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*This volume is dedicated to
the memory of Sidney Dell.*

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About the authors

- **Chris Allen** is Research Fellow, Centre for Economic Forecasting, London Business School, London, United Kingdom.

- **José María Fanelli** is Senior Researcher, the Centre for the Study of State and Society, Buenos Aires, Argentina.

- **Roberto Frenkel** is Director of the Economic Department, the Centre for the Study of States and Society, Buenos Aires, Argentina.

- **C. Randall Henning** is Research Associate, Institute for International Economics, Washington, D.C., USA.

- **C. Nurul Islam** is Senior Policy Advisor, International Food Policy Research Institute, Washington, D.C., USA.

- **José Antonio Ocampo** is Senior Researcher, FEDESARROLLO, Bogotá, Colombia.

- **Peter Pauly** is Professor of Economics, University of Toronto, Toronto, Canada.

- **Lance Taylor** is Professor of Economics, Massachusetts Institute of Technology, Cambridge, Massachusetts, USA.

- **David Vines** is Professor, University of Glasgow, University of Cambridge (United Kingdom) and Australian National University.

Introduction

The Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24) was established in November 1971 to increase the negotiating strength of the developing countries in discussions that were going on at that time in the International Monetary Fund on reform of the international monetary system. Developing countries felt that they should play a meaningful role in decisions about the system, and that the effectiveness of that role would be enhanced if they were to meet regularly as a group, as the developed countries had been doing for some time in the Group of Ten (G-10).

It soon became apparent that the G-24 was in need of technical support and analysis relating to the issues arising for discussion in the Fund and Bank, including the Interim and Development Committees. In response to representations by the Chairman of the G-24 to the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD), and following discussions between UNCTAD and the United Nations Development Programme (UNDP), the latter agreed in 1975 to establish a project to provide the technical support that the G-24 had requested. This was to take the form, principally, of analytical papers prepared by competent experts on issues currently under consideration in the fields of international money and finance.

Mr. Sidney Dell, a former Director in UNCTAD's Money, Finance and Development Division and subsequently Assistant Administrator of UNDP headed the project from its establishment until 1990. During this period, some 60 research papers were prepared by the Group of Twenty-Four. The high quality of this work was recognized by the Deputies and Ministers of the Group and the reports were given wide currency, some being published in five volumes by North-Holland Press and others by the United Nations.

The project work was resumed in 1990 under the direction of Professor G.K. Helleiner, Professor of Economics, University of Toronto, Toronto, Canada. The UNCTAD secretariat continues to provide both substantive and administrative backstopping to the project. Funding for this new phase has been provided by trust funds established by the G-24 countries themselves, the International Development Research Council of Canada, the Government of the Netherlands and UNDP. As a result, it has been possible to continue to provide the Group of Twenty-Four timely and challenging analyses. These studies will be reissued periodically in compendia. This volume is the first in this new series of G-24 research papers. A second volume, already under preparation, will be published in the near future.

THE WORLD DEVELOPMENT REPORT 1991: A CRITICAL ASSESSMENT

José María Fanelli, Roberto Frenkel and Lance Taylor*

Introduction

Development experience in different countries appears to vary widely. So, a sensible question to begin with could be: is it possible to have a general and single approach to development policy? The answer of the 1991 *World Development Report* (or *WDR*) to this question is a clear-cut yes. While recognizing that "the processes driving economic development are by no means fully understood" (page 1), the *WDR* affirms that "a consensus is gradually forming in favor of a 'market-friendly' approach to development" (page 1). Indeed, the consensus seems to be so firm that the *WDR* concludes by saying that "what remains is to put these ideas into practice everywhere" (page 157).

This paper assesses the internal consistency and credibility of the "emerging consensus" on the basis of the arguments presented in the *WDR*. As a general theory, the Bank approach addresses every developing nation over a very ample span of time, and from both deductive and empirical standpoints. Given the broad range of issues raised, this analysis will concentrate on a critical evaluation of the *WDR*'s underlying assumptions concerning the relative importance of outside forces and domestic policy in determining developing countries' growth rates and income distributions.

Our central critique is that the *WDR*'s framework is not fully consistent; in particular it underrates factors external to individual economies. Our own approach is essentially macroeconomic, since we emphasize how the foreign resource constraint interacts with other key aggregate variables (mainly the fiscal constraint, investment, and saving) and with economic policy in determining patterns of distribution and growth.

The exposition is organized under three broad headings. In the first, we review and criticize the *WDR*'s characterization of paths to development. Secondly, we will examine the consistency of the macroeconomic model(s) behind the market-friendly approach. Finally, we take up structural reform.¹

I. Development and growth

The *WDR* starts from a definition of economic development as "a sustainable increase in living standards that encompass material consumption, education, health, and environmental protection" (page 31). According to the *WDR*, the countries that have achieved rapid development have shared two characteristics: they invested in the education of men and women and in physical capital; and from these investments they achieved high productivity by giving leading roles to markets, competition, and foreign trade. The argument expands upon these "stylized facts" about development, and derives several policy lessons.

The *WDR*'s rationale for its stylized facts or development assumptions goes as follows: Growing productivity is the engine of development, and productivity is driven by technical

* Comments on a previous draft by Gerry Helleiner are gratefully acknowledged.

¹ The arguments herein draw on many sources (see the references). Some have been presented previously in Fanelli, Frenkel, and Rozenwurcel (1990) and Taylor (1991a).

progress. There is strong evidence² linking productivity increases to investment in human capital and the quality of the economic environment, i.e. the extent to which markets are not distorted. History shows that policies and institutions largely determine how much is invested in human capital and the extent of market distortion; hence, it follows that policies and institutions are crucial in explaining the difference between success and failure with regard to development. In accordance with these theses, the *WDR* focuses on the relationship between Government and markets.

Our view is that the *WDR*'s rationale is not in complete accord with its own stylized facts, and moreover that other generalizations can be made regarding the experience of economic development. In other words, the *WDR*'s argument has both loose ends and missing information.

A. Loose ends of the market-friendly approach

The *WDR* stresses the importance of productivity increases in determining growth. Its analysis starts by estimating the contributions that capital and labor have made to output expansion in a sample of 68 developing economies.³ Since the sum of the contributions of those two factors of production fails to account for overall growth, the residual or "total factor productivity" (TFP) growth is identified with the efficiency of using inputs - in standard neoclassical fashion. The *WDR* tries to explain variations in residual "efficiency" in terms of the market friendliness of economic policy.

Other factors are also singled out as determinants of the income growth rate because they "... appear fairly robust for alternative groupings of countries and measures of policies" (page 46). One is education. First, according to the *WDR*, many studies (including research sponsored by the World Bank) show that returns on investment in education are high. Secondly, domestic policies can affect both the quantity of inputs and their productivity. Specifically, a strategy of import-substituting industrialization (ISI) may artificially increase investment at the outset but may have grave long-term costs in terms of low efficiency and slow technical progress, i.e. low productivity growth.⁴ A third observation is that external openness and competition are associated with high growth and productivity. These linkages are said to hold for various measures of greater openness, e.g. movements of domestic prices for traded goods toward international prices, and increases in trade shares. Fourthly, country studies suggest that macroeconomic instability diminishes the return on investment and the growth of output. Finally, the effects of external factors such as changes in the terms of trade, growth of the OECD economies, international interest rates, and capital flows are asserted not to account for differences in performance of individual countries. However, not much evidence is presented.⁵

1. Determinants of output growth

Comparing the 1960-1973 and 1973-1987 periods, the *WDR* argues that slower output growth almost everywhere after 1973 was "due" to a lower residual - there was no significant change in the total contribution of capital and labor growth. When the evidence supporting this finding is presented, the inclusion of some relatively high income countries in the sample is said not to influence the results. However, in table 2.2 one can easily observe that while there was no important change in the growth rate of capital after 1973 for the sample as a whole, the same is

² The evidence adduced for the importance of market-friendly development policy comes from comparative studies starting with Bhagwati (1978) and Krueger (1978) and continued by numerous teams at the World Bank. The *WDR* indicates that experience ranging from that of the Nordic countries starting in the 1870s to East Asian economies after World War II demonstrates that education, openness, and competition are the best roads to development while import substitution strategies have shown disappointing results.

³ In fact, the sample contains some countries now classified as having high incomes but the reader is told that the results are not affected by their inclusion.

⁴ Nonetheless, it is recognized that theory is ambiguous with respect to the net effects of tariffs on technical advance.

⁵ Indeed, a great deal is asked of the reader. For example he is told that a Bank-sponsored investigation by Mitra and Associates (1991) did not find a statistical association between differences in growth rates and magnitudes of external shocks. The results of any such study will of course be sensitive to its time frame and sample of countries, as well as econometric methodology and even its variables' definitions. Moreover, cross-country average results can easily blur economically significant responses in individual nations, as will be argued repeatedly in this critique.

not true at a more disaggregated level. Between the periods there was a decline of 1.8 percentage points for Latin America, and 0.8 for South Asia. Consequently, the constant overall average capital stock growth rate depends on East Asia and Europe making up the difference. But the higher income countries in the sample are located in these regions. Would the results have been the same had they been dropped? Do external shocks (let us say the debt crisis) play no role in explaining differences in rates of capital accumulation between regions?

Similar doubts apply to the *WDR's* conclusions regarding the growth effects of education and ISI. With regard to the former, it is a truism that the labor share - or the estimated elasticity of output with respect to labor in growth analysis - is somewhat lower in developing than industrialized countries. The *WDR* argues that "... the much lower levels of education in developing countries probably account for much of this difference" (page 43), then deduces that more education enhances productivity. There are at least two problems with this logic:

- (a) First, if (as is likely) "labor share" in the *WDR* means the share of wage payments in value-added at factor cost, then it will automatically be lower in poor countries since the incomes of independent proprietors such as peasants, small tradespeople, etc. are not imputed to labor. As market economies grow richer, institutions change and proprietors tend to be proletarianized. Their income shares decline, while those of wage-earners and corporate enterprise go up - a point having little to do with education, as was brought out by Kuznets (1966) a long time ago.
- (b) Secondly, the equivalence of the labor share to the elasticity of output with respect to labor holds only under assumptions of perfect competition. Yet the *WDR* stresses throughout that development problems occur precisely because of strong distortions in product and factor markets. If the counter argument is that the factor productivity results should be interpreted as good approximations to reality using the "as if" clause, then an obvious question is: How is it that departures from perfect competition so weakly affect econometrics but so strongly explain differences in development performance?

When it takes up the effects on productivity of market distortions, the *WDR* treats import substitution as a major culprit, especially in Latin America. This factor is explicitly blamed for the fall in TFP growth observed in the region after 1973. This conclusion may (or may not) be true, but the *WDR* does not present much supporting evidence. Data in table 2.3 of the *WDR* show that TFP accounted for 25 per cent of output growth in Latin America during 1960-1973, but took away 48 per cent during 1973-1987. The ISI strategy can scarcely account for this shift, since in one form or another it guided Latin American development thinking throughout the entire post-war period.

The biggest difference between the sub-periods before and after 1973 is not the dominance or gradual weakening of ISI doctrines but rather the impact of two international "earthquakes": the oil shock and the debt crisis. In trying to manage external instability in the late 1970s and throughout the 1980s, successive Latin American economic teams have combined the remnants of ISI with an impressive array of new policy packages (many akin to the *WDR* version of market-friendliness), on the whole with disappointing results for development. Indeed, a plausible deduction from table 2.3 might be that "pure" ISI during 1960-1973 was not that bad at fostering productivity. But, again, such an assumption would entail ignoring the importance of subsequent external shocks.

The *WDR's* chapter 2 discussion of TFP closes with a set of policy regressions aiming to show that a low parallel market premium on the exchange rate (purportedly signaling an absence of government-induced distortions) and high education levels can interact to boost growth by over 2 per cent per year. Given the experimental design of the statistical universe of developing nations, the two variables neatly isolate East Asian economies, which undeniably grow fast. Their causal relevance, however, is less clear: rampant black markets are a signal of economic trouble for whatever reason, and there are significant counter-examples to the positive education/growth correlation (Brazil and Sri Lanka are obvious historical cases in opposite directions). East Asia's successes are not solely due to credible exchange rates and low school drop-out rates. Rather than demonstrating that eliminating distortions and supporting education will speed growth, the spectacular numbers in table 2.4 and figure 3 of the "Overview" section summarize a nearly meaningless statistical association.

Even if these results were not based on a regression fallacy, it is not clear that they would constitute evidence in favor of a market-friendly strategy - the results can easily be accounted for

in other theoretical frameworks. The two- and three-gap models discussed in detail below differ from the *WDR* in stressing the importance of the external constraint, but do not contradict the notions that fast growth is associated with more education and a low parallel market premium. A big spread between the official and parallel exchange rates is as much an indication of a shortage of foreign exchange as it is of market distortions.

2. *The advantages of investing in people*

Apart from the regression fallacies just noted, further arguments about human capital accumulation appear in chapter 3. The main piece of evidence is that more educational attainment is associated with higher personal income at the micro level (table 3.2). But it is a long jump from data in the table to the *WDR*'s contention that more education is a sufficient condition for faster overall output growth.

No one denies that in most societies, peoples' years of schooling and their earned incomes are positively correlated. However, the relationship is not easy to explain. There is a long-standing, unsettled debate in the United States of America (typically with human capital partisans on one side and radical economists on the other), as to whether school attainment is a strong explanatory factor for income by itself, or more of a proxy for family background, "ability," and "luck." This inconclusiveness no doubt carries over to the developing world.

Moreover, even if more school years do increase an individual's potential productivity at the margin, there is no assurance that s/he will get a job. Jumping from the micro evidence in table 3.2 to a macro relationship between extra education and faster growth requires buying into strong assumptions. The "new" theories of economic growth that underlie the emphasis on human capital in the 1991 *WDR* postulate that output is determined solely by supply factors and that all resources are fully employed.⁶ Especially after the poor countries' dismal performance over the past decade, many economists would prefer not to presume so much.

A less radical analysis starts from the observation that both public and private actions condition the availability, remuneration, and skill content of jobs. In particular, an economy in chronic recession as in Latin America and Africa is not likely to be starved for skills. Recent studies sponsored by the World Bank show, for example, that rates of return to extra years of schooling in urban labor markets in developing economies dropped significantly during the 1980s. Even if there are bottlenecks, job requirements can often be modified accordingly; more generally, labor market structures vary across nations and strongly influence the nexus among years and type of education, personal characteristics, and payment for work.

These observations do not deny experience in the Republic of Korea and elsewhere, where increased skills and education have been associated at the micro level with technology acquisition, productivity increases, and growth, nor can one quarrel with the worldwide social consensus that better health and schooling are desirable in and of themselves. But human capital accumulation is not a sufficient condition for higher productivity; it is more a necessary or accommodating factor which cannot be absent in the long run. For all these reasons, the fact that shares of public expenditure on health and education in GDP fell during the 1980s in one-half of a large sample of countries (page 66) is not good news. Reversing this trend, however, will not lead to sudden accelerations of accumulation and growth.

3. *Profits and growth*

The *WDR*'s next theme is that market liberalization will make physical capital's profitability go up. Chapter 4 attempts empirical proof. *Ex post* rates of return on World Bank investment projects at the country level are regressed on the parallel market premium, the fiscal deficit, the real interest rate, and the degree of trade restriction (a subjective index). Profits decrease as these measures of distortion worsen, but as usual the causal linkages are unclear. If a country gets into

⁶ Although arguably they add little to the insights of Nicholas Kaldor and colleagues 30 years ago, "new" growth models had proliferated in neoclassical economics during the latter part of the 1980s. They have heavily influenced thinking in the research complex of the Bank. Romer (1989) provides a favorable, semi-technical review.

macroeconomic trouble, for example, profitability will suffer at the same time as the black market premium increases, the fiscal deficit widens, inflation speeds up, and the authorities slap on import quotas. Under such circumstances, distortions look less like causes than simple correlates of low rates of return induced by economy-wide disorders - we are back to the macroeconomic shocks that many developing economies received after the mid-1970s.

The regressions also show a strong positive effect of public investment on the rates of return of World Bank projects, although a kink is carefully built into the specification to show that complementarity tails off when the public share in total capital formation exceeds about 40 per cent. Regardless of whether the kink is a statistical artefact or not (only detailed country evidence which is not provided could help resolve this question), the fundamental result is that by increasing profitability, public investment can "crowd in" capital formation by the private sector.

Unfortunately, during the 1980s this potentially beneficial linkage operated in reverse. African and Latin American nations ran into fiscal difficulties as their export proceeds (from both public firms and taxation of the private sector) shrank and foreign interest obligations increased. As discussed in country studies sponsored by the World Institute for Development Economics Research (WIDER), to be published in Taylor (1992), the resulting cutbacks in public investment combined with high interest rates and low capacity utilization provoked the fall in capital formation that the *WDR* underlines in its table 1.2.

4. *Integration with the world economy*

Chapter 5 takes up "Integration with the Global Economy," leading with discussions of technology transfer, labor flows, and direct foreign investment (DFI). Michael Porter (1990) - the Harvard Business School's reigning Deepest Thinker - is invoked as endorsing domestic competition, while the roles of the Japanese and Korean States in pushing local firms to acquire technology are played down. The recent spurt in DFI as a source of foreign finance for a dozen or so developing economies (mainly in Asia) is noted, as well as its uncertain prospects for the future.

The discussion next turns to the World Bank's grand obsession over the years: trying to establish a causal linkage between economic openness and the rate of output growth. Again, statistical red herrings cavort. Defining openness by high trade shares in GDP, for example, Syrquin and Chenery (1989) in a World Bank paper split a sample of countries into four groups by size and primary/manufactured goods export specialization. For the period 1950-1983, they compared growth rates in the halves of each group with low and high export shares. The median GDP growth rate *per capita* for small countries with primary product specialization and high export shares was 1.1 per cent per year higher than that of similar countries with low shares, a striking difference. However, the obvious conclusion to be drawn from the performance of countries such as Chad, Ghana, and Madagascar (the three slowest growers in the sample) is that both growth and exports will be low when the entire socio-economic system is in the fire. The policy implications are that somehow overcoming internal disruption and searching out plausible export lines are prior conditions for economic viability; not that liberalizing an economy will miraculously "open" it to growth through trade. In the other three groups, the differences in mean growth rates between the high and low export subgroups substantially exceed differences in medians, suggesting the presence of outliers. Sure enough, dropping Japan and the rapidly growing East Asian industrializing economies from the appropriate classes makes the differences in mean tend toward zero.

Other cross-country studies such as McCarthy *et al.* (1987) also point to an agnostic conclusion about the effects of high or rising trade shares on growth. Nor do exports appear to lead output expansion in time. For example, a recent study of 47 African economies found that there was no "Granger causality" link between more exports and faster growth (Jaleel and Kwan, 1991).

Among individual countries, there are numerous counter-examples: Jamaica, Uruguay, and Portugal historically have combined high manufactured trade shares with slow growth; corresponding shares in Colombia and Brazil have averaged two or three per cent and they historically have grown fast. Despite the East Asian examples of simultaneous expansion of exports and output (backed by steadfast import substitution, heavy state intervention, big capital inflows at critical junctures, etc.), counter-cases all over the globe rule out strong trade/growth associations.

The same conclusion carries over to statistical associations between trade distortions and growth; the *WDR* itself admits that the evidence is weak. Indicators standing for distortion and openness are put through endless permutations in the note to table 5.1 (page 163). Of 37 reported regression coefficients, five have the "wrong" sign (i.e. greater distortion is associated with faster growth), and only 13 of the 32 other relationships are significant at the 5 per cent level. One learns (on page 164) that R^2 values in partial correlations between lower distortions and growth (after taking into account the effects of human and physical capital and other variables) range from 0.03 to 0.3. With such weak relationships, many economies in the *WDR*'s samples are bound to have behaved the "wrong" way.

For practical purposes, these results weaken the *WDR*'s cross-country case about the deleterious effects of distortions. Similar findings are the rule for individual economies, e.g. a Bank-sponsored study of Chile found no changes in sectoral productivity levels after external liberalization; the rationale for this was that improvements may have been masked by macroeconomic shocks (Tybout *et al.*, 1991)!

B. Missing issues in the market-friendly approach

As we have seen, the *WDR*'s main rationale for slow output expansion may be reduced to zero or negative growth rates of TFP or the "residual". This model omits or underestimates crucial factors affecting economic performance in developing countries. As a consequence, the World Bank's vision of which forces could help foster growth in the immediate future would be by no means clear.

Let us take a look, for example, at the growth projections appearing in the *WDR*. After a useful Box 1.4 showing how *WDR* 10-15 years ago was overly optimistic about the prospects for LDC growth, chapter 1 concludes with table 1.5 which suggests that during the 1990s annual rates of increase in output per capita will rise by 0.4 per cent or fall by 0.3 per cent per year in "baseline" and "downside" projections, respectively.

The driving forces behind the baseline forecast seem to be an increase in long-term North-to-South resource transfers from US\$63 billion to 103 billion between 1989 and 1995, led by higher DFI (table 1.3), plus "... increased [LDC] domestic savings and a greater efficiency of investment" (page 24). This projection does not take into account the fact that recent DFI flows have largely gone to economies in Asia, which at this stage are not wanting in foreign exchange. Neither does it recognize that domestic savings are heavily obligated to meet payments on foreign liabilities in highly indebted countries; and that advice to invest with greater efficiency is beside the point when capital formation is limited by lack of available savings, a low level of economic activity, macroeconomic instability, and no international creditworthiness.

We will now review key elements missing from the *WDR*'s framework: the sources of and incentives for capital accumulation; the difficulties of building up a domestic capital market in an increasingly integrated financial world; and the difference between allocative and productive efficiency.

1. Investment and saving

Economic growth entails three related but distinct problems. To sustain growth, it is necessary to generate sufficient savings - the feature of the process emphasized by the classical or Smithian tradition of thought: the "wealth of nations" is explained by the thriftiness of their populations. Hence part of available resources should always be put into savings in order to increase wealth.

In the second place, it is necessary to ensure that the non-consumed flow of income be invested because one cannot count on savings being automatically channeled into capital formation. This problem is highlighted by the Keynesian tradition,⁷ which focuses on two determinants of growth. One is the state of investors' animal spirits, primarily affected by their expectations re-

⁷ Especially by Harrod's "real" growth model and Tobin's "monetary" one.

garding the future evolution of the economy. The other takes the form of marginal productivity decisions in the allocation of a given flow of savings between real and financial assets. These choices among different possible components of asset-holders' portfolios heavily influence the degree of capital deepening and hence the long-term rate of growth.

A third important factor influencing the growth rate is the efficiency with which given real resources are allocated. This can be called the neoclassical approach to the theory of growth. It should be underlined that neoclassical models concentrate on allocative efficiency, implicitly assuming that it leads to productive efficiency as well. We expand on this distinction below.

The arguments in the *WDR* tend to dismiss the Smithian and Keynesian traditions. Its policy reform proposals understate the need to generate more savings and reinforce the linkages between savings and investment in order to restore growth. This stance is consistent with the neoclassical philosophy underlying the *WDR*, which presupposes that market forces can simultaneously resolve the classical, Keynesian, and efficiency problems. Saving cannot be scarce *per se* because the market-determined interest rate will call forth the optimal flow. Animal spirits/portfolio decision bottlenecks will not occur because neoclassical growth models postulate that investment and saving are instantly equalized by the market. Likewise, the *WDR*'s financial models incorporate a portfolio structure that contains money as the only asset competing with real holdings in an economy closed to foreign wealth.

This approach has several flaws when it comes to address linkages among savings, investment, and growth in developing economies:

- (a) There is no empirical evidence of a strong relationship between the interest rate and the supply of savings.⁸
- (b) Nor are there many observable examples of a scenario tracing back to McKinnon (1973) and recently emphasized by the World Bank (e.g. the 1989 *WDR*), whereby a higher interest rate leads to a portfolio switch towards bank deposits. The increased financial intermediation implicit in a higher deposit/output ratio is supposed to cause the incremental capital/output ratio to decline. As will be argued below, adjustments in the opposite direction are more likely to take place.
- (c) The neoclassical model assumes that the substitution effect of an increase in the interest rate is stronger than the income effect.⁹ However, the existence of a significant amount of public debt, both domestic and internal, implies that any increase in private savings owing to a higher interest rate could be more than offset by the decrease in public sector savings owing to the increment in the cost of debt service. Even supporters of the market-friendly approach recognize that public dissaving owing to higher debt service could have explosive macro implications.¹⁰
- (d) Many developing economies are open to external capital movements. The corresponding portfolio decision between local real and foreign financial assets (the "capital flight" phenomenon) is a crucial determinant of investment and therefore growth.
- (e) The importance of institutions in determining the national saving rate is not addressed in neoclassical models because they emphasize the equilibrating role of movements in the interest rate. Likewise, institutional determinants of investment are underrated. These omissions are particularly striking with regard to the State as a generator of both savings and investment. Mainstream models emphasize the importance of the government budget constraint in inflation/stabilization questions but not with regard to growth.

2. External shocks

National saving and investment performances in developing countries have proven to be highly sensitive to external shocks. In fact, the *WDR* presents a clear description of the

⁸ Dornbusch (1990) discusses the empirical evidence on the relationship between interest rates and saving. See also the 1989 version of the *World Development Report*.

⁹ See for example Blanchard and Fischer (1989), chapter 2.

¹⁰ This possibility is mentioned by Williamson (1990) and in chapter 6 of the *WDR*. Its consequences, however, are not integrated into the *WDR*'s macroeconomic analysis of the highly indebted countries.

macroeconomic disequilibria that external misfortunes can induce. In chapter 1, in connection with table 1.2 on global saving-investment balances, one learns that during "... the decade [of the 1980s], aggregate net resource transfers to [developing] countries shifted from positive to negative. The investment-output ratios of the low- and middle-income countries fell in the 1980s and have not recovered" (page 23). This change is reflected in the trade surpluses of many countries in the developing world.

Reading from the *WDR's* table 1.2, average annual total saving in LDCs exceeded investment (representing a net resource transfer from South to North) by 0.7 per cent of world GDP during 1981-1985 and 0.5 per cent during 1986-1988, with the flow being US\$94 billion in 1988. Although the *WDR* does not make the connection, this "perverse" transfer surely is related to the fact that annual average GDP growth rates in Sub-Saharan Africa and Latin America dropped by about 2.5 percentage points between 1973-1980 and 1980-1989 (figure 1.5). The sustained external shock represented by these transfers amounted to approximately 3 per cent of total developing countries' GDP (now about US\$3.1 trillion) per year. It is scarcely surprising that their output growth rates slowed.

Using Occam's Razor, the simplest explanation for the low growth rates of total factor productivity noted above is that after the mid-1970s in developing economies, lagging output expansion reduced the estimated residual, not the other way round. A more complete discussion of separate trends in capital and labor productivity than the *WDR* presents would have been far more helpful in analyzing output growth deceleration, since they would illustrate how in many economies capital/output ratios rose in response to capacity under-utilization as they adjusted in contractionary fashion to increasingly severe external strangulation.

Likewise, had the effects of external shocks been integrated into an analysis of macroeconomic disequilibria, it would have been natural to take account of the Smithian (or saving) constraint on growth. The observed decreases in national saving rates in many developing countries have been closely correlated with reductions in real national incomes induced by higher external payments flows after the early 1980s.

3. *Capital flight and financial intermediation*

According to the *WDR*, "Capital flight, however defined or measured, is above all a symptom of macroeconomic mismanagement - in many instances compounded by political instability" (page 124). Box 6.4 discusses the issue, but it does not mention the fact that in such countries as Argentina, Chile, and the Philippines, capital flight was a direct consequence of the failure of ill-considered, Bank-supported trade and financial liberalization experiments conducted during the late 1970s and early 1980s. The omission is all the more striking in view of the *WDR's* recommendation that liberalization should be applied "everywhere."

Thinking of capital flight as only a consequence of "macroeconomic mismanagement" trivializes the problem that many countries face. Adverse private capital movements are a symptom of structural weaknesses of the financial system - they are the counterpart of demonetization and shrinkage of domestic asset markets. In Argentina, Mexico, the Philippines, and Venezuela, private capital outflows approximated the increase in their foreign debt. Alienation of national wealth and assignment of a substantial fraction of the flow of domestic savings toward foreign holdings means that many developing economies face local financial disintermediation as a direct consequence of liberalization. Foreign governments and investors reap the gains, while domestically there is a liquidity squeeze.

