	1134	422	-980	-2939	-2766	1457	- 1248	..
Private	717	541	-281	-2244	-2200	-1272	-1398	..
America								
Total	869	-219	-758	-905	264	1289	409	..
Private	458	-241	-993	-1050	260	1455	115	..
West Asia								
Total	1492	402	-303	183	754	1451	351	..
Private	1377	477	-243	217	1071	1560	-177	..
South and South-East Asia [b]								
Total	1852	205	-754	-2910	-1895	399	306	..
Private	1196	338	-101	-821	-1345	514	234	..

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

B. External financial positions

For net debtor developing countries as a whole the indicators of their external financial positions in table 13 have improved since 1989. Their total outstanding debt and their exports have grown approximately in parallel and their interest payments have fallen in both years, while the difference between their receipts of new disbursements of debt and their payments of interest and principal (their net financial transfers) has turned positive. The position of the 15 highly indebted countries[15] has moved in a direction similar to that of net debtor developing countries as a group, the ratio of their interest payments to their exports decreasing more sharply and the absolute size of their net financial transfer contracting but (according to a provisional estimate) none the less remaining negative in 1991. The falls in the ratios of debt and interest payments to exports for the countries of sub-Saharan Africa are strongly influenced by provisional estimates indicating rapid growth in their exports of goods and services in 1990-1991. In contrast to the recent trend characterizing net debtor developing countries,

15 The 15 highly indebted countries are those whose external debt positions were the target of the Baker Plan of September 1985. Continuing use of the group for convenience of analysis should not be taken to imply that some of the countries included have not made substantial progress towards the resolution of their external debt problems.

Table 13

SELECTED INDICATORS OF EXTERNAL FINANCIAL POSITIONS OF NET DEBTOR DEVELOPING COUNTRIES AND CENTRAL AND EASTERN EUROPEAN COUNTRIES, 1982-1991

	1982	1984	1985	1986	1987	1988	1989	1990	1991
	Ratio of debt [a] to exports of goods and services (per cent)								
All net debtor developing countries [b]	192.8	211.4	231.8	269.7	255.1	216.4	205.7	199.0	202.1
Of which:									
Highly indebted countries [c]	283.3	303.1	306.8	374.7	366.0	310.1	277.0	255.3	269.8
Sub-Saharan Africa	188.3	226.2	257.9	354.0	400.2	407.9	460.2	475.4	436.7
Central and Eastern Europe and former USSR	34.0	29.9	105.9	116.4	123.1	116.8	122.1	149.1	164.7
	Ratio of interest payments [d] to exports of goods and services (per cent)								
All net debtor developing countries [b]	17.2	17.0	16.8	16.6	13.7	13.7	11.3	9.9	9.1
Of which:									
Highly indebted countries [c]	30.6	28.5	27.1	27.0	22.8	24.0	17.5	13.7	13.2
Sub-Saharan Africa	10.8	12.9	12.4	12.7	10.0	13.2	13.2	12.8	12.2
Central and Eastern Europe and former USSR	3.2	2.5	6.6	6.0	5.6	5.4	5.8	5.2	5.9
	Net financial transfers [e] ($ billion)								
All net debtor developing countries [b]	23.3	-20.3	-42.3	-47.2	-27.3	-30.6	-13.5	11.6	13.4 [f]
Of which:									
Highly indebted countries [c]	3.3	-34.5	-48.8	-47.4	-17.6	-25.0	-17.2	-3.5	-4.0 [f]
Sub-Saharan Africa	4.5	2.6	1.9	1.9	7.7	2.9	5.0	5.1	3.5 [f]
Central and Eastern Europe and former USSR	-0.4	-1.8	3.0	1.9	-1.3	-0.9	-3.1	-3.0	-1.3 [f]

Source: Figures for total external debt and interest payments for 1982-1990 were taken from World Bank, *World Debt Tables 1991-1992* (Washington, D.C., 1991); figures for 1990 were estimated on the basis of data in IMF, *World Economic Outlook May 1992* (Washington, D.C., 1992). Figures for exports of goods and services at current prices for 1982-1990 are data of the UNCTAD secretariat. Figures for 1991 were estimated on the basis of data in IMF, *op. cit.* The figures for net financial transfers for 1982-1990 were estimated from data in World Bank, *op. cit.*, and those for 1991 were estimated on the basis of data from the same source, and IMF, *op. cit.*

a Total short-term and long-term debt.
b Excluding Islamic Republic of Iran, Kuwait, Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia, Taiwan Province of China, and United Arab Emirates.
c See note *i* to table 10.
d Interest on total short-term and long-term debt.
e Disbursements of, minus repayments of principal and interest on, total short-term and long-term debt.
f Preliminary estimates.

the position of Central and Eastern European countries, as measured by the ratios of debt and interest payments to exports, has tended to deteriorate. Indeed, as a result of a sustained decline in exports, the debt-export ratio of the group is now at a level similar to that of net debtor developing countries in 1981.

The picture which emerges from table 13 is one of fairly widespread improvement for debtor countries but not on a scale likely to have a large impact on perceptions of their creditworthiness in most cases. Other features of relations between debtor countries and their creditors are in broad agreement with this picture. Thus, for example, as discussed in section H below, the number of reschedulings of official debt in 1991 fell to 16 in comparison to 20 the previous year, but the amount of debt restructured increased substantially. Preliminary estimates point to a decline in arrears on developing countries' long-term external debt in 1991 but figures for total arrears remain high in relation to those of the late 1980s.[16] In view of the at most limited improvements in developing countries' debt positions and the lack of improvements for Central and Eastern Europe, it is not surprising that the indicators of the costs and other terms of their financing and payments arrangements discussed below in section G should also not have improved substantially.

C. Renegotiation and reduction of bank debt

The reduction of bank debt resulting from restructuring was modest in 1991, amounting to roughly one third of the corresponding figure for the previous year. Debt restructuring agreements were reached with Uruguay in January and with Niger and Nigeria[17] in March. A preliminary agreement was reached with Brazil on interest arrears in May and with the Philip- pines in August.[18] In February 1992 an agreement in principle was reached with Argentina. At the time of writing, another 12 bank debt restructurings were under negotiation.[19]

Since the introduction of the Brady initiative in 1989 the emphasis of international debt management has shifted towards the reduction of debt and debt service. This approach underlies the agreement reached between Argentina and its commercial bank creditors in April 1992. The agreement covers $23 billion in medium-term debt and $8 billion in arrears on interest. The agreemenmt does not provide for any new loans. Banks will have the option of exchanging their claims for 30-year bonds carrying interest either at LIBOR plus 13-16 per cent or gradually increasing from 4 per cent to 6 per cent during the period of maturity. In both cases 12 months of interest are guaranteed by zero-coupon United States Treasury notes. The arrears on interest will be settled partly by a cash payment of $300 million and partly by the issue of a 12-year bond of the Government of Argentina. The contribution of the agreement to reduction of the country's debt and debt service is rather modest. Argentina's foreign debt, excluding arrears, totals $61 billion, of which only $23 billion is covered by the agreement. Moreover, the country's interest payments will also increase since, in spite of a cut in contractual interest likely amount to about one third,[20] it will have to start paying

16 See *World Debt Tables 1991-1992. External Debt of Developing Countries* - vol. I. *Analysis and Summary Tables* (Washington, D.C.: The World Bank, 1991), p. 15.

17 Nigeria's preliminary agreement with its creditor banks of March 1991 was revised in September 1991. The banks had chosen their options under the agreement by January 1992. As a result a total of $3.3 billion was converted at a discount of 60 per cent into short-term loans, fully collateralized by United States Treasury bills and repayable within one month. The remaining $2 billion of debt included in the agreement was exchanged for collateralized bonds at par value. The restructuring agreements of Uruguay and the Niger were discussed in *TDR 1991*.

18 The preliminary agreement of the Philippines included facilities with new money and the replacement of debt at par by two alternative issues of bonds carrying reduced rates of interest (which are to rise to a fixed level during the early years of the bonds' maturity) and credit enhancements in the form of collateralization of interest or principal, or both, during part or all of the bonds' maturity.

19 The countries concerned are Bolivia, Bulgaria, Cameroon, Côte d'Ivoire, Dominican Republic, Ecuador, Gabon, Guyana, Honduras, Jordan, Mozambique and Poland.

20 The precise effect of the agreement on the country's interest burden will depend on the options under the agreement chosen by the banks.

the remainder in full, whereas for the past year it has limited its payments to $60 million a month (only about one half of the contractual obligation). A positive result of the agreement is that the country can expect the restoration of normal trade financing and payments arrangements, which are typically restricted in situations where arrears on interest accumulate.

It appears that the agreement between Argentina and its bank creditors has also given additional impetus to efforts to achieve an accord for Brazil. The basis for negotiation is the proposal made by Brazil in August 1991. This would cover $40 billion of the country's medium- and long-term debt to commercial banks (or about 35 per cent of the country's total external debt at the end of 1990). Under any agreement eventually reached Brazil is likely to have to persuade a substantial proportion of its creditor banks to lend more money rather than give debt relief to make up for its lack of resources needed for guarantees on its restructured obligations, unless multilateral institutions provide the collateral. This need for new lending would limit the reduction in Brazil's debt stock, while at the same time the country's interest payments would be likely to increase, as for Argentina. Nevertheless, the effect of such an agreement on the confidence of both banks and investors could prove significant, and could broaden the country's access to international capital markets and improve the terms on which money is available from them.

D. Salient features of recent external bond issues of some Latin American countries

Recent borrowing from the international capital markets by the group of Latin American countries mentioned in section A has taken place despite the persistence of an overhang of external debt. However, this overhang has influenced the type of financing instruments used and the associated terms and conditions. Reliance on the issue of external bonds rather than bank credits for much of this borrowing reflects the perception that such bonds have priority over bank credits when it comes to repayment. Moreover, for the most part, these issues have carried relatively high yield spreads over benchmark interest rates[21] and have been enhanced by techniques designed to reduce risks for investors.[22] The most common form taken by these enhancements has been collateralization based on existing assets (such as real estate, gold or shares in companies), or on the assignment of future income streams. Other types of enhancement have included early redemption options, allowing either the creditor or borrower to seek early repayment. Among these the most frequently used were put options, giving the bondholder the right to seek early repayment of the bond at a prespecified price and date, which he would exercise if the perceived risk of default worsened or market interest rates increased. Less frequent use has been made of call options, under which the issuer of the bonds would have the right to redeem them after a specified period, thus taking advantage of falls in interest rates and improvements in its creditworthiness.

While the experience so far of the entities responsible for the increase in borrowing by Latin American countries in the form of external bonds has not been completely uniform, it does point to the substantial influence on the costs of such borrowing not only of collateralization but also of perceptions of creditworthiness. For example, of the 40 bond issues by Mexican entities during the period from 1989 until September 1991 listed in a recent study of IMF, 12 were collateralized, and the yield spread of such issues tended to be significantly lower than for the rest of the sample, the difference in some cases amounting to

21 Yield spreads over benchmark interest rates are measured as the difference between the yield of the bond in question and those on bonds of OECD Governments denominated in the same currency.

22 Some of these issues contained stipulations making part of the contractual payment contingent on the occurrence of exogenous shocks. Only upward contingency clauses have been included so far - in other words, the debt-servicing obligations increase if the position of the debtor country improves. Corresponding reductions of the debtor's obligations in the event of a deterioration have not been provided for.

several hundred basis points.[23] During the same period many of the country's borrowers benefited from a fall in yield spreads, the average figure for the unsecured issues of the public sector, for example, declining from 820 basis points in 1989 to 246 basis points in the first three quarters of 1991.[24] In February 1992 the public-sector oil company, Petroleos Mexicanos (PEMEX), issued a bond denominated in United States dollars at a spread of 2.15 per cent compared with a figure of 3.20 per cent for an issue made a year earlier, reflecting mainly the favourable movement in the country's creditworthiness.

The number of Venezuelan borrowers during the period 1989 until September 1991 was smaller, but here too the influence of perceptions of creditworthiness is evident in their costs of borrowing; for example, the average yield spread on unsecured issues of the private sector declined from 730 basis points in the first half of 1990 to 362 basis points in the first nine months of 1991. In January 1992 the Venezuelan company, Bariven, launched an issue at a yield spread of 2.6 per cent. However, more recently there has been a setback to the improvement in Venezuela's creditworthiness as a result of difficulties over its programme of economic adjustment and the attempted *coup d'état* of February 1992. As regards the two other Latin American countries in the group mentioned in section A (Argentina and Brazil) the number of bond issues since 1989 is still small. The issues of borrowers from these countries have been at relatively high yield spreads and have mostly carried relatively short maturities (though the former may reflect unwillingness to have recourse to collateralization as well as perceptions of creditworthiness).[25]

It is of some interest to compare the experience of this Latin American group to that of Hungary. The access to the international bond markets of borrowers from that country has not been subject to periods of exclusion. Its bond issues during the period from 1989 to September 1991 were at yield spreads mostly in the range of 100-250 basis points, and none of them was collateralized.[26]

E. Recent increases in non-debt-creating financial flows to Latin America

The revival of non-debt-creating financial flows to certain Latin American countries (some aspects of which during the previous year were discussed in *TDR 1991*)[27] continued in 1991. Foreign direct investment in the region as a whole is estimated to have increased from $5 billion in 1990 to $14 billion in 1991.[28] Of this amount, about $3.5 billion was associated with the privatization of government enterprises, the investment in many cases being carried out by means of debt-equity swaps. The rise in FDI was accompanied by still more rapid growth of equity investment in the region, which is estimated to have amounted to about $6.5 billion in 1991.[29] These flows were concentrated on the stock markets of Mexico, Brazil, Argentina, Chile and Venezuela, and were in response to returns in dollar terms in 1991 which varied from about 50 per cent for Venezuelan equities to almost 400 per cent for those of Argentina. Although some of this financing is likely to have been based on a longer-term view of economic prospects, foreign equity investment is a potentially volatile source of funds and there have been several indications of the speculative character of recent movements of stock prices in these countries.

23 See *Private Market Financing for Developing Countries*, World Economic and Financial Surveys (Washington, D.C.: IMF, December 1991), table A.17.

24 *Ibid.*, table 8, p. 16.

25 In May 1992 a Uruguayan borrower launched a bond issue at a yield spread of approximately 2.8 per cent, which reflects relatively favourable creditworthiness.

26 *Private Market Financing for Developing Countries*, table A.17, *op. cit.*

27 Part One, chap. II, sect. B.3.

28 Estimates of Salomon Brothers, reproduced in *Latin American Weekly Report*, 28 May 1992.

29 *Idem.*

The vehicles for this equity investment included purchases by foreigners of both international equities and investment funds. International equities are stocks launched and traded on markets other than those of the issuer, by far the largest number of which are those quoted in New York in the form of American Depositary Receipts (ADRs).[30] These are registered negotiable documents, issued in the United States, which certify that a specific number of foreign shares have been deposited with an overseas branch of a United States bank or other financial institution, which acts as custodian in the country of origin. ADRs provide the opportunity to raise capital from a broader range of sources of finance than bonds or credits. Among Latin American countries Mexico has been the most active in its recourse to ADRs, raising $4.3 billion through 19 issues in 1991. The ADR issue by Telefonos de Mexico alone was worth $2.7 billion. This surge of new ADR issues was supported by the strong performance of the Mexican stock market and the prospect of a trade agreement with the United States and Canada, and fuelled by the search of United States banks for fee income.[31] Recently, a slowing down of the process has occurred and profit taking seems to have been taking place, and the prices for Mexican ADRs have been falling. As a result, the most recent international equity issue by Cementos Mexicanos (Cemex) failed to meet its sales' target, thus emphasising the vulnerability of this source of external financing to the volatility of investors' perceptions.[32] Direct purchases of local stocks by overseas investors have been relatively modest, partly because of legal restrictions and, probably more importantly, because markets are illiquid. Investors have preferred funds, which hold shares of Latin American companies selected either from the whole region or from a specific country. These attracted approximately $600 million during 1991.

F. Recent relaxations of external financial stringency viewed in a broader perspective

In *TDR 1991* reference was made to the indications of revived confidence in Mexico's economy which accompanied the increased flow of foreign investment to that country during 1990.[33] As discussed in the previous section, not only has this revival been sustained but also the improvement in foreign investors' perceptions has begun to extend to certain other Latin American economies, influenced in certain countries by Governments' achievement of tighter control over their public finances. The relaxation of external payments pressures, together with greater investors' confidence have to some extent improved the environment for decision-making by both Governments and enterprises, making necessary smaller adjustments of key variables to achieve policy objectives and lowering risk premiums used by economic agents in their calculations.[34]

However, there remains a danger that the developments just described may prove too transitory to have favourable effects of a lasting nature. The speculative character of much of the capital inflow leaves it susceptible to sudden reversal and limits the contribution it is

30 Global Depositary Receipts (GDRs) were introduced in late 1990. These are issues placed in several national markets simultaneously. Recently, Mexican firms have issued international equities in the form of ADRs including a GDR component.

31 For example, Goldman, Sachs & Co. earned fee income of almost $100 million for lead-managing the above-mentioned issue of Telefonos de Mexico. See M. Bensman, "Latin America's year of the deal", *Institutional Investor*, March 1992.

32 See *Latin American Economy and Business*, May 1992, p. 1.

33 Part One, chap. II, sect. B.3.

34 As described at greater length in a recent survey by the Economic Commission for Latin America and the Caribbean, "With the improvement in the climate of confidence on the part of economic agents, economic policy now has the possibility of managing variables within narrower margins. In other words, the increased confidence on the part of economic agents leads to the disappearance of part of the 'risk premiums' which previously had to be included in the exchange rate, interest rate, and the magnitude and speed of adjustment of the fiscal deficit". Economic Commission for Latin America and the Caribbean (ECLAC), "Preliminary overview of the economy of Latin America and the Caribbean", December 1991, p. 3.

likely to make to a revival of long-term capital formation. Moreover, although the recent turn-about in net financial transfers is large, levels of foreign investment such as those observed since 1990 will have to be sustained for several years if they are to contribute substantially to making up for the cumulative effects of the decline in the pace of capital formation in these countries since the early 1980s.[35] It is also noteworthy that the favourable changes in the environment for policy-making may be balanced by problems of macroeconomic management arising from the increased financial inflows. For example, the sterilization of the potential impact on the money supply of sharply increased inflows can lead to higher levels of government debt. At the same time, any consequent appreciation of the exchange rate can put severe pressure on enterprises through its effects on their competitiveness in the markets for exports and import substitutes. Finally, while reversals of foreign investment remain possible, debtor countries' obligations are mostly unconditional and often reinforced by collateral. Thus, the risk that the capital inflow will not be sustained reduces Governments' room for manoeuvre. (Various aspects of recent changes in flows to certain Latin American countries are discussed in more detail in annex II.)

More generally, as already noted in section A, recent increases in external financial inflows have been restricted to only a few countries. The more typical experience is still one characterised by difficult access to, and high costs of, such financing, aspects of which are exemplified in section G. Pressures on external payments positions continue to lead to widespread difficulties in meeting debt service obligations, the consequences of which for debtor countries' relations with official creditors are taken up in section H.

G. The costs and other terms of private export credits

The figures in section A indicate that after a significant increase in 1989 net lending to developing countries in the form of private export credits[36] has subsequently contracted. For Central and Eastern Europe, except Poland, the decline started earlier and also has yet not been reversed. As already noted, this movement reflects partly influences on the demand side and, in the case of developing countries, the effects of the Gulf crisis. But depressed levels of lending are also consistent with the continued prevalence of high costs and restrictive conditions applying to official insurance for financing the imports of most developing countries as well as those of Central and Eastern Europe.

The cost of private export credits consists mainly of interest and premiums on official insurance. The availability of such insurance for trade financing may be subject to more or less restrictive terms which specify the proportion and amount of credit for which cover is available, the limit on the amount of financing below which the exporter can exercise discretion in granting insured credits, the length of the period after the occurrence of non-payment before claims are met (the claims-waiting period), and the types of security required, which includes guarantees from a national public entity. Although precise figures for the interest cost of export credits to developing countries and to Central and Eastern European countries are not available, it can be seen from table 14 that most major international interest rates fell in 1991 and early 1992, while the rates of interest for medium and long-term export credits under the OECD Arrangement on Guidelines for Officially Supported Export Credits (the OECD Consensus) were unchanged. But for

[35] In 1981-1982 the ratio of gross investment to GDP for Mexico was 25 per cent, while the average for 1983-1990 was 19 per cent. The corresponding decline for Argentina was from 18 per cent to 11 per cent, for Venezuela from 24 per cent to 18 per cent, and for Brazil from 20 per cent to 17 per cent. (For Mexico and Argentina the figures are those in G.P. Pfeffermann and A. Madarassy, "Trends in private investment in developing countries, 1992 edition", *Discussion Paper No. 14* (Washington, D.C.: The World Bank, 1992), while that for Venezuela is taken from IMF, *International Financial Statistics*, and that for Brazil from Instituto de Economia do Sector Publico, *Indicadores IESP*, June 1992, p. 40).

[36] The export credits in tables 11 and 12 include not only the private lending carrying official insurance or guarantees which is discussed in the present section, but also direct lending by OECD Governments (whose determinants are not discussed in this Report).

Table 14

SELECTED INTERNATIONAL INTEREST RATES

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

(Period averages in per cent per annum)

	United States dollars	Deutsche mark	French franc	Japanese yen	Pound sterling
1982	13.60	8.62	19.45	6.99	12.58
1983	9.93	5.60	16.53	6.57	10.18
1984	11.29	5.83	12.77	6.43	10.02
1985	8 64	5.37	10.76	6.68	12.25
1986	6.85	4.64	9.46	5.12	10.97
1987	7.30	4.06	8.64	4.26	9.80
1988	8 13	4.33	8 09	4.51	10.36
1989	9.27	7.09	9.35	5.46	13.94
1990	8.35	8.51	10.29	7.76	14.79
1991	6.08	9.31	9.61	7.38	11 67
1992 *(Ist quarter)*	4.35	9.63	10.07	5.17	10.63

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*
November 1981	11.00	10.50	10.00	11.25	11.00	10.00
July 1982	12.15	10.85	10.00	12.40	11.35	10.00
October 1983	12.15	10.35	9.50	12.40	10 70	9.50
July 1984	13.35	11.55	10.70	13.60	11.90	10.70
January 1985	12.00	10.70	9.85	12.25	11.20	9.85
January 1986	10.95	9.65	8.80	11.20	10.15	8.80
July 1986	9.55	8.25	7.40	9.80	8.75	7.40
January 1988	10.15	8.85	8.00	10.40	9.35	8.00
July 1988 *a*	..	9.15	8.30	..	9.66	8.30
July 1990 *a*	..	10.05	9.20	..	10.55	9.20
January 1992 *b*	..	..	9.20	..	..	9.20

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 July 1988 matrix minimum interest rates for Group I countries were abandoned.

b As from January 1992 matrix minimum interest rates for Group II countries were abandoned.

the majority of these countries levels of interest rates were probably less important determinants of this type of borrowing than perceptions of creditworthiness. Among the indicators of such perceptions are the premiums and other terms associated with official insurance for trade financing just described (although both of these indicators are for certain countries influenced by policy considerations other than creditworthiness). Another indicator is the terms on which private insurance is available for the same purpose. These indicators are generally correlated with conditions in the markets for other arrangements for financing and payments for developing countries' imports, such as, for example, charges on banks' letters of credit and the margins over inter-bank interest rates for *à forfait* financing.

As shown in tables 15 and 16, there have recently been only limited changes in the terms on which official credit insurance is available to developing countries from the Export-Import Bank of the United States (EXIM) and the Export Credits Guarantee Department of the United Kingdom (ECGD).[37] These changes applied mainly to countries of Latin America, for which there were reductions in the number of instances where official insurance cover was completely unavailable or where its availability was subject to no special terms, together with an increase in those where it was available only on restrictive conditions.[38] In the other developing regions shown changes in the terms on which official insurance was available from the two agencies were almost completely absent. In transition economies favourable and unfavourable changes balance each other during the most recent year shown, the most significant unfavourable ones applying to Bulgaria and the former Soviet Union. Czechoslovakia is now the only country of the region enjoying normal terms on both short- and medium-term cover from either of the agencies. Table 15 also indicates for Africa and Latin America the relatively small number of instances in which insurance is available on normal terms, and the prevalence of those in which it can be obtained only on restrictive conditions or not at all. Only for countries of South and South-East Asia have there recently been no special restrictions associated with official insurance in most instances (one third for both short-term and medium- and long-term credits).

The instances in which there were changes in the terms of official insurance for Latin America continue to be concentrated among its highly indebted countries. Six countries from this region experienced significant changes in the terms on which private insurance was available for the financing of their imports, three being in a favourable direction and three in an unfavourable one. Here too the majority of changes - three of the favourable and one of the unfavourable ones - applied to highly indebted countries. After a long period characterized by very little movement in the terms associated with private insurance such changes may indicate the beginning of a return to greater sensitivity in the evaluation of creditworthiness for this region as the external financial positions of some of its countries improve. An analogous process does not yet appear to be under way for countries in other regions which have experienced serious debt problems in recent years, since there were very few changes elsewhere in the terms on which private insurance is available - none at all for countries of South and South-East Asia and one favourable change together with two unfavourable ones for those of Africa. In the case of the transition economies private insurance terms, after changing little during a long period, recently became more unfavourable for four out of five countries.

The terms on the insurance available from the ECAs of OECD countries tend to be affected by the institutions' own financial positions, since they are generally obliged to be self-supporting in their commercial operations in the longer run. These positions have led to the adoption of more restrictive terms in recent years, as evidenced by the losses of 65 per cent or more of the sample in table 17 in every year since 1984 on account of the coincidence of the slow growth of developing countries' imports and disruptions of their external debt service.

37 The use of figures referring to the costs and other terms of export credit insurance from these two agencies is dictated by the availability of published information in the form required.

38 As is also explained in note *a* to table 15, the term "restrictive conditions" for the purpose of the figures therein includes both surcharges on official insurance premiums and other restrictions on the availability of insurance such as those mentioned in the text above. As explained in note *c* to the table, an "instance" corresponds to the terms on official insurance cover either for short-term or for medium- and long-term credits available from one or the other of EXIM or ECGD.

Table 15

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

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

	Normal terms [a]		*No cover* [a]		*Restrictive conditions* [a]	
Region/period	*Short-term* [d]	*Medium- and long-term* [e]	*Short-term* [d]	*Medium- and long-term* [e]	*Short-term* [d]	*Medium- and long-term* [e]
Africa						
Late 1986/early 1987	6	4	14	18	50	48
Late 1988/early 1989	9	8	18	21	43	41
Late 1989/early 1990	9	8	18	18	43	44
Late 1990/early 1991	9	8	18	19	43	43
Late 1991/early 1992	9	8	18	19	43	44
Latin America						
Early 1987	7	7	5	8	40	37
Late 1988	7	7	6	9	39	36
Late 1989	7	7	6	8	39	37
Early 1991	15	8	5	21	32	23
Early 1992	7	7	5	17	40	28
South and South-East Asia [f]						
Early 1987	16	14	5	5	27	29
Early 1989	16	16	3	3	29	29
Early 1990	16	16	3	3	29	29
Early 1991	16	16	3	3	29	29
Early 1992	16	16	3	3	29	29
Central and Eastern Europe and former USSR						
Early 1987	3	1	5	5	4	6
Early 1989	3	1	4	4	5	7
Early 1990	3	1	4	4	5	7
Early 1991	2	1	5	4	5	7
Early 1992	1	1	5	4	7	7
Memo item:						
Highly indebted countries [g]						
Late 1986/early 1987	2	1	3	4	25	25
Late 1988/early 1989	3	3	4	5	23	22
Late 1989/early 1990	3	3	4	4	23	23
Late 1990/early 1991	9	4	3	9	18	17
Late 1991/early 1992	3	3	3	7	24	20

Source: Exporter's regional guides in *Trade Finance*, various issues.

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

b The Export-Import Bank (EXIM) of the United States and the Export Credit Guarantee Department (ECGD) of the United Kingdom.

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

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

e Insurance cover for credits other than short-term.

f Including Oceania

g See note *i* to table 10.

Table 16

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

(Number of instances)

Region	More favourable terms [a]				Less favourable terms [a]			
	Late 1986/ early 1987- Late 1988/ early 1989	*Late 1988/ early 1989- Late 1989/ early 1990*	*Late 1989/ early 1990- Late 1990/ early 1991*	*Late 1990/ early 1991 Late 1991/ early 1992*	*Late 1986/ early 1987- Late 1988/ early 1989*	*Late 1988/ early 1989- Late 1989/ early 1990*	*Late 1989/ early 1990- Late 1990/ early 1991*	*Late 1990/ early 1991- Late 1991/ early 1992*
Africa	14 [c]	3	-	1	15 [c]	-	1	-
Latin America	3	1	10 [d]	4	6	-	13 [d]	9
South and South-East Asia [e]	4	-	-	-	-	-	-	-
Central and Eastern Europe and former USSR	2	-	-	3	-	-	1	5
Memo item:								
Highly indebted countries [f]	4 [b]	1	9	4	3 [b]	-	5	8

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

a All instances in which there has been a change in the terms of export credit insurance cover available to a borrower from EXIM or ECGD between the categories "normal cover", "no cover", and "restrictive conditions". (For "instances" and these three categories see table 15.) Such changes are recorded separately for short-term and for medium- and long-term credits.

b The Export-Import Bank (EXIM) of the United States and the Export Credits Guarantee Department (ECGD) of the United Kingdom.

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

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

e Including Oceania.

f See note *i* to table 10.

H. Official debt reschedulings

Total long-term debt of developing countries is estimated to have reached some $1,000 billion by the end of 1991, 51 per cent of which was owed to official creditors (30 per cent to official bilateral creditors only). These percentages reveal the importance of official debt for developing countries. For the majority of low-income and lower middle-income countries which have rescheduled their official debt through the Paris Club the share of debt owed to Paris Club creditors ranged from over 25 per cent to 50 per cent of their long-term debt.

The pace of official debt reschedulings within the Paris Club slowed down in 1991: 16 countries rescheduled their debt in that year, against 20 in 1990 and 24 in 1989. However, the total amount of debt rescheduled (over $67 billion) was more than five times that involved in 1990 (some $15 billion). The large amount of debt rescheduled in 1991 was principally due to the restructuring of the stock of debt of Egypt and Poland, which together accounted for $51 billion.

The reduced frequency of reschedulings does not reflect a substantial lessening of debt difficulties. For many Paris Club debtors, especially those which have repeatedly rescheduled their debt, debt service ratios have tended

Table 17

PROPORTION OF EXPORT CREDIT AGENCIES IN SELECTED DEVELOPED MARKET-ECONOMY COUNTRIES THAT INCURRED LOSSES [a] ON INSURANCE ACTIVITIES, 1981-1990

(Percentage)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*
Proportion:	50	60	85	70	65	70	70	75	71	67

Source: 1981: D. Bowen, D. Mills and M. Knight, *The Euromoney Guide to Export Finance* (London: Euromoney Publications, 1986), Part I; 1982-1988: M. Knight, J. Ball and A. Inglis-Taylor (eds), *The Guide to Export Finance 1988* (London: Euromoney Publications, 1988), Part I; J. Ball and M. Knight (eds) with the assistance of R. Saxena, *The Guide to Export Finance 1989* (London: Euromoney Publications, 1989), Part III; J. Ball and M Knight (eds), *The Guide to Export Finance*, Fifth Edition (London: Euromoney Books, 1990); and F. Carnevale, "ECAs sing the blues", *Trade Finance*, January 1991; 1989-1990: F. Carnevale and J. Lowenstein, "Exim and Jexim: a duopoly of ECA initiative", *Trade Finance*, April 1992.

a Losses occur when claims exceed the sum of premium income and recoveries (adjusted in some cases for the inclusion of other factors). The number of loss-making agencies is expressed as a proportion of the total number of agencies for which data were available (18 in 1981, 20 in 1982-1988, 17 in 1989, and 15 in 1990).

to increase. On the other hand, problems faced by a number of countries in obtaining new IMF arrangements have caused delays in reaching an agreement with Paris Club creditors, since an arrangement with the Fund is a precondition for Paris Club negotiations.

The process of categorization of debtor countries, which started in 1987 with the adoption of the Venice terms for the poorest sub-Saharan African countries and was pursued in 1988 with the introduction of Toronto terms for low-income countries and in 1990 with the implementation of the Houston terms in favour of lower middle-income countries, has resulted in the application of either standard terms or a menu of options for different groups of debtors. Three main categories of debtors have emerged: poorest, lower middle-income and other middle-income countries. With the exception of Egypt and Poland, which in 1991 received particularly favourable treatment, debtors in a given category have been granted similar repayment terms (i.e. with respect to debt or debt service reductions, where applicable, maturities and interest rates),[39] depending on the options chosen by specific creditor countries (see box 1). Conditions other than repayment terms, such as the length of the consolidation period, the coverage of arrears and previously rescheduled debt, can differ from one country to another. These conditions determine mainly the amount of debt rescheduled.

Debtor categorization is a recognition of the different needs of different groups of countries classified broadly by per capita income levels. However, the application of standard terms on the basis of such a categorization may sometimes result in the particular problems of specific countries not being adequately addressed, as discussed below for low-income countries. As a highly exceptional measure, if a country has been found to be in a particularly difficult situation, a divergence from current practice has been agreed. For example, the staunch opposition of Paris Club creditors to the rescheduling of post-cutoff date debt was waived in the special case of Peru in 1991, when it was agreed to defer all moratorium interest payments falling due during the consolidation period and to reschedule over a number of years arrears on post-cutoff date debt.[40] In the case of Uganda, the Paris Club

[39] A study on bilateral agreements between the debtor countries and their creditors, implemented after the general agreement framework reached at the Paris Club, led to the conclusion that, where market rates are applied, the same rates are applied by a creditor country to all its debtors. See the study by L. Goreux for UNCTAD, "Paris Club bilateral agreements: a study of eight African countries", Geneva, 1992 (mimeo).

[40] In the case of Peru, 70 per cent of moratorium interest was rescheduled over five years, including two years of grace after the consolidation period, and the remainder is to be paid over 18 months. Arrears on post-cutoff date debt are to be paid over six years (after the consolidation period). The deferment was contingent on Peru's performance under the IMF rights accumulation programme agreed in 1991.

Box 1

PARIS CLUB RESCHEDULING TERMS FOR DIFFERENT CATEGORIES OF DEBTORS

As a result of the changes introduced in Paris Club debt reschedulings in the past five years, debtor countries can now be classified into three main categories: (1) the poorest and most indebted countries, which are eligible for enhanced concessional treatment; (2) heavily indebted lower-middle income countries, eligible for the Houston terms; and (3) all others, mainly upper middle-income countries, that continue to receive the traditional Paris Club terms.

I. Poorest countries

In December 1991, Paris Club creditors agreed to grant new rescheduling terms, more concessional than those of the Toronto options, to low-income countries. The new terms are called the *enhanced concessional treatment for the poorest and most indebted countries.*

Terms:

1. Non-ODA debt:

The new treatment reduces by 50 per cent the net present value of the amount of arrears and debt service payments due during the consolidation period. To this end, creditors can choose among three options:

- Writing off one half of debt service obligations, with the remaining half to be consolidated at market rates over a period of 23 years (including a grace period of 6 years);
- Rescheduling at concessional rates, so as to reduce by 50 per cent the net present value of service payments due on non-concessional loans, with a repayment period of 23 years (no grace period);
- Combining interest rate reduction and partial interest payment capitalization (with no interest charged on the capitalized interest); the repayment period would also be 23 years (including 5 years of grace).

All three options are equivalent in net present value terms. In addition, the amortization schedules are drawn up so that total debt service payments would increase smoothly over time.

2. ODA debt:

ODA debt will be rescheduled with very long maturity and grace periods: 30 years and 12 years, respectively. Interest rates on the rescheduled amounts should be at least as favourable as the original concessional rates.

Debt coverage: Rescheduling applies to the service of eligible debt (contracted before cutoff date) falling due during the consolidation period. However, a clause contained in the agreements concluded under the new terms specifies that three or four years after the signature of these agreements creditors would consider the matter of the stock of debt, provided that the debtor maintained satisfactory relations with creditor countries and ensured appropriate arrangements with IMF.

Application of treatment by creditors: Not all creditor countries apply the new enhanced treatment. Those which are not yet prepared to agree to debt or debt service reduction (such as Australia and the United States) will apply option B of the Toronto terms (i.e. rescheduling at market rates, with a maturity period of 25 years, including 14 years of grace).

Eligibility of debtor countries: No specific criteria have been defined. However, it appears that countries which would be eligible for Toronto terms will receive the new treatment. Consequently, low-income, IDA-only countries would benefit from the new terms. To date, seven countries have benefited from the enhanced treatment: Nicaragua and Benin in December 1991, Bolivia and United Republic of Tanzania in January 1992, Uganda and Togo in June 1992, and Zambia in July 1992.

Debt conversion: In addition to the above-mentioned reduction, further reduction can be obtained through offical debt conversion mechanisms (subject to some general limits and conditions, as described below).

Box 1 (concluded)

2. Lower middle-income countries

Following the recommendations of the Houston Summit in July 1990, a new treatment (referred to as the Houston terms) was introduced in September 1990 for the rescheduling of the Paris Club debt of lower middle-income countries.

Terms: These terms provide for a lengthening of maturity and grace periods of up to 15 and 8 years, respectively, for non-concessional loans and 20 and 10 years, respectively, for ODA loans.

Debt coverage: Rescheduling applies to the service of eligible debt falling due during the consolidation period.

Eligibility: To be eligible, a country must have a per capita GNP not exceeding a specified threshold ($2,465). It must also have a high level of official debt, compared to commercial debt, and its debt indicators (ratios of debt to GNP and to exports, debt service ratios) must testify to its heavy debt burden.

