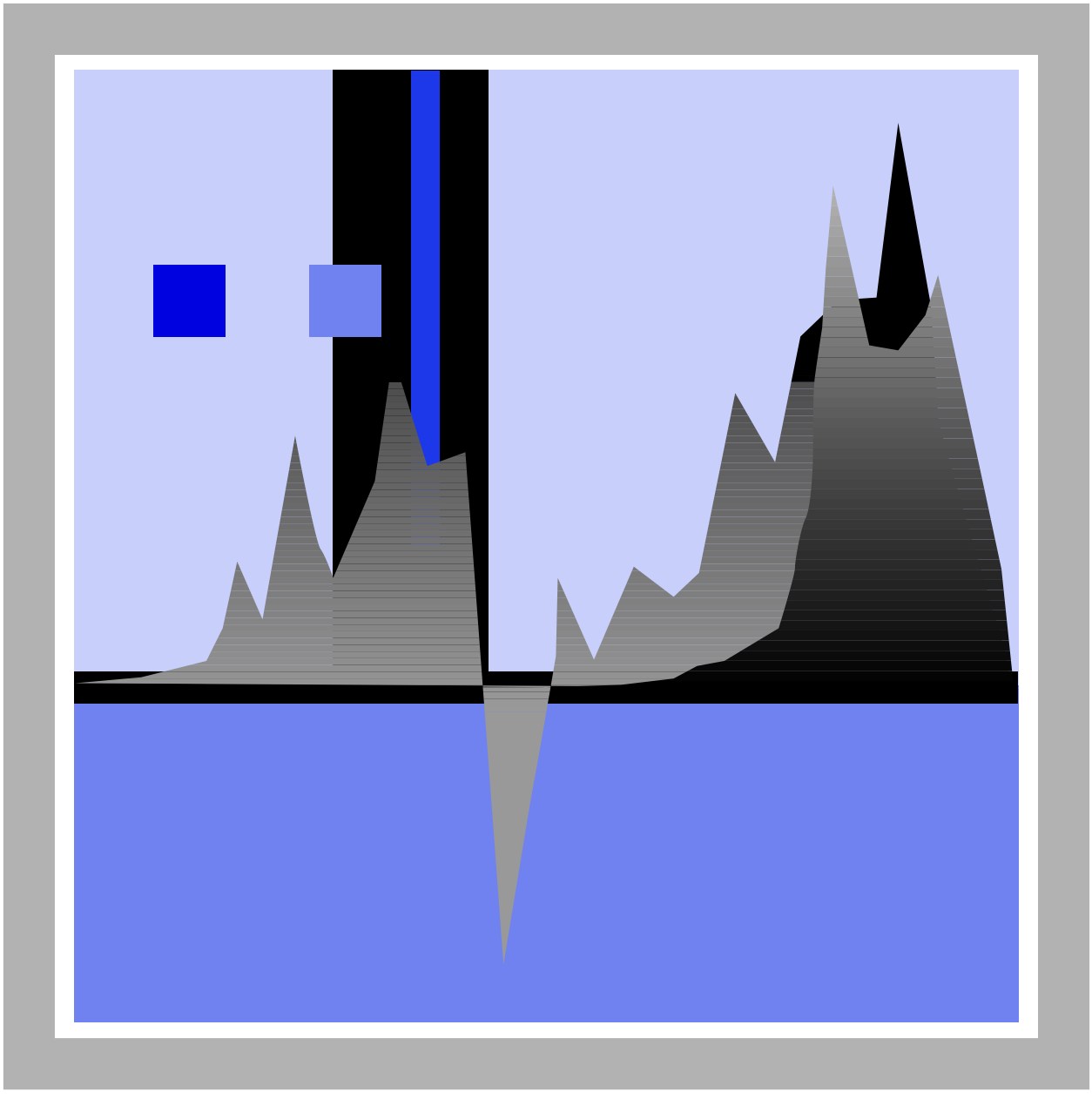
*Part Two*

# UNCTAD - TRADE AND DEVELOPMENT REPORT, 1999

## TRADE, EXTERNAL FINANCING AND ECONOMIC GROWTH IN DEVELOPING COUNTRIES



# Introduction

The belief that rapid integration into the global economy would create more favourable conditions for growth in developing countries has permeated much thinking in development policy in the past two decades. Severe and persistent balance-of-payments crises in the 1980s revealed the full extent to which faster growth in the South had come to depend on a steady rise in export earnings and on assured capital inflows, and how harmful interruptions to these external flows could be. When they occurred, they were interpreted as proof of self-inflicted structural wounds in developing countries resulting from years of inward-oriented development strategies and misguided policies. Close integration into the world economy through rapid liberalization of trade, finance and investment was thus seen as the surest foundation for success, allowing developing countries to overcome resource and foreign-exchange constraints on capital accumulation and growth.

Trade liberalization was expected to lead to greater efficiency and competitiveness, thereby boosting export earnings needed to finance imports of capital and intermediate goods. It was also thought that greater openness to private foreign capital, including FDI, would further accelerate growth by supplementing domestic resources and lifting the rate of accumulation, as well as by enhancing productivity through the transfer of technology and organizational skills. Such policies were expected not only to overcome the payments difficulties associated with the debt crisis, but also to set developing countries on a growth path that was faster and more sustainable, and more resilient to external shocks, than that of previous decades.

Simultaneously, with market-friendly reforms that were reshaping the domestic economic landscape, a new round of multilateral trade negotiations was transforming the global playing field. The Uruguay Round Agreements were expected to be doubly favourable to developing countries. On the one hand, a strong rule-based system administered by an impartial international secretariat was expected to benefit smaller and poorer economies by subjecting the conduct of trading partners to greater transparency and putting in place a system of reviews and sanctions which would not be subverted by powerful vested interests. On the other hand, a more liberal trading environment was expected to improve the growth prospects of developing countries through its direct effects on the efficiency of domestic producers and the opening of markets in industrial countries to their exportable products.

Part Two of this Report assesses the impact of these fundamental changes on the balance-of-payments and growth prospects of developing countries. Chapter IV examines the relationship between economic growth and external trade and payments in developing countries over the past three decades. It identifies a structural shift over the past 10 years whereby growth in developing countries is now generally associated with greater trade deficits than in the past. While there has been a strong recovery in export growth in the 1990s compared to the 1980s, it has not matched the rapid surge in imports. The chapter examines to what extent the association of widening trade deficits with falling or stagnant growth rates can be explained by adverse movements in the terms of trade, rapid liberalization and slower growth in the North.

Chapter V examines the trends in capital flows to developing countries. It shows that the recent surge of private capital flows represents a recovery from the depressed levels of the 1980s, rather than a new trend which could offset the structural rise in the external deficits of developing countries. The chapter further examines the composition, geographical distribution and stability of these flows, and the extent to which they are used to finance real resource transfers from abroad. It also discusses the recent increase in

direct investment flows to developing countries, its impact on the balance of payments of host countries and its sustainability in the longer term.

Chapter VI considers the policy options available to developing countries in the light of the disappointing results of increased openness of their economies. On the domestic front, it emphasizes the importance of appropriate management of exchange rates and capital flows so as to benefit from closer integration into the world economy, and discusses the policies needed to build competitive industries. However, given the systemic biases and asymmetries in the international trading system, it concludes that domestic efforts alone are unlikely to be effective in reducing balance-of-payments pressures. There is a need to reconsider provisions in the WTO Agreement that limit the policy options open to developing countries and to introduce special and differential treatment as an integral part of the contractual obligations of the rule-based trading system. The chapter also discusses some of the obstacles in industrial countries to exports from the South, particularly in low-technology manufactures, and assesses the increase in export revenues which the developing countries might be able to achieve if they were granted greater market access. ■

Chapter IV

# PAYMENTS DEFICITS, LIBERALIZATION AND GROWTH IN DEVELOPING COUNTRIES

## A. Introduction

The link between external payments and economic growth in developing countries has long been recognized. An early formulation of this relation, going back to the 1960s, was the so-called two-gap approach.[1] This approach emphasizes the dependence of capital accumulation and economic growth in developing countries on foreign capital and trade flows through two channels. The first involves resources needed for investment: external capital flows allow developing countries to invest more than they can save, thereby closing their savings gap. The current-account deficit is viewed as a measure of real resource transfers from abroad to supplement domestic savings. Accordingly, a sustained increase in the deficit is expected to be associated with faster capital accumulation and growth unless there is a leakage of resources through adverse terms-of-trade movements, a decline in domestic savings, persistent underutilization of capacity, or a decline in the efficiency with which that capacity is utilized.

The second gap relates to foreign-exchange availability and arises because of the dependence of investment and growth in developing countries on imported intermediate and capital goods. Even if domestic savings are sufficient to finance all the investment needed (or the investment that the public and private sectors are capable of undertaking efficiently), a developing country would still be unable to undertake the investment if it does not earn enough foreign exchange to pay for the imports required. Investment would thus be constrained by the lack of adequate foreign exchange rather than domestic savings. Consequently, production capacity would be underutilized, income and savings would be reduced, and growth would be below potential. Capital inflows can fill this foreign-exchange gap, allowing imports, investment, income and savings to be raised above the levels otherwise constrained by export earnings.

However, the two-gap model does not fully capture the link between trade and growth. As examined in *TDR 1996*, in developing countries the utilization of existing capacity, income and savings can depend on exports regardless of the extent to which the foreign-exchange gap is closed by capital inflows. In this context, the role of exports is not only to earn foreign exchange for imports and investment, but also to provide markets for goods which would not otherwise be produced or, more importantly, produced only to meet domestic consumer demand. In the first case, exports provide a "vent for surplus", while in the second they allow domestic savings to increase, as consumer goods industries can operate at full capacity without a commensurate increase in domestic consumption. Since export expansion in turn depends on investment, a sustainable growth process requires mutually reinforcing dynamic interactions between capital accumulation and exports, or an "export-investment nexus".

In this process exports, savings and investment all rise, both in absolute terms and as a share of GDP. Initially, the savings and foreign-exchange

gaps tend to be large, but over time they narrow as exports and domestic savings grow faster than imports and investment. Thus, the economy can continue to grow rapidly despite a relative decline in real resource transfers from abroad. If such a virtuous interaction between exports and investment cannot be established, however, growth will continue to depend on the availability of external resources and will be restrained when such resources are in short supply.

As discussed in earlier issues of *TDR*, such dynamic interactions between trade and growth have characterized the post-war industrialization of a few East Asian countries.[2] This chapter aims at a more general analysis designed to evaluate the evolution of the relationship between economic growth and external trade and payments in developing countries over the past three decades. The evidence presented below suggests a significant shift in this relationship. In recent years developing countries have generally run greater current-account deficits as a proportion of their GDP than in the past, but without achieving faster growth rates. These growing deficits have been primarily due to the balance of trade, as export earnings have generally been unable to keep pace with rapid import expansion. Only a few countries exhibit trade and growth patterns significantly different from this general trend.

Certainly, a country's trade performance is influenced by a large number of domestic factors, including the economy's structural characteristics, its resource endowment and policies pursued. It is also influenced by the external economic environment. These factors vary considerably from one country to another, and a full account of such influences requires detailed country analysis that goes beyond the scope of this report. Attention here is focused on a number of common factors which are believed to have influenced the trade and growth performance of a large number of developing countries, such as world demand, trends in the terms of trade, and trade and financial liberalization in developing countries. The effects of these factors are also examined for a sample of countries on the basis of an econometric analysis reported in the annex to this chapter.

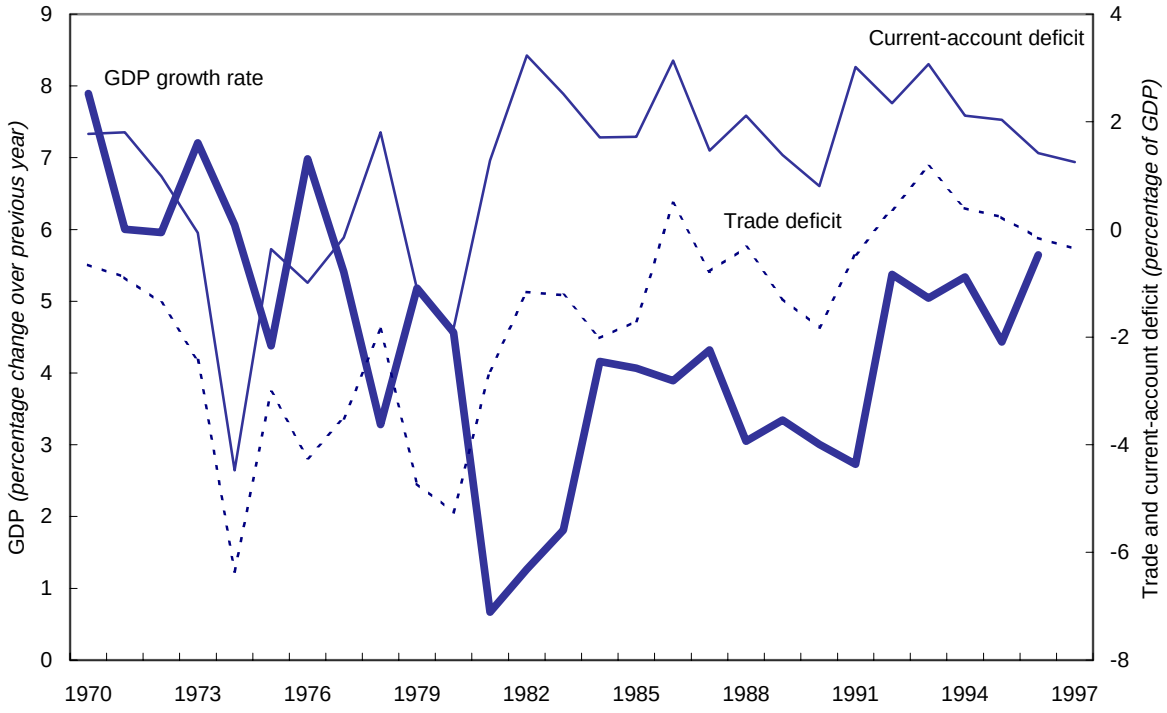
One of the crucial external factors influencing the trade performance of developing countries is the size and growth of markets in major industrial countries, which are the most important outlets for their exports. Slow growth of these markets, continued restrictions on access in areas of export interest, together with increased competition among developing countries themselves in those markets, tend to add to their trade deficits by slowing the pace of their export earnings and bringing about terms-of-trade losses. Deficits are further widened by rapid trade liberalization that results in a surge of imports, particularly where protection in the past was excessive and import-substitution strategies were not successful in establishing competitive industries, and where the liberalization is not accompanied by appropriate exchange-rate management. Moreover, managing the exchange rate is made more difficult by capital-account liberalization designed to mobilize private external financing. Instability in financial flows and the consequent misalignments and fluctuations of exchange rates aggravate payments difficulties by discouraging investment in traded-goods industries. Thus, capital flows tend to widen the resource gap through their adverse effects on exchange rates, imports and exports, rather than being driven by the requirements of the current account.

## B. A review of long-term trends

Since the beginning of the last decade, developing countries as a whole have constantly run current-account deficits averaging some 2 per cent of GDP and fluctuating moderately within the range of 1–3 per cent (chart 4.1).[3] This performance contrasts sharply with the 1970s, when they faced strong fluctuations in their current accounts, but ran surpluses in most years.[4] The trade account of developing countries has moved by and large in parallel with their current account. It was in surplus throughout the 1970s and the 1980s (except in 1986, when oil prices dipped sharply) but

***Chart 4.1***

**GDP GROWTH AND THE CURRENT-ACCOUNT BALANCE OF DEVELOPING COUNTRIES[a], 1970–1997**




***Source:*** IMF, *World Economic Outlook* database; UNCTAD, *Handbook of International Trade and Development Statistics*, table 6.2 (various issues).

***Note:*** Positive values for trade and current-account balance indicate a deficit, negative values a surplus.

***a*** Excluding Hong Kong (China), Republic of Korea, Singapore and Taiwan Province of China.

since the early 1990s it has been in deficit for several consecutive years.

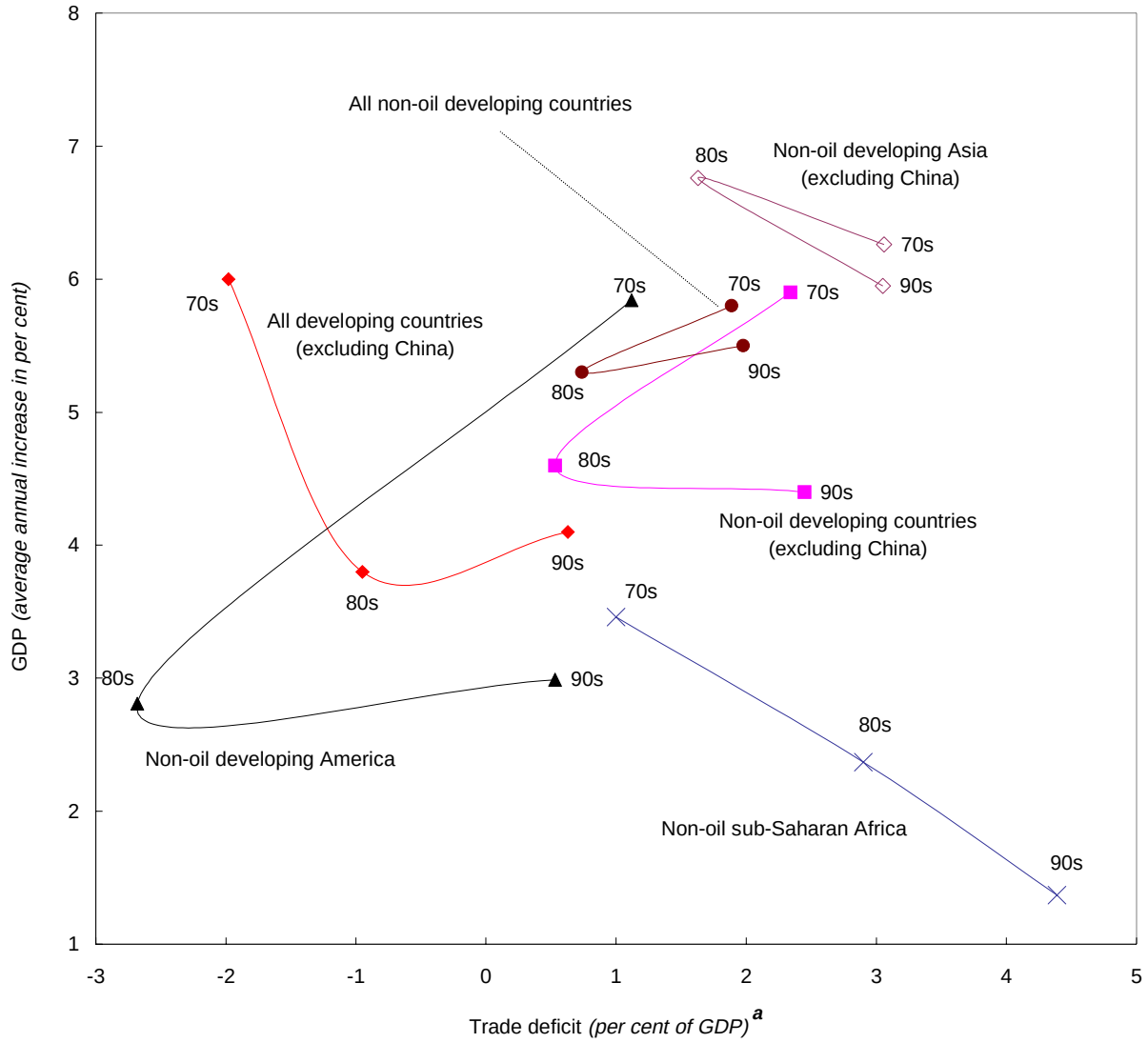
Growth in developing countries has also shown large swings over the past three decades. While fluctuating sharply throughout the 1970s, it averaged 5.7 per cent per annum and never fell below 3 per cent. There was a dramatic slowdown in the early 1980s due to a deep global recession and the resulting debt crisis which hit many developing countries. Growth was relatively stable at around 4 per cent during the second half of the decade, rising subsequently to an average of about 4.5 per cent during the first half of the 1990s.

Thus, the sharp decline in growth in developing countries in the 1980s was associated with a deterioration of their trade account. The worsening of the current account was even more pronounced because of rising interest payments on external debt. The payments position continued to deteriorate in the 1990s, while growth picked up. The decline in world interest rates since 1989 has reduced the pressure of debt-service payments on the current account, but deficits were not reduced because there was a worsening of the trade balance.[5] Despite recovery from the debt crisis, developing countries could not restore the configuration of the trade balance and growth of the 1970s; while their growth averaged less in the 1990s than in the 1970s, the trade surplus they had achieved in the latter period no longer prevailed.

These trends have been greatly influenced by the evolution of oil prices, since a good number of developing countries are highly dependent for their foreign exchange on oil exports. Oil-importing developing countries are also affected by oil prices, but to a much lesser extent. Indeed, for

***Chart 4.2***

**RELATIONSHIP BETWEEN GDP GROWTH AND THE TRADE DEFICIT IN DEVELOPING COUNTRIES, BY SELECTED REGIONS, 1970–1996**




***Source:*** UNCTAD database.
***Note:*** The "70s" relate to 1970–1979, excluding 1974 and 1975; the "80s" relate to 1982–1988; and the "90s" to 1989–1996.
***a*** A negative figure indicates a trade surplus.

this reason the price of oil is perhaps the single most important factor affecting the balance of trade between industrial and developing countries. For instance, while the price increases in the 1970s affected differently the oil-exporting developing countries and the non-oil exporters, there was a significant improvement in the trade balance of developing countries as a whole with industrial countries. This situation was reversed when oil prices collapsed after the mid-1980s and again after the recent downturn (see chapter II). Consequently, the long-term trends in growth and external payments will be examined both for all developing countries and for the non-oil exporters only.

Similarly, it is also appropriate to distinguish China from other developing countries, not only because it accounts for 15 per cent of total income of developing countries, but also because the

Chinese economy has undergone a fundamental change in terms of its overall orientation and integration into the global economy since the mid-1970s. In what follows China is treated separately. Nevertheless, it should be pointed out that while unfavourable trends in growth-deficit constellations of non-oil countries become more pronounced when China is excluded, the conclusions reached remain valid even if it is included.

## 1. Trade deficits and growth

Chart 4.2 relates the average trade deficit and GDP growth attained during the three sub-periods since 1970 for developing countries as a whole (excluding China), non-oil developing countries (including and excluding China) and three major developing regions.[6] Comparisons of these groups over time yield a number of conclusions.

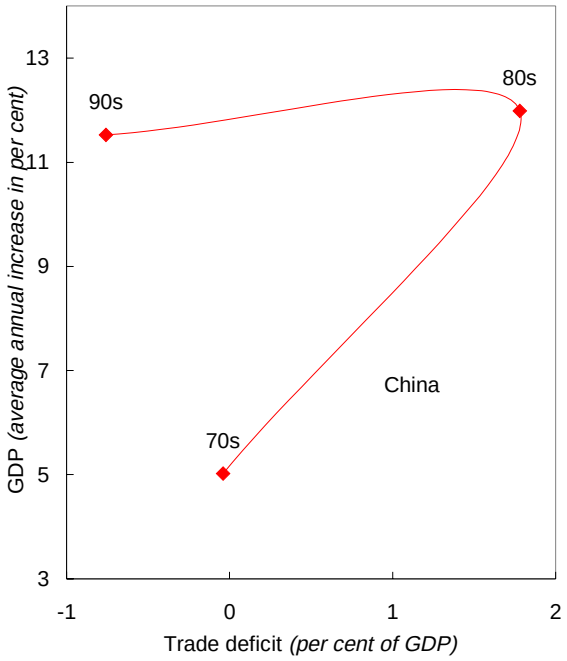
First of all, for developing countries as a whole (excluding China), with or without oil-exporters, there has been a considerable change for the worse in the relationship between economic growth and trade balances. Growth was lower in the 1980s than in the previous decade. While this fall was associated with a rise in trade deficits for the entire group, in non-oil countries the deficit narrowed, but the improvement was largely the result of import compression and cuts in investment and growth that were necessitated by cutbacks in commercial bank lending and the emergence of net negative transfers abroad, particularly in a number of highly-indebted countries in Latin America.

In both groups, the trade balance worsened significantly from the 1980s to the 1990s, while average growth rates remained relatively stable. Initially (during 1987–1990) rising payments deficits were associated with falling growth, i.e. a constellation which is clearly unsustainable in the longer run. During that period many developing countries introduced drastic changes in their trade policy regimes, dismantling quantitative restrictions and reducing tariffs – a stance that was generally maintained despite the worsening of trade balances. Subsequently, growth picked up, but the growth rates achieved were associated with higher payments deficits than in previous decades.

As can be seen from chart 4.2, when oil exporters are included the average trade deficit of

***Chart 4.3***

**CHINA: RELATIONSHIP BETWEEN GDP GROWTH AND TRADE DEFICIT, 1970–1996**




***Source:*** See chart 4.2.
***Note:*** The periods shown are those in chart 4.2.

developing countries in the 1990s was higher than in the 1970s by almost 3 percentage points of GDP, while the average growth rate fell by nearly 2 percentage points per annum. For non-oil developing countries, the trade deficit in the 1990s is at approximately the same level as in the 1970s, while the average growth rate is lower by nearly 2 percentage points. This result is particularly striking in view of the extensive policy efforts and structural reforms undertaken by most developing countries since the early 1980s in order to overcome the balance-of-payments constraint on growth.

If China is included among non-oil developing countries, the picture is not very different: the average growth rate is higher in the 1980s and 1990s than when China is excluded, because the country's growth rate was similar in the 1970s to that of the other countries, while it accelerated subsequently. Indeed, the average growth rate for China in the 1980s and 1990s was double that of the 1970s (chart 4.3). Faster growth in the 1980s

was associated with a sharp deterioration in the trade and current-account balances, particularly in the middle of the decade, when the trade deficit amounted to about 4.5 per cent of GDP. The situation was reversed subsequently when the deficit turned into a surplus at the beginning of the 1990s, a position which has generally been maintained subsequently. Thus, in recent years China has managed to sustain very high growth rates while nevertheless improving the trade balance, but the improvement has been considerably offset by a sharp reduction in net invisible income since the mid-1990s.

There are also significant differences among developing regions. Growth rates and trade deficits of non-oil exporters in Latin America follow the pattern of non-oil developing countries as a whole, but at a lower level, in all three periods. The average growth rate in Latin America was significantly lower in the 1990s than in the 1970s (by 3 percentage points per annum), while the trade deficits were much the same.

The non-oil exporters of sub-Saharan Africa have fared notably less well since the 1970s. In that initial decade they were able to combine an average growth rate of 3 per cent with moderate trade deficits, but thereafter growth slowed down and trade deficits rose continuously.

The record of the Asian non-oil developing countries is distinctly more favourable. In contrast to Latin America and Africa, where growth slackened during the 1980s, the Asian countries experienced accelerated growth but falling trade deficits. However, in these countries, too, the trade deficits rose in the 1990s, while average growth rates were lower than in the 1980s. Nevertheless, this is the only region where the growth-deficit configuration in the first half of the 1990s was not substantially different from that in the 1970s. This situation changed when the East Asian financial crisis broke out, resulting in a collapse of growth and a sharp turnaround in trade deficits, but it is not yet clear to what extent the adjustment to the crisis will lead to a permanent shift in growth-trade linkages in the region.

## 2. Imports and exports

Comparable movements in the ratio of trade deficits to GDP can be associated with quite different trends in exports and imports, with different implications for overall economic performance. An improvement in the trade balance brought about by a larger increase in exports than in imports generally has different implications for growth from an improvement achieved primarily through import cuts. A worsening of the trade balance associated with rapid increases in both exports and imports is more likely to be associated with faster growth than when it is due mainly to a surge in imports. Accordingly, an examination of movements in exports and imports can shed further light on the relationship between trade performance and economic growth discussed above.

Table 4.1 shows average annual rates of increase in export and import values for non-oil-exporting developing countries, with a regional breakdown along the lines of chart 4.2 discussed above. The rapid growth of both imports and exports in the 1970s was, in part, due to the rising unit values resulting from the global inflation that followed the oil price shocks. For all groups and regions, export growth rates were higher than import growth rates. In Asia (excluding China) the export growth rate exceeded that of imports by a large margin, as it did also in Latin America, though to a slightly lesser extent.

During the 1980s both export and import growth slowed considerably compared to the 1970s, partly reflecting a slower rate of world inflation, but mainly because of a considerable slackening in volume terms. The slowdown is much greater if oil exporters are included than when they are excluded, because of sharp declines in oil prices and cutbacks in imports. If the oil exporters are excluded, the rate of increase in import values falls off much faster than that in export earnings. However, this period witnessed increased disparities among developing regions regarding trade performance. In sub-Saharan Africa there was a dramatic drop in growth rates of both exports and imports, and the trade deficit continued to worsen; imports collapsed in volume terms while investment and growth declined sharply.[7] In Latin America import growth became negative not only in value terms but also in volume terms, while export growth dropped sharply compared to the 1970s, resulting in an improvement in the trade balance. By contrast, Asia maintained rapid growth rates for both exports and imports (though less rapid than in the 1970s), improving both its trade balance and GDP growth.

**Table 4.1**

**TRADE OF NON-OIL-EXPORTING DEVELOPING COUNTRIES, 1970–1996**

*(Average annual percentage increase in value)*

| | 1970–1979[a] | | 1982–1988 | | 1989–1996 | |
|---|---|---|---|---|---|---|
| | Exports | Imports | Exports | Imports | Exports | Imports |
| All non-oil exporters[b] | 21.4 | 17.5 | 8.8 | 4.8 | 11.7 | 13.5 |
| *of which:* | | | | | | |
| Sub-Saharan Africa | 14.0 | 13.4 | 3.2 | 1.0 | 6.2 | 6.1 |
| Latin America | 18.8 | 15.0 | 2.9 | -1.9 | 9.7 | 13.9 |
| Asia | 26.8 | 21.3 | 13.0 | 9.1 | 12.7 | 14.1 |
| ***Memo items:*** | | | | | | |
| All developing countries | 22.0 | 18.6 | 2.0 | 2.6 | 11.7 | 12.4 |
| *of which:* | | | | | | |
| China | 25.7 | 28.2 | 12.3 | 16.4 | 15.9 | 12.8 |

***Source:*** UNCTAD database.
***a*** Excluding 1974 and 1975.
***b*** Excluding China.

While both exports and imports accelerated during the 1990s in developing countries as a whole and in all regions, spending on imports generally rose faster than export earnings, and especially so in Latin America, where the annual rise in imports exceeded that in exports by more than 4 percentage points during 1989–1996. In Asia, too, there was an acceleration, but in that region also imports rose much faster than exports compared to the 1980s. In China, by contrast, exports have been rising faster than imports, contrary to the trend observed in previous decades.