This financial barrier between local economic actors whose savings exceed investment flows and firms and households with saving insufficient to finance desired levels of capital formation stems from the portfolio preferences of the domestic private sector and the credit policies of foreign institutions. In such countries as Argentina and Brazil, the demand for domestic financial assets can be as low as a few percentage points of GDP. If the Government seeks to finance a small increment in its deficit locally (its only possible choice since the foreign credit market is rationed), the induced excess demand will spill over into rapidly escalating real interest rates and/or a "panic" which will lead to capital flight.

Unfortunately, the possibility of panicky reactions is real. Perceived macroeconomic instability increases wealth-holders' preferences for liquid foreign assets as opposed to physical capital.

By the same token, foreign financial institutions tighten credit rationing and try to reduce their exposure in the country concerned. During the 1980s, capital outflows worked against domestic equilibrium - they reversed or dropped during relatively stable periods but intensified with macro-economic shocks.

By ignoring this destabilizing feedback, the *WDR* denies the existence of a major market failure. By themselves, "sound" macroeconomic policies alone cannot eliminate international disintermediation of funds.

While it is certainly true that a more stable environment would increase demand for domestic financial assets, thereby reducing the outflow of internal savings, it is also true that flight capital may represent a permanent reallocation of private agents' portfolios. Recent technological and institutional changes have made it easier for wealth-holders to store funds abroad when they perceive foreign financial institutions as being safer and more efficient than domestic ones. If a local agent thinks that the foreign bank where s/he deposits money offers an advantage in terms of information, why should this individual opt for financial assets denominated in domestic currency before the bank decides to restore voluntary credit to the country in which s/he lives?

Even if macroeconomic stability were attained, the restoration of growth would call for higher investment. In other words, repatriated flight capital should finance capital formation. But if animal spirits are weak, the outcome could be a stagnant equilibrium of self-fulfilling pessimistic expectations as private agents assume a wait-and-see attitude before taking the risk of immobilizing their funds in productive assets. The Government cannot "prime the pump" because restricted local markets mean that it cannot place its own liabilities. Even worse, the private sector may enter into speculation in local financial paper as in Chile, Turkey, the Philippines, and elsewhere during market liberalization experiments before and after 1980.

These difficulties suggest that financial liberalization alone is not likely to be a successful policy option. The case of Chile is instructive in this regard. After its internal financial boom-and-crash (discussed in more detail below), Chile's official donors increased their exposure in the country, supplementing commercial bank credit and relaxing the external liquidity constraint. There were two direct beneficial consequences:

First, increased external credits allowed the Central Bank to transfer non-performing loans from the commercial banks' to its own portfolio. Subsequently, this transaction was refinanced by a "big bond" exceeding US\$7 billion (in an economy with a GDP of US\$25 billion) from the national Treasury to the Central Bank, thereby making debt service a taxpayers' obligation. Bad debts still exist within the financial system, but for the moment their destabilizing effects have been neutralized.

Secondly, foreign financing permitted a high level of public investment. Beyond mere pump-priming, substantial copper export capacity was created and animal spirits were buoyed up. Chile enjoyed a steady inflow of official, multilateral credits which forestalled the worst aspects of international financial disintermediation. By 1991, the country had attained renewed access to international financial markets, but only on the basis of previous donors' lending sustained over a long period of time.

4. *Allocative versus productive efficiency*

In the contexts of industry and finance respectively, Hjalmarsson (1991) and UNCTAD (1991) show how the irrelevance of liberalization to growth can be dissected in terms of distinct notions of "allocative" and "productive" efficiency: the latter is by no means assured by putting the former into place. Market and capital stock structures, forms of financial intermediation, resource "endowments" as defined by changing technology and tastes, the size of the economy, historical fetters from colonialism, access to geopolitically determined capital inflows and penetrable markets, etc. affect productive efficiency in ways that the worldview reflected in the *WDR* cannot comprehend.

Nor is the *WDR* clear about how removing wedges separating prices - especially between international and national valuations of potentially tradable goods - is supposed to generate productivity gains. Meeting external competition, for example, may reflect low real wages as much as the high labor productivity essential for a high per capita GDP. Similarly, if capital markets

are reasonably competitive and stable, then getting rid of distortions is supposed to stimulate productive efficiency within firms. Enlightened neoclassical economists recognize that even this contingent guarantee breaks down under conditions typical of developing countries or those undertaking the transition from socialism (Tirole, 1991).¹¹

If productive efficiency is not assured by liberalization, then how can it be enhanced? There are no foolproof stimulants, but intriguing possibilities can be read from historical experiences. One example is the model of accumulation followed by the Nordic economies after 1930 and the Republic of Korea two decades later. It emphasized the advantages of workers' productivity growth when they were employed by firms big enough to benefit from best practice technology and economies of scale. Such enterprises were consciously sanctioned by Nordic and Korean authorities as monopolies or oligopolistic participants in export trade. After relatively short learning periods, Governments sought allocative efficiency by supporting their local champions in competition with counterparts abroad (the Nordics, though not the Koreans, also opened national markets to foreign competition). They learned to meet world prices of commodities and services with elastic export demands, so that labor productivity increases could be absorbed into foreign sales.

Pressures toward productive efficiency came not from capital markets, but from trade unions (e.g. in Scandinavia) and the State (e.g. in the Republic of Korea). Nordic workers strove for higher productivity on the understanding that it would be translated rapidly into real wages; without underwriting wage growth, economic bureaucrats in the Republic of Korea followed their Japanese mentors in adopting a pro-productivity line. Given the tightly held nature of (say) the Swedish Wallenberg bank-centered "group" of companies and the Korean *chaebol*, stock market discipline did not figure in production or investment decisions. Cross-financing of investment within the groups, industrial subsidies, and targeted, cheap credit in restricted national capital markets certainly did (Kosonen, 1991; Amsden, 1989).

Another missing link has to do with countries' size. It is natural for small and large nations to pursue different lines of industrial strategy to gain productive efficiency - a distinction not addressed at all by the *WDR*. Differences in development patterns between small and large economies have been studied for a long time; Syrquin and Chenery (1989) provide a recent summary. A line between the two types is most conveniently drawn on the basis of population, somewhere between 20 and 50 million.

Katzenstein (1985) and Pekkarinen, *et al.* (1991) suggest that economically successful small countries prospered along Nordic/Korean lines, with close state/capitalist/labor collaboration in supporting "thrust" sectors under an open trade (although not necessarily capital market) regime. Extended to incorporate active government dealing with transnational corporations (or TNCs) and more or less explicit labor repression, this approach has worked recently in small, growing raw-material exporters such as Malaysia and Chile. It is also fair to ask how long can the former country successfully court potentially footloose TNC assembly operations without a coherent national industrial structure, or the latter defer distributional strife (Taylor, 1992).

While small countries necessarily concentrate on a limited number of export industries in the search for profitable niches, large ones usually follow a more uniform pattern of industrial change. They enter earlier into import substitution and have higher manufacturing shares of GDP than do small nations at the same per capita income level; they pursue import substitution further into intermediate and capital goods and producers' services. The statistically "typical" large country's import and export shares of GDP are likely to be around 10 per cent (with a standard deviation of about the same size, e.g. the Republic of Korea with import and export shares in the 30 per cent range is far more open than the norm) while a small country's shares may be more than one-half.

The basic premise of large economy strategies is that protected markets at home can permit economies of scale and scope. At the same time, they allow the luxury of allocative inefficiency for extended periods of time - high-cost production need not represent a binding restriction on inward-oriented growth. Ultimately, a statically inefficient industrial sector may become the base for breaking into world trade with import-substituted products, as suggested by Turkey's example during the 1980s.

¹¹ Tirole's main arguments are: (1) Because of the instabilities that have been discussed, prices in asset markets are noisy and do not convey much information about firms' performance (especially since many enterprises in developing economies are closely held). (2) A noisy economic environment facilitates rent-seeking; as a counterpoise firms' incentive payments to managers may be kept low, meaning that they will not actively search for ways to raise efficiency.

Big countries have an internal economic space which it is socially efficient to explore, even if there are "welfare" losses in the form of distortions from world prices and limited access to a variety of goods. In the long run, confrontation with external competition makes sense (as the Turkish experience demonstrates), but large countries have the freedom to pick a place and time. In the medium term, intelligent use of multi-tiered pricing systems and targeted incentives along Indian lines (Alagh, 1991) can help transform an industry with an unbalanced capital stock into something closer to a potential world competitor. With a few hundred million people making up a potentially dynamic internal market, there is no compelling reason to jump into external liberalization *tout court*.

II. The macroeconomic foundation

Chapter 6 of the *WDR* is entirely devoted to macroeconomics and the questions raised by attempts at stabilization. Following a time-honored tradition, it distinguishes disequilibria arising from internal and external aggregate shocks.

Internally generated imbalances are mostly attributed to policy mismanagement. Excessive government spending in Brazil in the 1970s and the surge of private spending during the import/speculative finance boom in Chile in the early 1980s are presented as typical examples.

Shifts in the terms of trade are emphasized as causes of disequilibria originating outside the national economy. Commodity booms, in the *WDR*'s view, induce a government to raise expenditures, drive up the price of non-traded goods relative to that of traded ones, and draw labor and capital away from production of tradables. The real value of the currency appreciates¹² and the economy starts to suffer "Dutch disease." The *Report* further identifies a tendency for increases in state spending to outrun revenue gains from a trade windfall. Mexico and Nigeria, which increased their external debt levels after the oil shock, are cited as cases in point.

The *WDR*'s advice on how to avoid boom and bust episodes is to pursue policies that do not give rise to big macro imbalances, adjust quickly, and respond cautiously to shifts in the terms of trade. Indeed, "... countries should try to keep their spending consistent with their permanent income" (page 113). The conclusion that naturally follows is that independently of whether the origin of macroeconomic problems is internal or external, all disequilibria express themselves as excesses of domestic absorption over income. Taking into account caveats regarding adverse short-term consequences on growth and inflation (expressed in Box 6.1), the usual IMF package is recommended to restore equilibrium.

This vision of the macroeconomic problems of developing countries suffers from conceptual inconsistencies; moreover, country experiences that are supposed to support the Bank's macro framework in fact do not easily fit into it. As a consequence, the *WDR*'s recommendations for stabilization policy suffer from a certain lack of persuasiveness. These observations are spelled out in the sections that follow.

A. Macroeconomic disequilibrium

WDR macroeconomics recognize that an adequate supply of external capital is "essential," but beyond that, international capital market conditions are not given a significant role in accounting for macroeconomic disequilibrium. For instance, in the discussion of the Mexican experience (page 112), the abrupt jump in international interest rates and rationing of credit

¹² We follow standard but confusing terminology about the exchange rate. If the nominal peso/dollar conversion factor is increased, the local currency becomes weaker or depreciates. If the peso/dollar ratio is increased less rapidly than domestic inflation, then there is real strengthening or appreciation of the peso.

markets in the early 1980s were not even mentioned. Likewise, nothing has been said about the easy-credit 1970s, when commercial banks so aggressively pushed loans that they created a Dutch disease pandemic throughout the developing world.¹³

When imperfections (the existence of rationing) and volatility in international capital markets are seriously taken into account, advice to keep spending in line with permanent income borders on being vacuous. The *WDR* counsels that to smooth the cycles caused by fluctuations in the terms of trade "... the windfalls from temporary changes ... should be saved" (page 112). The question of course is how to do it.

If the domestic financial market is thin, an attempt on the part of the central bank to sterilize reserve inflows resulting from a favorable shock could create serious imbalances; on the real side of the economy, it would be virtually impossible to avoid higher absorption. If a seriously indebted country were to attempt to place extra funds in the international capital market, commercial banks would likely exert pressure on it to retire debt. The obvious question is whether it would be permitted to borrow when times turned bad. With rationed credit markets, that option may not be available.¹⁴

It is true that internal imbalances tend to be associated with policy mismanagement, not excluding past reform attempts along market-friendly lines. The latter "mistakes" are studiously ignored in the *WDR*'s description of internal shocks. For example, there is no mention that the Chilean crisis of 1980-1981 had followed the failure of a financial liberalization exercise in the late 1970s. Indeed, the Chilean case merits careful study by market-friendly scholars, since the economy went into external imbalance when the public sector was running a surplus of 5 per cent of GDP and reforms of the sort recommended by the *WDR* had been put into place.

The problem was that despite "sound" policy, the private sector chose to run a deficit of 16 per cent of GDP, leading via a speculative financial boom to a major crash. As already discussed, public debt from state intervention in the financial system plus lender-of-last resort activities still amounts to 30 per cent of GDP while a good part of the government's foreign debt has the same origin.¹⁵ *Mutatis mutandis*, a similar story could be told about countries such as Argentina and the Philippines.

Thinking of all macro disequilibria as problems of excess absorption is not always wrong, but it can be distracting. With this mind-set the *WDR* fails to see aspects of imbalance created by the debt crisis. Excess absorption clearly did not create large trade surpluses (as percentages of GDP) in highly indebted countries during the 1980s - as illustrated by the numbers in the table given below, they simply had to make the corresponding external transfers. Countries such as Argentina and Brazil which did not receive external finance slipped into macro disequilibrium; countries such as Chile, which did receive external donor support, fared much better.

In order to highlight how interlinkages among external shocks, internal (especially fiscal) factors, and the structural features of developing economies can lead to macroeconomic imbalance, many economists have recently started using a model akin to an old World Bank approach whereby the economy is seen in terms of two gaps, but a third fiscal/financial constraint is added to the specification.¹⁶

The liberalization literature postulates that if institutional obstacles were removed, a market economy would attain an equilibrium position by itself. The gaps approach, on the contrary, considers that disequilibrium phenomena may or may not persist after barriers to the free working of market forces are removed.¹⁷ With this model, the outcome will depend on whether or not

¹³ In a foreign-credit-starved economy, any capital inflow can trigger symptoms of Dutch disease. A very recent example has been Argentina, where in 1991 the privatization process plus low United States interest rates had led to large inflows of funds.

¹⁴ The point of these arguments is not that using assets to offset cyclical shocks is wrong. The problem is that managing intertemporal constraints is not easy for a country facing an imperfect capital market. It is well known that permanent income theories break down when liquidity constraints and market imperfections abound.

¹⁵ On the quasi-fiscal activities of the Chilean Government, see commentary by Eyzaguirre and Larrañaga (1990).

¹⁶ Chenery and collaborators such as Bruno (1962) set up models with internal and external balance relationships specified to capture the structural peculiarities of developing economies. This approach is dismissed in chapter 2 of the *WDR*, but no mention is made of the three-gap formulations which add a fiscal/monetary balance to the original two restrictions. The omission is striking, considering the issues to which the *WDR* is devoted.

¹⁷ See Bacha (1990); Fanelli, Frenkel, and Winograd (1987); Fanelli (1988); Carneiro and Werneck (1990); and Taylor (1991b) for interpretations of developing country disequilibria in terms of gaps.

DEVELOPING COUNTRY TRADE, INVESTMENT AND SAVINGS FLOWS

(Percentages of GDP)

	<i>Inter- mediate imports</i>	<i>Investment</i>				<i>Total</i>	<i>Savings</i>		
		<i>Foreign capital goods</i>	<i>Domestic capital goods</i>	<i>Public sector</i>	<i>Private sector</i>		<i>Public sector</i>	<i>Private sector</i>	<i>Trade deficit</i>
Argentina (1988)	6.0	1.8	12.6	7.6	6.8	14.4	0.8	15.6	-2.0
Brazil (1987)	3.8	2.1	17.9	6.2	13.8	20.0	6.2	18.3	-4.5
Chile (1988)	14.9	6.8	11.6	7.9	10.5	18.4	5.7	15.6	-2.9
Colombia (1988)	5.4	3.5	14.6	7.1	11.0	18.1	4.0	16.7	-2.6
India (1988)	4.5	2.4	20.8	12.7	10.5	23.2	2.4	18.9	1.9
Rep. of Korea (1987)	24.7	15.7	13.9	6.2	23.4	29.6	11.1	28.5	-10.0
Malaysia (1988)	22.1	11.5	11.7	9.3	13.9	23.2	5.9	27.5	-10.2
Mexico (1988)	7.9	2.5	18.1	6.4	14.2	20.6	4.2	20.1	-3.7
Nicaragua (1989)	17.5	12.1	12.1	2.1	22.1	24.2	-2.0	9.5	16.7
Nigeria (1986)	1.7	3.8	8.1	7.6	4.3	11.9	3.1	8.9	-0.1
Philippines (1988)	11.4	4.4	13.8	3.0	15.2	18.2	0.0	19.2	-1.0
Sri Lanka (1987)	11.5	6.5	19.9	14.9	11.5	26.4	4.4	18.0	4.0
Tanzania (1986)	5.7	11.9	15.0	8.3	18.6	26.9	5.6	11.8	9.5
Thailand (1987)	9.8	8.6	15.0	6.7	16.9	23.6	5.4	19.7	-1.5
Turkey (1987)	13.5	1.0	24.4	13.3	12.1	25.4	8.2	19.5	-2.3
Uganda (1987)	5.6	8.6	8.4	3.9	13.1	17.0	-5.6	16.0	6.6
Zambia (1987)	30.7	8.0	2.7	7.7	3.0	10.7	-16.7	32.5	-5.1
Zimbabwe (1986)	11.1	7.1	15.4	11.9	10.6	22.5	-5.1	30.9	-3.3

market signals by themselves induce economic actors to close the gaps; this in turn will be determined by structural features of the economy at hand.

For instance, liberalizing the foreign exchange market might lead to hyperinflation if the stock/flow disequilibrium between foreign liabilities and national income is large. Gap models do

not *a priori* disregard explosive paths that may occur during adjustment processes or the possibility that free markets could lead to a "bottom of the well" equilibrium with stagnant growth and persistent unemployment; the same cannot be said of the macroeconomic analysis in the *WDR*.

Indeed, gap models are designated explicitly to incorporate the diverse structural characteristics of developing economies. The World Bank's desire to set out a universal policy package applicable "everywhere" leads it to ignore such details. Often, at least five sets of factors contribute to macroeconomic imbalance, as pointed out in the recent WIDER country studies summarized in Taylor (1992). The table below presents numerical evidence:

- (a) The public sector plays an important role in capital formation in all the countries, from free market bastions such as Chile and Malaysia to statist India, Turkey, and Zimbabwe. As has already been noted, public investment typically facilitates or "crowds in" private capital formation. This linkage was found in most of the studies (and appears to be the rule in industrial countries as well). For macro programming, public capital formation may be the only vehicle for stimulating investment after adverse shocks. Unless export growth pulls investment demand up in a cumulative process along Korean lines (certainly an outlying case among developing economies), it is hard to see how private capital formation will recuperate in and of itself.
- (b) The public sector is typically a strong net saver. The only exceptions are macroeconomically distressed Nicaragua, Uganda, and Zambia, along with Zimbabwe, where for historical reasons the private saving rate is abnormally high. Saving by the public sector reflects its activity in capital formation, as well as the unique ability of the State to gather resources. This developing country pattern resembles that found in some industrialized countries, which historically have arrived at diverse institutional means for generating savings (Kosonen, 1991). For example, household savings shares of GDP range from around 20 per cent in Japan and Italy to 5 per cent in Finland, Norway, and Sweden.
- (c) Private savings flows are also large. They must be intermediated into capital formation and/or loans to the State to cover the public-sector borrowing requirement (or PSBR). This process can lurch into imbalance if a fall in the demand for domestic assets squeezes credit to the public sector or for private investment projects.
- (d) Most economies in the sample have negative trade deficits, i.e. surpluses. In many cases, these reflect foreign shocks suffered in the 1980s. Latin American and other countries had to run surpluses to meet foreign interest obligations while their Governments needed fiscal surpluses (apart from interest obligations) since they had nationalized foreign debt. This "double transfer" problem has crippled stabilization efforts and fiscal rectitude. Poor primary product exporters in Africa and elsewhere have been hit by steady declines in their terms of trade and lagging export volumes. Uganda, Tanzania, Sri Lanka, *et al.* became highly dependent on foreign donors to make up the difference; their support has produced trade deficits which will not be sustainable in the long run. Finally, economies such as Malaysia and the Republic of Korea enjoy surpluses owing to strong exports. Malaysia's position may erode as exploitable resources such as timber and oil are depleted, while the results of the Republic of Korea from decades of export-led growth are virtually unparalleled in the modern era.
- (e) The last point to be noted is the extreme import-dependence of developing economies. Taking into account the negative effect of a nation's size on its trade shares (discussed above), the proportions of both intermediate and capital goods imports in GDP are large, especially in East Asian economies such as the Republic of Korea, Malaysia, Thailand, and the Philippines.

In all LDCs, capital goods and intermediate imports are essentially "non-competitive" in the sense that they and similar products are not produced nationally, but they can play different strategic roles. Malaysia and Thailand, for example, increasingly are serving as platforms for assembly of exportable final goods by Japanese firms (Thai imports from Japan rose from US\$2 billion to 9 billion per year between 1986 and 1990; exports to the United States and Japan increased from about US\$1 billion to 4 billion each). The Republic of Korea's big import shares reflect poor natural-resource endowments and a hypertrophied industrial sector. Elsewhere, as in India and Brazil, intermediate import shares are low because they are large countries which have long pursued ISI.

The dynamic macroeconomic behavior of developing economies is strongly affected by these features, especially when they are hit by external shocks. A sudden cut-off of credits or a significant fall in the terms of trade, besides triggering inflation if devaluation is necessary, is likely to cause reductions in both output and investment. Three-gap models emphasize the following channels:

- (a) The data in the table suggest that by limiting imports, scarce foreign exchange squeezes either current production or capital formation, since local commodity production requires imported intermediates while foreign-made capital goods are an essential component in most investment projects.
- (b) At the same time, capital inflows are a source of saving, which has to be replaced domestically if it is curtailed. As discussed in detail below, the required reduction in aggregate demand is often realized through an acceleration in inflation.
- (c) Fewer funds will be flowing through the financial system, reducing the supply of credit and therefore affecting capital formation.

Precisely because international capital markets are imperfect, the economy tends to adjust to reduced point-in-time availability of foreign exchange via output reductions mediated by faster inflation and domestic credit rationing.¹⁸ For the time being, the much more efficient possibility of smoothing this flow by temporarily increasing external indebtedness is not available to most developing economies - regardless of whether policy-makers have clear perceptions of their countries' permanent incomes or not.

B. Stabilization policy

The International Monetary Fund is responsible for stabilizing economies. Despite recent rhetorical softening, its programs have not fundamentally changed: they still aim at cutting the inflation rate and the trade deficit by restraining aggregate demand through fiscal and monetary austerity. Without fundamental changes in international credit conditions, there is a risk that IMF-inspired adjustment policies will drive their recipients toward prolonged "stabilized stagnation," because these policies ignore crucial macroeconomic factors such as linked foreign exchange and fiscal constraints, financial fragility, and the dynamics of the inflation process. Issues of government austerity, monetary control, anti-inflation policy, and exchange rate complications will be reviewed below.

1. Austerity and the linkages between the fiscal and foreign constraints

According to the *WDR*, "Experience shows that when government spending has expanded too far, the result has often been large deficits, excessive borrowing or monetary expansion which has been quickly followed by inflation, chronic overvaluation of the currency, and loss of export competitiveness. Excessive borrowing can also lead to domestic and external debt problems and to crowding out of private investment" (page 8). This view of the causes and effects of fiscal duress presupposes that macroeconomic disequilibrium uniquely results from an imbalance between domestic income and absorption. It implies that adjusting the fiscal deficit is sufficient to restore stability. This view is dangerous because it ignores structural features linking the saving, external, and fiscal gaps and thereby understates the complexity of stabilization, especially if stagnation is to be avoided.

The *WDR*'s analysis of stabilization is particularly inappropriate for highly indebted economies. Policy there is constrained by two new stylized facts that have emerged during the past decade. The first is that the nature of the external constraint has changed. Before the debt crisis, periodic external imbalances caused short-run instability but did not impede growth in the long run. From time to time, scarce foreign exchange did induce misalignment between income and absorption; IMF-style policies helped restore foreign balance without completely stopping accumulation over time.

¹⁸ On the importance of point-in-time restrictions as opposed to neoclassical intertemporal budget constraints, see Chisari and Fanelli (1991).

Since the debt crisis, however, external disequilibrium has become structural. It is not generated by differences between flows of income and spending but from a stock-flow disequilibrium between foreign obligations and current income as reflected by a high debt/GDP ratio. While previously scarce foreign exchange used to create liquidity squeezes in the short run, during the 1980s chronic trade surpluses reflected a solvency as opposed to a liquidity problem. The result is negative long-run growth rather than a recession enduring for a limited period of time.

The second stylized fact is that the external crisis has assumed a fiscal form. In most highly indebted economies, Governments hold nearly all the external obligations; therefore, solvency problems rest in the hands of the public sector. The impact effect of the crisis has been to raise to unsustainable levels the ratios of the stock of public debt to current revenue.

In order to reduce their exposure, Governments have reacted by slashing expenditures, including public investment. This drop in capital formation still "crowded-in" private investment - but in reverse. Via the third gap, the government budget constraint became an independent restriction on growth. An essential question for the 1990s will be how to restore public investment in physical and human capital with associated externalities, while at the same time maintaining fiscal responsibility.

Because of the strong linkage between fiscal weakness and external solvency, the two problems have to be addressed simultaneously - both in debtor nations with an external double transfer problem and primary product exporters where incoming donor transfers simultaneously finance the trade deficit and PSBR. Using three-gap models simulated over time, it is easy to see that if fiscal and solvency difficulties are not jointly resolved, then an economy is almost certain to stagnate owing to inadequate capital formation at the same time as ratios of external and internal debt to potential GDP shoot up toward infinity (Fanelli and Frenkel, 1992). Bolivia, Uruguay, and numerous other small, primary exporting economies are observable examples.

Countries that had severe external shocks but succeeded in restoring growth have all utilized foreign exchange up front - for example, Colombia, Chile, Turkey, Ghana, Tanzania, Israel, Sri Lanka, and Mexico - and benefitted from other favorable circumstances. These included the ability of the State to tap natural resource rents (Colombia, Chile, Mexico), a fortuitous increase in demand for manufactured exports (Turkey), and truly massive external support (the rest).

Countries that avoided major disruptions (mostly in Asia) were relatively balanced in fiscal terms and in some cases lucky: Exchange rates in ASEAN countries apart from the Philippines weakened against the yen after the mid-1980s since they were pegged to the dollar. They also received ample DFI from Japan and the diversifying newly industrialized economies. This foreign investment has financed capital goods and intermediate imports which fed into export growth.

Continuing inflows even permitted repeated botched stabilizations while adjustment proceeded apace: Chile between 1973 and 1985 and Turkey in the early 1980s are cases in point. The stabilize-then-adjust sequence recommended by the *WDR* (see below) may be common but is not essential; such a smooth progression is certainly unlikely if a country is expected to attempt reform entirely by itself.

2. *Monetary policy and financial relationships*

Depth, amplitude, and persistence have been the salient features of macroeconomic instability in developing countries over the past 15 to 20 years. Unsustainable current account positions, government and private financial crashes, capital flight, and abruptly accelerating inflation (becoming hyperinflation in Latin America and economies making the transition from socialism) became the rule.

The long-lasting consequences of these coincident maladies for the fragility of the financial system, the dynamics of inflation, and relative price movements scarcely figure in the *WDR's* approach to stabilization. Although the *WDR* recognizes that "Reforms have to deal with trade-offs among policies - the so-called composition of instruments problem" (page 115), little more is said as the text recites the steps necessary to get to a sound macroeconomic framework.

Monetary guidelines are briskly pronounced. Since in the *WDR's* view, there are no effective capital markets in developing economies, monetary policy dissolves into fiscal restraint. Elsewhere,

however, it is recognized that the problem is not so simple: "... reform of the financial sector often calls for distressed financial institutions to be restructured; in the short run this may raise public spending and make it harder to cut the budget deficit" (page 115). The implication is that causality does not always run from fiscal imbalance to financial disequilibrium. This interesting mention of "trade-off among policies" is not followed up, even though the practical relevance is far from nil. In Chile, as already mentioned, monetary restructuring through the fiscal and foreign balances cost more than one-third of GDP, and Chile was not the only country in which such an episode occurred.¹⁹

Another problem for national economies is the disarticulation of finance. Debt and terms of trade shocks have led to demonetization as inflation accelerated and capital flight intensified. The natural consequence was "dollarization" of financial relationships, which has in turn created an inconsistency between the demand for and supply of financial assets (i.e. it created excess demand for external assets and excess supply of domestic ones). Movements of the relevant rates of return were unable to restore equilibrium without driving both the public and parts of the private sector toward insolvency.²⁰

Since the main source of supply of domestic assets is the Government, these portfolio adjustments have made it extremely difficult to finance the public deficit - for a given national propensity to save, dollarization and the denationalization of savings put a tighter financial limit on the public sector than would otherwise have occurred. Solving this problem will take more than mere remonetization if and when inflation is contained; there has to be renewed access to foreign finance. Official lenders can play a fundamental role in providing credits to restore growth, before (and to assist) the restoration of creditworthiness and the reversal of capital flight. That is, they can decisively support government investment and restructuring of the public finances. The *WDR* does not demonstrate much enthusiasm for this task.