Debt conversion: Official debt conversion was the major innovation introduced by this new treatment for lower middle-income countries. A clause in the agreements allows creditor Governments, on a voluntary and bilateral basis, to sell or swap ODA loans as well as a limited amount of non-concessional credits (10 per cent or $10-20 million, whichever is the highest) through debt-for-nature, debt-for-aid, or debt-for-equity swaps or other local currency debt swaps. (This clause has subsequently been included in agreements for poorest countries and for Egypt and Poland).

3. Other middle-income countries

Countries not falling in either of the above categories (mostly upper middle income-countries) receive traditional Paris Club terms: debt service payments due during the consolidation period are rescheduled with a maturity of 10 years, including 5 years of grace. However, in 1992, Brazil rescheduled its debt with a longer maturity (13.5 years). Market interest rates apply in the case of non-concessional debt, while ODA debt is rescheduled at rates at least as concessional as the original ones.

creditors agreed in June 1992 to defer by an average of one year the payment of arrears on debt not covered by the agreed minute (that is, principally, post-cutoff date debt). Some other countries also had their moratorium interest deferred (Zambia and Poland in 1990 and Nicaragua in 1991).[41]

In the late 1980s and early 1990s the Paris Club noticeably improved rescheduling practices, especially concerning maturities and debt reduction. Maturities have been lengthened for all debtor countries. Thus, the maturity of upper middle-income countries' debt has been lengthened from about 8 years to nearly 10 years, including about four and a half years of grace; in February 1992, however, Brazil was accorded a maturity of 13.5 years, including two years of grace. Nevertheless, the maturity agreed within the Paris Club for upper middle-income countries is shorter than the more than 15 years agreed by commercial banks for the same debtor countries. For lower middle-income countries, the maturity has been lengthened to 15 years (as compared to about 10 years in 1987), while for low-income countries it has been extended to 23-25 years for non-concessional debt (as compared to 15-21 years in 1987).

The concept of debt and debt service reduction has also been more widely applied within the Paris Club. It was first introduced in 1988 with the Toronto options for low-income countries, which allowed some creditors to reduce the eligible debt by one third and

41 In the case of Zambia, 30 per cent of moratorium interest and the service on post-cutoff date debt were deferred until the end of the consolidation period (i.e. one and a half years after the date of the agreement); the remaining 70 per cent of moratorium interest is to be paid six months after the consolidation period. Likewise, Poland obtained in 1990 a rescheduling of 70 per cent of moratorium interest over a period of 12 years, including two years of grace, while in 1991, Nicaragua had 50 per cent of its moratorium interest rescheduled over two and a half years, including one year of grace.

Box 2

THE PARIS CLUB: THE SPECIAL TREATMENT ACCORDED EGYPT AND POLAND

The agreements signed between Paris Club creditors and Poland in April 1991 and Egypt in May 1991 are exceptional in many respects. When fully implemented, they will accord a 50 per cent reduction in the net present value (NPV) of the entire stock of eligible debt.

Terms: To achieve this reduction creditors can choose among three options:

(A) Partial debt cancellation, the balance being rescheduled at appropriate market interest rates;

(B) Rescheduling at reduced interest rates;

(C) Combining interest payment reduction and partial interest payment capitalization (with no interest charged on capitalized interest);

In addition, in the case of Poland, the United States announced that it would provide debt relief equivalent to a 70 per cent reduction of NPV.

The reduction will be made in stages:

- An initial 30 per cent, between 1991 and 1994 (with 15 per cent up-front and 15 per cent 18 months later in the case of Egypt). During this first phase no payment of principal will be made and all creditors (independently of the option chosen) will reduce interest payments by a percentage specified by the agreements within the 30 per cent reduction of NPV; the amount of interest payment reduction, discounted back to the base date using the "appropriate market rate", will be credited against the NPV reduction target;
- The remaining 20 per cent, becoming effective in 1994.

Sucessive reductions are contingent on many conditions: the two countries should implement their agreed programmes with IMF; they should have worked out debt restructuring arrangements with their other creditors to the satisfaction of Paris Club creditors; and they should remain current on payments into the special deposit account.

The maturity of rescheduled debt is also extended. For Poland, the maturity is 18 years, including 6 years of grace, under option A, 18 years, including 4 years of grace, under option B, and 23 years, including 12 years of grace, under option C. For Egypt, the maturity of restructured ODA loans is 35 years, including 25 years of grace, while the maturity of non-ODA loans is 25 years, including 3-4 years of grace. In addition, both agreements include a progressive amortization schedule, so that total debt service payments increase steadily over time.

Debt coverage: One important feature of these agreements is that the reduction applies to the entire stock of outstanding eligible debt contracted before the cutoff date (including arrears). This feature, as well as the size of the reduction, is unprecedented in debt rescheduling in recent years.

Eligibility: Creditor countries have emphasized that, in view of their special circumstances, Egypt and Poland are exceptional cases which cannot set precedents for other cases.

Debt conversions: These are also possible, within the limits specified in box 1.

some others to cut the interest rate by a half or by 3.5 percentage points. In early 1991, Paris Club creditors reduced the stock of debt of Egypt and Poland by 50 per cent in net present value terms (see box 2). In December 1991, the low-income countries were granted new concessional terms (referred to as "enhanced concessional treatment") which provided for larger debt reductions than the Toronto terms[42] (see box 1). Moreover, in most Paris Club agreements there is provision for partial debt reduction through conversion

42 Under the Toronto terms, option A on partial debt reduction resulted in a reduction of 33 per cent of the net present value (NPV) of debt, while option C on interest rate reduction resulted in a reduction of 27 per cent of NPV (using the prevailing rates in 1988-1989 as discount rates). Under the enhanced concessional treatment, the options of both debt reduction and interest rate reduction should result in a reduction of 50 per cent of NPV (using the market interest rates as discount rates).

of official debt, but this treatment has not yet been extended to upper middle-income countries.

The traditional practice of Paris Club creditors to reschedule only debt falling due during the short consolidation period has resulted in a series of repeated reschedulings for debtor countries. Repeated rescheduling has been a source of great uncertainty for those countries concerning the financing of their adjustment programmes and has also occasioned important administrative costs and an additional debt management burden.[43] The agreements reached with Egypt and Poland represented, however, a noticeable exception: for the first time in almost 20 years, Paris Club creditors have agreed to deal with the whole stock of eligible debt (i.e. all debt contracted before the cutoff date). Furthermore, the new agreements reached with low-income countries under the enhanced concessional treatment contain a provision whereby Paris Club creditor countries would consider the matter of the stock of debt three or four years after the date of the first agreement under the new terms. This could be understood as a commitment by creditor countries to consider a reduction of the entire stock of debt. However, it was made conditional on the satisfactory performance of the debtor countries under appropriate arrangements with IMF.

Using the same assumptions as in last year's Report[44] for the evaluation of Trinidad terms, the UNCTAD secretariat has made a preliminary assessment of the likely impact of the enhanced concessional treatment on the projected debt service ratios of 22 low-income debtor countries[45] which have so far benefited from Toronto terms or are likely to benefit from enhanced concessional treatment. It should first be noted that the new enhanced concessional treatment carries a grant element of 50 per cent, while the Trinidad terms that were proposed by Prime Minister John Major (then Chancellor of the Exchequer) involved a grant element of 67 per cent. The Trinidad terms would also tackle the stock of debt from the start.

Assuming that a benchmark debt service ratio of 20 per cent reflects the debtor's capacity to pay,[46] the new terms have a differentiated impact on four groups of these 22 countries:

- For the first group of countries (Benin, Central African Republic, Chad, Malawi and Togo), whose debt is essentially on concessional terms, the new terms would have an important impact. However, for these countries, debt service ratios were originally well below 20 per cent.
- For a second group of countries (Equatorial Guinea, Guinea, Niger, Senegal, Zaire, and Zambia), the new terms would have a significant immediate impact, as they would lower their debt service ratios to less than 20 per cent by the third year after the assumed first rescheduling in 1992.
- For a third group of countries (Bolivia, Madagascar, Mali, Mauritania, Somalia and United Republic of Tanzania), the new terms would reduce significantly the debt service ratios. However, these ratios

43 One consequence of repeated reschedulings is the cutting of the same original loan into several tranches, each refinanced at different terms; the complexity of the resulting repayment schedule increases further when arrears and moratorium interest are rescheduled at different terms, rendering debt management even more cumbersome.

44 See *TDR 1991*, box 4. The assumptions used were the following: (1) export earnings grow by 5 per cent annually; (2) a benchmark debt service ratio, which is taken to reflect the debt servicing capacity of low-income debtor countries, is set at 20 per cent. A debt service ratio of 20 per cent has been retained here for a number of reasons. During the past decade, severely indebted low-income countries were actually able to make debt service payments equivalent on average to 25 per cent of their exports of goods and services (after debt reschedulings and accumulation of large arrears). However, despite significant capital inflows, these countries achieved per capita GDP growth rates which were negligible (and sometimes negative). A debt service ratio of 20 per cent perhaps would allow these countries to release additional resources to finance some per capita GDP growth, especially if export growth is weak and if external capital inflows stagnate. Such a ratio is still quite high, compared with the ratio of 12 per cent which prevailed in low-income countries in sub-Saharan Africa in 1980-1981.

45 The 22 countries are: Benin, Bolivia, Central African Republic, Chad, Equatorial Guinea, Guinea, Guinea-Bissau, Guyana, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Senegal, Somalia, Togo, Uganda, United Republic of Tanzania, Zaire, and Zambia. Owing to data inadequacies, two other countries (Burkina Faso and Sao Tomé and Principe) are not considered here.

46 It is also assumed here that debt service falling due each year from 1992 to 1994 and the stock of debt in 1995 would be rescheduled (in accordance with the provision that creditors will consider the matter of debt three years after the first rescheduling). The first option (a 50 per cent debt reduction) is applied to non-concessional debt (the remaining debt being rescheduled at an interest rate equivalent to 8 per cent), while ODA debt is assumed to be rescheduled according to the new terms (a maturity of 30 years, including 12 years of grace, at a concessional interest rate assumed to be equivalent to 2 per cent). The amortization schedule follows a smooth progression of payments determined by the new terms. The debt statistics used are derived from World Bank debt and debt service projections for individual countries. These tend to underestimate future debt service obligations, as new commitments, short-term debt and IMF credit, as well as accumulated payments arrears, are not taken into account.

would remain quite high, although for Bolivia, Mali and Mauritania they would approach the benchmark of 20 per cent by the third year.

- For a fourth group of countries (Guinea-Bissau, Guyana, Mozambique, Nicaragua and Uganda), the impact of the new terms is less significant. Their debt service ratios would remain high, sometimes extremely high. In these countries, Paris Club creditors account for a minor part of their debt, which is owed principally either to non-Paris Club bilateral official creditors and/or to multilateral institutions.

It follows from the above that for half of the potential beneficiaries the new terms would help to considerably reduce their debt service ratios, to a level which would be compatible with their capacity to pay. However, for the other half, their debt burden would still remain high, sometimes very high, after the full implementation of the new terms.

Finally, it should be added that the estimated impact of the new terms could be somewhat optimistic, as it is assumed that all creditors would agree to reduce debt (while in reality two creditor countries agreed only to reschedule over 25 years) and the debt considered in this exercise also includes post-cutoff date debt (since on the basis of available data it is not possible to distinguish it from debt incurred prior to that date).■

Chapter II

THE UNDERCURRENT OF DEBT DEFLATION

A. Introduction

The ability of the world economy to recover from recession and return to conditions of sustained expansion in the 1990s will depend in large part on the spending decisions of firms and households. These decisions will in turn depend not only on expectations regarding future economic conditions, but also on the ability of firms and households to finance expenditures from their earnings or through borrowing from financial markets. Since recessions are characterized by a fall in earnings, the willingness and ability of firms and households to issue equity and incur debt will be especially important. However, the current recession is occurring after a decade of rising debt burdens, which makes further debt accumulation difficult. The behaviour of short and long-term interest rates at which existing debt can be refinanced and new debt contracted will also be an important factor, as will the solidity of financial institutions. Since debt accumulation has to be underpinned by growth in earnings, sustained recovery will depend on resumed profit growth for firms and on a stable expansion of wage earnings and employment, as well as on rising tax receipts for Governments. In short, recovery requires (a) healthy and stable financial institutions, (b) a reduction of both short and long-term interest rates and (c) improved enterprise profitability to provide internal funds for debt repayment and further expansion, and to strengthen expectations and hence the drive to invest.

In many industrialized countries, the current financial condition of virtually all sectors of the economy, including households, firms, Governments, and - most critically - financial institutions, is weak, and the weakness of various sectors is interrelated. In almost all countries debtors are having to service debts that have been contracted in the expectation that incomes and prices would continue to rise, whereas they now face conditions of falling incomes and sharp falls in the value of their real and financial assets. The persistence of the recession has increased the number of defaults and delinquencies, thereby reducing the value of both bank assets and equity capital; and the natural response of banks has been to attempt to rebuild capital and invest in less risky assets. The consequent reduction in bank lending has been a major impediment to recovery.

The key question is whether the financial fragility that has been brought about by a combination of financial liberalization, tight monetary policies and bank deregulation will be self-correcting. This chapter argues that there exists a high risk that, without a change of policies, the process of financial restructuring will be protracted or even perverse, and that financing problems will continue to be a drag on economic activity.

B. Current conditions in financial markets

When borrowers that normally qualify for credit from financial institutions suddenly become unable to borrow, the result is a "credit crunch". In the past, this term was applied to a shortage of bank reserves caused by the inability of banks to raise funds, as happened in the United States in the 1960s and 1970s owing to "regulation Q" ceilings on interest rates; when market interest rates went above "regulation Q" ceilings, disintermediation led to a loss of bank deposits. These ceilings no longer exist; nor is there a shortage of bank reserves. Nevertheless, the attempts currently being made by weakened banks to strengthen their balance sheets (often under pressure from bank supervisors) appear to be having much the same result. Thus, the expansion of lending needed to finance recovery is being prevented.

Since the problem facing the banks is not so much a loss of reserves as a decline in the market value of their investments, "debt deflation" provides a better description of the conditions now prevailing in financial markets in the United States - and for that matter, also in Japan, the United Kingdom, Canada, Australia and a number of other countries. Since a bank's capital is the difference between the value of assets and liabilities, loan delinquencies and defaults reduce capital and hence the bank's ability to lend, even to solvent borrowers. Unless the latter have alternative sources of finance to meet their commitments, they may have to cut down on operations or resort to "distress" sales of inventories or assets; or even have to declare bankruptcy. The resulting cutbacks in output, employment and incomes may then create a downward spiral, possibly causing a prolonged recession or even a full-scale depression.

In the absence of government action to support incomes and prices of real and financial assets, a debt deflation process, once begun, will be reversed only when prices have fallen so much that owners of unutilized assets find it more profitable to hold on to them, in anticipation of a recovery of demand that will push up prices to more normal levels. The limit on the fall in prices depends crucially on the costs of holding assets (primarily interest, storage and insurance costs) and on the time that is expected to elapse before the recovery in demand will absorb the excess supplies. If interest rates are kept high, and/or if expectations remain low because of recurring difficulties, the decline may continue unabated.

Current conditions in industrialized countries are far from a full-scale debt deflation but the unfortunate coincidence of the banks' desire to become more liquid in order to strengthen their balance sheets and the introduction of the BIS risk-adjusted capital adequacy requirements (see annex I to this Part) in conditions of falling asset prices has made banks more discriminate in their lending. Conditions in some sectors, such as real estate, and in some highly leveraged firms (recently subject to takeovers or which have been taken private) are a cause of concern, and could contaminate otherwise healthy sectors. Besides, the reduced ability of households and firms to meet commitments because of declines in asset prices or incomes has had a significant impact on the banking system. This combination of factors could prove to be strong enough to obstruct a sustained recovery from recession.

1. *The United States*

(a) *The banking system*

The new BIS capital requirements will become fully applicable at the end of 1992, but are already generally applied. They require banks to hold higher ratios of capital on lending against more risky assets. Banks can in theory increase their capital either by increasing earnings or by issuing equity in capital markets. But, in practice, because of increasing loan defaults which have required writing down existing capital, and of delinquencies which have reduced reported earnings, banks find it more difficult and expensive to convince investors in capital markets to buy their equity. Instead, they are seeking to achieve the minimum capital requirements by reducing the size of their asset portfolios and the proportion thereof that carries a high risk.

Banks in the United States have experienced a considerable deterioration in the quality of their assets in three major areas of lending, namely commercial and industrial loans, consumer loans, and commercial real estate loans. Their lending against commercial real estate increased by 15 per cent per annum from 1985 to 1989, almost three times more rapidly than their commercial and industrial lending to domestic firms. However, by the end of 1991 virtually no new lending was taking place. The decline in occupancy rates in major urban centres and the massive overbuilding in recent years mean that pressure on earnings in real estate will increase, since rentals will continue to fall as leases are renewed. The trend of increasing default and delinquency, combined with attempts to recover and recall past loans, is therefore likely to persist.

Other major types of bank lending have fared little better. Between 1988 and 1990, charge-offs against commercial and industrial lending to domestic business (expressed as a proportion of total loans) rose by more than 25 per cent for medium-sized and large banks, while the share of non-accrual loans in total commercial and industrial lending doubled for medium-sized banks, to reach 3 per cent of outstanding loans.[47] The increased riskiness of lending to private business is reflected in the rise in the ratio of interest to income for the United States non-financial corporations to over 25 per cent in the second half of 1990; while this figure has fallen subsequently, it has remained above the peaks of the 1975 and 1982 recessions.

During the 1980s banks had also been rapidly expanding their lending to consumers to make up for reduced lending possibilities in other sectors. The rate of expansion, which had hit 14 per cent in 1985, fell to almost nil in 1990. Between 1985 and 1990 net loan losses on consumer debt rose by 50 per cent; on credit card lending alone they rose by 30 per cent from 1985 to 1986 and have remained at the 1986 level since then. Delinquencies increased from around 2 per cent of consumer debt outstanding in 1984 to over 4 per cent in 1990.

As a result of this deterioration in the quality of assets, net loan losses in terms of total lending of medium-sized and large commercial banks doubled from 1985 to 1990. Despite the sharp decline in short-term interest rates which has occurred over the last 18 months, banks' net interest margins have continued to fall, as the increase in non-performing loans absorbed the expanding lending margins. In 1990 banks' return on assets fell to a mere 0.5 per cent.

Although profits improved for banks in 1991, as they did for most other financial institutions, this was largely due to transitory factors such as capital gains on portfolios of securities, reclassification of some loans to developing countries, and "riding the yield curve", i.e. buying medium-term government securities with funds borrowed through short-term deposits or CDs. However, this practice involves a maturity mismatch; a rise in short-term rates will reduce profitability and if sufficiently large will occasion bank losses. The new capital adequacy rules do nothing to limit this type of traditional interest rate exposure, and indeed in present conditions encourage it.

The decision of banks to meet capital requirements by strengthening their capital base and by adjusting the composition of the asset side of their balance sheets is evident in the reduction in the rate of expansion of commercial and industrial lending in 1990, the virtual elimination of net lending to commercial property borrowers by the end of 1991 and the slower rate of expansion of consumer loans to near zero in 1990. In an attempt to increase earnings and reduce capital requirements, banks sharply increased their purchases of government securities and shifted the composition of real estate lending in favour of residential housing and government-guaranteed mortgages (since these carry much lower risk weightings than commercial real estate).[48] The retrenchment on the asset side of banks' balance sheets is also reflected by the decline in the rate of growth of total loans relative to total deposits.[49]

While banks are lending less to business, the general view that they have been squeezed out by alternative sources of lending does not appear to be correct; the increase in funding from these latter sources via the issue of commercial paper is not large. But since the market is only open to the most creditworthy large companies, it does point to another source of deterioration in the quality of bank loans. The reduced share of bank lending to non-financial

47 The increase was lower for the money centre banks, although their absolute level of such loans in commercial and industrial lending in 1990 was substantially higher, at 4.8 per cent.

48 There was also some adjustment on the liability side, with the substitution of relatively expensive "managed" or purchased liabilities by an increased proportion of savings and small time deposits, largely the result of transfer of funds to banks from failed, or failing, thrift institutions.

49 Total deposits contracted by 3.5 percentage points from 1987 to 1991, whereas by the middle of 1991 the rate of growth of total loans of United States banks had fallen to zero. The rate of expansion of lending by banks that do not meet the minimum 8 per cent requirement became negative in 1991 and by mid-year had fallen below -5 per cent; for those banks that meet the requirement, loan expansion has remained positive, but only marginally so.

Table 18

UNITED STATES: COMPOSITION OF THE DEBT OF NON-FINANCIAL CORPORATIONS

(Percentage share)

Type of debt	*1970*	*1980*	*1990*
Investment-grade bonds	47	40	35
High-yield bonds	-	4	10
Bank loans	29	28	25
Finance company loans	3	5	6
Commercial paper	2	3	6
Other	18	19	17

Source: *Structural Change in a Capital-short World* (Salomon Bros.), December 1990, p. 4.

corporations has been accompanied by a fall in the proportion of investment-grade corporate debt, as may be seen from the change in the composition of non-financial corporate debt (see table 18).

The recent difficulties in the primary high-yield (junk bond) securities market have thus reduced the alternatives to bank funding for non-financial corporations, and conditions in the commercial paper markets have also become more stringent. The alternative sources of funding that were increasingly employed in the 1980s have thus narrowed because of uncertain economic conditions, making firms more reliant on bank borrowing.

There has been increased reliance on finance companies and foreign banks as sources of commercial lending, but this has been generally limited to larger corporations; the restriction in bank lending is thus having a larger impact on small and medium-sized business. Foreign banks doubled their lending in the United States in the 1980s, and accounted for a third of all bank lending in 1990. However, as a result of the BCCI affair (discussed in annex I to this Part), foreign banks have come under increasing regulatory scrutiny. New legislation under consideration that would require them to operate as subsidiaries of United States corporations would determine their ability to lend on the basis of capital of the subsidiary rather than of the parent bank, hence sharply reducing it. Further, the retrenchment which has occurred in Japanese banks (see the next subsection) has also meant a reduction in the scale of their operations in the United States.

(b) *Household finance*

Because the largest single asset for most families is their principal residence, the fall in real estate values has also weakened family finances. Further, since the 1986 tax reform eliminated deduction of interest payments except for home and home improvement lending, an increasing proportion of consumer lending has taken the form of home equity loans. According to a survey of family finances,[50] such loans as a proportion of total household borrowing rose five-fold from 1983 to 1989 (largely as a result of an increase in borrowing for investment in real estate other than principal residence), credit card borrowing by 20 per cent and automobile lending by 30 per cent. Over the period the proportion of families in the population holding debt increased, while the average real debt rose by 42 per cent, from $31,700 to $45,000 in constant 1989 dollars. The ratio of non-mortgage debt payments to income shows a roughly similar increase for all income levels.[51] For the economy as a whole, the ratio of consumer instalment debt to con-

50 *Federal Reserve Bulletin*, January 1992.

51 For families with annual incomes of less than $10,000 the ratio rose from 32 per cent to 40 per cent, while for those with incomes above $50,000 it rose from 14 per cent to 19 per cent, indicating a generalized reduced ability to meet interest payments and principal.

Table 19

HOUSEHOLD INDEBTEDNESS IN THE UNITED STATES SINCE 1981

(Percentage of disposable income)

Type of credit	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992 a*
All credits	17.2	16.9	17.7	19.2	20.9	21.5	21.3	21.0	20.9	20.1	..	..
Instalment	14.6	14.4	15.2	16.6	18.3	19.0	19.1	19.1	19.3	18.6	17.3	16.7
of which: Automobile	5.6	5.6	5.9	6.5	7.4	8.2	8.3	8.2	7.8	7.2	6.3	6.1
Non-instalment	2.6	2.5	2.6	2.6	2.6	2.5	2.2	1.9	1.6	1.4	..	..

Source: *Survey of Current Business* (United States Department of Commerce), various issues.
a February.

sumer disposable income reached its lowest point in 1982 but had quickly expanded by 1986, remaining at that level (around 19 per cent) until 1989, when it started to decline (see table 19).

The increase in household borrowing in the 1980s did not reflect the increase in family assets; rather, the ratio of household financial assets to liabilities fell considerably.[52] Household interest payments on outstanding debt and payments of principal as a proportion of personal disposable income rose from less than 15 per cent in 1983 to above 19 per cent in 1990, and fell only slightly in 1991. The increased difficulties encountered by households in meeting loans is evident from the rise in the ratio of their arrears of one month or more to their total borrowing, from a low of 1.9 per cent in 1984 to 2.5 per cent in 1990.

(c) Corporate finance

The 1980s also saw a substantial change in the structure of the balance sheets of non-financial corporations, with a sharp increase in corporate leverage after 1985. Part of this change was due to the increased number of mergers and acquisitions, and of management and leveraged buyouts. Periods of substantial merger activity had also occurred in the 1960s and 1970s, but these were usually acquisitions to create large conglomerates via sectoral diversification, and were financed by exchanges of stock or new equity issues based on the assets acquired. In the 1980s, by contrast, most acquisitions were by cash takeover bids, with the purchases financed by borrowing from banks or by a special issue of debt by the acquirer. The purpose was not diversification, but to purchase a company for a lower price than the buyer believed it could fetch on resale, either because the company was underleveraged, the stock market valued the company at less than its break-up value, or management was thought to be performing poorly.

The ability to repay the debt issued to finance these takeovers thus depended on the post-takeover realization of the anticipated value of the assets. In short, the purchase of such debt amounted to taking a share participation in a speculative operation; the high interest rates offered on the debt reflected this risk. If the company was already indebted, the effect of a takeover bid financed in this way was to convert it automatically from investment to non-investment grade, producing an automatic reduction in its market value. Frequently the expected cash flows were insufficient to meet the debt service obligations without a successful divestiture of assets. Takeovers in which this could not be achieved not only produced default on the debt issued, but also meant that the acquired company instantly became bankrupt.

In addition, fear of takeover bids led many companies to issue debt simply in order to attempt to fend off such bids, which both

52 This ratio was 5:1 in 1970 and 4.5:1 in 1983, has fallen in every subsequent year, with the exception of 1989, and now stands at about 3.5:1. Liabilities were the equal of household annual disposable income in 1989 but exceeded income in 1990.

Table 20

UNITED STATES: SOURCES OF NET EXTERNAL FINANCE OF NON-FINANCIAL CORPORATIONS

(Percentage distribution)

Source	1973-1975	1976-1978	1979-1981	1982-1984	1985-1987	1988-1989
Commercial paper	23.9	21.1	30.9	19.0	18.8	30.2
Banks	46.2	58.3	69.2	109.9	91.3	97.0
Short-term loans	18.0	30.4	43.3	59.8	39.6	61.7
Long-term loans	28.2	27.9	25.9	50.0	51.6	35.3
Capital market	45.6	32.2	30.3	29.1	11.8	-17.9
Equity	11.3	5.0	-1.6	-6.8	-54.4	-101.4
Bonds	33.9	23.8	23.4	34.5	62.7	68.6
Other securities	0.4	3.4	8.5	1.4	3.4	15.0
Other sources	-15.7	-11.5	-30.4	-58.0	-21.8	-9.4

Source: OECD *Financial Statistics*, part 2, *Financial Accounts of OECD Countries* (various issues).

reduced the quality of their outstanding debt and increased their debt servicing obligations. Other firms acquired new debt to buy back their equity in order to increase their stock market value and so fend off takeovers (see table 20).

United States tax law has traditionally favoured the use of debt finance because of double taxation of dividends and the possibility of counting interest payments as operating costs. The 1986 tax reform, which reduced corporate and personal tax rates but eliminated the preferential personal tax rate on capital gains, further increased the advantage of debt over equity financing. Thus, the ratio of debt to total assets for non-farm business increased by more than 10 percentage points to 32 per cent between the early 1980s and 1990.[53]

Before the 1980s, the failure of United States companies to increase their leverage in line with the prediction of financial theories may have reflected the segmentation and controls which existed in the bond market, where only companies rated as being of investment grade could have access at the current market rate. The creation of an active secondary market in the debt of non-investment-grade companies and the subsequent development of a primary market for these securities opened up the possibility of higher leverage to companies previously prevented from borrowing, since securities purchased by most large investors were restricted to holdings of investment-grade issues. But it also created new possibilities for financing takeovers, and brought banks into the takeover business by providing bridging loans on highly leveraged transactions before the floating of the debt necessary to purchase the stock tendered.

Most of the mergers and takeovers were predicated on a continuation of economic expansion. The recession, the effects of which began to be felt in 1989, quickly rendered many of the projects impossible to complete, and left bondholders with sharply devalued portfolios and firms with debt that was not only excessive but also contracted at extremely high interest rates. As interest rates fell, and the stock market continued to remain strong, many companies have been involved in restructuring their balance sheets. Companies which had been taken private in buyouts again issued equity, and firms with large amounts of bonds outstanding at high interest rates issued new bonds

53 From 1984 to 1990, United States non-farm corporations increased their indebtedness by over $1,000 billion, of which $640 billion was used to finance stock retirements through acquisition or direct repurchase. Net issues of corporate equities declined from 1980 to 1990 by $512 billion.

Table 21

SOURCES OF NET FINANCING OF NON-FINANCIAL CORPORATE INVESTMENT IN FOUR MAJOR OECD COUNTRIES, 1970-1985

(Percentage share)

Source	*United States*	*Japan*	*United Kingdom*	*Germany* [a]
Retained profits	85.9	57.9	102.4	70.9
Loans	24.4	50.4	7.6	12.1
Commercial credit	-1.4	-11.2	-1.1	-2.1
Bonds	11.6	2.1	-1.1	-1.0
Equity	1.1	4.6	-3.3	0.6

Source: C. Mayer, "Financial Systems, Corporate Finance and Economic Development", in G. Hubbard (ed.), *Asymmetric Information, Corporate Finance and Investment*, Chicago 1990; *Bank of England Quarterly Bulletin*, May 1991.
a Refers to the former Federal Republic of Germany.

to take advantage of the prevailing lower market rates.[54]

The impact of the increase in corporate indebtedness can be seen in the evolution of profits before and after deduction of interest costs. Since the oil crisis of the early 1970s corporate profits have been around 6 per cent of GDP. After interest, they fell from around 4 per cent to below 2 per cent in the recession at the beginning of the 1980s; they recovered somewhat in the mid-1980s, but fell back to 2 per cent in 1991, with the gap between the two ratios increasing from 2 percentage points in the 1970s to around 3 points in the 1980s. Thanks to the possibility of refinancing at lower interest rates, corporate interest payments could be reduced by $30 billion in 1992, but this will raise profits after interest by only 0.5 per cent of GDP.

The increased indebtedness of the 1980s has thus led non-financial firms as well as financial ones to try to strengthen balance sheets by downsizing their activities and cutting costs. Since the preferred form of financing for firms (*pace* the predictions of the modern theory of finance) is generally retained earnings (see table 21), the first casualty of a fall in profits after interest payments is the ability to finance expansion internally. Higher indebtedness also increases the risk premium on capital market funding. It is for this reason that the issue of equity to retire debt is attractive, since it both increases profits and makes possible the upgrading of existing debt.

2. *Other financial markets*

Similar conditions prevail in a number of other major industrialized countries. In the United Kingdom and Japan, as in the United States, there was a rapid expansion of bank lending against real estate after the mid-1980s (see table 22).[55] The trend was more accentuated in the United Kingdom than in the United States.

Outstanding bank loans on property in the United Kingdom rose from £5 billion at the end of 1980 to £40.2 billion at the end of 1991 and had only fallen by £1 billion early in 1992. Estimates for late payments on these loans range up to as high as one-third. Vacancy rates for office buildings in the City of London have risen to 20 per cent.[56] In 1990, the rate of return

54 In the first nine months of 1991, the net issue of securities, at $44.1 billion, was positive for the first time in a decade. In 1991 as a whole the new bond issues traded on the New York Stock Exchange were twice as high as in 1990, in both number and value.

55 The figure for Japan is understated because much of the lending for real estate speculation was to companies not classified as real estate investors.

56 This excludes the new space in the Canary Wharf project in London's Dockland region, the value of which is esti-

Table 22

NET BANK LENDING FOR REAL ESTATE IN THREE MAJOR OECD COUNTRIES, 1984-1990

(Average annual amount)

	United States ($ billion)	United Kingdom (£ billion)	Japan (Y 000 billion)
1984	376	5.4	16.5
1985	426	7.1	20.1
1986	494	9.3	26.6
1987	587	13.3	31.3
1988	672	21.3	35.8
1989	761	31.9	41.0
1990	820	37.0	42.0
Increase 1984-1990 (per cent)	118	585.0	155.0

Source: UNCTAD secretariat calculations, based on *Structural Change in a Capital-short World* (Salomon Bros.), December 1990.

to investment in commercial property became negative.

In the United Kingdom the annual rate of expansion of net lending by banks and building societies peaked in mid-1988 at around 30 per cent, and lending continued to grow at 20 per cent rates until 1990, when it fell sharply to 12 per cent; in 1991 the increase was only around 7 per cent, and in early 1992 net lending became negative. Although most of this decline was in commercial and residential mortgage lending, the pace of lending to corporations also fell; net lending to manufacturing industries grew very little in 1990, and subsequently it actually fell. This reflected not only a slowdown in banks' overall lending, but also a deterioration in company balance sheets due to the recession, which was first visible in the United Kingdom; ratios of net interest payments to cash flows after tax more than doubled between 1987 and 1990, reaching 35 per cent. Banks' provisions for bad debts also increased (see table 23), as company bankruptcies rose by 48 per cent in 1990 and 88 per cent in 1991. As in the United States, United Kingdom firms have responded by issuing equity. Large companies delayed payments to small companies, supposedly in order to augment their own cash flow. Recognizing this situation, and also other problems faced by medium and small-sized firms, the Government provided some assistance, including tax relief and measures designed to accelerate payments on public sector contracts.

Household balance sheets mirrored those of firms; the ratio of debt to income (including mortgage debt) increased from less than 60 per cent in 1980 to over 115 per cent in 1990, a performance unequalled by other industrialized counries and rivalled only by Japanese households. Moreover, the substantial fall in house prices has greatly increased the number of homeowners whose outstanding mortgage debt is greater than the value of their property. Since selling property to pay off debt was not a feasible option, many such homeowners went into arrears, which eventually led to possession of their property. In 1990 over 2 per cent of all mortgages in the United Kingdom were delinquent and the proportion of delinquent mortgages to total mortgage lending was 3.5 times the 1988 figure.

The growth of bank lending in Japan was over 10 per cent per annum from 1987 to 1990 but dropped to less than 4 per cent in 1991. The monetary tightening initiated in 1989 has caused a more than 50 per cent decline in stock

mated to be half of its cost - £1.3 billion - and which will contribute as much as $2 billion to writedowns on Olympia and Yorks' balance sheet.

Table 23

DOMESTIC LOAN LOSS PROVISIONS BY MAJOR UNITED KINGDOM BANKS, 1989 AND 1990

(£ million)

Bank	*1989*	*1990*
Barclays	187	807
Lloyds	198	732
Midland	82	461
National Westminster	320	655

Source: *Bank of England Quarterly Bulletin*, various issues.

prices and finally started to reverse the spiralling of land prices, which have declined by about 5 per cent from their peak. Banks have consequently been confronted with problems of the quality of credit, since they have been lending against real estate, either directly or indirectly, via loans to non-bank financial institutions or the stock market. Japanese banks' lending to real estate companies alone is about 185 per cent of their equity capital, and the amount of non-performing real estate loans for the 21 largest banks is currently in excess of Y21,000 billion, or around 6 per cent of loans outstanding.

Japanese banks have not benefited as much as their United States counterparts from reductions in short-term rates because of competition from the postal savings bank. Their lending margins have consequently come under pressure from the recent decline in long-term lending rates caused by the deregulation of long-term prime rates. Actual loan losses and provisions against possible losses are eroding bank earnings, while some banks are under an additional strain due to the loan losses of affiliated non-bank financial companies which hold assets related to property.[57] Japanese banks are further weakened by the fact that instead of setting aside reserves against potential losses, they have been counting on the capital gains on security investments to offset loan losses. The fall in the stock market has virtually eliminated this cushion: it is estimated that existing loan loss reserves cover less than 15 per cent of potential bad debts on property lending by 5 of the 11 "city" banks which have default rates similar to those in the United States money centre banks. There are thus quite likely some unwelcome surprises in store for Japanese banks as the full extent of the impact on balance sheets of the decline in property prices unfolds.

The difficulties of Japanese and United States banks differ because for the latter the linkage between stock market and real estate lending is not as close, since they do not invest in shares. In Japan the problem of falling rental values is not yet important, but the fall in stock prices has exacerbated the decline in real estate values, and both types of asset are collateral against loans and bank investments. Since not more than 45 per cent of accrued, but not realized, capital gains on investments could be accounted as BIS Tier 2 capital, the Japanese banks have had an even greater need for portfolio restructuring, which has restricted their lending potential. It is estimated that at a value of the Nikkei index of 17,000 (it stood above 16,000 at the beginning of July 1992) the city and long-term credit banks would fall short of the international capital adequacy requirements by Y1,540 billion, irrespective of any additional charge-offs that might have to be made due to actual losses on real estate or other lending. The decline in share prices on the domestic exchange has also created difficulties for Japanese brokerage houses; only one of the big four houses is expected to show a profit this year. This weakness in the financial sector is coupled with a sharp fall in corporate profitability, which is thought to have fallen by 20 per cent in 1991, as well as a slowdown in the growth of industrial production.

57 Nomura Research Institute, *Quarterly Economic Review*, November 1991, p. 8; February 1992, pp. 18-19; May 1992, p. 12; *Financial Times Survey*, 27 March 1992.