For developing countries, excluding both China and the oil exporters, while trade balances as a proportion of GDP were similar in the 1970s and the 1990s, exports grew faster than imports in the earlier period, while the reverse holds for the 1990s. This reversal was generally associated with slower GDP growth and was particularly pronounced in Latin America, but also took place in Asia, even though the difference between import and export growth rates in Asian countries was much smaller.

## 3. The experience of different countries

The evolution of trade balances and growth rates over the past three decades shows considerable variation not only among different developing regions but also among individual countries. Tables 4.2 and 4.3 classify 84 developing countries for which comparable data are available according to changes in their average growth rates and trade balances as a proportion of GDP from 1982–1988 to 1989–1996 and from 1970–1979 to 1989–1996, respectively. The first comparison sheds some light on the extent to which the developing countries facing serious external financial difficulties in the 1980s have been able to restore growth and sustainable payments positions in the 1990s, while the second measures this adjustment against the performance of these countries before the outbreak of the debt crisis of the 1980s. A number of conclusions can be drawn from these comparisons:

- In 51 countries, the trade balance worsened from the 1980s to the 1990s, and in half of

**Table 4.2**

## CLASSIFICATION OF DEVELOPING COUNTRIES ACCORDING TO MOVEMENTS OF THE TRADE BALANCE AND GDP IN 1989–1996 COMPARED WITH 1982–1988

| | | ***Improvement in the trade balance by*** | | | | ***Deterioration in the trade balance by*** | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | *more than 10 per cent of GDP* | *5–10 per cent of GDP* | *2–5 per cent of GDP* | *less than 2 per cent of GDP* | *less than 2 per cent of GDP* | *2–5 per cent of GDP* | *5–10 per cent of GDP* | *more than 10 per cent of GDP* |
| ***GDP growth higher by*** | *more than 5 percentage points* | | *Syrian Arab Rep.* | *Libyan Arab Jamahiriya*[a] | *Iran (I.R. of)*[a] | | | Guinea<br>Guyana | Sudan[a] |
| | *3–5 percentage points* | Papua New Guinea<br>**Singapore** | Jordan<br>*Trinidad and Tobago* | *Gabon* | | Argentina | Bolivia[a] | Guatemala<br>Liberia[a]<br>**Malaysia**<br>Nicaragua<br>Philippines<br>Uganda | El Salvador |
| | *1–3 percentage points* | Benin<br>*Nigeria* | *Saudi Arabia*[a] | Mali | Niger | *Ecuador* | Chile<br>Fiji<br>*Indonesia*<br>Peru<br>**Thailand**<br>Uruguay | *Kuwait*<br>**Mexico** | Mauritania<br>United Republic of Tanzania |
| | *less than 1 percentage point* | | | *Venezuela* | Bangladesh<br>Colombia<br>Sri Lanka<br>Tunisia | Côte d'Ivoire | Dominican Rep.<br>Honduras<br>Jamaica<br>Nepal | Paraguay | |
| ***GDP growth lower by*** | *less than 1 percentage point* | Guinea-Bissau | *Congo* | Central African Republic<br>China<br>Senegal | India | | Costa Rica<br>Zambia | Malawi | Ghana |
| | *1–3 percentage points* | Burkina Faso | | Pakistan | *Algeria*<br>Cyprus<br>Morocco | **Brazil**<br>Kenya<br>**Turkey** | **Hong Kong (China)**<br>**Republic of Korea**<br>Madagascar | Mauritius<br>Zimbabwe | Gambia[a] |
| | *3–5 percentage points* | | Chad | Togo | | Barbados[a]<br>Egypt<br>Haiti | Sierra Leone | **Taiwan Province of China** | |
| | *more than 5 percentage points* | Cameroon | *Iraq*[a] | | | Botswana<br>Dem. Republic of the Congo<br>Rwanda | Burundi | | |

***Source:*** UNCTAD database; World Bank, *World Development Indicators.*

***Note:*** 14 major oil-exporting countries are specified by italics and the 9 main exporters of manufactures by bold type.

***a*** Change from 1982–1988 to 1989–1995.

**Table 4.3**

## CLASSIFICATION OF DEVELOPING COUNTRIES ACCORDING TO MOVEMENTS OF THE TRADE BALANCE AND GDP IN 1989–1996 COMPARED WITH 1970–1979 [a]

| | | ***Improvement in the trade balance by*** | | | | ***Deterioration in the trade balance by*** | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | *more than 10 per cent of GDP* | *5–10 per cent of GDP* | *2–5 per cent of GDP* | *less than 2 per cent of GDP* | *less than 2 per cent of GDP* | *2–5 per cent of GDP* | *5–10 per cent of GDP* | *more than 10 per cent of GDP* |
| ***GDP growth higher by*** | *more than 5 percentage points* | | | | Chile<br>China | | | | Uganda |
| | *3–5 percentage points* | Papua New Guinea | | | | | Cyprus | Guyana | Ghana<br>*Kuwait* |
| | *1–3 percentage points* | Benin | Chad | | | Argentina<br>Bangladesh<br>India<br>Mauritania<br>Niger<br>Uruguay | **Thailand** | | Jamaica<br>Nepal |
| | *less than 1 percentage point* | Guinea-Bissau<br>Jordan<br>**Singapore** | | | Pakistan | | | **Malaysia**<br>Peru<br>Sri Lanka | El Salvador |
| ***GDP growth lower by*** | *less than 1 percentage point* | | | | Senegal | Guinea<br>Madagascar | Bolivia[b]<br>*Indonesia*<br>*Iran (I.R. of)*[b] | Liberia[b]<br>Zimbabwe | Nicaragua<br>Sudan[b]<br>United Republic of Tanzania |
| | *1–3 percentage points* | Barbados[b]<br>Burkina Faso<br>*Nigeria*<br>*Syrian Arab Rep.* | | Fiji<br>*Venezuela* | Costa Rica | Central African Republic<br>Colombia<br>Tunisia | Honduras<br>Mali<br>Mauritius<br>**Turkey** | Guatemala | Dominican Rep.<br>*Libyan Arab Jamahiriya*[b]<br>Zambia |
| | *3–5 percentage points* | *Trinidad and Tobago* | **Republic of Korea** | **Hong Kong (China)** | **Mexico**<br>Sierra Leone<br>**Taiwan Province of China**<br>Togo | Kenya<br>Malawi<br>Morocco | | Philippines | Paraguay |
| | *more than 5 percentage points* | Botswana<br>*Congo* | *Algeria*<br>Cameroon<br>*Gabon* | **Brazil**<br>Côte d'Ivoire<br>*Ecuador* | | | Dem. Republic of the Congo | Egypt<br>Haiti<br>Rwanda | Burundi<br>Gambia[b]<br>*Iraq*[b]<br>*Saudi Arabia*[b] |

***Source:*** See table 4.2.

***Note:*** See table 4.2.

***a*** Excluding 1974 and 1975, which were exceptional years due to the sharp rise in oil prices.

***b*** Change from 1970–1979 to 1989–1995.

them GDP growth stagnated or declined (table 4.2). The majority of the countries which have experienced worsening trade balances but higher growth rates in the 1990s are in Latin America. Eighteen countries have been able to improve both trade balances and growth rates, and about half of them are major oil exporters.

- Of the countries that were classified as highly-indebted during the 1980s (i.e. the so-called Baker-15 countries), only Nigeria had a significant improvement in both its trade balance and its growth rate in the 1990s.[8] In Argentina the deterioration in the trade balance was moderate despite a rapid acceleration of growth. Other Baker-15 countries with faster growth rates in the 1990s than in the 1980s have had significantly larger trade deficits. Both Brazil and Morocco failed to achieve higher growth, and Brazil was the only country in this group for which growth slowed in the 1990s while the trade balance worsened. During the 1980s growth in Brazil was relatively rapid and was accompanied by a trade surplus, but the subsequent period of slower growth was accompanied by a trade deficit.

- Singapore is the only main exporter of manufactures for which the trade balance improved from the 1980s to the 1990s, while that of Brazil, Hong Kong (China), Malaysia, Mexico, Republic of Korea, Taiwan Province of China, Thailand and Turkey worsened. It is also noteworthy that in all the emerging-market economies which were most affected by the recent bouts of financial crisis (Brazil, Indonesia, Malaysia, Republic of Korea and Thailand) trade balances worsened in the 1990s.

- A comparison of the 1970s with the 1990s (table 4.3) shows that in 34 of the 84 countries growth was lower and the trade deficit was higher in the latter period. In view of the relatively poor economic performance of sub-Saharan Africa over the past three decades, it is not surprising that almost half of the 34 countries are in that region. However, the group also includes four of the biggest developing countries (Colombia, Egypt, Philippines and Turkey). In 41 countries, growth rates and trade performance moved in opposite directions, with 23 countries experiencing slower growth and improved trade balances and 18 faster growth and a worsening of the trade balance. Only nine countries managed to achieve improvements in both growth and trade performance. China, together with Chile, stands out in this latter group in combining an impressive acceleration of growth with an improvement in the trade balance.

- Of the Baker-15 countries only Chile, Argentina and Uruguay achieved higher growth rates in the 1990s than in the 1970s, associated in the latter two countries with worsening trade balances. The others had slower growth in the 1990s, which in four instances (Bolivia, Colombia, Morocco and Philippines) was associated with larger trade deficits.

## C. Factors influencing trade performance

The evidence presented above shows that, with some notable exceptions, the relationship between trade balances and economic growth in developing countries has taken an unfavourable turn during the past decade. In many countries the trend has been one of widening trade deficits, with stagnant or even falling growth rates. Such countries include exporters not only of oil and non-oil commodities, but also of manufactures. Where trade balances have improved, there has generally been a slowdown in imports and economic growth. Among the countries which have managed to raise their growth rates in the 1990s, the majority have seen a deterioration in their trade

balances, financed by large inflows of private capital; in some such cases the deficits and capital inflows could not be sustained, eventually giving rise to payments crises, economic contraction and a sharp turnaround in trade balances. Only a few countries appear to have been able to buck this general trend by combining faster growth with an improved trade performance.

A full analysis of the factors influencing the trade and growth performance of developing countries is beyond the scope of this report. Here attention is focused on two factors which are believed to have played a significant role in the worsening of the relationship between trade balances and economic growth in the majority of developing countries over the past two decades: declining terms of trade, with a consequential reduced purchasing power of exports (partly influenced by economic slowdown in industrial countries); and rapid trade and financial liberalization in developing countries.[9]

**Table 4.4**

**EXPORT VOLUME, PURCHASING POWER OF EXPORTS AND TERMS OF TRADE OF DEVELOPING COUNTRIES, 1982–1996**

*(Average annual percentage change)*

| | *1982–1988* | *1989–1996* |
|---|---|---|
| All developing countries | | |
| Export volume | 4.7 | 8.2 |
| Terms of trade | -5.4 | 0.2 |
| Purchasing power of exports | -1.4 | 8.3 |
| Non-oil exporters | | |
| Export volume | 8.6 | 11.6 |
| Terms of trade | -1.3 | -1.5 |
| Purchasing power of exports | 7.2 | 9.9 |

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

## 1. Terms-of-trade losses

Adverse movements in the terms of trade are one of the main reasons for the rising trend in trade deficits relative to growth rates in developing countries since the early 1980s. When the terms of trade decline, a larger volume of exports is necessary to finance a given volume of imports, and the same volumes of imports and exports, and hence of real transfer, will result in a larger trade deficit. According to the two-gap model, this also means that, *ceteris paribus*, a given growth rate will be associated with higher trade deficits.

Developing countries as a whole (i.e. including oil exporters and China) experienced a sharp decline in their terms of trade from 1982 to 1988, by more than 5 per cent per annum (table 4.4). Consequently, although their export volumes rose nearly as much, the purchasing power of those exports actually fell by over 1 per cent per annum, implying a considerable drop in real resource transfers without a commensurate decline in trade deficits. With an average share of trade in GDP of more than 20 per cent, these terms-of-trade losses translate into an income loss of no less than 1 per cent a year.

In the subsequent period (1989–1996), the terms of trade stabilized, and hence the volume and purchasing power of their exports rose broadly in parallel. The stabilization was largely due to a recovery in commodity prices (including oil) towards the middle of the 1990s. However, recovery was short-lived, and the trend was sharply reversed with the outbreak of the East Asian crisis. Oil and non-oil primary commodity prices declined by 16.4 per cent and 33.8 per cent, respectively, from the end of 1996 to February 1999, resulting in a cumulative terms-of-trade loss of more than 4.5 per cent of income during 1997–1998 for developing countries (see chapter II).

If oil-exporting countries are excluded from the totals discussed in the two preceding paragraphs, the terms-of-trade changes are less abrupt; there is a steady downward trend since the early 1980s, averaging 1.3 per cent in the first period and 1.5 per cent in the second. Consequently, the growth of the purchasing power of exports has constantly been below that of export volumes. Income losses were greater in the 1990s than in the 1980s not only because of larger terms-of-trade losses, but also because of the increased share of trade in GDP.

Economies with a relatively narrow export structure are more vulnerable to terms-of-trade

shocks than those where exports are more diversified. Many developing countries, particularly in SSA, continue to be heavily dependent on a narrow range of primary commodities for their export earnings. There is strong evidence to suggest that the decline in commodity prices since the early 1980s has been mostly of a secular nature, and that it is attributable only to a small extent to reversible cyclical forces. It also shows that short-term volatility in commodity prices has increased considerably since the early 1970s.[10]

The sharp downward trend in commodity prices reflected a decline in the world demand for commodities that coincided with a continued expansion in world supply. While a slowing of growth in industrial countries played a major role on the demand side, another important factor was continuing technological change and innovation, which reduced the use of natural materials in industrial countries in favour of synthetics and lighter materials and also reduced wastage. The increase in world supply involved both developed and developing countries and took place at a faster rate than previously. In the mineral and metals industries, for example, new capacity came on stream as a result of the investment undertaken during the period of relatively favourable prices of the late 1970s. In developed countries support policies generated huge domestic surpluses and stocks, leading to intense price competition in export markets. In most developing countries, the expansion of commodity exports was driven primarily by the severe foreign-exchange squeeze resulting from the fall of commodity prices themselves and the debt crisis.[11] Despite these adverse trends in world commodity markets, stabilization and adjustment policies continued to promote exports of traditional products, adding to world surpluses and leading to fallacy of composition.[12]

Clearly, under these circumstances commodity-exporting countries will face difficulties in securing sufficient export earnings to finance the imports required to step up growth. It obviously also follows that developing countries need to diversify their exports, raising the share of manufactures in the total. However, even those developing countries for which manufactures have been the main source of export earnings have faced terms-of-trade losses. Indeed, since the beginning of the 1980s, the terms of trade of such countries have fallen on average by over 1 per cent per annum.[13] Furthermore, the barter terms of trade of manufacturing exports of developing countries with the European Union declined by an annual rate of 2.2 per cent from 1979 to 1994.[14]

A possible explanation of this apparent paradox lies in the technology content of these manufactures. While a few developing countries have come to export a wide variety of products, most have concentrated on labour-intensive or natural-resource-based products, including low-technology inputs to the electronics industry. There is growing concern that such low-technology manufactures are beginning to acquire the features of primary commodities in world markets, facing a secular downward trend as well as the dilemma of fallacy of composition. In this respect, the emergence as major producers of low-wage countries such as China appears to have contributed to the decline in the terms of trade of developing countries' manufactured exports since the mid-1980s.[15]

The varying incidence of this phenomenon on developing countries shows how important it is, in pursuing policies of export diversification, to promote industries that have a scientific and technological content. The decline in the manufacturing terms of trade of developing countries vis-à-vis EU was found to be largest for the least developed countries and smallest for the East Asian NIEs, i.e. the two groups of developing countries which are farthest apart with respect to their general level of scientific and technological development. The adverse price movements vary by product category, with significant declines for resource-based and labour-intensive exports but little evidence of a strong downward trend for more skill- and technology-intensive goods.[16]

Various studies confirm a significant relationship between a country's general level of scientific and technological development and the medium-term trend in its manufacturing terms of trade, but the recent experience of the Republic of Korea also shows that a developing economy can be highly vulnerable to changes in the terms of trade even when exports are concentrated on high-tech products.[17] The studies suggest that, on the eve of the Asian crisis, Singapore, Taiwan Province of China and the Republic of Korea were the only developing economies which had consistently been on a technology-intensive growth trajectory, protecting their manufactured exports from the vagaries of price competition and hence from terms-of-trade losses. They found that there was no significant trend in Korean manufacturing

terms of trade with developed countries. Even though the unit values of products comprising the Republic's exports to those countries did not rise as fast as the unit values of products imported from them, the composition of its manufactured exports was found to be shifting towards products with above-average increases in unit value. Moreover, its manufacturing terms of trade improved significantly vis-à-vis other developing countries, suggesting that the Republic of Korea was shifting into higher-technology manufactures faster than other developing countries.

The pursuit of such a strategy could not, however, prevent large terms-of-trade losses. While the country had increasingly moved into a relatively high-technology niche market of the electronics sector (i.e. dynamic random-access memories), price competition in the sector became fierce during the 1990s.[18] Thus, by the mid-1990s, manufactured exports were also facing declining terms of trade, at a rate similar to that of most other developing countries; from 1995 to 1997 the decline amounted to by 25 per cent (see chapter II). As discussed in *TDR 1998*, this was largely the result of a glut in world markets generated by excessive investment that was facilitated by the availability of relatively low-cost foreign financing, in a sector where supply expansion is typically associated with sharp declines in prices.

## 2. Liberalization and trade performance

Since the mid-1980s there has been widespread and rapid trade liberalization in developing countries, undertaken principally not in the context of multilateral trade negotiations but rather in that of conditionality attached to structural adjustment and stabilization programmes. The liberalization has often been of a "big bang" type, adopted unilaterally in large part as a response to the failure to establish competitive industries behind high barriers. There has consequently been an asymmetry in the pace of trade liberalization between developing and developed countries; starting generally from lower rates of protection, the commitments of the latter countries, as well as their implementation, have been much more gradual and cautious than in the "big bang" approach adopted by many developing countries. Only a few countries in East Asia followed a selective and gradual approach to trade liberalization, tailoring the process of integration to the level of economic development and the capacity of existing institutions and industries.

The economic rationale for trade policy reform has been debated extensively among academics and policy makers. It is commonly based on the view that liberalization would lead to more efficient resource use and allocation through, inter alia, the exposure of the domestic economy to world market disciplines and better access to state-of-the-art technologies. Thus, the move towards a more open economy was expected to enhance the medium-term growth prospects of developing countries. A large body of empirical evidence has been produced to show that countries with more open trade regimes grew faster than those that were more inward-oriented.

As discussed in past reports, these views, as well as the empirical evidence on the relation between openness and growth, have been challenged on both theoretical and methodological grounds.[19] Moreover, it has been recognized that trade liberalization does not come without economic and social costs, which can be large for some groups and individuals (e.g. workers in import-competing industries).[20] It has also been agreed that rapid liberalization of imports can cause payments difficulties as well as dislocations in the economy, unless it is appropriately sequenced or combined with effective measures designed to enhance competitiveness and to promote exports.

Balance-of-payments constraints have always had a decisive influence on the design of trade policies in developing countries. Interventionist trade regimes with high rates of protection, export subsidies and foreign-exchange controls had been set up as a response to chronic current-account deficits with a view to preserving macroeconomic stability and growth. Before the widespread adoption of more liberal trade policies, developing countries routinely tightened their trade regimes when experiencing balance-of-payments difficulties.[21] Such concerns were also reflected in GATT rules allowing member countries to have recourse to temporary restrictions on trade in goods and services.

Similarly, before the 1980s developing countries tended to relax controls over imports mostly in periods of trade surplus. However, recent reforms, particularly in Latin America and Africa, have diverged radically from this pattern. Indeed in most cases "big bang" trade liberalization has

taken place during external payments difficulties, and been maintained despite mounting trade deficits. It is generally recognized that such a sudden shift of policy adds to payments difficulties, at least temporarily. On this view, rapid liberalization introduced after a long period of import compression often leads to a surge in demand for foreign goods. Even though import growth tends to level off subsequently, trade deficits can mount initially, since there is usually a lagged export response.

To prevent increased payments difficulties, it is sometimes recommended that import liberalization should be accompanied by macroeconomic tightening. However, this would not necessarily promote a rapid export response either through switching production to foreign markets or, more fundamentally, through increased investment in tradeable sectors. A more effective way could be to combine liberalization with currency devaluation. Such a one-off adjustment should be followed by appropriate management of the exchange rate so as not to allow the erosion of the effects of devaluation of over time.

Indeed, this was the conventional approach to trade liberalization until recent years, studied extensively in both theoretical and empirical literature.[22] Such a policy mix would be particularly effective in countries with significant manufacturing export potential and sufficient capacity to replace imports by domestic production. It was recognized that in countries dependent on primary commodities devaluations might be less effective in offsetting the impact of trade liberalization on the trade balance. Again, they could simply result in terms-of-trade losses or lead to an inflationary price spiral. Despite these complications, however, it was generally agreed that real-exchange-rate adjustment should be an integral part of rapid import liberalization in developing economies.

More generally, it has been recognized that appropriate management of exchange rates holds the key to success under open trade regimes:

> The historical record shows also that the management of the exchange rate is considerably more important than import policy for successful exporting and for sustained growth generally. All countries that have succeeded in generating a sustained growth of their exports, leading to high rates of growth of output over the long term, have also been able to maintain exchange rates that are attractive to exporters over long periods of time. The exchange rate in such countries has also tended to be fairly stable, enabling producers of tradeables to make long-term investment plans.[23]

However, the practice in developing countries during the past decade has often departed from such fundamental principles. When tariff reductions were accompanied by devaluations, exchange-rate misalignments often quickly re-emerged due to macroeconomic imbalances and price instability. More importantly, capital-account liberalization and associated financial inflows were counted upon as a means of avoiding hard policy options. In a number of countries experiencing chronic price instability, notably in Latin America, trade and capital-account liberalization provided a new populist policy mix whereby price stability could be achieved without running into serious distributional conflicts. Whereas previously the successful management of exchange rates depended on the maintenance of price stability, the new stabilization programmes put the cart before the horse: the exchange rate was used as an instrument for attaining price stability, at the cost of delinking it from the exigencies of trade and competitiveness.[24] On the other hand, some East Asian countries which had successfully managed exchange rates throughout their post-war industrialization succumbed to the temptation of using nominal exchange-rate stability as a way of attracting international arbitrage flows.[25] Even in some poorer developing countries which are typically left out of the international financial circle, capital movements have come to exert a greater influence on exchange rates than have trade flows.[26] Thus, while the influence of the exchange rate on investment decisions has increased as a result of greater openness and the growing importance of foreign trade in most countries, the exchange rate has been increasingly left to the vagaries of short-term capital movements delinked from trade and investment. In many countries, the combination of rapid trade liberalization, opening up of the capital account and mismanagement of the exchange rate has produced large trade imbalances without generating rapid and sustainable growth.

The evidence presented in table 4.5 strongly supports these considerations, and is consistent with the evidence on the overall behaviour of exports, imports and trade deficits of developing countries examined in section B above. The table provides information on the behaviour of exports,

**Table 4.5**

**GROWTH OF IMPORTS AND EXPORTS AND MOVEMENTS OF THE REAL EXCHANGE RATE AFTER TRADE LIBERALIZATION IN SELECTED DEVELOPING COUNTRIES**

| Country | Year of trade liberalization | First two years after trade liberalization (Period I) | | | Subsequent 10 years[a] (Period II) | | |
|---|---|---|---|---|---|---|---|
| | | Growth[b] of | | Real exchange rate[c] | Growth[b] of | | Real exchange rate[c] |
| | | exports | imports | | exports | imports | |
| ***Latin America*** | | | | | | | |
| Argentina | 1991 | 2 | 65 | 87 | 22 | 13 | 76 |
| Brazil | 1990 | 2 | 5 | 110 | 8 | 33 | 104 |
| Chile | 1976 | 17 | 31 | 98 | 9 | 4 | 119 |
| Colombia | 1991 | 2 | 24 | 93 [d] | 14 | 12 | 75 [d] |
| Mexico | 1986 | 6 | 18 | 93 | 15 | 16 | 64 |
| ***Asia*** | | | | | | | |
| Indonesia | 1986 | 2 | 9 | .. | 13 | 16 | .. |
| Malaysia | 1988 | 18 | 32 | 103 [d] | 18 | 18 | 104 [d] |
| Philippines | 1986 | 15 | 18 | 107 [d] | 15 | 19 | 98 [d] |
| Thailand | 1986 | 31 | 32 | 98 | 17 | 19 | 86 |
| Turkey | 1989 | 5 | 15 | 85 | 11 | 18 | 82 |
| ***Africa*** | | | | | | | |
| Ghana | 1985 | 22 | 18 | 141 [d] | 12 | 21 | 247 [d] |
| Kenya | 1993 | 12 | 21 | 82 | .. | .. | 72 |
| Morocco | 1984 | 7 | 2 | 157 [d] | 7 | 9 | 119 [d] |
| Tunisia | 1989 | 16 | 13 | 103 [d] | 9 | 9 | 100 [d] |
| Uganda | 1988 | -21 | -25 | 136 [d] | 35 | 39 | 242 [d] |

***Source:*** UNCTAD database; IMF, *International Financial Statistics*, CD-Rom.

***a*** Subsequent (under 10) years until 1996, where liberalization was after 1986.

***b*** Annual average growth of value in per cent.

***c*** Index of average real exchange rate with the dollar, unless otherwise indicated (year of trade liberalization = 100); an increase in the index indicates a depreciation of the currency.

***d*** Real effective exchange rate.

imports and real exchange rates in 15 developing countries, five each from Latin America, Asia and Africa, during the period following trade liberalization in these countries.[27] In most of these countries trade liberalization was implemented after the mid-1980s. Many also opened their capital accounts soon thereafter.[28] In the table a distinction is made between the behaviour of exports and imports in the immediate aftermath of trade liberalization (that is, within the first two years – period I) and during subsequent years (period II).

In the first two years of trade liberalization, imports grew faster than exports in all countries except three of the African ones (Ghana, Morocco and Tunisia), where it should be noted that the real exchange rate depreciated during the same period. However, for Brazil, Malaysia and Philippines depreciations did not always succeed in pushing exports ahead of imports, confirming that they cannot always offset the adverse impact of trade liberalization on the trade balance. In all other cases trade liberalization was associated with real appreciations, thereby adding to import surges

generated by tariff cuts, especially in Argentina, Kenya, Mexico and Turkey.

After the initial phase export growth accelerated only in half of the 15 countries. In some (such as Argentina and Colombia) it was accompanied by slower import growth, whereas in others (such as Indonesia, Mexico and Turkey) imports were sustained and continued to grow faster than exports. In only five countries did the export growth match (as in Malaysia and Tunisia) or exceed (as in Argentina, Chile and Colombia) import growth during period II. However, even then the trade deficit did not always narrow either because the pre-liberalization deficit was large, the initial surge in imports was too strong, or the subsequent growth rates of imports and exports were similar.

Real exchange rates remained overvalued after the initial two-year phase compared to the time of trade liberalization in all the Latin American and Asian countries in table 4.5 except Brazil, Chile and Malaysia, but in Brazil the currency started to appreciate during period II as a result of the exchange-based stabilization programme adopted in 1994; together with a further relaxation of import controls, the appreciation contributed to a rapid expansion of imports until 1999, when the currency peg was abandoned (see chapter III). In Chile, the real exchange rate depreciated sharply in the course of period II (in the early 1980s), as the Southern Cone experiment with financial liberalization ended in crisis.[29] Of the other countries shown in the table, in Mexico the peso continued to appreciate in period II until the crisis of 1994–1995, and real appreciation continued also in Colombia, Kenya, Thailand and Turkey, ending up in Thailand with a collapse of the currency and financial crisis in 1997. Turkey experienced a similar currency crisis in 1994 when it attempted to use the exchange rate as an anchor to bring down inflation and encourage capital inflows. Malaysia was able to maintain a relatively stable real exchange rate over the eight years (periods I and II) since liberalization in 1988, but that proved no protection from currency turmoil in 1997. Thus, in most cases rapid liberalization was followed by a combination of large inflows of capital, currency appreciations and mounting trade deficits, but often ended with a crisis involving a reversal of capital inflows, collapse and overshooting of exchange rates, sharp cuts in imports and a strong economic contraction.

It should be noted that the exchange-rate instability and currency misalignments that have characterized recent experience resulted from a new policy approach that was originally intended to overcome the problems of persistent currency overvaluations and chronic payments deficits that pervaded developing countries in the 1970s and early 1980s. Before the shift to more liberal trade and currency regimes, developing countries had indeed, with some notable exceptions, allowed considerable appreciation of their real exchange rates and had resorted to devaluation only when payments imbalances could no longer be sustained; that is to say, nominal exchange rates were kept unchanged for prolonged periods but were then followed by large devaluations. An examination of exchange rates in 58 developing countries for which comparable data are available shows that eight of them resorted to sharp real devaluations (of 25 per cent or more) in the 1970s but as many as 24 in the 1980s. Most of these countries were in Africa and Latin America. From 1990 until 1997, 19 of the countries experienced comparable declines in their exchange rates, often brought about by financial market pressures and almost invariably coming after years of persistent appreciations. If the years of subsequent currency turmoil in emerging markets in Asia, Europe and Latin America are also taken into account, the number of countries involved is as high as in the previous decade. In other words, despite widespread pursuit of open trade regimes, there has been hardly any improvement in exchange-rate management in developing countries. Indeed, with a few notable exceptions (such as China and India), even those countries which traditionally followed prudent exchange-rate policies have joined the ranks of the others, where currency misalignments and instability have been serious impediments to sustained expansion of investment, output and exports.