3. *Anti-inflation policy*

The *WDR's* discussion of the process of inflation and policies to contain it is as cursory as its treatment of money and finance. There is not much besides considerations of the negative consequences of inflation on information, income distribution, and the efficiency of the financial system. A few paragraphs summarize the risks of stopping inflation, on the basis of a fixed exchange rate.

There is no analysis of inflation as a disequilibrium process that plays a crucial role in closing (*ex post*) the gaps in a highly imbalanced macroeconomic setting. Such analysis is essential precisely because in one developing country after another, inflation has accelerated as the economy sought some sort of macro balance after suffering an adverse foreign shock.

Steady price increases amount to a crude but effective means for cutting aggregate demand to an externally constrained level of supply, via the "inflation tax" on money balances (which ultimately proves self-defeating as people and firms reduce cash holdings to a few per cent of GDP) and "forced saving" resulting from inflation-induced income redistribution against low savers (real wages have fallen by more than 50 per cent in economies all over Africa and Latin America). In Argentina and elsewhere, unexpected accelerations in inflation helped stave off massive bankruptcy by reducing the real liabilities of heavily indebted economic actors in both the public and private sectors.

In Israel and several Latin American countries, the "equilibrating" role of faster inflation had major institutional implications, including destabilization of the dynamics of prices itself. Because of the spread of implicit or explicit contract indexation, a "high inflation regime" came to be established, making anti-inflation policy a central social question.

Broadly speaking, there are only five ways to break a cumulative inflation process:

- (a) Relative prices can be manipulated, e.g. the exchange rate can be allowed to appreciate in real terms or the real wage to fall (by allowing the nominal exchange rate or wage to

¹⁹ The Savings and Loan/junk bond misadventures in the United States naturally spring to mind, not to mention developing country cases which are discussed elsewhere in this paper.

²⁰ On this topic, see Fanelli and Frenkel (1989) and Fanelli (1988). Broadly speaking, insolvency can be modeled as rapidly rising debt/income ratios for the parties concerned.

rise less rapidly than a general index of prices). Ultimately, the nominal wage and/or exchange rate has to be held fairly stable as an anchor against further price increases.

- (b) Imports can be increased to ease local supply bottlenecks, at least for internationally traded goods. Often, purchases abroad (and capital flight) must be financed by the central bank as it spends reserves to support an exchange rate pegged as a price anchor.
- (c) Incomes policies and other forms of market intervention can be deployed to muffle the most acutely conflicting social claims. The most obvious example is a "social pact" to reduce wage inflation while holding profit claims in line.
- (d) In a more extreme case, a price freeze plus contract deindexation - a "heterodox shock" in the jargon - can be attempted as a policy surprise.
- (e) Austerity can be applied, i.e. a cut in the public sector borrowing requirement coupled with monetary restriction based on increased interest rates and credit restraint.

As noted above, the *WDR* approach leans toward austerity, but successful anti-inflation packages - which are relatively few and far between - always combine several of the listed measures. Each economy's inflation process is unique, making it difficult to generalize about which policies will be effective in any particular case. A few observations are worth making in this regard, however.

Austerity is likely to work better when "most" market transactions occur in a regime of flexible prices, i.e. mark-up pricing and contract indexation are not widely spread. In practice, the IMF often combines austerity with real wage cuts, reductions in income support programs and subsidies, and so on. All these measures reduce demand, so that the outcomes include output contraction and a lower trade deficit (via import cuts) along with slower inflation.

The relative impacts of austerity and associated measures on inflation, output, and the external deficit are of obvious importance; experience, unfortunately, suggests that regressive income redistribution and output losses may come rapidly while inflation reduction can be slow. An unpublicized aspect of the orthodox Bolivian stabilization of the mid-1980s was its heavy-handed repression of public sector wages and the tin-miners' union (Pastor, 1991).

Combining austerity with incomes policies has been a recipe for success in other circumstances. Mexico and Israel, for example, blended a modicum of demand restriction with heterodox shocks in successful packages. Both included social pacts more or less democratically ratified and massive foreign exchange support (from external sources in Israel and reserves built up during several years of austerity in Mexico). These conditions are somewhat unusual - to say the least - and also underline the difficulties of coordinating several policies simultaneously in the anti-inflation fight.

4. *The external gap and exchange rate policy*

The *WDR* considers that maintaining a competitive exchange rate is one of the most important guarantees for closing the external gap. The problem is that the pre-stabilization situation often includes an "overly strong" exchange rate, making it necessary to devalue early on.

Devaluation entrains complicated, economy-wide effects. By increasing import costs, it may be price inflationary and output contractionary. However, if foreign exchange is severely constraining the system, the outcome may go the other way: any net export response to depreciation generates scarce dollars. They can be used to reduce excess demand by allowing intermediate imports and production to rise, with a corresponding reduction in inflation.

Recent Tanzanian and Ghanaian experiences suggest that capital inflows provided to support devaluation will make such an outcome more likely. A reasoned judgment about the likely effects of devaluation is essential to the design of stabilization programs. If any rule applies, it might be that small, open economies which are externally constrained are more likely to respond favorably to a devaluation/capital inflow package than are large, closed ones.

Problems also arise in coordinating devaluation with other policies, in both stabilization and adjustment contexts. For anti-inflation purposes, the exchange rate may be frozen as a nominal

anchor. But then if inflation continues, there will be real currency appreciation. Imports will rise and export growth decline, upsetting the real side of the economy as in numerous failed stabilization attempts in Latin America over the past two decades.

With regard to fiscal policy, if depreciation is expansionary, then it can usefully be combined with austerity. The exchange rate change improves the trade balance, while fiscal policy helps avoid an inflationary, excess demand situation. If devaluation is contractionary, on the other hand, combining it with austerity can lead to the sort of policy "over-kill" for which the IMF is (un?)justly renowned.

Indeed, especially in an African context with many parastatals and marketing boards present, the exchange rate must not only be coordinated with tax and spending initiatives but must be recognized as a tool of fiscal policy in and of itself. Exchange rate changes affect parastatal cash-flow positions which ultimately feed into either fiscal revenues or outflows or net credit creation by the banking system. Tracing through these linkages can be very tricky.

A further question is whether devaluation will by itself markedly improve trade performance. A considered answer might well be in the negative. Getting rid of extreme price distortions appears to be a necessary condition for (or at least is correlated with) greater "tradeability" of domestic activities. However, as argued below, price incentives are never sufficient. A real exchange rate with a reasonable, stable value is an invaluable stimulant to net exports. But it must be supplemented with directed trade-promotion policies such as tax drawbacks, export subsidies, cheap credits, etc. as well as state interventions to improve infrastructure and the economic environment more generally.

Finally, how should the real exchange rate be held stable? Crawling peg policies involving frequent nominal mini-devaluations to keep the exchange rate in line with the domestic price level have a fairly respectable track record in all corners of the developing world. The outcomes of exchange auctions have been spotty, since they lead at times to speculative surges of consumer imports.

Besides the exchange rate itself, one also has to consider the implications for stabilization of commercial and capital market policy. Import quotas can be intelligently deployed to offset external shocks; they can also play a pivotal role in industrial policy. Changes in trade regimes can bring substantial benefits: e.g. permitting "own-exchange" imports (no questions asked!) creates some problems with big imports of luxury goods but can also effectively widen forex bottlenecks and perhaps reduce incentives for smuggling. Removing exchange controls in general, however, can prove an open invitation to capital flight. All such possibilities have to be weighed in terms of the history and institutions of the economy at hand.

III. Structural reform and the priorities for action

According to the *WDR*, there is a neat division of labor between stabilization and structural reform. As it says: "Stabilization policies work mainly on the demand side to reduce inflation and external deficits," while "structural policies are concerned with the supply side; they address the efficiency of resource use, emphasizing reforms in specific sectors - especially trade, finance, and industry" (page 113). Moreover, reforms should be implemented in a specific order: "At the outset comes macroeconomic stabilization, which can either precede or accompany structural reform. Many kinds of structural reform (the substitution of quantitative restrictions by tariffs, for example) complement stabilization. Next comes the liberalization of product markets, including deregulatory reform. It would be preferable not to delay domestic reforms until after trade reform. In the area of the liberalization of the external sector, the trade account best precedes the capital account. Asset markets adjust faster than goods markets, so the premature deregulation of capital flows can lead to speculation and financial instability" (page 118). There are, in addition, many counsels on how to manage factors more closely related to politics, such as timing, speed, credibility, and scope.

The arguments supporting these recommendations are not as neat and tidy as the *WDR's* analysis of the sources of output growth. But at least they signal that the task of stabilizing and reforming an economy is much less a science than an art.

A. *The art of policy sequencing*

The *WDR* sticks to its guns: the market-friendly approach is the way to restore growth while the Fund model correctly addresses stabilization. These dichotomous interventions fall naturally into the stages just outlined. But are there really solid arguments supporting the inevitability (and thereby the "desirability") of the *WDR's* preferred sequence of steps from stabilization via reform to growth?

In principle, the answer to such a question has to be ambiguous, on both theoretical and empirical grounds. Even the *WDR's* authors admit that "more research is needed" with regard to several key points, especially those bearing on the dynamics of the economic system as it passes from "repression" toward liberalization under a deregulated market.

First, the *WDR's* implicit division of labor between the Fund and the Bank, with the former dealing with stabilization and the latter designing the policy package for growth, has no firm basis in theory. The only attempt to combine the Bank's and Fund's approaches that Fischer (1987) quotes in his survey of policies for development is one outlined by Khan *et al.* (1986).²¹ The problem is that while the market-friendly strategy heavily relies on adjustment of relative prices to get a better resource allocation, this mechanism is scarcely mentioned by Khan and associates.

Secondly, as Michalopoulos (1987) clearly recognizes in a paper advocating World Bank programs for adjustment and growth, great uncertainty is unavoidable when reforms are implemented precisely because little is known about their likely dynamic effects. Michalopoulos thinks that the framework appearing in the *WDR* makes sense "in most countries," but that one can be much more confident about the long-term outcome of policy reform than the time profile of its results.

At least two sets of considerations are relevant here, regarding (a) the sequencing of policy measures aimed at stabilization and those that focus on adjustment; and (b) the optimal sequence of reforms to remove distortions when they are present throughout the economic system. We are back to the question of how stabilization and adjustment interact. If, as Michalopoulos recognizes, economic theory (read the liberalization approach) offers scant guidance about an optimal sequence for removing market distortions, then why should one assume *a priori* that the dynamics of the process will never be explosive? How can one even evaluate the benefits and costs of policy reform?

With regard to the dynamics question, recent experience in Africa and Latin America suggests that one cannot *a priori* rule out rapidly rising debt/income ratios, inflation rates, and other indicators of instability when orthodox packages are imposed. Costs and benefits are no less relevant. "Mistakes" in sequencing financial, trade, and capital account liberalizations in the Southern Cone in the late 1970s cost countries in the region tens of billions of dollars in terms of increased foreign debt. Was it wiser to pay the price of these failed liberalizing "global shock treatments" than to move away gradually from repressed economic structures? More successful adjustment in Colombia over the 1980s or in Hungary since the late 1960s has relied upon piece-meal changes as opposed to immediate eradication of the ISI development model or the central planning system. These examples suggest that a degree of risk aversion may be advisable with regard to massive changes in policy design.

Thirdly, the *WDR* takes for granted that "sound" domestic policies will call forth external financing, from official sources or even from commercial lenders via Brady-like initiatives. In Africa, causality often seems to run the other way. Countries such as Ghana and Tanzania are picked out by the Bretton Woods institutions as targets for support; visiting staff missions then vigorously lobby local authorities to push their policies in "sound" directions.

²¹ The authors are all associated with the Bretton Woods institutions.

In Latin America, such countries as Uruguay, Bolivia, and even Mexico have undertaken deep reforms but external money arrived in amounts too limited to restore growth and after long delays. Latin American external debt now totals over US\$500 billion, while inflows under the Brady plan at most will amount to US\$20 or 25 billion. In 1991-1992, Chairman Greenspan was far more helpful than Secretary Brady in this regard, e.g. Argentina could receive a reduction in interest payments of about US\$1 billion under the Brady plan, while each percentage point fall in international interest rates saves the country US\$0.6 billion or 5 per cent of its total exports.

Beyond the *WDR's* stress on raising productivity via structural reform, the fact remains that countries which received financial support and were successful in boosting saving (especially public savings) were able to grow. In the Republic of Korea, Turkey, and Chile, for example, resources were reallocated with an ample savings flow at hand from domestic sources or abroad.²² Elsewhere, as in Uruguay and Bolivia, attempts were made to liberalize markets but in the face of very low savings and investment levels. Fully in accord with the Smithian and Keynesian analytical traditions discussed above, growth in these countries did not resume²³ until there was an upward blip in capital movements toward Latin America in 1991.

B. Structural reforms

It is not only the rationale behind the *WDR's* preferred sequence of policies that is weak. There are also major unsettled questions about the content of reform.

1. Trade policy reform

Sustained output growth in many countries has taken place with distorted trade regimes, trade policy shifts were overwhelmed by macroeconomic forces in the determination of LDC growth rates during the 1980s, and most formal models show that eliminating distortions is likely to be of second order significance anyway: "... trade policy orientation, while important, may not be a dominant determinant of growth and may not therefore deserve the attention that the World Bank and others have given it" (Helleiner, 1990). Despite all these objections, liberalizing trade is an essential component of the *WDR* policy reform program. It is interesting to explore the intellectual rationale, and inquire whether the underlying economic model can be restated to make it more relevant to historical developing country experience.

The *WDR's* position basically rests on textbook theorems about how interventions should be designed. If an economy is initially very distorted (say from an extended period of ISI with a high and complicated tariff structure and/or strict import quotas), most economists agree that steps should be taken to simplify and perhaps cut back on the interventions. There is professional consensus in this regard; the problem is that different authors' policy remedies diverge. Evans (1991) suggests that the market-friendly "pharmacopeia" may can be listed as follows:

- (a) The mainstream does recognize arguments for intervention, e.g. nurturing infant industries, attempts to repel foreign dumping (however defined), and optimal export taxes. However, in terms of complexity, red tape, and inflexibility, quotas and tariffs aimed at correcting these problems may well proliferate beyond reason under ISI.
- (b) When there is a market imperfection, the corrective policy should be applied as "closely" to it as possible, e.g. a subsidy for an infant industry makes more sense than a tariff, since the latter will induce a by-product consumption distortion.
- (c) Under competition in the standard Heckscher-Ohlin model, an import quota has an "equivalent" tariff, which will let the same quantity of foreign goods enter. Since the Government gets the tariff's proceeds while producers benefit from quota rents, the tariff may be preferable.

²² Corden (1990) discusses the cases of Turkey and other successfully stabilizing countries that received strong support from abroad.

²³ Stressing on the need to raise investment to restore growth does not deny that there is broad scope for improving efficiency. However, capital is not fully malleable and externalities and indivisibilities are always present - a minimum level of gross investment is unavoidable if the economy is to adjust to a new set of relative prices. Moreover, since technical progress is not manna from heaven, efficiency gains require new capital formation.

- (d) If producers have market power, they can squeeze extra rents from a quota. If they go after rent-seeking (or "directly unproductive profit seeking" or DUP activity) by devoting productive resources to lobby for more quotas, this form of protection looks even less desirable.
- (e) All this leads to the *WDR's* standard sequence of recommended policies: First, there should be macroeconomic stabilization; thereafter, quotas should be "tariffized," and then the tariff schedule simplified to two or three rates in the 10 to 50 per cent range, sufficient to provide some protection and generate revenue.
- (f) As part of the exercise, there will probably have to be real exchange depreciation to hold the trade deficit constant as quota/tariff protection is cut back. For this reason, capital market liberalization which may lead to appreciation should be postponed.

It is impossible to refute these arguments on their own terms; as often in neoclassical formulations, they sound like limpid practical reason. Their deficiencies lie in incompatibilities between their underlying assumptions and the world as it really functions. One clear example is the implicit orthodox presumption that DUP activity is solely a response to state interventions, although the private sector readily generates its own distortions and rents. For instance, national economic authorities have to deal with external agents with significant market power such as TNCs, local monopolies, and the divide-and-rule tactics of indigenous capitalists when confronting labor, in just a few important cases.

Secondly, the model treats its "distortions" as small perturbations to an economy assumed to be at full employment with investment determined by available saving (perhaps mediated by a variable interest rate). When these hypotheses are relaxed in investment-driven growth models, protection to a given sector can easily lead to faster overall expansion if it leads to a spurt in investment demand and/or endogenous technical advance. In a fully neoclassical framework, the saving counterpart can come from reshuffling intertemporal budget constraints (Buffie, 1991) and in a Kaleckian model from increased output or else income and wealth redistributions under inflation.

Finally, this approach does not incorporate the LDC trade patterns pointed out in connection with the attached table. Yet programming the level and composition of non-competitive intermediate and capital goods imports has been key to the success of developmentalist States. In relation of the Republic of Korea, for example, authors as diverse as Amsden (1989) and Pack and Westphal (1986) agree that instruments such as quotas, directed credits, and targeting were used to promote import substitution which led to export growth. Brazil used protection and licensing to build an automobile sector which flourished until the economy was derailed macroeconomically in the 1980s (Shapiro, 1991). In a large domestic market, small-scale producers of bicycles and machine parts were helped by local authorities and cross-firm cooperation/competition in Ludiana (India) and other cities in the Punjab - they now sell throughout India and are expanding abroad (Tewari, 1991).

Pack and Westphal (1986) emphasize that interlinked factors underlie these examples. Technology is imperfectly tradeable, since local producers and workers have to gain know-how to operate physical capital goods which are not produced at home. There are economies of scale in both production and technology acquisition, and externalities among output levels, prices, and technical choice. Room is created for intervention, which can be rationalized in neoclassical terms especially if it creates two-way information flows among regulators and producers, which raise productive efficiency as they expand. In this regard Evans (1991) underlines the following implications:

- (a) Protection is justified, and may be programmed more effectively if it is based on quotas. Quota rents on strategic, technology-bearing imports can help subsidize export activity. Quotas on competitive imports (which in effect persist in Japan and the Republic of Korea to this day) turn the national market into a place for profitable learning. Costs can be held down if firms are exposed to foreign competition on the export side; real wage increases force the cost reductions to come from productivity advance.
- (b) Rent-seeking may characterize the process of allocating quotas, but ultimately they can be tied to export and output performance. Ideology and public pressure can help keep DUP within "reasonable" bounds.

- (c) Two-way information flows are essential, whether top-down as with bureaucrats dealing with the vertically integrated, conglomerate *chaebol* in the Republic of Korea, or among small producers and local authorities as in the Punjab.

If a well-designed quota allocation system under this second line of policy action leads firms to use strategic inputs to acquire technology and to expand non-traditional exports, it may well raise potential output faster than *WDR*-style trade reform (especially if investment responds). Moreover, it allows for more decentralized decision-making than liberalization imposed from the top. Guessing tariff equivalents of quotas, phasing the liberalization to avoid bankrupting viable domestic producers by taking away effective protection, and getting the exchange rate "right" are not easy tasks. Policy-makers can never be in a practical position to solve realistically dynamic computable general equilibrium models to reprogram the price system in a liberalization "shock."

The implication is that interventionist policies have been and can be effectively utilized, which is more than can be said for orthodox reforms such as the one in Argentina in the late 1970s which got its effective protection and other incentive signals all wrong. As has already been noted, this neoliberal "mistake" aborted economic growth for at least a decade.

In contrast, on the other side of the Andes, a rhetorically *laissez faire* government's public investments in copper mines and quiet promotion policies for fruits, forestry products, and fisheries laid the base for Chile's export boom after 1985. These interventionist steps were taken while the economy reeled through a 12-year sequence of disastrous stabilization experiments amply supported by the Bank and Fund. The *WDR*'s recommended stabilize-then-adjust sequence was exactly reversed (Meller, 1991).

Of course, there have been interventionist failures as well. The implication for both sides is that there is room for debate about such questions, unacknowledged by the *WDR*. In this regard, the *WDR*'s assertion that convincing support exists for "... a general statistical association between less intervention and lower price distortions on the one hand and higher productivity growth on the other..." (page 99) goes counter to the conclusions of mainstream observers such as Pack (1988) and Rodrik (1992). The latter's contrasting summary of the evidence is that "... if truth-in-advertising were to apply to policy advice, each prescription for trade liberalization would be accompanied with a disclaimer: 'Warning! Trade liberalization cannot be shown to enhance technical efficiency; nor has it been empirically demonstrated to do so.'"

2. Financial reform

Financial restructuring is another broad plank in the market-friendly platform, although neither Williamson's (1990) version of the consensus nor the 1991 *WDR* goes into much detail about the means by which savings flows are converted into capital formation through financial markets. Their basic policy suggestions are simply to increase interest rates and deregulate the system. As observed by UNCTAD (1991), the goal again is to enhance allocative efficiency, in the sense that returns on financial saving instruments and investment projects should tend toward equality, presumably with "the" marginal product of physical capital.

Just as price liberalization does not ensure that firms will efficiently produce commodities, there is no particular reason to expect that removing wedges separating rates of return will guarantee a low-cost supply of financial services. Usually when it has been applied, in fact, the *WDR* reform package reduced productive efficiency in finance, leading to increased credit costs. The outcomes also included stagflation (lower capacity utilization coupled with faster inflation), a fall in investment demand, and a speculative flurry ending in a financial crash.

The *WDR* model of finance has the same basic shortcoming as its counterpart for trade and industrial policy: it ignores existing market structures. In most developing economies, the "formal" financial sector comprises public institutions, large private enterprises, and banks. Financial claims typically have short maturities, and the ratio of the outstanding value of either assets or liabilities to GDP is a fraction (much less than ratios in the 1.0 to 1.5 range observed in industrialized economies). Although their size is difficult to judge, informal markets may account for as much as one-half of total credit outstanding. Loans to the private sector from both formal and informal intermediaries to a large extent pay for working capital; investment finance comes from internal funds, the State, or informal sources.

Typical initial conditions for a high interest rate/deregulation package include ceilings on nominal interest-rates, and directed formal sector credit allocations by sector and form of use. Immediately imposing a reform gives the following sorts of results:

- (a) Getting rid of ceilings on bank deposit rates removes a nominal anchor holding the pricing system. Particularly if the external capital account has been deregulated, the alternative to a bank deposit in a citizen's portfolio is a foreign holding. The equivalent domestic return equals the foreign interest rate plus the expected rate of exchange depreciation plus a premium for higher risk. Such an alternative puts a floor under the local deposit rate which is usually strongly positive in real terms. Deposit institutions have to pass along their higher costs in the form of interest rates on their loans.
- (b) Eliminating credit targets in the absence of effective prudential regulation leads banks toward high-risk/high-return loans (a moral hazard made more acute if the government implicitly promises that failing banks will be rescued). The proportion of non-performing loans in bank portfolios rises; the implicit cost has to be carried by debtors still meeting their obligations.
- (c) Higher interest rates on loans for working capital tend to be passed along by firms through higher prices (especially if they have market power, common enough under ISI). Since production costs rise, supply may also be reduced, giving way to stagflation. Higher lending rates and lower output will constrict investment demand.
- (d) More attractive deposit rates can also pull funds from the informal market, reducing its credit flows and raising curb or bazaar borrowing costs with unfavorable effects on output and prices.
- (e) Although banks can (up to a point) protect themselves from these developments by raising the spread between borrowing and lending rates, the same is not true of their borrowers. The financial position of the private productive sector thus becomes precarious, while a higher proportion of the Government's fiscal receipts must be dedicated to interest payments on its internal liabilities outstanding. Refinancing these flows can reach manic dimensions as in the "overnight" market in Brazil during the 1980s. Profits on turning over the federal debt made bankers partisans of inflation in that country, a peculiar and risky situation.
- (f) The Brazil example suggests that with high interest rates and low investment, speculative holdings become attractive. Turkey had Ponzi schemes²⁴ around bank CDs; Chile witnessed a stock market boom for shares of prematurely privatized public firms (financed by loans from banks central to economic "groups" whose owners used the money to bid up prices of their own companies' equity); Argentina experienced destabilizing flows of foreign exchange. In all cases, speculation went together with deteriorating enterprise balance sheets to pave the way for a crash. As we have seen, the taxpayers ended up with bills amounting to tens of per cent of GDP to put the financial system back together.

During the past 10 to 15 years, scenarios along these lines have been played out in the countries just mentioned as well as the Philippines and Yugoslavia - a substantial list of neoliberal "mistakes" to be added to those involving trade policy. A more gradual reform in the newly industrialized Republic of Korea averted a debacle, while in Chile, after presiding over its stock market boom and crash around 1980, the Government later took advantage of ample support from its donors to privatize once again, restructure its internal debt, and set up an effective pension fund program to capture savings flows. From these experiences and those of developed economies, can anything sensible be said about productively efficient directions for LDC financial evolution?

One option that immediately presents itself is modernizing the development bank institution taking care to avoid rent-seeking and inflationary finance for the benefit of chronically derelict

²⁴ Charles or Carlo Ponzi operated in Boston in 1920. He promised to pay 50 per cent interest on 45-day deposits, to use in arbitrage operations between depreciated foreign currencies and International Postal Union coupons which could be exchanged for United States stamps. He took in US\$7.9 million and held only US\$61 worth of stamps when he was arrested. His ingenuity in using newly borrowed money to pay his prior obligations did not exceed that of more recent financial manipulators in developing economies - their imaginations have repeatedly been stimulated by liberalization experiments.

parastatals. Since (especially after fiscal restructuring) development banks can tap public savings flows, they fit naturally with the public/private patterns of saving and capital formation set out in the accompanying table.

Another idea worth pursuing is effective regulation and support of the bank-centered conglomerates which are common in the Third World, so that internal economies of scale and information flows can lead to low credit costs within the group. This model has broadly been followed in Germany and Scandinavia for well over a century; similar market structures have appeared in Japan. Less appealing are attempts to create capital markets along Anglo-American lines. These have rarely taken hold in developing economies, except at best as subsidized speculative playgrounds with minimal capacity to intermediate financial resource flows.

3. Privatization

The *WDR* sets considerable store by privatization, avowing that it "... is necessary and highly desirable, even though difficult and time-consuming. It is not to be undertaken as [an] end in itself, but as a means to an end: to use resources more efficiently" (page 144). Despite its laudable goal, the practical implications of privatization are difficult to judge.

Across nations, different historical divisions have emerged among public, local private, and foreign ownership of productive enterprises. There is no solid evidence to suggest that firms of one stripe are consistently more efficient in static terms than those of another. Dynamically, scholars such as Amsden (1989) have argued that the Republic of Korea's home-owned but publicly subsidized private conglomerates are more adept at indigenizing technology than TNC affiliates, while in Brazil before the last decade public enterprises were effective motors for capital accumulation and technical change (Shapiro, 1991; Carneiro and Werneck, 1992).

In economic terms, the effects of privatization on savings and investment flows will be the only effects amenable to evaluation for years - changes in productive efficiency will be difficult to trace, and in any case do not seem likely in the absence of financial market reforms and joint public sector/labor/management efforts to raise productivity growth. Finally, despite vigorous declarations of intent, outside Chile, Mexico, and Turkey, not much privatization has in fact taken place.

Even calculations of savings and investment effects are tricky, when discounting is taken into account. Marcel (1989) argues, for example, that in Chile's 1985-1988 second go at privatization, firms were sold below their current value and half the receipts were allocated to uses such as tax reduction. In other words, there were probably no positive impacts on capital formation; but there was a flow portfolio shift from public liabilities toward enterprise equity on the part of the private and external sectors.

More generally, local private sectors can finance acquisitions of public firms in just four ways: (a) increased private saving; (b) a fall in private investment; (c) a decrease in private-sector flow demand for financial assets; and (d) an increase in private-sector flow demand for credit.