C. The sources of current difficulties

The risk of an extended period of debt deflation in the major industrialized countries is the consequence of the prolonged expansion during the 1980s in liquidity and lending to particular sectors, such as commercial real estate and consumers, or for particular purposes, such as corporate mergers and acquisitions, which produced an asset inflation. A number of factors contributed to this liquidity and credit expansion, including: (a) the change in the conduct of monetary policy away from controlling interest rates and financial asset prices towards targeting some monetary aggregates, and the deregulation of interest rates; (b) the abandonment of fiscal tools in macroeconomic management, which put the whole burden of controlling the economy on monetary policy; and (c) the deregulation of domestic and external financial transactions, which increased the integration of financial markets internationally as well as the linkages between money, currency and capital markets.

While these elements have been present to varying degrees in most major industrial countries, the experience of the United States is particularly notable. Developments in the financial system in that country show how deregulation of interest rates and increased competition for deposits, by giving rise to pressures for deregulation also on the asset side of the balance sheets of financial institutions, lead to excessive risk taking and debt creation.

The decision of the Federal Reserve Board (commonly referred to as the "Fed") in 1979 to switch monetary policy to the targeting of certain monetary aggregates in order to influence the rate of inflation meant that both interest rates and exchange rates would fluctuate sharply. Thus, the promise of greater price stability in the real sector was exchanged for increased instability in the financial sector (i.e. in financial asset prices and interest rates) and increased uncertainty in financial markets. The change in the conduct of monetary policy also reduced the control of the Fed over the ability of different financial institutions to compete for funds. Ceilings on deposit rates (through regulation Q), together with a monetary policy operating procedure based on control of the federal funds (interbank) rate, had made control over bank lending very effective: to produce an impact on lending and activity, market rates only had to be moved marginally above the ceilings on deposit rates; or if higher rates were thought necessary, the ceilings could be adjusted upwards to prevent a massive outflow of funds. However, the new monetary policy made such procedures impossible to implement; with rates left free to fluctuate, it would have been necessary to adjust the limits daily. Thus, regulation Q became anachronistic and legislation introduced in 1980 provided for its gradual elimination by 1986.

The rise in interest rates had by then already created severe difficulties for mutual savings banks, which had portfolios of long-term Treasury bonds (with average maturities of around 25 years), and for Savings and Loan Associations (S&Ls), whose assets consisted of 30-year fixed-rate mortgages; both were faced with large drains in deposits and sharp losses on the value of their fixed assets. To shore up their ability to attract deposits, the same legislation increased deposit insurance up to and including $100,000, and granted greater freedom to all financial institutions to compete for funds. Restrictions on the types of investments permitted to S&Ls were relaxed to allow them to offer consumer and credit card loans and to make commercial loans up to 20 per cent of assets.

But these changes did little to increase earnings, which continued to lag behind the increased deposit rates. In 1982 additional legislation further deregulated the asset side of balance sheets, allowing S&Ls to invest in a wide range of assets with higher returns (but also with higher risks) such as non-investment-grade (junk) bonds, futures and options contracts, and also to invest up to 55 per cent of assets in commercial real estate financing. The limit on consumer lending was increased to 30 per cent. Many individual states introduced even more lenient legislation for state-chartered institutions.

In effect, the new legislation was an invitation to the banks to grow out of their difficulties by investing in higher-yielding assets. Since substitution of existing loan assets was impossible, the S&Ls had to expand their liabilities. This rapid expansion of funding was achieved by buying "brokered" deposits in insured lots of $100,000 which were not subject to regulation Q restrictions.[58] A major market, run by large Wall Street investment houses, grew up to distribute these brokered deposits to the highest bidders. These were the banks investing in projects with the highest returns, but which also incurred the highest risk. Among these projects was lending to speculative commercial real estate promoters, many of whom had bought failing S&Ls for precisely this purpose. On many of these projects, profits to the promoters and the interest due to banks were booked for several years in advance, at the time financing was arranged, and paid out of the borrowed funds. The banks' profits were thus all on paper, while the loans became the income of the promoters. This gave little incentive either to sell or to operate the projects and meant that failure to make the expected earnings did not appear as failure to meet interest payments until several years afterwards. For that reason, the rapid increase in the supply of commercial real estate and residential housing for rent had little impact on the housing market: it was more profitable in the short term to leave the premises unoccupied and unsold than to sell them at a loss.

But, as the government deposit guarantee agency (FSLIC) took over failing banks it had to start liquidating assets. Thus, although overbuilding and low occupancy rates had been visible since the mid-1980s, it was only in 1988-1989 that the real extent of the overbuilding and excess capacity came to be recognized. The attempt to sell the properties caused a collapse in market prices which quickly spread across the country.

A similar pattern of events took place in the high-yield (junk bond) securities markets when legislation to bail out FSLIC created the Resolution Trust Corporation and reintroduced restrictions on investments by S&Ls. This forced sale of bonds, together with the fall of the investment bank which had been the market leader, led to a collapse of prices, thereby weakening the condition of many previously healthy financial institutions, which were then obliged to sell their holdings cheaper.

Meanwhile, faced with competition from insurance companies and brokerage houses offering to underwrite commercial paper for their commercial and industrial borrowers, and after experiencing losses on lending to developing countries and in lending to the oil industry, banks were seeking new, profitable areas in which to expand. Banks, pension funds and insurance companies thus all followed the S&Ls in acquisition, development and construction loans. Opportunities for alternative business were also provided by lending to consumers during the recovery that started in 1983, by taking over the lending of S&Ls against commercial property and, in the latter half of the 1980s, by providing highly leveraged transaction financing for the issue of debt for mergers and acquisitions. At the same time, innovations such as credit card lending and home loans provided alternatives to the declining commercial and industrial loans as well as fee income and the possibility of packaging the assets into securities, which also produced fees. Thus, when prices in the property market collapsed as a result of the sell-off by S&Ls, the commercial banks were highly exposed. The recession which set in at this point reduced the demand for property at the very time that excess supply became manifest, thereby exacerbating the downward pressure on prices.

Feedbacks between the United States and Japanese financial markets have often served to transmit destabilizing influences. The opening of Japanese financial markets to non-residents in the mid-1980s, which was to be part of the policy to engineer a fall in the dollar, led to a substantial international diversification of the portfolios of Japanese financial institutions. These became major lenders to and investors in the United States and Canadian property markets in the late 1980s, when prices were at their peak. As a consequence, many of the subsidiaries had to be refinanced by their parent companies to cover losses.

In addition, as part of the bilateral agreement to reduce the United States trade deficit, Japan embarked on expansionary monetary and fiscal policies to accelerate the growth of the economy. In contrast to the 1970s, the response was not higher inflation (the reason being that the appreciation of the yen and the fall in oil prices in 1985-1986 kept goods prices down) but, rather, a sharp increase in asset prices. The stock market boomed, and residential and commercial real estate prices skyrocketed, fuelled by the expansion in lending and in incomes.

This expansion in global liquidity continued until 1987, when the United States started a sharp contraction which brought about a collapse of the bond market in the spring and finally the stock market crash in October which spread to international markets. After a short phase of sharp monetary expansion designed to ensure that the impact of these events would

58 The 1980 legislation had increased the insurance on deposits of up to and including $100,000 while the regulation Q interest rate restrictions only applied up to, but not including, $100,000. The result was that from 1980 to 1986 there were no interest rate restrictions on deposits of $100,000, although they continued to carry a deposit guarantee.

not depress the real economy, the United States resumed its restrictive monetary policy. Although the market crash had little impact on growth, the monetary tightening, along with some mild restriction in fiscal policy, produced a downturn in mid-1989. It was at this very point that Japan became concerned about asset price inflation and that the Bank of Japan began to tighten monetary policy and increase interest rates which, as noted above, caused a decline in the stock market of some 50 per cent. Current estimates are that the prices of building sites in central Tokyo may fall by 30-50 per cent from their 1987 peaks. As a result of the losses resulting from these stock market declines, Japanese financial institutions have been reducing their foreign lending in order to shore up their domestic operations. This further aggravated conditions in the United States and Canadian property markets.

Japanese financial institutions have proved to be no more immune than their United States counterparts to the temptations of fraudulent activity offered by the booming financial markets. The widespread fear of further discoveries of fraud is adding to the weaknesses of the financial system.

D. The likely consequences for recovery

The sectoral pattern of lending has also been reflected in the pattern of expansion of activity and employment. The property boom produced not only an increase in traditional construction jobs, but also a massive increase in associated services, including those of architects, engineers, insurance agents, lawyers, bankers, brokers and estate agents. In the United States, office employment rose by over 8 per cent a year and accounted for much of the shift of labour from manufacturing to services, as well as of the record increases in the overall number of jobs in the 1980s. However, as the difficulties in the saving and loan banks caused the property market to collapse, the growth in office employment declined and had turned negative by 1990. The United States currently has a 10-year supply of vacant office space and developed building sites; in some areas (e.g. Houston) in which abuse of lending by S&Ls was greatest, the situation is much worse.

To the decline in service sector employment was added a decline in manufacturing employment because of the strength of the dollar. As the dollar weakened subsequently, business started to introduce new technology to increase labour productivity. Consequently, the recovery of competitiveness will produce fewer manufacturing jobs than were previously lost, and will thus generate little growth of real income and consumption.

As already noted above, the singular feature of the current recession is the dominance of balance sheet restructuring being undertaken by firms and households. This restructuring has been taking place in two ways: by means of a reduction in the overall size of balance sheets and by taking advantage of lower interest rates to refinance debts and increase earnings.

The first way involves scaling down the operations of firms, a reduction of assets by banks and a reduction in debt-financed consumption by households. This process will continue to restrain employment. Conditions will be especially difficult in those sectors where rising employment had produced the greatest impact on consumption in the 1980s because they primarily had recourse to middle-income "white collar" professionals.

The second way hinges on the decline in short-term interest rates which has been occurring over the last 18 months. Manufacturing firms whose fixed-interest debt burdens had become excessive as a result of takeovers have been able to refinance loans more cheaply and to issue bonds or equity on more advantageous terms. Similarly, households have been able to refinance mortgages, home equity loans and loans for cars at lower interest rates. But the greatest beneficiaries of the decline in rates have been the banks, which have reaped capital gains on their holdings of investment securities and widened their lending margins. They have also benefited from the failure of long-term rates to decline in line with short rates, since this has enabled them to borrow funds cheaply through deposits and short-term CDs and invest them in medium-term government securities at a yield differential of 300-400 basis points.

On the whole, the impact of the downsizing of balance sheets is deflationary. A fully-fledged debt deflation has been avoided thanks to the fall in short-term rates. While this has helped bring about balance sheet improvements and increased earnings, it has not produced any direct expansion in the overall level of net expenditures: in current conditions low short-term rates can only limit the deflationary impact of the process of downsizing, not produce recovery, since they generate gains in earnings and performance which are of a temporary nature, whereas the problems of asset quality in the property sector will in all likelihood persist for several more years. Besides, further falls in short-term interest rates, unless matched by falls in long-term rates, could create additional risks of financial instability if they result in a wider mismatch in the maturities of bank assets and liabilities. Any sudden rise in short-term rates that created an inversion of the yield curve would mean losses instead of gains for the banks. The same risks apply to other financial institutions, such as insurance companies, that have lent to property developers. If long-term rates fall both absolutely and relative to short-term rates, the loss of earnings from playing the yield spread would be counterbalanced by capital gains on long-term securities held by banks.

While lower interest rates quicken the process of restructuring balance sheets, the restructuring itself bears down on employment and incomes. Given the excess supply in construction and other sectors normally sensitive to interest rates, there is little to suggest that the required expansion in activity will be generated by those sectors, even if long-term rates also fell. On the other hand, until firms see more buoyancy in household spending, they are unlikely to expand. As long as employment prospects in moderate and high-income professional service sector jobs (many of which provide second incomes for "two-income" households) remain depressed and disposable incomes continue to decline, the recovery in consumer spending needed to underpin recovery will not take place.

Thus, while the process of balance sheet restructuring is needed for recovery, it will not by itself generate recovery; a stimulus to the level of activity from elsewhere will be necessary. In the absence of any spontaneous source of expansion, there would appear to be no alternative to government action.

The aim of government policy should be to create the conditions which allow balance sheets to be reconstructed as rapidly as possible and to provide the stimulus necessary to provide a "soft take-off" for the expansion. This means creating conditions in which the accumulated excess supply can be eliminated in the shortest period possible. The first step in this process is to ensure that the costs of holding on to excess stocks or capacity are sufficiently low to make it worthwhile for investors to retain them on their balance sheets instead of selling them and driving down prices further. The recent reduction in the discount rate to 3 per cent comes near to meeting this goal.

But other measures will also be needed (a) to increase incomes and demand, and (b) to ensure that, once the increase in expenditures has initiated employment and income growth and restored consumer confidence, rising interest rates do not choke off the recovery in private investment and cause an inversion of the yield curve.

Given the size of the existing federal deficit, can fiscal policy be used to provide a stimulus? The federal budget deficit increased from 2.4 per cent of GDP in the calendar year 1989 to 4.4 per cent in 1992, but this was largely the result of recession: i.e. the cyclically corrected deficit was neutral in 1991 and will be slightly restrictive in the current year. In other words, there has been an improvement in the structural deficit, masked by the rapid deterioration of the cyclical component. Even a modest expansion of employment should bring about reductions in the deficit towards the 1989 level. Besides, the deficit is in part due to the weakening of the balance sheets of firms and banks; as much as one third of the total deficit predicted for 1992 is committed to Resolution Trust Corporation and deposit insurance expenditures. Consequently, expansionary policies, by strengthening surviving S&Ls and banks and speeding up the process of financial restructuring, would themselves help reduce the deficit.

However, increased government expenditure clearly needs to be of a temporary, not structural, nature. This argues in favour of stepping up investment, not enlarging transfers. Moreover, given the excess capacity in certain areas such as housing, the increased expenditure should be so designed as not to aggravate the excess capacity problem. Since there is no glut of social overhead capital and infrastructure, investment in those areas would appear most desirable, especially since it would also increase efficiency, productivity and incomes by reducing operating costs for business.[59]

An increase in infrastructure investment would increase income and employment, increase confidence generally, and allow consumers to adjust their balance sheets through repayment rather than default. The consequent increase in profitability would allow firms to restructure their finances and expand, which would increase the demand for business and commercial property and reduce the downward pressure on asset values and on bank balance sheets. The reduction in delinquencies and write-offs would allow increased lending and further restructuring of the real economy. With a return of confidence in the financial system and a halt to the decline of real wealth, the risk premium on long-term lending would fall and the value of assets in banks and households' portfolios would improve.

It will also be necessary to ensure that the rise in activity does not raise interest rates, for this would counteract the expansionary impetus. Over the past year, despite the decline in short-term rates, rates on government securities with maturities longer than 10 years have remained unchanged, in the range of 7.5 - 8 per cent. The outlook is for inflation to fall to below 3 per cent. Real interest rates would thus remain as high as 4-5 per cent. In the past, sustained expansions have been associated with real long-term interest rates below 2 per cent. While investment expanded in the 1980s in conditions of high real rates, this can largely be explained by the anomalous financial conditions which have produced current difficulties. Current levels of real interest rates therefore appear to be an obstacle to private investment and sustained recovery.

Why have long-term rates failed to respond to the Fed's attempts to ease monetary conditions by reducing the discount rate and federal funds targets? One explanation often advanced is that people expect inflation to accelerate in the future. However, given that rates of increase of both prices and wages are declining, and that, despite the fall in short-term interest rates below 3.75 per cent, the money supply has been growing more slowly than targeted by the Fed,[60] it is not plausible to argue that there is a strong fear that monetary policy will be over-expansionary; nor does the budget deficit provide a valid source of concern. As already noted, the outlook is for an improvement in the structural component of the deficit, which is what matters.

Expectations that short-term interest rates will rise do not always stem from fears of inflation. They can also reflect expectations that monetary policy will be automatically tightened as soon as the economy begins to recover (as indeed happened in 1983, less than six months after the trough of the recession)[61] and the elections of November 1992 are over. The strength of United States equity prices suggests that recovery has been constantly expected by investors. Paradoxically, therefore, expectations of recovery, even though not well founded, may themselves keep long-term interest rates high, and act as a brake on recovery. The economy is then trapped in a vicious circle in which a fall in short-term rates generates false expectations of recovery which in turn prevents the fall in long-term rates necessary for recovery to emerge.[62]

Given the experience of the 1980s, the current weak growth of the money supply and the temporary nature of the recovery in bank earnings, it is hardly suprising that there are expectations that Fed operating procedures aimed at controlling inflation through the money supply will produce a rapid reversal in interest rates as soon as the recovery begins to take hold. Consequently, something more than another discount rate cut may be necessary to convince the markets that short-term rates will not subsequently escalate. The most effective method would be for the Fed to announce that it was returning to a policy of targeting short-term interest rates. This would avoid a sudden inversion of the yield curve, and allow real long-term rates to move down to the level that is normally associated with economic expansion - i.e. 1-2 per cent.

Such a move would constitute a complete reversal of the change in operating procedures introduced by the Fed in 1979, when it was reacting to the particular economic conditions prevailing at that time, namely a wage-price spiral produced by a severe supply shock. Current conditions are just the opposite, the risk now being debt deflation stemming from

59 One such detailed programme is provided by S Jay and David Levy, *How to Restore Long-Term Prosperity in the United States*, The Jerome Levy Economics Institute, New York, 15 January 1992.

60 For example, the expanion of M2 so far this year has not exceeded 2 per cent, as against the 2.5 per cent target minimum; the June 1992 figures give an annual rate of less than 1 per cent.

61 See *TDR 1986*, chap. II, sect. B.2.

62 Another factor which has consistently kept long-term interest rates well above short-term ones over the last decade has been the increased risk premium due to the greater volatility of interest rates and financial asset prices, as discussed in *TDR 1990* and *1991*.

severe excess supply, especially in those sectors that have traditionally been most responsive to monetary policy and which have typically been used as cyclical regulators. Common sense suggests that a different operating procedure is required in this radically new environment.

Recovery in the United States is not the only challenge. Western Europe is currently entering a period in which expectations of recovery will be disappointed and financial surprises will be reported with increasing frequency. Continental Europe was insulated from the so-called "English-speaking" recession by the transformation of Germany into a locomotive as the result of unification. Germany is now, however, playing a role vis-à-vis the rest of Western Europe very similar to that played by the United States vis-à-vis the rest of the world in the first half of the 1980s: a rising government deficit, a deteriorating trade balance and a tight monetary policy leading to high interest rates and capital inflows. This configuration boosted demand and exports in Germany's EEC partners, but it has also forced them to tighten their monetary policies in accordance with the Exchange Rate Mechanism of the European Monetary System. In 1990-1991 for most countries the balance of advantage was positive, especially given a slight weakening of the deutsche mark towards the end of the period. But it began to shift in the opposite direction at the end of 1991 as German growth slowed, inflation accelerated, and interest rates rose further. The current round of wage negotiations (which has produced increases of 6-7 per cent, roughly double what the Bundesbank considered compatible with price stability) will only lengthen the period of monetary restraint, while the Government's intention to increase taxes and reduce the deficit will ensure that growth remains depressed until there is a "miracle" recovery in the eastern Länder.

The recent recovery of the deutsche mark has made the interest costs even higher as investors shifted assets out of ECU-denominated assets and the weaker EEC currencies into marks. The increased uncertainty over European union suggests that the Western European economies may experience conditions similar to those of the late 1970s and early 1980s, when changes in the strength of the dollar affected cross rates between the deutsche mark and the currencies of the other countries. A further weakening of the dollar, whether it results from the fragility of United States financial markets or from the real economy, is likely to cause an appreciation of the deutsche mark relative to the other EMS currencies, which would then elicit more restrictive monetary policies to defend parities. This would be a strong impediment to recovery. Without the benefit of exports to Germany and without the expansion of the United States economy, financial weakness could emerge in a number of countries. Stimulation of the economy, such as has been announced in France and the United Kingdom, can only be sustained if it does not weaken the currency.

In Japan, the asset deflation produced deliberately by the Government through high interest rates and the fall in stock and land prices has produced a slowdown in growth and an increase in the trade surplus to a record level - some three times higher than the previous peak registered in the 1980s. However, much of the expansion in Japan, as well as its ability to increase productivity and hold down costs, has been due to the near-zero cost of financing capital investments. From 1987 to 1990, when the share of investment in GNP rose from 27 per cent to 31 per cent, borrowing costs were low because of a sharp reduction in the costs of equity finance due to the boom in the stock market (until 1989) and the use of convertible bonds and bonds with equity warrants attached. The values attached to the bond conversion privileges and the warrants to buy stock gave many internationally known Japanese firms the possibility of borrowing below interbank rates. Reinvestment of these funds (via *Zaitech* financial engineering) in higher-yielding market assets further reduced the costs of funding.

The stock market decline that started at the end of 1989 has ended all this. Hardly any of the estimated Y8,000 billion of convertible bonds and warrant bonds due to mature in fiscal year 1992 (beginning in April) will be converted into equity; the bulk will have to be refinanced or repaid. The most usual technique of refunding has been to issue straight fixed-interest rate paper with maturities ranging from 3 to 7 years. Interest rates on the most recent issues have been around 5.5 per cent, representing a substantial increase in the cost of funding investment. The fall in demand and accumulation of inventories have already reduced the return to capital in manufacturing to the level of the average lending rate. Consequently, in spite of the recent fall in lending rates, capital spending and production are being cut back in an effort to run down inventories. Between the third and the fourth quarter of 1991 investment spending fell by 2.5 per cent at an annual rate.

The Government has acted to counter this likely shortfall, first by reducing interest rates and second by announcing increases in spending. More recently it has adopted a new Five-Year Plan for Fiscal Years 1992-1996 designed to improve consumer welfare by improvements in housing and social overhead capital as well as by cuts in working hours. The economy is expected to grow by about 3.5 per cent annually. However, growth in 1992 is likely to be much lower, if at all positive. Moreover, even if the plan is fully realized, its contribution to global recovery will be limited as aggregate domestic demand will grow by only 0.25 percentage points faster than GDP, or one-half of the rate envisaged in the previous Five-Year Plan.

Of potentially greater importance, however, is the impact of the weakness in the Japanese financial market on the rest of the world. Japan has been a major global investor and provider of funds, and Japanese corporations have increased investment abroad in order to escape protectionist pressures from the United States. But many Japanese firms have recently announced that they will be reducing their expansion plans in United States and other markets. Moreover, the share of assets of Japanese banks held abroad has fallen from 24 per cent in 1990 to 21 per cent in 1991. In 1990 Japanese holders sold $14.8 billion of United States Treasury securities and $2.9 billion of equity investments against purchases of $0.7 billion of corporate bonds, in order to repatriate funds to meet domestic financial difficulties. Thus, without further domestic stimulus, not only will Japan not have a clear positive impact on global recovery, but also financial difficulties are likely to produce sales of foreign assets and a reverse flow of funds to Japan which will cause further difficulties in international financial markets.

On balance, the world economy is in a danger zone. Stop-gap actions have been able to avert a full-scale debt deflation, something which would sharply reduce the wealth of financial institutions and households. However, they have not been able to foster a sustained, durable recovery. The financial restructuring now under way could set the path for sustained expansion with low inflation, but only if long-term interest rates are brought down and if a boost is given to demand to as to raise incomes and strengthen confidence. It is difficult to identify any spontaneous source for this boost (the optimists of 1991 who saw reconstruction in Kuwait, or rehabilitation in the former USSR or Eastern Germany, are now silent). One lesson to be learned from the experience of the 1980s is that while government stimulus may be very effective in producing economic expansion, the problem is how to ensure that it provides the basis for a sustained and sustainable expansion of employment. Current conditions do not call for a permanent increase in government expenditures, but for a carefully drafted programme limited in time. In the United States and the United Kingdom the emphasis could be on infrastructure, but in other countries other types of spending may be more appropriate.

Under current conditions, lower interest rates will raise demand for output in industrial countries more by reducing debt service in developing countries, which would increase the latter's imports from them, than by adding to domestic investment and consumption demand. It should be recalled that an important component of the decline in demand of the industrialized economies in the early 1980s was the fall in exports to developing countries facing debt crisis. The loss of developing country export markets may have cost the United States economy as many as one million jobs.

The recent decline in United States interest rates has significantly reduced the debt service payments of some developing countries. In particular, it has played an important role in allowing some Latin American countries to increase their imports, though in some instances the savings in interest payments were partly used to add to foreign exchange reserves. The contribution made by lower interest payments to the recent increase in United States exports to Latin America is difficult to estimate precisely, but there can be little doubt that the recession in the United States would have been deeper in its absence. The increase in developing country imports would have been considerably greater if interest rates outside the United States had not stayed high. If the decline in the United States interest rates is sustained, as suggested, by a change in the operating procedures of monetary policy, and if other industrial countries join the United States in permanently lowering their interest rates, they will all benefit greatly from increased export markets in developing countries. In short, by acting on interest rates, developed countries can simultaneously help resolve the debt servicing difficulties of developing countries and their own problem of stagnation and unemployment.■

Annex I to Part Two

GOVERNANCE OF INTERNATIONAL BANKING AND THE WORK OF THE BASLE COMMITTEE ON BANKING SUPERVISION

A. Introduction

Recognition of the opportunities and problems posed by international banking since the 1960s has led to several multilateral initiatives regarding its governance. These initiatives have been driven by three underlying objectives: the strengthening of prudential supervision; the opening up of the banking markets to greater international competition; and the harmonization of national regulatory regimes to the extent required to prevent them being a source of unfair advantage in competition between banks. The negotiations on financial services in the context of the Uruguay Round of multilateral trade negotiations have been concerned with the second and third of these objectives. The issues under consideration at these negotiations and progress up to mid-1991 were reviewed in the previous two editions of the TDR.[63] An integrated set of measures aimed at all three objectives is being introduced as part of the EEC programme to establish a single market. However, these measures are limited to the Community's member countries (although their indirect effects will be felt more widely). The main focus of this chapter is the work of the Basle Committee on Banking Regulation and Supervisory Practices, recently renamed the Basle Committee on Banking Supervision and hereafter referred to as the Basle Committee. Among the results of this Committee's work is a series of agreements concerning strengthened prudential supervision and increased harmonization of national regulatory regimes. While these agreements are directed in the first instance at the member countries of the Basle Committee,[64] they have been accompanied by efforts to achieve wider acceptance of the principles which they contain. Moreover, although the work of the Basle Committee does not comprise the opening of banking markets as such, the framework of governance for international banks being evolved by it is increasingly acknowleged as a necessary complement to global financial liberalization. Indeed, perceptions concerning the effectiveness of this framework can be expected to influence many countries' attitudes towards attempts to achieve such liberalization.

Prudential control over banks is intended to reduce both the risks and the costs of bank failures, which not only damage borrowers from, and lenders to, the institutions in question but also, owing to the danger of contagion within the banking sector and the links between this sector and non-financial activities, are capable of causing much more widespread economic destabilization. The main instruments of prudential control are the following: con-

[63] See *TDR 1990*, Part Two, chap. II, and *TDR 1991*, Part Three, chap. IV.

[64] The member countries of the Basle Committee are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and United States.

straints on the permissible activities of banks, designed to reduce the risk of insolvency; rules about banks' capital and liquidity; licensing requirements, designed to ensure the fitness of entrants into banking and, in many cases, to control the intensity of competition; supervisory monitoring of banks' activities and internal controls; provision of formal guarantees or insurance for bank deposits or the fostering by other means of a perception by the public that such deposits are safe; and arrangements for handling the problems of particular banks in difficulty as well as wider banking crises. These latter arrangements typically include lender-of-last-resort facilities and modalities for intervention in the affairs of banks in trouble by means such as official takeovers or the replacement of management.

Historically there have been considerable divergences between countries' regulatory regimes for banks. Such divergences reflect partly national differences in the levels and character of economic development. But another reason, particularly important during the internationalization of banking during the last 30 years, is many countries' conscious use of regulatory laxity as a policy instrument for attracting foreign banks. These regulatory divergences became a source of growing concern as supervisory authorities realized that threats to the stability of their countries' financial systems could originate not only internally but also following bank failures resulting from operations outside their jurisdiction. The reality of these dangers was dramatized in 1974 by the failures of Bankhaus I.D. Herstatt and the Franklin National Bank, which played an important role in the decision to establish the Basle Committee.

This Committee's work (major features of which are the subject of the following two sections) exemplifies the problems of improving the governance of international banking. The initial agreements reached by the Committee concerned primarily the levelling-up of prudential standards for international banking and the delineation of supervisory responsibilities in parent and host countries. More recently the scope of these agreements has extended more specifically to the contents of prudential guidelines, the Committee's most important initiative in this area so far being that on capital measurement and standards in 1988. The process of reaching these agreements and of achieving acceptance of their contents by countries which are not members of the Committee has been gradual, and several subjects, especially those relating to different types of banking risk, have yet to be covered. Implementation of certain guidelines in the Committee's statements has sometimes proved difficult, particularly with regard to the relaxation of constraints on supervisory cooperation due to banking secrecy and the exercise by authorities of their respective supervisory responsibilities in the different countries of international banks' operations. An especially notable illustration of these difficulties is the recent collapse of the Bank of Credit and Commerce International (BCCI), discussed in section D below. The final section of this chapter takes up certain implications of experience so far with the guidelines produced by the Basle Committee, and points to some of the main items on the unfinished agenda of governance for international banks.

B. Principles enunciated by the Basle Committee

1. The 1975 Concordat

The first of the Basle Committee's major statements was the Concordat of September 1975,[65] which was concerned with delineating the distribution of supervisory responsibilities for foreign banks between host and parent authorities. For this purpose the Concordat distinguished between three different types of legal entity, namely branches (which are integral parts of the foreign parent bank), subsidiaries (which are legally independent institutions incorporated in the host country and controlled by one foreign parent bank), and joint ventures (which are also legally independent banks incorporated in the host country but controlled by two or more parent institutions, most of them foreign but not all necessarily banks). Its

65 Committee on Banking Regulations and Supervisory Practices, "Report to the Governors on the supervision of banks' foreign establishments" (Basle, September 1975).

more specific recommendations related to three different subjects of banking supervision, namely liquidity, solvency and foreign exchange operations and positions. These three subjects are conceptually distinct but in practice there is considerable overlapping. Solvency, for example, is the ability to meet financial obligations as they fall due, while liquidity is the ability to ensure the availability of funds to meet commitments without incurring excessive or unreasonable costs. Thus it is easy to see that a liquidity squeeze can quickly become a threat to a bank's solvency. The close connections between different subjects of banking supervision is one reason for the importance of joint supervision by both parent and host authorities. The Concordat also emphasized that host authorities' interest in the operations of banks in their territories was necessarily paralleled by the concern of parent authorities with the same entities as part of the larger institutions which it was their responsibility to supervise.

Under the scheme of the Concordat primary responsibility for the supervision of the liquidity of foreign banks (branches, subsidiaries or joint ventures) was attributed to the host authority, owing to the importance in liquidity management of local practices and regulations. However, it was also acknowledged that the liquidity of branches cannot be judged in isolation from that of the whole bank and hence that parent authorities, as part of their supervision of parent banks, need to take account of potential calls for liquid resources by foreign branches. Moreover, the Concordat noted the need of parent authorities to take account of facilities placed by parent banks at the disposal of foreign subsidiaries.

Responsibility for supervising solvency and foreign exchange operations and positions was also to be shared. In the case of subsidiaries and joint ventures primary responsibility was to rest with host authorities, but attention was drawn to the need for parent authorities to take into consideration domestic banks' exposure to such entities. The solvency of foreign branches is indistinguishable from that of the bank of which they form a part, and consequently the main responsibility for their supervision was attributed to parent authorities.

Two other subjects of great importance in the light of subsequent developments were taken up in the 1975 Concordat. Firstly, there was an acknowledgement that, owing to the structure of certain international banking groups, there could be gaps in the supervision of some of their entities (for example, because they were classified for the purpose of regulation as banks by the authority in the parent but not in the host country, or because there was no supervision at all in the host country). Secondly, considerable emphasis was placed on the need for the exchange of information between supervisory authorities. Note was taken in this context of impediments to such exchange, particularly those due to laws on banking secrecy in host countries.

2. The 1983 Concordat and its antecedents

Limitations of the 1975 Concordat soon became evident. Wide divergences remained between countries' supervisory standards, and disagreement persisted as to the practical application of the Concordat's guidelines concerning the distribution of supervisory responsibilities between host and parent authorities. The Concordat had recognized the first of these problems, emphasizing the desirability of adequate supervision as judged by the standards of both host and parent authorities. But a way of reducing differences between such standards was not proposed. The absence of consensus concerning the location of primary responsibility for supervising the operations of international banks became apparent in various communications of the central banks of member countries of the Basle Committee.[66]

In October 1978 the Basle Committee issued a statement recommending that supervision be conducted on the basis of the consolidated balance sheet of all an international bank's constituent entities.[67] Such supervision was presented as an aid to the supervisors of parent banks in monitoring solvency. It was also pointed out that consolidated supervision makes possible control over the use by a bank of subsidiaries and joint ventures to achieve large increases in gearing on the basis of a given amount of capital through a corporate structure resembling an inverse pyramid.[68] In spite of the emphasis in the statement that consolidation should be

66 For examples of such communications see R. Dale, The *Regulation of International Banking* (Cambridge: Woodhead-Faulkner, 1984), pp. 173-174.

67 Committee on Banking Regulations and Supervisory Practices, "Consolidation of banks' balance sheets: aggregation of risk-bearing assets as a method of supervisory bank solvency" (Basle, October 1978).

68 The way in which such an inverse pyramid could be established is illustrated in an appendix to the Basle Committee's

viewed as a supplement to, and not as a substitute for, other supervisory techniques, it has been argued that this recommendation may actually have contributed to the confusion as to the location of supervisory responsibilities.[69] A blurring of the principles of the 1975 Concordat was possible if host authorities viewed consolidated supervision as lessening their responsibility for locally incorporated subsidiaries while the authorities in the countries of parent banks continued to observe only the role attributed to them by the Concordat.

Worries about continuing weaknesses in the supervisory regime were given a further fillip by the events which followed the collapse of the Banco Ambrosiano in the summer of 1982. By transferring the bank's business to a new entity the Italian authorities protected Italian depositors. However, they disclaimed responsibility for the obligations of Banco Ambrosiano's Luxembourg subsidiary, Banco Ambrosiano Holdings SA (BAH), as well as for those of BAH's Latin American subsidiaries, on the grounds that BAH was a holding company rather than a bank and was located outside their jurisdiction. For their part the supervisors in Luxembourg took the view that foreign parents did have a duty to support their subsidiaries, while rejecting any responsibility for BAH's obligations since it was licensed as a holding company rather than a bank and thus under Luxembourg law was not subject to their authority.

Thus the revised Basle Concordat of May 1983[70] was an attempt to meet the perceived weaknesses of its 1975 predecessor in the light of more recent experience and subsequent work of the Basle Committee on various subjects relevant to banking supervision. Concerning the distribution of supervisory responsibilities for international banks' solvency, liquidity and foreign exchange operations and positions the new Concordat mostly fleshed out the principles enunciated in the 1975 version. But in its treatment of the last of these three subjects it also emphasized the need for parent banks to have in place systems for monitoring their entire group's foreign exchange exposure, a recommendation which presumably reflected work undertaken by the Committee in response to the prominence of foreign exchange operations in the bank failures of 1974.[71]

The 1983 Concordat's attempts to handle the problems posed by divergent supervisory standards and the complex structures of many international banking groups were embodied in two principles, firstly, that no foreign banking entity should escape supervision and, secondly, that the supervision should be adequate. The Concordat acknowledged that holding companies could make both principles difficult to achieve. In the case of holding companies at the head of banking groups which include subsidiaries in different countries it recommended that the responsible authorities co-ordinate their supervision on a basis that takes account of the group's overall structure. When the holding company is not at the head of a group but is an intermediate link, the authority in the country of the parent company should ensure that both the holding company and its subsidiaries are adequately supervised. Alternatively (presumably in cases where such supervision by the parent authority is not feasible) permission to operate such intermediate holding companies should be withheld. When banking groups included non-bank organizations, the Concordat recommended liaison between the responsible banking supervisory authorities and the bodies charged with supervising the non-banking organizations.

Aside from the 1983 Concordat's remarks on specific difficulties caused by the complex structure of international banking groups, its general approach to achieving comprehensive and adequate supervision involves two essential components. The first is its insistence on the complementary and overlapping responsibilities of host and parent authorities (described by one commentator as a "dual key" approach).[72] If the parent authority judges the supervision of the host authority to be inadequate, it is to extend its supervision or actually discourage the parent bank from continuing to operate in the host country in question. If, on the other hand, the host authority is not satisfied as to the adequacy of the supervision by the parent authority of banks operating on its territory, it is

statement. On the basis of capital of one unit and deposits of nine, parent bank A invests 10 units in a wholly owned subsidiary B, which uses its 10 units of capital and 90 of deposits as the basis for investment of 100 units in a wholly owned subsidiary C. The balance sheet of subsidiary C then consists of 100 units of capital and 900 of deposits as its liabilities, and of 1,000 units of loans as its assets. In this way a bank subject to a ratio of capital to assets of 10 per cent at each stage of its operations has been able to achieve a risk exposure equal to 1,000 times its initial capital.

69 Dale, *op. cit.*, p. 173.

70 Committee on Banking Regulations and Supervisory Practices, "Principles for the supervision of banks' foreign establishments" (Basle, May 1983).

71 Concerning the Basle Committee's discussions on foreign exchange trading see G.G. Johnson with R.K. Abrams, "Aspects of the international banking safety net", *Occasional Paper No. 17* (Washington, D.C.: IMF, March 1983), p. 26.

72 Dale, *op.cit.*, p. 175.

to discourage or forbid the continuation of their operations within its jurisdiction or, alternatively, to attach specific conditions to such continuation.