## 3. Growth and deficits: empirical estimates and alternative scenarios

The analysis above suggests that declines in the terms of trade, losses of purchasing power of exports, and "big bang" liberalization of trade and of capital accounts have contributed to the worsening of trade balances of developing countries over the past decade. Slow growth in industrial countries has been an important factor in the movement of terms of trade against developing countries, but technological and supply-side factors have also played a role.

In order to further explore these relationships, an econometric equation has been estimated for 16 countries which account for about 60 per cent of total GDP of developing countries (excluding China) and 70 per cent of their capital inflows, with a view to quantifying the effects of these factors on trade balances. The results, given in the annex to this chapter, point to the following main conclusions:

- The growth rate in industrial countries is a major determinant of trade balances in developing countries. Consequently, the slowdown in the North has widened trade deficits in the South. The slowdown during the past two decades compared to the 1970s may have increased trade deficits of developing countries by almost 1 per cent of GDP.

- Trade liberalization has worsened the inverse relation between the growth rate and trade balances in developing countries. It has also diminished the positive impact of increases in the purchasing power of their exports on trade balances, suggesting that liberalization raises the propensity to import.

- By contrast, trade liberalization has strengthened the impact of growth in industrial countries on trade balances in developing countries. This is a natural consequence of deeper integration, resulting from increased outward orientation of developing economies, but it is also valid for countries which are not closely integrated into the world economy, but are export-oriented (such as China today or the East Asian NIEs until the past decade).

The results thus indicate that rapid liberalization has increased the import content of growth in developing countries and also that their growth prospects are greatly influenced by the pace of economic activity in industrial countries. However, while faster growth in the North may help alleviate payments constraints, it may not suffice to achieve rapid growth in developing countries under current trade and exchange-rate regimes.

Table 4.6 describes three scenarios designed to predict the current-account deficits that could result from a sustained growth rate of 6 per cent per annum in the 16 developing countries studied in the annex to this chapter, under different assumptions with respect to the growth of purchasing power of their exports (i.e. the income terms of trade) and the growth of income in industrial countries.[30] Under each scenario the adverse impact of liberalization on the current account (shown in the last row of the table[31]) is seen to be lower, the higher the growth rate in industrial countries, in accordance with the conclusions noted above.

An assumption of 6 per cent growth has been made because it is widely believed to be the rate needed if developing countries are to overcome their social and technological handicaps and narrow the income gap with the developed countries. It is roughly equal to the average growth achieved by the developing countries of Asia (excluding oil exporters and China) during 1989–1996, almost twice that of non-oil Latin America, and substantially higher than that of Africa (chart 4.2). Of the three growth rates assumed for industrial countries, 2 per cent is slightly above that attained during the past decade, 2.5 per cent is around what is often considered as their potential growth rate, while 3.5 per cent is close to the rate achieved in the United States during its current upswing. Under each scenario there is also an assumption about the growth of purchasing power of exports of developing countries. In the first scenario, it is assumed that the growth is faster than the rate achieved in 1989–1996 by the countries included in the table (which was some 4.5 per cent per annum), but slower than the 9.9 per cent achieved by developing countries as a whole (see table 4.4).

The group of developing countries studied here grew on average by 3.3 per cent per annum during 1989–1996, running a current-account deficit of 2.5 per cent of GDP. The estimates in table 4.6 show that raising their growth rate to 6 per cent could result in a considerable increase in their current-account deficits even under optimistic assumptions. Under scenario 1, where the assumed growth of purchasing power of exports of developing countries and of income in industrial countries are close to recent trends, a 6 per cent growth seems almost an impossible task, even allowing for possible errors of estimation; it would entail a sharp increase in their current-account deficits, necessitating much greater inflows of foreign capital than they have actually been receiving. The deficit narrows very little even on the assumption in scenario 2 of somewhat higher growth in industrial countries, to reach its potential level.

By contrast, a 3.5 per cent growth rate in industrial countries, together with a faster growth

**Table 4.6**

**CURRENT-ACCOUNT DEFICITS ASSOCIATED WITH A 6 PER CENT GDP GROWTH IN 16 DEVELOPING COUNTRIES UNDER DIFFERENT ASSUMPTIONS**

*(Per cent)*

| | *Scenario 1* | *Scenario 2* | *Scenario 3* |
|---|---|---|---|
| Assumptions[a]: | | | |
| GDP in developed countries | 2.0 | 2.5 | 3.5 |
| Purchasing power of exports of developing countries | 6.0 | 8.0 | 12.0 |
| Projections[b]: | | | |
| Current-account balance of developing countries | -4.3 | -3.9 | -3.1 |
| Impact of liberalization in developing countries | -1.1 | -0.8 | -0.4 |

***Source:*** UNCTAD secretariat calculations.

***Note:*** The 16 countries are Argentina, Brazil, Chile, Colombia, Ghana, Indonesia, Kenya, Malaysia, Mexico, Morocco, Philippines, Republic of Korea, Thailand, Tunisia, Uganda and Venezuela. For further explanations see text and the annex to this chapter.

***a*** Annual percentage increase.

***b*** Percentage of GDP.

of purchasing power of exports of developing countries (scenario 3), could significantly reduce the current-account deficits in terms of GDP. However, at 3.1 per cent the deficit could still be well above the level of recent years and, as discussed in the next chapter, it is unlikely that it could be financed by international capital markets. Moreover, while a 3.5 per cent growth may be attainable in some major industrial countries or regions with surplus labour, such as the European Union, it may be difficult to achieve in others. As discussed in chapter VI, a number of policy options are available to reduce the current-account deficits of developing countries without sacrificing growth. They include export promotion and a reduction of the import content of growth through a reorientation of their financial, trade and industrial policies and increased access to northern markets in labour-intensive and resource-based products. ■

## Notes

1 One of the pioneering studies based on the two-gap approach was done by UNCTAD. See *Trade Prospects and Capital Needs of Developing Countries*, New York, United Nations, 1968; see also Marris R, Can we measure the need for development assistance?, *The Economic Journal*, vol. 80, Sept. 1970: 650–667.

2 See *TDR 1996*, Part Two, chap. II. For a brief discussion of sub-Saharan Africa in this context see *TDR 1998*, Part Two, chap. IV, sect. C.

3 Comprehensive current-account data for developing countries for the 1970s are available only from IMF's *World Economic Outlook* database. Chart 4.1 is based on IMF data, which no longer include Hong Kong (China), Republic of Korea, Singapore and Taiwan Province of China among developing countries.

4 The evolution of the current account of non-oil developing countries during the past three decades has been dominated by movements of their trade and

factor income accounts, while their balances on services and current transfers have not been subject to important changes. The ratio to GDP of the services account has been between 0 and -0.5 per cent, while for current transfers it has been 1.5–2.0 per cent. If oil exporters are included, the average services/GDP ratio fluctuates between -0.8 and -3.0 per cent and the ratio for current transfers between zero and 0.8 per cent. For detailed evidence see table 31 of the Statistical Appendix of each issue of IMF, *World Economic Outlook*.

5 In the 1980s the trade balance showed, on average, a surplus of 1.6 per cent of GDP, while the current account was in deficit by 1.7 per cent. In the 1990s the trade surplus disappeared, while the current-account deficit rose to an average of 2.1 per cent of GDP.

6 To eliminate the one-off effects of oil price shocks, the years 1974–1975 are not included in the averages of the first sub-period, while the second subperiod starts in 1982.

7 For a discussion of import compression in sub-Saharan Africa during the 1980s see *TDR 1993*, Part Two, chap. II; see also *TDR 1988*, Part One, chap. IV, sect. C.5, which also contains a discussion of import compression in the highly-indebted countries (mainly in Latin America).

8 The Baker-15 countries comprise Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia. All except Yugoslavia are among the 84 countries included in tables 4.2 and 4.3.

9 An econometric analysis of the effects of these factors is provided in the annex to this chapter.

10 See Reinhart CM and Wickham P, Commodity prices: Cyclical weakness or secular decline?, *IMF Staff Papers*, 1994, 41 (2). For a detailed discussion of these trends see Maizels A, *Commodities in Crisis*, Oxford, Clarendon Press, 1992, WIDER Studies in Development Economics.

11 See also Gilbert CL, The impact of exchange rates and developing country debt on commodity prices, *The Economic Journal*, 1989, vol. 99, Sept.

12 Fallacy of composition is a situation where simultaneous expansion of export volumes by a number of producers results in lower export prices and export revenues for each of them. For a discussion of this problem see *TDR 1993*: 100–101. The group of commodities for which this problem has been documented includes bananas, cocoa, coffee, cotton, tea and tobacco. See Akiyama T and Larson DF, The adding-up problem: Strategies for primary commodity exports in sub-Saharan Africa, Policy Research Working Paper no. 1245, Washington, DC, The World Bank, 1994.

13 UNCTAD, *Handbook of International Trade and Development Statistics 1996–1997*, United Nations publication, sales no. E/F.98.II.D.16, New York and Geneva, 1999, table 2.5. The developing countries classified as major exporters of manufactures are Brazil, Hong Kong (China), Malaysia, Mexico, Republic of Korea, Singapore, Taiwan Province of China, Thailand, Turkey and former Yugoslavia.

14 *TDR 1996*, table 39. See also Maizels A, Palaskas TB and Crowe T, The Prebisch-Singer hypothesis revisited, in Sapsford D and Chen JR, eds., *Development Economics and Policy: Essays in Honour of Sir Hans Singer*, London, Macmillan, 1998.

15 Wood A, Openness and wage inequality in developing countries: The Latin American challenge to East Asian conventional wisdom, *The World Bank Economic Review*, 1997, 11(1).

16 Maizels A et al., op. cit.

17 See Kaplinsky R, If you want to get somewhere else, you must run at least twice as fast as that!: The roots of the East Asian crisis, Institute of Development Studies, Brighton, mimeo, June 1998; Berge K and Crowe T, The terms of trade facing South Korea with respect to its trade with LDCs and DMEs, Working Paper no. 12, Queen Elizabeth House, University of Oxford, August 1997.

18 See Kaplinsky R, op. cit.

19 One of the criticisms directed at this literature is the dependence of the empirical findings on a debatable classification of East Asian economies as "open" (see *TDR 1997*). For a critical assessment of the empirical evidence see also Rodriguez F and Rodrik D, Trade policy and economic growth: A skeptic's guide to the cross-national evidence, National Bureau of Economic Research, Working Paper no. 7081, Cambridge, MA, April 1999; and Mosley P, Globalization, economic policy and growth performance, in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. X, United Nations publication, sales no. E.99.II.D.14, New York and Geneva, 1999.

20 See e.g. Rodrik D, *Has Liberalization Gone too Far*?, Washington, DC, Institute for International Economics, 1997; and Wood A, Globalization and the rise in labour market inequalities, *The Economic Journal*, vol. 108, Sept. 1998.

21 For a discussion see, for example, Little IMD, Cooper RN, Corden WM and Rajapatirana S, *Boom, Crisis, and Adjustment. The Macroeconomic Experience of Developing Countries*, New York, Oxford University Press for the World Bank, 1993.

22 See Dornbusch R, Policies to move from stabilization to growth, *Proceedings of the World Bank Annual Conference on Development Economics 1990*, Washington, DC, The World Bank, 1991; and Edwards S, *Real Exchange Rates, Devaluation and Adjustment*, Cambridge, MA, MIT Press, 1989.

23 Agosin M and Tussie D, An Overview, in Agosin M and Tussie D, eds., *Trade and Growth. New Dilemmas in Trade Policy*, London, Macmillan, and New York, St. Martin's Press, 1993: 22.

24 For exchange-rate-based disinflation experiences in Latin America see, for example, Amadeo EJ, The knife-edge of exchange-rate-based stabilization: Impact on growth, employment and wages, *UNCTAD Review, 1996*, United Nations publication, sales no.

E.97.II.D.2, New York and Geneva, 1996. For a recent general discussion of these issues see Calvo GA and Vegh CA, Inflation, stabilization and balance-of-payments crises in developing countries, Working Paper 6925, National Bureau of Economic Research, Cambridge, MA, Feb. 1999.

25 For a discussion of the role of nominal exchange-rate stability in the East Asian crisis see *TDR 1998*, Part One, chap. III.

26 For the African experience see Kasekende L, Kitabire D and Martin M, Capital inflows and macroeconomic policy in sub-Saharan Africa, in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. VIII, United Nations publication, sales no. E.97.II.D.5, New York and Geneva, 1997.

27 The classification is based on data from three studies: Little IMD, Cooper RN, Corden WM and Rajapatirana S, op. cit.; Rajapatirana S, Trade policies, macroeconomic adjustment and manufactured exports: The Latin American experience, *Weltwirtschaftliches Archiv*, 132(3), Sept. 1996; and Sachs J and Warner A, Economic reform and the process of global integration, *Brookings Papers on Economic Activity*, 1995, 1: 1–118. See also Dean JM, Desai S and Riedel J, Trade policy reform in developing countries since 1985: A review of the evidence, Discussion Paper 267, The World Bank, Washington, DC, Dec. 1994.

28 See Williamson J and Mahar M, *A Survey of Financial Liberalization*, Essays in International Finance, no. 211, Department of Economics, Princeton University, Princeton, New Jersey, 1998: 12–25. The authors classify 10 of the 15 countries in table 4.5 (the exceptions being Brazil, Ghana, Kenya, Tunisia and Uganda) as having "largely liberalized financial sectors", i.e. convertible capital accounts.

29 See *TDR 1998*, Part One, annex to chap. III.

30 The current-account deficits in table 4.6 have been estimated using trade data for individual countries from the UNCTAD database and payments data of IMF. Comprehensive IMF data by country are available only from the mid-1980s, although for group aggregates they go back earlier. UNCTAD country trade data go back to 1950. They differ from the IMF data in coverage, valuation, timing, inland freight, etc. Since the model in the annex to this chapter is estimated on the basis of data for 1970–1995, the use of trade deficit estimates to make current-account predictions consistent with the IMF current-account data requires UNCTAD data to be adjusted. This has been done by applying the ratio between UNCTAD and IMF data for 1995 for the sample of countries in the annex to the estimated trade deficits from equation (2A). The ratio of the difference between current-account and trade deficits to GDP as given by IMF for this group of countries is added to this adjusted trade deficits figure to arrive at the current-account balance as a percentage of GDP (reported in table 4.6). Owing to possible errors in combining the two sets of data, the results in table 4.6 should be interpreted with caution, particularly as regards the absolute values of current-account balance/GDP ratios; comparisons between different scenarios are expected to be less susceptible to such errors.

31 These figures are obtained by comparing the estimates of current-account deficits with and without liberalization. The calculation of the latter is based on a re-estimation, without the interaction terms, of equation (2A) in the annex to this chapter, rather than by setting these terms to zero in the estimations made with these terms.

Chapter V

# CAPITAL FLOWS TO DEVELOPING COUNTRIES

## A. Introduction

The size, composition and geographical distribution of external capital flows to developing countries[1] have undergone fundamental shifts during the past three decades. Until the early 1970s the most important sources of external financing for developing countries were official loans and aid, the provision of which was based on the recognition that developing countries suffered from resource gaps resulting from their low levels of income and savings and that their ability to fill these gaps through commercial borrowing at market terms was severely limited. Official development assistance (ODA) continued to expand rapidly in the 1970s thanks, in part, to cold war politics. Simultaneously, however, there was also a rapid expansion of private financial flows, primarily in the form of syndicated credits from banks in industrial countries, which served to recycle the surpluses of major oil exporters. This expansion was greatly facilitated by the liberalization of capital markets following the demise of the Bretton Woods system.

The expansion came to an end with the debt crisis of the 1980s, when total net capital inflows of developing countries fell sharply because of a cutback in commercial bank lending, and stagnated at this level during the rest of the decade. Official financing also stagnated, while its terms and conditions became more stringent, reflecting the policy of the major creditor countries and the multilateral financial institutions of emphasizing private financing for development.

The 1990s have indeed witnessed a rapid expansion of private capital inflows, while official financing, notably ODA, declined. The surge in private inflows was greatly influenced by rapid liberalization of markets and privatization of economic activity in most developing countries. In contrast to earlier decades, the private sector has become the principal borrower in international markets as most developing countries relaxed control over such borrowing.[2] An important proportion of private inflows, however, has taken the form of so-called non-debt creating inflows, notably FDI.

It is important to bear in mind that net capital flows result from the transactions not only of non-residents but also of residents of a country (see box 5.1). As a result of the liberalization of capital transactions and markets, outward movements of capital by residents have gained increasing importance in determining a country's net capital flow. A closer examination of the recent trends, bearing in mind these considerations and distinguishing among various sources and types of capital flows, draws a less favourable picture:

- The growth of private capital inflows in the 1990s represents, to a large extent, a recovery from the depressed levels of the 1980s rather than a break with past trends. Compared to the period prior to the debt crisis of the 1980s, there was no increase in net capital inflows in terms of their share of recipient

**Box 5.1**

**DEFINITION OF DIFFERENT TYPES OF CAPITAL FLOWS**

There is ambiguity in terminology for the different kinds of international capital flows. The same terms used by different institutions or writers often cover different categories of capital transactions, while the same categories are sometimes referred to in different terms. The definitions used throughout this Report are as follows:

***Capital inflow***: This term refers to the acquisition of *domestic assets* by *non-residents* (plus grants). Sales of domestic assets are defined as a negative capital inflow. Thus the term *net* capital inflow denotes acquisitions minus sales of domestic assets by non-residents. The types of asset included in these flows vary according to the institution publishing the data. The term *net resource flows* used by the World Bank in its *Global Development Finance*, for example, refers to capital transactions by non-residents, but excludes assets that give rise to short-term debt. In the IMF *Balance of Payment Statistics*, capital inflows are the items included in the capital and financial accounts of the balance of payments, comprising mainly credit items (such as debt forgiveness and migrants' transfers) under the heading of "capital transfers", "direct investment" in the country concerned, and the liability items under "portfolio investment" and "other investment" (which includes both short-term and long-term debt in such forms as bank loans, other types of trade credit, and borrowing from IMF).

***Capital outflow***: This term refers to the acquisition of *foreign assets* by *residents*. Sales of foreign assets are defined as a negative capital outflow. Thus the term *net* capital outflow denotes acquisitions minus sales of foreign assets by residents. In the IMF *Balance of Payments Statistics*, capital outflows consist of the debit items under the heading of "capital transfers", "direct investment abroad", and the asset items under "portfolio investment" and "other investment".

***Net capital flow***: This term refers to total net capital inflow less total net capital outflow as defined above. It is positive when net inflow exceeds net outflow.

***Net transfer***: This term refers to net capital inflows less net factor payments abroad; the latter include interest payments on external debt as well as profit remittances. Net transfer is thus a broad measure of a country's capacity to finance its trade deficits.

countries' GNP. Furthermore, the inflows are increasingly concentrated in a small number of developing countries, the so-called emerging markets.

- An increasing proportion of private capital inflows has been offset by capital outflows by residents, notably short-term outflows, or has been devoted to costly reserve accumulation to safeguard against instability of capital flows and speculative attacks on the currency rather than to finance current-account deficits. Both phenomena are closely linked to capital-account liberalization in developing countries.

- There has been a marked increase in the instability of private capital flows to developing countries. Since the beginning of the 1990s a number of emerging markets have experienced booms and busts in private financial flows whereby surges in capital flows were followed by equally sharp reversals of these flows, triggering currency and financial crises.[3] Thus, an important part of the capital inflow constitutes an unreliable source of development finance.

- Finally, while there are reasons to believe that FDI is less unstable than most other types of private capital flow, FDI flows to developing countries are increasingly being linked to mergers and acquisitions, including acquisitions associated with privatization, which are of a one-off nature. It is consequently questionable whether the recent surge in FDI

can be sustained over the longer term. Likewise, it can also be questioned whether the inflows associated with one-off adjustments in the portfolios of global investors made possible by the opening-up of the capital markets in developing countries can be sustained.

The evidence thus suggests that there are serious shortcomings regarding the size, stability and sustainability of capital flows to developing countries. For those which are not favoured by international private capital, paucity of external financing remains one of the key constraints on adjustment and growth. For those which do have access to private capital, the stability and sustainability of capital flows are key issues. However, even for them the question of the adequacy of external financing arises to the extent that such flows are subject to the boom-bust phenomenon or are of a one-off nature.

## B. Capital inflows: a review of long-term trends

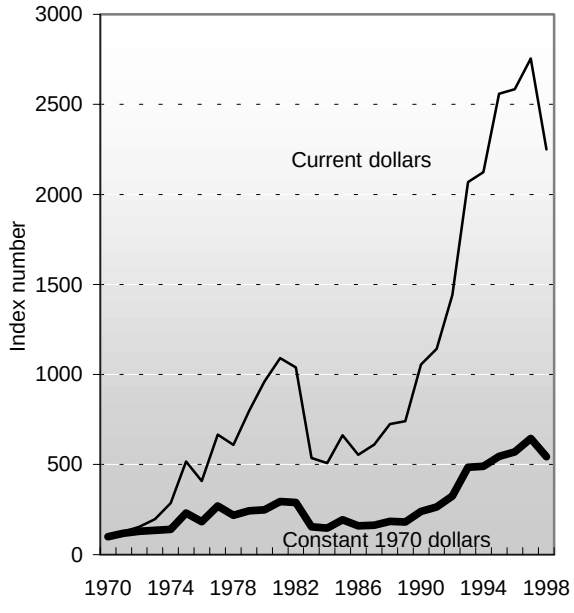
Net capital inflows into developing countries have risen more than 20-fold in nominal terms since 1970 (chart 5.1), reaching an estimated $255 billion in 1998, down from a record level of almost $312 billion in the previous year. In real terms, however, the increase is much less impressive. If the import price index of developing countries is used to deflate these current values (i.e. to express them in terms of their purchasing power over foreign goods), the increase in the net capital inflow is about fivefold. At around 12 per cent, the average annual growth of real flows is only moderately higher in the 1990s than in the inflationary years of the 1970s.

Capital inflows can be better assessed if expressed as a proportion of GNP of the recipient countries. On this measure (table 5.1 and chart 5.2) the recent surge in inflows merely constitutes a recovery from the stagnant levels of the 1980s rather than an increase over the levels attained during the years preceding the debt crisis. Indeed, despite the much acclaimed absolute rise in capital inflows of developing countries in the 1990s, they have averaged around 5 per cent of GNP since the beginning of the decade, which was roughly the level prevailing before the outbreak of the debt crisis of the 1980s. If China is excluded, the ratio during 1990–1998 was more than one percentage point lower than during 1975–1982 (table 5.1).

***Chart 5.1***

**DEVELOPING COUNTRIES: AGGREGATE NET CAPITAL INFLOW, 1970–1998**

*(Index numbers, 1970 = 100)*




***Source:*** UNCTAD secretariat calculations, based on World Bank, *Global Development Finance, 1999* (CD-Rom).
***Note:*** For the definition of net inflows see box 5.1.

There can be little doubt that in some respects capital inflows in the 1970s were unsustainably high as they were encouraged by a number of temporary factors such as oil price shocks, negative real interest rates and under-assessment of sovereign risk. It is also true that there has been some

***Table 5.1***

**DEVELOPING COUNTRIES: AGGREGATE NET CAPITAL INFLOW BY TYPE OF FLOW, AND NET TRANSFER, 1975–1998**

*(Percentage of GNP)*

| *Flow* | *1975–1982* | *1983–1989* | *1990–1998* |
|---|---|---|---|
| Total net inflow | | | |
| Including China | 4.91 | 2.87 | 5.00 |
| Excluding China | 5.45 | 2.97 | 4.22 |
| Official inflows | 1.58 | 1.57 | 1.03 |
| ODA grants | 0.53 | 0.62 | 0.56 |
| Other official | 1.05 | 0.96 | 0.47 |
| Private inflows | 3.33 | 1.29 | 3.97 |
| Non-debt-creating inflows | 0.42 | 0.55 | 2.21 |
| FDI | 0.42 | 0.53 | 1.67 |
| Portfolio equity | 0.00 | 0.02 | 0.54 |
| Bonds | 0.11 | 0.05 | 0.52 |
| Bank credit | 2.46 | 0.44 | 1.17 |
| Short-term | 1.10 | 0.10 | 0.72 |
| Long-term | 1.36 | 0.34 | 0.44 |
| ***Memo item:*** | | | |
| Portfolio inflows | 0.12 | 0.07 | 1.06 |
| Interest payments | 1.49 | 2.58 | 1.79 |
| Profit remittances | 0.93 | 0.54 | 0.56 |
| Net transfer | 2.48 | -0.26 | 2.65 |

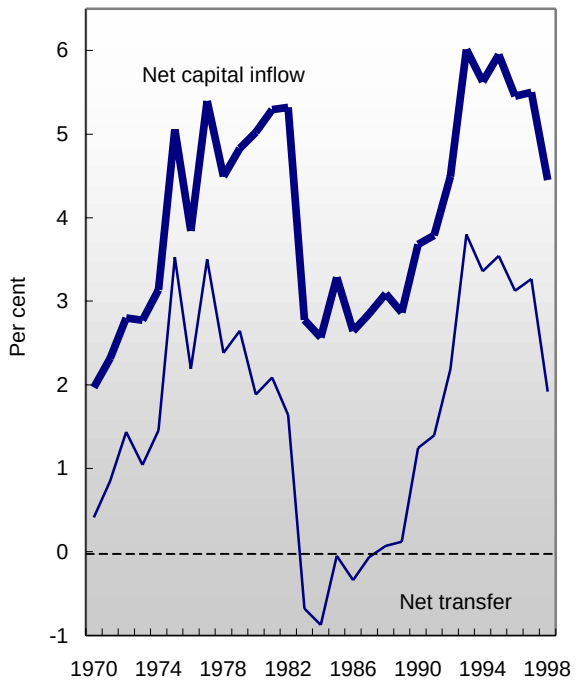
***Source:*** As for chart 5.1.
***Note:*** For definitions see box 5.1.

imprudent lending and investment in the 1990s. As discussed below, it is not easy to judge to what extent recent flows to developing countries are more sustainable and more soundly based than those in the 1970s. However, the relevance of comparing those two decades lies primarily in assessing the adequacy of recent capital inflows in filling the external resource gap which, as noted in the previous chapter, has widened in recent years.

Net transfers in these two periods showed a similar pattern (chart 5.2). In the early 1970s they were less than 1 per cent of GNP, as net capital inflows were offset to an important extent by profit remittances. During that period interest payments were on average less than one half of profit transfers; this proportion more than doubled after 1974, despite a significant increase in interest payments as a result of rapid accumulation of external debt. While net inflows stagnated after the outbreak of the debt crisis, interest payments on external debt stocks continued to mount, on account of both the rapid accumulation of debt and the rise in international interest rates. Net transfers actually became negative, necessitating the generation of trade surpluses in a number of highly indebted developing countries. Like net capital inflows, net transfers as a proportion of GNP have remained at about the same level in the 1990s as in the period before the outbreak of the debt crisis. Despite the declines from the very high levels reached in the 1980s, interest payments in relation to GNP have remained higher than in the earlier period due to increased external indebtedness.

***Chart 5.2***

**DEVELOPING COUNTRIES: AGGREGATE NET CAPITAL INFLOW AND NET TRANSFER AS A PERCENTAGE OF GNP, 1970–1998**

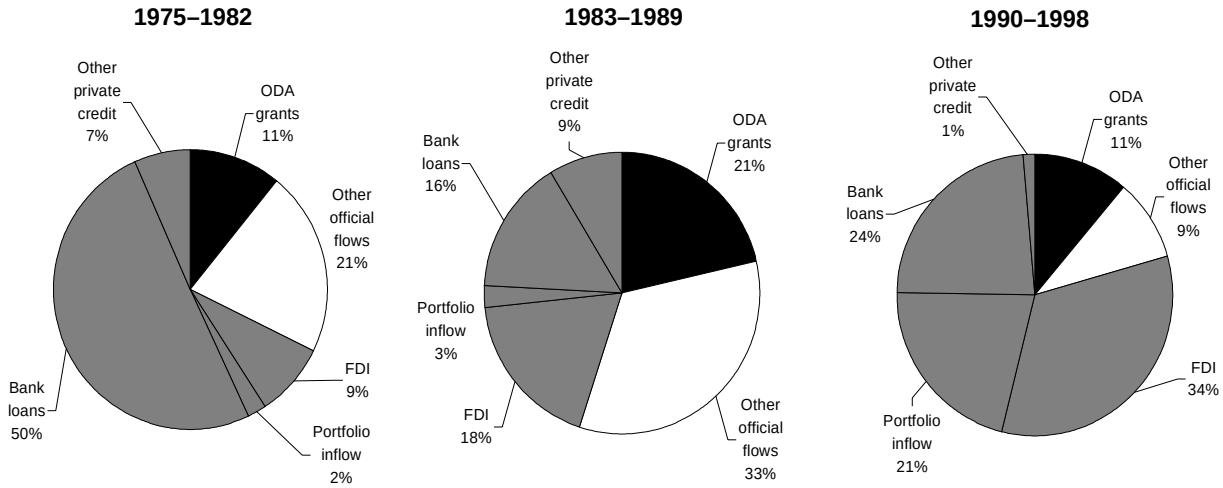



***Source and definitions:*** See chart 5.1.

**Chart 5.3**

**DEVELOPING COUNTRIES: NET CAPITAL INFLOW BY TYPE OF FLOW, 1975–1998**

*(Percentage of aggregate net inflow)*




***Source and definitions:*** See chart 5.1.

These overall trends have been associated with major shifts in the composition of capital inflows (chart 5.3). During the first half of the 1970s net private and net official inflows[4] were of roughly the same order of magnitude. From 1975 onwards, private capital accounted for about two thirds of the total net inflow. Despite the fall in the share of official flows, their contribution increased in terms of GNP of the recipient countries. This trend continued until the outbreak of the debt crisis in the early 1980s, when the share of private inflows in total inflows fell as a result of reduced bank lending.