Alternative (a) could be helpful for growth if accompanied by a jump in investment. The public sector would probably have to be the motor, taking into account the crowding-in effects discussed above. In other words, privatizing Governments should reinvest the proceeds instead of following Chile's example of cutting the current fiscal deficit. This observation becomes doubly relevant if under alternative (b) the private sector cuts its own capital formation to take over public firms.

Alternative (c) is more likely than (d), especially in countries where financial markets have contracted in the wake of adverse shocks. However the Government will then find it increasingly difficult to place its own liabilities, provoking it to emit money or bear higher interest burdens or both. As in the Chilean case, there will be strong pressure to use the proceeds of privatization just to cover the PSBR with no spill-over to capital formation.

Finally, if public firms are sold to foreigners, is their DFI "additional" to what would have arrived, in any case? What about remittance obligations in the future? It is true that TNCs which are doing more than simple sourcing do not readily leave a country once they have entered and built up sunk capital, and that they can serve as vehicles for technology acquisition. But can the same be said of debt-swapping banks? Even in terms of current financial flows, privatization need not produce great benefits.

C. Reform at any cost: does the WDR love risk?

The *WDR* states that "Economic theory and practical experience suggest that interventions are likely to help provided they are market-friendly" (page 5). However, it has been observed that many aspects of the market-friendly approach are controversial. The job of reforming economies is an art; it can also be a highly risky endeavor.

In addition to an economic analysis of the problems faced by developing countries, the *WDR* closes with a chapter dealing with restrictions on policy arising in the political arena. The present assessment will conclude with two comments relating to such issues.

First, the *WDR* suggests that government interventions should follow specific mandates: "Intervene openly, make interventions simple, transparent, and subject to rules rather than official discretion" (page 5). It is not clear, however, whether avoiding arbitrary interventions is desirable when the time comes for liberalization. Elsewhere in the *WDR*, it is stated "the challenge for governments is to implement reforms in the face of sometimes trenchant political opposition. Structural reforms may hurt powerful interests" (page 145). Obvious questions are how the "powerful interests" are to be defined and who is going to write the definitions. Practical experience suggests that these steps will require (ab?)use of "official discretion" - we come back to an interventionist State. Doubts about its efficacy and possibly autocratic nature (even in a market-friendly context) are conspicuously missing in the *WDR*. Partisans of democracy might find this to be a risky political stance.

Secondly, with regard to the timing, speed, and scope of reform, the *WDR* articulates the following beliefs: "The timing of reforms involves political considerations. New governments are in a strong position to institute reforms ... [and] economic crisis also improves the conditions for reform" (page 116). "Should reform be gradual or shock therapy?' ... In general, the analytical case for speed is strong ... Gradualism may not be feasible for economies in acute crisis or for governments with limited credibility" (page 117). "Comprehensive packages of reform exploit the complementarities and therefore promise the greatest benefits" (page 118).

It can easily be deduced that according to the *WDR*, there is a good probability of success if, following the precepts of the market-friendly approach, a shock-therapy global reform is put into practice by a new government with limited credibility in the midst of an acute economic crisis.

Who walks where angels fear to tread?

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DEVELOPING COUNTRIES AND THE GATT URUGUAY ROUND: A (PRELIMINARY) BALANCE

José Antonio Ocampo*

Introduction

The Uruguay Round is the most ambitious effort so far in the history of GATT to negotiate multilateral rules for international trade. Its agenda, in the traditional area of transactions of goods, has included sectors subject to exceptional treatment in GATT for many decades (agriculture and textiles) and the multiple forms of protectionism typical of recent times, such as the use of unfair trade laws, voluntary export restraints (VERs), orderly marketing arrangements (OMAs), etc. It has also included such completely new areas as international trade in services and intellectual property. As a result of the enlarged area of activity, a new Multilateral Trade Organization (MTO) is expected to be created to manage the new international rules for trade in goods, services and intellectual property.

This paper presents an evaluation of the results of the Uruguay Round from the point of view of developing countries. At the time of writing (early March 1992), negotiations of offers in the areas of goods and services were in full swing. Such negotiations may lead to variations in the Agreements included in the Draft Final Act of December 1991. Thus this evaluation can only be considered preliminary. The paper is divided into five parts, the first being this introduction. The second presents an overview of developments in international trade policy which are relevant to negotiations during the Uruguay Round. The third reviews major results in the Round in the areas of institutional arrangements, goods and intellectual property. The fourth discusses in depth the negotiations which may affect financial adjustment and flows. The final section is intended to present a brief balance sheet of the Round from the perspective of developing countries.

I. International trade policy prior to the Uruguay Round

There is a general perception that the era of international trade liberalization, which started with the creation of GATT in 1947 and reached its climax during the Kennedy Round of negotiations (1963-1967) has given way in recent decades to opposite trends.¹ Protectionist practices have been eroding all major GATT principles: those of gradual trade liberalization; reciprocity; non-discrimination; transparency of regulations; fair trade; use of quantitative import restrictions (QRs) only as an emergency tool, particularly to manage critical balance-of-payments conditions.² It should be recalled in this regard that the principle of non-discrimination is expressed in the most-favoured nation (MFN) and national treatment clauses, whereas that of fair trade has been interpreted to mean non-subsidization of exports, avoidance of domestic subsidies which may affect trading partners and elimination of price discrimination between domestic and international markets (defined as "dumping" in GATT).

Some of the major issues have long standing in the international trade policy area and had even gained ground during the era of trade liberalization. Thus, since the mid-1950s, under strong

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1 See, for example, Bhagwati, 1990a, 1990b; Low, 1990; Winters, 1990; World Bank, 1987, Chs. 8 and 9; and the successive issues of UNCTAD's *Trade and Development Report*.

2 Article XI also allows the use of export QRs to guarantee adequate domestic supplies of essential goods, export and import QRs for quality control, and import QRs for agricultural goods under several circumstances.

pressure initially by the United States, and later on by the European Economic Community, agriculture became a major exception to GATT's general principles of gradual trade liberalization and non-subsidization. To the extent that quotas have been increasingly used for protection, this device has also become an exception to the general presumption against using QRs. Since the latter part of the 1950s, industrialized countries also came to use quotas on an increasing scale to protect themselves against textile imports. Such arrangements led, at the request of the United States, to the negotiation, under GATT auspices, of the 1961 Short Term Cotton Textiles Agreement, which was replaced in 1962 by a Long Term Agreement and, since 1974, by a series of four Multifibre Agreements, the last of which was extended in 1991 to December 1992. Whereas textile arrangements were explicitly taken out of the agendas of the Kennedy and Tokyo (1973-1979) Rounds, agriculture was brought to both Rounds, only to end in major deadlocks.

In more recent decades, new country-selective forms of protectionism have gained ground in the trade practice of industrialized countries, thus eroding another major GATT principle: that of non-discrimination. Such schemes - VERs and OMAs - also implied the extensive use of QRs in other "sensitive" sectors of some developed countries, particularly such sectors as steel, automobiles and electronics, aimed at curbing the exports of other industrialized countries (Japan), but also some NICs. As they avoided the use of GATT safeguard mechanisms (Article XIX), they came to be known as "grey area" measures. Indeed, in the protectionist trend of industrialized countries in the 1970s and 1980s, GATT safeguards were only used as an exception, no doubt in order to avoid the multilateral dispute settlement mechanisms and the non-discriminatory principles of the Agreement. The attempt to define clear rules in regards to safeguards during the Tokyo Round ended, as in agriculture, in a stalemate.

In parallel fashion, the provisions of GATT itself were increasingly used in a non-transparent, protectionist manner. This was particularly so of its anti-dumping and countervailing duties procedures. Anti-dumping investigations and measures became a widely used practice in the 1970s and 1980s in the United States, the EEC, Canada and Australia; countervailing processes were also used extensively in the United States. Moreover, by the late 1980s, anti-dumping procedures had extended to developing countries, many of which had been victims of them in the past (Boltuck and Litan, 1991).

A major attempt was made during the Tokyo Round to establish new rules in the area, by revising the Kennedy Round Anti-dumping Code, and drafting new Agreements on Subsidies and Technical Barriers to Trade, among others. However, such efforts did not break the underlying protectionist trend. On the contrary, the unilateral interpretation by the United States of provisions in the Subsidies Code became a major source of unilateral pressure on developing countries. The American Government refused to apply the injury test if countries did not sign the Code and commit themselves to the dismantling of export subsidies. The latter requirement was clearly contrary to the Tokyo Code, which limited the use of such subsidies by developing countries only in those cases where they generated adverse effects on trading partners - a provision similar to that of domestic subsidies when used by industrialized parties.

More generally, contrary to the ideas which prevailed in the first decades of the post-war period, free trade and multilateralism lost considerable ground in the ideological and political debates of major industrial countries. This was particularly true of the United States, which had been the major advocate of such a trading system. Dissatisfaction with free trade has taken many different directions (Lawrence and Schultze, 1990; Bhagwati, 1990a, 1990b): (a) towards "aggressive unilateralism", as embodied, in particular, in the "Super 301" provisions of the Omnibus Trade Act of 1988, which allows for unilateral sanctions on countries which do not comply to United States expectations in regard to trade and intellectual property policies; (b) the closely related idea that "aggressive reciprocity" or bilateralism should be used to complement multilateral processes in the search for a free trade order, as it is perceived that other trading partners do not play the game by the same rules (Dornbusch, 1990); (c) the also closely associated defense of regionalism, embodied in NAFTA or, more recently, in the "Enterprise for the Americas"; (d) the academic and non-academic defenses of "managed trade" (Tyson, 1990; Kuttner, 1991) and the practice of it in VERs and OMAs; and (e) even in the case of economists who do not accept a protectionist interpretation of new trade theories, at least the acceptance that the United States should adopt an explicit industrial policy, i.e. a decision frankly to subsidize some sectors, particularly in the high-technology area (Krugman, 1990, esp. chapter 10). In other industrialized countries, some of these approaches have likewise been defended and pursued, particularly regionalism and managed trade in the EEC.

Given the trends in the concept and practice of protectionism by industrialized countries, it is no surprise that developing countries have come to view with growing mistrust the commitment of the industrialized countries' to a multilateral trading order. Trade liberalization in GATT has, in fact, emphasized the reduction of barriers to trade among developed countries and has thus resulted in a structure of tariffs in the industrialized countries which discriminates against the manufacturing exports of developing countries, particularly against the further processing of their raw materials. Since developing countries have also tended to have a comparative advantage in those sectors which have remained outside normal GATT rules for decades (agriculture and textiles), the most successful among them have become major targets of "managed trade" in more recent times (see, for example, World Bank, 1987, chapter 8).

A lack of confidence in the rules of the game is combined in complex ways with demands for special and preferential treatment, as a way to bridge wide international income gaps.³ Dissatisfaction with existing multilateral rules as appropriate tools to manage North-South relations had led to the formation of UNCTAD in 1964. As an institutional response, Part IV of the framework GATT Agreement, on trade and development, was added in 1965. The major result of the demand for special and differential treatment was the creation of the Generalized System of Preferences (GSP) in 1968 and its implementation by major industrial countries in the early 1970s. At the same time, up to the Uruguay Round, the developing countries were not asked to make any major commitments on tariffs (see Part II below); moreover they were given great latitude in the use of quantitative restrictions for balance-of-payments purposes or infant-industry considerations (Article XVIII) and were granted a set of special advantages in the Tokyo Round codes, the most important of which was the ability to use, with some restrictions, export subsidies as a development tool.

The practical implications of special and differential treatment have been rather mixed. On the one hand, as it does not apply to the "sensitive sectors" of industrialized countries and, in other countries, tariffs and, thus, margins of preference are small, the benefits from GSP have been modest. According to an existing estimate (Karsenty and Laird, 1987), in 1983 GSP increased developing country exports by only 2 per cent, with half of the benefits accruing to Hong Kong, Republic of Korea, Taiwan Province of China, and Brazil. Moreover, it never took the form of a generalized, non-discriminatory system subject to multilateral notification and consultation, but rather became an optional and unilateral policy of the industrialized countries, which had the possibility of "graduating" developing countries from the system with total discretion.

On the other hand, from the perspective of some industrialized countries, the lack of clear, multilaterally agreed graduation rules, also turned the balance against special and differential treatment. Indeed, it came to be viewed as a mechanism by which developing countries were free-riding on the benefits of the multilateral trading order. Likewise, with respect to the benefits from technological innovation, it came to be regarded that developing countries protected intellectual property weakly, that existing international agreements, particularly the Paris convention, allowed too much latitude for such practices, and that the World Intellectual Property Organization (WIPO) was an ineffective mechanism to control infringements on intellectual property rights. Such perceptions became, in particular, the basis for use by the United States of the 301 provisions of its 1984 and 1988 Trade Acts to press harshly some Latin American and Asian countries both to dismantle export subsidies and to adopt intellectual property regimes as close as possible to the system of the United States, as well as to urge them to offer significant tariff and non-tariff concessions in the Uruguay Round negotiations.

This complex set of practices and perceptions came to play a significant role in the controversies preceding the Uruguay Round, particularly in the October 1982 Ministerial meeting, in the definition of the agenda of the Round in Punta del Este in 1986 and in the negotiations themselves. The compromise was to place all the issues and grievances on the agenda. Some developing countries strongly resisted the inclusion of services and, even more, intellectual property, as they claimed that such all-inclusive negotiations would detract from the debate on how to deal with the backlog issues of traditional GATT concern (agriculture, textiles, VERs, etc.) and on how to introduce greater discipline in the use of the unfair trade provisions. They also feared that a broader agenda would allow 301-type "cross retaliation", particularly retaliation in goods trade for non-compliance with rules in the area of intellectual property. The inclusion of new areas was, nonetheless, the only way whereby industrialized countries and, particularly, the United States, could

³ For an elaborate discussion of the topics to follow, see Whalley *et. al.* (1989); Low (1990); Whalley (1990); and Lawrence (1992).

be induced to incur the eventual costs of greater discipline in sensitive sectors, "grey area" agreements and in the use of unfair trade provisions.

From the point of view of developing countries, there has also been throughout the negotiations a strong demand to accept greater commitments in GATT. The end result has been, as will be shown, a considerable weakening of special and differential treatment. The implications of this result must be judged, however, in the context of the deterioration of the multilateral trading order in recent decades, the scant returns for such treatment in the past and the more recent, but fairly generalized, unilateral trade liberalization of developing countries.⁴ The latter reflects, in turn, the strong pressure exercised since the 1980s by international financial institutions in the context of both short-term and structural adjustment programmes, as well as the considerable ground gained by liberal ideologies at a world level. Given the global context in which this has taken place, a claim may be made that weakened special and differential treatment or even its continued erosion in the near future is not a high price to pay if current negotiations effectively strengthen the multilateral trading system and reverse the protectionist trends of industrialized countries.

II. Negotiations regarding institutional arrangements, goods and intellectual property⁵

The complexity of the Uruguay Round, which includes the 28 texts included in the Draft Final Act and the very active negotiations on market access (which were still going on at the time of writing), makes a global summary and evaluation difficult. A selective review of major issues is, thus, warranted. This part of the paper will concentrate on the negotiations regarding institutional arrangements, liberalization of the trade of goods (including agriculture and textiles), safeguards and unfair trade provisions, and intellectual property. The issues most relevant to international financial adjustment and flows - the use of import restrictions for balance-of-payments purposes, restrictions on the use of import licenses, foreign investment regulations and financial services - are analysed in Part III.

Table 1 summarizes the negotiations, including some topics not covered in the discussion below. It also offers a simple picture of the status of each issue prior to the Uruguay Round and the standing of the negotiations up to the December 1990 Brussels Ministerial Meeting, where the Round was initially expected to end, and the standing as of December 1991. In the latter case, it differentiates between those cases where a consensus (*ad-referendum*) text was available or, alternatively, where the lack of agreement on major issues was reflected in proposals presented by the Chairmen of the negotiating groups. This differentiation is crucial, as the latter texts may be subject to important revisions, at the request of those countries which feel unsatisfied by the other parties' offers in the areas of goods and services.

A. Institutional arrangements

Although institutional matters and dispute settlement mechanisms were on the agenda of the negotiations, the proposal to create a Multilateral Trade Organization (MTO) as a successor to GATT was a late and unforeseen outcome of the Round. On the other hand, as a result of the decision taken in Punta del Este whereby "the launching, the conduct and the implementation of the outcome of the negotiations shall be treated as parts of a single undertaking", all agreements of the Uruguay Round will be incorporated into a single legal instrument. This means that, contrary to the principle followed in the Tokyo Round, according to which parties were free to sign or not the non-tariff Codes, all members of the MTO must now accept all agreements of the Uruguay Round in the areas of goods, services and intellectual property. Parties are only exempted

⁴ See, on the latter, the International Monetary Fund (1991).

⁵ For a detailed examination of the development and preliminary results of the negotiations, see UNCTAD (1991 and 1992). The considerations which follow draw largely from these analyses as well as from a detailed scrutiny of the Draft Act and regular reports of the Colombian delegation to GATT.

PROGRESS OF NEGOTIATIONS IN THE URUGUAY ROUND

<i>Subject</i>	<i>Prior to Uruguay Round</i>	<i>Brussels Meeting</i>	<i>December 1991</i>	<i>Major provisions</i>	<i>Developing countries</i>
Institutional arrangements	GATT institutions and procedures	Integrated dispute settlement in provisional operation. Idea to create a MTO	Consensus texts on MTO and dispute Settlement	<ul style="list-style-type: none"> - Creation of a Multilateral Trade Organization (MTO) covering goods, services and intellectual property - Integrated Dispute Settlement System 	- No special provisions
Tariffs	Low tariffs in developed countries; high and largely unbound in developing countries	Preliminary and incomplete offers	Preliminary and incomplete offers	- Similar cut to that of the Tokyo Round (33 per cent) expected in 1993-1997, without general formula	- Significant increase of tariff bindings at lower than 1986 levels
Agriculture	Multiple exceptions under GATT	Major disagreements	Chairman's proposal	<ul style="list-style-type: none"> - Moderate reduction of distortive domestic supports, import duties and export subsidies in 1993-1999 - Non-distortive domestic subsidies allowed - Transitional safeguard mechanisms 	<ul style="list-style-type: none"> - Not applicable to least developed countries - Smaller reductions (2/3) for developing countries, 10 years to adjust and longer list of allowed subsidies
Textiles	Outside normal GATT rules	Preliminary text with some issues unsettled	Consensus text	<ul style="list-style-type: none"> - Gradual phasing-out of MFA in 10 years - Transitional safeguard mechanisms 	- Special treatment for least-developed exporters, small suppliers and fibre-producing countries
Subsidies	Tokyo Round Code	Preliminary text with some issues unsettled	Consensus text	<ul style="list-style-type: none"> - Greater discipline in the use of subsidies - Non specific, regional assistance and research grants allowed 	- No restrictions for countries with GDP per-capita below US\$ 1,000. Others "graduated"
Antidumping	Kennedy Round Code revised in Tokyo Round	Major disagreements	Chairman's proposal	- More discipline concerning the determination of dumping and injury	- Special regard for developing countries in investigations

PROGRESS OF NEGOTIATIONS IN THE URUGUAY ROUND

<i>Subject</i>	<i>Prior to Uruguay Round</i>	<i>Brussels Meeting</i>	<i>December 1991</i>	<i>Major provisions</i>	<i>Developing countries</i>
Import licences	Tokyo Round Code	Consensus text	Consensus text	- More discipline in the use of licences	- May delay application of some provisions for 2 years
Customs valuation	Tokyo Round Code	Consensus regarding interpretation of some provisions in Tokyo Code	Consensus regarding interpretation of some provisions in Tokyo Code	- Valuation according to "transactions value" - Shifts burden of proof under certain circumstances	- May delay application for 5 years - May temporarily use minimum valuation prices
Technical barriers to trade	Tokyo Round Code	Consensus text	Consensus text	- Guarantees that neither national nor regional Governments use technical norms as protectionist devices	- Technical assistance
Rules of origin	No provisions	Preliminary text with some issues unsettled	Consensus text	- Establishes global rules, except for preferential and integration agreements	- No special provisions
Preshipment inspection	No provisions	Preliminary text, with some issues unsettled	Consensus text	- Transparency of regulations	
Government procurement	Tokyo Round Code	Only accession procedures revised		- Defines transparent and equitable tendering procedures for some government agencies.	
Trade-related aspects of Intellectual Property Rights (TRIPS)	Not covered by GATT rules	Major disagreements	Chairman's proposal	- International upward harmonization of standards of intellectual property protection irrespective of levels of development	- Longer transition period to bring national legislation into conformity (5 years for developing, 10 for least developed countries) - Technical and financial assistance

PROGRESS OF NEGOTIATIONS IN THE URUGUAY ROUND

<i>Subject</i>	<i>Prior to Uruguay Round</i>	<i>Brussels Meeting</i>	<i>December 1991</i>	<i>Major provisions</i>	<i>Developing countries</i>
Trade-Related Investment Measures (TRIMS)	Only general provisions of GATT	Major disagreements	Chairman's proposal	- Eliminate TRIMS (local content, trade balancing and similar requirements) in 2 years	- Longer transition period (5 years for developing, 7 for least developed countries) - Allowed under Article XVIII
Safeguards	Only general Article XIX provisions	Preliminary text, with major issues still unsettled	Consensus text	- Establishes clear rules for the use of transitional safeguards (up to 8 years) - Phases out VERs and OMAs in 4 years	- Can use them up to 10 years - Small suppliers protected against their use by industrialized countries
Balance-of-payments	Only general Articles XII and XVIII-B provisions	Major disagreements	Consensus text	- Strict disciplines in the use of balance-of-payments provisions - Price-based measures preferred	- Simplified consultation for least developed and for developing countries pursuing liberalization efforts
Services	Not covered by GATT rules	Preliminary text, with some issues still unsettled	Consensus text, with some issues still unsettled	- General framework agreement with special provisions for financial services, telecommunications and air transportation - Allows for negotiation of national treatment and 10-year exemptions for most-favored nation principle	- Principle of increasing participation of developing countries - For financial services, less stringent provisions for non-signatories of the "Understanding"

from signing the Tokyo Agreements which were not renegotiated during the current Round.⁶ This provision is, no doubt, focused on developing countries, as few of them had signed the Tokyo Codes (table 2), thus effectively evading GATT discipline.

However, it should be noted that, in December 1991, contrary to its initial offer, the United States withdrew its support for the elimination of the Protocol of Provisional Application, which gives a legal basis for national legislation enacted prior to countries becoming GATT members. The survival of this Protocol will thus allow the continued application of some unilateral provisions which have been subject to much controversy in recent years.

According to its mandate, the proposed MTO would facilitate the implementation and operation of the agreements in the areas of goods, services and intellectual property. It will also continue to enforce the trade-policy review mechanism and to serve as the forum for further negotiations. Finally, it will administer an Integrated Dispute Settlement Mechanism, which, compared to the pre-existing mechanisms, is substantially more predictable and automatic and defines stricter disciplines for compliance. In principle, this mechanism allows for "cross-retaliation" (i.e. that of across goods trade and such "new" areas as intellectual property and services), a controversial issue in the definition of the agenda. Nonetheless, any such eventual outcome of the new system would seem rather unlikely, as: (a) it is defined only as the third of a series of alternatives; (b) retaliation has rarely been used in GATT; (c) the Understanding on dispute settlement establishes that due regard be given to developing countries; and (d) it also determines that decisions should be taken by consensus.

Thus, despite some worrisome features, particularly the loss of freedom not to sign certain agreements and the possibility of cross-retaliation, the stronger multilateral trading system which would result from the proposed MTO would certainly be an improvement for developing countries with respect to the unilateral pressures by powerful industrialized countries to which they have been subjected in recent years.

B. Market access for goods

Negotiations in this area have centred during the Round on three different areas: (a) tariff concessions which, according to the Draft Act, will be implemented in a four-year period starting 1 January, 1993; they will cover other import duties (surcharges) and may also include commitments with respect to non-tariff barriers; (b) agriculture; and (c) textiles. The initial negotiations in the areas of tropical products and natural resources have been subsumed under these general headings.

Offers in the first of these areas have been very active but still largely unsettled at the time of writing. As a result of opposition by the United States, no general formula will be used for tariff cuts such as those used during the Kennedy and Tokyo Rounds. It has been decided, however, that the average tariff cut would be similar to that of the Tokyo Round (33 per cent).

Given the relatively low tariff levels of the industrialized countries after the Tokyo Round - a weighted average of under 5 per cent for manufactures⁷ - tariff cuts by these countries would be likely to have rather modest impacts on trade flows compared to the reductions of previous Rounds. Moreover, as the "zero-zero" option (i.e. the total reciprocal elimination of tariffs in certain sectors) presented by the United States in 1991 indicates, it is likely that they may concentrate on manufactures where industrialized countries have a strong comparative advantage, probably increasing the existing tariff discrimination against manufactures of special interest to developing countries.

Conversely, strong pressures have been exerted on developing countries to increase significantly tariff bindings and to fix their commitments as close as possible to the tariffs prevailing after the unilateral trade liberalizations of recent years. Since, as table 2 indicates, the proportion of developing countries' imports corresponding to tariffs bound in GATT is relatively low (21 per cent, against 95 per cent for developed countries), this implies that major advances in this area

⁶ Government procurement, civil aircraft, dairy and bovine meat agreements.

⁷ See GATT, 1980, Annex A, and World Bank, 1987, table 8.1.

Table 2

**SCOPE OF BINDINGS, TARIFF OFFERS AND
COUNTRY COVERAGE OF TOKYO ROUND AGREEMENTS**

	<i>Developed countries</i>	<i>Developing countries</i>				
		<i>Total</i>	<i>Africa</i>	<i>America</i>	<i>Asia</i>	<i>Europe</i>
GATT membership (December 1990)	23	77	33	21	16	7
Countries making tariff offers (mid-1991)	23	26	4	9	9	4
Per cent of imports bound						
Previous	95	21	31	46	10	55
Offer	98	51	51	69	40	93
Average weighted tariff bound (per cent)						
Previous	5.9	15.3	23.0	35.2	12.0	10.2
Offer	3.7	15.2	18.9	35.7	11.5	13.2
Signatories of Tokyo Round Agreements (December 1990)						
Technical barriers	21	18	3	4	7	4
Government procurement	20	3	0	0	3	0
Subsidies	22	14	1	4	8	1
Customs valuation	22	15	4	3	4	4
Import licences	22	17	4	3	5	5
Anti-dumping	22	13	1	2	5	5

during current negotiations will be associated with commitments made by these countries as to the coverage of tariff bindings.

Although many developing countries have shown a willingness to do so, and even to bind the whole tariff schedule, they have, nonetheless, offered only to establish caps above current levels, so as to maintain a degree of discretion in their tariff policy; they have asked, instead, for explicit recognition for their unilateral trade liberalization. Those industrialized countries which are strongly committed to incorporating developing countries into GATT disciplines have refused to do so. As a compromise, an implicit agreement has been reached to give partial credit towards the "33 per cent tariff reduction" to both cuts of those tariffs previously committed and to the increase in the number of items bound at or below 40 per cent, as well as "appropriate recognition" by other partners of unilateral trade liberalization, including non-tariff barriers. This implies that their bound tariffs will continue to be substantially higher than those of industrialized countries. This is, thus, the way in which special and differential treatment will continue to be granted in this field; the principle, embodied in GATT Part IV and explicitly incorporated into the Punta del Este Ministerial Declaration, whereby "the developed countries do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to trade of developing countries", now seems a dead letter.

Pressure on developing countries to make significant additional commitments in market access has not been matched by the willingness of industrialized countries to dismantle agricultural and textile protection at a rapid rate. Indeed, the deadlock in the agricultural negotiations had led

to the failure of the Mid-term Ministerial Review Meeting at Montreal (December 1988) and the Brussels Ministerial Meeting. By December 1991, there was still no consensus text. Current market access negotiations were still largely associated with major disagreements on the part of Japan and some members of the EEC on some provisions incorporated into the December 1991 Chairman's proposal in this area.

The agricultural negotiations have centred on four interrelated topics: (a) market access; (b) domestic support schemes; (c) export subsidies; and (d) sanitary and phytosanitary measures. The last issue, on which a consensus text has been available since Brussels may be left aside. The nature of the 1990 proposals by the United States, the EEC, Japan and the Cairns Group of agricultural exporting countries⁸ are summarized in table 3. They differ in the magnitude of the cuts (substantial in the United States and Cairns Group proposals, very modest and limited to domestic supports in those of the EEC and Japan), the reference period for them (a high year of subsidies, 1986, in the proposals of the EEC and Japan, a relatively low one, 1988 or 1987-1989 in that of the Cairns Group, with an intermediate suggestion by the United States) as well as in the time frame for the reforms.