The second essential component of the general approach of the 1983 Concordat is consolidated supervision. Its recommendation of such supervision reinforces the role of the parent authority and has the potential to lessen (though not to eliminate) problems due to divergences between national supervisory standards. The Concordat emphasizes that the application of consolidated supervision should not imply any reduction of host authorities' supervisory responsibilities, and that supervision of individual banking establishments on an unconsolidated basis by both parent and host authorities should continue to be carried out.

Like its predecessor, the 1983 Concordat draws attention to the importance of the exchange of information between national banking supervisors. In particular, it stresses the need for speedy communication between host and parent authorities of information concerning serious problems in any part of a banking group for whose supervision they are jointly responsible. It also notes the dependence of consolidated supervision on the access of parent banks and parent authorities to all relevant information concerning the operations of different entities of international banking groups.

The Basle Committee's concern over exchange of information between supervisory authorities led it to undertake further work on the subject. The results were published in a Supplement to the 1983 Concordat which not only covers information flows between supervisors but also contains recommendations elaborating the discussion in the Concordat of the relation of prudential considerations to the granting of market access.[73]

The parts of the Supplement treating this latter point give special attention to situations in which there is dissatisfaction on the part of either the host or the parent authority about the way in which supervisory responsibilities allocated under the 1983 Concordat are being discharged in practice. As far as the host authority is concerned, the Supplement elaborates the principles of the Concordat to cover situations where the entity requesting a banking licence either is not subject to prudential supervision in the parent country or is a joint venture for which there is no clear parental responsibility. In either case the Supplement recommends that market access should be granted only provided that the host authority is capable of exercising a parental role. Moreover, as a general principle, before granting market access host authorities should routinely check that the entity's parent authority has no objection. Independently of this consultation procedure parent authorities have the responsibility for preventing banks in their jurisdiction from undertaking unsuitable expansion abroad.

The sections of the Supplement on the information needs of parent and host authorities consist partly of a reiteration of points already made in the Concordat. But, especially with regard to the needs of host authorities, there is a fuller spelling-out of the kind of information which parent authorities should divulge. This information includes supervisory measures in the parent country, the scope of the parent bank's operations, its banking group, its internal controls, and impending changes of ownership. The Concordat had already recommended that parent authorities should inform host ones of major problems involving parent banks likely to affect their foreign entities in the territories of the latter. This recommendation is made more explicit in the Supplement, particular attention being drawn to cases where the parent authority intends to act to protect depositors' interests, and where it is desirable that the action be co-ordinated with the host authority. The Concordat had also covered cases where the parent authority considers the supervision of the host authority to be inadequate. If in consequence the parent authority envisages action likely to affect entities in the host country, then the Supplement recommends advance consultation with the host authority to give it a chance to remedy the inadequacies in question.

The 1983 Concordat had acknowledged the impediments posed to coordinated banking supervision by secrecy laws, especially as regards implementation of the principle of consolidated supervision. The Supplement urges review and amendment of the aspects of secrecy laws responsible for such impediments, subject to strict safeguards that the information disclosed should be used only for the purpose of prudential supervision in the recipient country. Moreover, the authority in the recipient country is to consult with its counterpart in the other country if it judges that information furnished by the latter justifies action.

A new subject raised by the Supplement is that of external auditing, which is viewed as having a particularly important role in the case

73 Basle Committee on Banking Supervision, "Supplement to the Concordat. The ensuring of adequate information flows between banking supervisory authorities" (Basle, April 1990).

of the foreign entities subject to inadequate inspection in their host countries and beyond the supervisory reach of the authorities in the countries of their parent banks. Ideally, according to the Supplement, the parent bank and its foreign entities should be audited by the same firm. If this is not possible, the auditor of the parent bank should have access to the audit papers of the foreign entity. Moroever, good lines of communication should be established between the different supervisors and auditors of a parent bank and its foreign entities. Regarding the quality of auditors, the Supplement expresses a preference for internationally qualified firms with experience of banking audit in the country of the banking entity. When supervisors are dissatisfied with the quality of audits, the Supplement recommends that they "should address criticism to the local representative body of auditors and should be empowered, where necessary, to have the auditor replaced". But the modalities of this empowerment are left unclear. For example, is it to apply to both parent and host supervisors? Whilst the dismissal by the host authority of an auditor judged unsatisfactory is easily envisaged, the same cannot be said of situations in which the pressure for an auditor's replacement comes from the parent authority. Here it is difficult to see the parent authority being able to do more than recommend such replacement to its counterpart in the host country.

3. The proliferation of banking risks and strengthened prudential supervision

The two Concordats and the Supplement are directed mainly at issues related to the distribution of responsibilities between supervisors in parent and host countries. Other subjects to which the Basle Committee has devoted considerable attention pertain to the management of financial risk and banking solvency, both topics related to the broader question of banking stability. Its concern with these subjects reflects the growing recognition that strengthened prudential supervision is the necessary counterpart of financial deregulation and an essential vehicle for increasing banks' protection against the greater risks now attaching to many of their operations. Several of these risks are associated with the intensified competition which has accompanied deregulation. This competition has tended to raise banks' costs of funding and also to decrease profit margins on much of their business in other ways. The resulting pressures have increased incentives to engage in new and riskier activities. Innovations involving instruments such as futures, options and swaps have expanded the possibilities for banks of managing financial risk. But the protection thus afforded is not complete,[74] and the instruments themselves can be used for speculation, thus becoming a potential source of losses as well as profits. The perceived urgency of strengthened prudential supervision received an additional fillip in the second half of the 1980s from the deterioration in the quality of banks' assets in many OECD countries resulting from their exposures to borrowers from developing countries and from sectors and regions at home affected by unfavourable economic out-turns. These indications of banks' weakness were accompanied by fears in certain countries, particularly the United States, that if the consequent tightening of prudential regulation and supervision was introduced through uncoordinated national policy initiatives, it could be a source of unfair competitive advantages to some banks. As a result, the prudential initiatives of the Basle Committee have incorporated the objectives not only of raising prudential standards but also of making such standards more internationally uniform.[75]

Much of the Basle Committee's work in the area of prudential supervision has been designed as much to contribute to the development of banks' own internal controls as to provide guidance to supervisors. For example, in early 1982 (before the outbreak of the developing countries' debt crisis) the Committee published a paper on banks' exposure to country risk.[76] Its focus was banks' procedures for assessing and controlling the risk that borrowers from particular countries would be unable or unwilling to make payments on their loans. The principal message of the statement for banking supervisors was the need for them to

74 Concerning gaps in the protection furnished by such instruments against unpredictable movements of economic variables see, for example, *TDR 1988*, Part One, chap. II, sect. D.

75 Concerning the effect on the Basle Committee's work of fears about differences among national regulatory regimes as a source of unfair competitive advantage in international banking see E.G. Kapstein, "Supervising international banks: origins and implications of the Basle Accord", *Essays in International Finance No. 185* (Princeton, New Jersey: International Finance Section, Department of Economics, Princeton University, December 1991), pp. 12-24.

76 Committee on Banking Regulation and Supervisory Practices, "Management of banks' international lending: country risk analysis and country exposure measurement and control" (Basle, March 1982).

ensure that banks did indeed have adequate procedures of this kind.

The Committee's statement of March 1986[77] concerning off-balance-sheet exposures was designed not only to assist in the harmonization of such items' supervisory treatment but also to contribute to understanding among bankers and auditors of the different kinds of risks involved. Off-balance-sheet exposures arise from activities involving contingent commitments not included in a bank's assets or liabilities under standard accounting procedures. They include commitments to advancing funds and thus acquiring a credit exposure at a future time, the underwriting of another party's obligations, securities underwriting, and transactions involving agreements regarding interest and foreign exchange rates which mostly do not entail exchanges of principal but leave the bank open to profits or losses stemming from movements of the variables in question. Some of these exposures result from traditional banking instruments such as acceptances and commercial letters of credit, but more recently there has been a proliferation of new ones such as futures and options in an increasing number of currencies and interest rates.

A survey undertaken by the Basle Committee in 1984 had indicated significant weaknesses, and differences among countries, in the supervisory treatment of many off-balance-sheet exposures with the result that in some cases they were not properly accounted for in measures of capital adequacy.[78] A large part of the Committee's 1986 statement consists of a glossary of off-balance-sheet instruments and techniques and an analysis of the different types of risk associated with banks' exposure to them. The references to supervisors' role emphasize the need to keep abreast of developments regarding such exposures through a continuous dialogue with banks. Only in this way will supervisors be able to ensure that all major off-balance-sheet activities are adequately covered in banks' supervisory returns. The qualitative evaluation in this statement of the risks incurred represented a step on the way to the quantitative guidelines put forward in the subsequent agreement of the Basle Committee on an international standard of capital adequacy.[79]

4. Capital standards

Since 1988 the Basle Committee has put forward a number of more explicit guidelines for prudential supervision and has also issued a statement of principles of banking practice regarding money laundering. The most important of its statements on prudential guidelines is the agreement of July 1988 entitled "International Convergence of Capital Measurement and Capital Standards" (henceforth referred to as the Basle Agreement). Underlying the Basle Agreement is the assumption that a bank's strength and safety is importantly related to the size of its capital base.[80] The Agreement's guidelines for the measurement and levels of capital are also designed to meet the fears about unfair competitive advantage mentioned earlier by reducing divergences between national regulations regarding capital adequacy. The Agreement establishes an overall target figure for the ratio of capital to a risk-weighted sum of assets and off-balance-sheet exposures. Eligible constituents of capital are divided into Tier One, consisting of shareholders' equity and disclosed reserves (which must constitute at least 50 per cent of total capital), and Tier Two, consisting of specified categories of reserves not eligible for inclusion in Tier One, hybrid financial instruments with characteristics of both equity and debt, and subordinated term debt. Each asset in the denominator of the ratio (or off-balance-sheet item after conversion to its credit equivalent by means of a factor selected for this purpose) is assigned a weight varying from zero to 100 per cent corresponding to its relative risk.[81] An intermediate target for the ratio of 7.25 per cent was to be achieved by the end of 1990, and a final one of 8 per cent by the end of 1992.

Two other papers recently issued by the Basle Committee treat matters concerning

77 *Idem*, "The management of banks' off-balance-sheet exposures: a supervisory perspective" (Basle, March 1986).

78 *Idem, Report on International Developments in Banking Supervision*, No. 5 (Basle, September 1986), p. 31.

79 The broader macroeconomic, prudential and informational issues associated with the growth of off-balance-sheet activities were covered in the report by a study group established by the central banks of the Group of Ten countries, *Recent Innovations in International Banking* (Basle: BIS, 1986).

80 Although the adequacy of a bank's capital undoubtedly influences perceptions of its strength and safety, scepticism has been expressed by several analysts that lack of capital *per se* is a major reason for banks' failures in practice. See, for example, M.K. Lewis and K.T. Davis, *Domestic and International Banking* (Oxford: Philip Allan, 1987), pp. 148-149.

81 For further details on the eligible constituents of capital in the numerator of this ratio and the risk-weighting of assets and off-balance-sheet items in its denominator see *TDR 1989*, annex 2, and chapter I of this Part.

which the guidelines in the Basle Agreement were recognized as incomplete. The subject of the first of these papers is the monitoring and control of large exposures.[82] The paper is designed to deal with the point that the use of the guidelines in the Basle Agreement could lead to an underestimate of the loss to a bank which might result from the concentration of risks due to large exposures to a single counterparty or a group of related counterparties.[83] For example, under these guidelines certain short-term commitments undertaken by a bank are assigned risk weights of zero for the purpose of estimating target levels of capital. However, if a counterparty or group of related counterparties to which the bank's exposure was large experienced difficulties, amounts under such commitments could be drawn and the bank could be put at serious risk. In cases of this kind the paper recommends that the measure of the bank's exposure to the counterparties in question should include the "par value" of a wide range of potential claims and contingent liabilities.[84] It is also suggested that large exposures should not be permitted to exceed 25 per cent of a bank's capital as defined by the Basle Agreement, and that there should be a special reporting threshold for such exposures at a lower level not exceeding 10 per cent of capital. In addition to these recommendations the paper emphasizes the need for banks to develop procedures enabling them to identify and measure above-average exposure to particular regions or economic sectors.

The second of the two papers[85] is intended to meet the commitment in the Basle Agreement to clarify the question of the extent to which a bank's general provisions and general loan-loss reserves can be recognized as part of its capital. The underlying principle enunciated is that amounts under these headings should be included in capital only if they are freely available to meet losses not currently identified. In addition to provisions for specific losses, banks commonly establish general provisions or general loan-loss reserves which are not earmarked in this way. These balances are not part of measured profits, sometimes not even being publicly disclosed. They are thus available to offset impairments of a bank's assets before these have been passed through its profit and loss account. The paper accepts the inclusion of these balances in Tier Two capital up to a limit of 1.25 per cent of the value of risk-weighted assets. Hidden reserves no less freely available than measured profits, which are held by banks in some European countries, are also to be assigned only to Tier Two capital, owing to the lack of transparency of their accounting treatment.

5. *Money laundering*

The Basle Committee's concern with money laundering reflects not only the general objective of fostering the banking sector's cooperation in law enforcement but also awareness of the threat to a bank's stability which can result from loss of public confidence due to reports of its association, howsoever inadvertent, with criminal activities. A recent example of these dangers is furnished by the large-scale withdrawal of funds and subsequent bankruptcy in the United States of two subsidiaries of Deak and Co. (Deak Perera Wall Street and Deak Perera International Banking Corporation) in response to information in a 1984 report of the Presidential Commission on Organised Crime concerning Deak Perera's involvement in money laundering.

In December 1988 the Basle Committee endorsed a statement of principles concerning money laundering.[86] The statement is directed at four aspects of banks' operations: firstly, banks should make reasonable efforts to determine the true identity of customers using any of their services; secondly, banks should ensure that laws and regulations pertaining to financial transactions are adhered to and high ethical standards are observed, withholding their ser-

82 Basle Committee on Banking Supervision, "Measuring and controlling large credit exposures" (Basle, January 1991).

83 Related counterparties are defined in the paper as borrowers whose connection results from the direct or indirect control exercised by one of them over the others, or from the likelihood that failure of one would entail the failure of the others.

84 The use of the term "par value" presumably denotes the application of a conversion factor of unity to these off-balance-sheet exposures for converting them to their credit equivalents. The commitments corresponding to these exposures would almost inevitably be to counterparties whose credit risk would be assigned a weight of 100 per cent under the Basle Agreement.

85 Basle Committee on Banking Supervision, "Proposals for the inclusion of general provisions general loan-loss reserves in capital" (Basle, February 1991).

86 Committee on Banking Regulations and Supervisory Practices, "Prevention of criminal use of the banking system for the purpose of money-laundering" (Basle, December 1988). Under the heading of money laundering the Basle Committee draws specific attention to the use of the financial system by criminals and their associates "to make payments and transfers of funds from one account to another; to hide the source and beneficial ownership of money; and to provide storage for bank-notes through a safe-deposit facility".

vices in the case of transactions believed to be linked to money laundering; thirdly, within the constraints of customer confidentiality banks should cooperate fully with national law enforcement agencies; and, fourthly, banks should adopt policies with regard to matters covered by the Basle Committee's statement which are designed to ensure that staff adhere to the principles which it contains. Changes in national legislation and regulation required for the practical application of these principles is left to the Governments of the Basle Committee's member countries.

As in other areas covered by papers of the Committee, banking secrecy and customer confidentiality are potential impediments to the achievement of its objectives. Thus it is noteworthy that the task force of 15 countries established to combat money laundering by the Economic Summit of the Group of Seven in July 1989[87] not only endorsed the Basle Committee's statement of principles but also urged banks to notify law enforcement agencies of suspicious activities by their customers. Implementation of the latter recommendation would require changes in the laws concerning banking secrecy in many countries.

C. The Basle Committee's relations with other supervisory groups

In spite of its restricted membership the Basle Committee has been the main focal point of initiatives regarding the governance of international banking, owing to the influence which it exerts on regulatory regimes throughout the world. Its success in this respect reflects partly the financial importance of its member countries. But its achievement also results from the Committee's efforts to reach consensus with other groups of banking supervisors by such means as regular contacts, joint working parties, and the periodic International Conferences of Banking Supervisors organized by its member countries.

The groups of banking supervisors with which the Basle Committee maintains contact are the Contact Group of EC Supervisory Authorities, the EC Banking Advisory Committee, the Offshore Group of Banking Supervisors, the Commission of Supervisory Authorities of Latin America and the Caribbean, the SEANZA Forum of Banking Supervisors, the Gulf Cooperation Council Committee of Banking Supervisors, and the Caribbean Banking Supervisors Group.[88] The most important from the point of view of evolving a regime for the governance of international banking have been the two EEC groups and the Offshore Group of Banking Supervisors.

Membership of the EEC groups[89] and of the Basle Committee is characterized by substantial overlapping, and much of their work has been in parallel. Indeed, their close relations have contributed to the high level of convergence between the Committee's initiatives concerning different aspects of international banking and EEC's directives and recommendations.[90] Examples of the latter regarding subjects closely connected to those in the statements of the Basle Committee dis-

87 Among the measures directed at the drug problem decided at the Economic Summit of July 1989 was the convening of a financial action task force whose mandate was "to assess the results of cooperation already undertaken in order to prevent the utilization of the banking system and financial institutions for the purpose of money laundering, and to consider additional preventive efforts in this field, including the adaptation of the legal and regulatory systems so as to enhance multilateral judicial assistance". The 15 countries participating in this task force were the members of the Basle Committee, Australia, Austria and Spain.

88 This list is based on Basle Committee on Banking Supervision, *Report on International Developments in Banking Supervision*, No. 7 (Basle, BIS, September 1990). The names of the different groupings have in some cases varied in recent years.

89 The EC Banking Advisory Committee was formed in 1979 and consists of high-ranking banking supervisors with the responsibility of giving advice and making recommendations to the Commission of the European Communities in the preparation of new proposals for EEC banking legislation, and of ensuring the proper implementation of such legislation in member States. The Committee is supported in its work by the Contact Group of EC Supervisory Authorities (established in 1972), which provides a more informal forum where banking supervisors can exchange information and produce studies on subjects of mutual interest.

90 EEC Directives are binding on member States, while leaving the method of implementation to national governments.

cussed above in section B are the directive of April 1989 on the own funds of credit institutions, the directive of December 1989 on a solvency ratio for credit institutions, the second directive, also of December 1989, on the coordination of laws, regulations and administrative provisions relating to taking up and pursuit of the business of credit institutions ("second" because it amended an earlier banking directive of December 1977), the directive of June 1983 on the supervision of credit institutions on a consolidated basis, and the recommendation of December 1986 on monitoring and controlling large exposures of credit institutions.

Significant parts of the global networks of banks with parents in the member countries of the Basle Committee and in other OECD countries are located in those belonging to the Offshore Group of Banking Supervisors.[91] The generally looser regulation of international banks in offshore centres is capable of hampering efforts to ensure that all such banks are adequately supervised. In particular (as already mentioned in section B) laws regarding confidentiality and secrecy can impede parent authorities from fulfilling their supervisory responsibilities under the Basle Concordat of 1983. Since the cooperation of supervisory authorities from countries of the Offshore Group is thus critical to the success or failure of initiatives regarding the governance of international banking, the Basle Committee has made special efforts to obtain their agreement to the principles promulgated in its statements. The results have included endorsement of the Concordat by the Offshore Group and its participation together with the Basle Committee in preparing an elaboration of the Concordat's principles regarding the exchange of information between parent and host supervisors which was eventually issued as the Supplement of April 1990.[92]

Nevertheless, despite the consensus reached by the Basle Committee and the Offshore Group, the existence of offshore entities of international banks continues to be widely considered as making their effective supervision more difficult, and the discussion of the BCCI case in section D below provides support for this view. So the question arises why the actual practice of cooperation between supervisors in OECD countries and offshore centres has not been fully satisfactory. In its own attempt to answer this question the Basle Committee gives four main reasons.[93] Firstly, lack of resources, particularly human ones, at the disposal of offshore authorities is an impediment to the collection and dissemination of information which regular consultation with parent supervisors would entail. Secondly, disparities in the scope and depth of offshore and parent authorities' approaches to supervision probably inhibit initiatives by the former regarding consultation. Thirdly, a parent authority may not be interested in consultation so long as the scale of a bank's operations in the offshore centres in question is relatively small and the consolidated data provided by the head office of its parent entity is considered adequate. Fourthly, a parent authority may actually be reluctant to consult with offshore ones in the case of a bank already experiencing difficulties concerning which there is a wish to restrict the spread of sensitive information. Responsibility for weaknesses in the process of cooperation between offshore and parent supervisors is here viewed as being a shared one. Moreover the Offshore Group has since drawn attention to the absence of any suggestion by members of the Basle Committee that their requests for information have not been fulfilled.[94]

Although part of the responsibility for failures of cooperation between offshore and parent supervisors no doubt does belong to the latter, it remains true that underlying the problems in this area are the standards of banking supervision in some offshore centres and their ambivalence concerning steps which might compromise their attraction of banking custom through the promise of secrecy and confidentiality. Indeed, the lack of unfulfilled demands for information by parent supervisors which was mentioned above may reflect partly lack of interest in making such demands due to doubts as to the ability of the supervisors in many offshore centres to satisfy them. Such an

Recommendations are statements of the Commission designed to influence practice regarding the subject specified but without binding legal force.

91 Current members of the Offshore Group of Banking Supervisors are Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Cyprus, Gibraltar, Guernsey, Hong Kong, Isle of Man, Jersey, Lebanon, Malta, Mauritius, Netherlands Antilles, Panama, Singapore and Vanuatu. The membership has expanded during the period covered in this chapter.

92 For the Offshore Group's endorsement of the Concordat see Committee on Banking Regulations and Supervisory Practices, *Report on International Developments in Banking Supervision 1983* (Basle: BIS, March 1984), pp. 18-19; the stages involved in the preparation of the statement which eventually became the Supplement of April 1990 are described in *idem., Report on International Developments in Banking Supervision*, No. 5 (Basle: BIS, September 1986), chap. VII, and No. 6 (Basle: BIS, September 1988), chap. IV, as well as in the Supplement itself.

93 Committee on Banking Regulations and Supervisory Practices, *Report on International Developments in Banking Supervision*, No. 5 (Basle: BIS, September 1986), pp. 52-54.

94 *Idem., Report on International Developments in Banking Supervision*, No. 7 (Basle: BIS, September 1990), pp. 84-85.

attitude on the part of parent authorities would be consistent with their unwillingness on occasion to accept the responsibility of being the main supervisors of international banks concerning which they envisage difficulties over obtaining information essential for this purpose owing to the presence in offshore centres of important parts of the banks' networks.[95]

D. The BCCI case and the governance of international banking in practice

The shutdown by regulators of most of the global network of BCCI which started in July 1991 was their response to evidence of fraud on a large scale, which included false accounting and the use of different types of financial transaction for the purpose of concealing massive losses and, in the United States, the illegal acquisition of banks by means of nominees. Several dimensions of this highly complex fraud are not yet clear, but a number of questions as to the effectiveness in practice of the current system of governance for international banking are raised by what has already been disclosed. Indeed, the Basle Committee itself at a meeting in Stockholm in September 1991 began an evaluation of the lessons of the BCCI affair.[96] The discussion in this section is limited to three issues: the role of secrecy in enabling BCCI to acquire a major bank in the United States; the difficulties experienced by regulators over the assignment of responsibilities for supervising BCCI; and the delay by BCCI's external auditors in uncovering the fraud.

The acquisition by BCCI of First American Bankshares illustrates how the opportunities for concealment furnished by a global banking network can be used to evade a country's banking laws and frustrate its system of regulatory oversight.[97] Financial General (First American Bankshares under its earlier name) was a bank holding company which had been "grandfathered" under the Bank Holding Company Act and thus permitted to continue to own banks in several states. In late 1977 and early 1978 BCCI, allegedly on behalf of four clients, began to purchase shares in Financial General until these clients as a group had acquired about 20 per cent of the bank's voting shares, although the holding of each individual investor amounted to no more than 5 per cent. After a complaint filed by the Securities and Exchange Commission that those purchases were in violation of the Williams Act,[98] in

[95] For example, in 1985 BCCI apparently requested the Bank of England to assume greater regulatory responsibilities for it, but was turned down partly on the grounds that the Bank could not satisfy itself of its ability to be kept fully informed of BCCI's offshore operations. "BCCI: the role of central banks", *Central Banking*, vol. II, No. 1, Summer 1991, p. 15.

[96] A paper commissioned by the Basle Committee at this meeting is to cover the following subjects: (1) standardization of criteria for the establishment by foreign banks of branches or subsidiaries; (2) the steps which might be taken to strengthen procedures for the cross-border sharing of supervisory information, especially in times of stress; (3) the question whether the dangers of contagion associated with the difficulties of particular banks are such as to render the legal distinction between branches and subsidiaries of little utility at such times; (4) the relations between supervisors in parent and host countries as they pertain to the supervision of branches; (5) the question whether consolidated supervisory responsibility should be assigned to a single parent supervisor or should be shared among several supervisors acting as a college; and (6) the extent to which supervisors should require changes in corporate structures in cases when these are viewed as impeding effective supervision. (Statement by J. Virgil Mattingly, Jr., General Counsel, and William Taylor, Staff Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and E. Gerald Corrigan, President, Federal Reserve Bank of New York, before the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, 13 September 1991, reproduced in *Federal Reserve Bulletin*, November 1991.)

[97] The discussion here of how BCCI obtained control of First American Bankshares is based primarily on testimony to Committees or Subcommittees of the United States Congress by senior officials of the Federal Reserve System, in particular the statement cited above in footnote 34 and that by J. Virgil Mattingly, Jr., General Counsel, Board of Governors of the Federal Reserve System, before the Subcommittee on Consumer and Regulatory Affairs of the Committee on Banking, Housing, and Urban Affairs, United States Senate, 23 May 1991 (reproduced in *Federal Reserve Bulletin*, July 1991).

[98] The Williams Act of 1968 established the framework of procedures for tender offers for a company's shares, the principal provisions being designed to ensure that investors have access to the information which they require to make intelligent decisions. ("Tender offer" is a term lacking precise legal definition but, somewhat roughly, denotes a

March 1978 the investors, without admitting fault, entered into a consent decree under which they agreed to make a tender offer for all of Financial General's Shares. For this purpose they established Credit and Commerce American Holdings (CCAH) in Netherlands Antilles.

After eventually reaching agreement to its proposed acquisition with Financial General's management, CCAH sought the approval of the Federal Reserve Board, as required by the Bank Holding Company Act. This approval was granted only after the Board had received assurances that BCCI would not be involved in the acquisition except as an investment adviser and thus would not finance it. However, in the late 1980s disclosures resulting from the investigation into the involvement in money laundering of BCCI's agencies in Florida[99] appeared to indicate the existence of secret links between First American Bankshares and BCCI. These links were subsequently confirmed by a report of BCCI's external auditors to which the Federal Reserve obtained access in December 1990. The report showed that BCCI had made substantial loans to CCAH secured by shares in the company. Subsequent investigation by the Federal Reserve uncovered evidence that this case was part of a broader pattern of the use by BCCI of secret loan and nominee arrangements under which it acquired, in the name of customers, the stock of First American Bankshares and other banking institutions in the United States. In many cases the loans in question were subject to side agreements that the customers would not be required to service the loans, and that BCCI could sell the shares and retain any resulting profits.

The question arises how this information could have been concealed from the Federal Reserve at the time of its initial approval of the purchase of Financial General and for a substantial subsequent period. An important part of the explanation lies in impediments to the Federal Reserve's access to crucial information about CCAH's links with BCCI. For example, the register of CCAH's shareholders and other records available for scrutiny by the Federal Reserve in the United States and Netherlands Antilles indicated that the individuals and companies listed in CCAH's filings with the Board were indeed the company's owners. The evidence of the arrangements between CCAH's shareholders and BCCI was kept where it could be concealed from the Federal Reserve, which thus had to await its access to the report of the bank's external auditors before it received confirmation of its suspicions concerning BCCI-CCAH links.

The holding company at the centre of BCCI's global network, BCCI Holdings (Luxembourg) S.A., was chartered in Luxembourg. However, neither BCCI Holdings nor BCCI S.A., its banking subsidiary in the same country, seem to have conducted banking business locally, BCCI's most important concentration of deposits apparently being in the United Kingdom. The 1983 Concordat was intended to ensure that complex corporate structures of this kind were subject to effective supervision, recommending in such cases that "Where holding companies are at the head of groups that include separately incorporated banks operating in different countries, the authorities responsible for supervising those banks should endeavour to coordinate their supervision of those banks, taking account of the overall structure of the group in question."

The Institut Monitaire Luxembourgeoise (IML) was not prepared to exercise supervision on a consolidated basis in the case of an organization whose principal business was not conducted in its territory.[100] Moreover, as already indicated above in section C, the Bank of England was unwilling to become BCCI's principal supervisor. Eventually, in May 1988, at the instigation of the IML, a college of eight regulators drawn from the Cayman Islands, France, Hong Kong, Netherlands, Spain and United Arab Emirates in addition to Luxembourg and the United Kingdom, was formed to monitor BCCI. This initiative was in accord with the supervisory co-ordination recommended in the 1983 Concordat. However, it does not seem to have provided the required control over BCCI owing to the dilution of supervisory responsibilities. Indeed, as an investigating team of the *Financial Times* put it, the formation of the college ensured that "each

widespread, public offer to purchase a substantial proportion of a company's stock. See, for example, D.L. Ratner, *Securities Regulation in a Nutshell*, 3rd edition (St. Paul, Minnesota: West Publishing Co., 1988), pp. 105-112.)

99 BCCI's officially authorized presence in the United States consisted of agencies and representative offices licensed at state level in a number of cities. Representative offices serve primarily liaison functions and are prohibited from engaging in general banking activities. Agencies cannot engage in domestic banking activities but may undertake certain operations associated with financing international trade.

100 Under a circular issued in 1984 IML assumed the responsibility for consolidated supervision only of credit institutions. In the case of groups headed by holding companies the assignment of responsibility for consolidated supervision was to be decided on after consultation with other concerned authorities and with the consent of the group itself. See Committee on Banking Regulations and Supervisory Practices, *Report on International Developments in Banking Supervision 1984* (Basle, April 1985), p. 67.

college member felt only one-eighth responsible".[101]

In view of its emphasis on transparency as a prerequisite of effective supervision, as indicated in section B, the Basle Committee has devoted considerable attention to the external auditing of international banks. In the mid-1980s BCCI's auditors began to uncover the large losses incurred by the bank in some parts of its business, in particular its trading activities, despite recourse by employees to various techniques to conceal their true magnitude.[102] However, even after auditing responsibilities for BCCI's most important entities were centralized in a single firm in 1988, a significant further period of time elapsed before the auditors became convinced of the existence of major fraud and contacted the authorities. Accounting history indeed contains a number of instances in which such fraud continued for substantial periods before being discovered. In two well known cases, that involving the McKesson-Robbins company (uncovered in 1938) and that involving the Equity Funding Corporation of America and its subsidiaries (uncovered in 1973), major frauds lasted about 15 years and about 10 years, respectively. Such instances generally lead to scrutiny of the relevant accounting and auditing procedures by both Governments and the bodies responsible for the two professions' standards and practices, and often result in reforms. However, it would be optimistic to expect that, in the face of the possibilities for concealment furnished by financial innovation and by complex corporate structures spanning several countries, deliberate fraud by the upper management of international banks can be rendered invariably susceptible to speedy discovery.[103]

E. The agenda for supervisory co-operation and the liberalization of international banking

The preceding discussion has indicated the wide range of subjects which need to be covered by a supervisory regime for international banking as well as the difficulties of applying the principles of such a regime when this requires non-routine co-ordination on the part of national supervisors. The process being undertaken by the Basle Committee may seem frustratingly slow, especially when compared to the speed with which banking itself has changed in recent years. However, such slowness is inevitable owing to the technical complexity of the Committee's work and to the divergences among the national systems of regulation and supervision of both its member countries and others whose agreement is needed for the success of its initiatives.[104] There can be no doubt that the principles promulgated by the Basle Committee have already had wide-ranging effects not only on Governments' regulation of banking but also in the area to which the Committee itself gives great emphasis in its statements, namely the internal controls employed by banks in their day-to-day business.

[101] *Behind Closed Doors. BCCI: the Biggest Bank Fraud in History*, a series of special feature articles reprinted from the *Financial Times*, 9-16 November 1991 (London, etc.: *Financial Times*, 1991), p. 37.

[102] One such technique was to offset losses on some categories of trading with sales of option contracts. Proceeds from the sales would be booked in the period in which they were made, no account being taken of future liabilities to buyers of the options. When the options were exercised, resulting losses to BCCI were offset by additional sales, and so on. (*Behind Closed Doors*, p. 16.)

[103] In his discussion of these two particular cases of fraud a Deputy Assistant Comptroller of the General Motors Corporation concludes that "in spite of all this activity [intended to improve auditing practices], the fact remains that, to this day, a well-planned fraud conducted by a group of persons in key positions cannot be detected by auditors until the size of the fraud grows out of control". (E.H. Flegm, *Accounting: How to Meet the Challenges of Relevance and Regulation* (New York, etc.: John Wiley and Sons, 1984), p. 134.)

[104] The new chairman of the Basle Committee describes this slowness in the context of achieving agreement on recommendations in the aftermath of the BCCI affair: "I want to caution about expecting too much too soon. Getting eleven countries to agree on these complex matters that strike so close to legitimate issues of national prerogative, if not national sovereignty, will not be easy, especially in a setting in which majority rule is not enough. That is, in this forum, everyone must agree on the chosen course of action or there is no action." (Statement by E. Gerald Corrigan, President, Federal Reserve Bank of New York, before the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, 13 September 1991 (reproduced in *Federal Reserve Bulletin*, November 1991), p. 920.)

Furthermore, from a broader, long-term perspective, it can be argued that even the failures of bank supervisors to achieve effective coordination in recent instances should contribute to the identification and eventual remedy of weaknesses in what are still relatively new arrangements for the supervision of international banking.

The unfinished agenda of an effective system of such supervision is already long, and can be expected to expand in response to continuing innovation in financial techniques and to the development of the information technology on which financial markets crucially depend. Some of the items on this agenda have already been mentioned in the discussion of the work of the Basle Committee, such as the implications for banking supervision of the BCCI affair and the regulation of, and the improvements in banks' internal controls over, trading risks. Its concern with the latter subject is a response to the increased importance of banks' activities which involve trading risks. The work entails an overlap with that on the supervision of securities trading not only of EEC but also of the International Organization of Securities Commissions (IOSCO).[105]

Other important items on the unfinished agenda of international banking supervision include the scope and harmonization of national arrangements for deposit insurance and the assignment of rights and responsibilities in the case of failures of international banks. In view of the disparity of national schemes for deposit insurance, initiatives regarding global harmonization would be unrealistic. However, as part of its introduction of a single market for financial services, including retail banking, EEC is inevitably having to face this issue, and the subject has recently been under study by both the Contact Group of EC Supervisory Authorities and the EC Banking Advisory Committee. The assignment of rights and responsibilities in the event of the failure of an international bank was not taken up in the 1983 Basle Concordat in spite of the problems raised by the collapse of the Banco Ambrosiano the previous year (which were discussed in section B above). Important aspects of such an assignment relate to deposit insurance for the retail banking facilities provided by international banks. For example, if branches of foreign banks are required to participate in the deposit insurance scheme of a host country, then there arises the question of what claim the authorities in that country would have on the bank's assets if it failed.[106] Thus, as indicated by this brief discussion, some of the steps required to improve the supervisory regime for international banking are likely to be taken by bodies such as those of EEC rather than the Basle Committee. But there will inevitably be a close relation between their work in these areas and the Committee's future initiatives.

Scrutiny of the quality of supervision in the parent's country is a normal part of the procedures followed by many countries in response to foreign banks' applications for market access. Indeed, some countries insist on parent authorities' acceptance of the principles of the 1983 Concordat as a condition for granting such access. Standardization and reinforcement of the country's regulations regarding the market access and supervision of foreign banks is one of the objectives of the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act passed by the United States Congress in late 1991 (whose section on the regulation of such banks was in part a response to recent disclosures of fraud and other criminal activity by some of them).[107] This Act establishes uniform minimum standards for foreign banks' entry and expansion, and provides for coordination of supervisory examinations of the branches, agencies, and affiliates[108] of foreign banks under the authority of the Federal Reserve Board. Among the conditions to be met for the granting of entry and expansion are that the foreign bank is subject to consolidated supervision in its home country, and that it furnishes the Federal Reserve with the information required to ensure that it is in compliance with United States laws.

Insistence on stringent prudential standards in policies towards the entry of foreign banks is in full accord with the 1983 Concordat and its 1990 Supplement which, as already noted in section B, support the adoption of a

105 IOSCO is a forum for regulators of the securities business whose total membership includes more than 90 countries but whose technical committee is drawn from those with large financial centres.

106 For a fuller discussion of the assignment of rights and responsibilities in the event of the failure of an international bank and its relation to the problem of divergences among national schemes of deposit insurance see S.J. Key and H.S. Scott, "International Trade in Banking Services: A Conceptual Framework", *Occasional Papers No. 35* (Washington, D.C.: Group of Thirty, 1991), pp. 26-29.

107 Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, 11 June 1991 (reproduced in *Federal Reserve Bulletin*, August 1991), pp. 644-645.