In the 1990s the surge in private flows and the decline in official financing resulted in private capital accounting for almost 80 per cent of the aggregate net capital inflow of developing countries. In nominal terms official financing has been only slightly higher than during the years of debt crisis; ODA has declined almost continuously and stood at $20 billion in 1998, against more than $28 billion at the beginning of the decade. Other official flows remained relatively stable until the mid-1990s, but thereafter were subject to annual fluctuations as a result of financial bail-out operations in emerging markets. Thus, they rose sharply in 1995 as result of the Mexican bail-out operation, falling to negative levels in 1996 after repayment. There was another sharp increase in 1998 due to official intervention in the East Asian crisis.

There have also been considerable changes in the composition of private inflows during the past three decades. From the mid-1970s until the outbreak of the debt crisis, bank loans constituted three quarters of total private net capital inflows of developing countries, the rest consisting of FDI. This pattern changed drastically after the debt crisis, when bank loans collapsed and FDI predominated. Bank lending remained in the doldrums throughout the early 1990s; it picked up only after the Mexican crisis, with flows largely to East Asian emerging markets. While FDI accelerated rapidly, portfolio inflows emerged as a major form of private net inflows in large part as a result of debt-equity swaps, privatization and

Brady bonds associated with the resolution of the debt crisis of the 1980s.[5]

The increased share of international private lenders and investors in total capital flows to developing countries reflects the rapid increase since 1988 in private sector borrowing (chart 5.4). Before the debt crisis of the 1980s, the share in total net external borrowing constituted by private flows not covered by an official guarantee in the recipient country was around 15 per cent. Thereafter it fell even further; indeed, net private non-guaranteed borrowing was negative or negligible throughout the rest of the decade. It rose rapidly in the 1990s, both in absolute terms and in relation to public and publicly-guaranteed flows, exceeding the latter from 1995 onwards. However, this trend was sharply reversed with the East Asian crisis, when non-guaranteed borrowing almost disappeared while public and publicly-guaranteed debt shot up, largely as a result of the socialization of private debt.

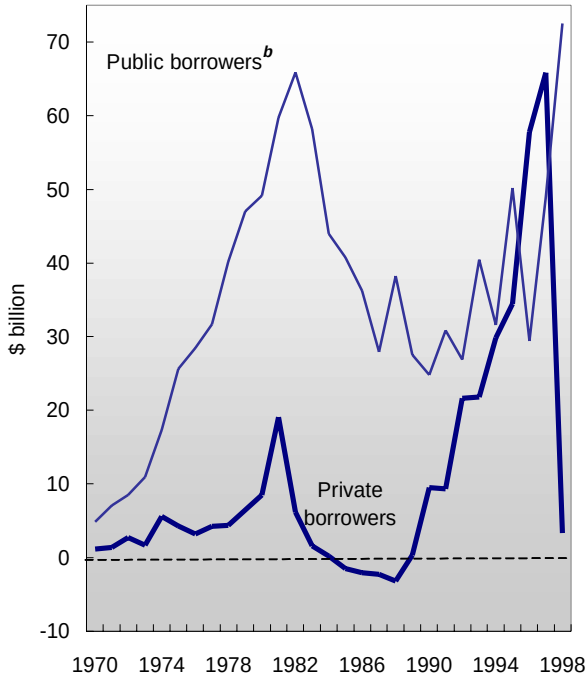
Finally, these changes in the composition of net capital inflows have been accompanied by shifts in their distribution among developing countries and regions. In particular, since official flows tend to favour poorer developing countries and regions, their movement relative to that of private capital flows has been a major determinant of the trend in the share of total net inflows of different groups of developing countries. Thus, the share of sub-Saharan Africa and of South Asia, the major recipients of official finance, increased from 1975–1982 to 1983–1989, while that of Latin America declined sharply when private flows dried up on account of the debt crisis (chart 5.5). During the 1990s the movement has been in the opposite direction. As regards East Asia, the share of private flows has constantly risen in the past three decades as the region emerged as an attractive location for foreign capital and managed to avoid, until 1997–1998, sharp reversals and withdrawals of such flows.

The shift in the composition of capital inflows towards private capital has also meant their concentration in a small number of developing countries, mainly the so-called emerging markets.

***Chart 5.4***

**DEVELOPING COUNTRIES: NET INFLOW OF CREDIT[a] BY TYPE OF BORROWER, 1970–1998**

*(Billions of dollars)*




***Source and definitions:*** See chart 5.1.

***a*** Excluding short-term credit.

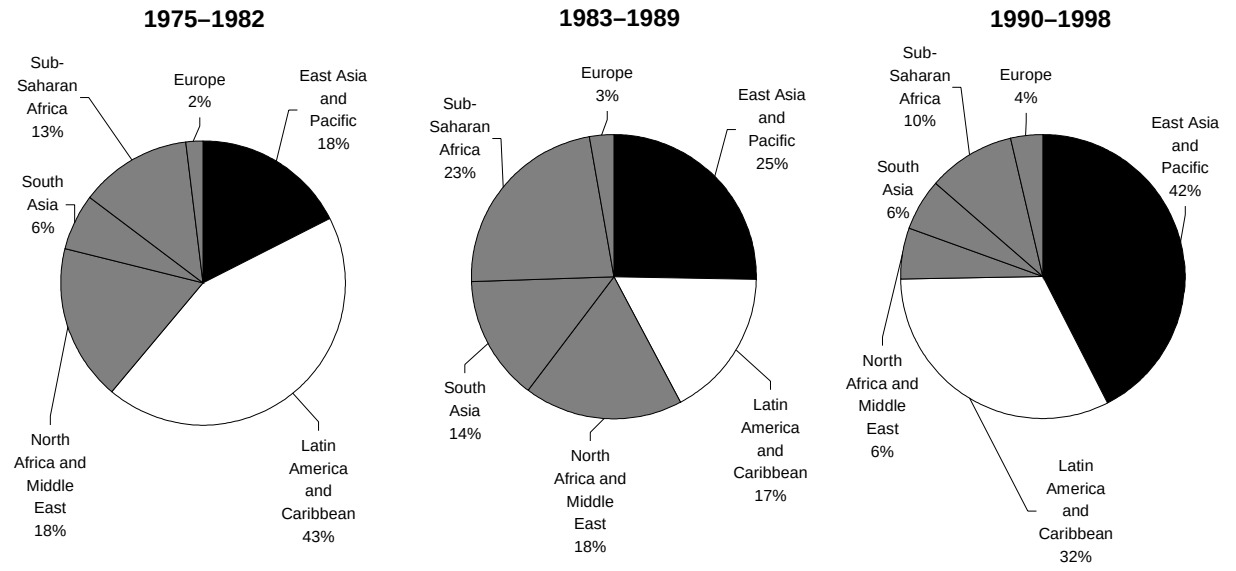
***b*** Including publicly-guaranteed credit to private borrowers and IMF lending.

Twenty countries[6] among the latter received, on average, around 50 per cent of the total net capital inflow of developing countries during the 1970s and 1980s, and their share rose to over 90 per cent in the 1990s; the remaining 100 or so developing countries had to share the 10 per cent left over. While these 20 countries account for as much as 69 per cent of developing countries' total population, in per capita terms the foreign capital they received was nevertheless around 4.5 times that of the other countries.

**Chart 5.5**

**DEVELOPING COUNTRIES: NET CAPITAL INFLOW BY REGION[a], 1975–1998**

*(Percentage of aggregate net capital inflow)*




***Source and definitions:*** See chart 5.1.

***a*** Regional classification of the World Bank, except for Europe, which comprises Malta and Turkey only.

## C. Capital flows and the current account

It is often overlooked that net capital inflows received by developing countries from non-residents do not necessarily give the amount available for financing current-account deficits and closing resource gaps. Account also needs to be taken of net capital outflows by residents, which can result in a significant reduction in the availability of net external financing or net capital flows (see box 5.1). The importance of capital outflows through acquisition of assets abroad depends, *inter alia*, on the capital account regime adopted by the countries concerned. During the past 10 years, a growing number of developing countries have liberalized outward capital flows, enabling their residents to shift funds to foreign financial markets for short-term investment as well as for outward FDI and long-term financial assets. However, such outflows can also occur under more restrictive capital-account regimes, constituting what is often referred to as capital flight. Traditionally the errors-and-omissions item of the balance of payments is taken as a measure of such unrecorded capital flows.

Recorded and unrecorded outflows, together with inflows used to accumulate international reserves, constitute offsetting capital transactions by residents, while that part of inflows which is available for financing current-account deficits determines the additional inflow of real resources

**Table 5.2**

**NET CAPITAL INFLOW, CURRENT-ACCOUNT FINANCING AND OFFSETTING FINANCIAL TRANSACTIONS IN DEVELOPING COUNTRIES AND 16 EMERGING-MARKET COUNTRIES[a]**

*(Billions of dollars and per cent)*

| | *All developing countries* | | | *Emerging-market countries* | |
|---|---|---|---|---|---|
| | *1990–1994* | *1995–1998* | *1990–1998* | *1980–1989[b]* | *1990–1997* |
| | | | *Billions of dollars* | | |
| Net capital inflow | 825.8 | 1 064.9 | 1 890.6 | 355.3 | 1 083.8 |
| Net capital outflow | -142.0 | -435.3 | -577.2 | -49.6 | -256.2 |
| *Net capital flow* | *683.8* | *629.6* | *1 313.4* | *305.7* | *827.6* |
| BoP errors and omissions | -49.9 | -106.3 | -156.2 | -39.5 | -53.2 |
| Change in reserves[c] | -221.2 | -216.5 | -437.7 | -10.6 | -231.6 |
| Current-account balance[d] | -412.7 | -306.8 | -719.5 | -255.6 | -542.7 |
| | | | *Percentage of net inflow* | | |
| Net capital outflow | 17.2 | 40.9 | 30.5 | 14.0 | 23.6 |
| BoP errors and omissions | 6.0 | 10.0 | 8.3 | 11.1 | 4.9 |
| Change in reserves[c] | 26.8 | 20.3 | 23.2 | 3.0 | 21.4 |
| Current-account balance[d] | 50.0 | 28.8 | 38.0 | 71.9 | 50.1 |
| | | | *Percentage of net flow* | | |
| BoP errors and omissions | 7.3 | 16.9 | 11.9 | 12.9 | 6.4 |
| Change in reserves[c] | 32.3 | 34.4 | 33.3 | 3.5 | 28.0 |
| Current-account balance[d] | 60.4 | 48.7 | 54.8 | 83.6 | 65.6 |

***Source:*** World Bank, *Global Development Finance, 1999* (CD-Rom); IMF, *World Economic Outlook*, October 1998; IMF, *Balance of Payments Statistics,* various issues.

***Note:*** For definitions see box 5.1.

***a*** Argentina, Brazil, Chile, Colombia, Egypt, India, Indonesia, Malaysia, Mexico, Pakistan, Peru, Philippines, Republic of Korea, South Africa, Thailand, Turkey.

***b*** Excluding 1987 and 1988, which were years with current-account surpluses.

***c*** A minus sign indicates an increase in reserves.

***d*** The sum of net capital flow, BoP errors and omissions and change in reserves.

(which is generally significantly less than the total net inflow). Table 5.2 gives the breakdown of the use that has been made of total net capital inflows during the 1990s by developing countries as a whole[7] and during the 1980s and 1990s by 16 emerging markets; chart 5.6 shows the evolution of net capital inflows and net capital flows in the 1990s for developing countries as a whole (in terms of their percentage of GNP).[8] They both show that offsetting financial transactions have become increasingly important during the 1990s.

## 1. Capital outflows

Net capital outflows (net acquisition of assets abroad by residents) constitute an increasing part of offsetting financial transactions (table 5.2). In the emerging markets, for each dollar of net inflow there was a net outflow of 14 cents in the 1980s but of almost 24 cents in the 1990s. For developing countries as a whole, this share more than doubled during the 1990s alone. If unrecorded net capital outflows (errors and omissions),

a substantial proportion of which generally consists of residents' purchases of foreign assets, are added to recorded flows, the proportions are even higher. In the emerging markets the proportion of net inflows absorbed by unrecorded outflows shows a sharp drop from the 1980s to the 1990s. In the latter period, as could be expected, this proportion is lower for the emerging markets than for developing countries as a whole.

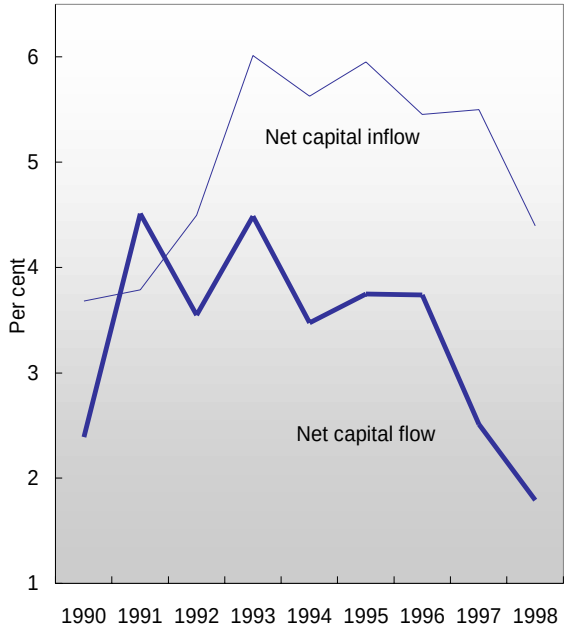
The evolution of unrecorded capital outflows as given by the errors-and-omissions item is particularly noteworthy. With the loosening or dismantling of exchange controls, improved recording of external transactions and standardization of data collection, this item could be expected to decline in importance. It could also be expected to display random behaviour over time, rather than persistently staying negative. The figures in table 5.2 show that its relative size has indeed been falling in the emerging markets, but not in the developing countries as a whole. More important, however, is the persistence of negative values for this item for both groups of countries, suggesting continued unrecorded capital outflows despite increased liberalization of exchange-rate and capital-account regimes.

The coexistence of capital inflows with outflows is a natural outcome of global financial integration. It is a widespread phenomenon in the developed world, reflecting in part the global reach, portfolio diversification and risk management of financial institutions. It can also reflect the disparate behaviour of different categories of financial flows. For instance, since the early 1980s net inflows of capital in the United States have continuously exceeded net outflows, but the economy has often been a net exporter of FDI. Again, lending and investment abroad by United States banks and funds have coexisted with massive amounts of net portfolio inflows.

Cross-border financial activities have increasingly become a feature of financial institutions in emerging markets which are at a relatively advanced level of development. Around 300 banking entities from 10 leading developing countries were operating in OECD countries in 1996.[9] Opening of the capital account in emerging markets presents profitable opportunities for portfolio diversification not only for lenders and investors in industrial countries, but also for asset holders in these markets themselves. It also allows business to take positions abroad in order to hedge against exchange-rate risks. Furthermore, some developing countries have become significant providers of FDI in recent years, with the cumulative outward flow reaching $52 billion during 1991–1996, or 21 per cent of total net capital outflows from developing countries.[10]

**Chart 5.6**

**DEVELOPING COUNTRIES: NET CAPITAL INFLOW AND NET CAPITAL FLOW AS A PERCENTAGE OF GNP, 1990–1998**




***Source and definitions:*** See chart 5.1.

However, as discussed in the next section, an important part of outflows, as well as of inflows, consists of liquid capital driven by short-term arbitrage opportunities. In such cases, the coexistence of net outflows with net inflows may reflect different assessments of risks and return by residents and non-residents. These may be due to implicit or explicit government guarantees extended to the assets held by non-residents as well as to incentives for round-tripping by domestic investors. For instance, an important part of recorded FDI flows to China is believed to originate in that country itself. Again, during the late 1980s, the tax exemption of foreign depositors in the United States, together with the tax deductibility

of interest payments in Mexico, gave Mexican enterprises an incentive to shift their funds abroad and recycle them back as loans to themselves or to enterprises under their control, thereby avoiding taxes on interest income received in the United States while deducting interest payments on loans from their taxable income in Mexico.[11]

### 2. Reserve accumulation

An equally important component of offsetting financial transactions is reserve accumulation. During the 1990s more than 20 per cent of total net capital inflows were absorbed by additions to reserves in both developing countries as a whole and in the emerging markets listed in table 5.2. In relation to total net flows, the proportion is one third for the former and 28 per cent for the latter.[12] It is worthy of note that for emerging markets this proportion is considerably greater than in the 1980s, a feature which is closely related to increased private capital flows and the vulnerability of developing countries to their volatility. So long as private capital flows are restricted and private borrowing is subject to approval by the governments of recipient countries, such flows can be expected to be closely related to imports and current-account financing. Under such circumstances, there would be little need to import more capital than can effectively be used to finance additional inflows of real resources, nor would there be much scope for spontaneous capital flows to exceed the amounts needed for financing current-account deficits. The need to maintain a certain level of reserves would then arise from time lags between payments for imports and receipts from exports and from miscellaneous temporary disequilibria in the current balance of payments. Traditionally, reserves covering on average three or four months' imports are considered as adequate for such purposes, and even smaller reserves would be needed to the extent that governments are more willing to respond to current-account disturbances by exchange-rate adjustments. Again, increased access to trade financing would reduce the need for reserves.

The trend in developing countries has, however, been to accumulate reserves, reaching levels well above the norm. Despite policy reforms designed to ensure greater flexibility in the adjustment of exchange rates to market conditions and increased integration of these economies into global capital markets, their reserve holdings have tended to rise in both absolute and relative terms during the past two decades. Indeed, while the stock of reserves in developing countries covered on average about 3.5 months of imports during the 1980s, this ratio had risen to 5.3 months in 1998 even after the depletion of reserves in a number of countries facing currency turmoil. In emerging markets, it was around 5.5 months on the eve of the Asian crisis, compared to less than 4.0 months in the 1980s. For the developing countries as a whole, the increase in reserves from 1990 to 1998 amounted to 60 per cent of the total increase in their import bill during the same period. There has also been a sharp increase in emerging markets from the 1980s to the 1990s in the proportion of capital inflows absorbed by reserve accumulation, an increase which exceeded what was necessary either for financing current transactions of those countries, even after allowance is made for the possibility that the external financial stringency of the 1980s may have pushed their reserve ratios below optimal levels, or for increasing reserves as a precautionary buffer against current-account shocks.

A probable explanation of this build-up of reserves is the need to safeguard against discontinuation or reversal of capital flows and speculative attacks on the currency. One criticism directed at East Asian policy-makers was their failure to ensure that reserves were adequate to cover short-term debt, even though in some cases they were nonetheless adequate to meet the needs of import and current-account financing. Indeed, developing countries have been strongly advised to cover their short-term debt by reserves and credit lines on the grounds that "as long as foreign reserves are well in excess of short-term external debt, individual creditors may feel reasonably assured that their assets are protected from a 'run' by other creditors ... Countries can reduce their vulnerability to liquidity-driven panics by maintaining sufficiently high reserve cover".[13]

While on average reserves now tend to be higher, they also display considerable instability in countries that experience boom-bust cycles in capital flows. In the boom stages of these cycles net autonomous private capital flows may well exceed the current-account deficits by a large margin, adding to reserves as well as creating problems of sterilization for monetary authorities. As discussed in past issues of *TDR*, such a situation can persist when relatively high domestic interest

rates create sizeable arbitrage opportunities. Although real currency appreciations that occur under such circumstances tend to widen trade deficits, which absorb a greater part of capital inflows, reserves can still continue to accumulate for a long time, particularly when there is a strong herd behaviour in lending and investment. However, they will eventually level off and start declining as the trade deficit widens and capital flows stabilize. When the boom ends and the currency comes under attack, reserves tend to be depleted rapidly as authorities try to defend the currency. These efforts are often unsuccessful, resulting in both the collapse of the currency and loss of reserves. As economic contraction sets in, reserves are replenished in large part as a result of drastic import cuts and a swift turnaround in the trade balance.

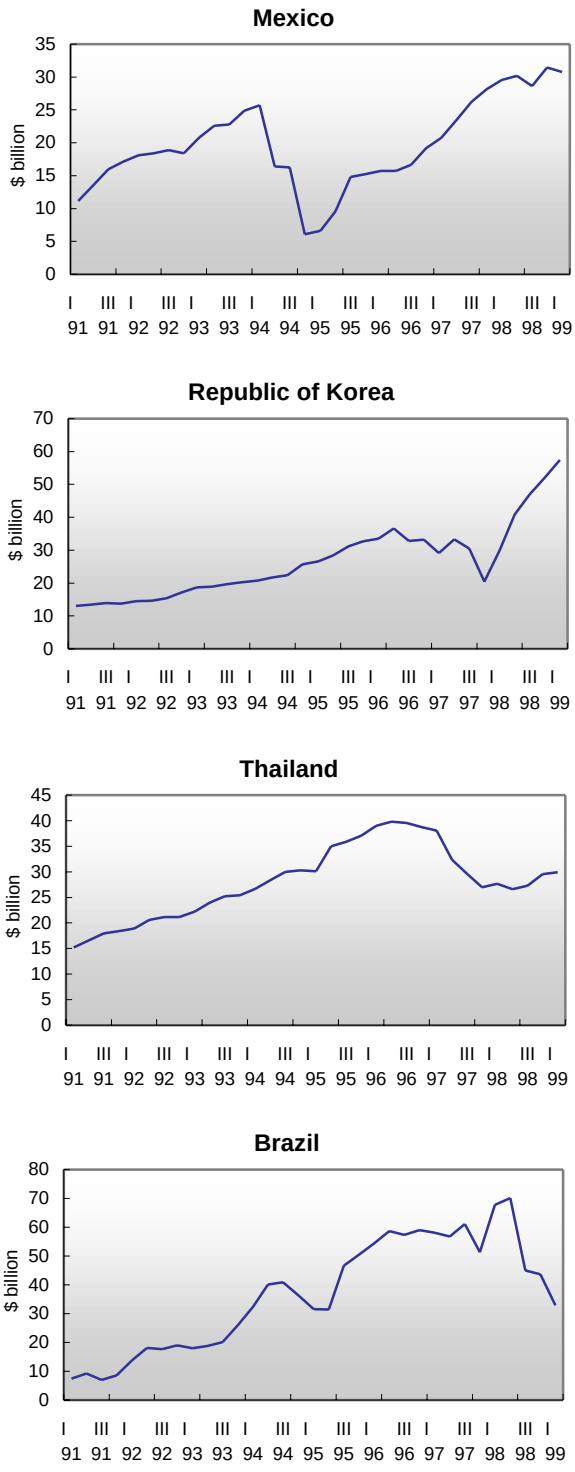
Since the early 1990s such boom-bust cycles in emerging markets have been observed with increasing frequency, first in Mexico, then in East Asia and Brazil (chart 5.7). In Mexico, after a sharp increase in the early 1990s reserves collapsed in 1994 and early 1995, when the currency came under attack. They recovered subsequently in the context of massive cuts in imports, to exceed their previous peak reached on the eve of the crisis. The experience of the Republic of Korea was similar. There was also a boom-bust cycle in Thailand, but the post-crisis recovery of reserves was slower. In Brazil, there was an accumulation of reserves throughout 1993–1998, notwithstanding two moderate dips, the first of which was associated with the Mexican crisis and the second with the East Asian crisis, but reserves collapsed in late 1998 and early 1999.

Holding reserves involves opportunity costs, since it ties up purchasing power that could be used for the import of goods needed to increase output and investment. Certainly, income can be earned on reserves by investing them in international assets, but large losses will be incurred when reserves are borrowed at much higher rates, as is invariably the case for developing countries. Moreover, these losses will fall on the public sector when governments issue domestic debt to purchase foreign exchange, since real domestic interest rates on government debt generally exceed by a still larger margin the rates earned on reserves. When arbitrage is undertaken by non-residents, losses will be equal to arbitrage profits (i.e. the difference between international interest rates and the rate on domestic public debt, cor-

***Chart 5.7***

**THE QUARTERLY LEVEL OF INTERNATIONAL RESERVES IN MEXICO, REPUBLIC OF KOREA, THAILAND AND BRAZIL SINCE 1991**

*(Billions of dollars)*




***Source:*** Datastream/ICV.

**Box 5.2**

### THE ASSESSMENT OF ADEQUACY OF RESERVES UNDER ARTICLE XV OF GATT 1994 AND ARTICLE XII OF GATS

The discussion in this chapter of the increased reserve holdings of developing and transition economies associated with their growing integration into global capital markets and their consequent vulnerability to large swings in capital flows has implications for the appropriate way to evaluate the adequacy of such reserves as part of the scrutiny of import restrictions undertaken for balance-of-payments reasons under GATT 1994 and GATS.

In considering the justification of the imposition, maintenance or intensification by a country of exchange restrictions to safeguard its balance of payments, WTO members are required – under article XV of GATT and article XII of GATS – to take as a basis the assessment by IMF of the country's balance of payments and other aspects of its external financial situation, such as the adequacy of its foreign-currency reserves. Much of the case history of the application of GATT article XV in this context relates to an earlier period, before the existence of the large international capital flows which have accompanied growing global financial integration. In recent years, payments pressures on a country have become much more important as a result of this financial integration. An approach to assessing the adequacy of a country's foreign-exchange reserves should consequently make allowance for these new pressures. One approach would be to require the Fund, in its evaluation of a country's reserve adequacy, to take account of the many different elements of external sector statistics specified in its own Special Data Dissemination Standard (SDDS) for economic and financial data.[1]

Under the heading of balance-of-payments statistics, for example, SDDS recommends a breakdown of relevant financial transactions between direct and portfolio investment, presumably because of the difference in volatility between the two. As regards the international investment position, it calls for a classification of external assets under the headings of direct investment, portfolio investment (with a breakdown between equity and debt), other investment, and reserves; and in respect of external liabilities it distinguishes (within portfolio investment) securities and loans according to the currency of issue and (for debt instruments) original maturity.[2] This classification is clearly intended to comprise categories relevant to the evaluation of countries' external payments and international investment positions in a global economy characterized by large international capital movements.

A measure that goes some way to meeting these objectives – the sum of outstanding short-term liabilities (by residual maturity) and the mark-to-market value of the stock of portfolio investment – was used by IMF in information provided to a WTO panel[3] reporting on the complaint by the United States concerning the recourse by India to section B of GATT article XVIII, which provides for special and differential treatment to developing countries introducing import restrictions as a protection against the threat of a serious decline in reserves.

In responding to the presentation of the IMF measure before the WTO panel, the Government of India suggested what it considered to be more suitable criteria, as follows:

- a three-month import coverage, plus 50 per cent debt service, plus the value of one month's imports and exports;
- 1.66 times short-term debt, plus the stock of portfolio equity, with all marginal additions to be matched 1:1;
- a foreign-asset-to-currency ratio of not less than 40 per cent, but ideally of 70 per cent.

The increased attention to policies regarding foreign-exchange reserves, as part of the broader issue of the management of external assets and liabilities in an international financial system characterized by large capital movements, and the need for revised guidelines concerning the adequacy of such reserves, has also been made clear by Alan Greenspan, Chairman of the Board of Governors of the United States Federal Reserve System. In a recent speech[4] he noted:

> In recent years volatility in global capital markets has put increasing pressure on emerging-market economies and this has important implications for financial management in those economies. There have been considerable fluctuations in the willingness of global investors to hold claims on these economies over the last two years .... These changes ... had a particularly severe impact on currencies operating under fixed or pegged exchange-rate regimes. Accordingly, those countries' foreign-exchange reserves, and reserve policy, played an important role in the recent financial crises.

**Box 5.2 (concluded)**

He also mentioned a number of possible guidelines in this area for policy makers in emerging-market economies. One of these guidelines (proposed by Pablo Guidotti, Deputy Finance Minister of Argentina) would require foreign-exchange reserves to exceed scheduled amortization of foreign-currency debt (assuming no rollover of such debt) during the following year. Greenspan envisaged that new guidelines could also involve stochastic standards taking into account the foreseeable risks faced by a country. As a possible example of such a standard, "countries could be expected to hold sufficient liquid reserves to ensure that they could avoid new borrowing for one year with a certain *ex ante* probability, such as 95 per cent of the time".

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1 On the Internet at http://dsbb.imf.org/category/spec_ext.htm.

2 Clearly, with regard to loans of a medium- or long-term original maturity it would be preferable to distinguish according to the *residual* maturity, which is a more important feature of the external payments and the international investment position of a country threatened by, or experiencing, a financial crisis owing to difficulties of obtaining refinancing, which can involve refinancing of medium- and long-term debt as well as rolling over short-term debt.

3 See the report of the Panel (WTO document WT/DS90/R), Geneva, 6 April 1999.

4 Speech at the World Bank's conference on Recent Trends in Reserves Management, Washington, DC, 29 April 1999 (reproduced in *BIS Review*, 4 May 1999).

rected for exchange-rate changes) plus the spread over the rates earned on reserves.[14] When arbitrage is undertaken by residents, the losses to the economy will be smaller but the public sector losses will still be the same, since there will be a net transfer from the public to the private sector in addition to the net cost incurred by the economy as a whole.[15]

Another implication of increased reserve needs relates to the assessment of the legitimacy of measures that could be adopted to safeguard the balance of payments in the context of WTO provisions. The analysis above suggests that when there is increased vulnerability of developing countries to greater instability of capital movements, the conventional criteria based on imports or current-account deficits would not provide an appropriate basis for assessing reserve adequacy. The increased need of emerging markets for precautionary reserves to reduce their vulnerability to reversals of capital flows should be taken into account in evaluations by IMF of the adequacy of their reserve holdings (see box 5.2).

### 3. Current-account financing

Total offsetting financial transactions in the form of recorded and unrecorded net capital outflows by residents and international reserve accumulation have thus absorbed an increased proportion of net capital inflows in the 1990s compared to the 1980s. For the 16 emerging market economies in table 5.2, this proportion rose from less than 30 per cent in the 1980s to 50 per cent in the 1990s. Conversely, while 72 cents of every dollar of capital inflow in these countries were used, on average, for current-account financing during the 1980s, 50 cents were used in the 1990s. A similar decline, during the 1990s, is observed also for the developing countries as a whole, for which the proportion of net capital inflows absorbed by offsetting financial transactions rose from around 50 per cent in the first part of the decade to around 70 per cent during in the second part.[16]

The results are equally striking when expressed in terms of the use of net capital flows – that is, net inflows by non-residents less (recorded) net outflows by residents. For the developing countries as a whole, the average proportion of net capital flows used for current-account financing during 1990–1998 was 55 per cent; it was higher during the earlier part of the decade than subsequently. For the 16 emerging markets in table 5.2, the proportion fell sharply from the 1980s to the 1990s, largely on account of a dramatic increase in reserve accumulation.