During 1991, the United States took a low profile in the negotiations and, thus, the Chairman's proposal looks quite close to the EEC's 1990 initiative. It involves: (a) the tariffication of non-tariff barriers and a 36 per cent average cut in resulting tariffs in a six-year period, with a minimum of 15 per cent per tariff item, with an additional "minimum access opportunity" of 3 per cent in 1993, which will increase to 5 per cent in 1999; the reference period for these and other reductions is that originally proposed by the United States: 1986-1988; (b) a 36 per cent cut in export subsidy outlays and 24 per cent in quantities subsidized in the same period; and (c) a 20 per cent cut in price-distorting domestic supports.

Nonetheless, a fairly generous "green box" of domestic subsidies which do not have price-supporting effects will remain in place, with no limitations. Such subsidies include general services (research, pest control, training, extension, inspection, marketing information and infrastructure), public stockholding, domestic food aid, decoupled income support, income insurance and income safety-net programmes, disaster relief, structural adjustment programmes, environmental policies and regional assistance. Given the announced changes in the Common Agricultural Policy of the EEC, this will allow it to survive with only minor scratches. Although such subsidies do not directly distort markets, they certainly do have an effect on agricultural supplies and, thus, indirectly on prices. Equally important, the Agreement includes very generous special safeguard provisions. First, if imported volumes exceed by more than 25 per cent the average of the three previous years or the minimum access opportunity, an additional duty up to 30 per cent of the normal tariff for that year can be imposed. Secondly, if the import price is below the average for the reference period, an additional duty may also be adopted to compensate partially for the difference.

As table 3 indicates, developing countries will be allowed to cut tariffs, export subsidies and domestic supports by two-thirds of the industrialized partners' commitments and be given a longer period (10 years) to adjust; they will also be able to maintain certain domestic and export supports without any restrictions.⁹ Moreover, least-developed countries will have no commitments. It should be emphasized, however, that, since current agricultural policies strongly distort only the markets for temperate zone goods, of which many developing countries are importers, the net effect on them of reforms is mixed.¹⁰ According to UNCTAD (1992), the net effect of the reform is favourable only for Latin America; it is, on the contrary, adverse for Africa and Asia. For the developing countries as a whole, the impact of increasing international prices of temperate zone agricultural goods is, in fact, negative. The Draft Agreement deals with these unfavourable effects on many poor countries by allowing industrialized countries to increase the concessional or grant terms of food aid, with sympathetic consideration of requests for technical and financial assistance to improve agricultural productivity and infrastructure.

The textile negotiations were somewhat less controversial. A consensus on dismantling the MFA had already been reached by 1990, but major disagreements remained on all the major

⁸ Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Hungary, Indonesia, Malaysia, New Zealand, Philippines, Thailand and Uruguay. The proposal summarized in table 3 was not supported by Canada, which presented separate suggestions.

⁹ Such special subsidies include general investment grants, domestic support to encourage the diversification from illicit narcotic crops, agricultural input subsidies to low-income or resource-poor producers, and subsidies to export marketing and internal transportation costs of exported goods.

¹⁰ See, on this issue, World Bank (1986), Abreu (1989) and UNCTAD (1991).

Table 3

**COMPARISON OF 1990 AND DRAFT FINAL ACT (1991)
PROPOSALS FOR AGRICULTURAL REFORM**

	<i>Domestic support</i>	<i>Market access</i>	<i>Export subsidies</i>
1990 Proposals			
United States	- 75% reduction on 1986-88 base, to end in 2001	- Tariffication and 75% reduction to end in 2001 - 50% tariff ceiling in 2001	- 90% reduction of budgetary outlays and quantities subsidized on 1986-88 base, to end in 2001
EEC	- 30% reduction on 1986 base, to end in 1996 - 10% for some products	- Limited tariffication and bindings	- No quantitative commitment but discipline on the use of subsidies
Japan	- 30% reduction on 1986 base, to end in 1996	- Reductions on request - offer basis	- No proposal
Cairns Group	- 75% reduction on 1988 base, to end in 2001	- Tariffication and 75% reduction to end in 2001, with minimum of 50% per tariff item - 50% ceiling in 2001	- 90% reduction of budgetary outlays and quantities subsidized on 1987-89 base, to end in 2001
1991 Draft			
For industrialized countries	- 20% reduction on 1986-88 base, to end in 1999 - Non-distorting subsidies allowed	- Tariffication and 36% reduction, to end 1999 - Minimum access of 3% in 1993, 5% in 1999	- 24% reduction of quantities, 36% of budgetary outlays on 1986-90 base, to end in 1999
For developing countries	- 2/3 commitment, 10 years transition period - Longer list of allowed subsidies	- 2/3 commitment, 10-year transition period	- 2/3 commitment, 10-year transition period
For least developed countries	- No commitments	- No commitments	- No commitments

characteristics of the transition process. Phasing out of the MFA had been proposed by the exporting developing countries and the EEC, whereas the United States and Canada had recommended a "global quota" scheme, by which, contrary to current conditions, EEC textile exports would have been restricted.

The 1991 draft text allows for a very gradual incorporation of textiles into GATT. The process will take place during a transition period of 10 years. Some 16 per cent of 1990 imports are to be incorporated into the general Agreement at the outset of the programme (January 1, 1993); this proportion would increase to 33 per cent in 1996 and 51 per cent in 2000. The draft text also allows for a marginal increase in the growth rate of quotas under the current MFA, and for the obligation of all signatories to phase out non-MFA restrictions on textile imports according to a programme presented to the GATT Textiles Monitoring Body. Special preferences have been set for least developed countries, small suppliers (shares of 1.2 per cent or less of the importing countries' markets) and natural-fibre producing countries.

Given the nature of the transition programme, UNCTAD (1992) claims that the agreement will not affect major restrictions until the beginning of the next century. Moreover, there will be very generous transitional safeguards, including country-selective quotas, which can be used for a period up to three years. This scheme contradicts two basic principles of GATT: the most-favoured

nation clause and the use of quotas only as emergency balance-of-payments devices. Countries are also allowed to use the general safeguard provisions (Article XIX) within the year after the product has been integrated into GATT, with the exporting partner subject to quotas not being able to exercise the right to suspend substantially equivalent concessions during the next three years. In such cases, however, as has been typical of the MFA, exporting countries will manage the restrictions to allow them to appropriate the quota rents.

Given the continued exceptional treatment of both sectors, either permanently or during a long transition period, the major gain for agricultural and textile-exporting developing countries is the GATT discipline which is gradually introduced in both areas.

C. Safeguards and unfair trade provisions

As has been observed, the use of "grey area" measures and unfair trade provisions has been an outstanding feature of protectionism by industrial countries in recent decades. The attempt to bring the former into the GATT discipline, by regulating the use of the safeguard mechanism of the general agreement (Article XIX), failed during the Tokyo Round. A consensus in this area may thus be regarded as a significant achievement during current negotiations.

The agreement prohibits the use of VERs, OMAs and similar measures and forces parties to phase them out within a four-year period, with one exception per trading partner, which it can maintain up to 31 December 1999 (the EEC has already announced that it will continue to restrict car and light truck imports from Japan). Under threat of serious injury in a specific sector, countries can in the future only use the general safeguard mechanism, subject to the usual multilateral notification, consultation, surveillance and dispute-settlement provisions of GATT. Contrary to the EEC's position up to the Brussels meeting, such safeguard measures cannot be country-selective and price-mechanisms should be preferred. Nonetheless, QRs administered by the importing countries are not forbidden and, if adopted, more latitude with respect to sources of supply would be permitted.

Such a mechanism will allow restrictions up to four years, these may be extended to eight years (10 for developing countries) if they remain necessary and if there is evidence that the sector is adjusting. However, no new safeguard measures can be used in the same sector for a period of time equal to that during which such a measure was used (half this period for developing countries), with a minimum non-application period of two years. Under exceptional circumstances, short safeguards (180 days) can, nonetheless, be used, contrary to the general rule. Safeguards should not be used against developing countries with market shares no greater than 3 per cent (unless such countries share as a whole more than 9 per cent of the reference import market).

With respect to the unfair trade provisions, considerably more discipline was introduced concerning price comparisons for the determination of dumping and it was agreed that the method used to calculate subsidies must now be set in each country's legislation or implementing regulations. In both cases, the determination of injury will also be subject to additional provisions, including the obligation of authorities to investigate other factors which may adversely affect the industry. Consumer and industrial users of the goods in question must also be consulted in anti-dumping investigations. Other procedures included in the Tokyo Codes were improved. It was agreed that countries must establish arbitration tribunals or procedures in this area.

New *de minimis* general provisions will force the termination of processes in which the dumping margin is less than 2 per cent or the subsidy component less than 1 per cent. Although the proviso is similar for developing countries in the case of dumping; the new *de minimis* subsidy would be 2 per cent for them and 3 per cent for those countries which renounce export subsidies prior to the deadline mentioned below. Anti-dumping investigations should also cease if dumped goods make up 1 per cent or less of the market, unless the share of small suppliers taken as a whole is larger than 2.5 per cent; similar provisions apply to countervailing duty investigations with respect to developing countries, for which the reference shares are 4 and 9 per cent. Provisional measures are also restricted in the new Code; in particular, they can be applied only if a formal investigation has been initiated, a preliminary determination of the dumping/subsidy-injury connection has been made and in any case no sooner than 60 days after the investigation had started. "Sunset clauses" also determine that no dumping margin or countervailing duty should be

in place for more than five years without a new investigation.

All these provisions, which favour exporting countries, are balanced by the fact that, in both cases, parts and components of assembling activities can be the subject of unfair trade provisions under certain conditions¹¹ and, particularly, by the greater discipline introduced with respect to subsidies. The latter are divided into three groups: prohibited, actionable and non-actionable. The former include export subsidies or domestic subsidies contingent upon the use of domestic inputs. As in the Tokyo Code, a detailed illustrative list of export subsidies is included. To avoid double-taxation, countries can continue to exempt indirect taxes on inputs physically incorporated into exports or to establish drawback mechanisms for such purposes. Detailed guidelines on consumption of inputs into production processes and on substitution drawback mechanisms are now incorporated as annexes to the Code.

On the opposite side, non-actionable subsidies include horizontal non-specific incentives (such as those on employment or for small industry in general), regional assistance and restricted research grants (to cover up to 50 per cent of basic industrial research and 25 per cent of applied research). All other subsidies are actionable, subject, as in the Tokyo Code, to the demonstration of injury. However, serious prejudice to the interests of other signatories will now be presumed if subsidies exceed 5 per cent, or with respect to mechanisms to cover operating losses or write-off of debts. It can also be decreed prejudicial if actionable subsidies generate significant price undercutting or increase the world market share of the subsidizing countries.

Equally important for this analysis, an explicit "graduation" rule has now been established for developing countries. Those nations with a GDP per capita over \$1,000 will now be subject to the same discipline as industrialized countries; other developing and least developed countries will also graduate in those sectors in which their world market share is 3.25 per cent or more for two consecutive years. They will have, however, eight years to adjust (two years in the latter case), and there would be no presumption that their actionable subsidies generate serious prejudice. Also, centrally planned economies in transition to market systems will be allowed to use prohibited subsidies for seven years, and developing countries would be able to use without limits actionable subsidies if they form part of privatization programmes.

Thus, greater discipline is introduced with respect to safeguards and unfair trade practices, at the cost of "graduation" in the Subsidies Code for developing countries with a per capita GDP over \$1,000 or large market shares. In practice, such graduation was being unilaterally forced by the industrialized countries and, thus, the greater multilateral discipline is a net gain even to those developing countries which will now be restricted by the provisions of the Code.

D. Intellectual property

If, despite significant losses in special and differential treatment and the reduced or slow pace of liberalization of the industrialized nations' sensitive sectors, developing countries stand to gain from greater multilateral disciplines in the areas previously analysed, the contrary is true with respect to intellectual property (IP). In the Draft Act on Trade-Related Intellectual Property Rights (TRIPs), the upward harmonization of standards to those of the industrial countries, with no regard for the considerable gaps in technological capabilities between developed and developing countries, is clearly a major cost to the latter.

This conclusion has been reached from different theoretical perspectives. Thus, according to the 1991 *Trade and Development Report* of UNCTAD (page 191):

Depending upon the point of departure in terms of technological and industrial development, strong systems of protection may limit the possibility of following an imitative path of technological development, based on reverse engineering, adaptation and the improvement of existing innovation. A premature strengthening of the international intellectual property system can then be viewed as a one-way scheme that favours monopolistically controlled innovation over broad-based diffusion through free-market competition, a scheme that does not conform to the practices of many of today's most developed countries at earlier stages of their growth.

¹¹ Imported parts must be at least 70 per cent of all parts and assembling value added less than 25 per cent.

On the other hand, Maskus (1990, page 168) argues that:

A strong case can be advanced that a fully harmonized international system of IP protection, with all countries providing complete legal safeguards to creators along the lines of the current U.S. system, could be harmful. To be sure, TICs (technology-importing countries) would realize some benefits from greater foreign innovative activity, which could result in new products designed for their needs. However, it would result in substantial increases in the short-run costs to TICs in the form of large rents transferred to foreign IP owners, with little certainty of those countries procuring significant long-run benefits. Further, the presumption that standardized IP protection at advanced levels would stimulate innovation in each economy over some reasonable time frame is clearly false, and the existence of varying levels of economic and technological development across countries points to the desirability of different national protection schemes, if not outright discrimination. Indeed, the GATT rarely insists on uniform levels of trade protection (as opposed to non-discrimination), and to do so in the area of IP seems inconsistent and excessive.

It could be claimed, finally, that such an international system of protection does not significantly contribute to a more rapid rate of technological change at a world level, as research and development expenditures are largely recovered in the markets of the industrial economies (UNCTAD, 1991).

Despite these considerations, which were systematically put forward by many developing countries, and the claim that the Punta del Este mandate referred to the trade-related aspects of IP, and not to intellectual property as such, the Draft TRIPs text establishes high and even enhanced standards in traditional and more recent areas (copyrights, including computer software; trademarks; geographical indications of origin; industrial designs; patents, including those referring to new technologies, such as bio-technology; and integrated circuits), including the obligation of all parties to incorporate into their national legislation existing international conventions. Moreover, it extends IP rights to undisclosed information (know-how), which is subject in most countries to secrecy or confidentiality laws. According to some analysts, this type of protection clearly erodes the principles of the patent system and all forms of IP rights, which require disclosure as the basis for protection.

Most of the major areas of tension between industrialized and developing countries have been clearly resolved in the TRIPs negotiations on the side of the former. Thus, patentability was forcefully extended to food, microorganisms, pharmaceuticals, chemicals, and the processes to produce them. Only diagnostic, therapeutic and surgical methods for the treatment of humans and animals, animals (except microorganisms) and biological (except microbiological) processes to produce plants or animals were excluded from forceful patentability; it was established, on the other hand, that plant varieties could be protected by either patents or an effective *sui generis* system. A generalized minimum patent protection of 20 years was granted, with controversial privileges, which are currently denied by some developing countries - the exclusive right of importation, in particular - and no working obligations. The burden of proof was placed on the presumed infringer in cases of process patents. Protection for layout-designs of integrated circuits was increased from eight to 10 years. Finally, border (customs) measures to protect intellectual property rights were adopted, a provision which, by itself, may become an additional trade barrier and would prove out very difficult to manage in developing countries.

Only in two areas could it be said that the new system included some provisions which were strongly advocated by developing countries in the negotiations. Article 31 maintains, with major procedural restrictions, compulsory licensing, under the heading: "other use without authorization of the right holder". Such form of licensing can continue to be used for national emergencies, public non-commercial use, second patents, to correct anti-competitive practices or when the holder refuse to grant patents on reasonable commercial terms. In a related manner, Article 40 allows parties to introduce in their legislation licensing practices or conditions that may constitute an abuse of IP rights having an adverse effect on competition in the relevant market. The legislation can thus prohibit such practices as licensing with grant-back conditions or coercive technological packaging, but obviously cannot undermine the basic rights conferred to the patent holder (such as the import monopoly or the ability to determine in which markets a particular licensee can sell, which is the basis for prohibitions to export which are currently forbidden by some developing countries).

Developing countries were given a five-year period to adopt national legislation consistent with the TRIPs Agreement; the period may be extended to 10 years for countries which currently limit the scope of patentability and for the least developed countries. Although such transition

periods were considered minimal by developing countries, even to enact the legislation and build the administrative structure necessary to protect effectively IP rights, the transition period has been considered excessively long by the United States private sector and, according to some analysts, may jeopardize the U.S. support for the entire Round.

III. Negotiations relevant to financial adjustment and flows

A. *Balance-of-payments restrictions and quantitative restrictions (QRs)*

As has been stated at the outset of Section I, one of the major principles on which GATT - as well as other international treaties, such as the Charter of the International Monetary Fund - has been founded is that price-based policy instruments are superior to quantitative restrictions as a means to manage international economic relations, but that the latter can be used under emergency balance-of-payments conditions, preferably on a temporary basis. Thus, Article XII allows all parties to use QRs during payments crises; Article XVIII incorporates a similar provision for developing countries.

An evaluation of the use of these provisions (Eglin, 1987) indicates that consultation procedures under Article XII have proved an effective way to discourage industrial countries from using QRs. However, surveillance under Article XVIII has proved to be ineffective; in particular, it has not permitted a clear distinction to be made between cyclical and structural balance-of-payments problems and has not required the application of alternative adjustment measures to ease progressively QRs. Thus, the concept of temporary application of the restrictions has been lost.

This point of view was the basis for the Uruguay Round Agreement on the balance-of-payments provisions of Article XVIII. The new Agreement establishes that, under foreign exchange payments difficulties, developing countries should prefer price-based measures (import surcharges, import deposit requirements, etc.) to QRs and, particularly, to non-automatic import licences. However, when either of these alternatives is used, developing countries will in the future have to announce from the outset a time schedule to remove them. More rigorous notification, periodic review and consultation procedures were also established, forcing countries to justify the use of QRs in all instances. Finally, it was established that routine simplified consultations (i.e. those which do not require a detailed examination of controls currently in place) could only be held for least developed countries or for developing countries pursuing liberalization efforts agreed on in previous consultations.

In a parallel vein, the Tokyo Round Code on import licences was strengthened, to guarantee that such procedures would be administered in an equitable manner and in such a way as to minimize their restrictive effects on imports. In particular, new notification requirements were established along with periodic reviews by GATT based on annual information presented by the parties. It was also agreed that publication of licensing procedures and rules, including lists, should take place, whenever practicable, 21 days prior to the effective date of requirement and, in no case, later than that date. It was also agreed that the period for processing licences should normally be 30 days, if licences are considered on a first-come first-served basis, or 60 days if they are analysed simultaneously.

The greater discipline in both areas should be welcomed by developing countries as a contribution to a stronger multilateral trading system. It should be emphasized, however, that preference for price-based mechanisms under Article XVIII has been matched by similar provisions with respect to agriculture (tariffication of existing restrictions), but not in other crucial "sensitive" areas of interest for the industrialized countries, such as the general safeguard mechanism and textiles (see sections II.B and II.C above). Taken as a whole, these regulations have thus turned upside down the principle of special and differential treatment for developing countries in the critical area of quantitative import restrictions.

B. Regulations affecting direct foreign investment

Although foreign investment regulations were outside the scope of the Uruguay Round, at least two sets of agreements will have implications for such capital flows. The first relates to provisions regarding services, since trade in services largely takes place through physical presence in other parties' territories. Such provisions will be analysed in section C below. The second is associated with discussions on trade-related investment measures (TRIMs). In this area, as in TRIPs, there was considerable disagreement during negotiations on the scope of the Punta del Este Declaration. Thus, industrialized countries interpreted the mandate as including investment measures *per se*, whereas developing countries argued that it referred only to its trade-restrictive effects. As a result of such disagreement, no consensus text existed as of December 1991.

The Chairman's proposal included in the Draft Final Act establishes that no party shall apply TRIMs inconsistent with the principles of national treatment or the general elimination of QRs. It thus forces all countries to dismantle such restrictions, which are widely used in assembling activities and in some other manufacturing sectors in developing countries and, to a lesser extent, by some developed countries. They include local content specifications, export and trade balancing requirements, or other mechanisms which tie foreign exchange access to exports or domestic production.

According to the proposal, the period to eliminate TRIMs will be two years for developed countries, five for developing countries and seven for the least developed countries. It includes no provisions to manage the anti-competitive practices of transnational corporations, at which TRIMs are aimed. However, it allows developing countries to deviate temporarily from the decision if warranted according to Article XVIII of GATT. This should be interpreted to mean that TRIMs could be used either for balance-of-payments or infant-industry purposes, the two alternatives contemplated in that Article.

C. Services, with special reference to financial services

Despite the initial opposition by some developing countries to the inclusion of services on the agenda, this topic proved out to be one of the least controversial during negotiations. This fact is reflected in a balanced text, which provides a general and flexible framework for negotiations in services - a General Agreement on Trade in Services, GATS -, which mirrors the General Agreement on Tariffs and Trade. In fact, the major unsettled issue relates to the opposition by the United States (the major supporter of including services on the Uruguay Round agenda) to the application of the most-favoured nation (MFN) principle in certain service activities.

GATS is meant to apply to all services, except those supplied in the exercise of governmental functions. As its annex on financial services indicates, such exceptions include the activities of central banks, social security systems or those financial services conducted by public entities for the account, or using the financial resources, of the Government; the latter two exceptions are covered by the Agreement only if they are conducted under competitive conditions in the country in question. Although the basic principles of GATT - gradual trade liberalization, reciprocity, non-discrimination, transparency of regulations, fair trade and use of QRs only as an emergency tool - have been incorporated into the new Agreement, there are also major exceptions reflecting the conditions specific to service sectors. In particular, the principles are meant to take account of the fact that domestic regulations are particularly important in services activities, that some international service markets are highly distorted, and that trade in this area largely requires a physical presence in other countries' territories; the latter implies that trade regulations intersect with foreign investment and immigration rules. Other specific features of GATS relate to the highly distorted international markets which currently prevail. This is the basic reason why air traffic has been totally excluded from the Agreement and why certain exemptions from the MFN principle were also adopted.

MFN exemptions are, in fact, considerable. Some of them are quite natural and consistent with GATT, such as that for integration processes or frontier regions.¹² Others appear less genuine

¹² Article XXIV of GATT allows countries to grant special advantages to frontier regions and to those nations with

and are basically associated with specificities of these economic activities. Particularly, the GATS annex on Article II allows countries to exclude totally specific sectors from the Agreement for up to 10 years, subject to later negotiations. Equally important, since domestic regulations may include precepts contrary to the MFN principle - reciprocity provisions or special bilateral agreements, for instance - countries can maintain such norms if they so desire.¹³

Protection of existing and future domestic regulations is explicitly embodied in GATS, thus preserving national autonomy. In financial services, such autonomy is maintained, in particular, for prudential regulations. Such national ordinances may not only limit the MFN principle, but also national treatment and the general presumption against QRs. As for the latter of these issues, legal monopolies, exclusive service providers and licensing procedures, including qualification requirements, are protected. As in GATT, QRs for balance-of-payments purposes are allowed, including payment restrictions. More generally, although it is presumed that, except in a balance-of-payments crisis, countries will not restrict foreign exchange transfers and payments for current transactions relating to specific commitments under the Agreement (not so for capital transactions, unless the country has negotiated them), it is also stated that rights and obligations under the IMF Agreement take precedence over GATS. It is well known that under the IMF agreement most developing countries maintain restrictions on payments and transfers even for current transactions.

The most significant difference between GATS and GATT is, however, the fact that national treatment is not presumed, but rather subject to international negotiations. Thus, offers in services will refer to both market access and national treatment. As will be seen below with respect to financial services, such principle, as well as the preservation of domestic regulations contrary to the MFN clause, to which reference has already been made, allows for different forms of discrimination against all or some foreign service providers. Nonetheless, as national treatment is stated as a general principle in the Agreement, this could become a source of friction in the implementation of GATS. This point is particularly problematic in the light of a very controversial provision incorporated into Article XVII, referring to national treatment, which says:

Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service providers of the Party compared to services or service providers of another Party.

This principle implies that equal legal treatment may, nonetheless, violate national treatment. For instance (as UNCTAD, 1991, argues), exchange controls, even if protected by domestic regulations and the IMF Agreement, may become contestable, as they adversely affect those financial institutions which specialize in foreign exchange transactions (foreign versus domestic banks). Moreover, this principle is just one step away from that which equates equality of opportunity with "equality of observed outcomes", which has been one of the bases for the "aggressive reciprocity" practiced by the United States in recent years.

Other provisions of GATS are quite similar to those of GATT. Thus, GATS includes emergency safeguards, anti-subsidy (though not antidumping) stipulations, a general exemption for government procurement and general exceptions to the Agreement (public order, protection of life, national security, privacy, prevention of fraudulent practices, etc.), and similar provisions for modification of commitments, consultation, dispute settlement, etc. The first three of the aforementioned areas will be subject to negotiations in the coming years.

An annex to the Agreement establishes the special standing of telecommunications as the underlying transport means for other economic activities and thus guarantees access to "public telecommunications transportation networks" by all service providers. On the other hand, a disappointing annex on labour movements essentially reaffirms one of the basic asymmetries of the international economic system: that increasing freedom of movement of goods, services and capital is not matched by a free movement of labour nor, indeed, any recognized rights of immigrants.

which they form a free trade zone or a customs union, so long as two conditions are met: (a) prior concessions to third parties are not affected; and (b) the free trade zone or the customs union covers "substantially all trade" between member countries. Such agreements have neither been considered inconsistent with the principle of gradual trade liberalization at a world level nor, in a sense, with the MFN clause, as they may be thought to imply that the units which grant among themselves reciprocal advantages in GATT have simply been enlarged. Similar principles for economic integration processes have been incorporated into GATS.

¹³ Also, as in GATT, temporary waivers may be used, and countries at the time they become parties to the Agreement can indicate that they do not consent to its application with respect to any other particular country.

Special and differential treatment for developing countries is asserted in two ways. First, it is stated that developing countries will be given the appropriate flexibility to open fewer sectors or transactions, if they so desire. Secondly, the Agreement establishes the principle of increasing participation of developing countries in the world supply of services, a precept which should lead to special commitments in the areas of access to technology, distribution channels, information networks and liberalization of sectors of special export interest to them. Note, however, that restrictions on labour movement may eliminate, *per se*, the comparative advantages of developing countries in the area of service exports.

According to the Draft Act, liberalization of financial services can take place through two different channels. The first is the framework Agreement. Under this scheme, offers may include highly restrictive provisions on both market access and national treatment or even altogether exclude some activities. This is probably the route that developing countries will follow in negotiating their offers.

The alternative, which will probably become the basis for negotiations among developed countries, is the "Understanding on Commitments in Financial Services". This mechanism implies a general standstill on all existing regulations and excludes from the Agreement only central banking, social security and some types of domestic insurance. It grants MFN and national treatment to purchases of financial sector services by public entities and establishes that countries must endeavour to eliminate special monopoly rights. It also allows residents to buy non-insurance financial services in other countries, creates the right to commercial presence in the territories of other parties and permits service providers established in another country to offer any new financial service. Nonetheless, it allows countries to impose terms, conditions and procedures for authorization of commercial presence.

Table 4 summarizes the nature of offers in this area as of January, 1992. It is difficult to compare these offers, as they use different formats, and take positive (list of activities included and commitments as to market access or national treatment) or negative (no limitations except those specifically mentioned) list approaches. They likewise differ in how explicit or detailed they make restrictive characteristics of the offers in question. Thus, those limitations summarized in the table should be understood as a minimum rather than an encompassing list.

By the date mentioned, all developed but, on the contrary, few developing countries had presented by then offers in this sector. Generally, the former used the "negative list" approach and (with only one exception) covered the whole financial sector. This allows a detailed account to be made of the numerous limitations to either market access or national treatment. Some restrictions were, in fact, not listed in table 4, as they are general to all (or most) countries. They include: (a) prudential regulations, including licensing/authorization procedures; (b) unequal treatment of branches versus subsidiaries. In some countries this amounts to a total prohibition on branches in a few sub-sectors or requirements that certain services be provided by subsidiaries of foreign intermediaries or by institutions incorporated in the country in question); and (c) no commitments on movement of personnel, except in a few countries, which bind only the free movement of managers and technical staff.