108 A foreign bank and an affiliate are subject to common ownership by a holding company. An affiliate may provide broad or more limited banking services in accordance with the permission granted by the state where it operates.

negative position by host authorities towards the approval of operations on their territories by foreign banks judged to be inadequately supervised in their parent countries. The connection between the effectiveness of bank supervision and the prudential side of countries' policies towards the right of establishment has important implications for any framework for global financial liberalization. Until the initiatives of the Basle Committee and of other bodies to strengthen the supervision of international banks have become comprehensive in scope and are perceived to be genuinely effective in practice, continued reluctance can be expected on the part of many countries to accept substantial restraints on their policy autonomy regarding the right to refuse market access on prudential grounds. From the discussion in this annex it is evident that, in spite of real progress made since the first steps of the mid-1970s, there remains a long way to go before such a system of supervision is in place.■

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THE NATURE AND SUSTAINABILITY OF RECENT CAPITAL FLOWS TO LATIN AMERICA

To arrive at a balanced assessment of recent capital flows to Latin America it is necessary to examine both the nature of these flows and the factors attracting them. To the extent that the inflows are a response to reduced long-term risks and improvements in profit opportunities, they can be considered sustainable, offering the recipient countries the chance to free themselves from the financial stringency that has arrested their growth for over a decade. However, to the extent that they represent short-term movements of speculative capital, there is a risk that they will be reversed. Moreover, the inflows can create problems of macroeconomic management and generate distortions and other impediments to investment, growth and competitiveness.

Short-term inflows motivated by the lure of quick, windfall gains are often associated with positive *real* interest rate differentials in favour of the recipient. However, it must be borne in mind that such a differential is not always necessary or sufficient. Such inflows usually occur when there are nominal interest rate differentials that markets do not expect to be matched by a nominal exchange rate depreciation. Such differentials may emerge when domestic inflation is much higher than abroad and domestic financial markets have been liberalized. Similarly, an expectation that a rise in equity prices will more than offset domestic currency depreciation can prompt an inflow of capital. Both types of expectations can be self-fulfilling, since the inflow of funds, if large enough, can itself maintain the value of the currency and boost equity prices.

Initially such inflows are typically a response to a favourable shift in market sentiment regarding the recipient country. This shift may result from external causes, such as a sudden rise in export prices, or from internal ones, such as lower inflation, better growth prospects, and greater political stability and confidence in official policies. After the initial shift in market sentiment, bandwagon-type behaviour often develops and creates a speculative bubble whereby people lend or invest simply because everybody else is doing the same. Such booms often end not with a soft landing but with a sudden capital outflow, usually associated with expectations of a sharp depreciation of the currency, which may be difficult to check with even a very large positive real interest rate differential.

To judge the nature of external capital inflows it is important to know both how the capital is being raised abroad and how it is being used in the recipient country. It is usually the latter aspect that determines its degree of volatility. FDI or enterprise borrowing abroad for investment in productive capacity is generally less susceptible to reversal than inflows directed at the equity market or acquired for relending in the domestic money market or depositing in domestic financial institutions.

While not the whole of the recent capital inflow into Latin America has been for short-term uses, much of it does appear to have been for this purpose. Of the total estimated inflow of $40 billion in 1991, FDI accounted for only about one-third, and if receipts from privatization are excluded the proportion is about one-quarter. Medium- and long-term bank lending was less than 6 per cent of the total; the rest was raised through bond issues, commercial paper and other short-term money market instruments, much of it being used for relending in domestic capital markets, equity investment or refinancing. There were significant differences among countries in the shares of different types of capital inflow. In Chile about two-thirds consisted of FDI, and in Mexico one-third. By contrast, for Brazil about three-quarters seems to have been short-term.

As noted in *TDR 1991*,[109] Chile was the first country in Latin America to receive large short-term capital inflows and to experience in consequence real currency appreciation because of its high interest rates and the stable nominal exchange rate. The interest rate and inflation rate did not change much between mid-1990 and mid-1991 but the rate of real currency appreciation fell. This was because "the monetary authorities adopted a cautious policy based on the assumption that the oversupply of foreign exchange was only temporary and was due to the unusually high price of copper ... and the low international interest rates",[110] and thus tried to slow the capital inflow and the appreciation of the currency through various measures designed to increase the demand for the dollar and to reduce the arbitrage margin. These measures seem to have had some success, since in 1991 the capital inflow declined moderately (by $0.3 billion), whereas in most other countries of the region such inflows accelerated.

In Argentina, where capital inflows are partly connected with privatization, the dollar/peso rate remained virtually unchanged between March 1991 and March 1992 owing to the Government's policy of stabilizing it as part of efforts to bring down inflation. Domestic interest rates were around 16 per cent, i.e. two-and-a half times dollar rates, giving a considerable margin for arbitrage. This period was marked by oversupply of foreign currency, a booming stock market where prices increased more than 300 per cent in 1991, a dramatic rise in imports (encouraged partly by trade reform), and a drop in exports.

In Mexico average interest rates (average cost of procuring funds and Treasury certificate rates) were above 30 per cent in 1990, and above 20 per cent in 1991, whereas the currency depreciated in nominal terms by only about 10 per cent in the former year and even less in the latter. Capital inflows played a major role in the boom in the stock market, where the index more than doubled during 1991, foreigners being estimated in the second quarter of 1992 to be holding equities worth more than $25 billion, or about a quarter of the market's capitalization.[111] One consequence of the capital inflows and currency appreciation has been sharp increases in reserves, as well as in imports and the trade deficit.

In Brazil inflows began to increase sharply at the beginning of 1992, amounting to about $8 billion during the first quarter (of which about $2 billion was for investment in the stock market). There has also been considerable borrowing abroad by exporters and other companies for relending or refinancing, and some accumulation of non-resident's foreign exchange deposits in special accounts. In nominal terms the cruzeiro has been depreciating in 1992 by almost as much as inflation, about 22 per cent per month. Early in the year, for the first time for many years, the rate for the dollar was lower in the parallel than in the official market. Due to a very tight monetary policy, monthly interest rates were around 30 per cent (or 5-6 per cent in real terms), giving a net arbitrage profit of 17 per cent over the first three months. The rise in prices on the stock exchange was even greater; Sao Paulo stock prices doubled in dollar terms from December 1991 to April 1992. Large purchases of foreign exchange raised central bank reserves to $13.7 billion in March 1992, up from $7.5 billion in the same month of 1991. The central bank has been issuing domestic debt in order to sterilize the effects of its dollar purchases on the money supply. Since reserves can earn no more than 5-6 per cent per annum in international markets, while domestic debt carries as much as that *per month*, the operation is extremely costly. On the assumption of a constant real exchange rate and 3 per cent real interest rates per month on domestic debt, the cost of carrying an extra $5 billion of reserves can be estimated to be of the order of $2 billion per annum.

In attempting to evaluate how far such capital inflows can be sustained it is necessary first to distinguish that part which is of a one-off nature. This includes repatriated flight capital and capital attracted by privatization. The latter has been important in Argentina and Venezuela (over one-quarter and three-quarters of their total inflows in 1991, respectively). Repatriated flight capital is difficult to estimate but seems to be particularly important in Mexico and Chile. With regard to the rest of the capital inflow, it should be noted that the particular configuration of interest rates, exchange rates and stock prices currently prevailing in many Latin American countries, and which attracts short-term capital flows, cannot be expected to last. When the configuration changes, these flows could be suddenly reversed, thus setting off a cumulative process which might extend to all kinds of capital flows, including those unrelated to considerations of short-term gain.

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109 See Part Two, chap. III, sect. F.2.

110 ECLAC, *Economic Panaroma of Latin America, 1991*, Santiago, September 1991, p. 41.

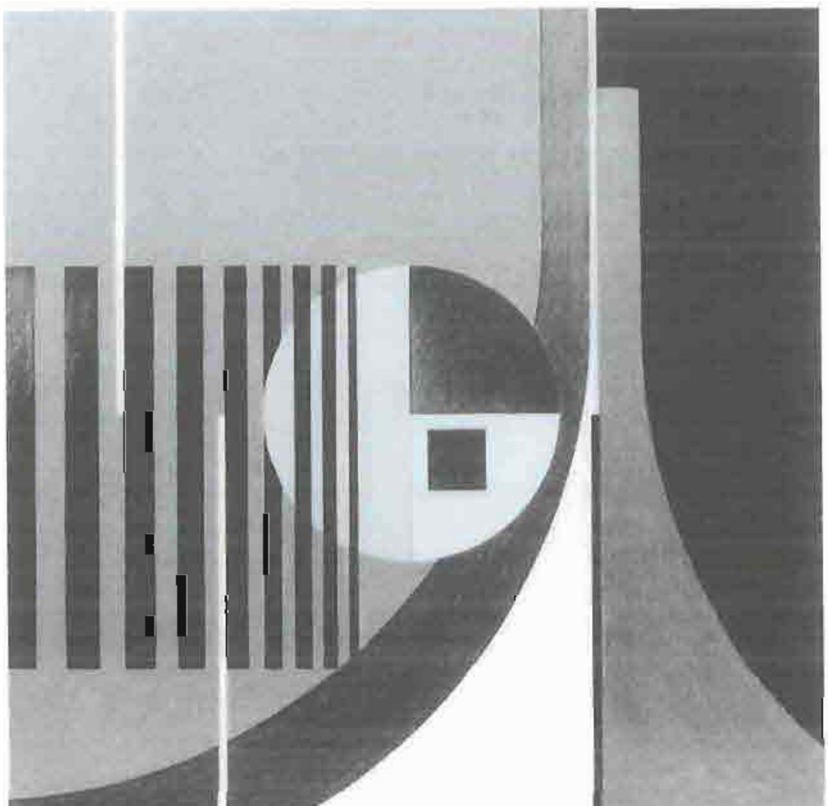
111 *Latin American Economy and Business*, May 1992, p. 4.

Ideally, capital inflows should be accompanied by a corresponding increase in domestic investment in traded goods sectors. However, in most Latin American countries the real lending rate exceeds 10 per cent and exchange rate uncertainties are widespread, making it difficult to restore vigorous growth based on private investment but perhaps conducive to the buying and selling of existing assets. The high interest rates and/or currency appreciation that attract capital from abroad tend to deter the investment on which growth, and hence the sustainability of capital flows, depends. It is not yet possible to determine the extent to which the capital flows have been translated into higher investment in Latin America over the last two years. Although there seems to have been a considerable increase in capital goods imports in some countries, encouraged partly by tariff reductions, the increase in investment in the region appears significantly smaller than the sharp swing in the transfer of resources abroad, which amounted to about 4 per cent of the region's GDP. Indeed, Brazil which has been receiving large capital inflows, is in a deep recession and the rate of investment seems to have fallen below 16 per cent of GDP for the first time for many years. Similarly, Argentina does not appear to have been able to raise its investment ratio above 10 per cent, or well below levels attained during the late 1980s when the country was making net transfers abroad.

A foreign exchange glut generated by unsustainable capital flows can damage industry through currency appreciation, particularly when it is accompanied by tariff reductions. Concerns on this score are widespread in Latin America, one prominent industrialist being recently quoted as saying that there was a danger that the remainder of his country's industrial base would be wrecked because goods were being imported at prices which domestic industry could not possibly meet.[112] The dilemma is that if currency appreciation is prolonged, it leads eventually to an external payments crisis; but if it is suddenly reversed, the arbitrage margin disappears, possibly triggering a sharp reversal in short-term capital flows. When currency appreciation is prevented by the accumulation of reserves and the issue of domestic debt, as in the Brazilian case discussed above, the burden falls on the public sector. Fiscal problems can be avoided only if the currency depreciates sufficiently to raise the real domestic currency value of reserves to a level at which the real capital gain on them offsets excess interest payments on domestic debt (i.e. payments arising from the difference between domestic and foreign rates in dollar terms). However, the real depreciation required may have to be very large - more than 35 per cent, for example, in the case of Brazil. Expectations of such a sharp depreciation can easily trigger a large capital outflow. Besides, since the Government makes a net transfer abroad to service its external debt, the depreciation increases the real domestic currency value of interest payments abroad.

As a result of the risks associated with speculative capital inflows a number of techniques have been used in order to slow them down. These include reserve requirements (sometimes non-interest-bearing ones) for liabilities of banks denominated in foreign currencies (Chile and Mexico); minimum holding periods (Chile); extension of the fiscal stamp tax to foreign credits (Chile); restrictions on company borrowing abroad through stock and bond issues (Brazil); and limits on the dollar amounts that banks can raise in deposits abroad as a proportion of their total deposits (Mexico). However, such measures have generally had only limited success, thus raising the question of the desirability of imposing or re-imposing direct controls.■

112 *Ibid*, p. 6.



POLICY REFORM IN DEVELOPING COUNTRIES

In recent years, structural adjustment has been high on the agenda of numerous developing countries, and is now also the order of the day in countries in transition. Some aspects of the process in developing countries have already been examined in past issues of this Report: TDR 1989 looked at macroeconomic adjustment and trade policy reform in developing countries, while the 1991 issue discussed financial reform. The present Report revisits trade policy reform, and in another chapter takes up the question of reforming public sector enterprises. The two discussions have a unifying theme: namely, that while reform is an urgent necessity, it needs to be handled with care, and be based on practical experience rather than text-book paradigms.

Chapter I starts with a discussion of issues in trade policy reform, and reviews the statistical evidence in the 1970s and 1980s on the links between trade policy and export growth, trade and productivity growth, and export growth and GDP growth. It goes on to examine the concepts of inward and outward orientation and the evidence on the relation between export sucess and trade and industrial policy. It concludes with a discussion of the phasing of reforms in various areas of policy and the role of trade policy in this process.

Chapter II begins with a review of the characteristics of public enterprises (PEs) in developed and developing countries, including their role, origins and objectives. It then examines the performance of PEs, using various concepts and measures of performance, and reviews the evidence on the profitability and efficiency of PEs compared to enterprises in the private sector. It discusses the main determinants of enterprise performance: financial discipline; ownership and control; political pressures; clientelism and corruption; and competition in product markets. It then goes on to discuss various dimensions of reform, including the principles that should guide enterprise operations; the application of performance indicators; and managerial autonomy, accountability and incentives. This is followed by a close look at three key problems, namely financing, pricing and pay and employment. The chapter concludes with a brief review of recent reform experience in the context of structural adjustment programmes.

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Chapter I

REFORMING TRADE POLICIES

A. Introduction

A large number of developing countries liberalized their trade regimes in the late 1980s and early 1990s. These reforms were generally part of a more comprehensive set of structural adjustment measures aimed at accelerating economic growth. The measures, in turn, were a response both to the economic crisis which many developing countries faced in the past decade and to a general disenchantment with excessive State intervention in economic affairs. As a result of these reforms, the number of developing countries with fairly free trade regimes (and, indeed, fairly liberal overall economic environments) has increased markedly over the past few years.

The pros and cons of trade liberalization in developing countries have been debated extensively. Proponents of liberalization point to the possibility of fully exploiting the benefits from international specialization, the incentives for more rapid technical change associated with a more open and competitive environment and the reduced room for "economic rent-seeking" and similar unproductive activities.

This chapter reviews some issues concerning the relationship between trade liberalization and economic performance in developing countries and examines some of the evidence from the past two decades, particularly the 1980s. The final section analyzes the relation between macroeconomic policy and the implementation of trade liberalization.[113]

B. The issues and the evidence from the 1970s and 1980s

1. A review of the arguments

At least four different arguments are used to explain why exports are positively correlated with overall economic growth. The first may be called the "Keynesian" link: because exports are a component of aggregate demand, they exercise both a direct and a multiplier effect on domestic production. The latter includes the effects which faster growth exercises on investment (the accelerator mechanism). A second connection between exports and economic growth may be referred to as the "structuralist-external gap" link: rapid export expansion helps

[113] The chapter draws on an ongoing UNCTAD project on trade policies in developing countries, and on a parallel UNU/WIDER project directed by Professor Gerald K. Helleiner.

to lift the foreign exchange constraint on economic growth that has been a recurrent problem of developing countries in the postwar era.

The third relationship is the "structuralist-production" link. According to this explanation, developing countries are characterized by heterogeneous technologies, with large-scale manufacturing as one of the more productive sectors. In a closed economy, however, manufacturing output is limited by domestic demand. This domestic demand constraint is critical because many manufacturing activities offer economies of scale. If its manufactured products can be exported, a country can transfer resources from low to high productivity sectors at a faster rate and better exploit economies of scale.

The fourth explanation, and probably the most popularized in recent decades, may be called the "neo-classical" link. According to this explanation, faster economic growth is basically associated with a more rapid rate of technical change. Export growth, in this interpretation, allows faster productivity growth for four different reasons. First, in the transition to a more open economy, resources are transferred from non-competitive, inward-oriented sectors to more productive outward-oriented sectors. Second, much in line with the "structuralist-production" explanation, export activities may be generally more productive because the competitive pressure which they face in the world market forces them to keep near or at the world technical frontier. Third, exports have positive effects ("externalities") on other economic activities; in particular, they are an excellent vehicle for the international transfer of technology. Finally, the more competitive trade regime that is required for exports to grow rapidly also forces firms producing essentially for the domestic market to keep up with world technological standards.

Many of these arguments depend in part on which sectors generate the exports in the different countries. Indeed, many observers believe that it is industrial exports, rather than exports in general, that lead to faster growth. Consequently, many of the arguments used to support export-led growth are similar to those used in the past to promote import-substituting industrialization. In particular, the latter strategy used to be defended in the past as a vehicle for technological advance. This may indicate that export growth and import substitution are not incompatible strategies.

Statistical evidence on the link between exports and economic growth and its underlying factors is strong in some respects, but inconclusive in others.[114] Data for different periods and groups of countries suggest a strong link between exports and economic growth, but this interpretation must be taken with care. First, this relationship has not been found to be valid for all groups of countries or all subperiods in the postwar era.[115] Secondly, some studies have shown that such a link is particularly strong for manufactured exports,[116] whereas others have shown that very open, primary-exporting countries have tended to fair particularly poorly in terms of economic growth.[117] Taken together, these findings provide some support in favour of an industrial bias in development policy.

Statistical tests have been inconclusive as to the causal link between exports and economic growth. On balance, they tend to indicate that overall economic growth - by improving supply capabilities - leads to faster export growth, rather than the inverse.[118]

The statistical findings have been even less conclusive in two other areas. The first is the association between trade policy and export growth. Some prototypes of free trade regimes (notably Hong Kong and Singapore) have

114 See Gerald K. Helleiner, "Trade, trade policy and economic development in very low-income countries", University of Toronto (mimeo), September 1991.

115 See Gershon Feder, "Growth in semi-industrial countries: A statistical analysis", in Hollis Chenery, Sherman Robinson, Moshe Syrquin *et al.*, *Industrialization and Growth: A Comparative Study* (New York: Oxford University Press, 1986). This study found the link to be very strong only for semi-industrialized countries in 1964-1973, but not for those same countries in 1955-1963 or 1974-1977, or for developing countries. A study by Jose de Gregorio ("Economic Growth in Latin America", *Journal of Development Economics*, forthcoming) also failed to find any positive relation between trade variables and economic growth in the region in the period 1950-1985 when other variables were taken into account.

116 See, in particular, Moshe Syrquin and Hollis Chenery, "Three decades of industrialization", *The World Bank Economic Review*, vol. 3, No. 2 (May 1989). Feder (*op. cit.*), also found that industrial growth was more decisive than export growth in explaining the overall economic performance of semi-industrialized countries in 1964-1973, the period in which he found the export-growth link to be stronger.

117 Desmond McCarthy, Lance Tayor and Cyrus Talatti, "Trade patterns in developing countries, 1964-1982", in Pranab Bardham, Albert Fishlow and Jere Behrman (eds.), *International Trade, Investment, Macropolicies and History: Essays in Memory of Carlos F. Diaz-Alejandro* (Amsterdam: North Holland, 1987).

118 Woo S. Jung and Peyton J. Marshall, "Exports, growth and causality in developing countries", *Journal of Development Economics*, vol. 18, 1985; and Peter C. Y. Chow, "Causality between export growth and industrial development: Empirical evidence from the NICs", *Ibid.*, vol. 26, No. 1 (June 1987).

achieved fast, export-led growth. None the less, other countries with strong State intervention and the maintenance of import protection, sometimes for long periods, have also managed to generate rapid export growth. The list of export-growth "success stories" includes the Republic of Korea and Taiwan Province of China, whose strong interventionist industrial policies are well documented.[119] It also includes such countries as Brazil, Israel, Portugal and Spain, which were also characterized by strong trade and industrial policies, at least in some phases of their export booms.

In a similar vein, no link between trade and productivity is apparent from the evidence. At a macroeconomic level, faster growth of total factor productivity has been found to be generally associated with more rapid economic growth and the latter with faster export growth in many periods. However, the association between productivity and inward or outward orientation does not necessarily stand out at the sectoral level. The performance of total factor productivity in manufacturing has been good in relatively inward-oriented countries in some periods and has been rather poor in some outward-oriented countries. If changes in total productivity in different economic sectors within a country are compared, there is generally a strong link between sectoral value added and productivity growth. This has been generally interpreted as indicating that faster growth induces enhanced productivity, through the exploitation of economies of scale, better overall use of resources and greater incentives to invest and innovate. When these causal links are taken into account, there is no clear evidence that export orientation has a positive influence on productivity, or that greater protection or inward-orientation has a negative influence.[120] Country studies on Brazil, Colombia and Mexico have failed to find consistent associations between greater openness and faster productivity growth.[121] Chile has also so far failed to show a strong productivity performance, despite massive liberalization and domestic adjustment since the mid-1970s.[122] In contrast, despite high protection, Brazil was up to the late 1970s one of the best productivity performers of the developing world. A study on India indicated that import substitution had adverse effects on productivity but also that the first half of the 1980s - a period not only of high but also of rising tariff protection, and of moderately falling non-tariff barriers - was the period of fastest productivity growth in manufacturing.[123]

2. Further evidence for the 1980s

Data for a sample of 34 developing countries for the 1980s show a strong positive correlation between export growth and GDP growth (see chart 1).[124] This could be explained by a "structuralist-external gap" interpretation that ascribes the result to the severe foreign exchange constraint caused by the interruption of capital flows to many countries, high interest rates in the early part of the decade, the general collapse of commodity prices and the low and unstable growth in the developed market economies. Export growth by itself explains 51 per cent of the statistical variance of GDP performance over the decade. If investment rates are added, these two variables explain 64 per cent of the variance.

If the period 1973-1989 as a whole is considered, the association is much weaker and is strongly affected by a few exceptional cases. Export growth during this period explains only

[119] See, for example, Howard Pack and Larry Westphal, "Industrial strategy and technological change: Theory vs. reality", *Journal of Development Economics*, vol. 22, 1986; Alice Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (Oxford: Oxford University Press, 1989); and Robert Wade, *Governing the Market* (Princeton: Princeton University Press, 1990).

[120] For general conclusions on the unclear links between inward outward orientation and productivity performance, see Howard Pack, "Learning and productivity change in developing countries", in Gerald K. Helleiner (ed.), *Trade Policy, Liberalization and Development: New Perspectives* (Oxford: Clarendon Press, 1992); and James Tybout, "Researching the trade-productivity link: New directions", World Bank (PRE Working Paper WPS 638), Washington, D.C., March 1991.

[121] These studies are contained in Gerald K. Helleiner (ed.), *Trade and Industrialization in Turbulent Times* (forthcoming).

[122] James Tybout, Jaime de Melo and Vittorio Corbo, "The effects of trade reforms on scale and technical efficiency: New evidence from Chile", World Bank (PRE Working Paper WPS 481), Washington, D.C., August 1990; R. Agacino, G. Rivas and E. Roman, "Apertura y eficiencia productiva: la experiencia chilena 1975-1989", Inter-American Development Bank (Working Paper 113), Washington, D.C., March 1992.

[123] Winston Fritsch and Gustavo Franco, "Import repression, productivity slowdown and manufactured export dynamism: Brazil 1975-1990", and Isher Judge Ahluwalia, "The role of trade policy in Indian industrialization", in Helleiner (ed.) *Trade and Industrialization...* (*op. cit.*).

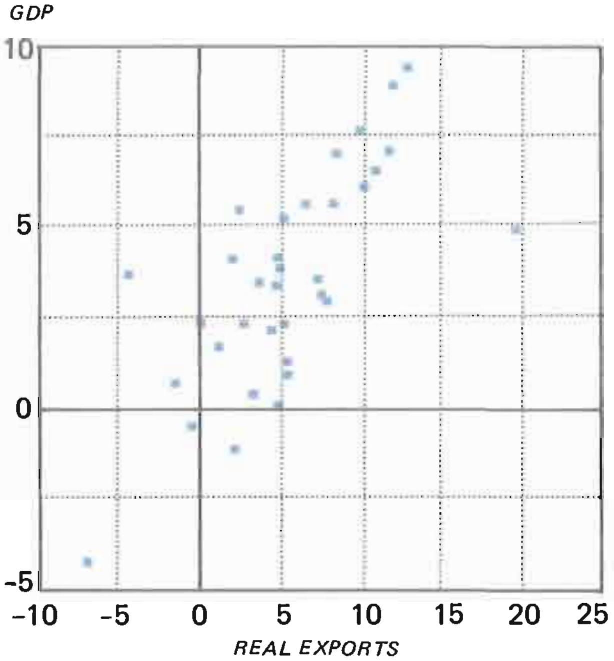
[124] For previous UNCTAD analyses on this subject, see *TDR 1989*, Part One, chap. V, and Manuel Agosin, "Trade policy reform and economic performance: A review of the issues and some preliminary evidence" (UNCTAD Discussion Paper No. 41), Geneva, August 1991.

40 per cent of GDP growth for the 34 countries in the sample. However, this proportion falls to 15 per cent if two extremely successful economies (Hong Kong and the Republic of Korea) and a strong failure (Trinidad and Tobago) are taken out of the analysis.

Chart 1

GROWTH OF REAL GDP AND OF REAL EXPORTS, 1980-1989, IN DIFFERENT DEVELOPING COUNTRIES [a]

(Annual average growth in per cent)



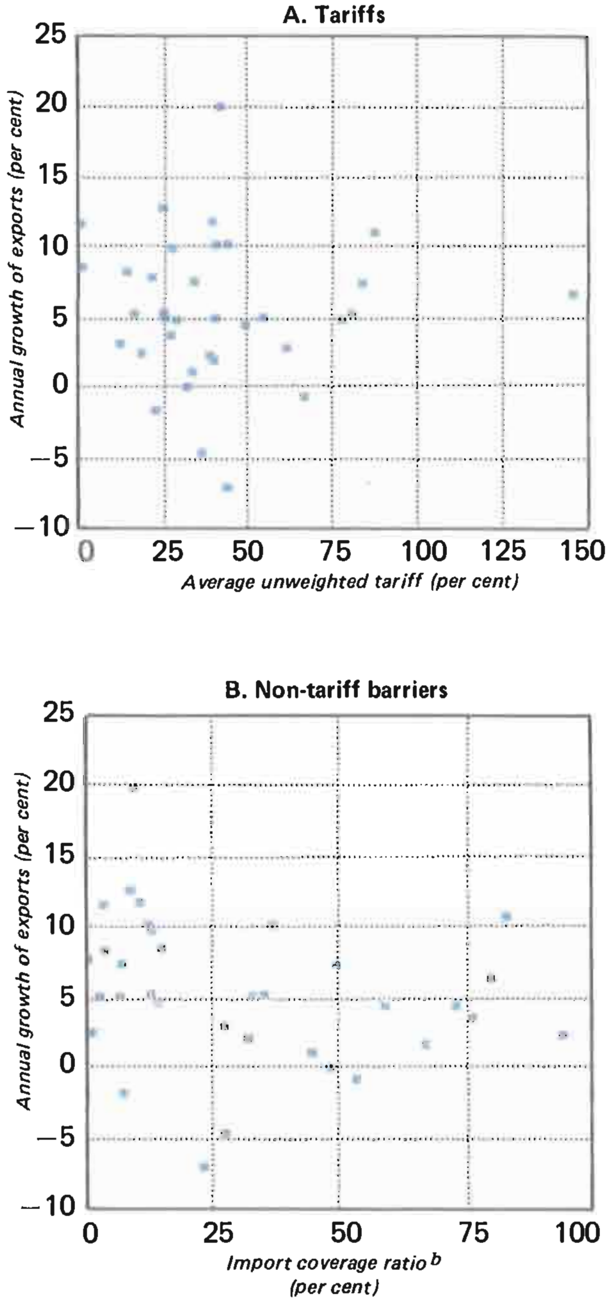
Source: UNCTAD secretariat calculations, based on data from the UNCTAD Data Base on Trade Control Measures and from the United Nations Statistical Office.

a Countries whose manufactured exports exceeded $150 million and 15 per cent of their total exports in 1988. Each asterisk shows the position of a particular country.

Chart 2

GROWTH OF EXPORTS COMPARED WITH THE HEIGHT OF BARRIERS TO IMPORTS IN 1980-1989 IN DIFFERENT DEVELOPING COUNTRIES [a]

(Percentage)



Source: As for chart 1.

a See note *a* to chart 1.

b For definition see table 24.

The association between the growth of GDP and exports, on the one hand, and the protectionist measures adopted by the sample of countries, on the other, is unclear.[125] The data suggest that export performance in the 1980s was not associated in any simple way with either low tariffs or non-tariff barriers - or indeed, any combination of the two (see chart 2).

The sample of countries can be divided into four broad groups according to their levels of tariffs and non-tariff barriers (see table 24). Classified in this way, the differences among the groups in terms of the trade policy variables are statistically significant. The major difference

125 The data are taken from the Supplement to *Handbook of Trade Control Measures of Developing Countries* ("A Statistical Analysis of Trade Control Measures of Developing Countries", UNCTAD DDM/Misc.2). The measures used in the analysis refer to unweighted global averages for the different countries. However, similar conclusions can be reached if either weighted averages or averages for manufacturing only are used.

Table 24

CLASSIFICATION OF MAJOR DEVELOPING COUNTRY EXPORTERS, [a] BY TRADE REGIME AND GROWTH OF THE VOLUME OF EXPORTS

Country group/ trade regime [b]	*Export volume growth, 1980-1989 (Per cent)*		
	Under 3	*3-8*	*Over 8*
I. Low tariffs, low NTBs	Guatemala	Chile [c] Mexico	Malaysia Singapore Hong Kong
II. Medium or high tariffs, low NTBs	Costa Rica [c]	Côte d'Ivoire [c] Senegal Sri Lanka Uruguay [c] Zimbabwe	China Jordan Republic of Korea Thailand Turkey
III. Medium or high tariffs, high NTBs [d]	Argentina Morocco [c] Philippines [e] Trinidad and Tobago	Bangladesh [c] Brazil Egypt [f] Yugoslavia [f]	Mauritius
IV. Medium or high tariffs, high NTBs [g]	Indonesia [e] Kenya [e] Peru	Colombia [c] Ecuador India [c] Tunisia	Pakistan

Source: UNCTAD secretariat calculations, based on data from the UNCTAD Data Base on Trade Control Measures and from the United Nations Statistical Office.

a Developing countries whose manufactured exports exceeded $150 million and 15 per cent of total exports in 1988.

b *Circa* 1987. The classification by (unweighted) tariff level is as follows: low: under 25 per cent; medium: 25-50 per cent; high: over 50 per cent. The classification by extent of non-tariff barriers is as follows: low: under 20 per cent; medium: 20-50 per cent; high: over 50 per cent. These coverage ratios are measured by the number of tariff lines that were subject to NTBs (other than prior import deposits) as a proportion of the total number of lines in the tariff schedule.

c Moved to the over 8 per cent category in 1985-1989.

d This group also includes Yugoslavia, which has low tariffs.

e Moved to the 3-8 per cent category in 1985-1989.

f Moved to the under 3 per cent category in 1985-1989

g This group also includes Indonesia, which has low tariffs.

between Groups I and II is in terms of average tariffs. Group III has both higher tariffs and, particularly, higher coverage of non-tariff barriers than Group II, whereas Group IV has very high indicators of protection on both accounts.

The group of countries with the lowest import barriers (Group I) includes some of the best export performers (Hong Kong, Malaysia and Singapore), to which Chile would be added if only the second half of the 1980s were considered. However, some of the successes of the decade in terms of export growth belong to the group of countries with relatively high tariffs (35.7 per cent on average), albeit low non-tariff barriers (NTBs) (Group II). Moreover, good export performers can also be found in the most protectionist group of countries - those with high tariffs and high NTBs (Group IV). If only the latter half of the decade is considered, the export success stories in this group include Colombia, India and Pakistan.

Despite the large differences in trade policies within each of the groups, there are few statistically significant differences in the indicators of economic performance (see table 25). This indicates that intra-group variations are more important than inter-group ones and im-

Table 25

AVERAGE ECONOMIC PERFORMANCE OF DIFFERENT GROUPS OF DEVELOPING COUNTRIES [a] CLASSIFIED ACCORDING TO TRADE REGIME

(Percentage)

	Group [b]			
	I	*II*	*III*	*IV*
Trade regime [c]				
Average tariff	12.5	35.7 [d]	47.5 [d]	64.5 [d]
Coverage of non-tariff barriers	7.0	9.0	34.4 [d]	73.5 [d]
Annual GDP growth				
1973-1989	5.1	4.6	3.6	4.4
1980-1989	4.1	4.4	1.9	3.7
1985-1989	5.5	4.8	2.5 [d]	4.0
of which:				
Manufacturing				
1973-1989	5.0	5.6	3 6	6.0
1980-1989	3.7	5.1	1.5	4.8
1985-1989	7 8	6 3	2 7 [d]	4 7
Annual export volume growth				
1973-1989	8.5	7.8	3.7 [d]	3.5 [d]
1980-1989	6.6	8.5	2.5	4.2
1985-1989	9.0	10.3	5.0	7.1
of which:				
Manufactures (SITC 5-8 less 68)				
1973-1989	12.3	10.8	8.5	10.5
1980-1989	11.0	10.8	7.7	7.3
1985-1989	15.9	9.1	6.9	8.3
Investment ratio [e]				
1973	23.0	20.3	18.8	23.5
1980	29.5	27.2	26 6	25.5
1983	25.1	21.4	20.2	22.7
1989	22.9	19.2	18.6	19.9

Source: As for table 24

a The 34 major exporters shown in table 24.
b The countries groups are those shown in table 24
c *Circa* 1987. Average tariffs and coverage of non-tariff barriers (see table 24 for the definition of the latter) are unweighted, as are also the country groups average growth rates.
d Statistically different from Group I at a 95 per cent confidence level.
e Ratio of gross investment to GDP.

plies that it is not trade policies in general, but rather how specific countries manage them, that really determines economic performance. Overall, the poorest performance tends to be concentrated in Group III rather than Group IV countries, whereas the best performance in many cases is displayed by Group II and, in a few cases, by Group IV countries. All groups displayed a better overall export performance in the second half of the 1980s than in the decade as a whole or the entire period 1973-1989. The contrary is true, however, when investment ratios are analysed; in particular, all groups still had investment rates in 1989 lower than in 1980.

Taken as a whole, these results indicate that rapid export growth was crucial to economic performance in the past decade, but that there is no simple link between protection and export success. Countries under very different import regimes have been able to perform well in international markets. Moreover, this recent experience does not suggest that there is necessarily any incompatibility between domestic protection and export promotion, i.e. that the former has any inherent bias against exports. The two have been important complements in many cases. Indeed, the highly varied economic performance within each of the four groups of countries indicates that export success is probably associated more with individual country experience than with general characteristics of trade policy. The following section examines some of these specific experiences.

C. Inward and outward orientation in development

1. *Economies of scale, protection and exports*

Those with a pessimistic view of export prospects for developing countries emphasize production for the domestic market (and therefore protection) as the only viable development path. This point of view profoundly affected the policies followed by many developing countries, even in the face of the spectacular export successes that a few of them achieved after 1960. More recently, the pendulum has swung in the opposite direction and there are those who see no role for protectionism or, indeed, active industrial or agricultural policies of any sort.

International trade theories, economic history and the most recent experiences of developing countries indicate that no generalization can be made on the universal virtues of either inward or outward orientation. The relative strengths of one or the other depend on several historical and country-specific conditions such as the size of the country involved, the availability of natural resources, its stage of development, the strength of its governmental institutions, the quality of its State intervention, world market conditions and its geographical location. More importantly, however, the history of successful developing countries suggests that it is more sensible to look at inward and outward orientation not as incompatible, but rather as complementary, strategies under different circumstances.

Manufacturing production has some characteristics which must be taken into account in the design of trade policy. These are related essentially to the static and dynamic economies of scale which trade theories have emphasized in recent decades. Such economies are of three basic types. First, large fixed costs are common in many manufacturing activities, generating important economies of scale at the firm level. Second, manufacturing is subject to a wide range of external economies: it thrives only when it has adequate infrastructure, functioning capital markets, appropriate labour and managerial skills and complementary industries and services located nearby. Finally, many manufacturing activities require heavy investment in human resources in terms of managerial capabilities, the creation of a complex set of skills in the labour force and, more generally, learning how to master technologies and to keep up with world technological developments.

Such economies of scale have many important implications. The first is that the early stages of industrial development are particularly difficult because they require the generation of significant external economies and an economy-wide learning process. It is therefore not surprising that manufacturing has been the favourite target of protection by all countries entering into the industrialization process since the nineteenth century. In the present developing countries, the creation of managerial capabilities and labour skills and industrial fixed capital formation on the scale that is known today would have been impossible without the import substitution policies that were widely used in the past. Most of the successful exporters of manufactures among the developing countries underwent a prior phase of import substitution.[126] Indeed, many of the export successes of the 1980s have shown how it is possible to convert previously inward-oriented industries into outward-oriented ones.

On the other hand, economies of scale also suggest that it might be costly to overemphasize industrialization, particularly widespread industrialization, under several

[126] See, in particular, Chenery, Robinson, Syrquin *et al.* (*op. cit.*).

circumstances. The costs will be relatively higher, the smaller the size of the economy involved.[127] One clear implication for smaller economies is that they should place greater emphasis on the production of raw materials and on natural-resource oriented industries.[128] However, an important caveat is that aggressive exchange rate policies and outward-oriented trade strategies in the developing world in the 1980s have had an adverse impact on world prices of traditional, and even non-traditional, raw materials.[129] This has made the transition to export-led growth more difficult for the smaller developing countries that have opted to pursue a strategy along these lines.