The findings presented so far thus strongly suggest an unfavourable trend in the external fi-

nancing available to developing countries for the acquisition of additional real resources. While in the 1990s there has been a recovery in capital inflows, an increasing proportion has been absorbed by capital outflows by residents and reserve accumulation, and in consequence less has been available to finance imports for current production and capital formation. Short-term capital has played an important role in this respect: short-term outflows account for a large proportion of total capital outflows from developing countries, and the instability of short-term capital flows in general is a major reason for the increased reserve needs.

## D. Short-term capital flows

Short-term capital flows have been the major focus of attention since the recent bouts of financial crisis in emerging markets. It is now generally accepted that such flows can be highly volatile and susceptible to large swings in relatively short periods, causing gyrations in exchange rates. Accordingly, there is now greater agreement on the need to regulate such flows with a view to attaining greater exchange-rate stability and insulating the domestic financial system from their destabilizing effects.

It is not, however, always clear what is meant by short-term capital flows and what categories of transactions fall under this description. Certainly, from the point of view of volatility, it is not only the maturity of assets held by investors or lenders that matters. The flow of assets for which there are well-established markets can also exhibit considerable volatility, independently of their maturities. In this respect, liquidity as much as maturity is the distinctive feature of volatile flows. As discussed extensively in *TDR 1998*, volatile flows are driven by international arbitrage opportunities arising from large international interest-rate differentials and by prospects of short-term capital gains.

The main categories of financial flows that fall under this description include short-term bank loans, much portfolio investment (in particular in short-term government securities as well as equities), and non-inter-bank deposit holdings. Not all short-term bank loans are driven by international arbitrage, since such loans include trade credits, which may also show significant variations but are governed less by changes in perceived arbitrage opportunities than by changes in trade flows. However, as the East Asian experience has demonstrated, such loans could also be subject to fluctuations in creditworthiness and contagion effects. Nonetheless, it is still useful to distinguish between trade credits and arbitrage loans in examining the volatility of short-term capital flows, since the former are not an independent source of disruption.

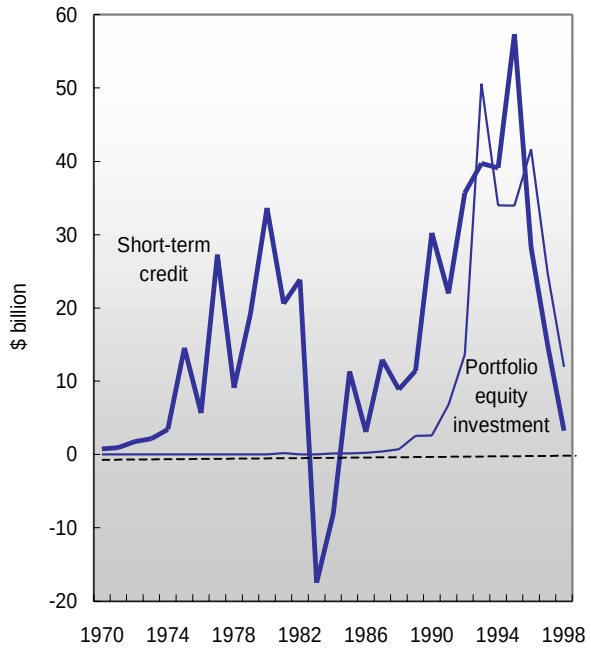
In analysing financial instability a distinction should also be made between short-term inflows and outflows, as done in the previous section for total capital flows. One of the areas of controversy during the recent bouts of crisis in emerging markets was whether it was residents or non-residents who were taking money out. The evidence set out below suggests that it was short-term outflows which have accounted for much of the increase in total capital outflows from developing countries in recent years. Moreover, such outflows have shown a higher degree of volatility than other categories of capital outflow.

Chart 5.8 gives the evolution of two major components of net short-term capital inflows in developing countries in the past three decades, namely short-term credit (including trade credits) and portfolio equity investment. The chart shows two booms, followed in each case by declines. The first boom started in the second half of the 1970s, lasting well into the 1980s, and was based entirely on a surge in short-term bank lending, since there was virtually no flow of portfolio equity in that period. The surge coincided with the first wave of financial liberalization in the Southern Cone of Latin America. The boom ended with the debt crisis, net short-term inflows actually turning negative during 1983–1984.

**Chart 5.8**

**DEVELOPING COUNTRIES: SHORT-TERM CREDIT AND NET PORTFOLIO EQUITY INVESTMENT, 1970–1998**

*(Billions of dollars)*




***Source and definitions:*** See chart 5.1.

The second boom started in 1989 and lasted well into 1995. It was much more broad-based geographically and strongly influenced by the liberalization of the capital account and the dismantling of exchange controls in developing countries. Portfolio equity and short-term loans together reached almost $100 billion by the middle of the decade, accounting for more than 30 per cent of total net capital inflows and almost 40 per cent of private inflows. Short-term loans declined rapidly after the Mexican crisis, while portfolio equity inflows held up until the East Asian crisis. After the crisis both fell drastically, summing no more than $15 billion in 1998.

While these two principal components of short-term inflows follow the trend in total capital inflows, they show much greater instability. Taking 1988 as 100, total net capital inflows and FDI in developing countries had risen by 1995 to 353 and 468, respectively, whereas the index number for net short-term inflows was 950. From 1995 to 1998, the decline in short-term inflows was 83 per cent, while FDI rose by almost 50 per cent and total net inflows fell only by 12 per cent.

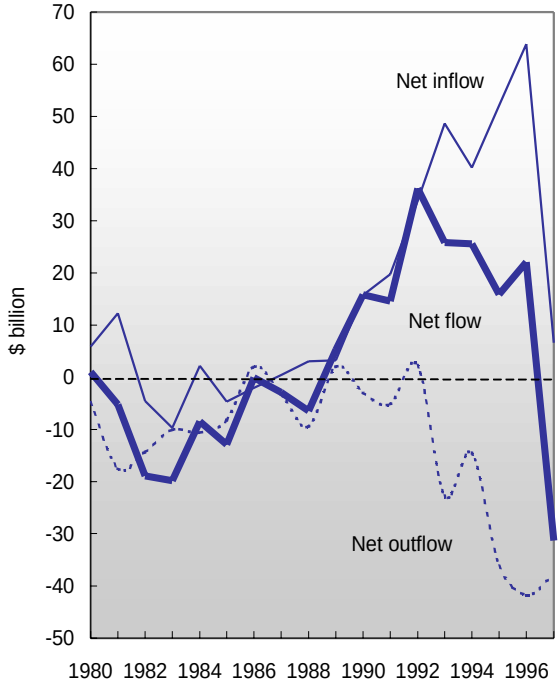
A more comprehensive picture of the evolution of short-term arbitrage flows can be derived from balance-of-payments statistics of IMF, which include both inflows and outflows and cover a wider range of capital flows but exclude short-term trade credits. Analysis of this data for 13 emerging markets (chart 5.9 and table 5.3)[17] suggests a number of conclusions:

- Total short-term net outflows account for a large proportion of total net outflows, amounting to some two thirds during 1990–1997;
- Short-term net outflows have absorbed a large proportion of net inflows. During the 1980s

**Chart 5.9**

**NET INFLOW AND OUTFLOW OF SHORT-TERM CAPITAL IN 13 EMERGING-MARKET ECONOMIES[a], 1980–1997**

*(Billions of dollars)*




***Source and definitions:*** See chart 5.1.
***a*** For the list of countries see note ***a*** to table 5.3.

**Table 5.3**

**NET INFLOW AND OUTFLOW OF SHORT-TERM CAPITAL IN 13 EMERGING-MARKET COUNTRIES[a], 1980–1997**

*(Cumulative totals, in billions of dollars)*

| | *1980–1984* | *1985–1989* | *1990–1994* | *1995–1997* | *1990–1997* |
|---|---|---|---|---|---|
| Net inflow | 6.1 | 0.1 | 158.3 | 122.5 | 280.8 |
| Net outflow | -57.5 | -18.0 | -43.2 | -115.9 | -159.1 |
| Net flow | -51.4 | -17.9 | 115.1 | 6.6 | 121.7 |
| ***Memo items:*** | | | | | |
| Short-term credit, net inflow | .. | -10.7[b] | 101.7 | 98.5 | 200.2 |
| Total net capital outflow | -33.6 | -30.0 | -89.5 | -151.4 | -240.9 |

***Source:*** IMF, *Balance of Payments Statistics,* various issues; BIS, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending*, various issues.

***Note:*** See also box 5.1. Short-term inflows and outflows comprise: portfolio investment in equity and in short-term debt instruments (e.g. treasury bills); non-commercial short-term loans; changes in domestic currency and deposit holdings by non-residents; and other short-term external liabilities of banks. Errors and omissions are considered as unrecorded short-term capital flows.

***a*** Argentina, Brazil, Chile, India, Malaysia, Mexico, Pakistan, Peru, Philippines, Republic of Korea, South Africa, Thailand and Turkey.

***b*** 1986–1989.

they exceeded inflows by a wide margin, resulting in negative net short-term flows. This was entirely due to outflows from Latin America, particularly Argentina, Brazil and Mexico. However, even during the recent boom years, net short-term outflows were quite important, reaching almost 30 per cent of total net short-term inflows during 1990–1994;

- On average, leakages from short-term net inflows are significantly higher than those from other capital inflows. For the period 1990–1997, the outflow/inflow ratio for short-term capital was about 56 per cent for the 13 emerging market economies in table 5.3, compared with a ratio of about 24 per cent for total net capital flows to the emerging markets in table 5.2. Thus, liberalization of short- term capital movements brings very little in the way of net flows of capital, while provoking significant instability;

- The volatility of short-term capital flows as measured by year-to-year variations appears to have been increasing in recent years. A comparison of the 1980s with the 1990s of the standard deviation of annual percentage changes for the emerging markets shows that, on that basis, volatility of net flows increased in nine countries. This reflected a greater prevalence of volatility in outflows than in inflows;

**Table 5.4**

**NET INFLOW AND OUTFLOW OF SHORT-TERM CAPITAL IN SELECTED DEVELOPING COUNTRIES DURING THE FINANCIAL CRISES OF 1995–1996 AND 1997**

*(Billions of dollars)*

| | *1995–1996 (Argentina and Mexico)* | *1997 (East Asia[a])* |
|---|---|---|
| Net inflow | -6.7 | -23.5 |
| Net outflow | -35.4 | -23.8 |
| Net flow | -42.1 | -47.3 |

***Source:*** As for table 5.3.

***Note:*** For definitions see box 5.1.

***a*** Malaysia, Philippines, Republic of Korea and Thailand.

- For individual emerging markets there is little correlation over the long term between current net short-term inflows and outflows. However, as noted above, during periods of intense turbulence declines in net short-term inflows tend to move in tandem with outflows. This suggests that assessments of risk and return by residents can differ from those by non-residents in normal times but converge at times of crisis: during recent episodes of financial instability in emerging markets net short-term inflows became negative, but in East Asia net outflows were just as great, while in Argentina and Mexico they were as much as five times greater (table 5.4). This suggests that at times of crisis restrictions on short-term outflows from this source may be a key element of the appropriate policy response;

- Causality tests using annual data show that current short-term outflows are not explained by past inflows, suggesting that short-term capital outflows by residents are a potential threat to instability, independently of past short-term inflows;

- Finally, there are strong correlations of current flows to individual countries within regions of major emerging markets (Latin America and East Asia), suggesting herd behaviour and contagion in entering as well as exiting.

## E. Foreign direct investment

With the decline in official financing and the instability of private financial flows, FDI is increasingly seen as a solution to the problem of resource gap and external financing. The significant upturn of FDI flows to developing countries since the beginning of the decade, the success of some countries in attracting large amounts of FDI, and the relative stability of such investment flows in the aftermath of the East Asian financial crisis have led to predictions that FDI, as a more stable form of capital flow linked to an emerging international production system, is likely to offer new and, on some accounts, unprecedented growth opportunities to developing countries.[18] Whether or not FDI can really fulfil this role in developing countries requires a closer examination of recent inflows, including their size, distribution, sources and utilization, and an assessment of their contribution to balances of payments.

### 1. Recent trends

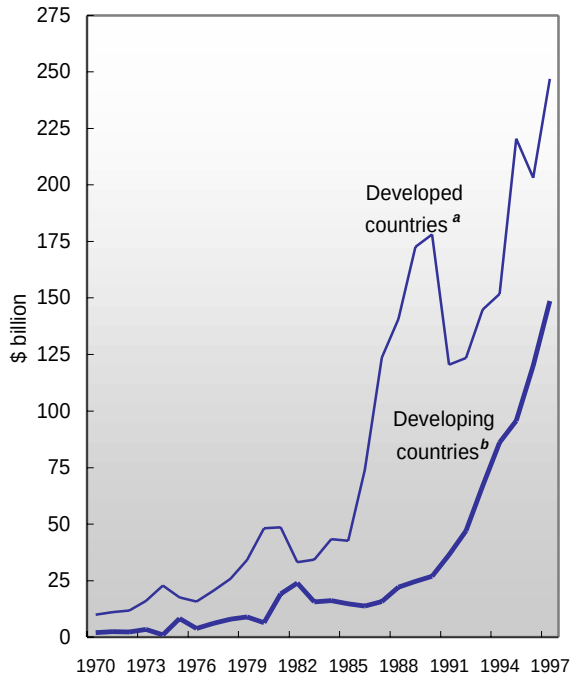
Of about $2,000 billion of net capital inflow in developing countries during 1990–1998, more than $700 billion have been direct investment. The inflow during the 1980s had lagged behind the global surge of FDI which followed the emergence of Japan as a significant source of such investments and the consolidation of economic integration in the European Union, particularly during the second half of the decade. The average annual growth of these inflows in developing countries rose from 15 per cent during the 1980s to 28 per cent in the 1990s (chart 5.10), reflecting in part structural and policy changes in potential southern hosts. Thus, the share of world FDI that was received by developing countries has risen from around 16 per cent in the second half of the 1980s to 28 per cent in the 1990s.

However, these flows are increasingly concentrated in a small number of locations. During 1990–1997 the 10 leading emerging-market countries accounted for more than three quarters of total FDI inflows of developing countries; China, Brazil and Mexico alone account for almost half of the total inflow. Adjusting FDI flows on a per capita basis does little to diminish their highly uneven distribution: over the period 1990–1997, per capita FDI in sub-Saharan Africa was under $5 a year, compared to $62 in Latin America and $31 in ASEAN. Per capita FDI in Uganda and

**Chart 5.10**

**NET INFLOW OF FDI IN DEVELOPED AND DEVELOPING COUNTRIES, 1970–1997**

*(Billions of dollars)*




**Source:** UNCTAD, FDI/TNC database.
**a** Including also Hong Kong (China) and Singapore.
**b** Including Taiwan Province of China, excluding Hong Kong (China) and Singapore, transition economies and some small island economies with offshore banking facilities.

Ghana was $3 and $6, respectively, while it was $21 in China, $35 in Brazil, $79 in Mexico and $223 in Malaysia (chart 5.11).

The recent FDI-led integration is thus a highly selective process. Although in developing countries this is a longstanding feature of FDI inflows, there have been some important changes in the geographical distribution of these inflows over the past three decades (chart 5.12). In the 1970s, Latin America was not only the dominant recipient but also saw its share rise over the decade. This trend was reversed in the 1980s, and the reversal was accelerated in the early 1990s, mainly due to privatization. By contrast, the countries of East Asia have seen a significant increase in their share ever since the early 1980s. Initially, this was due to the growing attractiveness of the newly industrializing economies of South-East Asia, but the more marked rise in the share of the region ever since the late 1980s reflects the opening of the economy of China. Indeed, in the 1990s China has accounted for two thirds of the total FDI inflow of East Asia and one third of the inflow of all developing countries. Among the most troubling aspects of the regional distribution of inflows is the continual decline in the share of sub-Saharan Africa – a trend which parallels the declining shares of low-income developing countries more generally.

## 2. Sources and utilization

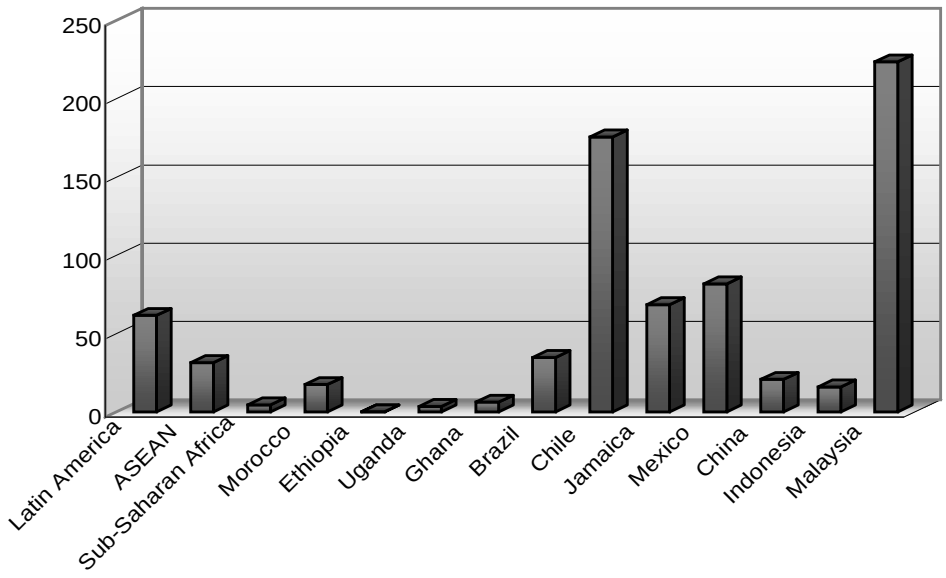
The sources of FDI flows and their utilization have important implications for their stability and sustainability and their contribution to the balance of payments. A distinction is usually made among three different sources of FDI flows: equity capital, undistributed profits, and loans from parent companies to affiliates. In empirical quantification, the equity component is defined as "investment that is made to acquire a lasting management interest (usually [at least] 10 per cent of voting stock) in an enterprise operating in a country other than that of the investor",[19] whether in a new or an existing firm, while acquisitions below 10 per cent are considered as portfolio equity flow. This definition is somewhat arbitrary and raises conceptual problems; nor does it always reflect accurately national practices regarding the classification of FDI.[20] However, it is worthy of note that while total FDI inflows thus defined have been growing at a relatively steady rate in developing countries, total portfolio equity inflows have shown considerable instability since their emergence in the mid-1980s (charts 5.8 and 5.10).

Undistributed profits can constitute a relatively important proportion of measurable FDI flows,[21] although the share of reinvested earnings in total FDI in developing countries has been declining in favour of equity and loans during the 1990s.[22] To the extent that FDI is financed by domestically generated profits, it will depend even more heavily on the overall economic performance of the host country, and is not an autonomous source of external financing. Observing that "more than half the total outflow of what is labelled as 'foreign direct investment' from the United States

**Chart 5.11**

**NET INFLOW OF FDI PER CAPITA IN SELECTED DEVELOPING REGIONS AND COUNTRIES, 1990–1997**

*(Annual average, in dollars)*




***Source:*** UNCTAD, FDI/TNC database and UNCTAD, *Handbook of International Trade and Development Statistics, 1995,* United Nations publication, sales no. E/F.97.II.D.1, New York and Geneva, 1997.

consists of the earnings of foreign subsidiaries retained by them and not remitted to the U.S. parent", Vernon has recently questioned the validity of "contending that [FDI] is functionally indistinguishable from fresh capital inflows" as if "representing a flow of foreign resources crossing the borders of two countries".[23] Clearly, such reinvestments do not involve any cross-border flows and their treatment as a one-way inflow item in the capital account of the balance of payments would not be admissible. This difficulty is resolved by registering reinvested profits as an inflow of FDI in the capital account and as a factor income payment abroad in the current account. However, the existing statistical measures cannot always distinguish between the use of retained earnings for investment in equity capital, on the one hand, and acquisition of other financial assets such as government bonds, on the other. As discussed in *TDR 1997*, together with the many other changes in global financial markets that have facilitated capital mobility, such features of FDI make it difficult to evaluate its stability.

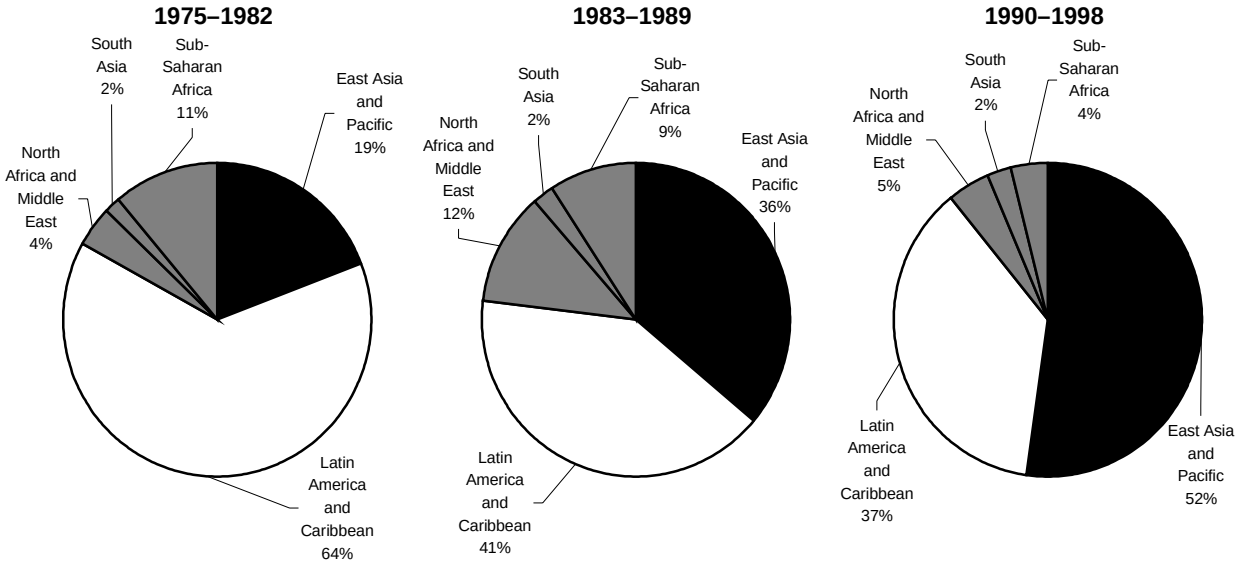
Whether FDI inflows are utilized for mergers and acquisitions (M&A) or for so-called greenfield investment also has an important bearing on their stability and sustainability, and on their balance-of-payments impact. While from a corporate perspective both are additions to productive assets, this is not so for the economy of the host country, notwithstanding that changes in ownership may lead to productivity gains and additional real investment.[24] Conventional analysis has usually treated FDI as if it consists essentially of additions to the real capital stock of the host country. However, although long-term considerations play a role, M&A may also be greatly influenced by prospects of quick capital gains, particularly during periods of crisis (see below).

In practice, data do not allow independent estimation of these two components of FDI. However, since data on cross-border M&A are available, it is possible to estimate greenfield investment but only as a residual, i.e. as the difference between total FDI and M&A. Available

***Chart 5.12***

**DEVELOPING COUNTRIES: SHARE OF DIFFERENT REGIONS IN TOTAL NET INFLOW OF FDI IN DEVELOPING COUNTRIES, 1975–1998**

*(Per cent)*




***Source and definitions:*** As for chart 5.1.

information suggests that cross-border M&A activity has accounted for between one half and two thirds of world FDI flows in the 1990s.[25] The figure is higher for developed than for developing countries, but the difference is principally due to the smaller role of M&A in China. If China is excluded, the share of M&A in cumulative FDI in 1992–1997 turns out to be 72 per cent, up from 22 per cent during 1988–1991. Treating the residual as the greenfield component of FDI, it turns out that its absolute annual level during 1992–1998 was consistently below the level reached in 1991 (chart 5.13). Thus, the recent boom in FDI flows to developing economies has, with the exception of China, consisted predominantly of M&A,[26] largely in the services sector.

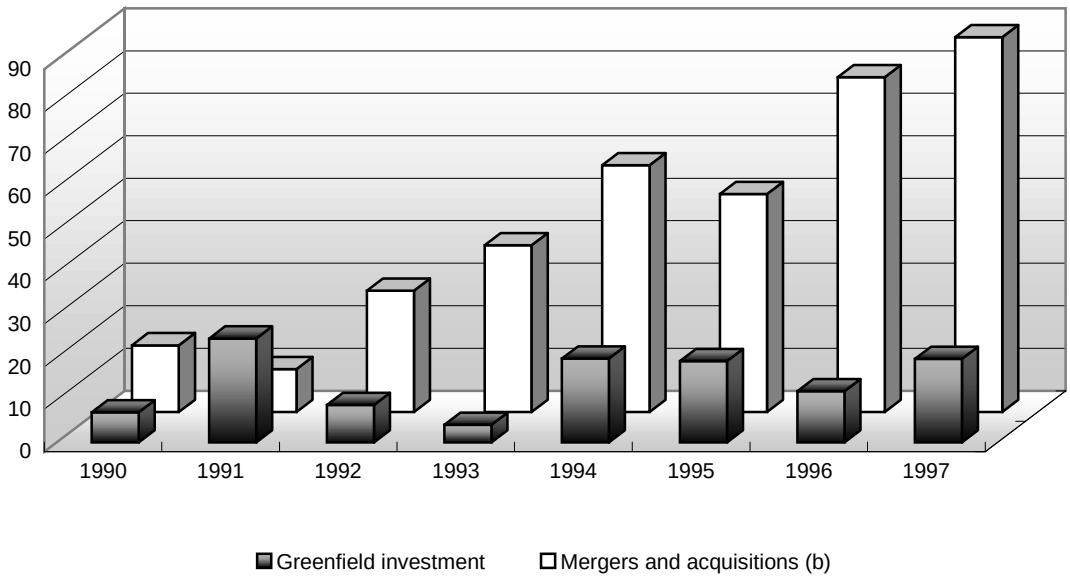
The surge in M&A, especially in the services sector, is closely linked to privatization programmes adopted during the 1990s in which TNCs have often played a prominent role.[27] It can be estimated from World Bank data that during 1990–1997 privatization via foreign investors amounted to 12 per cent of total FDI inflows in developing countries excluding China.[28] The inflow was largely concentrated in Latin American countries, which have pursued the most extensive programmes and received two thirds of the FDI inflows linked to privatization. For individual countries in the region the relevant ratios have been strikingly high in certain years. For example, according to OECD estimates FDI linked to privatization accounted for 73 per cent of FDI inflows in Chile in the 1980s and 80 per cent of inflows in Argentina during 1990–1995.[29] The picture has been similar for Brazil since 1996.

Owing to the consequent (frequently drastic) falls of the exchange rate and declines in asset prices, financial crises in emerging markets can also create opportunities for highly profitable M&A. Simultaneously, uncertainties generated by the crisis itself, together with economic contraction, can discourage investment in new capacity. While political uncertainties may have some deterrent effect, the share of M&A in total inflows

**Chart 5.13**

**NET INFLOW OF FDI IN DEVELOPING COUNTRIES[a] BY TYPE OF INVESTMENT, 1990–1997**

*(Billions of dollars)*




***Source:*** UNCTAD, FDI/TNC database.

***a*** Excluding China.

***b*** In accordance with World Bank practice, only acquisitions of 10 per cent or more of voting stocks are treated as FDI; acquisitions of under 10 per cent are treated as portfolio equity investments.

in the post-crisis period nonetheless tends to be higher than in the period immediately preceding the crisis, which simply reflects the process by which bankruptcy leads to a reallocation of assets to new owners. In 1998, while total FDI flows to the five Asian countries affected by the crisis declined by $1.5 billion, cross-border M&A in those countries are estimated to have risen to more than $3 billion.

The shift of FDI towards acquisition of ownership rights over existing assets has been associated with changes in its sectoral composition. FDI in the primary sector has been declining for some time, although it remains a relatively more important component of total FDI in developing than in developed countries. The secondary sector still accounts for the largest share of total FDI in many developing countries, but the pattern in the 1990s has definitely involved a shift away from manufacturing industries towards the tertiary sector, where much of the merger and acquisition activity has taken place. For example, in a number of countries, including Argentina, Brazil, Indonesia, Mexico, Peru, Thailand and Turkey, the share of the secondary and primary sectors in FDI inflows has declined during the 1990s and the service sector is now the largest recipient in most cases.[30] If a comparison is made of the sectoral shares of the outward FDI stock of the United States, Japan, Germany, Italy and United Kingdom in 1984 and 1996, it turns out that the importance of the primary sector declined, as it did also for the secondary sector (except in the United Kingdom), while the tertiary sector has gained in importance.[31] Notwithstanding the growth of cross-border transactions in services, these trends testify to the rising share of non-tradeable sectors in total FDI flows.