Table 4 also shows that there are five types of restrictions which are fairly widespread in the industrialized countries. They include (in order of importance): (a) reciprocity provisions; (b) limitations on who can provide some types of insurance, particularly (but not solely) compulsory insurance; (c) nationality requirements for directors or managers, or residence requirements for the former; (d) some types of foreign-exchange controls on capital movements; and, to a lesser extent, (e) restrictions on direct foreign investment in financial institutions. In fact, some of these restrictions may be more general than suggested in table 4, as some countries may not enumerate the restrictions explicitly in their offer, but rather include them implicitly in other provisions. Among restrictions specific to a few countries, but not included in table 4 are: special monopoly rights, tests of economic need or national interest in the licensing/authorization process, and establishment requirements to issue bonds or securities denominated in the national currency.

Most of the offers by developing countries are quite restrictive. Of 17 which had been presented by the date indicated, 13 were restricted either in their sectoral or regional (in the case of China) coverage. Most of them included additional and fairly stringent restrictions on national treatment or (the equivalent) foreign ownership of financial institutions. Thus, only four offers were comparable to those of developed countries: those of Argentina, Chile, Colombia and Hong Kong. Even then, they generally provided for only to market access and national treatment with respect to commercial presence (i.e. the provision of financial services in the country), with no

OFFERS IN FINANCIAL SERVICES

(As of January 1992)

		Major restrictions of offers				
		1	2	Other		
		3	4	5		
Developed countries						
Australia	- No limitations except those specifically mentioned	X	X	X	X	
Austria	- No limitations except those specifically mentioned; offer to eliminate most foreign exchange controls		X	X	X	
Canada	- Binds existing market access and national treatment					
EEC	- No limitations except those specifically mentioned		X	X	X	X
Finland	- No limitations except those specifically mentioned	X			X	X
Iceland	- Important limitations on foreign ownership of financial institutions	X			X	
Japan	- No restrictions on movement of consumers and commercial presence, except those specifically mentioned - No commitments on cross-border trade, except in a few activities			X		X
New Zealand	- Limited sectoral offer					
Norway	- Important limitations on foreign ownership of financial institutions	X		X	X	
Sweden	- No limitations except those specifically mentioned		X			X
Switzerland	- No limitations except those specifically mentioned		X	X		
United States	- No limitations except those specifically mentioned				X	X
Developing countries						
Argentina	- No restrictions on commercial presence - No commitments on cross-border trade and movement of consumers					
Brazil	- Limited sectoral offer, with no commitments on cross-border trade and movement of consumers	X				X
Chile	- No restrictions on commercial presence (except in few activities) and movement of personnel - No commitments on cross-border trade and movement of consumers in most sectors					
China	- Offer limited to Special Economic Zones					
Colombia	- No restrictions on commercial presence - No commitments on cross-border trade and movement of consumers		X			X

OFFERS IN FINANCIAL SERVICES

(As of January 1992)

<i>Major restrictions of offers</i>		<i>Other</i>				
		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Egypt	- Limited sectoral offer with no commitments on commercial presence in some activities	X				
Hong Kong	- No restrictions on national treatment - No restrictions on movement of consumers and commercial presence					
Hungary	- No commitments on national treatment - Limited market access and no commitments on cross-border trade and movement of consumers	X				
India	- Restricted sectoral offer	X				
Republic of Korea	- Restricted national treatment and market access - Important limitations on foreign ownership	X		X		
Mexico	- No commitments on cross-border trade and movement of consumers - Important limitations on foreign ownership	X				
Peru	- Restricted sectoral offer					
Philippines	- Restricted sectoral offer with no commitments on national treatment - Important limitations on foreign ownership	X	X			
South Africa	- Limited commitments		X		X	
Uruguay	- Restricted sectoral offer	X				
Venezuela	- Restricted sectoral offer - Important limitations on foreign ownership					
Yugoslavia	- Restricted sectoral offer - Important limitations on foreign ownership	X				

Note: Types of restrictions:

- 1 Restrictions on direct foreign investment in financial institutions.
- 2 Foreign exchange controls on capital movements.
- 3 Reciprocity provisions.
- 4 Nationality requirements for directors or managers, or residence requirements for directors.
- 5 Limitations on which institutions can provide certain types of insurance; particularly (but not solely) compulsory insurance.

commitment as to cross-border trade or movement of consumers (i.e. supply of services from abroad to consumers in the country, or access by consumers to financial services supplied in foreign countries). Only Hong Kong made commitments on the movement of consumers. Also, of all countries presenting offers, only Chile made general commitments on free movement of personnel.

The characteristics of the initial offers indicate that few additional commitments have been made so far on the liberalization of the international trade of financial services. Indeed, in most cases, the offers indicate no more than a standstill on market access or national treatment. Often they even establish conditions more stringent than current legislation. Moreover, in the case of developing countries, not much substance has been included in the proposals, except by a handful of nations. If this is indicative of the final result of the negotiations, it may mean that the issue of liberalization of services will become a new source of contention, as developed countries may use it as evidence of the lack of commitment by the developing partners to a liberal international economic order.

IV. Conclusions: a brief balance sheet of the Uruguay Round for developing countries

As stated above, given the adverse global trends in recent years, a weakened special and differential treatment may not be a high price for developing countries to pay if current negotiations would strengthen effectively the multilateral trading system and reverse the protectionist trends typical of recent decades. Viewed from this perspective, the balance of the Uruguay Round for developing countries is rather mixed. Special and differential treatment certainly came out weaker if not totally obliterated, especially for those developing countries for which "graduation" rules were made explicit.

Particularly worrisome, as has been, is the upward harmonization of intellectual property rights, which may generate significant costs to developing countries. Significant discipline was also imposed on them with respect to the use of QRs for balance-of-payments purposes, trade-related investment measures, and export and domestic subsidies. They were also asked to increase considerably tariff bindings and to contribute to the international liberalization of trade in services.

Multilateral rules were certainly strengthened. Although the new institutions which will come out of the Round are not free of risks, particularly that of cross-retaliation, they certainly will be an improvement over the belligerent unilateralism exercised by powerful nations over many developing countries in recent years. Increasing discipline in anti-dumping and countervailing duty investigations and the substitution of "grey area" measures by clear safeguard mechanisms is also a significant improvement. The flexible framework for liberalization of services likewise represents major progress.

Nevertheless, the sluggish pace of liberalization of agricultural and textile trade by industrial countries and the incorporation in both sectors of generous transitional safeguards, reflects an imbalance in the overall outcome, when compared to the additional discipline imposed on developing countries, particularly but not solely in the area of intellectual property. The gradual introduction of GATT discipline in these two sectors, however, will mean a long-run gain for developing countries.

Finally, one of the most contradictory results of the Round is the treatment of quantitative import restrictions. Whereas considerable discipline on the use of QRs by developing countries for balance-of-payments purposes has been introduced, and the preference for price-based mechanisms has been clearly established in this area and in agriculture (albeit with significant resistance from some developed countries), quantitative restrictions came out as a rather easy alternative to follow as a general safeguard or as a transitional mechanism in textiles. In these areas, special and differential treatment was not only eroded but actually turned upside down.

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TRANSFERS, REAL INTEREST RATES AND REGIONAL DEVELOPMENT: INTERNATIONAL ECONOMIC IMPLICATIONS OF FINANCIAL SUPPORT FOR THE ECONOMIES IN TRANSITION

Peter Pauly

Executive Summary

Considerable public international economic debate has recently focused on the perceived threat of a potential international financial crunch caused by increased investment needs in various areas of the world, coupled with stagnant or even falling national savings rates in traditional surplus countries. In this paper, an attempt has been made to address these issues both theoretically and empirically. Empirical analysis has focused primarily on the effects of transfers to Central and Eastern Europe and the CIS. The analysis concludes by observing that, based on the limited set of simulations examined, sufficiently conditionalized Western public support in the form of loans, combined with some grants, can apparently play an important role in the restructuring efforts of the countries of Eastern Europe without necessarily straining the Western financial system. Provided that the institutional environment in the recipient countries continues to improve, as assumed in this paper, Western transfers can stimulate the process of increasing Eastern productivity while at the same time generating sufficient positive feedback effects on global economic activity.

An important aspect of these results is that there exists a wide range of assumptions under which the net gains for third countries, particularly those in the developing world, are positive, though likely to be small. Important sources of regional imbalances in the resultant effects on economic activity have also been identified, and may, at least in part, explain the political difficulties currently faced in the international efforts to implement any such scenario. Furthermore, for developing countries that have in the past depended upon official international concessionary lending, even minor spill-overs of international capital shortages onto their present allocations could generate significant obstacles to medium-term development, however small amounts involved are relative to the global scale.

The analysis can be extended in a number of ways. Many analysts would claim that computations, such as those presented here, under-estimate the positive effects of the initial stimuli by under-estimating the efficiency gains through marketization and privatization; moreover, it is argued that those gains might be obtainable even without financial transfers. While some allowance to a systematically higher contribution over time of the Solow-residual could be implemented exogenously, the extent of such effects cannot but remain highly speculative. Also, while these channels may indeed in the long run turn out to be more important than the replacement and expansion of the capital stock, they may not be dominant over the short- to medium-term horizon considered here.

Finally, the results are of course model-dependent. They appear, however, to be broadly in line with those obtained in other work [e.g. Alexander and Gagnon (1990), Masson and Meredith (1990), McKibbin (1990), International Monetary Fund (1991)]. The major conceptual short-coming of the present framework is the absence of forward-looking elements in the system. That will, however, generally not affect the long-run effects, but only the timing of the short-run adjustment.

In addition, there is substantial empirical evidence indicating that it takes only small changes in parameters to generate sufficiently large increases in private savings in the industrial world. Such increases would probably eliminate the problem altogether, and even allow for a significant reduction in real interest rates. That is to say, relatively small changes in private and public sector behaviour can alleviate some of the critical contributing factors, such as the large North American claims on global surpluses.

Introduction

Since 1990, the world economy appears to have experienced a rather dramatic increase in claims on global financial resources.¹ To a considerable extent, the incremental demands reflect the costs of German unification and the financial requirements of the economic restructuring in the economies in transition in Central and Eastern Europe (EE5)² and the States of the Commonwealth of Independent States (CIS). There is every indication that the root causes for this excess demand will persist for most of the decade.

At the same time, many developing countries have renewed their calls for a large-scale resumption of net transfers of financial resources to the South, both in support of restructuring programmes, such as in parts of Latin America, and as emergency aid to low-income countries in Africa and in South and South-East Asia. What has emerged appears to be an intensifying competition for scarce international financial resources. Economic conditions in the industrial world remain unfavourable in that large private and public sector deficits in North America persist, and the pace of the recovery is slow. Finally, the situation can be expected to be aggravated further by a decline in excess resources generated in traditional surplus countries such as Germany and Japan, as a result of medium-term structural adjustments in both countries.

Obvious questions may be posed as to the capacity of world financial markets to absorb these additional demands for funds. Many economists and policy-makers are concerned about a "global capital shortage". In an analysis of that proposition it will be useful - for a number of reasons - to distinguish between those (private and official) international financial flows that operate on a largely unsegmented international capital market and other (mostly public) capital flows that prevail in the financial relations between Western industrialized countries and developing countries.

With respect to the former category, the concern about "shortages" is somewhat misleading: in a global sense, measurement errors aside, there cannot be a gap between saving (the supply of capital) and investment (the demand for capital). Any existing discrepancies between *ex ante* ("notional") demands and supplies of capital will be reflected in adjustments in the price of international capital, the world real interest rate. From that perspective, the relevant policy issue with respect to interregional transfers of funds is whether the stimulus to world economic activity resulting from transfers into the recipient countries will be sufficient to facilitate continued growth at stable (or even declining) world real interest rates. Alternatively, the concern must be whether important crowding-out effects in developed market economies and/or in the economies of the developing world are likely. From a policy perspective, the issue clearly is how to ensure that internal and external adjustments on a global scale do not jeopardize growth objectives.

On the other hand, a number of developing countries rely on highly concessional capital flows which are allocated through non-market forces, and generally not registered through conventional market approaches to demand analysis. The effects of incremental claims on world financial resources are likely to be felt in these countries as an increase in the (already existing) gap between their needs and the allocation available to them, within the framework of multinational agencies as well as in terms of bilateral support. Whether as a result of a shrinking supply of funds or through changes in the allocation mechanism, rationing of international financial support may, for this group of countries, be as important as the potential deterioration of the terms of international lending. For the smallest and most vulnerable countries, small adjustments of the level of support can, of course, translate into significant development set-backs, even though the numerical orders of magnitude remain negligible on a global scale. The issue is particularly important in light of the recognition that even under the *status quo ex ante* some developing countries would have been likely to remain dependent on concessionary public funds for the foreseeable future.

As a result of both price and quantity adjustments, world capital markets will probably become increasingly competitive. Most of the potential third-world capital importers, the economies in transition in Central and Eastern Europe and in the CIS, as well as the traditional deficit countries in the OECD region will face scarcer capital supplies. While, *ex post*, excess demands for world savings will not persist, the issue is how much upward pressure on prices and real interest

¹ For a comprehensive discussion, see e.g. Bosworth (1990), the summaries in *European Economy* (1989, 1990) and the extensive treatment of the issue in the *IMF World Outlook* (1991).

² Bulgaria, Czechoslovakia, Hungary, Poland and Roumania.

rates, as well as direct credit rationing, is likely to result from the temporary insufficiency of global savings, and what are the probable costs in terms of real economic activity.

Five issues are of particular concern: First, there is the need to identify the relevant transmission channels and estimate the extent of the strain that additional capital needs in both industrial and developing countries, combined with a redirection of financial resources from industrialized countries into the recipient countries in Eastern Europe and the CIS will place on the world financial system. Without corresponding spending adjustments in the North, interest rates on industrial financial markets might indeed increase by enough to wipe out the potential activity gains that are usually associated with a capital transfer. Secondly, there is the need to identify and estimate the macroeconomic responses to changes in the world real interest rate, i.e. the effects on levels of activity (consumption, investment) and trade flows through exchange rates, price and income effects. Thirdly, there is legitimate concern over the effects on world trade and global economic activity through trade redirection and trade creation as a result of differences in marginal propensities to import between donor countries and recipient countries. Similarly, the allocation of the welfare effects of such transfer packages depends crucially on the regional distribution of the trade gains and losses caused by the stimulus to activity in the East. Fourthly, the results may in an important way depend upon policy adjustments in third countries in response to the externally imposed financing constraints, i.e. to the crowding-out effects. Fifthly, it will be important to ascertain the sensitivity of these results to changes in private and public sector saving behaviour in major industrial countries.

This paper attempts to provide some empirical information pertaining to these issues based on simulation exercises performed with the world econometric model system of Project LINK. In particular, the short- to medium-term effects of various scenarios will be examined in terms of international financial transfers of different orders of magnitude and with different characteristics to economies in Central and Eastern Europe (including the "Länder" of the former German Democratic Republic)³ and the CIS. These transfers are grants and loans, of about equal shares in the total amounts. They are financed out of public-sector programmes and/or international multilateral facilities such as the IMF, the World Bank and the newly established European Bank for Reconstruction and Development (EBRD). The sensitivity of the results to alternative assumptions about accommodating monetary policies as well as to adjustments in public and private savings behaviour will also be examined.

While motivated primarily by current events, the issues addressed in this paper are, of course, far from novel both in academic and in political debates. The determinants of real interest rates on a world-wide scale have recently been explored by Barro and Sala-i-Martin (1990), building on earlier work by Blanchard and Summers (1984), among others. There is also rather extensive literature on fiscal policy effects in open economies, most prominently represented by the work of Frenkel and Razin (1985, 1987). Finally, the discussion explores the controversy over the relative stimulus provided to developing countries by increases in industrialized countries' absorption compared with more benign global financial conditions, as treated by Sachs (1988). The present empirical analysis within the framework of a complete dynamic global econometric model will hopefully provide a better assessment of the general equilibrium effects of such transfers, while at the same time allowing for a rich characterization of short- and medium-term adjustment paths.

The paper is organized as follows. Section I examines historical trends and provides estimates of the likely claims on world financial resources over the coming years. Section II contains a brief discussion of the expected international macroeconomic effects of financial transfers to EE5 and the CIS, with particular emphasis on third-country effects. Section III presents empirical results aimed at evaluating the global macroeconomic implications of financial assistance. The sensitivity of these results to some basic assumptions is examined in section IV. A brief critical discussion of the general merits of external financing of development appears in section V. Section VI presents a summary of results.

³ Through accession of the German Democratic Republic to the Federal Republic of Germany with effect from 3 October 1990, the two German States have united to form one sovereign State. As from the date of unification, the Federal Republic of Germany acts in the United Nations under the designation of "Germany".

I. Historical trends and future financial needs

It has become apparent to most international economic analysts that the past decade has been quite atypical with respect to the existing demand pressures on world financial markets, in that *ex ante* real interest rates have stubbornly remained at unprecedented levels. Figure 1 displays a weighted average of G-7 real long-term interest rates. After fluctuating around zero for most of the 1970s (and, incidentally, the preceding two decades), rates climbed dramatically in the early 1980s and have since then stayed in the range of 4 to 6 per cent. Several hypotheses have been advanced to explain this phenomenon (e.g. Blanchard and Summers (1984), Atkinson and Chouraqi (1985)), ranging from a permanent increase in the real rate of return on capital to the Latin American debt crisis. To the extent that high real interest rates may have reflected a secular shortage of saving, obvious concerns are generated by incremental claims on these scarce resources for purposes of aiding the transition in the countries concerned, namely the EE5 and the CIS, as well as the process of economic reconstruction in the eastern part of Germany.

On a global scale, both saving and investment have declined, as a percentage of GNP, since the early 1970s (figures 2 to 5). In addition, since the mid-1970s, the OECD countries have become net importers of capital, reflecting a difference of about 1 per cent between the region's saving and investment rates by the late 1980s. While, throughout the 1970s, the OPEC countries have provided most of the funds in support of insufficient OECD saving, during the 1980s the Asian NIEs have played an important role in this regard, providing, towards the end of the decade, up to 10 per cent of GNP to international capital markets. As for the industrialized countries, those in North America have emerged as the largest capital importers, while Japan - during the 1980s - provided substantial excess savings to the world (figure 4). In recent years, with the build-up of Japanese surpluses and some improvement in the North American position, the weighted average of current account deficits of the G-7 countries had dropped to little more than 1 per cent of GNP (figure 5). Figure 4 also illustrates the differences across developing regions: Africa has consistently suffered from insufficient saving, although the ratio did improve slightly during the 1980s. At the same time, after a long period of insufficient regional saving, Asia reached a balanced position during the 1980s, which has now become an excess of saving in recent years. As a result of the adjustments imposed in the wake of the debt crisis, many Latin American countries became excess savers during the 1980s.

In total, the amount of world financial resources ("world saving") is currently in the range of US\$4.5 to 5 trillion; the last reliable estimate puts the number at about US\$4.2 trillion for the year 1989 (table 1). What are the orders of magnitude of incremental claims on these sources of funds likely to emerge in the coming years? The answer depends to a considerable degree on a definition of "needs", since these cannot be defined without explicit reference to some development targets.

The countries and regions considered in this paper will be examined first. Estimates for the average amount of required intra-German transfers during the period 1991-1995 range from about US\$30 to 60 billion annually. Less information is, of course, available on the financial resources likely to be made available to the EE5 and the CIS countries. Based on experience in 1991, and on current announcements, the range of estimates is as wide as US\$10 to 30 billion annually for the EE5 and US\$15 to 35 billion for the CIS. For the purposes of this study, the scenario designed assumes amounts in the lower end of these ranges; this package would involve a feasible amount of direct financial support from industrialized Western countries. With an average annual amount in the range of US\$50 billion, it involves an incremental claim on world saving of little more than 1 per cent.

The "needs" of the recipient countries in terms of reasonable development targets are likely to be substantially larger, and well beyond any realistic estimate of available international funds. A recent study (Papadia *et al.* (1991)) has attempted to quantify the needs. It may be assumed that, over an adjustment period of 20 years, the aim of the eastern part of Germany is to reach a level of per capita income close to that of the western part, while the countries of the EE5 and the CIS by the end of that period would attempt to reach per capita income levels comparable to those of low- to middle-income EEC countries. Based on estimates of current labour productivity, and assumptions about the nature of the production function in these countries, they would need - at constant national savings rates in recipient countries - the following annual required net capital inflows: Eastern Germany, US\$80 billion; EE5, US\$100 billion; and CIS, US\$160 billion. Those

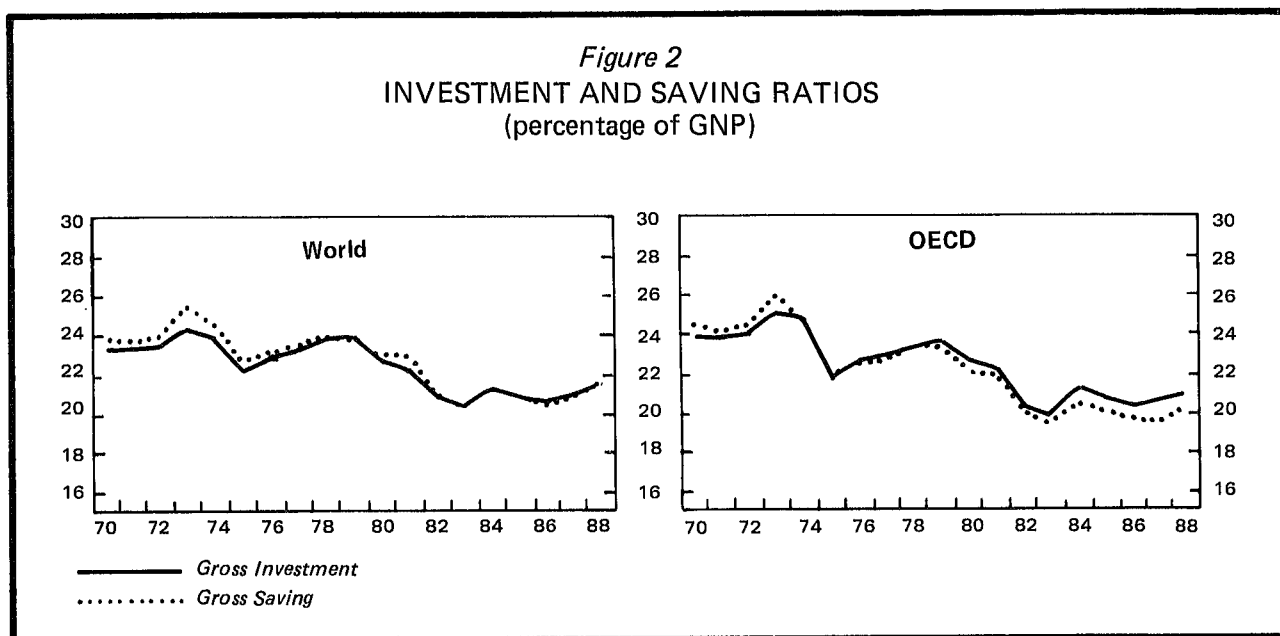
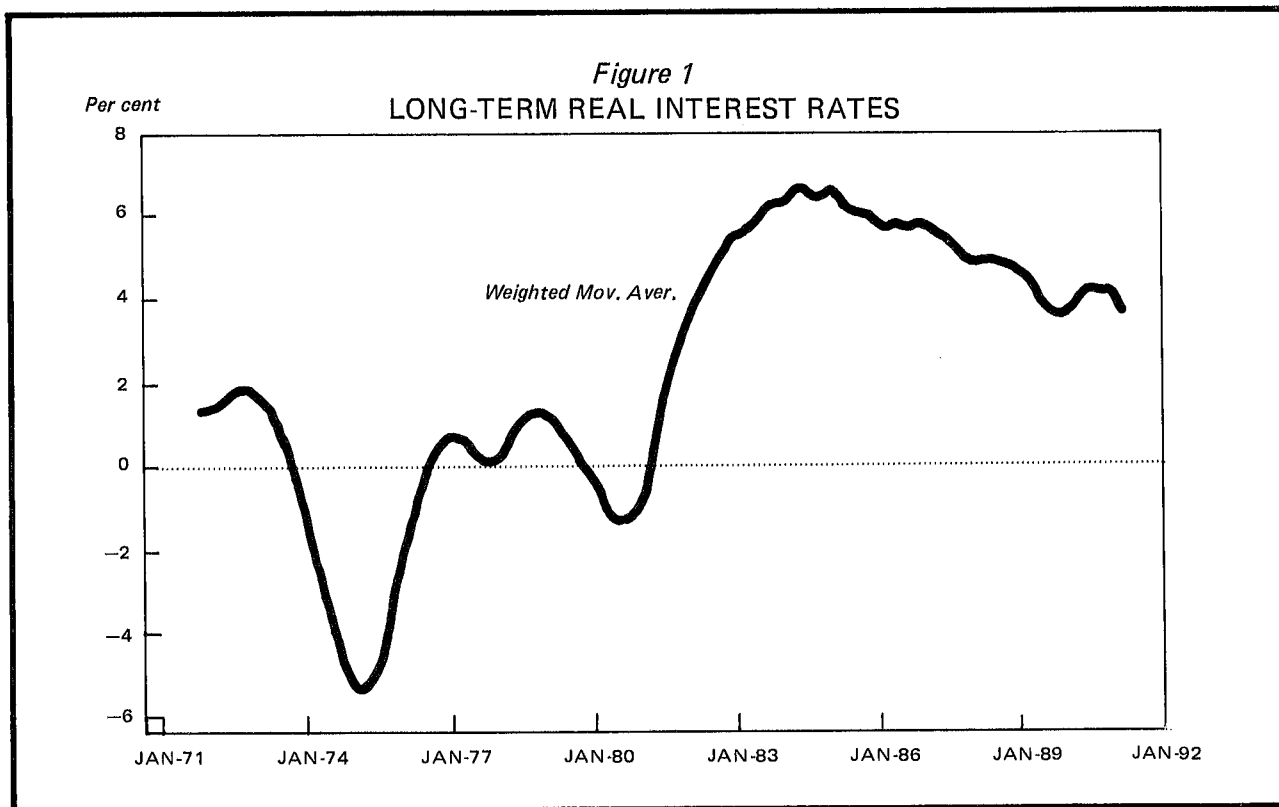
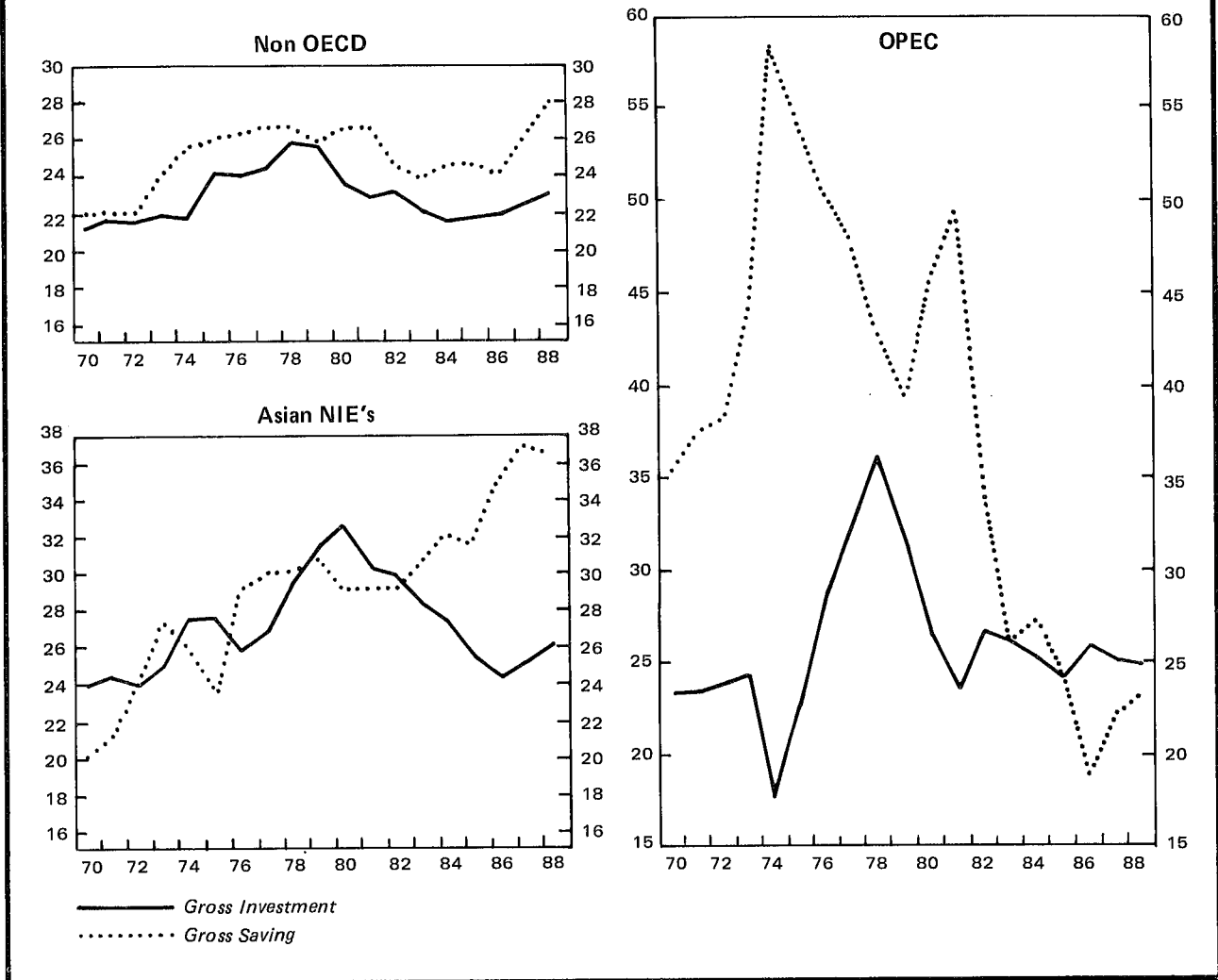


Figure 3
INVESTMENT AND SAVING RATIOS
(percentage of GNP)



orders of magnitude are, of course, unrealistic, yet they clearly illustrate the ambiguity of the concept of "need" in the present situation.