For larger countries, economies of scale have three additional implications. The first is that the costs of not making the transition from protected to competitive industrial sectors may be high. In a sense, economies of scale make temporary infant-industry protection more attractive, but they also raise the costs of permanently protecting a sector which fails to become internationally competitive. The second implication is that the larger the weight of sector-specific, rather than industry-wide, dynamic economies of scale or external economies, the larger the costs of generalized protection and the greater the benefits from selective policies which promote the development of industrial sectors that make an early transition from import substitution to exports. The third implication is that, in the present context of constant structural change, the new industries of today are the export sectors of tomorrow. Thus, trade policy should be aimed at both providing an impetus to exports from traditional sectors and, at the same time, protecting new industries. For these new industries, combining the two strategies at an early stage in their development may be the optimal solution because domestic protection provides a basis on which the sector can grow, while exports allow the creation of external economies and accelerate the acquisition of technical capabilities.

These considerations suggest that protection and export promotion are not incompatible strategies. There are intermediate mixed strategies which can successfully combine elements of both, as the experiences of successful export development in the 1980s indicate. The foregoing arguments also imply that it might be inappropriate to judge the anti-export bias of a trade regime simply by the levels of protection or by the extent to which there is a difference between the incentives to produce for the domestic market and the incentives to export. When economies of scale are present, protection may generate various incentives that favour exports. Conversely, a system of measures which appears to be neutral in its treatment of imports and exports may be biased against exports because of its failure to generate sufficient investment in infant industries which could later become successful exporters. The analysis of export success or failure associated with specific trade regimes is thus more complex than simply measuring the extent of deviation from an uniform system of incentives.

This is the more so in economies which are in transition from more inward- to more outward-oriented strategies. In the short run, using an economy's existing stock of capital, labour skills and technical abilities to generate additional exports is better than developing totally new sectors. In this situation, temporary incentives (in the form of either protection or subsidies) may serve as a mechanism to maintain production and earning levels while firms improve their production processes and accumulate the skills to enter the international market. Reducing protection too quickly may generate irreversible losses, as firms are unable to adapt rapidly to the new circumstances. The larger the role of fixed capital accumulation of all sorts (i.e. including skills and technology) and the larger the role of scale economies in contracting sectors, the greater the losses are likely to be.

The presence of economies of scale of all sorts, internal or external to the firm, static or dynamic, is the source of well known market failures. Such market failures imply that active trade and industrial policies are preferable to neutrality of incentives. The need for more selective policies increases, the smaller the economy and the more sector-specific the economies of scale. None the less, active State intervention and selectivity have important costs which have been emphasized in recent years. Referred to as "government failure", these costs arise because of the increased scope that intervention gives to pressure groups, economic rent-seeking activities and corruption, the inappropriate incentives that arise if the information on which policies are based is incorrect and the likelihood of wide-ranging inefficiencies

127 This was recognized long ago by defenders of import-substituting industrialization and led to proposals for regional integration and South-South trade as the only viable route to industrialization for smaller economies.

128 Many small European countries have demonstrated the viability of this approach.

129 See D. Evans, I. Goldin and D. van der Mensbrugghe, "Trade reform and the small country assumption", in I. Goldin and A. Winters (eds.), *Open Economies: Structural Adjustment and Agriculture* (Cambridge: Cambridge University Press, 1992).

in the targeted sectors. It is often argued that these costs, which are largely immeasurable, can be high.

The proper balance between market failure and government failure has to be judged in each specific context. However, the solution is highly unlikely to be "neutrality of incentives". There are many possible solutions, going from fairly liberal regimes through non-uniform systems of incentives to elaborate systems of public/private sector interaction.

A major aim of trade policy should be to facilitate the creation of external economies and the learning processes of new sectors. This suggests that a combination of measures is likely to be preferable to a system of uniform incentives. This combination might involve three components: some explicit temporary protection and export incentives for new sectors at moderate levels; more general systems of incentives for investments and for technology creation, transfer and adaptation; and active mechanisms for interaction between the private and public sectors in order to identify investment opportunities and, in some cases, to coordinate investment decisions.

2. *Some country experiences*

An examination of successful export experiences illustrates the fact that developing countries have used very different strategies to build export success and have been able to combine protection for the domestic market with export promotion in many different ways. However, aside from the liberalization of imported inputs used by export sectors, other forms of import liberalization have not necessarily been an ingredient of successful trade policies.

The *Republic of Korea* is the best known example among developing countries of active industrial policies and targeting.[130] The availability of directly allocated long-term credit to targeted industries was an important element of this strategy. The country also used export subsidies for a large part of its long export boom. Rapid growth took off after the launching of a comprehensive export promotion programme in 1964-1965, which included the active use of export and credit subsidies and export targeting. A moderate liberalization of quantitative restrictions (QRs) on imports took place in 1967, but tariffs remained high and direct import controls extensive until as late as 1978, when a gradual preannounced programme of import liberalization was initiated. In 1973, however, the Government launched an ambitious heavy and chemical industries promotion plan, which included the granting of fiscal and credit incentives and increased protection for some of the targeted industries. After important problems associated with the world recession of the early 1980s, this plan became the basis for the new export industries of the second half of the decade.

Despite the general characterization of the economies of Latin America as inward-oriented, most countries in the region abandoned active import-substituting industrial policies in the early or mid-1970s. *Brazil* and *Mexico* were among the few countries in the region which continued to follow active policies of this nature until the debt crisis.[131] They used a mixture of policy measures and actions, including high tariffs (more so in Brazil than in Mexico), high non-tariff barriers, special industrial programmes, domestic content requirements and direct investment by public enterprises. For almost two decades, starting in the late 1960s, Brazil succeeded in combining high protection with rapid export growth and an improvement in the composition of its manufacturing exports. It did so by using a combination of export incentives and gradual devaluation, adopting an import liberalization programme only in 1991. The interruption of its export boom in the mid-1980s was a consequence of the major problems created by the macroeconomic imbalances in the country, rather than of deficiencies in trade policies.

Although Mexico designed its own export processing zones (the *maquila* programme) in the 1960s, development of its manufactured exports was limited for a long time and even experienced a major setback with the sharp rise in oil revenues and the greatly increased foreign indebtedness in the late 1970s and early 1980s. However, with an active exchange rate policy after 1982, Mexico experienced a boom in manufactured exports, effecting a large-scale

130 See the studies cited in footnote 119, and Kwang-Suk Kim, "Trade and industrialization policies in Korea: An overview", in Helleiner (ed.), *Trade and Industrialization... (op. cit.)*.

131 See Winston Fritsch and Gustavo Franco, *Trade policy issues in Brazil in the 1990s*, UNCTAD, Trade Policy Series, No. 4 (forthcoming); Winston Fritsch and Gustavo Franco, "Import repression, productivity slowdown and manufactured export dynamism: Brazil 1975-1990", and Jaime Ros, "Mexico's trade and industrialization experience since 1960", in Helleiner (ed.), *Trade and Industrialization... (op. cit.)*; Adriaan Ten Kate, "El ajuste estructural en Mexico: Dos historias diferentes", *Pensamiento Iberoamericano*, No. 21 (January-June 1992).

transformation of its former import-substituting sectors into export industries. The Government initiated a liberalization of imports in mid-1985, which was speeded up in December 1987. However, it continued to use QRs on imports to shelter some of its most successful export industries, particularly automobiles, which will not be fully liberalized until 1994. The growth of manufactured exports slowed down and was concentrated in fewer sectors after adoption of the liberalization programme. This has been the result of the significant appreciation of the currency which accompanied the stabilization programme that was adopted simultaneously with the import liberalization of December 1987.

China is one of the most notable examples of a country with rapid growth in the 1980s, based on a programme of measures adopted in the late 1970s.[132] These included a significant devaluation of the currency; the decentralization of the management of foreign trade; an export contract system, by which the foreign trade corporations entered into contracts for the implementation of the plan (in terms of foreign exchange earnings, production costs for exports and total size of the trade deficit); the active use of Hong Kong's commercial agents and facilities; and the establishment of several Special Economic Zones (which did not make an important contribution to export expansion until the second half of the decade). Although foreign trade continued to be highly regulated and protected, real exports tripled in the decade following these reforms.

Turkey was also able to transform many of its import-substituting sectors into export industries in the 1980s.[133] Although a boom in manufactured exports was experienced in 1970-1973, it was cut short by the real appreciation of the currency in the mid-1970s. The combination of a subsequent real devaluation and high export subsidies, including special incentives for foreign trading companies, led to a manufacturing export boom, starting in 1980. Although some export incentives have been reduced since the mid-1980s, they have been compensated for by increases in other incentives and remained high (just under 30 per cent) in 1990. Import liberalization was not adopted until exports had already begun to take off. Import QRs were reduced in 1984 but tariffs remained very high. In 1988, QRs were virtually eliminated and in 1989 and 1990 tariffs were cut substantially. As in Mexico, however, these reforms coincided with a slowdown in the growth of manufactured exports, on account of a concomitant anti-inflationary programme, which brought about a real appreciation of the currency, starting in 1989. In consequence, the relative price incentive for exports was eroded.

Malaysia is an example of a country which underwent rapid export growth in the 1980s through the establishment of export processing zones.[134] Together with other countries of South-East Asia, it has also enjoyed significant external economies resulting from the relocation of industrial operations from Japan and the leading newly industrialized countries of the region. This relocation has been brought about by the latter countries' loss of competitiveness in the most labour-intensive activities and by the imposition of non-tariff restrictions against them by developed countries. Although Malaysia has low non-tariff barriers and relatively low tariffs, domestic trade policies are not neutral. Effective tariff protection rose, particularly in the machine and capital goods sector, as a result of a heavy industrialization programme launched in the early 1980s. On the export side, taxes on many of the agricultural and mineral raw materials in which the country has a strong comparative advantage have been used to generate incentives to the processing of such materials; some of these were abolished only in 1991.

Costa Rica, with a small economy, has been able to resume moderate but stable growth after the collapse of the early 1980s.[135] This growth, based on a rapid diversification of exports towards non-traditional agricultural and manufactured goods, was assisted by a sharp real devaluation brought about through a crawling peg system; preferential access to the United States market under the Caribbean Basin Initiative; and intensive use of export subsidies, based on a system of export contracts between the Government and exporting firms. Under the export subsidy system, exporters may receive direct income tax cuts and rebates of 15-20 per cent on gross foreign sales, as well

132 See Hong Wang, "Export promotion: Policy and performance in China", UNCTAD (mimeo), Geneva, 1992.

133 See Ercan Uygur, *Policy, trade and growth in Turkey, 1970-1990*, UNCTAD, Trade Policy Series No. 6 (forthcoming). Merih Celasun, "Trade and industrialization in Turkey: Initial conditions, policy and performance in the 1980s", in Helleiner (ed.), *Trade and Industrialization... (op. cit.)*.

134 Mohammed Ariff, *The Malaysian external sector: Policy and performance*, UNCTAD, Trade Policy Series, No. 2 (forthcoming).

135 See Carlos Herrera, "La apertura gradual en Costa Rica a partir de 1983", *Pensamiento Iberoamericano*, No. 21 (January-June 1992).

as the usual duty exemptions for imported inputs. Import liberalization was not introduced until 1986 and was only moderate; high effective protection rates remained the rule in the early 1990s.

These country experiences, as well as the comparative performance of Chile and Colombia illustrated in box 3, indicate that export success has involved at least three different strategies, or a combination of them: very active industrial policies and targeting; active management of the exchange rate and use of export subsidies (such as direct cash payments, preferential and subsidized export credits and income tax allowances) in the early stages of export growth; and the establishment of export processing zones. More generally, successful export growth has also involved maintaining competitive exchange rates and enabling exporters to acquire raw materials, intermediate goods and, in some cases, capital goods duty-free.

Except for the imported inputs used by export sectors, import liberalization has been introduced only after the upturn of exports, sometimes well after the upturn. This suggests that trade reform should not only be implemented gradually, but should also follow a sequence in which protection is reduced substantially only after rapid export growth is already in place, i.e. after export supply capabilities have been built up. Whereas exchange rate policies are crucial, the role of import liberalization in export success is less clear.

Finally, it should be noted that rapid export growth has been accompanied in some of the countries examined by sharp, even dramatic, reductions in real wages. However, there is no clear pattern of the effects of trade policy reform on income distribution. The evidence from Colombia, the Republic of Korea and Malaysia shows that increasing real wages can accompany sustained export growth in the long run; the effects of real devaluation on this trend were marginal in the latter two countries. In constrast, in Mexico, Turkey and Chile real wages fell considerably in the early stages of the export boom. However, even in these countries the relative contribution of trade policies to this outcome is unclear because they were accompanied by other, equally far-reaching, economic and political events.

D. The phasing of reforms

Based on the experiences of economic liberalization in developing countries since the 1950s, the optimal nature of structural reforms and their link to macroeconomic policy has been extensively discussed.[136] The early conclusions of work in this area were that macroeconomic stabilization should take place prior to structural reforms, including trade reforms. The several arguments in favour of this sequence included the following: (1) higher rates of investment will reduce the burden of structural adjustment, but investment is unlikely to be encouraged by the contractionary policies characteristic of stabilization periods; (2) macroeconomic instability may result in unstable relative prices, which will give inappropriate incentives for the reallocation of productive resources; (3) an overvalued real exchange rate will continue to prevail if the fiscal deficit is not reduced beforehand and will jeopardize the results of the structural reforms; and (4) balance of payments deficits should be brought under control prior to import liberalization because the latter is likely to generate additional strains on foreign exchange availability, which would be difficult to manage if macroeconomic conditions are not stable when the structural reforms are launched.

The experience of developing countries in the 1980s supports the view that macroeconomic stability - reflected, in particular, in only moderate inflation - is a necessary condition for successful structural change and for economic growth. Macroeconomic instability is characterized by constant changes in relative prices, variable macroeconomic policies and the possibility of profiting from speculation on changes in short-term conditions and policies. This is not an appropriate environment for investment

136 See, for example (in chronological order) Anne O. Krueger, *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences* (New York: National Bureau of Economic Research, 1978); Sebastian Edwards, "The order of liberalization of the external sector in developing countries", *Princeton Essays in International Finance*, No. 156, December 1984; Michael Michaely, Demetrios Papagergiou, and Armeane M. Choksi, *Liberalizing Foreign Trade: Lessons of Experience from Developing Countries* (Oxford: Basil Blackwell, 1991); and Vinod Thomas and John Nash *et. al.*, *Best Practices in Trade Policy Reform* (Oxford: Oxford University Press, 1991).

Box 3

TRADE POLICY AND GROWTH IN CHILE AND COLOMBIA IN THE LAST TWO DECADES

Chile is the prototype of a country which switched early and rapidly from an extremely inward-oriented economic policy to a neutral regime in the 1970s. [1] *Colombia*, on the other hand, has had a long tradition of protectionism and strong intervention in trade and foreign exchange management, although it has also mixed these policies with export promotion and gradual devaluation since the 1960s. [2] There was a gradual liberalization of imports from the early 1970s to 1982, but in the face of a balance of payments crisis this policy was sharply reversed in 1983-1985. After 1985, it was resumed, but it was only in August 1991 that the traditional gradualist stand on liberalization was abandoned.

The Colombian economy has grown faster and in a more stable manner than that of Chile, particularly in 1974-1981, despite slower export growth in that period (see the chart and the table below). Moreover, unlike Chile, growth in Colombia has been consistent with an improvement in income distribution. Both economies responded to the crisis of the early 1980s with a substantial real devaluation, but Colombia also increased tariffs, quantitative restrictions and export subsidies. Departing from its policies of the 1970s, Chile also introduced some export incentives and increased its uniform tariff level from 10 per cent to a peak of 35 per cent in the early part of the crisis, bringing it down again to 11 per cent by 1991.

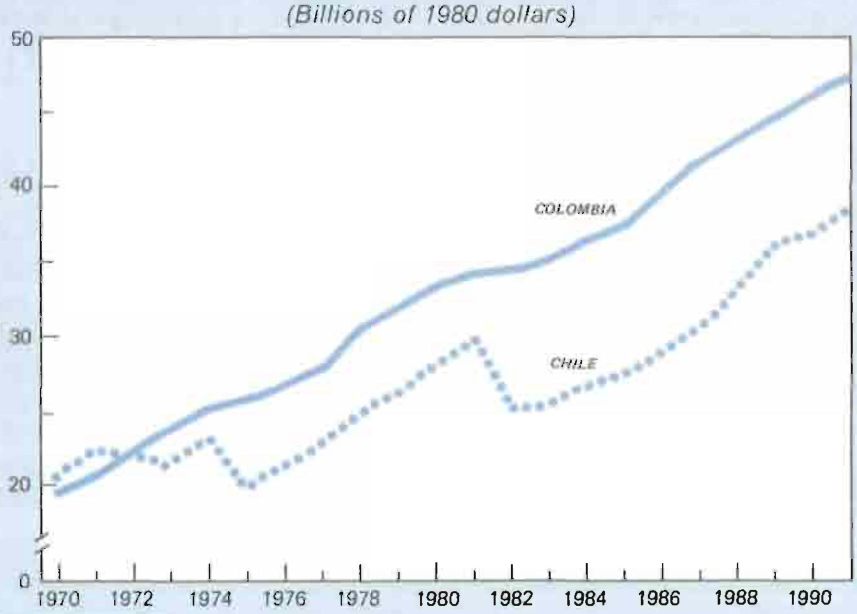
Despite protectionism and the collapse of prices of its major export (coffee), real export growth in Colombia in 1981-1991 was faster that than of Chile and its exports also diversified more rapidly. These results indicate that the cost to Chile of discarding the possibility of converting import-substituting industries into export industries was high, while Colombia was able to achieve export success gradually, based on a transformation of this sort. In both countries, diversification relied not only on large mining investments and on exchange rate incentives, but also on more direct incentives to non-traditional agricultural and manufactured goods, particularly in Colombia as regards to the latter.

1 See Ricardo Ffrench-Davis, Patricio Leiva and Roberto Madrid, *La apertura comercial en Chile* (UNCTAD/ITP/68), Trade Policy Series No. 1 (United Nations publication, Sales No. S.91.II.D.18); and Patricio Meller, "Review of the Chilean trade liberalization and export expansion process, 1974-90", in Helleiner (ed.), *Trade and Industrialization*... (*op. cit.*).

2 See Jose Antonio Ocampo and Leonardo Villar, "Trayectoria y vicisitudes de la apertura economica colombiana", *Pensamiento Iberoamericano*, No. 21 (January-June 1992); and Jose Antonio Ocampo, "Trade policy and industrialization in Colombia, 1967-1991", in Helleiner (ed.), *Trade and Industrialization*... (*op. cit.*).

GROSS DOMESTIC PRODUCT OF CHILE AND COLOMBIA, 1970-1991

(Billions of 1980 dollars)



Source: United Nations Statistical Office.

Box 3 (concluded)

COMPARATIVE ECONOMIC PERFORMANCE OF CHILE AND COLOMBIA, 1975-1991

	Chile	*Colombia*
Indicators of trade regime		
Movement of the real exchange rate (1985=100)		
1975-1981	169.1	114.2
1982-1990 [a]	104.1	89.0
Average tariff (unweighted) (percentage)		
1975-1981	22.3	36.0
1982-1990	17.5	39.7
Extent of quantitative import restrictions [b]		
1975-1981	-	46.3
1982-1990	-	56.8
Average export subsidy (percentage)		
1975-1981	-	12.3
1982-1990	-	18.4
Indicators of economic performance		
	Per cent per annum	
Real GDP growth		
1974-1981	3.6	4.5
1981-1991	2.7	3.3
Real export growth		
1974-1981	9.2	4.1
1981-1991	7.4	8.2

Source: Ffrench-Davis *et. al.*, *op. cit.*; Ocampo and Villar, *op. cit.*, and national accounts data of the United Nations Statistical Office.

[a] The fall in the index in 1982-1990 indicates a real depreciation with respect to 1975-1981.

[b] Average annual percentage of the total number of tariff lines that were subject to non-automatic import licensing.

and growth. The experience of many Latin American and African countries suggests that growth is unlikely to be resumed unless macroeconomic stability is guaranteed. Brazil is a notable example of how macroeconomic instability - associated primarily with unsettled fiscal conditions in this particular case - can hamper a successful structural transformation: since the mid-1980s, the country has experienced a sharp slowdown in the rapid rate of growth of exports that it had enjoyed since the late 1960s. At the same time, experience has also shown that macroeconomic stability, while it is a necessary, is not a sufficient, condition for economic growth.

In the face of such frustrating experiences, policy recommendations have increasingly favoured ultra-shock treatment, in which major stabilization policies and structural reforms are adopted simultaneously, thus breaking the traditional sequence that used to be suggested. This "big bang" approach has been defended on three main grounds: first, overall credibility is enhanced; secondly, conditions for sustained growth should be laid down early in the process; and thirdly, an open trade regime imposes discipline on economic agents, which is a great support to the stabilization effort.

- Experiences with the "big bang" approach are not encouraging. The earliest example (which was mild by later standards) was Chile in the mid-1970s; the result was that economic growth remained moderate and unstable for a long period. Bolivia also adopted a large-scale stabilization-*cum*-liberalization programme in 1985. Hyperinflation was stopped, but economic growth remained under 3 per cent per annum over the period 1986-1991. More recent experiences in Latin America have pointed to some of the more dangerous effects of this approach. In particular, in those countries where a "big bang" has been used to stop hyperinflation, a common characteristic has been massive overvaluation of the domestic currencies. Such a result is particularly unsatisfactory because expectations of devaluation may continue to fuel inflation, and also because structural adjustment then becomes extremely painful.

The tendency to mix structural adjustment policies with anti-inflationary programmes is much more general than the "big bang" episodes may indicate. Major trade reforms were adopted as part of essentially anti-inflationary packages in Mexico in 1987, in Turkey in 1989-1990 and in Colombia in 1991. In these cases also, real appreciation was a by-product of the programme, simultaneously reducing the incentives to both import substitution and exports. In all these countries, rapid export growth slowed down after the stabilization-*cum*-trade reform programme was adopted. The more traditional prescription, which would recommend increasing the incentive to export in order to facilitate overall structural adjustment in the face of contracting import substitution activities, would seem more appropriate.

Political consensus is perhaps the major requirement for long-term credibility, and thus for the stability, of reforms. A major disadvantage of shock treatment is that it increases both the contractionary and the adverse balance of payments effects of reforms. It therefore increases both short-term political resistance to reforms and the likelihood that policies will be reversed as a result of foreign exchange constraints, making the "credibility" and "political economy" arguments in favour of shock treatment intrinsically contradictory. In any case, the generalized positive attitude to market-oriented structural reforms in recent years, together with the more elastic supply of international finance that has usually accompanied the adoption of structural reforms, indicates that the credibility issue is no longer as important as it was when liberalization in the developing world was the exception rather than the rule. Under current world conditions, resistance to reforms is perhaps less "credible" than their adoption.

With respect to structural reforms as such, it has been generally argued that trade reforms should take place prior to the liberalization of international capital flows.[137] In some countries, such liberalization may result in capital flight, thereby endangering the fragile balance of payments situation which accompanies the liberalization process. In others (e.g. the Southern Cone of Latin America in the late 1970s and early 1980s), the elimination of controls on foreign borrowing generates massive capital inflows. Such inflows, in turn, cause an unstainable growth of external debt, which results in large risk premiums and, consequently, high domestic interest rates. They also induce an appreciation of the currency, and thereby endanger export growth, the major target of trade reform.

Indeed, the liberalization of the international capital market, in particular of rules for contracting foreign indebtness, has been widely used in the past as a mechanism to finance payments deficits associated with currency overvaluation, as a result of either expansionary monetary policies or of anti-inflationary programmes which use the exchange rate as an anchor for the price level. Among recent experiences surveyed in this chapter, massive capital inflows have been a major factor underlying recent real appreciations of the domestic currencies of Chile, Colombia, Mexico and Turkey. The extent of the appreciation has varied greatly, having been substantial in the latter two countries and more moderate in Chile and Colombia, which have also been the countries which established restrictions on such flows. In the late 1970s and early 1980s, real appreciations supported by capital inflows ended up in disaster. It is unclear whether in current conditions such a policy will lead to a different result, as is optimistically predicted for some countries (e.g. Argentina and Mexico).[138]

In general, greater freedom for capital movements introduces additional uncertainty and leads to a more erratic behaviour of the balance of payments and the exchange rate. This makes for a confusing variety of signals regarding the allocation of resources and thereby weakens the expected response to structural reforms. Hence, mechanisms to reduce such vulnerability may be necessary, either in the form of permanent exchange controls (particularly on capital movements), dual exchange rates or some form of tax on capital flows (for instance, reserve requirements, as were recently imposed in Chile). However, exchange controls may generate considerable distortions if they are used as permanent substitutes for, rather than complements, to adequate exchange rate and demand management.

In favour of gradualism in trade policy reform, it has usually been argued that adjustment costs are high and that rapid liberalization may lead to an irreversible loss of capital, labour skills and technological capabil-

137 For a discussion of external financial liberalization, see *TDR 1991*, Part Two, chap. III, sect. F.

138 See the discussion of this subject in Part Two, annex II.

ities. As indicated above, static and dynamic of economies of scale raise these costs and make it more likely that such capital, skills and technology can be usefully employed in promoting the export sector. In favour of "shock treatment", it has been argued that gradualism may not be "credible" in that it may allow resistance to liberalization to build up and to generate political conditions which would lead to a reversal of policies.

With respect to the specifics of trade liberalization, it has been argued that QRs should be eliminated early in the reform process and replaced by tariffs having the equivalent effect. The reason for this is that QRs eliminate the price mechanism and provide the recipients of the quota or licence with an economic rents from the scarce imports they are able to secure. Tariffs are preferable, it is argued, because they are more transparent and the revenue accrues to the Government.

There are three reasons why the general presumption against QRs may be invalid. First, QRs are a very useful temporary balance of payments device, as recognized in such international agreements as GATT. Indeed, they may be useful in reducing the short-term inflationary and contractionary effects of devaluation and as a temporary complement to gradual devaluation and demand policies (as indicated by the experience of Colombia in the mid-1980s). Secondly, QRs function as a "hard" signal to economic agents and may be useful if complemented by other "hard" signals (e.g. export targets) in order to generate adjustment when marginal price signals do not induce the desired outcome. Finally, under imperfect competition, price rigidities and uncertainty, it is generally accepted that tariffs and QRs are not equivalent and that "tariffication" of QRs is not always a real alternative. Moreover, in practice, many tariff items include a heterogenous group of goods and it is impossible to do the "tariffication" without generating adverse effects.[139]

None the less, the generalized, permanent use of QRs which has been the normal practice in many developing countries can generate monopoly profits, corruption and other adverse effects, especially if they are used as permanent substitutes for exchange rate and demand policies. Consequently, their virtues have to be considered in the light of the specific economic and political circumstances.

Overall, the evidence suggests that a more traditional sequencing is preferable to the current inclination to mix together stabilization and structural reforms. The experiences reviewed in the previous section suggest that import liberalization should be adopted only when substantial export success has been guaranteed. It should also be gradual, as export supply capabilities are rarely generated rapidly, and it should be accompanied by active industrial (and agricultural) policies. Some degree of control on capital flows should also be maintained. The speed of the reforms, the relative weights to be given to tariffs and non-tariff measures, the alternative forms of industrial policy adopted, the different mechanisms to control capital inflows and the resulting importance of interventionism in the overall programme all have to be evaluated on the basis of specific domestic conditions.■

139 This is particularly so for intermediate and capital goods, where many qualities (or even different goods) are often included in the same tariff item. In such cases, tariffication could in principle grant a similar level of protection tothe domestically produced goods, but only at the cost of increasing the expenses of those sectors which use other intermediate and capital goods included in the same item and which may not necessarily be close substitutes. Because of the lack of information, the only real alternative is to disaggregate the tariff item, but this is a time-consuming and complex task. After extensive discussion of these issues in the context of Colombian liberalization, it was decided that tariffication was only possible for consumer goods (and possibly also for very homogeneous intermediates, such as agricultural goods), but that QRs for intermediate goods in general and for capital goods should be temporarily maintained.

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Chapter II

REFORMING PUBLIC ENTERPRISES

A. Introduction

It is generally agreed that in most developing countries public enterprises (PEs) have performed poorly, and need to be radically overhauled in order to accelerate economic growth. However, there is less agreement on the nature of the reforms needed. On one view, they should be directed at reducing the role of the State in the economy and freeing the private sector to operate on the basis of incentives and market mechanisms generally. This view puts special emphasis on privatization.

On another view, while poor performance by PEs is widespread in developing countries, such enterprises are not always poor performers: many of them have played a strategic role in industrialization and helped to attain a variety of objectives. Moreover, in some cases the objectives sought cannot be achieved through private ownership; nor can the objectives themselves be abandoned. Experience has shown that privatization of PEs is desirable in some instances, but not in others. In any event, a good deal of public ownership is likely to endure, especially in economies undergoing transition from an initial position of pervasive State ownership. The question is therefore how to ensure that PEs operate efficiently.

Whichever viewpoint is adopted, restructuring PEs must play a central role in the reform process. Success here, as in privatization, will depend on a correct diagnosis of the nature and origin of the problems. The main purpose of this chapter is to set out the analytic framework for such a diagnosis.

Section B starts with a brief description of the size and activities of PEs in both developed and developing countries, and goes on to discuss why PEs were established in the first place and what objectives they are expected to serve. Section C examines the question of performance. It starts by discussing how the performance of PEs should be measured and then surveys the quantitative evidence on their performance and on differences between public and private enterprises, in developed countries, on the one hand, and developing countries, on the other, as well as differences among sectors. Section D discusses the main factors influencing the performance of enterprises, whether public or private. The factors discussed include the tightness of the "budget constraint" and financial discipline; patterns of ownership and control; the extent of political influence and corruption; and the impact of market structure and competition. Section E discusses organizational reforms, concentrating on objectives, autonomy, control and incentives, and policy reforms, especially as regards financing, pricing, and pay and employment. A final section draws some conclusions from the foregoing discussion and from evidence of the outcome of recently undertaken programmes for PE reform in developing countries.

B. The characteristics of public enterprises

1. Importance in the economy

Public enterprises in developing countries operate in almost all sectors of the economy, but the sectoral pattern varies considerably among countries and with the level of economic development.[140] In low-income agricultural countries marketing boards have occupied an important position, while in mineral-rich countries, PEs have been important in mining and petroleum production. Almost everywhere railway and air transport and telecommunications have been organized around PEs. State ownership in the energy sector has also been widespread in developing countries. In manufacturing, PEs have usually been concentrated in industries such as steel, cement, chemicals, pharmaceuticals, shipbuilding, motor vehicles and transport equipment. But in many countries they have also been involved in the production of non-durable consumer goods such as sugar, beverages, tobacco, textiles and footwear.

There have been some common patterns among the developing countries regarding ownership and markets of PEs. In heavy industry, transport and communications PEs have generally enjoyed a monopolistic position, but in other industries they have often operated side-by-side with private enterprises. Public monopolies have usually been fully owned by the State, whereas elsewhere joint ownership with the private sector has not been uncommon.

The size of the public sector's controlling stake in an enterprise can range from 100 per cent to a minority shareholding of less than 50 per cent. The structure of both public and private shareholdings in a PE may differ in the same way as ownership patterns in a private enterprise. Private sector stakes in a PE may thus be large and concentrated on a few owners, or small and widely dispersed. Equally, public control over an enterprise can be exerted by a single or several government institutions (for example, by both a central *and* a local authority) or by a public holding company with a certain degree of independence. But it may also involve different forms of cross shareholdings among public enterprises.

In developed countries, PEs have usually been the only firms in utilities such as postal services, railways and telecommunications; in many countries electricity, gas and civil aviation have also been in the public sector. Competition between public and private enterprises has been found in sectors such as railways, steel, broadcasting, pulp and paper, automobiles, trucking, shipbuilding and aeronautical industries in a number of developed countries (e.g. United Kingdom, Canada, France, Germany, Italy and Spain).

PEs have held an important place in the postwar period in a variety of developed and developing countries with differing economic performance, political regimes and philosophies. Available data for the 1970s and early 1980s indicate that in developing countries the share of PEs in GDP was about 10 per cent and in total gross investment 27 per cent. In the developed countries their share in GDP was

140 Public enterprises are enterprises which are wholly or partially owned and/or controlled by a government authority as a trustee for the community. There is no generally agreed terminology to denote enterprises partly or entirely owned, subsidized and controlled by different layers of Government or managed in the public interest. Terms such as Government-owned, State-owned, publicly-owned or State economic enterprises often reflect more the ideological position of authors and institutions dealing with public sector issues than differences in definition. Moreover, the borderline between government agencies, parastatals and public enterprises is not always easy to draw. In general, control has been considered to be more important than ownership in defining the public nature of an enterprise. As subsidization of entirely privately-owned enterprises sometimes causes the enterprise to be controlled by the subsidizing authority, even such types of enterprise could be considered public. For a discussion of ownership, subsidization and control as criteria for public enterprises see W.G. Shepherd, *Public Policies Toward Business* (Homewood, Ill.: Richard D. Irwin, seventh ed. 1985), p. 441. On definitions also see IMF, *A Manual on Government Finance Statistics* (Washington, D.C.: International Monetary Fund, 1986), pp. 20-22; M. Shirley, "Managing State-Owned Enterprises", *World Bank Staff Working Paper*, No. 577, Washington, D.C., 1983, p. 2; V. Powell, *Improving Public Enterprise Performance* (Geneva: International Labour Office, 1987, Management Development Series No. 22), p. 5.

similar, but in total gross investment considerably lower (11 per cent).[141]

Ideology and political philosophy have not been the only factors determining the size of the public sector in developing countries. For instance, PEs have had much the same relative importance in Kenya and Côte d'Ivoire as in Algeria, Egypt and the United Republic of Tanzania. In general, the public sector has tended to be more pervasive in low-income countries. In Africa the shares of PEs in GDP and investment were about 17.5 per cent and 33 per cent respectively during the 1970s, and in many African countries the share of PEs in value added in manufacturing exceeded 50 per cent. PEs have been as important (if not more important) in the early development of the Asian "success stories", such as Taiwan Province of China and the Republic of Korea, as in Argentina, Brazil, India, Mexico, Philippines and Peru; for instance, in Taiwan Province of China PEs accounted for one third of total gross investment in the period 1950-1975.

In the seven major industrial countries, the average share of public utilities in industrial value added during 1980-1987 varied from 10.0 per cent (Japan) to 12.5 per cent (Canada), and in gross industrial capital formation from 10.9 per cent (Italy) to 18.7 per cent (Canada).[142] In some countries, such as the United States, public ownership is unimportant outside utilities; in that country the entire PE sector accounted for only 5 per cent of total capital formation but in a number of other developed countries (e.g. Australia, Austria, Norway and the United Kingdom) the proportion was close to 20 per cent. In four Western European countries (Austria, France, Italy and Sweden) where State ownership has been important, PEs in 1982 accounted for 22.5 per cent of total industrial output, 27.2 per cent of gross investment and 18.2 per cent of employment.[143] Again, of the 500 largest industrial corporations (other than those of the United States) on the *Fortune* list for 1990, 49 were PEs (15 from developing countries and 34 from developed countries), accounting for more than 10 per cent of the total sales, assets and employment of the 500 firms.

2. *Objectives of State ownership*

Objectives of public ownership of enterprises are diverse. The most important reason for PEs is the failure of certain markets to ensure the attainment of a number of social and economic objectives. This failure may arise either because such objectives are incompatible with private ownership and the profit motive, or because the markets in question lack the full range of mechanisms needed to attain them.

One important instance of market failure arises when the scale of investment needed for efficient production is too large for private entrepreneurs to undertake with their own resources, and the necessary finance cannot be mobilized because capital markets are underdeveloped. Another example is when productivity is gained through "learning by doing" over time, but only after initial losses. Capital markets and/or private entrepreneurs may be unwilling or unable to take a sufficiently long view for such investments to be made. In some such cases, the Government has helped the private sector raise the necessary resources or supported it with subsidies. But in others it has stepped in and established PEs, particularly where it was considered that there was room for only one firm in the industry or where the private sector's response to support and subsidies was disappointing.

"Externalities" are another reason for establishing PEs. For instance, firms that are pioneers in a particular industry generate useful information for other potential investors and/or business for other enterprises; while they pay the costs, they cannot always reap a sufficient share of the benefits to make the investment worthwhile. This impedes entrepreneurial risk-taking and innovation by the private sector, and explains why many Governments have chosen to establish PEs.

141 See R. Short, "The Role of Public Enterprises: An International Statistical Comparison", in R. Floyd, C. Gary, and R. Short (eds.), *Public Enterprises in Mixed Economies: Some Macroeconomic Aspects* (Washington, D.C.: International Monetary Fund, 1984), table 1. While it is true that PEs generally operate in more capital-intensive sectors and employ more capital-intensive techniques than private enterprises, the figures cited do not necessarily imply that this difference is more accentuated in developing countries; current output depends on the existing stock of capital, not on the addition to it (i.e. investment).

142 See H. Oxley, M. Maher, J.P. Martin, and G. Nicoletti, "The Public Sector: Issues for the 1990s", *Working Paper*, No. 90, OECD Department of Economics and Statistics, Paris, December 1990, table 16, p. 53.

143 See M.A. Ayup and S.O. Hegstad, *Public Industrial Enterprises: Determinants of Performance*, Industry and Finance Series, vol. 17, World Bank, Washington, D.C., 1986, table SA-2; "The Role of the Public Sector", *OECD Economic Studies*, No. 4 (Spring 1985), tables 20 and 21.

Direct government intervention is also warranted where there is a natural monopoly; that is, where the technology requires a single firm to take the whole market. This has often been the case in utilities such as telephone and electricity services. In a few countries the danger of overpricing and associated capacity underutilization has been dealt with by franchising private firms and imposing price limits. But in most, public ownership has been preferred.