Clearly, cross-border M&A are circumscribed by the stock of assets of the host country, in both the public and the private sectors. In a sense, cross-border M&A constitute a finite process as

**Table 5.5**

**NET TRANSFERS TO DEVELOPING COUNTRIES[a] ON ACCOUNT OF FDI, 1970–1998**

*(Billions of dollars)[b]*

| | 1970–1974 | 1975–1979 | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1998 |
|---|---|---|---|---|---|---|
| Net inflow of FDI | 10.2 | 29.7 | 42.1 | 63.4 | 161.0 | 309.8 |
| Profit remittances | 39.9 | 69.7 | 84.9 | 66.0 | 102.5 | 114.6 |
| Net transfer | -29.7 | -40.0 | -42.8 | -2.6 | 58.5 | 195.2 |

***Source:*** As for chart 5.1.
***Note:*** For the definition of net transfer see box 5.1.
***a*** Excluding China.
***b*** Cumulative totals for each period.

the assets available for it are progressively reduced. The limits of such FDI are even tighter in poorer developing countries, with a much smaller capital stock. While these limits may not have been reached in most developing countries, the initial momentum encouraged by liberalization and the opening-up to foreign capital cannot be sustained indefinitely. That is certainly the case for capital attracted by privatization of public assets, which is of a one-off nature. As for FDI involving acquisition of existing private equity, it was noted above that the presence of non-residents in the stock markets of many emerging markets has already reached high levels, and if the recent pace of foreign equity acquisitions is to continue the corporate sector will need to grow very rapidly, a process which may require a rate of investment far above that observed in recent years – and not only for equity acquisition classified as FDI, but also for portfolio equity investment. These considerations suggest, *inter alia,* that any simple projection of recent FDI trends may not be a sound basis on which to assess the sustainability of such flows.

### 3. Balance-of-payments impact

The impact of FDI on the balance of payments can be analysed in two ways. The first is from the viewpoint of the *net transfers,* which compares FDI inflows with associated payments abroad, including profit remittances, royalties, licence fees and wage remittances as well as interest paid on the net loans of the parent company to its affiliates. While this was a prominent issue in the early literature on FDI and development, it is so no longer. Earlier studies concentrated on a simple comparison of FDI inflows with profit remittances. Countries with a long history of TNC involvement (hence a large stock of capital generating high profits) usually had negative net transfers in this narrow sense, and for developing countries as a whole (excluding China) they remained negative until 1988. It is the boom in FDI rather than any stagnation in profit remittances which has reversed the situation in favour of developing countries in the 1990s (table 5.5). In fact, profit remittances continued to increase at an average rate of 10 per cent per annum from 1988 to 1998.

Data limitations preclude a comprehensive quantitative analysis covering all developing countries regarding the broader concept of net transfers, which takes account also of royalties, licence fees and interest payments to parent companies (although the sums involved appear to be substantial in many countries). UNCTAD estimates of royalties and licence fees for Argentina (1986–1996) and Mexico and Thailand (1987–1996) give a total outflow of $9.9 billion for these items during the years covered, amounting to over 10 per cent of the total FDI inflow for these countries.

A second line of approach is broader in scope and includes the effect of FDI on exports and imports in addition to net transfers. With respect to the trade balance, immediate effects associated

**Table 5.6**

**DIRECT EFFECTS OF FDI ON THE BALANCE OF PAYMENTS OF MALAYSIA, 1980–1992**

*(Millions of ringgit)*

| Year | Net FDI inflow (1) | Exports of foreign firms (2) | Imports of foreign firms (3) | Trade balance of foreign firms (4)=2-3 | Income flows[a] (5) | Net effect (6)=1+4+5 |
|---|---|---|---|---|---|---|
| 1980 | 2 033 | 9 066 | 11 191 | -2 124 | -142 | -233 |
| 1981 | 2 914 | 9 094 | 11 599 | -2 505 | -2 576 | -2 167 |
| 1982 | 3 263 | 10 344 | 13 349 | -3 005 | -2 691 | -2 433 |
| 1983 | 2 926 | 11 483 | 13 251 | -1 768 | -3 202 | -2 044 |
| 1984 | 1 869 | 14 255 | 15 671 | -1 416 | -3 445 | -2 992 |
| 1985 | 1 725 | 13 496 | 15 884 | -2 388 | -3 084 | -3 747 |
| 1986 | 1 262 | 13 894 | 14 489 | -595 | -2 341 | -1 674 |
| 1987 | 1 065 | 19 492 | 18 464 | 1 028 | -4 115 | -2 022 |
| 1988 | 1 884 | 24 863 | 22 352 | 2 511 | -4 088 | 307 |
| 1989 | 4 518 | 33 606 | 28 778 | 4 828 | -5 509 | 3 837 |
| 1990 | 6 300 | 41 822 | 39 694 | 2 129 | -6 444 | 1 985 |
| 1991 | 9 600 | 50 284 | 53 865 | -3 581 | -7 125 | -1 106 |
| 1992 | 10 500 | 56 847 | 55 960 | 888 | -7 641 | 3 747 |

***Source:*** Phang Hooi Eng, *Foreign Direct Investment: A Study of Malaysia's Balance of Payments Position,* Malaysia, Pelanduk Publications, 1998.

***a*** Profits and dividends plus rents and royalties.

with investment and medium-term effects resulting from production activities are involved. Particularly with greenfield FDI, the initial capital inflow is soon followed by imports of capital goods required to install production capacity. The immediate impact on the current account (even before profit remittances and other payments occur) is consequently negative, but the deficit is financed by the inflow of FDI. The subsequent impact on the trade balance depends on the extent to which the FDI was concentrated in tradeable sectors, and on the import content of the associated domestic production. The net outcome of these diverse factors, together with the income payments affecting net transfers, determines the overall impact of FDI on the balance of payments.

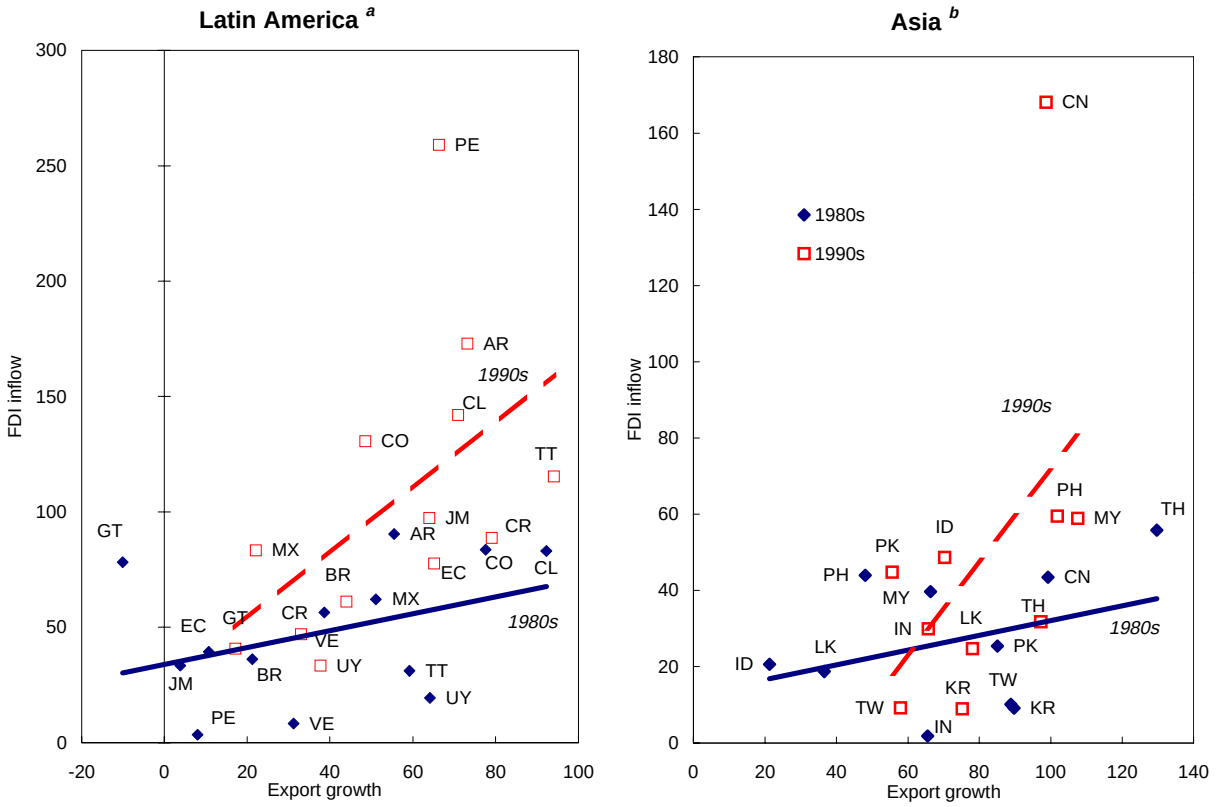
A few country studies are available on the overall payments impact of FDI. They consider export earnings, spending on imports and income payments abroad resulting from the utilization of the existing stock of foreign-owned capital as well as current inflows of FDI and imports of capital goods associated with them. An interesting example concerns Malaysia, which has been one of the most successful developing countries in attracting TNCs and using FDI for capital accumulation and technological progress. The total impact of the trade balance of foreign firms and their income flows on Malaysia's current account has been estimated as negative in every year during 1980–1992 (table 5.6, columns 4+5). The impact on the trade balance became positive during the late 1980s owing to strong export expansion by TNCs in those years. However, as their exports became more import-intensive, this effect diminished. Net foreign-exchange outflows on current account were offset by new FDI inflows on capital account only after the late 1980s, but the cumulative payments impact during the whole period was negative.[32]

A similar picture emerges for Thailand, where FDI surged after 1986, mainly from Japan and the Asian NIEs as those economies suffered loss of competitiveness in labour-intensive indus-

***Chart 5.14***

**THE LINK BETWEEN FDI INFLOW AND EXPORT GROWTH IN LATIN AMERICA AND ASIA, 1985–1990 AND 1991–1996**

*(Percentage)*




***Source:*** UNCTAD databases.

***Note:*** Export growth figures refer to growth from the initial to the final year of each period. The FDI figures refer to the sum of inflows during each period as a percentage of 1987 and 1993 exports, respectively.

***a*** Argentina (AR), Brazil (BR), Chile (CL), Colombia (CO), Costa Rica (CR), Ecuador (EC), Guatemala (GT), Jamaica (JM), Mexico (MX), Peru (PE), Trinidad and Tobago (TT), Uruguay (UY) and Venezuela (VE).

***b*** China (CN), India (IN), Indonesia (ID), Malaysia (MY), Pakistan (PK), Philippines (PH), Republic of Korea (KR), Sri Lanka (LK), Taiwan Province of China (TW), and Thailand (TH).

tries. This large inflow of FDI had a positive impact on investment and growth in Thailand, and is part of the explanation of the rise in its export/GDP ratio from 29 per cent in 1987 to 36 per cent in 1992. However, it was also the cause of an even stronger rise in imports because the associated investment and production was highly import-intensive. It has been estimated that 90 per cent of all machinery and equipment used for foreign investment projects and 50 per cent of raw materials were imported and that in consequence FDI had a negative net impact on the trade balance in the late 1980s and early 1990s, which was reinforced by the rising payments abroad for royalty and licence fees and rising profit remittances.[33] These features of FDI in Thailand appear to have contributed to the external imbalances that played an important role in its subsequent crisis.

The recent surge of FDI in Brazil has so far had a negligible impact on its current account. However, the ECLAC secretariat has concluded that, because of the upward trend in associated remittances, the increased concentration of FDI in non-tradeable sectors, and the gradual exhaustion of privatization-linked FDI, "in the near future

there will be a significant deterioration in the balance of payments of transnational corporations in the Brazilian economy".[34] It also noted that the TNC-led restructuring of the automotive sector, which has been an important factor behind the renewed FDI inflows in the region, has worsened the trade balance in both Brazil and Argentina because of the import dependence of such FDI, whereas in Mexico the impact has been strongly positive.

However, even when FDI-linked activities incur foreign-exchange deficits, such investment may still improve the balance of payments if it creates significant externalities that enhance the export potential of the economy. Similarly, even when FDI leads to payments outcomes less favourable than domestic investment, there may still be net benefits if there are significant technological spillovers from FDI and the presence of TNCs.[35] Nevertheless, such benefits are not spontaneous and may not compensate for additional foreign-exchange deficits if FDI predominantly takes the form of M&A in non-traded sectors. In any case, if the payments outcome of TNC-related activities is constantly a deficit, the economy would need to generate net foreign exchange elsewhere, since meeting such a deficit by simply relying on a new inflow of FDI would mean engaging in an unsustainable process of Ponzi financing.

Indeed, examining and comparing the relationship between export growth and FDI inflows during the 1980s and 1990s in South and East Asian countries, the Bank for International Settlements has singled out "significant weakening of the relationship between foreign direct investment and the growth of exports in the 1990s" as a factor contributing to payments problems and the crisis in East Asia, noting that prospects had become "dimmer that the initial deterioration of the current account, brought about by the imports of capital goods associated with foreign direct investment, would eventually be corrected by new export activity generated by the increase in capacity".[36]

The same comparison for a larger number of developing countries, including several in Latin America, shows that this weakening of the link between FDI and exports is widespread in the developing world (chart 5.14). The same inflows of FDI were associated with less rapid expansion in exports during 1991–1996 than during 1985–1990 in both Asia and Latin America. Notwithstanding other possible influences originating from global economic conditions, such as increased competition in world markets, slow growth and adverse price movements, the increasing concentration of FDI in services sectors seems likely to have played an important role in the weakening of the link between FDI and export growth. ■

## Notes

1 Unless otherwise specified, developing countries in this chapter exclude Hong Kong (China), Singapore, Taiwan Province of China, the transition economies of Eastern Europe and Central Asia, and some small island economies with offshore banking facilities.

2 An important exception in earlier decades was private debt accumulation in the Southern Cone of Latin America; see *TDR 1998*, Part One, annex to chap. III.

3 The term "instability" is used here to refer to the boom-bust phenomenon rather than year-to-year variations. For an account of such crises in emerging markets see *TDR 1998*, Part One, chaps. III and IV.

4 In this report net official capital inflows are defined as net official inflows on debt plus official development assistance (ODA). The former comprises loans provided by international organizations (the World Bank, IMF, regional development banks, and other multilateral and intergovernmental agencies) and from governments and related agencies, including central banks and export credit agencies. ODA corresponds to the item "grants" as defined by the World Bank in *Global Development Finance* and excludes funds allocated through technical cooperation.

5 See *TDR 1998*, Part One, chap. III.

6 Argentina, Brazil, Chile, China, Colombia, Ecuador, Egypt, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Republic of Korea, Thailand, Tunisia, Turkey, Uruguay and Venezuela.

7 The following analysis of net capital flows is based on IMF data in *World Economic Outlook* and *Balance of Payments Statistics* and hence totals for de-

veloping countries do not include the Republic of Korea. Consequently, adjustments have been made to net capital inflow data used in the previous section, which are based on data of the World Bank in *Global Development Finance*.

8 Consistent data with the same country coverage are not available to enable a comparison to be made with the 1980s.

9 Cornford A and Brandon J, The WTO Agreement on Financial Services: Problems of financial globalization in practice, in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. X. United Nations publication, sales no. E.99.II.D.14, New York and Geneva, 1999, tables 1 and 2.

10 World Bank, *Global Development Finance, 1998,* Washington, DC, The World Bank, 1998, table 1.11.

11 See *TDR 1990*, Part Two, chap. I, sect. A.3. The subsequent tax reform in Mexico appears to have effectively reduced the scope for such tax arbitrage.

12 According to one estimate, this proportion was around 50 per cent for Latin American and Asian emerging markets during 1989–1992. See Reisen H, Managing volatile capital inflows: The experience of the 1990s, *Asian Development Bank Review*, 1996, 14 (1): 78.

13 Blondal S and Christiansen H, The recent experience with capital flows to emerging market economies, Working Paper no. 211, OECD Economics Department, Paris, 1999: 10, 12. For a discussion of this issue see *TDR 1998*, Part One, chap. IV.

14 This is, of course, equal to the difference between the rate on government debt and the rate earned on reserves. If non-residents can borrow in international markets at 5 per cent and lend in emerging markets at 12 per cent while reserves can earn 3 per cent, and in the absence of exchange-rate changes, the loss incurred on each dollar will be given by (0.12-0.05)+ (0.05-0.03), i.e. arbitrage plus the spread on reserves, or 0.12- 0.03.

15 The magnitude of such costs to the economy can be illustrated by the following arithmetic, assuming that the arbitrage is carried out by residents. With an average 300-basis-point margin between the borrowing and lending rates for additional reserves accumulated from 1990 until 1997, the cost to developing countries can be estimated at some $50 billion – about 11 per cent of the amount of the additional reserves or 2.5 per cent of total net inflows over the same period. Since arbitrage is at least partly carried out by non-residents, the cost is greater because the margin between the rate on the government paper and the rate on reserves is typically much wider.

16 According to one estimate, for 54 developing countries, the share of current-account financing in total capital inflows declined, on average, from 84 per cent to 39 per cent from 1982–1989 to 1990–1995; see Bosworth B and Collins SM, Capital flows to developing economies: Implications for saving and investment, Brookings Papers on Economic Activity, 1999, 1, table 1.

17 Owing to lack of data, three emerging markets included in table 5.2 (Colombia, Egypt and Indonesia) could not be included in the analysis.

18 For a recent survey of empirical findings on the relationship between FDI and growth, see Milberg W, Foreign direct investment and development: Balancing costs and benefits, in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. XI, United Nations publication, New York and Geneva, forthcoming.

19 World Bank, *Global Development Finance 1997*, vol. 1, Washington, DC, The World Bank, 1997: 180.

20 On the conceptual and statistical difficulties surrounding FDI see IMF, *Balance of Payments Manual*, 5th edition. Washington, DC, IMF, 1993, chap. XVIII; Helleiner GK, Transnational corporations and direct foreign investment, in Cheney H and Srinivasan TN, eds., *Handbook of Development Economics*, vol. II, Amsterdam, Elsevier, 1989; and R Vernon's review of UNCTAD's *World Investment Report 1997*, in *Economic Development and Cultural Change*, 1999, 47(2).

21 This is particularly true for outward FDI from the United States and the United Kingdom; see Lipsey, op. cit. In his "The effect of outbound foreign direct investment on the domestic capital stock" (NBER Working Paper no. 4668, March 1994), M Feldstein observes that about 20 per cent of the value of assets owned by United States affiliates abroad is financed by capital outflows, 18 per cent by retained earnings and the rest by foreign debt and equity.

22 UNCTAD, *World Investment Report 1997*, United Nations publication, sales no. E.97.II.D.10, New York and Geneva, 1997, fig. 1.2.

23 Op. cit.: 2.

24 On the importance of sequential FDI linked to privatization in Latin America see UNCTAD, *World Investment Report 1995*, United Nations publication, sales no. E.95.II.A.9, New York and Geneva, 1995, box II.7: 77–78.

25 Total cross-border M&A may somewhat exaggerate the scale of FDI linked to such activity if not all M&A transactions are included in figures for total FDI.

26 Data for the United States inward and outward FDI also confirm the declining importance of greenfield investment; see UNCTAD, *World Investment Report 1997*, chap. I, sect. A.1.

27 About two thirds of privatization revenues in developing countries during 1990–1997 came from telecommunication and power infrastructure (almost half of the total) and financial and other services; see World Bank, *Global Development Finance, 1999*, Washington, DC, 1999, appendix 4.

28 Ibid., tables A4.8 and A4.9.

29 OECD, *Foreign Direct Investment and Economic Development: Lessons from Six Emerging Economies*, Paris, 1998: 29. See also Reisen H, op. cit.: 76.

30 See World Bank, *Global Development Finance, 1998*, Washington, DC, 1998, table 1.10.

31 OECD, *International Direct Investment Statistics Yearbook, 1998*, Paris, 1998. On average the share

of the secondary sector declined from 40 per cent to 33 per cent, whereas that of the tertiary sector rose from 39 per cent to 59 per cent. For data on the widening scope for investment by OECD countries in the banking sector in developing countries see Cornford A and Brandon J, op. cit.

32 Phang Hooi Eng, *Foreign Direct Investment: A Study of Malaysia's Balance of Payments Position*, Malaysia, Pelanduk Publications, 1998.

33 Jansen K, The macroeconomic effects of direct foreign investment: The case of Thailand, *World Development, 1995*, 2(2).

34 ECLAC, *Foreign Investment in Latin America and the Caribbean, 1998 Report*, United Nations publication, sales no. E.98.II.G.14, Santiago, Chile, 1998.

35 Generally, assessing the overall benefits of FDI involves difficult counterfactual exercises. A comparison can be made with domestic investment undertaken with foreign borrowing, since a country receiving FDI can also be expected to have access to international capital markets. The rate of return on FDI often exceeds by a large margin the cost of external borrowing; "most international companies carrying out FDI apply implicit hurdle rates of return in the range of 20 to 25 per cent per annum over relatively short capital recoupment periods" (Kregel J, Some risks and implications of financial globalization for national policy autonomy, *UNCTAD Review 1996*, United Nations publication, sales no. E.97.II.D.2, New York and Geneva: 58. *Ex post* rates naturally depend on the success of the enterprise, but they also seem to be quite high, reaching on average 27 per cent in East Asia in 1980–1993, 22.5 per cent in Africa, an 16.8 per cent for developing countries as a whole; see UNCTAD, *World Investment Report 1995*, table II.10: 94. Thus, FDI would need to offer additional benefits to offset the difference. One of the benefits often claimed is that, unlike interest payments on external debt, FDI would involve income payments abroad only when the enterprise is commercially successful. Success in this sense does not, of course, rule out payments difficulties.

36 Bank for International Settlements, *68th Annual Report*, Basle, 1998: 36.

Chapter VI

# RETHINKING POLICIES FOR DEVELOPMENT

## A. Introduction

In chapter IV it was seen that greater liberalization in the South coupled with slower growth in the North has resulted in increased external resource needs for developing countries. The increase in the import content of growth, together with the continued decline in their terms of trade, means that growth in developing countries is now associated with higher current-account deficits than in the past, necessitating greater inflows of foreign capital. On the other hand, the analysis in chapter V shows that the surge in capital inflows in the 1990s constitutes a recovery from the depressed levels of the 1980s, rather than signalling a new trend which could offset the structural rise in external deficits. The increased inflows have also been highly concentrated in a small number of emerging markets, and so the majority of developing countries have been bypassed. Moreover, the proportion of the net capital inflow that has been used to finance real resource transfers needed to support production and capital formation has been falling – a counterpart to the growing proportion absorbed by capital outflows by residents and by reserve accumulation required to safeguard against financial instability.

Given the speed at which global conditions can change, it is not easy to project the external capital flows to developing countries in the medium to long term; indeed, as discussed in chapter III, even short-term projections are subject to large margins of error. Nevertheless, on recent trends, the level and composition of net capital flows received by most developing countries are inadequate to meet their external financing needs. Even if these trends are maintained, the scenarios examined in chapter IV suggest that the flows will be insufficient to enable a sustained annual growth of 6 per cent to be achieved. Even under relatively optimistic assumptions, the external financing needs of developing countries can be estimated to exceed recent net capital inflows by over 40 per cent. The gap would be greater if growth in industrial countries remains sluggish and the terms of trade of developing countries continue to decline. If the recent trends in capital outflows by residents and reserve accumulation were to persist, net capital inflows required to sustain an average 6 per cent growth in developing countries would be no less than an estimated 8 per cent of their combined GNP, compared to some 5 per cent during the 1990s.

In the light of the above, development thinking and policies need a radical review if developing countries are to be assured better growth prospects, narrow the income gap with the advanced industrial countries, and remove the scourge of widespread and persistent poverty. They will need to manage better their integration into the global economy if they are to overcome the imbalances and instabilities associated with international flows of goods and capital. This calls for a reorientation of their policies in order to regulate capital flows and establish competitive industries that would not only increase exports but also reduce the import content of growth. However, action by developing countries alone cannot be

the complete answer. Serious attention should also be given to the systemic biases and asymmetries in the workings of the international trading system which limit their growth prospects. The successful pursuit of outward-oriented policies also requires greater openness of markets in industrial countries to their exports, all the more so in view of the current "aid fatigue" and the failure of private financial markets to provide adequate development finance. Without considerably increased aid or trade opportunities, developing countries will face a Herculean task.

## B. Developing countries: managing integration

### 1. Exchange-rate management

Developing countries need to improve the management of their exchange rates if they are to benefit from greater integration into the international trading system. They must not only sustain competitive rates over the longer term but must also retain policy autonomy to make orderly adjustments when faced with exogenous shocks. The question is not so much one of designing an appropriate exchange-rate regime as of managing and regulating capital flows; no exchange-rate regime can ensure the stability and autonomy needed for successful trade performance unless destabilizing capital flows are brought under control.

Recent debate on exchange-rate policies in developing countries has concentrated on the connection between exchange-rate regimes and financial crises, rather than on the implications of alternative regimes for trade and competitiveness. Pegged exchange rates have fallen out of favour on the grounds that financial and currency crises in emerging markets have often been associated with such regimes. Accordingly, developing countries are increasingly being advised to choose one of the two extremes: either to float freely or to lock in their exchange rates with one of the major currencies, often the United States dollar, through such arrangements as currency boards or even simply adopting the dollar as their national currency.[1] However, when capital is completely mobile, neither of these extremes is likely to provide better protection against currency instability and financial crisis than nominal pegs, or to allow the exchange rate to be tailored to the requirements of trade and competitiveness.

An examination of recent bouts of currency crisis in emerging markets suggests that two kinds of problems are associated with nominal pegs. First, they tend to give rise to real appreciations, thereby undermining competitiveness and leading to unsustainable current-account deficits. This problem is particularly acute when the exchange rate is used as a nominal anchor to bring down inflation; since prices of non-traded goods do not come down as rapidly as those of traded goods, real appreciation is inevitable. While this was the case in all episodes of crisis in Latin America in the 1990s, there was no serious overvaluation in most of the crisis-hit economies in East Asia.[2]

The second problem is more serious, since it involves stock disequilibrium and relates to external financial fragility. As examined in *TDR 1998*, stable nominal exchange rates, combined with interest-rate differentials, create one-way bets for speculators seeking to benefit from international arbitrage, and provide a strong incentive for domestic firms and banks to reduce their cost of finance by borrowing abroad. To the extent that the peg is successfully implemented, borrowers feel no need to hedge against the currency risk. In consequence, and quite independently of how the real exchange rate or the current account moves, the economy becomes vulnerable to capital flight. When capital inflows are reversed, the currency collapses and hikes in interest rates are often unable to check this process. Throughout this boom-bust cycle the nominal exchange rate first stays stable for prolonged periods, while the

real exchange rate shows a tendency to rise. This is followed by a collapse of the nominal rate and the overshooting of the real rate. Subsequently, the nominal exchange rate tends to recover, while the real rate may show some tendency to rise – a pattern which effectively mimics the behaviour of reserves examined in chapter V. Such gyrations in exchange rates create considerable uncertainty, raising the risk premium on investment in traded goods sectors, and thereby undermining trade performance and growth.

Abandoning a nominal peg without a "crash landing" is not easy, particularly if the peg has been maintained over a long period and the real exchange rate has been allowed to appreciate significantly. Similarly, introducing exchange-rate uncertainty as a way of discouraging arbitrage flows by signalling to markets that the peg may be changed suddenly could simply precipitate currency attacks. For these reasons, a freely floating rate is often suggested as a better way out.[3] Floating is expected to bring about a more cautious attitude to lending and borrowing by private actors and banks, encourage financial risk management and improve access to different instruments designed for this purpose. It would also give policy makers greater autonomy in monetary policy since they would no longer be defending a particular exchange rate.

However, the experience of the major industrial countries with floating rates since the breakdown of the Bretton Woods system does not support these considerations. This experience has been characterized not only by persistent currency misalignments among the major reserve currencies and by large trade imbalances, but also by gyrations in exchange rates over relatively short periods, with movements of 20 per cent or more in a matter of weeks.[4] Similarly, the notion that floating rates give greater policy autonomy has also proved to be illusory. It is no longer possible to ignore the consequences of exchange-rate changes for domestic policy objectives when their influence on stability and growth is greatly enhanced by the increased integration of markets.

The experience of developing countries with flexible exchange rates points in the same direction. Recent World Bank research has shown that over the past three decades countries with floating currencies have actually become more vulnerable to financial crises, leading the Bank to conclude that "crises are as likely to occur under flexible exchange rates as under fixed exchange rates".[5] Indeed, flexible exchange rates provide no more guarantee against real appreciation than fixed rates, since they may add nominal exchange-rate gains to interest differentials and reinforce rather than temper capital flows, thus aggravating unsustainable payments positions. As discussed in chapter V, in most episodes of financial crisis in emerging markets the boom phase is characterized by inflows of capital in excess of current-account needs, and by sharp increases in reserves. Under these conditions, leaving the exchange rate to markets could simply lead to appreciations and to higher arbitrage profits, attracting even further inflows of capital. Although appreciations would also heighten currency risks, markets tend to ignore them when they are driven by herd behaviour. For instance, it is probable that if currencies in East Asia had been allowed to float in the early 1990s, the result would have been further appreciations, thereby encouraging further inflows and aggravating external financial fragility.[6]

Locking exchange rates in through currency boards or outright adoption of a reserve currency as the domestic currency provides no more viable a solution for most developing countries. It effectively implies abolishing the central bank, discarding discretionary monetary policy and subordinating all other policy objectives to that of maintaining a fixed exchange rate. Ironically, the key factor for the success of a currency board is essentially political: credibility derives from the willingness of the Government to be firmly disciplined by external forces. Thus, as Martin Feldstein has recently argued, the success of such arrangements "depends on market confidence that the Government will let interest rates rise as long as foreign exchange reserves dwindle, no matter how much damage those high rates do to the economy".[7] In this respect, currency boards mimic the workings of the gold standard, and, much like the gold standard, such regimes do not insulate economies from external shocks and instability, since the impact of capital flows is transmitted via liquidity to economic activity and to prices of goods and financial assets. Sustaining such an arrangement despite high costs is only possible where there is "exceptional distrust of discretionary monetary policy".[8]

Speculative attacks against a currency can occur in a currency board system just as in any other exchange-rate regime. Again, as noted in

chapter III, a currency board cannot ensure that domestic interest rates remain at the level of the country to which the currency is pegged. A good example is the experience of Argentina during the Mexican crisis and that of Hong Kong (China) during the Asian crisis. In both cases, interest rates had to be raised dramatically, and the pegs could be maintained only at the expense of sharp declines in output, reaching 6 per cent. It thus appears that the costs of maintaining pegs in these instances were no less than those incurred by countries experiencing currency turmoils.