Finally, there are indeed important reasons to expect additional claims on national and international financial resources in a number of other regions. These include: in the United States of America - investment in infrastructure; in Japan - public investment projects (SDI); the reconstruction of the Gulf region; and additional international lending to low-income countries in Africa and Asia. While estimates of these claims are rather soft, it is not difficult to envisage additional financial demands in the range of US\$50 to 100 billion annually. They would thus be the same as or of an even larger order of magnitude than the needs considered in this paper.

Figure 4
SAVING MINUS INVESTMENT
(percentage of GDP)

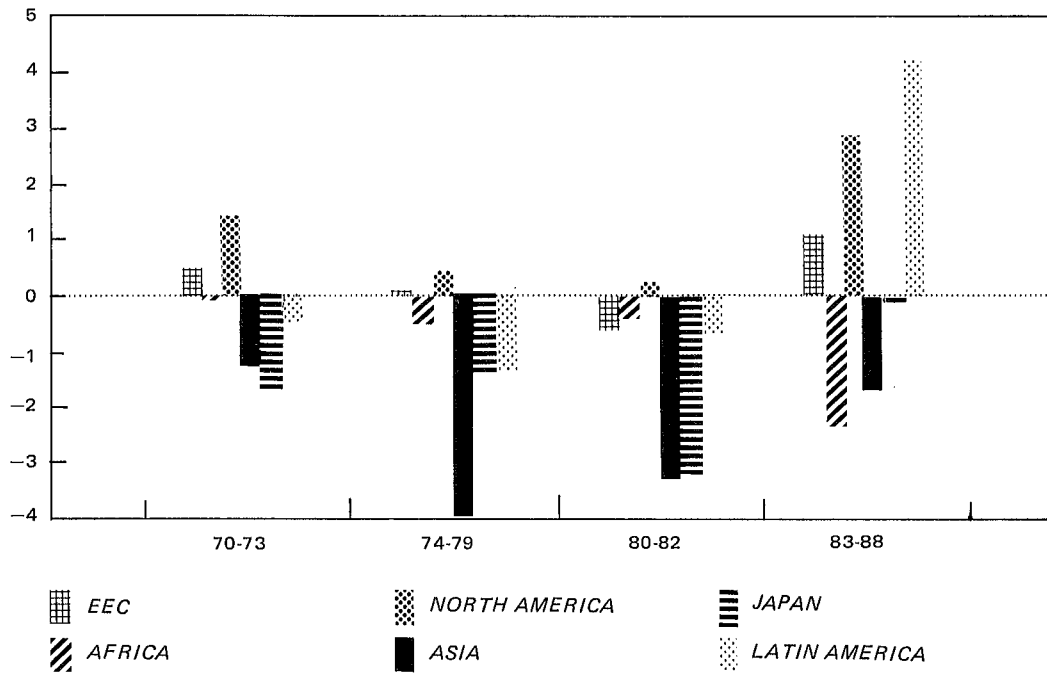


Figure 5
CURRENT ACCOUNT IMBALANCES : G-7 COUNTRIES

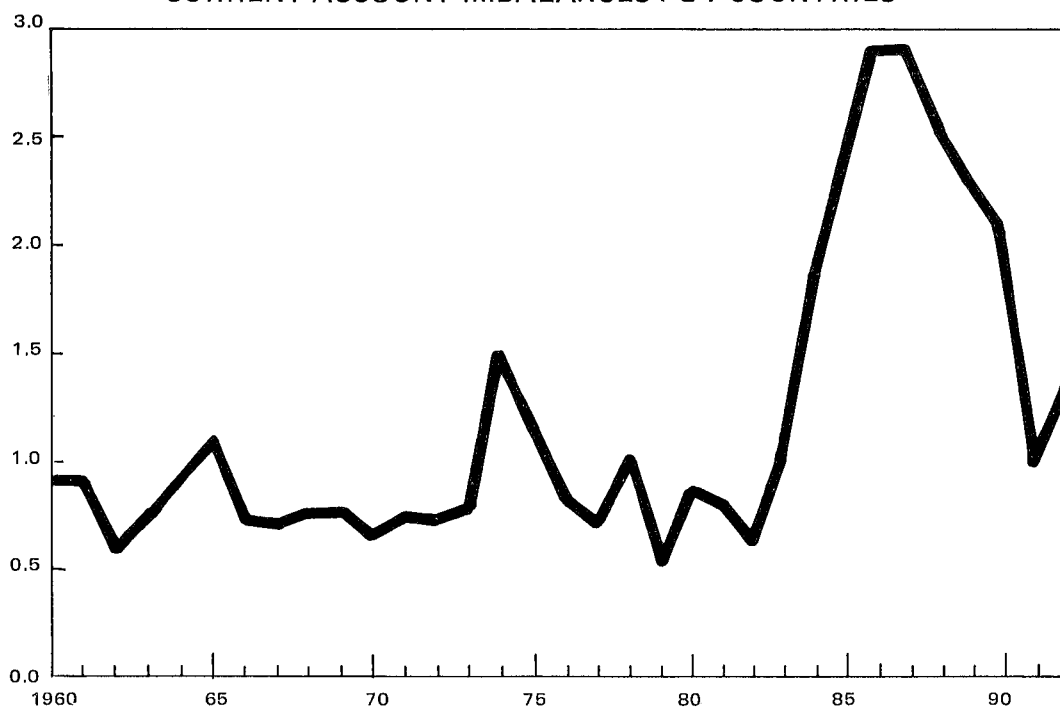


Table 1

GLOBAL SAVINGS, INVESTMENT AND GOVERNMENT DEBT FOR 1989

(In billions of US dollars)

	<i>Private savings</i>	<i>Private investment</i>	<i>Government deficit</i>	<i>Current account position</i>
United States	835	796	150	-111
Japan	989	917	15	57
Federal Republic of Germany	319	255	11	53
Other OECD	1,268	1,172	180	-83
Developing countries	783	691	104	-12
World total	4,194	3,831	459	-96

Source: International Monetary Fund, adapted from Masson and Meredith (1990).

II. The global macroeconomics of financial transfers

The analysis will now turn to an evaluation of the global macroeconomic effects of public bond-financed financial transfers; the discussion will focus on the example of transfers to Central and Eastern Europe and the CIS, emphasizing, in particular, the international macroeconomics of the issue under discussion. The specific micro-implications of the adjustment processes in Eastern Europe, will not be dealt with here except to point out that all results are generated under the implicit assumption of gradual successful continuation of the process of marketization.⁴ There are, of course, substantial uncertainties associated with an assessment of future developments in Central and Eastern Europe and the CIS, and the effects on these countries of Western support policies. While the process of reform has been rapid in Poland and Hungary, and is beginning to take hold in Czechoslovakia, the process of adjustment is only now beginning in Bulgaria and Romania. In the Russian Federation and some of the other States of the CIS, reform programmes have been implemented vigorously since early 1991, yet general support for these policies appears to be building only slowly. The speed at which the formation of markets proceeds, or the effects of marketization on economic activities, can hardly be analysed fully in a traditional macroeconomic framework. The subsequent empirical results, therefore, incorporate extraneous adjustments at various levels, representing the best current assumptions available.

On a global scale, the international economic implications of Western financial support depend upon a number of critical features, such as: (a) the size of the transfer, from a global perspective; (b) the order of magnitude of the supply and demand side effects of these transfers in the recipient countries; (c) the distribution of increased demand in the recipient countries across exporting countries in various regions of the world; (d) the interest elasticities of saving and investment in the donor countries and the resulting effects on world real interest rates; (e) the extent of adjustments in concessional lending from international agencies to other countries in need of support; (f) the formation of expectations on inflation and exchange rates in industrial countries; (g) the role of accommodating monetary and fiscal policies in industrial countries; (h) the medium-

⁴ In an important sense, the scenarios presented in this paper represent "best case" assumptions: they all ignore the possibility of failure of the economic reforms in Eastern Europe and the CIS, and also abstract from any politically motivated changes in the environment.

term dynamics of market shares on internationally competitive goods markets.

A simplified analysis of the important interactions on global goods and financial markets is annexed. The model incorporates most of the channels listed in the previous paragraph. Not surprisingly, the net effects on world and regional economic activity, inflation, and trade remain ambiguous, since they depend upon the relative size of growth and trade effects vis-à-vis the potential crowding-out effects of real interest rate changes. The latter, in turn, are determined by the interest elasticities of saving and investment and by behavioural changes in the private and public sectors. The subsequent discussion will focus primarily on the likely dynamics of internal adjustments to external shocks in the recipient countries, in Western industrialized countries, and in developing countries.

A. The dynamics of transfers to the East

It is generally recognized that, above and beyond the fundamental structural changes expected to be implemented in all the countries in transition to a market-oriented economic system, substantial technical assistance, conceptual advice, and financial support from developed market economies in the West will be required. The analogy with the European Economic Recovery Program, designed to rebuild the economies of Western Europe, after the Second World war comes to mind. Just as the Marshall Plan provided seed investment funds during that period, a concerted Western financial aid programmes for the countries of Eastern Europe might be a necessary component of a successful transition strategy at the present time. Western assistance programmes will, of course, be only one piece in the puzzle. Within the economies of the countries of Eastern Europe, the institutional, monetary and currency systems will have to be adjusted, marketization and privatization efforts continued, and the integration of these countries into the institutions of the international economic community will have to be intensified.

Where will these funds come from? Some corporations will be, and have already been, attracted to the new market potential of Eastern Europe. These investments can be only moderately helpful, however, particularly since they may be expected to be modest in size during the early adjustment period. Political uncertainty during the transition to a decentralized economy will continue to deter large investors. Corporate funds cannot overcome the burden of a weak infrastructure and a decaying industrial plant, and can hardly generate international competitiveness. Questions about ownership rights, the possibilities of profit repatriation, and currency convertibility still remain, and the scope of barter trade will always be rather limited. Indeed, recent experiences with large international commercial or institutional lending have been quite disappointing. Moreover, the current high level of global interest rates virtually precludes the countries in question gaining access to private funds. The only viable alternative, then, is for a consortium of major industrial countries, through institutions such as the IMF and EBRD, to provide grants, aid, and soft loans to Eastern Europe.

For the relevant near horizon this focus on the role of public monies is crucial to an understanding of the process. In the short run, initial investments are likely to be financed by foreign (and international) public monies, while in the medium term, the ensuing current account deficits will be financed through private net capital inflows as the increased prospects of positive returns attract private capital to exploit profit opportunities. With the exception of the German case, it is essential to examine specifically the catalytic nature of initial public flows. Incidentally, these sources are also the only ones that, at least potentially, carry the conditionalities that may be required to secure additional funds for a group of countries which are already heavily indebted.

What private sector reactions should be expected over the short- to medium-term? It is probably simpler to represent expected future private sector behaviour both in the East and the West as responses to an increase in the expected rate of return on capital. The basic notion underlying this argument is that the return on capital in Eastern Europe has historically been compressed by an ineffective system of incentives and resource allocation mechanisms. The current economic reforms consist of replacing, at different speeds and with important nuances in the actual implementation, this framework by a more efficient organization. As a result, system productivity is expected to increase, and with it the rate of return on capital.

The increase in the expected rate of return on capital is likely to raise investment and there-

fore domestic demand. In the short- to medium-term, this effect of increased demand will dominate the effects of increased supply resulting from productivity gains; consequently, the countries will generate current account deficits and continue to build up net external debt. In the long-run, the supply effects are expected to dominate the demand effects. Indeed, it is the defining characteristic of the "long-run" that increased productivity generates sufficient supplies to satisfy the demands triggered by higher investments. At this stage, the countries will increase their net exports, begin debt repayments to the lenders and resume a steady growth path. Incidentally, the transition problems for the "Länder" in the eastern part of Germany are scarcely different from the other countries. There are two major differences: the sources of financial transfers consist almost entirely of German funds, and the increased demand for goods and services will, for the most part, be satisfied by German production. Other countries will normally benefit indirectly.

B. Adjustment dynamics in the West

The expected repercussions on industrialized countries largely reflect the developments in Eastern Europe, constituting simply a mirror image. The initial seed financing for Eastern Europe's development will generate an incremental deficit in the public sector, and possibly exert upward pressures on interest rates. In the medium-term, increased demands by Eastern Europe for Western products will, through standard trade multipliers, lead to an increase in net exports. The positive demand stimulus should generate further upward pressures on interest rates, and cause Western currency rates to appreciate.

The effects on interest rates and exchange rates could, of course, be mitigated by an expansionary monetary policy. Accommodating the increased demand resulting from an increase in net exports would further fuel inflationary tendencies. In addition, on the budget side, the question is to what degree would the increase in net exports be allowed to crowd out net budgetary expenditures; the resulting increase in interest rates may crowd out interest-sensitive components of demand. Recent experience indicates that most additional transfers have indeed been entirely bond-financed, and that only minor fiscal policy adjustments are being made.⁵

Finally, a crucial aspect in examining global effects of transfers is their distribution across developed market economies. The increase of demand from Eastern Europe will be distributed unevenly. Trade data for 1990 and 1991 strongly confirm this conclusion. The pattern is likely to apply to future demand shocks as well. For a first approximation, the present shares of East-West trade in total trade of various countries will be indicative of these distributional imbalances. Thus, in Europe exposure to a positive demand shock will be greater than for OECD countries elsewhere. Germany, and to a lesser extent Italy and France, remain the prime beneficiaries of any incremental demand.

C. Third country implications

Just as for industrialized countries outside Europe, the main concern for advanced developing countries and the NIEs, in the context of these adjustment processes, is related to the nature of the trade effects, and the extent to which their national money markets and/or the international financial markets to which they have access will be affected. The short-to medium-term trade spillovers are likely to be unambiguously positive, if small. At the same time, however, the non-OECD countries face potential financial crowding-out effects as well as real trade crowding out.

On the financial side, while a certain part of the adjustment in financial markets will no doubt be contained within Europe, the nature of integration of global capital markets will unavoidably affect interest rates and exchange rates elsewhere. This will potentially impinge negatively on investment behaviour in these countries. Debtor countries may experience higher debt

⁵ The notable exception is Germany, where an array of tax measures has been implemented to support the costs of unification. Nonetheless, the revenues amount at present to only 15 per cent of the incremental costs, while the remainder is raised on capital markets.

service burdens. The strains on European capital markets brought about by heavy public borrowing of German authorities has already imposed a premium on international lending rates. Of equal importance, as was argued earlier, will be potential constraints on the amounts available for concessional lending to developing countries without access to private international capital markets. While the order of magnitude of these cutbacks is likely to be small, relative to the size of the new allocations to the EE5 and the CIS, their impacts on individual developing countries could be significant.

On the trade side, the initial stimulus of an increase in world trade will be positive for all regions of the world. However, with an improved level of competitiveness in Eastern Europe, it is widely assumed that at least some amount of trade diversion might occur. This concern has been most voiced by the group of developing countries, as well as by some NIEs and semi-NIEs, anticipating competition from Eastern Europe on global markets. The empirical evidence is sparse, yet it does indicate some potential for trade diversion. For example, a comparison of the composition of trade of the EE5 and the CIS with 12 Western European economies is quite revealing (table 2).⁶ While under their present product mix, these countries would appear to be their own closest competitors, a number of developing countries offer similar product spectra in Europe and can thus be expected to be affected at least at the margin.

III. Empirical results

Some empirical estimates will be given of the orders of magnitude of the short- and medium-term effects on global economic activity, trade flows, prices, exchange rates and interest rates. The estimates are based on simulation exercises performed with the world econometric model system of Project LINK. The model is particularly well-suited to such an exercise, since it represents explicitly all the economies of Eastern Europe and the former Soviet Union, as part of a system representing more than 130 countries of the world, represented by 79 econometric models. The international transmission mechanisms are captured through by a multi-faceted approach, modeling merchandise and service trade flows, international price linkages, capital flows and exchange rates, so as to generate a consistent representation of the global economy.

A. Scenario design

Explicit assumptions have to be made about the sources of these transfers, which are grants and loans of about equal shares in the total amounts. Some private investment may, in the medium-term, be attracted to the new market potential of Eastern Europe, particularly the eastern part of Germany. In the short run, however, substantial official seed money will, no doubt, be necessary. The current high level of interest rates globally militates against most of the recipient countries gaining access to private institutional funds, including those from large international commercial banks. Therefore, it may be assumed that most transfers will be financed out of public-sector programmes and/or international multilateral facilities.

Obviously, considerable uncertainty is also attached to any estimate of the size of financial transfers likely to be mobilized in international capital markets and through official channels in support of restructuring efforts. In the subsequent analysis, a rather agnostic stance is taken. The aim is to provide a realistic estimate of the amount of funds likely to be available under present conditions, taking into account the situation discussed earlier in section I. Incidentally, for the year 1991, the order of magnitude of the package almost corresponds to actual transfers.

The base case scenario examines the international implications of a transfer package totalling about US\$300 billion over a period of five years, from 1991 to 1995; the effects are traced over an

⁶ The index is based on an analog to the Grubel-Lloyd index that measures the extent of intra-industry trade in total trade. Essentially, an index value of zero indicates no overlap in the product spectrum, while an index value of 100 would correspond to identical composition of exports from the two countries into the EC12 region.

**RANK OF EXPORTING COUNTRIES ACCORDING TO THE SIMILARITY OF THEIR SALES PATTERN
TO THAT OF THE EE5 AND CIS IN THE EEC, 1985-1987**

Rank	<u>Soviet Union</u> ^a		<u>Poland</u>		<u>Romania</u>		<u>Czechoslovakia</u>		<u>Hungary</u>		<u>Bulgaria</u>	
	Country	Index	Country	Index	Country	Index	Country	Index	Country	Index	Country	Index
1	Canada	38	Hungary	55	Hungary	52	Poland	54	Yugoslavia	57	Hungary	47
2	Czechoslovakia	37	Czechoslovakia	54	Poland	51	Hungary	52	Poland	55	Czechoslovakia	44
3	Sweden	36	Romania	51	Yugoslavia	49	Austria	51	Romania	52	Yugoslavia	42
4	Brazil	35	Yugoslavia	50	Italy	43	Italy	46	Czechoslovakia	52	Poland	42
5	South Africa	34	Austria	44	Czechoslovakia	41	Belgium/Lux.	45	Austria	47	Romania	40
6	Finland	32	Italy	43	Bulgaria	40	Bulgaria	44	Bulgaria	47	Venezuela	37
7	Chile	32	Bulgaria	42	Portugal	38	Yugoslavia	44	Italy	44	South Africa	35
8	Ghana	32	Brazil	42	Austria	35	Brazil	44	Denmark	39	Austria	35
9	Poland	31	Belgium/Lux.	40	China	35	Sweden	42	Switzerland	39	Italy	33
10	Côte d'Ivoire	31	Portugal	40	Thailand	34	France	42	Netherlands	37	Belgium/Lux.	32
11	France	31	Spain	39	Greece	34	Netherlands	41	Belgium/Lux.	37	Greece	32
12	Israel	31	France	39	Turkey	34	Romania	41	Turkey	36	Brazil	32
13	United Kingdom	30	Sweden	38	Republic of Korea	33	Switzerland	39	China	36	Other Europe	32
14	Belgium/Lux.	30	Republic of Korea	37	Belgium/Lux.	33	Norway	39	Greece	36	Colombia	31
15	Norway	29	Denmark	37	Tunisia	32	Spain	39	France	36	China	30
16	Spain	28	Norway	36	Spain	31	Denmark	38	Portugal	35	Switzerland	30
17	Netherlands	28	China	36	Taiwan	29	United Kingdom	37	Republic of Korea	34	France	30
18	Mexico	28	Netherlands	35	Denmark	29	Soviet Union	37	United Kingdom	33	Turkey	29
19	Australia	27	Finland	33	Brazil	29	Finland	36	Israel	33	Algeria	29
20	Venezuela	27	Taiwan	33	France	28	GDR	35	Spain	32	Denmark	28

Source: Calculations of the DIW based on OECD foreign trade data; see text for methodology.

^a Since 24 December 1991, the name Russian Federation replaces the name Union of Soviet Socialist Republics or Soviet Union.

additional three years beyond that period (for a detailed description of the set-up, see Pauly (1990, 1991)). It is assumed that the amount is almost evenly spread over the five-year period of the programme. The total package amounts to more than twice that of the Marshall-Plan in today's prices. About two-thirds of these transfers are accounted for by intra-German transfers, i.e. support for the "Länder" of Eastern Germany amounts to about US\$200 billion over this period. The remaining US\$100 billion are split as follows: Bulgaria US\$5 billion, Czechoslovakia US\$10 billion, Hungary US\$15 billion, Poland US\$25 billion, Romania US\$5 billion, and the CIS US\$40 billion. One way to interpret the size of these transfers is to note that the total (excluding the intra-German payments) amounts to about six times the current allocation of the EBRD. On the other hand, the amounts assumed to flow into the Russian Federation are smaller in the model than those that have actually been made and/or are currently being discussed. In general, the reality will probably surpass the assumptions made in this paper by a large margin. Nonetheless, the results discussed here may also be indicative of the implications of the effects of larger flows. While funds for the EE5 and the CIS are assumed to be entirely from public sources, inflows into the eastern part of Germany are assumed to be generated in part by the private sector.⁷

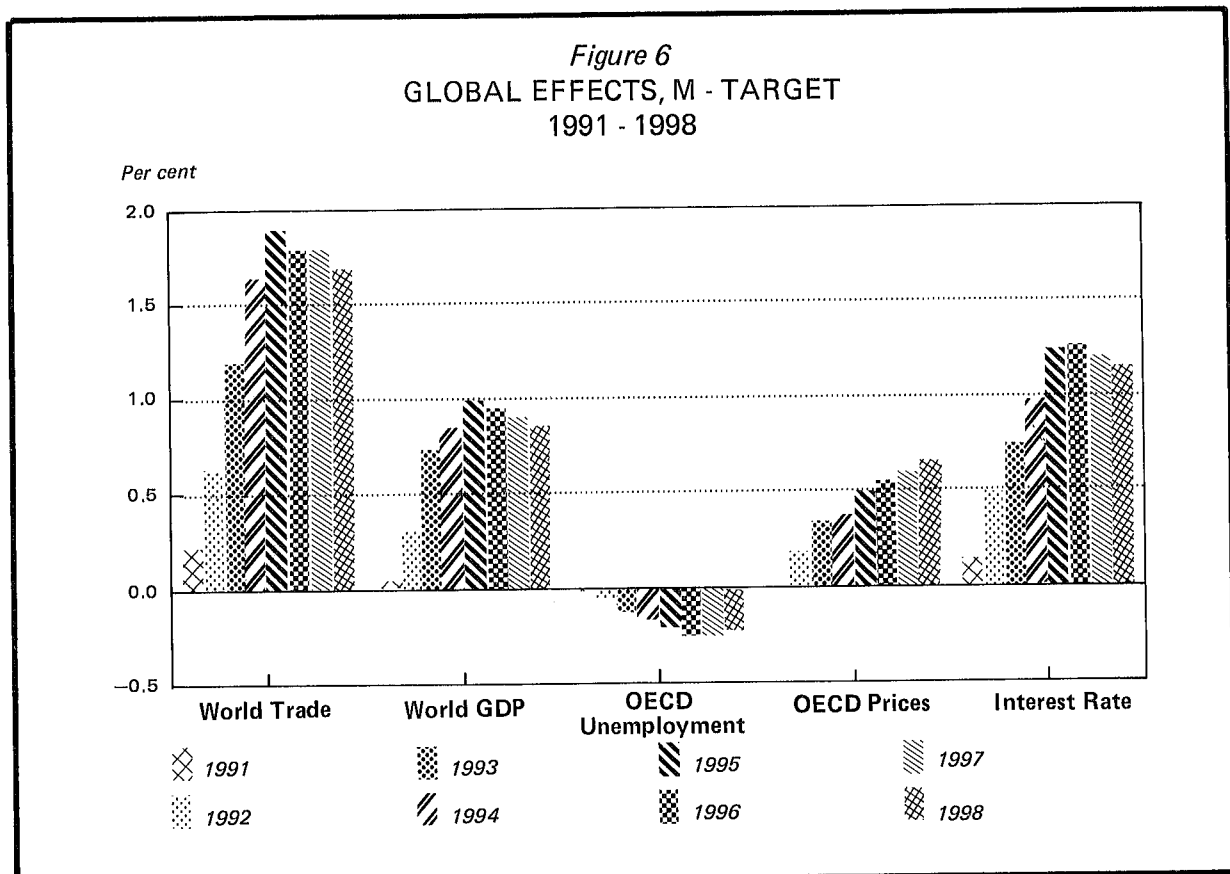
Regarding monetary policy, the base case assumes that monetary authorities in the OECD will follow policies aimed at stabilizing the paths of some appropriate monetary aggregates around baseline values. Note that it is assumed that the responses are the result of coordinated policy actions; they do not, however, constitute "optimal" policy responses in terms of a well-defined joint criterion function. In addition, in order to focus on the central issue of the paper, the following major supplementary assumptions are made: (a) Fiscal policies in all industrial countries (other than Germany) remain at baseline settings; particularly, no tax increases are implemented; (b) No allowance is made for a rescheduling of interest or principal payments for Eastern hard currency debts, or for any form of debt forgiveness; (c) In the recipient countries, the additional financial resources are used entirely to facilitate spending on fixed investment; (d) Except for the case of the eastern part of Germany, incremental imports are allocated completely to OECD and non-OECD exporters according to the pre-shock trade shares; (e) For the eastern part of Germany, three-quarters of the incremental imports are allocated to the West; the remainder is allocated according to pre-shock non-German shares; (f) No adjustments are made for third-country exports into recipient countries' export markets; (g) Official capital flows into third countries, in particular developing countries, remain at baseline levels.

B. Results

The results for the base case are summarized in figures 6 to 10, presented as deviations from the current baseline forecast. The monetary policy assumption underlying this scenario would imply that some of the global demand stimulus of the financial transfer is being accommodated, resulting in a moderate increase in nominal interest rates (G-7 GNP-weighted average) of a little more than 100 basis points. The implied monetary tightening would, for the OECD as a whole, generate virtually no GNP losses, since the trade stimulus from Eastern Europe would be quite substantial. The distribution of the Western activity effects remains, however, uneven. While for the EC the trade effects dominate, in North America the monetary tightening would not be accompanied by sufficiently large trade effects to avoid some GNP losses. For the other areas, the slightly higher interest rates would almost exactly offset the positive trade stimulus and keep levels of economic activity just about at baseline levels. Such a scenario would, therefore, trade off desired increases in economic activity in Eastern Europe and the Russian Federation against a trade balance shift in favour of the OECD. In other words, it would involve classical external debt financing of initial development in the region, without noticeable negative effects on activity elsewhere, since the response of *ex ante* real interest rates never exceeds the range of 50 to 70 basis points.