In practice, distributional and allocative considerations have also been very important. Thus, PEs have also been set up where the private sector has not responded as expected to incentives to invest in less developed regions (e.g in southern Italy), or to improve the economic position of an ethnic group in the society (e.g. in Malaysia). Poverty alleviation by generating employment in PEs has often been a priority. PEs in developing countries (as well as in socialist economies) have often provided a social security network. Wages for unskilled workers in the public sector are typically higher than in the private sector, public employees have better access to health insurance and old age pensions, and frequently benefit from education and housing grants and even from subsidized holidays and entertainment.

Providing essential consumption goods and intermediate inputs at a low price has also been a major motivation. Many Governments in developing countries have found it more practicable to do this through PEs than schemes involving taxation, subsidies and other types of government spending. Heavy involvement of the public sector in wage goods and intermediate input industries has been a cornerstone of the industrialization strategy in many developing countries. Considerable support has been given to the private sector through provision of subsidised intermediate inputs. For instance, in 1980 in Turkey about two-thirds of the gross output of industrial PEs consisted of intermediate inputs and 30 per cent of essential consumption goods sold, in large part, at subsidised prices. A similar pattern was also observed in Tunisia.[144] Moreover, PEs have taken minority shares in private companies to support their growth: for instance, in Tunisia in the 1980s there were 370 private corporations with minority public shares, in Turkey 271 and in Morocco 179. Finally, in both developed and developing countries PE procurement policies have been used to promote "learning by doing" by private firms; for instance, in Japan high-technology industries were for many years helped by the procurement policy of Nippon Telegraph and Telephone (now privatized).

In some cases, PEs have been established to alter price determination and resource allocation within the private sector. Thus, dampening fluctuations in the prices of certain important products in the agricultural sector, and influencing production and investment decisions and income distribution are the underlying reasons for marketing boards in commodity-dependent economies. Similarly, State-owned banks have been extensively used to influence the cost and allocation of credit among various sectors and regions.

Obtaining budget revenues has sometimes been another reason for establishing PEs, especially in mining and petroleum and particularly in countries with weak tax administration, such as many commodity-dependent countries; it is much easier to tax such earnings when output is purchased, distributed and exported by a State-owned marketing board. Indeed, in many such countries export taxes collected in this way account for a major share of government revenues.[145]

While the above considerations have been important in the postwar period, the initial expansion of the public sector in many countries was mainly due to nationalization. In some cases this transfer from the private to the public sector was done on purely economic grounds, for instance to allow development of local technological, management and know-how capabilities. But ideological and political factors were also important. For instance, in the United Kingdom many firms were nationalized after the accession to power in 1945 of a Labour Government, and in Austria, France and Italy the State expropriated firms owned by "collaborators". In developing countries, the nationalization was directed at foreign firms (although in some, e.g. Morocco, foreign-owned assets were transferred to the local private sector). Nationalization of domestic enterprises has been much less widespread, but there have been significant exceptions (e.g. Chile in the early 1970s and Egypt in the 1960s).

144 See K. Boratav, *Turkiye Iktisat Tarihi, 1908-1985* (The Economic History of Turkey) (Istanbul: Gercek, 1988); and S. Aouadi, "Privatisation, crise économique et défis du système productif en Tunisie" (IEDES, Paris, 1989 (mimeo)).

145 See *TDR 1989*, Part One, chap. IV, sect. B.

In many developing and developed countries rescue operations by the State resulted in *de facto* nationalization of private enterprises, often despite the Governments' political philosophy - for instance, in the Southern Cone of Latin America during the late 1970s and early 1980s. In Italy, many PEs were formed in the 1930s when the State undertook to rescue large private corporations on the brink of bankruptcy (giving birth to the Institute for Industrial Reconstruction, responsible for the overall administration of PEs in Italy) or again, in the 1950s some local governments in the United States took over urban transport companies facing serious financial difficulties. In Greece, 43 virtually bankrupt private companies were nationalized between 1983 and 1987.

While nationalization of foreign-owned assets and domestic private enterprises, together with rescue operations, has played some role in the expansion of the public sector, the most important factor has been the fast pace of public investment. In some countries (e.g. India) this was because the private sector was not allowed to invest (and divest) freely in a number of industries. In others, however, it was a lack of entrepreneurship and capital (as well as the necessary human resources and physical infrastructure) that was responsible for a slow pace of private capital accumulation. Indeed, in most countries private enterprises became dynamic only after a certain level of development had been attained.

The multiplicity of objectives of PEs has often made it impossible to spell out explicitly the objectives of individual enterprises. For instance, in the United Republic of Tanzania the law establishing the Development Corporation stated that "the business of the Corporation shall be to facilitate and promote the economic development of Tanzania", and a similar law in Uganda stated that the objective of the Development Corporation was "to facilitate the industrial and economic development of Uganda".[146] Similarly, the British Steel Corporation was established "to promote efficient and economic supply of iron and steel products in such quantities and at such prices as may seem to them best calculated to meet the reasonable demands of customers and to further the public's interest".[147]

Even where the objectives have been set more precisely, the operation of PEs has not always been consistent with them. Once established, PEs are often subject to a variety of influences which frequently cause them to be used for pursuing in their day-to-day operations other objectives than those which had originally given rise to public ownership. This is a particular problem in developing countries where political instability is high and changes in administration are often radical.

In some cases PEs have continued to operate even when their original rationale (e.g. lack of private capital and entrepreneurship) no longer held, because in the meantime they had been assigned other objectives, or because of administrative inertia. However, there are also examples where the enterprises have been adapted to changing needs in the course of economic development. In the Republic of Korea, for example, the State reduced its activity in sectors where the private economy had attained a certain level of dynamism, i.e. manufacturing and finance, while concentrating PE activity in other sectors supporting private industry, such as energy, transport and communications.[148]

In some countries Governments have used PEs to achieve macroeconomic objectives. They have served, particularly in developed countries (e.g. the United Kingdom and Spain), to create employment (not only directly, but also indirectly, through investment) during economic downturns. Similarly, pricing policies of PEs have been widely used for anti-inflationary purposes. This policy overload, together with the ambiguities surrounding objectives, has significantly impaired the performance of individual PEs, a subject which is taken up in the next section.

146 J.O. Udoji, "Some Measures for Improving Performance and Management of the Public Enterprises", in A.H. Rweyemamu and G. Hayden (eds.), *A Decade of Public Administration in Africa* (Nairobi: East African Literature Bureau, 1975), pp. 241-242.

147 Y. Aharoni, "Managerial Discretion", in R. Vernon and Y. Aharoni (eds.), *State-Owned Enterprise in the Western Economies* (London: Croom Helm, 1981), pp. 185-186.

148 See M. Shirley, "Improving Public Enterprise Performance - Lessons from Korea", *Policy, Planning, and Research Working Paper*, No. 312, World Bank, Washington, D.C., October 1989.

C. Performance of public enterprises

1. Concept and measurement of performance

Measuring the performance of PEs serves two purposes. For one thing, it helps to determine the impact of the operation of PEs on the budget, and for another, it is indicative of their efficiency in attaining objectives. Recent discussion of this subject has tended to concentrate on PEs' deficits and borrowing requirements. However, neither for private nor for public enterprises are these reliable performance indicators.

A deficit arises when the total revenues of an enterprise fall short of its total expenditures, including investment. Consequently, it may be due to losses on current account, or to an excess of investment over internally generated resources (i.e. undistributed profits or savings). Being principal investors in industry and commerce, business corporations normally run deficits, which are ultimately financed by household surpluses. Likewise, the extent to which a firm finances its investment with internal rather than external funds is no indicator of its efficiency. Its resort to external financing will depend on its investment programme, the pattern of corporate ownership and the structure of the financial system. Other things being equal, the rate of retention of profits and dependence on internal financing tend to be greater (and the dividends smaller) where the firm's ownership and management are not separated, since less attention needs to be paid to how its shares are valued in the market. But new corporations also often have to operate with high leverage and to seek external financing until they have accumulated considerable profits. Perhaps for that reason, corporate deficits and external financing of corporate investment have tended to be more pronounced in countries that are latecomers to industrialization. For instance, during 1970-1985 retentions met 58 per cent of corporate investment in Japan compared to 70 per cent in Germany, 86 per cent in the United States and more than 100 per cent in the United Kingdom.[149]

The losses or low rates of return on investment recorded by PEs are often taken as indicating lack of efficiency. However, profitability is not always an appropriate performance indicator even for private enterprises. It can be particularly misleading for those PEs that pursue explicit non-commercial objectives to compensate for a divergence of social benefits from private ones.

There are a number of serious technical difficulties in measuring profitability. There is, for instance, no consensus on the appropriate measure (i.e. operating surplus, or rate of return on assets or equity) or on accounting procedures. Besides, short-term profits and losses say little about the long-term performance of an enterprise. One enterprise may have low current profits because it has recently undertaken a dynamic learning process which will generate considerable profits in the future, whereas another enterprise may be generating high current profits at the expense of research and development or because of an inappropriate depreciation strategy.

Many large PEs are organized in the form of joint stock companies and often the bulk of their shares are held by private owners. However, it is generally not possible to rely on stock market valuation of companies. In developing countries, stock markets are underdeveloped and most company shares (including those of PEs) are not traded. Moreover, stock prices do not accurately reflect long-term profitability, being often dominated by the firm's most recent profit figures. These considerations are particularly important in evaluating the performance of PEs because such enterprises usually undertake longer-term tasks. Therefore, it is necessary to concentrate on the evolution of profits over time rather than on their level at any particular moment.

More important, the financial outcome does not gauge the social costs and benefits of the firm's activities. As noted above, PEs often pursue distributive policies in order to attain broader social and economic objectives and can generate considerable positive externalities for the private sector. The fact that such activities are commercially unprofitable does not necessarily mean that they are socially undesirable.

149 See C. Mayer, "Myths of the West. Lessons from Developed Countries for Development Finance", *Ibid.*, No. 301, Washington, D.C., November 1989.

Even when the PE does not pursue non-commercial objectives, the relevant concept of profits will be different if social and private costs and benefits diverge. Indeed, an assessment of an enterprise in terms of social costs and benefits of its activities will differ from a private (or market) assessment based on private costs and benefits whether the enterprise is publicly or privately owned, and whether or not it is pursuing social objectives; that is why Governments also interfere with markets and support private enterprises through active industrial policies. There are many instances where private costs are social benefits and private benefits are social costs. For instance, for a private company taxes (both direct and indirect) represent a cost. Profitability and dividends can be raised by lowering tax payments, and private corporations often expend resources to minimize taxes. For a PE, however, taxes are simply one type of transfer from the enterprise to the Government (its shareholder). However, this is often overlooked in assessing the performance of PEs and comparing them with private enterprises - a factor that weighs heavily against the public enterprise sector, which usually does not engage in tax minimization or tax evasion.[150]

Similarly, the prices actually paid and received by PEs may not be the right basis on which to assess the social costs and benefits of their activities. A PE may be able to earn large profits simply because it enjoys privileged access to cheap imports through an overvalued exchange rate, or monopolistic/oligopolistic market power either as a seller (e.g. electric power) or as a buyer (e.g. sugarbeet or tobacco). A World Bank study has noted that "some of the more profitable public industrial enterprises in Ghana ... owe their financial success almost wholly to monopolistic positions and to very high levels of protection from foreign competition, and they have negative value added at international prices".[151] In some countries the market power enjoyed by PEs has been countered by government control over their pricing policy that has prevented them from raising prices even when it was justified. More recently, however, there has been a tendency to use market power to improve financial performance; many loss-making PEs have raised their prices and earned very large profits without improving their efficiency.

It is possible in theory to design an alternative measure of profitability for enterprises, both public and private, taking into account externalities and market power, thus allowing for their "social profitability".[152] This would require valuation of inputs and outputs at prices that reflect social costs and benefits. Similarly, social costs and benefits that do not appear among the outlays and receipts of the enterprise (i.e. externalities) should be identified and valued. When multiple (including conflicting) objectives are being pursued, these need to be weighed and summed to obtain an overall measure of performance. In practice, however, these tasks are almost insurmountable. It is technically very difficult to measure social benefits of externalities and distributional objectives, and identify monopolistic/monopsonistic practices. Moreover, ambiguities and inconsistencies in the objectives pursued can make it hard to measure the extent of their attainment. In any event, it would be necessary to make value judgements about the social costs and benefits.

However, there is much merit in looking at the stream of output (value added) instead of profits to assess performance, since what matters is the total amount of value added generated by a given level of investment, rather than its distribution between labour and capital. Such a measure regards excessive employment and/or wage bill in a PE as a problem only if it reduces output generated by existing capacity. True, a greater share for profits may result in a higher level of future output and consumption (but lower level of current consumption) by making possible a faster rate of accumulation. However, it is not a question of PE efficiency. Rather, it raises the question whether such an objective is desirable for social welfare (which necessitates subjective and political judgements), and whether this is the best way to attain it (which requires assessment of policy alternatives). Concentrating on output may be justified when there is unemployment in the economy, for then the opportunity cost of excess employment will be zero or negligible.

There are, however, difficulties with this measure too, especially when the enterprise is expected to generate revenue for the budget (such as tobacco and alcohol monopolies and petroleum companies) or provide low-cost inputs (e.g. fertilizers, steel, and energy) to private producers; in such cases the input costs

150 For instance in measuring the net claims from the budget, the World Bank excludes PE taxes to the Treasury. See its *World Development Report, 1983*, pp. 74-75, and *World Development Report, 1988*, pp. 168-173.

151 M.A. Ayub and S.O. Hegstad, *Public Industrial Enterprises. Determinants of Performance*, World Bank, Industry and Finance Series, vol. 17, Washington, D.C., 1986, p. 12.

152 See, for instance, N. Kaldor, "Public or Private Enterprise - the Issues to be Considered", in W. Baumol (ed.), *Public and Private Enterprises in a Mixed Economy* (London and Basingstoke: Macmillan, 1980), p. 6.

(including wage costs) are themselves of importance. Similarly, for an enterprise established to promote learning by doing, the trend of labour productivity is an important indicator in its own right. Finally, this measure is subject to many of the problems (e.g. identification of externalities and social costs and benefits) associated with the profits measure.

These difficulties in using profitability or value added to assess performance have led some economists to develop technical efficiency measures based on input-output relations; namely, to determine how much input is used in order to produce one unit of output, often in the context of a production function. For enterprises producing a single homogeneous product (such as steel, coal, and oil) or where it is possible to aggregate output in terms of common measures (e.g. caloric units), notions such as labour productivity may be meaningfully quantified (provided also that there is considerable homogeneity in the labour employed). However, it is generally impossible to construct aggregate "outputs" and "inputs" independently of prices, which in turn can depend on the objectives pursued. Firms typically produce a range of products whose value cannot be summed without using prices, and they use a variety of material inputs the value of which, again, can only be aggregated by using prices. Thus, an enterprise providing subsidies to consumers by charging low prices for its products or paying high prices for its inputs to support domestic suppliers may appear technically inefficient even though it may be operating with the same input-output coefficients as a private enterprise. Similarly, a PE may be able to increase its output in value terms per unit of labour by making greater use of its market power rather than by increasing efficiency. Measuring inputs and outputs at some constant prices and concentrating on productivity growth (output per unit of inputs) can permit assessment of the enterprise's performance over time but not compared to other enterprises.

Thus, no single indicator may be an adequate measure of a PE's performance, and a number of measures may need to be considered simultaneously. These will need to differ depending on the objectives being pursued by the PE. That said, however, it is necessary to add that the objectives themselves should be examined, and an assessment made whether public ownership is the best instrument to attain them.

It should also be pointed out that although financial results are not always an appropriate performance indicator, in one particular sense they are always relevant in assessing government policies regarding PEs. Even if the performance of a PE pursuing non-financial objectives is considered satisfactory on the basis of some broad criteria, its losses will matter if the resources needed to finance them cannot be raised without causing disruption elsewhere and/or inflationary pressures. Then, the non-financial objectives may have to be scaled down and the policies of the enterprises revised accordingly.

2. *Some evidence on the performance of public enterprises*

Contrary to general perception, it is far from true that all PEs run losses all the time on their current operations. In most countries many operate with a profit, and in many countries even the PE sector as a whole shows profits.

Table 26 gives a comparison of profitability of the largest industrial enterprises, public and private, outside the United States, as reported in the *Fortune 500* lists for 1989 and 1990. It shows that about one in 5 PEs made losses in 1990, and one in 16 in 1989. While the average profits of the PEs as a proportion of their assets were smaller in these years than those of private enterprises operating in the same sectors, in all sectors except one some PEs had a higher profitability than the average of the private enterprises. The ranking of the sectors according to profitability was roughly similar for public and private firms; the two exceptions are electronics, where profitability was highest for private enterprises and lowest for public enterprises, and petroleum refining, where public ownership is particularly strong: here the profitability of public enterprises exceeded that of private ones by more than two thirds.

It is notable that while the share of public enterprises making losses has increased in 1990, none of the loss-making enterprises in that year was from a developing country. While the profitability of the private enterprises in developing countries was only half of that in developed countries, the rate of return on assets in public enterprises was, on average, much higher in developing countries; however, this was mainly on account of the mining and petroleum refining sectors.

A survey of 48 PEs in Africa found that in 1984, 12 firms reported net profit margins in excess of 4 per cent, 5 in excess of 10 per cent, and 10 of these enterprises had returns on eq-

Table 26

THE PROFITABILITY OF LARGE PUBLIC AND PRIVATE ENTERPRISES, 1989-1990

Sector	Number of public enterprises [a]								Average profitability, [b] 1989-1990						Highest public enterprise profitability [c]
	All countries				Developing countries				Public enterprises			Private enterprises			
	Total		Of which: loss-making		Total		Of which: loss-making		All coun-tries	Dev'g coun-tries	Dev'd coun-tries	All coun-tries	Dev'g coun-tries	Dev'd coun-tries	
	1989	1990	1989	1990	1989	1990	1989	1990							
Petroleum refining	16	15	-	-	10	9	-	-	6.7	8.5	3.8	3.7	2.1	3.9	31.0*
Chemicals and pharmaceuticals	14	7	-	2	1	-	-	-	3.9	12.0	3.5	7.6	-	7.6	13.0
Steel and metal manufacturing	13	7	2	1	2	2	1	-	2.9	0.7	3.5	4.0	1.6	4.0	8.8
Mining	6	6	2	1	4	3	1	-	0.4	10.3	-13.4	7.6	7.1	7.7	45.0*
Other [d]	16	14	-	5	2	1	-	-	2.1	6.4	1.6	3.8	1.9	3.9	11.3
Total	65	49	4	9	19	15	2	-	3.1	7.9	1.5	4.4	2.3	4.5	45.0*

Source: *Fortune*, August 1990 and August 1991.

a *Fortune 500* list of the 500 largest non-United States industrial enterprises.
b Net income as a percentage of total assets.
c In either 1989 or 1990. An asterisk indicates that the highest profitability was in a developing country.
d Including aerospace, beverages, computers, electronics, food, forest products, industrial equipment, motor vehicles, scientific equipment, textiles and tobacco.

uity of 25 per cent or higher.[153] In Turkey, the aggregate financial balance of PEs was in the red in only five years from 1967 to 1989; of 53 PEs, 35 made profits and 18 losses in 1987 and in aggregate there was a net profit amounting to 35 per cent of the total investment made by these enterprises. In countries such as Brazil, Ghana, India and Zambia, profitable PEs co-exist with loss-making ones in many branches of industry.[154] In some countries (e.g. Mexico and Thailand) most of the losses are incurred by a few PEs in transport, water and electricity; here, the losses are usually very large. The same is true for agricultural PEs in sub-Saharan Africa, especially marketing boards. On the other hand, there are PEs which earn large profits without relying on monopoly power; for instance a study of Singaporean shipbuilding firms in 1989 found that two PEs made more profits than private firms.[155]

When the performance of PEs is assessed by using efficiency measures, the widespread notion that PEs are inherently poor performers is refuted by the evidence. There are a number of outstanding examples of efficient PEs in many parts of the world, and public enterprises are not always less efficient than private ones (see box 4). A recent review of the available evidence on efficiency has concluded that "(t)here is no evidence of a statistically satisfactory kind to suggest that public enterprises in LDCs have a lower level of technical efficiency than private firms operating at the same scale of operation. (But) on a less formal level the tendency ... seems to be pointing in that direction".[156]

Moreover, no clear conclusions can be drawn from comparing the size of the public enterprise sector and overall economic performance. A study of a sample of 23 developing countries in Asia, Africa and Latin America for the period 1961-1981 found no significant inverse correlation between the share of PEs in GDP and investment, on the one hand, and per capita income and growth in per capita income, on the other.[157] Similarly a recent study on OECD countries found that the growth of the public sector (PEs and other components of Government) has had negative effects on economic growth in some countries, positive effects in others, but no discernible effects in most.[158]

Nevertheless, it remains true that the performance of PEs in developing countries deteriorated in the 1980s, as it did for firms in general. But PEs have been in especially acute distress: their capacity utilization fell, their profits declined sharply, and their productivity ceased to grow. This probably reflects the fact that because of the role played by the State in developing economies, the public sector often has served as a shock absorber. PEs were particularly vulnerable to the sharp swings that took place in international interest rates, terms of trade and commodity prices and net foreign lending. They were also adversely affected by adjustment policies. Certainly, the deterioration of performance had its roots in the structural weaknesses of the public sector in many developing countries which were laid bare by the external shocks and financial stringency of the 1980s. But the overall performance of the public sector deteriorated further because it absorbed many bankrupt private firms that Governments rescued to prevent the crisis from spreading.

Most PEs in developing countries have been operating in non-tradeable goods and services sectors, and have had relatively high capital intensity, import dependence and debt. The size, technology, product mix and markets of these enterprises reflected the relative prices of the 1980s, which changed suddenly. Thus, sharp increases in interest rates and real currency depreciations undermined their viability - very much in the same way that the oil price rise in the early 1970s rendered many companies in developed countries unprofitable. The optimal response would have been to restructure these enterprises with substantial new investment aimed at adjusting the product mix and factor intensity. However, financial stringency forcing swift balance of payments adjustment made this impossible; indeed, many PEs saw their problems aggravated by drastic

153 J. Nellis and S. Kikeri, "Public Enterprise Reform: Privatization and the World Bank", *World Development*, vol. 17, No. 5, 1989, p. 660.

154 See M.A. Ayub and S.O. Hegstad, *op. cit.*.

155 D. Skorski, "Competitive Advantages of State-Owned Enterprises - Comparative Case Studies of National and Private Companies in Singapore", *Public Enterprise*, vol. 9, No. 1, 1989.

156 R. Milward, "Measured Sources of Inefficiency in the Performance of Public and Private Enterprises in LDCs", in P. Cook and C. Kirkpatrick (eds.), *Privatization in Less Developed Countries* (New York: Harvester Wheatsheaf and St. Martin's Press, 1988), p. 157.

157 See C. Kirkpatrick, "The World Bank's View on State Owned Enterprises in Less Developed Countries: A Critical Comment", *Rivista Internazionale di Scienze Economiche e Commerciali*, vol. 33, Nos. 6-7, 1986.

158 See M. Conte and A. Darrat, "Economic Growth and Expanding Public Sector: A Reexamination", *Review of Economics and Statistics*, vol. 70, No. 2 (May 1988).

Box 4

COMPARING THE PERFORMANCE OF PUBLIC AND PRIVATE ENTERPRISES

Developed countries

Studies of how public and private enterprises have performed in developed countries have concentrated primarily on utilities (e.g. electricity and water) and services (e.g. insurance, railways, urban transit and airlines). There is very little on manufacturing (except for the British steel industry).

- A survey of 14 different studies undertaken between 1970 and 1989 comparing the performance of public and private enterprises in electricity in a number of developed countries, using various criteria, gives mixed results. Six of these studies showed private enterprises and seven showed public enterprises clearly as better performers. In the remaining case, the results were either neutral or depended on the criteria used. Similarly, in four studies for the water industry, public enterprises were better performers in two and private enterprises in one. In airlines in all the three studies surveyed private enterprises were found to have performed as well as or better than public enterprises.

- Studies of PE performance in the United Kingdom using different criteria such as output and productivity growth generally show that PEs performed as well as or better than private enterprises in the 1950s and 1960s. The situation was reversed in the 1970s, when PEs were widely used to lower inflation and unemployment, particularly after the first oil price rise. Both privatized enterprises and those still under public ownership improved their performance in the second half of the 1980s, with total factor productivity rising somewhat faster in the latter (e.g. British Coal and British Steel) than in the former (e.g. British Telecom).

Developing countries

Despite the importance of the subject and the widespread move towards privatization, there are relatively few studies comparing the efficiency of public and private enterprises in developing countries. Most existing studies suffer from methodological drawbacks. They are formulated in a static context, ignoring the learning curve; the enterprises examined are not always comparable in size and/or product mix; and the effects of non-technical factors on the efficiency measures used are not always properly allowed for. The results should therefore be interpreted with caution.

- A study of 500 firms in 10 sectors in 27 countries in Africa estimated production functions using responses to questionnaires during 1985-1987. It found that the technical efficiency index (the ratio of a firm's actual output to the level of output predicted by the production function) was on average lower in public than in private enterprises. However, there were considerable variations within each group, with some PEs performing better than some private enterprises.

- A study of four African countries (*Ghana, Senegal, United Republic of Tanzania* and *Zambia*) in 1983 used five groups of performance indicators (i.e. financial performance, productivity, balance of payments effects, employment and income distribution) and concluded that the performances of the PEs in all the countries were rather disappointing except for the "Africanization" of employees; except in Zambia, the aggregate financial balances were in deficit and everywhere productivity growth had decelerated considerably. The possibility that this was partly due to the deterioration of the overall economic environment, affecting also private enterprises, was not ruled out.

- A study of the steel industry in *Brazil* in 1971 with a sample of 22 firms with relatively homogeneous products estimated a production function for the best practice firms and constructed an efficiency index by comparing each firm's output with that of the best practice firms. It found that PEs ranged from the best to the worst practice firms and that there was no significant correlation between efficiency and ownership.

Box 4 (concluded)

- A study of *Indian* manufacturing over 1960-1975 found that total factor productivity increased in the PE sector but remained unchanged in private enterprises. A study for the fertilizer industry also found that productivity performance in the most efficient PEs was comparable with the best private enterprises, and that while all measures of productivity fell between 1969 and 1977 in both public and private enterprises, the decline was greater in the latter. These findings may, however, be attributed to restrictions on the private sector's acquisition of technology through new investment.

- A study of *Indonesia's* automated weaving industry compared firms using similar machinery and producing cloth of a similar type and quality. It found that output per man-hour and per unit of capital were higher in private firms. However, the private enterprises studied were considerably smaller in size than the PEs. Another study of several Indonesian industries estimated costs per ton or per unit of value added and found that differences between public and private industries were due to the effect of size rather than ownership.

- The State-owned steel company Posco (Pohang Steel Company) in the *Republic of Korea* is one of the outstanding examples of efficient PEs. In 1986 Posco produced 467 tons of crude steel per worker, compared with an average of 327 tons for Japan's five biggest steel producers. Posco charged domestic customers $320 per ton compared to $540 charged by domestic producers in the United States and $430 in Japan.

- There are also other outstanding examples of efficient PEs, including the Tanzanian Electric Supply Company, the Kenyan Tea Development Authority, the Ethiopian Telecommunications Authority, and the Guma Valley Water Company of Sierra Leone.

- A study on the *United Republic of Tanzania* estimated production functions for public and private enterprises (producing different goods) and found that PEs were less efficient. A study of the effect of the choice of technique on unit production costs in manufacturing enterprises in 10 industries found that Tanzanian PEs were less efficient largely due to their excessive size.

- Studies for *Turkey* show that in manufacturing PEs have had faster productivity growth (in terms of both total factor productivity and its components) than private enterprises during the last two decades although they had lower levels of productivity. This could partly be due to faster growth in demand for the products of PEs; the latter have also had a higher rate of capacity utilization than private enterprises.

cuts in investment and in imports of inputs and spare parts needed to maintain operations and capacity.

Many PEs working in tradeable goods sectors, such as marketing boards or mining companies, were hit by falling commodity prices. As already discussed in detail in *TDR 1989*, price declines cut deeply into the revenues of PEs producing oil and minerals and significantly widened budget deficits. Governments were generally unwilling to pass the fall in agricultural commodity prices onto domestic producers for fear of a sharp decline in living conditions, output and export earnings.

A number of conclusions may thus be drawn from the evidence on the performance of PEs. First, PEs generally perform less well in developing than in developed countries, both in absolute terms and relative to private enterprises, regardless of whether profitability or efficiency measures are used. However, there appears to be a close correlation between the performance of public and private enterprises; in countries where the private sector has performed well, PEs have also tended to. Second, although profitability has generally been lower in public than in private enterprises, efficiency measures show a narrower difference. However, poor commercial performance has not always been due to the pursuit of non-commercial objectives; there is widespread inefficiency in PEs in attaining their objectives.

The inability of the State to finance the attainment of the various non-commercial objectives typically pursued through PEs is at the heart of the current concern with the performance of PEs in many countries. Consequently, the reform issue must include the question of how the State obtains and uses resources. Nevertheless, the fact that highly profitable and efficient PEs exist in both developed and developing countries suggests that in many instances it may be possible through reform to greatly improve performance.

D. Factors influencing enterprise performance

It is essential to understand the reasons for the variations in the performance of PEs that are found both within and among countries, if reform of such enterprises is to be successfully pursued. However, since privatization is often an option, the determinants of enterprise performance generally, not only as regards PEs, needs to be considered.

One set of influences on enterprise performance consists of institutional, social, and cultural factors. They affect the work habits and discipline of the work force as well as of management, and play an important role in causing industrial performance to vary among both developed and developing countries. Shortage of managerial skills is especially important in the poor performance of private and public enterprises in low-income countries, as are deficiencies in the accounting system and lack of auditing on the basis of uniform standards.

A second set of factors explaining differences in performance are enterprise or industry-specific. For instance, enterprises operating in declining industries tend to be less efficient than those in dynamic sectors. Similarly, the age and size of a firm often influence its performance through such factors as technology, learning and scale economies.

Finally, there are factors that exert an influence through the behaviour of management. Some of these relate directly to ownership and its impact on the extent and nature of financial discipline and the budget constraint of the enterprise, the control exercised by owners over management, and the political influences on management. Equally important, however, is the degree and nature of competition faced by the enterprise in the markets for goods and services it is selling and buying. It is these determinants of managerial behaviour that can most easily be influenced through policy action.

1. *The budget constraint*

It is generally held that good enterprise performance involves a hard budget constraint, i.e. the requirement to cover expenditures by receipts from the sale of goods and services and/or earnings on assets. It is often argued that the budget constraint that a PE needs to take into account in planning its activities becomes soft when it can expect to cover any excess of spending over income through budgetary transfers and central bank credits.

It should be noted that the softness of the budget constraint depends on the existence of predetermined arrangements and contracts that are enforcable, rather than on their terms. Subsidies can be compatible with a hard budget constraint if they are non-negotiable and not subject to bargaining and lobbying,[159] while credit contracts that are not enforced soften the budget constraint even if they carry market interest rates. Again, low tax rates are compatible with hard budget constraint if they are strictly enforced - i.e. there is no room for *ex-post* bargaining to obtain postponement of tax liabilities and tax exemptions - whereas a system of pricing that allows all cost increases to be passed onto prices tends to soften the budget constraint.

The nature of the budget constraint has a strong influence on managerial behaviour. A hard budget constraint does not always elicit profit-maximizing behaviour, but a lack of financial discipline certainly precludes it. Soft budget constraints reduce the responsiveness of firms to price signals, including interest rates and exchange rates, wages, raw material and energy prices. This can greatly reduce efficiency in the allocation of resources, and by

159 See J. Kornai, "The Soft Budget Constraint", *Kyklos*, vol. 39, No. 1, 1986, for a more detailed discussion of these issues.

weakening work effort it can undermine the firm's cost efficiency. Allocative and cost efficiency are also reduced because time, energy and resources are then spent on bargaining, lobbying and creating a public opinion favourable to a soft budget constraint. Finally, since enterprises operating under a soft budget constraint can continue to undertake investment regardless of the rate of return, they will tend to generate excess demand for capital goods and foreign exchange ("investment hunger").

In many developing countries most of the means used by PEs to soften their budget constraint are also used by private enterprises, with the same adverse effects on efficiency and growth. Rent-seeking behaviour (i.e. efforts to capture resources allocated below their market value via State intervention) and the political patronage and corruption underlying it can stem from the relationship between the State and private businesses and can emerge under various forms of government involvement in the economy, including taxation and spending. In many countries the financial viability of some large private firms, and indeed entire sectors, has depended on continuous financial support by the public sector. Bailing-out large firms and banks has been widespread even in developed countries. Such practices, together with frequent tax amnesties and the practice of forgiving interest owed to State-owned banks, usually that owed by small producers (e.g. self-employed artisans and small farmers), can soften considerably the budget constraint of the private sector.

2. *Ownership and control*

It is widely argued that another important reason for inefficiency in PEs is the separation of ownership from management. Since managers of PEs do not share in the benefits of their firms and their performance is mostly much more difficult to assess in the absence of simple indicators like profits, turnover, market share etc., they often do not strive for efficiency. Neither the public as ultimate owners nor the Government as their proxy (i.e. the principals) have the means or the information to make an accurate assessment whether a change in performance is due to changes in the efforts of the managers (i.e. the agents) or to factors beyond their control. Moreover, this "principal-agent problem" also arises between the public and the Government since the former (the principal) finds it difficult to monitor whether the Government (its agent) is putting in enough effort to monitor the managers of PEs. According to this view, this problem does not exist in private firms, where rules for accountability are clearer and where the link between the private shareholders and the managers is much closer than that between the community and its agents managing a public enterprise.

However, the solution provided by private ownership to the principal-agent problem - namely, financial discipline - may be too strict, depending on the system of corporate ownership and control. Two such systems may be distinguished.[160] In one, ownership is highly fragmented, with corporate securities constituting an important part of household portfolios while large institutional investors hold equities in diversified portfolios. As pointed out in *TDR 1991* (Part Two, chapter I), that is the essence of the Anglo-American system (which may also be called the capital-market-oriented system), where banks and securities markets serve distinct functions. In the second, corporate ownership is concentrated within the corporate sector itself through cross shareholding, and household financial wealth tends to be held in the form of bank deposits rather than shares and other direct securities. This is an important feature of the German type of universal banking (or bank-oriented system), where commercial banks serve as an important source of investment finance, exercising considerable control over firms not only through their own equity holding but also through proxy votes for private investors, and are able to appoint representatives on the boards of firms. Concentration of control is also an important feature of the Japanese financial system: here, individual ownership of stocks accounts for a much smaller proportion of the shares of the publicly quoted companies than ownership by financial and non-financial corporations, and corporate equity is controlled through interlocking shareholding within industrial groups *(keiretsu)* in which banks play a central role.

Ownership and financing patterns differ in the type of financial discipline they impose on enterprise management. The Anglo-American type of system, with fragmented shareholding, encounters the problem that individual shareholders have neither the incentive nor the means to obtain the information needed

160 For a more detailed description of these systems see Y. Akyüz, "On Financial Deepening and Efficiency", *UNCTAD Discussion Paper* No. 43 (January 1992).

to monitor and control corporate management. This type of private ownership may not always provide a better solution to the principal-agent problem than public ownership, for market discipline is ultimately exercised through hostile takeovers which can be disruptive and wasteful. Besides, the evidence suggests that it is not always the unprofitable and inefficient firms that are subject to takeovers, size being a much more important factor. More important, the takeover threat creates pressures and incentives for the management to think short-term, the reason being - as Keynes pointed out long ago - that individual investors in modern stock markets are less concerned with forecasting the probable yield of an investment over its whole future than with anticipating the next changes in market valuation by speculating on the speculations of other players for capital gain.

The German and the Japanese systems are better equipped to deal with the principal-agent problem by giving banks (and banking groups) direct access to information through their close and long-term relations with firms as shareholders and creditors, which puts them in a position to monitor the performance of management and to intervene when needed in order to prevent failure. The fact that banks and business groups with a long-term stake in the corporation hold the controlling interest not only makes secondary markets less active and volatile, but also allows managers to pay much less attention to how the market values their assets from day to day, and to concentrate on the long term. The pattern of shareholding and corporate ownership also helps reduce liquidity preference and short-termism on the part of individual investors and portfolio managers, and encourages them to look for the capital gains that come from investment and growth rather than for short-term, windfall gains due to changes in market sentiment. In short, it relaxes the short-term budget constraint in favour of a superior long-term performance, which is of great importance for successful industrialization, particularly in developing countries. The patterns of ownership, control and financing in Germany and Japan have indeed not only proved remarkably stable, but have also encouraged a better corporate performance than the Anglo-American system.[161]

These are particularly important considerations to be taken into account in reforming the corporate sector and the financial system in developing countries, and for that matter in the former socialist countries of Eastern Europe also. It bears emphasizing that whether the enterprise is publicly or privately owned it must be able to take the long view if it is to succeed in "learning by doing", and that a budget constraint that is too hard for that purpose may be no more desirable than one that is too soft.

3. *Political influence, clientelism and corruption*

The tightness of the budget constraint of private and public enterprises and the nature of principal-agent relations in the latter also depend crucially on the role played by the State. While the emergence of the modern State as a guardian of the public interest has contributed to a general softening of budget constraints, in developing countries the demands put on the State can be excessive. In most such countries, many people consider that they have rights to education, employment, a degree of protection from external competition, and public support for various kinds of economic activity without corresponding obligations and duties. Thus, the State is often expected to pursue social objectives via the employment and pricing policies of PEs, without receiving help from trade unions through more moderate wage demands or from the business community through greater willingness to pay tax. A high degree of social consciousness is needed to keep demands upon the State within bounds. This, however, is very difficult to attain in the early stages of development.