For the same reason currency boards cannot guarantee the stability of the banking system. As in Argentina, the cost of preventing devaluation can be a severe banking crisis as well as a devastating shock to the real economy.[9] That reserves are sufficient to cover the monetary base provides no protection to the banking system. Each unit of currency withdrawn from circulation results in a greater reduction of the liquidity of the banking system through the money multiplier, forcing banks to recall loans. Thus, contrary to the underlying principles of currency boards, the central bank is often forced to provide some liquidity to the banking system in order to prevent collapse.[10]

More importantly, currency boards can lead to costly exchange-rate misalignments in developing countries if domestic adjustment is not rapid. For obvious reasons a combination of developing and industrial countries does not constitute an optimal currency area: they have different economic structures and price and productivity dynamics; labour mobility between them is limited; and they are subject to asymmetric shocks since, while most developing countries are commodity exporters and debtors, most industrial countries are commodity importers and creditors. These asymmetries could have serious costs in terms of output, employment or price stability. The problems would also be confronted in adopting a reserve currency as the national currency, particularly when there are no institutional arrangements for monetary cooperation and the monetary policy of the reserve-currency country is conducted without regard to its implications for the country or countries concerned.

Thus, under free capital mobility no regime of exchange rates will guarantee stable and competitive rates; nor will it combine steady growth with financial stability. Differences among systems of pegged, floating and fixed exchange rates lie not so much in the extent to which they can prevent volatility of capital flows or contain their damage to the real economy as in how the damage is inflicted. Damage can only be prevented or limited if there is effective regulation and control over destabilizing capital flows. While that may not be without cost, the cost is likely to be small compared to that of currency instability and misalignment and financial crises. Managing nominal exchange rates in a flexible manner in order to minimize fluctuations in the real exchange rate, in combination with controls on destabilizing capital flows, thus remains the most plausible option for most developing countries.

It is precisely those countries that have been most successful in managing their exchange rates that have retained the widest array of policy instruments, including measures to influence and control capital movements. Most European countries employed measures to control capital flows in the turbulent years that followed abandonment of the Bretton Woods System, and the United States deployed a wide range of measures to reduce capital outflows in the 1960s. As the experiences of China and India show, such measures can serve to deter speculative flows without prejudice to capital for productive investment. More recently, Chile and Colombia have used prudential measures to influence the maturity of their capital inflows, and Malaysia has been able to return to currency stability and increase its FDI inflows.

It is important to recognize that the main objective of controls in a world of integrated capital markets is to prevent the cumulative build-up of foreign liabilities that can be easily reversed. Consequently, controls on capital inflows should be a permanent feature of policy, to be used flexibly and in the light of circumstances. The techniques available to control inflows are well known and have been discussed at length in past issues of *TDR*.[11] A distinction needs to be made between direct restrictions (e.g. on banks' net external positions, borrowing abroad by non-banks, or foreign equity participation in domestic firms) and market-based disincentives that leave discretion to lenders and investors (e.g. non-interest-bearing reserve requirements on foreign liabilities or taxes designed to reduce the international arbitrage margin). Both sets of measures have been used in various industrial and developing countries. Their success depended on the extent to which the underlying economic conditions and policies were sustainable.

The exchange rate can also be used to deter arbitrage flows. A crawling exchange-rate band which is clearly targeted to avoid persistent real appreciation provides information to the market about the policy being followed and allows plans to be made accordingly, while the width of the band creates a modicum of uncertainty which allows the central bank to intervene selectively in the traditional manner to smooth fluctuations in capital flows and limit their impact on the exchange rate. In no case should the width of the band plus the announced adjustment margins be less than the forward discount on the currency (adjusted for the appropriate period). Otherwise, the band system becomes similar to a pegged exchange-rate system and invites speculative attack. However, direct intervention in the market should be supported by adjustments in control measures, such as changing the implicit or explicit tax on inflows. Such adjustments could be just as frequent as direct intervention. The goal should be to substitute changes in controls for the use of reserves and to free interest rates for domestic policy objectives.

Even where reversible capital inflows are deterred by various means, dollarization of an economy would pose a potential threat to exchange-rate stability, since it effectively eliminates the difference between residents and non-residents in the determination of the profitability of their investments and their ease of access to foreign assets. Thus, discouraging dollarization should also be part of the overall regime for capital controls.

The need for controlling outflows would be reduced to the extent that speculative inflows can be prevented and dollarization avoided. Nevertheless, no developing country is immune to a currency crisis, particularly if it limits its control over capital movements to market-based measures and prudential regulations. As discussed in *TDR 1998*, if all else fails, debt standstills accompanied by temporary exchange controls over all capital transactions, by residents and non-residents alike, including transfers involving deposits and investments in securities and stocks, provide an effective and equitable response to speculative attacks and self-fulfilling debt runs.

## 2. Establishing competitive industries

Effective exchange-rate management is clearly essential to overall economic stability in developing countries, and the benefits obtainable through growth and exports are generally recognized. Under some circumstances, and particularly when a period of currency appreciation has led to a loss of markets, devaluations can also provide a palatable alternative to nominal wage cuts in an effort to boost export performance.[12] However, any sustained improvement in the external balance of developing countries can only come about through productivity growth and technological upgrading, which can be achieved both by augmenting the existing stock of physical and human capital and by shifting existing resources away from traditional low-productivity activities.

For many developing countries, any initial expansion is likely to be concentrated in sectors with a high resource and/or unskilled or semi-skilled labour content. Such sectors tend to be technologically less demanding and can quickly absorb large numbers of workers from the more traditional primary and tertiary sectors.[13] Under favourable global economic conditions, developing countries can expect to see strong export growth in these same sectors. However, in some of them, particularly the larger economies, a more diversified production and export profile incorporating capital goods might be possible, even at earlier stages of development.

There is now a much greater appreciation by policy makers in developing countries of the need to secure a rapid growth of exports in order to expand investment and output. As discussed in chapter IV above, an export-investment nexus can capture the wider and mutually reinforcing linkages between trade, investment and economic growth. Because such a dynamic interaction is not a spontaneous outcome of market forces, pragmatic trade, financial and industrial policies remain a sine qua non for sustainable growth.

While emphasis on exporting is desirable for a variety of reasons, it may not alone remove the balance-of-payments constraint on growth. A sophisticated infant-industry programme designed to reduce the import content of growth also needs to be part of the policy arsenal available to developing countries. The current aversion to such programmes reflects a misreading of the reasons for the failure of an earlier generation of import-substitution policies. A careful review of past experience shows that design and implementation problems, and not misguided logic, were the main source of failure.[14] Moreover, the success of the

East Asian and other fast-growing developing economies shows that an export push often followed the build-up of domestic production capacity for the replacement of imports.[15] In view of the evidence that the import content of growth in developing countries is now an even greater constraint on sustained economic growth than in the past, a rethinking of this issue is an urgent necessity in many developing countries.

The mix and sequencing of trade, industrial and technology policies that successfully combined export promotion with import substitution in East Asia are well known and have been discussed extensively in past issues of *TDR* and elsewhere.[16] The lessons from this experience have lost little of their relevance. However, the post-Uruguay Round trading regime has circumscribed the scope in most developing countries for replicating some of the policy measures which contributed to East Asian success. The possibilities are greater for the least developed countries, but in some cases, such as the use of subsidies, most are not able to exploit them.[17] Nevertheless, there remains a need for more policy advice and technical assistance to developing countries in designing strategies to help promote competitive industries, rather than an emphasis simply on what is no longer possible under existing trade rules.[18]

More importantly, in view of the growing pressure on countries to push domestic producers into world markets, the concept of infant industries needs to be extended beyond the earliest stages of manufacturing and include nourishing more advanced competitive industries through appropriate protection and support. Developed countries cannot, on the one hand, justify protecting and helping mature producers in their agricultural and high-technology sectors and, on the other, deny such possibilities to developing countries facing their own particular problems. If existing multilateral rules are indeed impeding the learning and upgrading process in the industrial sectors of developing countries, then a reexamination is called for. Such examination is particularly desirable in respect of Article XVIII, sections A and C, of GATT 1994, where the compensation requirements are so onerous that they are likely to nullify the very intent of the article, which is to allow developing countries to promote new industries. Part IV of GATT 1994, together with the 1979 Tokyo Round Enabling Clause, which lay down broad principles and objectives of differential and more favourable treatment, could provide a good starting point, although their best-endeavour status is not adequate in the light of the remaining biases and asymmetries in the international trading system.[19] The shift in approach during the Uruguay Round, away from differential treatment allowing developing countries to protect their own industries and preferential access to northern markets and towards an ad hoc array of special terms on implementing agreements and on technical assistance to help developing countries integrate into the world economy, does not, however, in the light of the findings of this Report, represent a positive step forward. According to one recent review of the issue, the old approach, based on the existence of endemic balance-of-payments problems in developing countries and support for infant industries, was simply ignored by the proponents of conventional neoclassicism (whether because of a one-sided interpretation of the East Asian experience or of a general distrust of policy makers in developing countries) who came to dominate the intellectual scene in the trade negotiations of the mid-1980s.[20] The economics behind the old approach remains nonetheless valid. Serious attention should now be given to how special and differential treatment could be integrated into the contractual obligations of the rule-based trading system.

On the other hand, many of the policies needed to establish dynamic domestic firms are not directly governed by multilateral agreements, and there is much greater scope in this respect than has been exploited in many developing countries. There is considerable freedom in the choice of financial, fiscal and macroeconomic policies that can help create the basic conditions for faster capital accumulation and channel investment to areas consistent with broader development objectives. But at the core of any successful development experience lies a series of institutional ties and more informal individual networks that connect the public and private sectors, allowing information to flow between business and the public sector without compromising the ability of policy makers to propose and pursue development goals. In many developing countries, the capacities of the private and the public sectors in this respect have been steadily eroded, and the time needed to rebuild them may in some cases be considerable.[21]

Attracting FDI to obtain foreign technologies and secure other advantages associated with the international production network of TNCs can offer a faster route to the establishment of com-

petitive industries. However, the benefits from hosting TNCs are not automatic and the policy objectives of the host country in such matters as local content, technological upgrading and balance-of-payments stability may clash with the commercial interests of the corporations. As discussed in the preceding chapter, replacing the high import content of TNC activities in manufacturing with domestic production remains an important objective in many countries. Equally, the potential technological and other spillovers, particularly for middle-income economies and in sectors where specific knowledge and capital equipment are closely knitted together, still require that host Governments preserve their ability to bargain effectively with TNCs.[22]

Again, the objective of policy makers should not be to attract FDI under any conditions but to create a domestic economic base which can benefit from the presence of foreign firms. Thus, while TNCs can be important agents to help build or improve a country's competitive advantages, the terms on which this is done should remain variable.

As was the case with successful experiences in the past, all trade and industrial policies must be designed and implemented so as to reflect differences in levels of economic development, resource endowments and macroeconomic circumstances. In both export orientation and import substitution there are easy and difficult stages, and Governments must be ready to make timely shifts in the incentive structure as their economies graduate through different stages of industrial and economic development.

## 3. Fallacies of composition

There has been some concern that what worked in the past for a small group of economies will not work if a large number of developing countries pursue the same strategy simultaneously.[23] Indeed, export prospects could be weakened for manufactures with low elasticities of demand, particularly with slower global growth and the danger of proliferation of new forms of protectionism in the North. Any gains in volume under these conditions would be eroded by price declines. These were not the conditions that prevailed when the East Asian NIEs adopted their export-oriented strategy.

As noted above, there is some evidence that the relative price of manufactured exports from developing countries has fallen during the past two decades alongside the rapid expansion of their volume. Moreover, simulations by the UNCTAD secretariat undertaken in the context of a North-South trade model suggest that a widespread attempt by developing countries to increase exports of labour-intensive, low-elasticity manufactures to northern markets could lead to a collapse of their terms of trade. However, such an outcome depends on how quickly northern producers move out of such low-skill activities as clothing, on market access conditions in the North, and on the pace at which newly industrializing countries diversify their own production structures away from low-skilled exports.[24]

Already, with the rapid industrialization achieved by a number of East Asian and some other developing-country exporters of manufactures, dependence for growth on exports to industrial countries has weakened somewhat. Greater South-South cooperation in trade could help overcome the problem associated with inadequate growth of and access to markets in the North. Again, successfully reducing the import content of growth could alleviate the balance-of-payments pressures arising in developing countries. Still, the South needs to look to the North for capital and intermediate goods and to gain access to technology. Consequently, both the growth of northern markets and access to them are vital.

The fallacy of composition argument is not confined to trade relations but extends to other components of the global economy. Much of the rationale for developing countries to liberalize their regimes governing FDI and extend incentives to potential investors lies in the hope of replicating the success of some countries in Asia and Latin America, such as Chile and Malaysia, which by attracting TNCs were able to launch export-oriented industries. However, UNCTAD secretariat calculations have shown that the scale of FDI flows from the North implied by a general replication of these experiences is unrealistic.[25]

# C. Developed countries: obstacles to and opportunities for exports from developing countries

## 1. Beyond the playing-field metaphor

Low average duties resulting from the Uruguay Round have led some to a belief that a level playing field is being rapidly established in the international trading system, but that is far from being the case. Trade liberalization in developed countries was a gradual process which unfolded over eight rounds of multilateral trade negotiations under GATT auspices, and through the participation of those countries in regional trade agreements and customs unions. Exceptionally strong growth during the post-war years underpinned this liberalization process. By contrast, the large and active participation of developing countries in recent multilateral trade negotiations occurred at a time of sluggish growth, when many of them were implementing difficult adjustment programmes to address the payments difficulties associated with the debt crisis of the 1980s. Those programmes involved extensive liberalization measures, notably the removal or relaxation of quantitative import restrictions and exchange controls, as well as significant reductions in tariffs which were to a large extent bound in their concessions in the Uruguay Round; whereas for developed countries tariff bindings were increased from 96 per cent to 99 per cent, for developing countries the increase was from 14 per cent to 59 per cent. At the same time, negotiations in many areas of interest to developing countries did not advance very far.

### (a) Tariffs

As a result of the Uruguay Round, the average MFN tariff rate in the major advanced industrial countries should fall to between 3.7 per cent (United States) and 7.1 per cent (Canada), once the negotiated reductions are fully implemented. However, as noted in chapter II, both the level and the frequency of tariffs remain a matter of concern in a number of key sectors of direct interest to developing countries. Over 10 per cent of the tariff universe of the Quad countries (Canada, European Union, Japan, United States), made up of 4,000 tariff lines, will continue to face peak tariffs, i.e. tariffs in excess of 12 per cent *ad valorem*.[26] One fifth of the peak tariffs of the United States, 30 per cent of those of Japan, one quarter of those of the European Union and about one seventh of those of Canada exceed 30 per cent. Even after all concessions are fully implemented, frequent tariff peaks and significant tariff escalation will continue to provide high levels of import protection for a sizeable cross-section of northern producers.

Such peaks are frequent for agricultural products, particularly dairy products, sugar and cocoa products and canned fruit and vegetables, but are also common for many low-technology manufactures (table 6.1). A recent study by UNCTAD/WTO has shown that among agricultural tariff peaks excessively high rates (i.e. exceeding 70 per cent) are mainly applied to products that had been recently tariffed as a result of the Uruguay Round commitments. They include: frozen bovine meat, grape juice, fresh bananas, milk, maize and raw sugar cane in the European Union; stemmed tobacco, shelled or roasted peanuts and peanut butter in the United States; milled rice, shelled peanuts, milk, and prepared pork hams in Japan; and dairy products in Canada. All these products are generally considered to offer a potential for export diversification in developing countries.[27]

Although tariff peaks are not as high in traditional low-technology manufactures as in agriculture, northern producers continue to benefit from protection. Clothing and textile producers are still protected both by high tariffs and by stringent quantitative restrictions on imports from developing countries, and they will continue to enjoy high tariff protection even when all quota restrictions are removed in 2005. The preferential rates for clothing under EU's GSP scheme amount generally to 11.9 per cent.[28] The United States ex-

**Table 6.1**

**FREQUENCY OF POST-URUGUAY ROUND TARIFF PEAKS[a] BY PRODUCT GROUP**

*(Percentage of tariff lines within each group)*

| *Product group* | *United States* | *Canada* | *European Union* | *Japan* |
|---|---|---|---|---|
| Agriculture | 19 | 15 | 48 | 42 |
| Meat | 8 | 14 | 62 | 41 |
| Fish and crustaceans | 0 | 0 | 37 | 3 |
| Dairy products | 55 | 70 | 84 | 87 |
| Fresh fruit and vegetables | 12 | 8 | 34 | 19 |
| Cereals and flour | 0 | 26 | 72 | 61 |
| Vegetable oils | 6 | 9 | 10 | 13 |
| Canned meat and fish | 4 | 14 | 56 | 32 |
| Sugar and cocoa products | 29 | 12 | 79 | 73 |
| Canned fruits and vegetables | 17 | 24 | 80 | 63 |
| Other food products | 33 | 18 | 59 | 81 |
| Beverages and tobacco | 18 | 16 | 37 | 48 |
| Other agriculture | 1 | 2 | 14 | 5 |
| Manufacturing | 10 | 15 | 18 | 12 |
| Leather and leather products | 12 | 4 | 0 | 22 |
| Textiles | 21 | 45 | 1 | 1 |
| Clothing | 44 | 93 | 0 | 0 |
| Footwear | 42 | 67 | 0 | 71 |
| Glass products | 10 | 5 | 0 | 0 |
| Vehicles | 4 | 1 | 8 | 0 |

***Source:*** UNCTAD secretariat, based on United Nations Statistics Division, Trade Analysis and Information System (TRAINS) database.

***a*** Defined as tariff rates which exceed 12 per cent *ad valorem*; see text, note 26.

cludes most textiles and clothing products from its scheme, and its MFN tariffs range from 14 per cent to 32 per cent for most synthetic, woollen and cotton clothing. Canada applies MFN rates of about 18 per cent and the GSP rates of Japan range from 6 per cent to 11 per cent.

Developing countries also continue to face extremely high tariff barriers in footwear, leather and leather goods. Neither the United States nor Canada accords preferences for these products under their GSP schemes, and MFN rates range from 38 per cent to 58 per cent for certain sports, rubber, plastic and textile shoes in the United States and from 16 per cent to 20 per cent for all footwear in Canada. Tariffs on footwear in EU are generally at 11.9 per cent for GSP beneficiaries and 13 per cent for other suppliers. Japanese MFN tariffs reach 30 per cent for leather; for leather shoes the tariff is equivalent to 140 per cent for a pair priced at $25; GSP imports are subject to a stringent ceiling. Even some capital-intensive goods, such as trucks, buses and ships, face relatively high peaks in some northern markets. In high-technology sectors which involve largely unskilled labour in the production of components, such as TV receivers and tubes, video recorders and watches, MFN tariffs are also high and the major exporters are excluded from GSP treatment.

Although tariff escalation has decreased as a result of the Uruguay Round, rising tariffs from raw materials to intermediate products and sometimes peaking for finished industrial products continue to restrict export opportunities and hamper

vertical diversification and industrialization in developing countries. This remains a very important obstacle to their agricultural diversification.[29] Traditional low-skill industries such as textiles, footwear and clothing and resource-based industries such as rubber and wood products are also vulnerable.[30] As these markets are very large, a decline in tariffs for the processed products would significantly increase market access for exporting countries.

### (b) Non-tariff measures

With the entry into force on 1 January 1995 of the Marrakesh Agreement Establishing the World Trade Organization, some trade measures are losing their importance as barriers. The Agreement on Agriculture requires the elimination of quantitative restrictions and other frontier non-tariff measures. The Agreement on Safeguards renders resort to voluntary export restraints virtually impossible, although similar measures are being applied in the guise of "understandings" on subsidies. On the other hand, the threat of market penetration by southern producers has prompted northern industries to seek other protectionist measures consistent with the various WTO Agreements. Such measures can have a significant impact on access to northern markets; according to one recent study, the true average protection rate of European industry rises from 5.1 per cent if only tariffs are included and to 9 per cent if tariff and non-tariff barriers are considered together.[31]

Among the various contingency protection measures (often termed "trade remedies") allowed under GATT 1994, anti-dumping action is a widely exercized option.[32] This is partly due to the nature of the Agreement on anti-dumping (formally the Agreement on Implementation of Article VI of the GATT 1994), which, while setting out a series of procedural guidelines aimed at reducing the scope for arbitrariness and uncertainty, still contains many ambiguities and "loopholes". Sectors that have been the main targets for anti-dumping actions are metals and metal products, chemical products, machinery and electrical equipment, plastics and plastic products, textiles and clothing, pulp of wood or of other fibrous cellulosic material, prepared foodstuffs and beverages, stone and plaster products, other manufactured products, footwear and headgear. Although many such actions relate to conflicts between developed countries, the majority involve complaints against exporters from developing countries, sometimes by other developing countries. In 1997, out of 239 cases initiated in WTO, 143 concerned developing countries and countries in transition. As noted in chapter II, technical, health and safety standards and regulations, which may reflect the legitimate concern of consumers in industrial countries, also risk becoming tools for disguised non-tariff protection, especially in respect of agricultural products. Also, a major concern of developing countries is that linking labour market and environmental standards or the treatment of investors to trade obligations would open the door to a proliferation of "trade remedies".

Subsidies pose a major obstacle to exports from developing countries. During the Uruguay Round, for the first time an effort was made to establish effective disciplines on industrial subsidies, and a distinction between prohibited, actionable and non-actionable subsidies was also made.[33] The Agreement also contains important provisions on differential and more favourable treatment. However, the very broad definition of non-actionable subsidies, which includes those for research and development, regional development and environmental purposes, gives developed countries much latitude in continuing to use subsidies to obstruct market access, especially in agriculture. Although the Uruguay Round resulted in limits being set to agricultural subsidization, total annual levels of support for agriculture in OECD countries averaged $350 billion in 1996–1998, a figure which compares with total agricultural exports from developing countries of $170 billion. Although the bulk of this support is accounted for by Japan, the United States and major producers in Europe, the highest level of support per farmer is to be found in a number of smaller countries, including Switzerland, Norway and Iceland.[34] Direct export subsidies account for around one sixth of total EU agricultural subsidies.[35] According to a recent study commissioned by UNCTAD, over 80 per cent of all agricultural export subsidies in 1995 and 1996 were granted by the European Union, compared with under 2.5 per cent by developing countries.[36]

The effect of this agricultural support, whether in the form of direct export subsidies, processing subsidies or direct payments to farmers, is to allow agricultural products to be sold on domestic and world markets at below production cost. The impact on producers in developing countries can

be significant not only by precluding their entry into northern markets but also through unfair competition in their own markets. In dairy production, for example, subsidies in EU countries range from 40 per cent to over 100 per cent of the world market price of the products. Consequently, although EU producers are among the world's highest-cost producers of dairy products, they have a 50 per cent share of the world market. There is evidence that agricultural support in EU countries has been highly detrimental to production in Latin America and Africa.[37]

Northern industry is generally thought to be less subsidized than agriculture. Nevertheless, in the case of industrial subsidies there appears to be a strong bias against developing countries in the Agreement on Subsidies and Countervailing Measures. The "non-actionable" categories of subsidies, as defined by that Agreement, are those which form part of industrial policy in developed countries, while subsidies of key importance to developing countries fall within the "actionable" category. Furthermore, the non-actionable nature of the R&D subsidies permits firms in developed countries to subsidize the development of new products, for which they can subsequently gain protection under the TRIPs Agreement. In addition, fiscal incentives by developed countries, for example to attract investment, are often granted at sub-national levels and are not effectively disciplined.

## 2. Trading opportunities for developing countries

Analysis by the UNCTAD secretariat of the evolving trade structure of the fast-growing East Asian economies since the mid-1960s identified a group of industries where rapid entry into world markets could be achieved with relative ease in the early stages of industrial development and where strong export expansion would be essential to their subsequent growth. The industries include traditional labour-intensive ones such as footwear, leather goods, travel goods and handbags, textiles, toys and sports equipment, as well as more capital- and resource-intensive industries, such as clothing, wood and paper products, rubber and plastic products and fabricated metal products.[38] In addition, some sectors classified as high-technology, such as the electrical machinery sector, use low-skill labour and could successfully export, using the production network of TNCs either through subcontracting arrangements or directly through production by affiliates.[39]

Thanks to low unit labour costs relative to the United States and other developed countries, many developing countries are becoming increasingly competitive in such low and medium-technology sectors (table 6.2).[40] In most of these sectors a large majority of the developing countries covered in the table have a competitive edge over the United States and even more so over other industrial countries (e.g. Sweden). While some (e.g. Brazil, Chile, India, Indonesia, Republic of Korea and Turkey) are strongly competitive in almost all sectors, others can compete only in certain sectors. Such differences reflect not only wage and exchange-rate policies but also the success in raising productivity in specific industries and the general level of development reached.

As discussed in the previous section, these same sectors are among those most exposed to higher average tariffs, tariff peaks, tariff escalation and non-tariff barriers, which have had a fairly direct impact on their exports to northern markets. From chart 6.1 it can be seen that in general the growth of exports of developing countries to industrial countries is inversely related to the degree of tariff protection in the latter. During the first half of the 1990s developing countries achieved yearly export growth rates to the north above 15 per cent in products such as office machines, telecommunications equipment, power-generating machinery and automotive parts, where tariff and non-tariff barriers are relatively low (the weighted average MFN tariff in these dynamic sectors in the Quad countries was below 5 per cent). Their export growth was much slower in sectors such as clothing, textiles and footwear, where they have a competitive edge but face relatively higher levels of protection.

Recent assessments of liberalization measures agreed to in the Uruguay Round suggest that the gains to developing countries in terms of export growth will be small relative to the total size of the markets involved.[41] By focusing on the details of the negotiated outcomes of the Uruguay Round, such exercises provide a sobering reminder of what more needs to be done if developing countries are to obtain significant benefits from any future negotiations. However, because such studies tend to concentrate on *de jure* trade barriers, they can lose sight of the wider potential market

**Table 6.2**

**UNIT LABOUR COSTS IN SELECTED DEVELOPING ECONOMIES AND INDUSTRIES, 1995**

*(Ratio to the United States level)*

| Economy | Footwear | Textiles | Clothing | Metal products | Wood products | Rubber products | Plastic products | Electrical machinery | Leather and fur goods |
|---|---|---|---|---|---|---|---|---|---|
| Hong Kong, China | 1.75 | 1.38 | 1.70 | 1.35 | 1.24 | 1.33 | 1.40 | 1.23 | 1.44 |
| Republic of Korea | 1.03 | 0.81 | 0.91 | 0.79 | 0.83 | 0.74 | 0.58 | 0.59 | 0.78 |
| Singapore[a] | 1.67 | 1.25 | 1.84 | 1.02 | 1.28 | 1.33 | 1.28 | 1.02 | 1.36 |
| Taiwan Province of China | 2.21 | 1.45 | 1.29 | 1.71 | 1.81 | 1.86 | 1.85 | 1.80 | 2.30 |
| Brazil[a] | .. | 0.47 | .. | .. | 0.59 | 0.61 | 0.58 | 0.63 | .. |
| Chile | 0.69 | 0.83 | 0.79 | 0.75 | 0.61 | 0.69 | 0.75 | 0.93 | 0.72 |
| Egypt[a] | .. | 1.50 | 0.50 | 0.85 | 0.48 | 1.50 | 1.23 | 0.93 | .. |
| India[a] | 0.99 | 1.01 | 0.49 | 0.97 | 0.91 | 0.88 | 0.88 | 0.85 | 0.90 |
| Indonesia | 0.85 | 0.47 | 0.95 | 0.55 | 0.53 | 0.72 | 0.64 | 0.76 | 0.65 |
| Kenya | 1.13 | 1.61 | 1.17 | 0.91 | 1.20 | 0.61 | 0.63 | 0.56 | 1.36 |
| Malaysia | 1.08 | 0.73 | 1.42 | 0.83 | 0.85 | 0.76 | 0.92 | 0.97 | 1.19 |
| Mexico[a] | 1.62 | 0.96 | 1.20 | 0.76 | 0.76 | 0.96 | 0.83 | 0.83 | .. |
| Philippines | 1.36 | 0.69 | 1.12 | 0.79 | 0.90 | 0.71 | 0.69 | 0.84 | 1.44 |
| Thailand[a] | 1.23 | 0.87 | 1.70 | 0.71 | 0.57 | 0.56 | 0.83 | 0.65 | 0.92 |
| Turkey[a] | 0.69 | 0.42 | 0.38 | 0.46 | 0.96 | 0.57 | 0.34 | 0.51 | 0.62 |
| Zimbabwe | 0.95 | 0.56 | 1.26 | 0.99 | 0.73 | 0.74 | 1.36 | 1.05 | 1.39 |
| ***Memo item:*** | | | | | | | | | |
| Sweden[a] | 1.53 | 1.23 | 1.40 | 1.10 | 1.05 | 1.18 | 1.38 | 1.45 | 1.13 |

***Source:*** UNIDO, *International Yearbook of Industrial Statistics*, various issues.
***Note:*** Unit labour costs are estimated by taking the ratio of wages per employee to value added per employee.
***a*** Ratio in 1994.

opportunities which might be forthcoming under more favourable conditions.[42]

In *TDR 1996* the UNCTAD secretariat examined the potential trading opportunities in one particular industry, namely clothing, where developing countries have traditionally had difficulties of market access. It was estimated that if northern producers immediately opted for a more open trading regime in line with agreements made during the Uruguay Round and adopted a more progressive approach to moving out of these low-skill and low-wage "sunset" industries (along the lines, for example, of the German and Swedish clothing industries), then during the 10-year period dictated by the phasing out of the Multi-Fibre Arrangement annual clothing exports from developing countries could triple to around $180 billion.[43]

The characteristics of this particular industry, namely that significant production remained in the North behind high tariff and non-tariff barriers and that domestic demand in those countries was likely to remain fairly robust, are such that a significant expansion in southern clothing exports could take place without running into the danger of fallacy of composition. It was also the case that developing countries already had significant capacity in this industry or that such capacity could be quickly generated to meet any increased demand; clothing imports from developing countries, as a share of apparent consumption in the major northern markets, had already more than doubled from 1980 to 1994.

Clothing is only one among several industries where developing countries could gain a much greater share of northern markets. Table 6.3

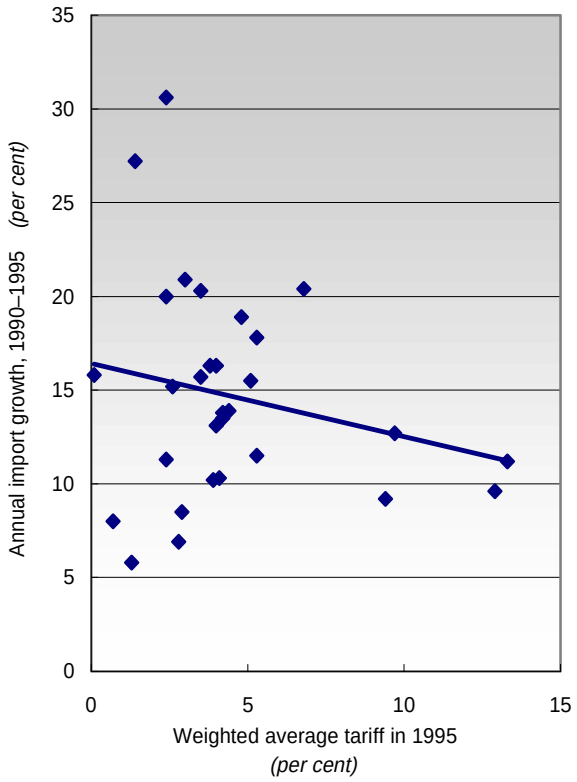
provides a summary of consumption, production and trade data for a number of other low- and medium-skill industries. For most of these industries the share of imports from developing countries in apparent consumption in the North is still very small even though, as shown in table 6.2, developing countries are competitive in these sectors. Textiles and footwear are the sectors that come closest to the clothing example. They are generally low-skill industries in which developing countries have already built up export capacity, and where tariff barriers in developed countries are relatively high (chart 6.2) and non-tariff barriers further restrict market access, allowing northern producers to remain competitive. However, in the case of textiles, the diversity of products which make up the industry raises a series of complex policy questions on how to achieve competitiveness even at this level of skill requirement.

How much might developing countries benefit under more favourable market access conditions for the products of these industries? Table 6.4 sets out the results of UNCTAD secretariat calculations under three alternative scenarios. Under the first (baseline) scenario, footwear and textile exports of developing countries are assumed to grow at the same rate as (apparent) consumption in industrial countries, so that their share in consumption (market penetration ratio) remains unchanged. Markets for these products are not growing particularly fast (they are assumed to grow by 5.2 per cent and 2.1 per cent, respectively, from 1995 to 2005): with the present geographical distribution of production, annual textile and footwear exports from developing countries are projected to grow from $35.1 billion in 1995 to $48.6 billion in 2005. Thus, the critical issue is how fast producers in industrial countries move out of these sectors. If it is assumed that in the developed countries output remains constant at the 1995 level and that the increase in apparent consumption in those countries is met entirely by developing countries (scenario II), the latter would secure an additional annual gain in export earnings of $24.4 billion in footwear and $47.3 billion in textiles by 2005 (i.e. over and above the gain in the baseline scenario). They would then account for 52.5 per cent and 18.9 per cent, respectively, of apparent consumption of industrial countries in these two industries. Arguably, these figures still significantly underestimate the export potential for such industries. In the United States, for example, the share of developing countries in apparent consumption of footwear rose from 17 per cent in 1982 to around 60 per cent in 1995, and domestic production dropped by one third. Assuming similar falls in output in other industrial countries over the period 1995–2005, footwear exports from developing countries would rise to around $60 billion by the end of the period, representing a share of apparent consumption of around 68 per cent (scenario III).

As noted above, the textile industry is more diversified and import penetration ratios vary considerably for different products and for different

***Chart 6.1***

**TARIFF BARRIERS IN MAJOR INDUSTRIAL MARKETS AND IMPORTS FROM DEVELOPING COUNTRIES, 1990–1995**




***Source:*** UNCTAD secretariat, based on United Nations Statistics Division, Trade Analysis and Information System (TRAINS) and United Nations COMTRADE database.

***Note:*** Data relate to imports of the Quad countries (Canada, European Union, Japan and United States). Each observation relates to a particular industrial sector or subsector of the Harmonized System.

**Table 6.3**

**LOW- AND MEDIUM-SKILL INDUSTRIES: OUTPUT AND CONSUMPTION IN DEVELOPED COUNTRIES[a] AND IMPORT PENETRATION BY DEVELOPING COUNTRIES (1995)**

*(Billions of dollars and per cent)*

| Industry | Output in 1995 | Apparent consumption | | Share of developing countries in 1995 in: | |
|---|---|---|---|---|---|
| | | 1995 | 1990–1995 growth rate[b] | Northern consumption[c] | World exports |
| | ($ billion) | | (Per cent) | | |
| Footwear | 41.5 | 52.6 | 5.2 | 24.5 | 47.3 |
| Textiles | 320.0 | 320.5 | 2.1 | 6.9 | 44.4 |
| Metal products | 697.9 | 694.1 | 5.7 | 1.9 | 35.2 |
| Wood products | 216.5 | 227.1 | 5.2 | 3.0 | 37.7 |
| Rubber products | 113.5 | 111.5 | 4.9 | 3.1 | 17.5 |
| Plastic products | 405.6 | 410.7 | 8.6 | 1.7 | 23.5 |
| Beverages (manf.)[d] | 238.5 | 234.8 | 7.0 | 0.6 | 10.9 |
| Tobacco (manf.) | 113.0 | 107.8 | 6.0 | 0.2 | 23.0 |
| Total, above industries | 2 146.5 | 2 159.1 | 4.9 | 2.8 | 34.4 |

***Source:*** UNCTAD secretariat calculations, based on UNIDO, Industrial Demand-Supply Balance Database 1998.
***a*** Refers to the Quad countries (Canada, European Union, Japan and United States).
***b*** Annual average 1990–1995, derived from data in current dollars.
***c*** Imports of the Quad countries from developing countries as a share of apparent consumption.
***d*** Products of the beverage industries, excluding coffee and cocoa products.

northern markets (table 6.5). However, it would appear that in the traditionally more open markets of Europe, such as Sweden and the Netherlands, penetration ratios for some textiles are already quite high, suggesting that under the right conditions sizeable export gains are achievable. A significant reduction in the frequency of non-tariff barriers in the Swedish textile industry, for example, coincided with a drop in domestic production of around 25 per cent from 1988 to 1994, allowing such gains to take place. Assuming that similar action was taken by other industrial countries and their output fell by 25 per cent from 1995 to 2005, annual exports from developing countries could reach $154 billion by the end of the period, and so account for nearly 40 per cent of apparent consumption in the industrial countries (scenario III of table 6.4).

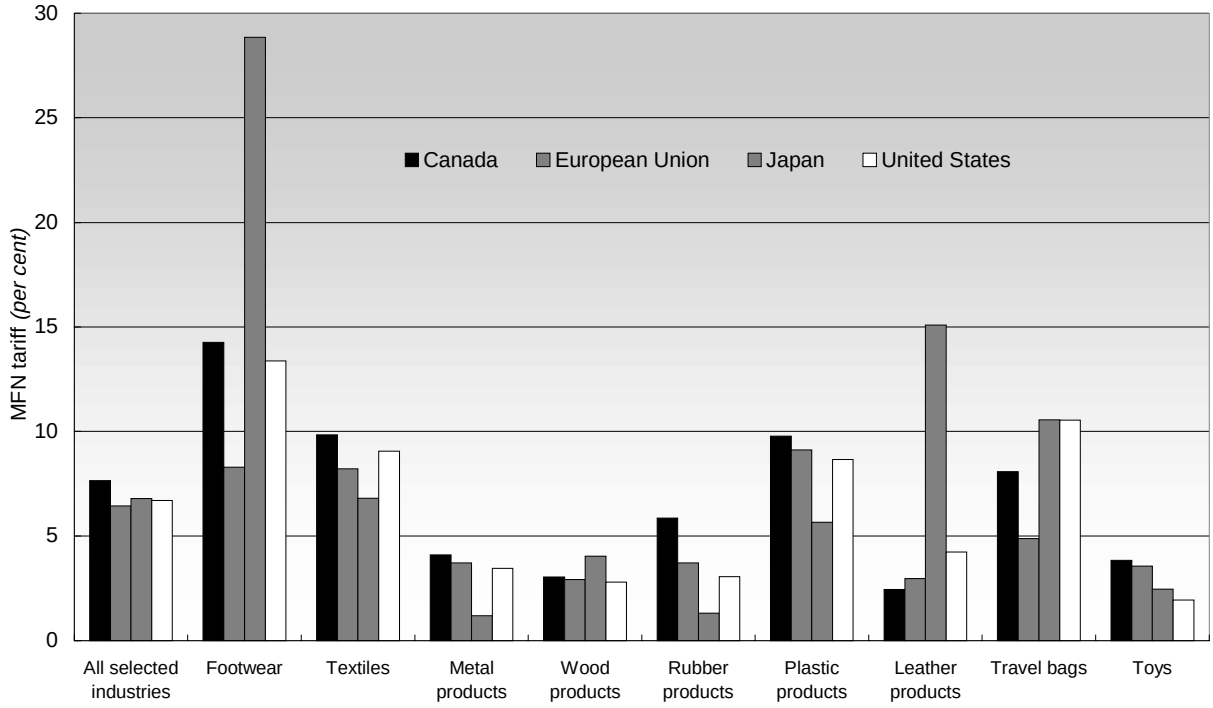
Comparable consumption and production data are not available for leather goods, travel goods and toys and sportswear, but in those sectors, too, a doubling or tripling of exports could be expected, generating increases in annual export earnings of $20–60 billion by the year 2005.

A second area of interest to developing countries includes resource-based manufactures, such as metal, wood, rubber and plastic products, which often have a fairly wide and diverse product range. During the 1990s they exhibited relatively strong growth in industrial countries behind moderately high levels of protection. For particular product lines and particular countries, peak tariffs are still high and core non-tariff measures can constitute further protectionist obstacles. Thus, although many developing countries have already built capacity in these sectors and have shown quite strong export performance in world markets in the 1990s (see table 6.3), their share of apparent consumption in the North is still low.

A continuation of present trends in these industries would see an increase in annual exports by developing countries of $25 billion by 2005. However, under the assumptions of scenario II

**Chart 6.2**

**AVERAGE MFN TARIFFS APPLIED IN DEVELOPED COUNTRIES TO THE PRODUCTS OF SELECTED INDUSTRIES IN 1998**




***Source:*** UNCTAD secretariat, based on United Nations Statistics Division, Trade Analysis and Information System (TRAINS).

they would double their share of apparent consumption in industrial countries and their exports would rise to $112 billion, an additional gain of $56 billion on the baseline scenario. Even more optimistic would be a move in a direction similar to that already experienced in the electrical machinery industries, which operate under low tariff barriers and where imports from the South account for 10 per cent of northern apparent consumption. This proportion has already been reached in some resource-based products, such as rubber in the United States and plastics in Sweden. Assuming that a similar proportion could be reached for all these resource-based industries, annual exports from developing countries would be higher by $97.8 billion for the metal industries, $26.4 billion for wood, $12.4 billion for rubber, and $77.8 billion for plastics (scenario III).

A final group of export interest to developing countries includes products such as beverage and tobacco manufactures. Markets for these products are growing rapidly in the industrial world, behind very high levels of protection. Growth of exports from developing countries has been sluggish, averaging under 7 per cent, for example, for manufactured tobacco, and their market penetration is particularly low; even if the share of developing country exports in northern consumption in these two product groups tripled, that would only generate an additional $6.6 billion in annual export earnings by 2005. Under more liberal import regimes in the North it might be possible for developing countries to secure the same share in those markets as they do in world markets (table 6.3). This would yield additional annual export revenue to the South of $103 billion for beverages and $21 billion for manufactured tobacco.

All in all, there are thus considerable potential export opportunities for developing countries in respect of the industries covered by tables 6.3 and 6.4. In the baseline scenario, where the share

***Table 6.4***

## DEVELOPING-COUNTRY EXPORTS TO DEVELOPED COUNTRIES AND MARKET PENETRATION: PROJECTIONS FOR MAJOR EXPORT INDUSTRIES ON ALTERNATIVE ASSUMPTIONS

| | | **Projections for exports from developing to developed countries in 2005** | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | ***Scenario I (baseline)[a]*** | | | ***Scenario II[b]*** | | | ***Scenario III[c]*** | | |
| | Exports to North in 1995 | Trend estimate of northern consumption[d] in 2005 | Annual growth rate[e] | Market penetration ratio | Export value | Annual growth rate[e] | Market penetration ratio | Gain in value[f] | Annual growth rate[e] | Market penetration ratio | Gain in value[f] |
| *Industry* | *($ billion)* | | *(Per cent)* | | *($ billion)* | *(Per cent)* | | *($ billion)* | *(Per cent)* | | *($ billion)* |
| Footwear | 12.9 | 87.3 | 5.2 | 24.5 | 21.4 | 13.5 | 52.5 | 24.4 | 16.5 | 68.3 | 38.2 |
| Textiles | 22.2 | 394.5 | 2.1 | 6.9 | 27.2 | 12.9 | 18.9 | 47.3 | 21.4 | 39.2 | 127.3 |
| Metal products | 13.2 | 1 208.2 | 5.7 | 1.9 | 23.0 | 13.3 | 3.8 | 22.9 | 24.8 | 10.0 | 97.8 |
| Wood products | 6.9 | 377.0 | 5.2 | 3.0 | 11.3 | 12.6 | 6.0 | 11.3 | 18.5 | 10.0 | 26.4 |
| Rubber products | 3.5 | 179.8 | 4.9 | 3.1 | 5.6 | 12.2 | 6.2 | 5.5 | 17.8 | 10.0 | 12.4 |
| Plastic products | 6.8 | 937.2 | 8.6 | 1.7 | 15.9 | 16.7 | 3.4 | 16.0 | 30.0 | 10.0 | 77.8 |
| Beverages (manf.)[g] | 1.3 | 461.1 | 7.0 | 0.6 | 2.8 | 20.4 | 1.8 | 5.5 | 55.3 | 23.0 | 103.3 |
| Tobacco (manf.) | 0.2 | 193.0 | 6.0 | 0.2 | 0.4 | 19.6 | 0.6 | 0.8 | 59.3 | 10.9 | 20.8 |
| Total, above industries | 67.0 | 3 838.1 | 4.9 | 2.8 | 107.6 | 13.7 | 6.3 | 133.7 | 24.8 | 15.9 | 504.0 |

***Source:*** As for table 6.3.

***Note:*** The table relates to apparent consumption in the Quad countries (see table 6.3) and their imports from developing countries.

***a*** Assumption: Import penetration ratios in 2005 are unchanged from 1995.

***b*** Assumption: Northern production of footwear and of textiles remains unchanged in 2005 from 1995; the import penetration ratio doubles for metal, wood, rubber and plastic products and triples for beverage and tobacco manufactures.

***c*** Assumption: Northern production of footwear falls by one third and of textiles by one quarter from 1995 to 2005; market penetration reaches 10 per cent for metal, wood, rubber and plastic products, 23 per cent for beverage manufactures and 10.9 per cent for tobacco manufactures.

***d*** Assuming continuation of the annual average growth of apparent consumption in 1990–1995.

***e*** 1995–2005.

***f*** Gain over export-value projection in baseline scenario.

***g*** Products of the beverage industries (ISIC 313), excluding coffee and cocoa products.

**Table 6.5**

**TEXTILES: MARKET PENETRATION IN SELECTED INDUSTRIAL COUNTRIES OF EXPORTS FROM DEVELOPING COUNTRIES, BY SUB-SECTOR, 1993**

*(Percentage of apparent consumption)*

| Sub-sector | United States | Japan | Germany | Netherlands | Sweden |
|---|---|---|---|---|---|
| Spinning, weaving, etc. | 6.5 | 6.4 | 12.6 | .. | 12.9 |
| Made-up textiles | 4.7 | 3.5 | 12.9 | 25.9 | 14.6 |
| Knitting goods | 0.7 | 1.1 | 3.9 | 11.2 | 7.7 |
| Carpets and rugs | 4.6 | 6.9 | 15.7 | 2.7 | .. |

***Source:*** UNIDO, Industrial Demand-Supply Balance Database 1998.

of apparent consumption remains unchanged, the additional annual export earnings by 2005 are only some $40 billion. On the more favourable assumptions of the second scenario there would be a further gain of $134 billion. On the most optimistic assumption (scenario III), where northern output actually declines in low-skill industries and southern exporters make more significant gains in the other industries, export earnings would grow by 25 per cent per annum and by 2005 would be over $500 billion above the baseline projection. Although that may appear ambitious, such growth has been achieved by developing countries in some high-technology sectors in the 1990s, including valves and tubes, office machines and electrical machinery and apparatus, and was achieved over sustained periods by the successful East Asian NIEs in the 1960s and 1970s.

If allowance is made for prospects for the clothing industry that were reviewed above, as well as for leather and other low-technology industries, the export potential rises to around $700 billion by 2005, implying a 75 per cent increase in the export earnings from manufactures over the 1995 level.[44] Perhaps more significantly, in the light of the findings elsewhere in this report (see chapter IV), this is approximately four times the annual average private foreign capital inflow in the 1990s. It corresponds to some 12 per cent of the combined GNP of developing countries but to no more than 3 per cent of that of industrial countries.

Agriculture is another area with considerable export potential for developing countries. With annual exports of some $168 million, these countries accounted for 29 per cent of world agricultural exports in 1997. However, although the Uruguay Round eliminated most non-tariff barriers, liberalization by developed countries has been slow and, as noted earlier in this chapter, peak tariffs remain prohibitively high for some producers in developing countries.

The results of recent efforts to assess the overall impact of the Agreement on Agriculture on developing countries are not encouraging. In a number of products with strong export potential protection has prevented them from benefiting to the extent otherwise possible, particularly with respect to cereals (in the EU and Japanese markets), sugar, fruit and vegetables, meat and meat preparations. Again, modelling exercises of the negotiated outcomes of the Uruguay Round find little encouragement for developing countries, with gains heavily concentrated on a small group of exporters.[45] These results contrast sharply with the expected gains to developing countries if real efforts were made to open these northern markets.

There are considerable disparities among developing countries in their capacity to exploit potential market opportunities in industry and agriculture, due to differences in resource endowments and levels of economic development. Moreover, trading opportunities in some sectors are more readily exploited than in others. However, the very fact that markets are protected strongly suggests that developing countries have indeed the potential to compete. A strong investment drive could, under the right conditions, put

most of them into a stronger competitive position by raising productivity and reducing unit labour costs.

An opening of markets in labour-intensive and resource-based products in industrial countries would not only alter the volume and pattern of trade between North and South; it can also be expected to affect the division of labour among developing countries themselves. Rising labour costs in some of the most successful NIEs (Hong Kong, China; Singapore; and Taiwan Province of China – see table 6.2) have already begun to erode their competitiveness in these same sectors; if they move out of these sectors, there will be further trading opportunities for a new generation of developing-country exporters. Such a shift of course depends on their being able to continue on the path of technological upgrading and structural transformation.

### 3. Adjustments in the North

The striking coincidence over the past two decades of declining manufacturing employment in the North, high levels of unemployment and widening wage and income inequality, along with a sharp increase in manufactured imports from the South, has revived concerns over destructive links running from trade to labour markets. However, a detailed examination of such links in *TDR 1995* showed these concerns to be greatly exaggerated. Indeed, the main difference between today and the 1950s and 1960s, when Japan and the newly industrializing economies of Southern Europe made a strong initial entry into the markets of their richer neighbours, is the lack of expanding industries and highly-paid service jobs in the North to absorb any displaced workers. The report showed that the rise in "structural unemployment" in the North since the mid-1970s was related to a slowdown in investment, which in turn was linked to restrictive macroeconomic policies and deregulation of financial markets. There has been little over the past few years to invalidate this conclusion, which quite to the contrary has recently been endorsed:

> There is little evidence that reducing employment protection is a solution to high unemployment although active labour market policies may help people to find work. Virtually every fall in unemployment in western Europe in the last two decades or so has been accompanied by an easing of macroeconomic policy (either fiscal expansion, or lower interest rates, or devaluation, etc.) .... Lowering unemployment will therefore need stronger demand, but to be sustained there will also need to be more investment.[46]

However, in the light of the projected increase in exports from developing countries, most industrial countries will need to make a much more determined effort to expand employment, if the danger of a protectionist backlash is to be avoided. Moreover, since for well-known reasons no single country will to that end embark on expansionary macroeconomic policies alone, any response will need to be internationally coordinated. ■

## Notes

1 For a discussion of these alternatives see Eichengreen B, *Toward a New International Financial Architecture*, Washington, DC, Institute for International Economics, Feb. 1999: 103–109.

2 See Ohno K, Exchange rate management in developing Asia, Paper submitted to the Eighth Seminar on International Finance, Asian Development Bank Institute, Tokyo, Nov. 1998.

3 See, for example, Obstfeld M and Rogoff K, The mirage of fixed exchange rates, *Journal of Economic Perspectives*, 1995, 9(4); Eichengreen B, Kicking the habit: Moving from pegged rates to greater exchange rate flexibility, *The Economic Journal*, vol. 109, March 1999; and Bird G, Exchange rate policy in developing countries: What is left of the nominal anchor approach?, *Third World Quarterly*, 1998, 9(2).

4 For an assessment of the experience in the 1980s see UNCTAD secretariat, The exchange rate system, and Akyüz Y and Dell S, Issues in international monetary reform, both of which are contained in UNCTAD, *In-*

*ternational Monetary and Financial Issues for the Developing Countries*, United Nations publication, sales no. E.7.II.D.3, New York, 1987. See also *TDR 1990*, Part Two, chap. I. For the more recent experience see *TDR 1993*, Part Two, chap. I; *TDR 1994*, Part Two, chap. II; *TDR 1995*, Part Two, chap. I; *TDR 1996*, Part Two, chap. I; and also chapter III above.

5 *Global Economic Prospects and the Developing Countries 1998/99*, Washington, DC, The World Bank, 1999: 134.

6 Counterfactual simulations over the pre-crisis period in East Asia show that alternative currency arrangements would not have reduced the risk of overvaluation and currency attacks; Ohno K, op. cit.

7 Feldstein M, A self-help guide for emerging markets, *Foreign Affairs*, 1999, 78(2): 107.

8 Eichengreen B, op. cit.: 109.

9 Zarazaga C, Argentina, Mexico and currency boards: Another case of rules versus discretion, *Economic Review*, Federal Reserve Bank of Dallas, 4th Quarter 1995.

10 See Roubini N, The case against currency boards: Debunking 10 myths about the benefits of currency boards. Stern School of Business, New York University, Feb. 1998; and Sachs J, Proposals for reform of the global financial architecture, Paper prepared for the UNDP meeting on Reform of the Global Financial Architecture, New York, 8 Dec. 1998. Indeed, Argentina introduced some flexibility into the system in this respect; see Banco Central de la República Argentina, Main features of the regulatory framework of the Argentine financial system, Jan. 1999.

11 See, in particular, *TDR 1994*, annex to chapter II; and *TDR 1998*, chap. IV, sect. C.

12 For a review of the evidence on the link between the exchange rate and trade see Helleiner GK, Trade, trade policy and industrialization reconsidered, World Development Studies no. 6, UN/WIDER, Helsinki, 1995.

13 The term "non-traditional" is often taken as referring to industrial activities. The links between industrial growth and overall productivity are indeed particularly strong but, as discussed in greater detail in *TDR 1998*, chapter IV, the term should be more broadly defined to include certain primary and service activities.

14 For such a review see Bruton H, A reconsideration of import substitution, *Journal of Economic Literature*, 1998, XXVI (2); for a more theoretical treatment of the issues see Ocampo J and Taylor L, Trade liberalization in developing economies: Modest benefits but problems with productivity growth, macro prices, and income distribution, *The Economic Journal*, vol. 108, Sept. 1998.

15 Helleiner GK, op. cit.

16 See in particular *TDR 1993*, *TDR 1994*, *TDR 1996* and *TDR 1997*. See also the papers in the Special Issue of *The Journal of Development Studies*, 1998, 34(6), "East Asian Development: New Perspectives". For similar interpretations see Stiglitz J, Some lessons from the East Asian miracle, *The World Bank Research Observer*, 1996, 11(2), and Rodrik D, *The New Global Economy and Developing Countries: Making Openness Work*, Washington, DC, 1999, Overseas Development Council.

17 On the policy options for African developing countries see *TDR 1998*; Elbadawi I et al., Export orientation, geography and competitiveness in a globalized world economy, The World Bank, Washington, DC, June 1999; on Latin America see Tussie D, Trade policy within the context of the World Trade Organization, *CEPAL Review*, no. 62, August 1997.

18 On the obstacles facing the smallest and poorest countries in WTO see Helleiner GK and Oyejide A, Global economic governance, global negotiations and the developing countries, Background Paper for the UNDP *Human Development Report 1999*, New York, 1999.

19 For an historical survey of special and differential treatment in global trade arrangements see Whalley J, Special and differential treatment in the Millennium Round, Working Paper no. 30/99, Centre for the Study of Globalization and Regionalization, University of Warwick, May 1999.

20 Whalley J, op. cit.: 40–44.

21 The ECE secretariat has made much the same point for transition economies in recent years, in its annual economic surveys, when it identified an "institutional hiatus" as one of the main obstacles to recovery and sustained growth in many of these economies.

22 See Milberg W, Foreign direct investment: Balancing costs and benefits, in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. XI (a forthcoming United Nations publication).

23 See for example Singer H and Alizadeh P, Import substitution revisited in a darkening external environment, in Singer H, Hatti N and Tandon R, eds., *Export-led Versus Balanced Growth in the 1990s*, Delhi, BR Publishing Corporation, 1998.

24 See *TDR 1996*, Part Two, chap III, sects. B.3 and B.4.

25 See *TDR 1997*, Part Two, chap. II, sect. F.1.

26 This peak rate refers to applied tariffs less all presently applied tariff suspensions, including GSP concessions to developing countries, in 1996–1997.

27 UNCTAD/WTO Joint Study, The post-Uruguay Round tariff environment for developing countries' exports: Tariff peaks and tariff escalation, TD/B/COM.1/14/Rev.1, Geneva, July 1999.

28 Following the Uruguay Round, developed countries substantially expanded their product coverage for all GSP beneficiaries, and also made additional improvements in favour of LDCs. However, in certain preference-giving countries many agricultural and food industry products and textiles and clothing are excluded from the GSP scheme or are subject to ceilings. Some advanced developing countries have been graduated from the GSP, and an increasing number of products exported by particular countries are excluded, as they are deemed to be competitive.

29 Lindland J, The impact of the Uruguay Round on tariff escalation in agricultural products, Rome, FAO, April 1997.

30 "Tariff escalation", note by the WTO secretariat. WT/CTE/W/25, Geneva, 22 March 1996, para. 13.

31 Messerlin P, Measuring the costs of protection in Europe, Institute for International Economics, Washington, DC (forthcoming), cited in *The Economist*, 22 May 1999: 104.

32 See Krueger A, The developing countries and the next round of Multilateral Trade Negotiations, Working Paper no. 2018, The World Bank, Washington, DC, May 1999.

33 Two types of subsidy are prohibited under the Agreement: those contingent on exports and those provided to domestic industry for the use of domestic inputs. Permissible subsidies are those which are not specific to particular industrial units or sectors or which are specifically for research and development, for disadvantaged regions or for environmental purposes. Subsidies which are neither prohibited nor permitted can also be given, provided they do not harm the industry and exporting capacity of another country. If harm is caused, the affected country can take action to have the subsidy removed or impose countervailing duties on the subsidized product.

34 OECD, *Agricultural Policies in OECD Countries – Monitoring and Evaluation*, Paris, OECD, 1999, graph 1.6.

35 Fokker R and Klugkist J, Coherence in EU policies towards developing countries, Eurostep Dossier on CAP and Coherence, Brussels, April 1999.

36 Tangermann S and Josling T, The interests of developing countries in the next round of WTO agricultural negotiations, Paper prepared for the Workshop on Developing a Proactive and Coherent Trade Agenda for African Countries in Support of their Participation in International Trade Negotiations, Pretoria, 29 June–2 July 1999.

37 Fokker R and Klugkist J, op. cit.

38 This analysis was based on a classification of exports into five broad categories of goods taking into account the mix of different skill, technology, capital and scale requirements. See *TDR 1996*, Part Two, chap. II, sect. C.3.

39 This was the strategy adopted in some second-tier South-East Asian NIEs. On the pros and cons of this strategy see *TDR 1996*, Part Two, chap. II.

40 Competitiveness vis-à-vis the United States is determined by relative wage costs in dollar terms and relative productivity (output per worker). High wages in dollar terms in developing countries may reflect high real wages or overvaluation of the domestic currency. In general, 1995 was a year when the dollar was weak, and for a number of countries in table 2 overvaluation is likely to have been a major factor undermining their competitiveness.

41 See in particular, the UNCTAD publication edited by Thomas H and Whalley J, *Uruguay Round Results and the Emerging Trade Agenda: Quantitative-based Analyses from the Development Perspective*, United Nations publication, sales no. GVE.98.O.26, New York and Geneva, 1998.

42 For a discussion of the links between trade barriers, exports and economic growth see *TDR 1997*, Part Two, chap. II, sects. E.1 and E.2; Rodriguez F and Rodrik D, Trade policy and economic growth: A skeptic's guide to the cross-national evidence, Working Paper no. 7081, National Bureau of Economic Research, Cambridge, MA, April 1999; Greenaway D et al., Trade reform, adjustment and growth: What does the evidence tell us?, *The Economic Journal*, vol. 108, Sept. 1998.

43 *TDR 1996*, Part Two, chap. III, sect B.3.

44 Some of these additional export opportunities may benefit transition economies rather than developing countries.

45 See Thomas H and Whalley J, eds., op. cit.

46 ECE, *Economic Survey of Europe, 1999*, no. 1, United Nations publication, sales no. E.99.II.E.2, New York and Geneva, 1999, chap. 1, sect. 1.2(1). OECD has also belatedly discovered that there is no link between employment protection laws and either employment or unemployment in its member countries. *OECD Employment Outlook*, June 1999.