Moreover, political and social systems that lack sufficient accountability contain a greater than usual potential for political patronage, bureaucratization, irregular practices and corruption. The underlying mechanisms may be better understood by distinguishing between the political and bureaucratic layers of the State (or, in democratic societies, between elected and appointed officials); the managers and supervisors of PEs are part of the latter. In countries with a one-party system, the bureaucracy is rarely independent of the political layer, and the ruling party expects it to share its political goals and to act in accordance with its interest. These two layers tend to become increasingly separated as de-

161 See R.N. McCauley and S.A. Zimmer, "Explaining International Differences in the Cost of Capital", *Federal Reserve Bank of New York Quarterly Review*, vol. 14, No. 2 (Summer 1989); J.M. Poterba, "Comparing the Cost of Capital in the United States and Japan: A Survey of Methods", and S.A. Zimmer and R.N. McCauley, "Bank Cost of Capital and International Competitiveness", *Ibid.*, vol. 14, No. 4 (Winter 1991).

velopment proceeds, particularly as a multi-party, parliamentary system evolves.

"Clientelism" and irregularities of various kinds can exist within both layers, affecting the relations of bureaucrats and politicians with the public and with each other. It is often argued that there is a global tendency for bureaucracy to emerge as a class of its own, and to pursue its own goals. On this view, government officials are as selfish as private agents, and there is no reason to expect them to act in the collective interest any more than private agents. It is also noted that the success of a bureaucracy is rarely defined in terms of effectiveness in attaining the goals of the entity it serves, but rather in terms of fostering the interests of those who hold control - something that promotes servile attitudes to superiors rather than a willingness to serve.

These criticisms are certainly not without merit, but it does not follow that excessive rule-bending, irregular practices and clientelism are inherent characteristics of bureaucracy. Rather, they depend on social and political conditions. Widespread clientelism between bureaucracy and the public is often found in countries where the public has little conception of the status and duties of the bureaucracy. For instance, according to a study undertaken in one Asian developing country during the 1960s, 75 per cent of the officials surveyed stated that most of their countrymen perceived public services as a personal favour of officials. Giving gifts to dignitaries is an old custom in many countries[162] which can easily be extended to officials and degenerate into extortion. Again, in many developing countries society in general expects government agents to use their discretionary powers in favour of friends, relatives, and tribesmen (nepotism being considered a form of loyalty).

However, there are also many instances where the bureaucracy has acted as the guardian of the common interest, especially when it has enjoyed a socially and materially privileged position and independence from politicians, and assumed a historical mission as the real protector of the State. Indeed, in a number of countries where these conditions were present, corruption was an exception, at least in the upper echelons of the bureaucracy. While some of these countries have had a democratic tradition, a few had authoritarian regimes. Nevertheless, PEs in the latter were run very efficiently: managers and bureaucrats put the public interest first despite the absence of control by the public over its agents through voting, and despite also a lack of strong financial incentives.

Interest groups exploit the State primarily by making alliances with politicians. Political influence and clientelism are much more important in determining how PEs operate than are bureaucratic irregularities. In developing countries, there is a greater tendency and scope for the political élite to use pricing, employment, wage and investment policies of PEs (as well as other economic instruments) to satisfy their constituencies (including social classes, ethnic or regional groups, and tribes) rather than meet broad social and economic objectives. To the extent that bureaucracy is independent of the political layer, or where there are political and legal institutions to prevent collusion between politicians and bureaucrats, such influences may be successfully resisted. This can also bring stability and predictability to policy making in other areas, thereby helping business groups undertake long-term decisions even in a politically volatile environment.

Political influence on PEs becomes especially important when the bureaucracy becomes dependent on the political layer. This often leads to the politicization of the bureaucracy, by encouraging it to establish ties with various interest groups. If there are no countervailing mechanisms, the result is not only greater political influence in decision making, but also widespread corruption and irregularities.

Clientelism in this sense has been widespread in developing countries. For instance, a study of one country under one-party rule in the late 1970s found a rate of continuity in the upper levels of bureaucracy of only 35 per cent, implying that in every three presidential terms, up to 90 per cent of the officeholders were replaced.[163] Such a situation encourages a rapid expansion of the bureaucracy, since the award of office becomes a major means of obtaining political support.

However, the politicization of bureaucracy is not confined to developing countries. For instance, top posts in the administration in one large developed country are filled with political appointees, and political patronage is a structural feature of the civil service; a similar state of affairs can also be observed in other developed countries.[164] More recently a number of Governments are said to have resorted

162 See R. Wraith and E. Simpkins, *Corruption in Developing Countries* (London: Allen & Unwin, 1963), p. 173.

163 S.K. Purcell, "Mexico: Clientelism, Corporatism and Political Stability", in S.N. Eisenstadt and R. Lemarchand (eds.), *Political Clientelism, Patronage and Development* (Beverly Hills: SAGE publications, 1981), p. 202.

164 See J.O. Udoji, "Tenure of Office of Top Civil Servants", in A.H. Rweyemamu and G. Hyden (eds.), *A Decade of*

to political appointments in order carry out their programmes to reduce the role of the State in economic activity.[165] However, developing countries doing so have often lacked mechanisms and institutions to prevent the strong links between politicians and bureaucrats from degenerating into collusion and corruption. The efficiency gains in the public sector from the implementation of liberalization programmes must therefore be weighed against the losses due to increased politicization of the bureaucracy and the insertion of officials into the political patronage process - something that has also been aided by the considerable deterioration in civil service salaries that has taken place in many countries.

4. Product market competition

The nature and extent of the competition it faces exert a strong influence on the performance of an enterprise, so long as it also faces financial discipline. If, however, an enterprise can cover its losses indefinitely, it can compete in markets without being as efficient as its competitors. It is thus essential to integrate competition policies with appropriate financial policies.

Even when an enterprise faces a competitive market, it will perform well only if it has the necessary freedom to compete. Thus, increased competition will not improve the financial performance of a PE if it is required to keep its prices artificially low and absorb the losses, or when it faces a stronger labour union than its competitors in the private sector. Similarly, even a highly efficient PE which regularly pays its taxes and social security contributions is put at a disadvantage when its competitors do not do so or else resort to certain kinds of action (e.g. bribery at home and abroad to secure better access to markets or obtain government contracts, foreign exchange, privileged imports, etc., or violation of restrictions regarding safe working conditions, environmental protection and the like).

In examining the effects of market structure on corporate performance, it is useful to distinguish natural monopolies producing non-traded services (as in utilities) from those operating in traded goods and services sectors. In the former case, price controls or administrative pricing are necessary to prevent monopolistic abuse and to bring about greater cost efficiency at the firm level; otherwise the monopolies will not expand output to the level where cost is minimized, since this will lower prices and profits. Even monopolies can face some competition from firms producing partial substitutes; for instance, there is often considerable competition among different modes of transport. Deregulating any one of these markets (e.g. road transport) can bring sizeable efficiency gains in monopolistic markets (e.g. railways or airlines). Competition can also take place among State monopolies producing substitutes. "In the United Kingdom there has been intense competition for some decades between the government-owned gas and electricity supply industries... Another example is the area of transport. Following the deregulation of long-distance road passenger transport in 1980, there arose fierce competition for long-distance transport between the government-owned bus company NBC and the government-owned railways BR. This competition forced the railways to improve their service in a variety of ways and led to a far more flexible pricing".[166]

It is often argued that the reform of PEs, or their privatization, should be accompanied by policies to promote greater competition, since competition is more important than ownership in determining efficiency. Reforms in two areas are advocated; namely, deregulation of domestic markets (i.e. elimination of entry and exit barriers, price controls, and output regulations such as capacity and quality requirements) and liberalization of foreign trade and investment. While these can indeed bring considerable efficiency gains, it must be noted that the kind of competitive pressures that enterprises need to face and the type of policies that need to be pursued regarding the markets for goods and services also raise the much wider issue of industrial policy. Reform of PEs does not necessitate abandoning industrial policy and every kind of intervention in markets. A number of factors need to be taken into account when undertaking deregulation and liberalization.

For natural monopolies operating in traded goods sectors, there is a dilemma be-

Public Administration in Africa (Nairobi: East African Literature Bureau, 1975); and S.N. Eisenstadt and R. Lemarchand, *op. cit.*

165 See, for instance, P. Jackson, "Policy Implementation and Monetarism: Two Primers", in P. Jackson (ed.), *Implementing Government Policy Initiatives: The Thatcher Administration 1979-1983* (London: Royal Institute of Public Administration, 1985).

166 B. Rowthorn, "Notes on Competition and Public Ownership", Faculty of Economics and Politics, University of Cambridge, 1990 (mimeo), pp. 7-8.

tween competition and productivity. Limiting enterprise size through licensing can result in a considerable loss of scale economies. Reducing import barriers and liberalizing foreign investment can avoid such losses if the domestic firm has already attained the size needed to compete with foreign firms in domestic and world markets. But, if it has not advanced in the learning process and/or suffers from scale disadvantages compared to foreign firms, a combination of export incentives and tariff protection may be needed. This is generally better than the alternative of combining price controls with complete protection from import competition, since that may not promote dynamic efficiency.

In sectors where the market is large enough to accommodate many firms, deregulation of domestic markets can bring significant efficiency gains; statutory monopolies established in such markets tend to breed inefficiency. The good performance of Finsider, the Italian PE producing steel, and Renault, the French car producer, over the last few decades is at least partly due to competition from domestic and EEC producers. If the enterprise needs infant-industry protection, some subsidies and/or tariffs may be necessary. But experience shows that although competition in world markets is essential for learning and attaining dynamic comparative advantage, import liberalization is not always necessary or desirable. Indeed, many PEs in a number of countries (e.g. POSCO in the Republic of Korea, CVRD in iron ore in Brazil, OCP in phosphates in Morocco, ICL in chemicals in Israel and HMT in machine tools in India) have been able to raise their productivity by competing in export markets while benefiting from some protection in home markets.[167]

E. Areas of reform

Reform of PEs is needed in many countries for at least two reasons: first, there is usually considerable scope for improving efficiency and second, government finances are often in poor shape.

There are several ways to reform PEs, the principal ones being privatization, liquidation and restructuring. The choice depends on how the objectives and performance of individual enterprises are assessed. Such an assessment is unlikely to be the same in all countries and under all circumstances. Recently there has been a very strong move towards privatization. However, privatization on a large scale may not be feasible, and in certain cases it may not even be desirable because it may be impossible to achieve a PE's objectives with private ownership or because privatization will not in practice yield the results sought. Many PEs can therefore be expected to remain under public ownership for many years to come. Serious attention thus needs to be paid to how to restructure them - much more than has been paid over the last few years, when the focus of attention has been almost entirely on privatization.

Inefficiency in PEs reflects shortcomings as regards the objectives set for them, the incentives they are given and the control exercised over them. Reforms should: (a) set clear objectives, separating to the extent possible commercial and social objectives; (b) establish well-defined performance indicators, and give managers incentives consistent with the objectives and indicators as well as autonomy in running the enterprise; and (c) design an effective control system based on indicators and set explicit rules and procedures for government intervention. This section reviews the main issues in these areas, and discusses policy reforms in the crucial areas of financing, pricing, and pay and employment.

1. *Defining the objectives*

There is often much confusion regarding the objectives of PEs, especially in developing countries. The objectives of individual enterprises are rarely defined precisely, and PEs are often required to serve multiple objectives without clear rules for resolving conflicts

[167] See M.A. Ayub and S.O. Hegstad, *op. cit.*, p. 18.

among these objectives. It is thus important to rethink the objectives of each enterprise and to specify them: otherwise, it will be difficult to assess performance and prevent political interference. The number of objectives should be kept low, with each enterprise being assigned only one non-commercial objective at most. Where multiple objectives are unavoidable, priorities should be assigned and guidelines set for making trade-offs.

It is also important to bear in mind that while realization of the non-commercial objective set for each PE may appear feasible when taken in isolation, it may not be so for all PEs taken together in the light of the overall financial constraint on the Government. When sufficient financial resources cannot be generated in the enterprise sector or the budget to achieve all the objectives, some of them will need to be scaled down.

It is also necessary to ask whether non-commercial objectives are not better served by other policy instruments, such as taxes and budgetary spending and incentives to the private sector, than by PEs. In practice these alternatives are rarely resorted to, perhaps because the objectives themselves are vague, but also sometimes because the necessary policy instruments are underdeveloped.

Finally, PE reform may have a number of undesirable side-effects, such as increasing unemployment. Policies to deal with them should also be considered, if only to avoid pressures to hold back reform.

2. Operating principles and performance indicators

One way to separate commercial from non-commercial objectives is to require the PE to work on commercial principles except insofar as it is explicitly set a non-commercial goal. By bringing greater transparency this procedure can provide an objective basis for establishing indicators to assess performance, and prevent hiding poor financial outcomes behind social objectives.

In some cases the social objectives of PEs are reflected entirely in the decision to establish them and do not affect subsequent managerial decisions on their operation. For instance, PEs established with an initial subsidy for reasons of national security, self-sufficiency, regional development or lack of private entrepreneurship or capital can sometimes operate on strictly commercial principles. However, in most cases, the pursuit of such objectives affects the operation of the enterprise. The costs of non-commerical objectives will have to be estimated and allowed for in determining profit targets and assessing profitability. But their benefits must also be taken into account, even though they are normally much more difficult to quantify.

A number of difficulties will be encountered in practice. Even when the social objectives of the enterprise do not affect the way it is managed, the initial choice may raise current costs and/or lower revenues; for instance, a PE established for regional development purposes can incur higher procurement or marketing costs due to inadequate infrastructure. This effect, too, has to be estimated and allowed for. Sometimes the costs may be estimated on the basis of the prices charged by privately owned firms, for instance, when low pricing is used to provide a subsidy. However, such a yardstick may not be available (e.g. when the PE is a monopoly) or reliable (e.g. when private enterprises are themselves inefficient).

Alternatively, the cost of non-commercial objectives may be determined through bargaining between the enterprise and the Government as in the "contract system", which is used in France and in some developing countries (Senegal, Argentina, Brazil, Mexico, India and Bangladesh).[168] However, this system is viable only if the management of the PE has the autonomy to decline to pursue a non-commercial objective at the price offered, and can enforce the contract. Moreover, since much the same procedure can be used vis-à-vis private enterprises, the rationale for the existence of the PE must lie elsewhere. Such a system is best used to assign tasks to public enterprises additional to those justifying public ownership or control in the first place.

Social benefits may not be calculable precisely. It is nevertheless important to assess whether the costs of pursuing non-commercial objectives are justified in view of the results and compared to the costs of other policy instruments. Specific performance targets and indicators may need to be designed not only for

[168] See M. Shirley and J. Nellis, *Public Enterprise Reform* (Washington, D.C.: Economic Development Institute of the World Bank, 1991), pp. 22-24.

this purpose, but also to make it possible to exercise control.

When prices are set with non-commercial purposes in mind, profits will need to be assessed on the basis of "shadow" prices (as in Pakistan, for example). In the case of public monopolies that are allowed to determine their own prices, quantity indicators (such as excess capacity) may be used to judge if the prices charged are close to cost-minimizing levels; but price regulation is in principle preferable.

Other adjustments to profit figures may also need to be made to reflect efficiency. Some countries (e.g. the Republic of Korea) assess performance by adjusting the private measure of profits through the addition of taxes, depreciation and interest payments and the subtraction of non-operating income and the cost of working capital so as to arrive at "public profits". The rationale is that these costs and receipts do not reflect operating efficiency and/or are beyond the control of managers.

In principle, PEs must yield a positive "public rate of return" on their equity (after allowing for costs of non-commercial objectives). The return on public equity cannot be compared on a one-to-one basis with private rates of return, but comparisons can nevertheless be useful, particularly when the PE is operating in a competitive market. More important, it will be necessary to monitor the rate of return over time in order to gauge the pace of learning and prevent short-termism, particularly when considerable autonomy has been given to the management. Performance indicators can be used to emphasize innovation, corporate planning, and research and development, alongside single-period indicators. They have constituted an important part of the performance evaluation system in some countries with a good record of public sector performance and industrialization; for instance, their weight is about one-third in the evaluation system in the Republic of Korea (see box 5).

In short, while it is possible neither to design one perfect indicator to evaluate the performance of PEs nor to rely completely on partial indicators, the latter are often far more preferable to using no indicators at all. Considerable scope exists for further advances in developing and applying performance indicators to PEs.

3. *Autonomy, control and incentives*

Any enterprise needs to take decisions in areas such as investment, financing, production, employment, pricing, procurement and marketing, some of which have to do with current operations and others with long-term strategy. Such decisions by PEs need to be compatible with the Government's broad industrial strategy. Once PE objectives are set and their constraints and performance indicators specified, decisions on operations should be left to the management; the Government should exercise control by monitoring outcomes and not by interfering in the process leading up to them.

In practice PEs in developing countries have tended to have either too much or too little autonomy. Often, there is very little effective control by the relevant government agencies because of direct links between managers of PEs with political authorities. As a result, PEs are often left free to accumulate considerable debt, inflate the labour force, invest in unviable projects, establish subsidiaries, and go into new lines of business. They are also often granted privileged access to subsidized credits and enjoy tax exemptions, until their situation becomes unsustainable; when they are taken over, they lose their power of decision even on simple day-to-day matters. Similarly, enterprises whose losses are subsidized out of the budget tend to be more subject to government interference and have much less autonomy, even when they need financial support only to finance the non-commercial objectives assigned to them.

Having a special body within the Government to evaluate performance can improve control by increasing its effectiveness and reducing arbitrary intervention, provided that the body has autonomy, skill and clout. The Special Secretariat for Control of State Enterprises in Brazil, the Experts Advisory Cell in Pakistan and the Board of Audit and Inspection in the Republic of Korea are good examples.[169] In particular, the reform in the Republic of Korea provides a number of useful lessons on how enterprise performance can be improved through organizational changes (see box 5). However, the creation of such bodies is commonly resisted by government departments.

169 See World Bank, *World Development Report 1983* (New York: Oxford University Press, 1983), p. 80, box 8.4.; M. Shirley and J. Nellis, *op. cit.*; and D. Song, "The Role of Public Enterprises in the Korean Economy", in K. Lee (ed.), *Industrial Development Policies and Issues* (Seoul: Korea Development Institute, 1986).

Box 5

REORGANIZING PUBLIC ENTERPRISES IN THE REPUBLIC OF KOREA

Although the PE sector in the Republic of Korea has been one of the most efficient in the world, not all PEs have performed well. In the early 1980s the major problems were: lack of a coherent performance evaluation system; inadequacy, if not absence, of incentives for good performance; political appointments at the top management level; and excessive government intervention in day-to-day operations.

In 1984, the Enterprise Management Law was revised to provide more managerial autonomy, an improved performance evaluation system and a better incentive structure. Managerial autonomy was increased by lessening government control over budget, procurement, and personnel management. For example, previously all procurement for PEs had been made through the Office of Supply, but under the new provision, the central executive officer of a PE can choose between purchasing directly from outside sources and commissioning the Office of Supply. To eliminate political influence over managerial appointments, the new system banned appointing outsiders to senior executive positions.

Another important change introduced in 1984 concerned inspection. Previously, the Government had monitored the PEs very tightly through various audits and inspections conducted by the Board of Audit and Inspection and various relevant ministries. An enormous amount of time and energy of PE managerial staff was spent in preparing for such inspections. For example, the Electricity Company underwent eight government inspections, lasting for 108 days, in 1981 alone. Under the new system, the Board of Audit and Inspection was made the sole inspection agency for the PEs, thus reducing the burden on both ministries and the PEs.

The reform also introduced a new evaluation system, to which bonus payments for the employees of the enterprise were linked. Enterprise performance was now to be evaluated using multiple criteria, including both quantitative measures (70 per cent weight) such as private profitability, public profitability and productivity, and qualitative ones (30 per cent weight) such as R and D, long-term corporate planning, organizational improvements, product quality and improvement in the managerial system. The profitability measure chosen was pre-tax, pre-interest payment profit, reflecting the idea that essentially non-value-adding activities such as tax saving should not be rewarded.

The reform brought a noticeable change in managerial attitudes, leading to a universal adoption of long-term corporate planning, not something practised by all PEs before the reform. Operating profit rose by 50 per cent in 1984 and 20 per cent in 1985. The ratio of R and D to sales increased from 1 per cent to 1.2 per cent from 1984 to 1985. There were also reports of noticeable improvements in product quality for both goods and services.

For effective control and monitoring of enterprise performance, a continuous flow of information in standardized form is essential. However, some countries lack the most basic information on earnings, spending, debt, employment and other vital elements regarding PEs, and even the managements of the enterprises may not know enough about their own operations. Often, therefore, the first task is to establish an information system for both the enterprises and the regulating agencies, and to adopt basic accounting standards.

Other organizational changes can also serve to improve performance. One possibility is to turn the PE into a joint-stock company and to distribute ownership of its shares among various public institutions, including pension funds, State-owned banks and insurance companies, and other PEs. Such cross-control among enterprises, akin to the Japanese and German type of corporate ownership, can bring into play quasi-market pressure without encouraging short-termism. It can be combined with government supervision designed to attain non-commercial objectives.

One example of this kind of organization is the public holding company. These exist as industrial conglomerates in some developing countries and as development corporations in others. The main argument in their favour is that their size gives them greater autonomy vis-à-vis Governments, permits them to reap economies of scope and scale, and allows them to organize internal control mechanisms and internal capital markets for cross-financing and subsidies. On the other hand, they can easily become bureaucratic interest centres with monopoly power. They are not, therefore, substitutes for an appropriate combination of objectives, incentives, autonomy and control. Autonomy must go hand-in-hand with rewards and penalties linked to performance indicators. Penalties alone are effective neither in preventing failure nor in promoting efficiency. In the absence of an appropriate reward system, managers and workers will be inclined simply to minimize effort rather than maximize results.

In designing rewards, it is important to keep in mind long-term performance and to discourage use of monopoly power. They need to be linked to various indicators of overall performance rather than financial results alone. Be that as it may, if PEs continue to constitute an integral part of clientelist politics, their performance will not be improved through such "policy" solutions alone. The number of jobs and the volume of resources involved in the operations of PEs make these a very attractive means for rulers to redistribute income to politically favoured groups through managerial appointments, politically decided contracts and so on. Political reform may therefore be a prerequisite for effective enterprise reform in many developing countries.

4. Financing

PEs should be financially self-sufficient on their current operations after allowing for the costs of the non-commercial objectives assigned to them. In principle, these should be covered not by special concessions, but by explicit transfers from the budget. This would assist Governments in judging how far they can afford their policies, and, by making the situation more transparent, help prevent arbitrary shifts in the burden of social objectives.

In practice there are also many other transfers from the budget, e.g. into investment funds or purchases of equity. The purpose of each transfer is identified in some countries (e.g. Mexico and Turkey), but not in others. Moreover, even in countries where transfers are tied to specific purposes, effective control over their use is often absent.

It is often stated that to ensure financial discipline, PEs should borrow only at market interest rates. However, there is no reason why PEs working in priority areas should not receive preferential credits on the same basis as private enterprises. For instance, many countries have in recent years been promoting exports through preferential credits, specific tax rebates and tariff drawback schemes. Where such measures are justified, they should also be applied to PEs. However, preferential treatment should not be granted to an enterprise simply because it is publicly owned.

These cases apart, as long as the Government meets the costs of non-commercial objectives, PEs in principle should be able to earn enough on their equity to cover the cost of borrowing on commercial terms. This implies that, even where investment decisions have to be reviewed and approved, choices on financing should be left to management. However, since investment financing in practice often requires government funds or guarantees, financing decisions have to be made subject to approval. Moreover, in many developing countries PEs have a weak equity base: they were usually created with little equity and have been unable to generate funds internally through undistributed profits. Their equity base needs to be strengthened, and control exercised to maintain solvency, for instance by monitoring the debt-equity ratio, as in the Republic of Korea.

Experience shows the dangers of driving PEs into financial markets before their efficiency is improved and equity base strengthened. The usual result is not more discipline but more debt. The PEs' finances are further impaired when the move coincides with interest rate liberalization and currency depreciation. Borrowing by PEs was in fact one of the causes of the external debt crisis and financial instability experienced by a number of countries. More recently, PEs in some countries have again been pushed into external borrowing as budgetary transfers have been reduced and more strict central bank credit limits applied. In some cases (e.g. Turkey) this move has been facilitated by liberalization of the capital account. Such a course can lead to a new round of excessive debt accumulation, particularly if enterprise reform does not take place.

There can be little doubt that freedom to tap financial markets and closer links with commercial banks can serve to increase financial discipline on PEs, provided that other conditions are met. Even without major privatization programmes PEs can also play an important role in developing stock markets by issuing minority shares. However, it should be kept in mind that PEs are often much larger than private enterprises, and their insertion into financial markets can have a major impact on the way these markets operate, especially if financial institutions lack the capacity to take on major new functions.

5. Pricing policy

One of the most important questions that arise with respect to PEs is whether their prices should be used to subsidize certain sectors and activities or be based on strictly commercial principles. Subsidizing can mean selling at prices either below cost or below market-clearing levels. The latter gives rise to a black market both when the PE is a monopoly and when it is under-cutting private competitors.

A distinction needs to be made between general and selective subsidies. An example of a general subsidy is provision of various inputs for agriculture (e.g. chemicals, fertilizers, machinery etc.) below market prices or costs. Selective subsidies through pricing are often found in natural monopolies such as transport, electricity and water, where differentiation of fares, charges and rates among different classes of users is much easier. The important question here is whether such subsidies should be financed from within the enterprise by positive mark-ups in other areas. Such a practice is compatible with financial self-sufficiency, but it is objectionable in that it can shift the burden arbitrarily. Its merits in any specific case depend on the extent of the subsidies to be given and the income difference between those who receive and those who ultimately pay the subsidies.

It is difficult to achieve the same result with other policy instruments, such as direct income payments to particular users from the budget. An argument in favour of differential price subsidies is that direct income payments to users cannot guarantee that the subsidies are used in the way intended. But differential pricing can only ensure this result in the case of services provided by utilities and of other services that cannot be easily resold by subsidized consumers at higher prices. Therefore, to the extent possible, differential pricing should not be used for the sale of goods by PEs.

Under-pricing goods to provide a general subsidy can generate considerable rents when capacity cannot be expanded; attempts to fix both prices and quantities at levels different from those justified by demand conditions can then give rise to turmoil, as amply demonstrated by the experience of many of the former socialist countries and of many developing countries. But if more resources can easily be allocated to the activity, no rent-seeking will occur. The issue then is whether the intervention is justified because of market failure.

Replacing price subsidies with other instruments such as taxes and direct subsidies will in theory bring greater transparency to the operations of PEs, and hence promote efficiency. In practice, however, most developing countries lack the sophisticated administrative mechanisms needed to operate such schemes efficiently. Besides, the tax system in many countries is already overburdened with special tax rates and exemptions designed to advance industrialization. Thus, the true choice is often between retaining such subsidies and abandoning them. Such a choice should only be made after a careful analysis of which subsidies are unnecessary or ineffective. Where price subsidies are retained, they need to be clearly defined and allowed for in assessing the performance of the PEs concerned (see above).

When commercial pricing is practised, it is necessary to discourage PEs from passing every cost increase onto prices: as already noted, cost-plus pricing tends to soften the budget constraint and impedes efficiency. Public monopolies should therefore be no less regulated than private ones, particularly when the management is given autonomy and incentives are linked to financial performance. In such cases, a system of tariffs is needed that brings about a competitive-market-like outcome regarding costs, prices and output. In practice, tariffs have more often been used as a device for revenue collection rather than to promote efficiency. Now that commercial pricing has gained favour (albeit often as a substitute for needed tax reforms), it is particularly important to establish autonomous bodies able to restrain Governments from using State monopolies to extract revenue.

6. Employment and pay

Perhaps the most problematic area of PE reform, whether it takes the form of divestiture or of restructuring, is employment. Employment policy is not only one of the principal causes of poor PE performance, but also the most difficult to change. In dealing with this problem it is important to distinguish between how to handle the excessive labour force that characterizes many PEs and what policies to pursue to generate more employment in the future. The scope of action on these two fronts differs considerably.

Many PEs in developing countries operate like social security agencies, paying unemployment benefits rather than remunerating for useful labour. This cannot be justified on economic or social grounds, for although employment generation is a valid objective, its costs and benefits must be calculated carefully. In principle, disguised unemployment in PEs should not be allowed, for there is no economic justification for employing labour when its contribution to output is nil or negligible, or when overmanning damages work ethics. If some income support is desired, it is better to extend it through institutions designed to provide social benefits rather than soak up surplus labour in PEs. Neither efficiency nor social reasons justify the granting of quasi-property rights in jobs in PEs: these constitute an obstacle to changing employment patterns and create a privileged section of the working class in the midst of massive unemployment.

It does not follow, however, that PEs should employ labour only when its contribution to output equals or exceeds the wages paid. Many developed and developing countries have legitimately pursued regional employment policies, either directly by establishing PEs in less developed areas, or indirectly by providing subsidies to private investment. An example of the former is the Norwegian State-owned aluminium company (ASV) established primarily to provide employment in a region with little alternative employment opportunities; and an example of the latter can be found in the North-East region of Brazil, whose development was mainly advanced through subsidized private investment.[170] Employment subsidies have also been used in a number of developed countries in order to generate jobs in regions with dangerously high unemployment. Such policies can also add considerably to national output. Employment generation by means of subsidies to the private sector, accompanied by effective controls to ensure that they are used for the purpose intended, can be more effective than increasing employment in PEs. If employment must be generated in the public sector itself, this should be done through schemes that add to the country's capital stock, such as infrastructure and rural development projects, rather than through overmanning operations.

The conventional way of dealing with the employment problem in PEs in developing countries has been to try to reduce the wage bill through wage restraint. This emphasizes profitability rather than efficiency: lowering real wages and salaries can run counter to efforts to improve management and raise productivity. There is a dilemma because, while the basic problem is usually the number of employees and their productivity, rather than their wages, it is invariably much more difficult to reduce staff than to cut real wages. Consequently, the performance of many PEs is continuously impaired by both low wages and an excessive labour force, especially since the wage reductions typically affect skilled workers and managers rather than unskilled labour, leading to a drain of talent to the private sector. Across-the-board wage cuts often give only temporary relief, since after an initial freeze nominal wages usually have to be allowed to catch up with inflation.

Much of the difficulty of reducing excess labour arises because the typical approach is large once-and-for-all reductions rather than a medium-term programme for retraining and redeployment. Large-scale reductions usually require lump-sum severance payments which usually cannot be borne by the enterprise alone. Partial or total deferment of the payments does not necessarily reduce the financial burden. Similarly, early retirement schemes shift the burden onto provident funds, which are also often financially fragile. The cost of retrenchment would appear to be related to the level of wages, but in practice low wages usually go hand-in-hand with overmanning because of political pressures on management to hire more rather than better workers.

These factors largely explain why in practice pay and employment problems in PEs remain unresolved in many countries' adjustment programmes. As one assessment of this experience points out, "(World) Bank pay and employment operations have tended to take a short-term perspective, ignoring issues of redeployment, retraining and pension and severance obligations. The Bank should take a more comprehensive approach that considers all stages of the reform process and makes more specific provisions for implementation over the medium term".[171]

Lack of a medium-term perspective often prevents even reduction through attrition. Indeed, because many developing countries allow retirement after 20-25 years of work regardless of age, on average the existing labour force in PEs can be reduced by a quarter within four to six years if there is no fresh recruitment. But

170 See M.A. Ayub and S.O. Hegstad, *op. cit.*, p. 25.

171 B. Nunberg, "Public Sector Pay and Employment Reform. A Review of World Bank Experience", *World Bank Discussion Paper*, No.68, Washington, D.C., 1989, p. vii.

such a process normally requires retraining the remaining workers and redefining their duties and responsibilities. However, measures taken to reduce the labour force through such a process (fewer temporary workers, elimination of unfilled posts and a freeze on recruitment) are often short-lived as political influence and patronage resume. Thus, pay and employment reforms in PEs only succeed when they form part of an overall reform that redefines objectives and changes incentives, enlarges managerial autonomy and increases accountability.

F. Conclusions

The PE sector in developing countries has contributed to the severe fiscal crisis of the 1980s. Poor management of enterprises has been an important influence, but even more important has been the role assigned to the public enterprise sector and the relationship of the enterprises with Government and different interest groups. The functions PEs are expected to perform are often determined by various forms of influence on the public administration, and the Government has often been ill equipped to exert adequate control over management of the enterprises. Particularly in developing countries, PEs are typically assigned a variety of non-commercial tasks, whose costs are often not covered by government revenues, with the result that the ensuing deficit in government finances finds its counterpart in the deficits of public enterprises.

Another important reason for the poor performance of many PEs has been external shocks and some of the policy responses to them. In the 1980s many PEs in developing countries were hit by sharp increases in interest rates, real currency depreciations and falling commodity prices. The changed pattern of relative prices would have required substantial restructuring, but financial stringency made new investment impossible. On the contrary, policies aiming at swift balance of payments adjustment meant drastic cuts in investment and imports of inputs, which further aggravated the problems of many PEs.

PE reform under structural adjustment programmes has frequently not been aimed at obtaining a sustained improvement in efficiency. Initially, the programmes concentrated on improving short-term financial performance, often through price increases. More recently, they have been geared towards reducing the size of the PE sector. Adjustment policies have often failed to deal with the underlying social and distributional problems which PEs are designed to address. Moreover, they have also frequently failed to achieve the results sought.[172]

Success in cutting the relative size of the PE sector in developing countries has been very limited. Divestiture has often consisted of selling profitable small- and medium-sized enterprises rather than large unprofitable ones - something which generates few social problems and hence meets with little political resistance, but which does not provide much relief (if any) to the budget. The evidence on the budgetary impact of PE reform is inconclusive. In a few countries cuts in subsidies to PEs had an immediate positive impact on public finances; elsewhere, the enterprises reacted by accumulating arrears to or by over-borrowing from other PEs. Profitability has improved only in some of the countries undertaking structural adjustment programmes. For example, in Africa an improvement was achieved only in 8 out of 18 countries under World Bank-supported programmes, while in 2 countries there was a deterioration. Moreover, where financial results improved, this was frequently achieved by monopoly price increases rather than better management. However, staff reductions, which were part of most PE reform programmes, also appear to have contributed to short-term financial improvements in some countries.[173]

Reform has frequently met fierce resistance from the groups for whom it implied significant real income losses. Improving the financial situation of PEs by price adjustments

172 For a more detailed discussion of the reform experience which follows, see World Bank, *Privatization: The Lessons of Experience*, Washington, D.C., April 1992, pp. 4-8; and A. Galal, "Public Enterprise Reform. Lessons from the Past and Issues for the Future", *World Bank Discussion Paper*, No.119, Washington, D.C., 1991.

173 See World Bank, *Report on Adjustment Lending*, Washington, D.C., August 1988, p. 67.

has tended to be easier than by employment or wage reduction, since groups affected by price increases are usually less organized than labour. Nevertheless, price increases have sometimes provoked stiff resistance and have had to be reversed. In many countries, plans to cut employment could not be implemented because of the strength of trade unions in the PEs and in the country generally, on the one hand, and the problem of financing severance payments on a large scale, on the other. In other cases, initial gains in staff reductions apparently were not sustained as some of those laid off were absorbed elsewhere in the public sector.[174] Thus, the stop-go character of reforms has damaged economic growth.

Focusing on short-term budgetary benefits can jeopardize the long-run success of PE reform. Measures such as staff reductions and price increases to compensate for across-the-board cuts in transfers from the budget can also be harmful.[175] Keeping wages down to reduce overmanning can encourage the departure of skilled staff with easier access to the private sector and thus damage enterprise efficiency.[176] In monopoly situations price increases not accompanied by changes in modes of management and production can simply hide, rather than solve, the problem of cost inefficiency.

In order to rationalize PE operations, political interference in the management of these enterprises needs to be reduced to the minimum and the accountability of their managers to competent supervisory bodies strengthened. But institutional reforms such as the implementation of improved systems of performance evaluation and auditing have also met serious difficulties. Only in four countries in Africa is there evidence that institutional reforms have had an impact on managerial motivation and enterprise efficiency,[177] the reason probably being the small pool of skilled managers.

Experience suggests that reforms of PEs in developing countries require a long time horizon, because they involve changes in social behaviour and political customs. Clientelism, patronage and corruption are likely to pose the same kind of problems to the reform of PEs as they do to their efficient functioning. Since the degree to which the PE sector is subject to such influences depends to a large extent on the level of economic and social development, lasting public sector reform has to be a continuous process and cannot be achieved quickly and in isolation. The timing of specific steps in public sector reforms is also important. PE reforms often have an impact on real income distribution which is much more difficult to digest in periods of recession and financial stringency than of growth.

Reform of PEs has to begin with an identification and review of objectives, including an assessment of the distributional impact of their operations and how these are financed. In many cases, rationalization of PEs will require to release them from certain tasks they have been allocated. However, the crucial policy choice is whether to abandon the related objectives altogether - as has frequently been the case in the reforms undertaken so far - or to develop and assign alternative policy instruments for these purposes. In any event, it is indispensable at an early stage of reform to review the priorities given to different objectives, both commercial and non-commercial; to the extent that non-commercial objectives are assigned to enterprises, the costs must be financed appropriately and their distributional effects made transparent. It is thus necessary to view PE reform in the context of a broader reform of the public sector, taking into account the political dimension.■

174 *Ibid.*

175 See M. Shirley, *The Reform of State-owned Enterprises. Lessons from World Bank Lending* (Washington, D.C.: World Bank, 1989, Policy and Research Series No.4), p. 9.

176 *Ibid.*, p. 10.

177 See A. Galal, *op.cit.*, p. 20.

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