The GNP effects for the recipient countries would reach about 5 per cent after five years. This seems small relative to the effects of the Marshall Plan, after making proper adjustments for the size of the stimulus. However, the economic environment in which the aid can be effective is quite different in the present case. The post-war economies had state-of-the-art technologies, con-

⁷ While the support for the EE5 and the CIS is modelled as a multilateral effort, transfers into Eastern Germany are assumed to originate almost entirely within the country.



vertible currencies and, free-enterprise systems in place, along with a reservoir of entrepreneurially inclined individuals and a broad base of well-qualified skilled workers. Many of these components are still not in place in Eastern Europe.

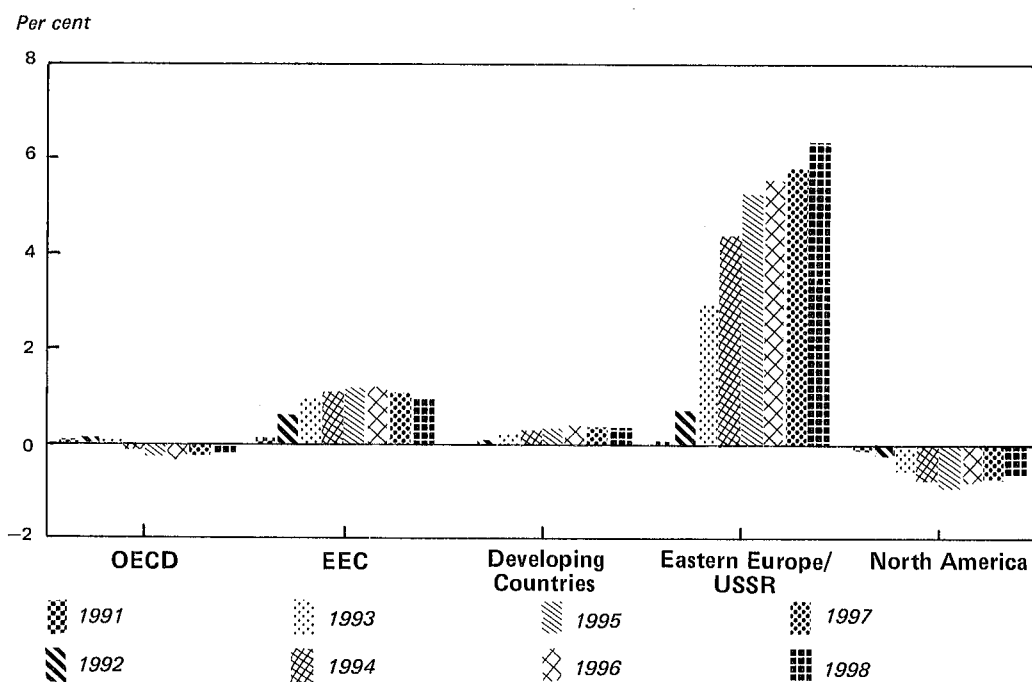
Furthermore, a large fraction of the transfer would not immediately lead to domestic production activity, but would leak into imports. While the shock as implemented corresponds to a classic supply-side policy by restricting the use of funds to investment purposes, the capacity effects of such investments are usually relatively slow to materialize. The trade-balance effects are indicative of this: the recipient countries would accumulate an incremental net foreign debt of more than US\$90 billion, almost the equivalent of the initial transfer. While some trade balance benefits would accrue to developing countries, most of the counterpart to the deficit of Eastern Europe would appear in the OECD and, most significantly, in the EEC.

C. Effects on developing countries

The details of the effects of these transfer policies on economic activity in various regions of the developing world are summarized in figures 9 and 10; the former reports regional aggregates, while the latter shows aggregates according to functional characteristics of the economies in question.

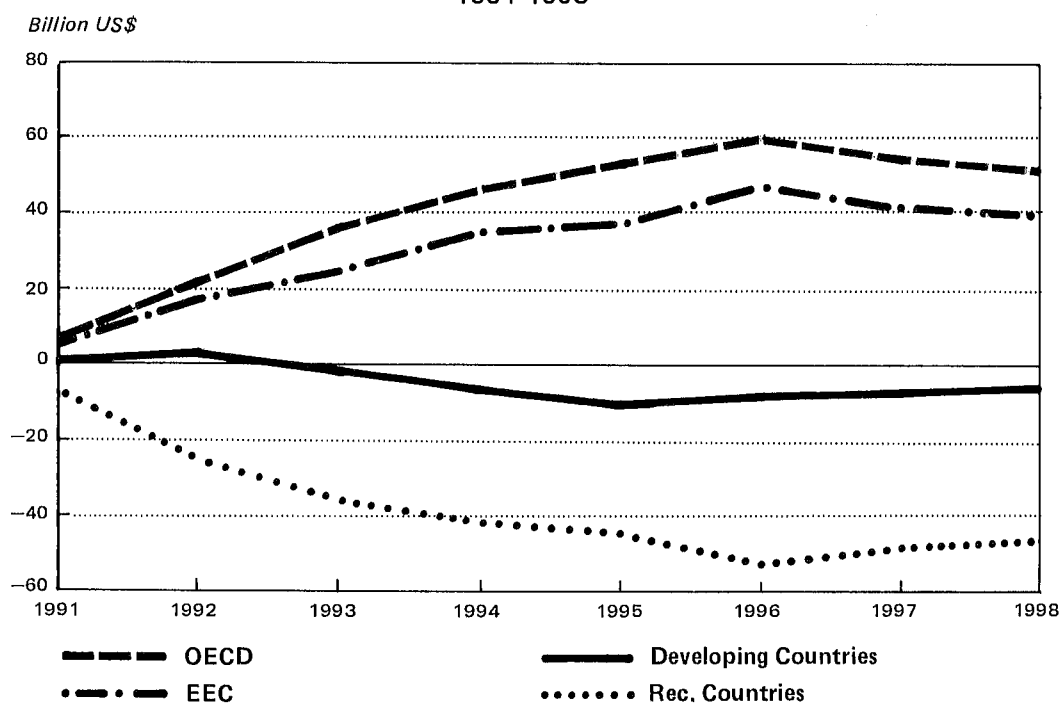
The base case implies, as discussed earlier, slightly positive net effects on developing countries as a whole. Yet, not unexpectedly, there are significant differences across regions. Most importantly, these differences reflect variations in the degree of exposure to the strength (and composition) of the world demand shock initiated by the original transfer. In addition, they indicate the severity of exposure to the tightening of world financial conditions, i.e. the original level of indebtedness.

Figure 7
REGIONAL EFFECTS, M - TARGET
1991 - 1998



Source : Project LINK

Figure 8
TRADE EFFECTS, M - TARGET
1991-1998



Source: Project LINK

Figure 9
DEVELOPING COUNTRIES, GDP
1991-1998

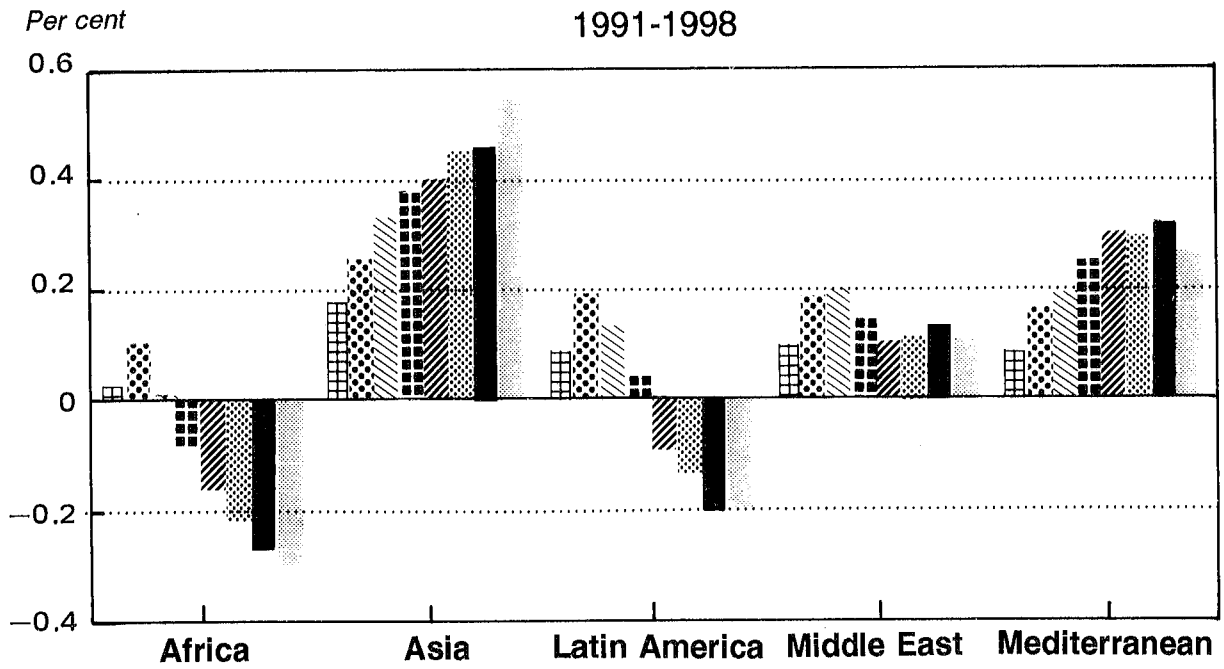
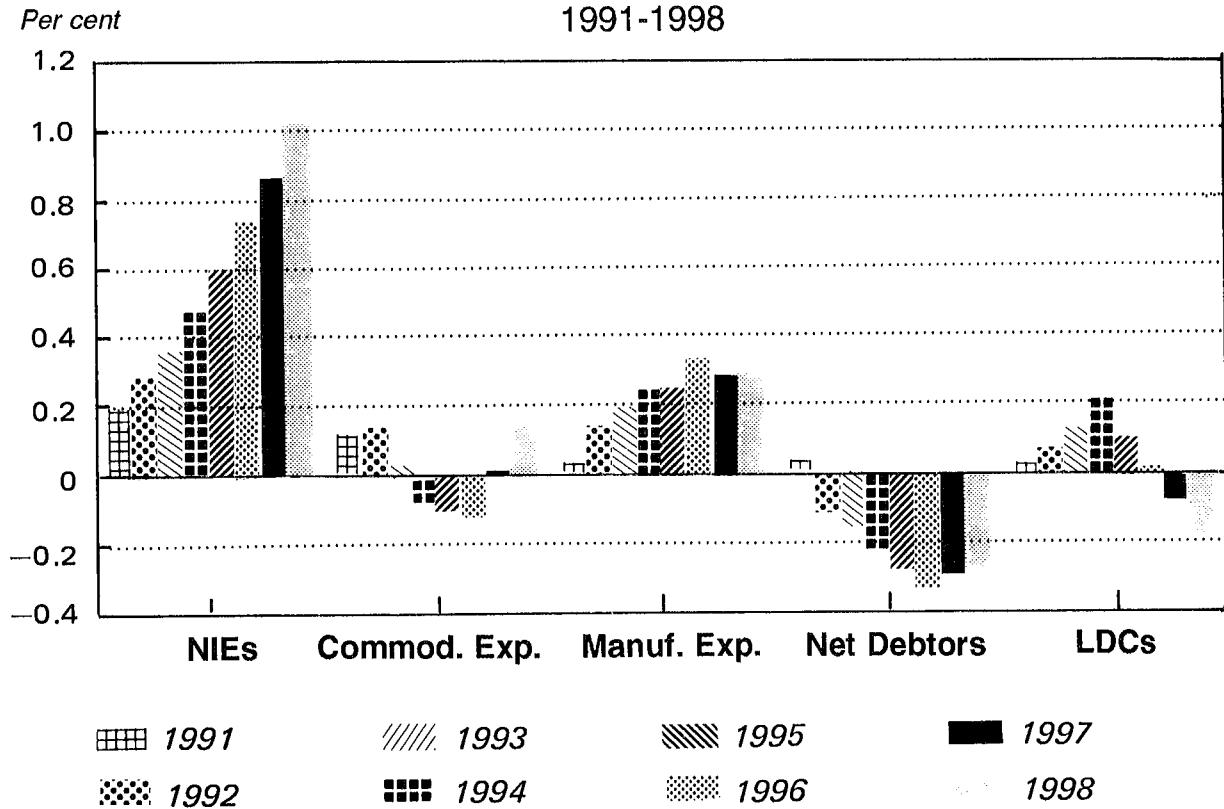


Figure 10
DEVELOPING COUNTRIES, GDP
1991-1998



1991	1993	1995	1997
1992	1994	1996	1998

The strongest net positive effects can be expected in Asia, mostly as a result of positive trade stimuli to the manufactured goods exporters in the region, in particular the East Asian NIEs. To a somewhat smaller extent, the Mediterranean countries and the countries of the Middle East would benefit from the increase in global economic activity. In these cases, the effects would be mostly indirect, via the stimulus to Western European economic activity. While in the short-run, there are slight positive spillovers into Africa and Latin America also expected, in the long-run the net gains turn unambiguously negative. Above all, this reflects the increased debt service burden on the part of net debtor countries in these regions. That fact becomes even more obvious when the group of net debtors is examined in isolation, as in figure 10. Furthermore, the functional disaggregation also indicates that the burden of adjustment, primarily in terms of losses in trade shares and of reductions in net capital inflows, falls on primary commodity exporting developing countries and, in a focus on the current development status, on the 20 least developed countries.

As indicated in the previous section, the present simulation models make no allowance for a further tightening of quantitative allocations of concessionary loans to least developed countries. The order of magnitude of such constraints is difficult to assess. Additional calculations with the LINK system indicate, however, that even a small reduction of these flows, by say 10 per cent, can contribute to a doubling of the GNP loss on the part of the group of least developed countries. It will thus be crucially important to shape any transfer schemes in such a way that present commitments to least developed countries, particularly in sub-Saharan Africa, are maintained.

IV. Sensitivity analyses

A. *Alternative monetary policies*

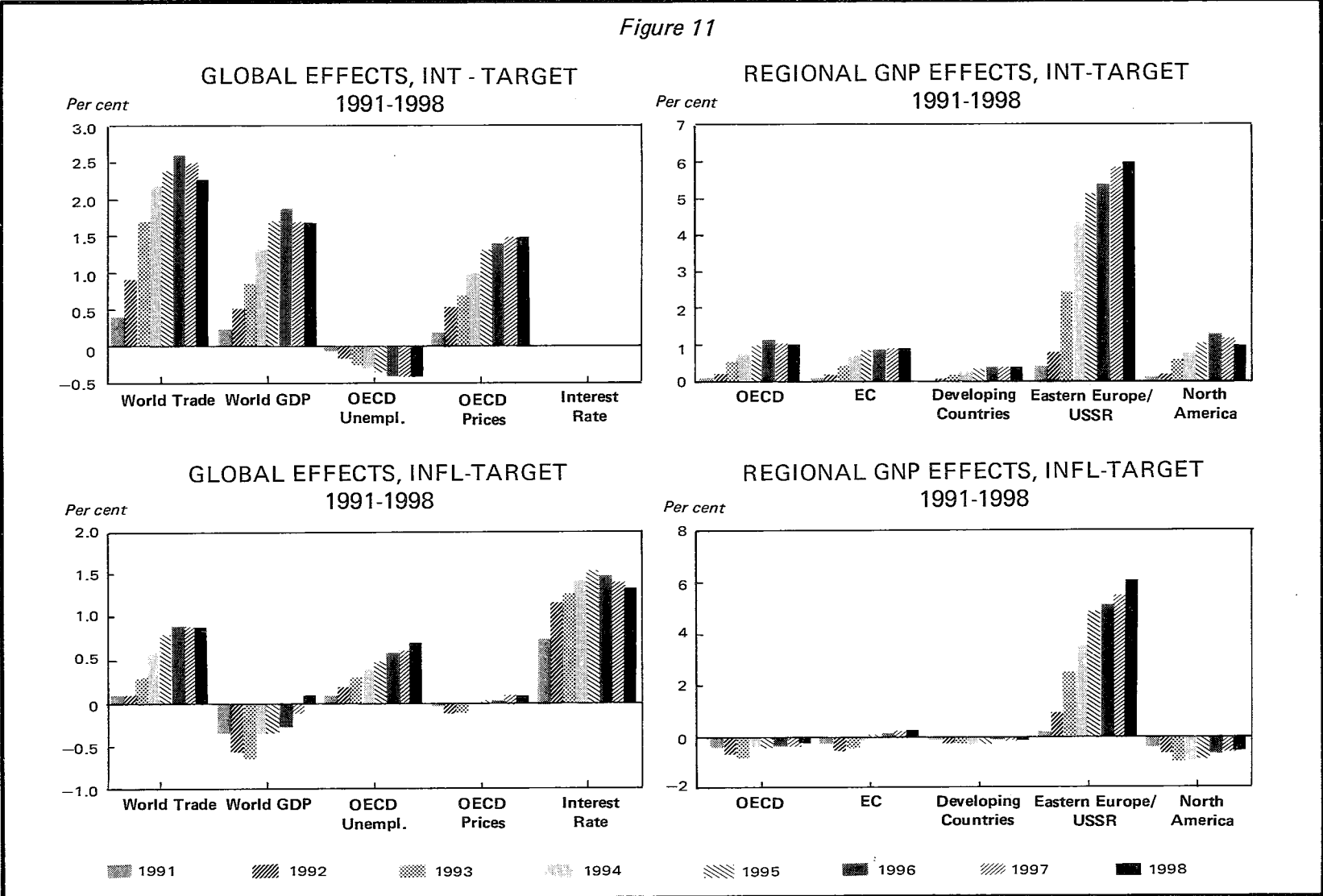
In order to evaluate the sensitivity of the results to the nature of accommodating monetary policies, the transfer scenarios have been performed under two alternative assumptions regarding the response of monetary authorities in the West (see summary of results in figure 11):

- The first set of results is based on the assumption that monetary authorities monetize the ensuing public deficits and stabilize nominal interest rates at baseline levels;
- At the opposite end of the spectrum of possible responses, a monetary policy aimed at stabilizing inflation is implemented, thus allowing for a significant increase in interest rates worldwide, in response to the additional withdrawal of financial resources from Western capital markets.

The detailed results for these alternatives have been reported (in Pauly (1990, 1991)). In the absence of noticeable interest rate effects, financial transfers into Eastern Europe and the Russian Federation would, of course, generate unambiguously favourable effects for all parts of the world, thus reflecting simply the positive transfer. Increased purchasing power in the countries of Eastern Europe would lead to an export demand stimulus for developed market economies as well as all developing countries, reflected in increased world trade and larger GNP effects than in the base case. Unemployment rates would be slightly lower, while the inflationary impact would be markedly higher than in the base case. The GNP gains would be concentrated in Western Europe, mostly in Germany, although the trade multipliers generate positive spillovers everywhere.

The results would, of course, be quite different if a sharp rise in world interest rates occurred as a result of activist monetary policies in the face of additional claims on world financial resources. The growth effect in Eastern Europe would be virtually the same, but the stimulus to Western and Southern economic activity would be completely negated; in fact, for developing countries, the net effect would likely be unambiguously negative. The negative effects of interest rate increases would dominate, and most economies would experience a net loss in economic activity. Despite the larger trade multiplier, this is the case even for the EEC, since for the European region, the interest rate effect is at the same time larger than elsewhere. The trade effects are somewhat smaller than in the earlier scenario. Obviously, then, if the risk of imposing additional

Figure 11



Source: Project LINK

strains on world financial markets really is deemed non-trivial or if a tight monetary policy response is considered likely, a policy of providing substantial financial aid to Eastern Europe may indeed entail the possibility of real losses for the OECD countries.

A tentative conclusion based on the empirical results is that fears of significant real interest rate effects, and corresponding negative impulses to real economic activity in donor countries, as a result of incremental claims on public funds over the next few years, may be somewhat exaggerated. For transfers in the order of magnitude of around US\$50 to 60 billion annually, as has been assumed in this analysis, there exists a wide range of accompanying non-inflationary monetary strategies which limit the real interest rate effects to a range of between 50 and 70 basis points, with relatively benign effects on industrial countries' economic activity. In fact, for most countries, the gains from the implied trade stimulus dominate unambiguously.

In some sense, the results should not be too surprising. After all, total world savings in current dollars are about US\$4,000 billion (see Masson and Meredith (1990), table 2). Hence, an incremental programme of the order of magnitude considered here amounts, at best, to an initial excess demand for world savings of about 1.5 per cent. Under worst case assumptions, involving neither compensating fiscal measures to increase public savings (such as the German tax increase) nor changes in private sector spending behaviour, the issue is whether real interest rate increases in the range of between 50 and 70 basis points appear reasonable. Compared with average baseline real rates of around 4 percentage points, that would represent an increase of around 8 per cent. Therefore, on a G-7 scale, an elasticity of real interest rates with respect to the excess demand for savings would be on the order of five.

B. Private and public savings rates

The size of the programme simulated here clearly underestimates the need, and probably understates the actual flows over the next few years by as much as US\$100 billion, given current claims and recent proposals in particular for the CIS. However, apart from possible adjustments in private saving behaviour in the industrialized countries, there exists the possibility of major increases in public sector savings in the recipient countries, mostly as a result of reductions in military expenditures. The order of magnitude of a Western "Peace Dividend" clearly exceeds the needs considered in the present context.

Most importantly, however, the results discussed here may also under-represent the extent of private sector adjustments. The offset, in terms of private sector saving in the present set of scenarios, is relatively small, amounting to less than 20 per cent of the public sector stimulus. While the empirical evidence on the extent of Ricardian equivalence remains sketchy, the possibility of a more significant adjustment cannot be ignored. In fact, given the magnitudes entertained here, it would take only a small further adjustment in private sector behaviour to virtually eliminate the initial excess demands. For example, preliminary LINK scenario analyses indicate that an increase of private savings rates in Germany of less than 2 percentage points, combined with an increase in the United States private savings rate of less than 1 percentage point would virtually eliminate the strain on monetary sectors. At current levels of GNP, that would generate sufficient funds to support the present package. Under such conditions, the nominal interest rate implications of a public transfer would be negligible. The crowding out revealed in the base case scenario presented above would disappear and the trade multipliers would be positive for all countries, including the developing world. Further work will be necessary to examine these issues in more detail.

V. Should the West lend to the East?

Much of the argument in favour of Western financial support of the process of transition rests, as in this paper, on the proposition that foreign finance may act as a spur to growth much as it is thought to have contributed to developing countries' progress. In addition, the concern about financial crowding out is, among other reasons, fueled by the observation that both the economies in transition in Eastern Europe and developing economies seek to remedy their shortages of indigenous physical capital with imports from industrialized countries, to the extent that external finance is available.⁸ While having argued earlier that Western financial support, for balance of payments purposes as well as to stimulate domestic investment, must accompany the provision of technical assistance and institutional support, this recommendation is nonetheless subject to some caveats.

In the developing countries, during the past two decades, growth was generally lower in countries that borrowed than in those which did not, largely as a result of the interest rate shocks which the high debtors suffered in the 1980s. Even in earlier years, however, borrowers' growth rates were only marginally higher than those of non-borrowers. While the transfers played, of course, an important role in increasing per capita incomes in the recipient countries, it is less likely that access to foreign capital acted as a spur to economic growth. This is quite in line with traditional growth theory, and the channels through which capital imports generate endogenous growth have not yet been fully explored. In addition, both general and specifically earmarked lending are highly prone to leakage, and similar problems are already apparent in both Eastern Europe and the CIS. However, access to Western technical assistance and institutional know-how may indeed generate important endogenous growth of total factor productivity in the recipient countries.

Concern has been raised over the solvency and the existing debt burden of some of the potential recipient countries. Hungary, Poland, the smaller EE5 countries and the CIS all have growth-adjusted per capita debts broadly comparable to the large Latin American debtors. Even though some of them have not yet rescheduled their debt, and are still viewed as bearable risks, the international financial system would likely trade those debts at substantial discounts. In the case of Poland, the international lender community has indeed already granted a proportionally much larger debt write-off than for any other debtor. Thus, the issue is not only whether the West should embark on a new round of lending to the East, but also how it should treat the existing Eastern European (and CIS) debt, in particular in relation to the past treatment accorded debtors in the Third World.

Finally, differences in developing countries' economic growth have largely been the result of differences in their rates of domestic saving. Recent results suggest that the medium-term return on an investment of 1 per cent of GDP has been in the range of 0.1 to 0.15 per cent in annual average growth rates. In relation to these figures, foreign lending has had only negligible effects. The EE5 and the CIS should make every attempt to utilize their private and public sector saving potential. As a result, in the medium-term they may be able to limit their use of external debt to smoothing the cycles resulting from fluctuations in the terms of trade. The CIS, in particular, could tap into a large potential of domestic saving by way of reducing government spending in non-civilian programs. In the short-run, however, given the existing institutional rigidities, Western public financial support appears to be indispensable to jump-start the process of transformation.

⁸ They do, of course, differ markedly in other respects; private agents in developing countries have considerable practice of operating in a market environment, while, on the other hand, Eastern European countries have better endowments of human capital than most Third World countries.

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Annex

The global macroeconomics of financial transfers can best be illustrated within the context of a simple multi-region AD-AS framework.¹ For purposes of our analysis, we define three regions: a (current account) surplus region, roughly thought to represent the OECD region (developed market economies); a non-OECD region, assumed to be a net capital importer; and the recipient region consisting of the economies in transition in Central and Eastern Europe and the CIS. For simplicity, we shall assume that all funds are provided by those industrial countries which are in surplus; we thus also ignore the complications inherent in the existence of substantial deficit areas within the West, most notably in North America.² Figure A.1 analyses regional price and activity reactions. A conditionalized transfer into the recipient region provides a stimulus to demand and, in the medium-term, through increases in the capital stock and improvements in total factor productivity, supply side effects as well. Equilibrium income is raised to Y' , and prices adjust to p' . At the same time, both the original donor region and third countries benefit from trade creation as a result of improved activity in recipient countries. The resulting demand shock shifts aggregate demand to D' , respectively, and will tend to increase prices and real activity. In industrial countries, this outward shift in aggregate demand will be counteracted by the crowding-out effect of higher real interest rates (shift to D''). In the non-OECD area, i.e. for developing countries, the primary stimulus is likely to be smaller, as present trade shares with the economies in transition are smaller. In addition, the secondary leftward shift of the AD curve is expected to be stronger than for the OECD region. This is so because it reflects not only real interest rate effects but also the loss of trade shares to producers in eastern Europe. For both the OECD and non-OECD countries, the ultimate effects on inflation and activity remain ambiguous and depend upon the relative size of trade effects vis-à-vis the crowding-out effect of real interest rate changes. As the graph indicates, the potential for negative spillovers in third countries is undeniable.

In a world of (nearly) integrated capital markets, the real interest rate will adjust so as to equilibrate regional saving-investment imbalances on a global scale: the current account constraint determines the interest rate. In figure A.2, saving and investment functions for the three regions are graphed. At the initial interest rate r , the current account surplus in the surplus region just offsets the corresponding deficit elsewhere; the current account in the recipient region is assumed to be in equilibrium initially. The incremental investment projects in the recipient region *ceteris paribus* generate an excess demand for funds which would raise interest rates to a new level at r' , at which rate the ensuing current account deficit in the recipient region is facilitated by an increased surplus (reduced deficit) in both other regions. Obviously, the outcome depends critically on saving and investment behaviour in the original surplus and deficit regions. Any autonomous increase in private or public sector saving, or reduction in investment, in either of these regions would allow world interest rates to remain at the original level or increase to a level below r' . The global real interest rate effects thus depend as much on the interest elasticity of saving and investment as on behavioural reactions in the private and public sectors.

¹ For a more detailed theoretical discussion of these issues in the context of a multi-region intertemporal Ramsey growth model, see Avesani, Gallo and Pauly (1991).

² The analysis could easily be extended to allow for part of the transfers to originate in industrial countries with current account deficits; the present simplification is adopted for purposes of illustration only. For a more detailed treatment of the policy conflict within industrial countries, see Avesani, Gallo and Pauly (1991).

Figure A.1
GLOBAL FINANCIAL TRANSFERS
QUANTITY AND PRICE EFFECTS

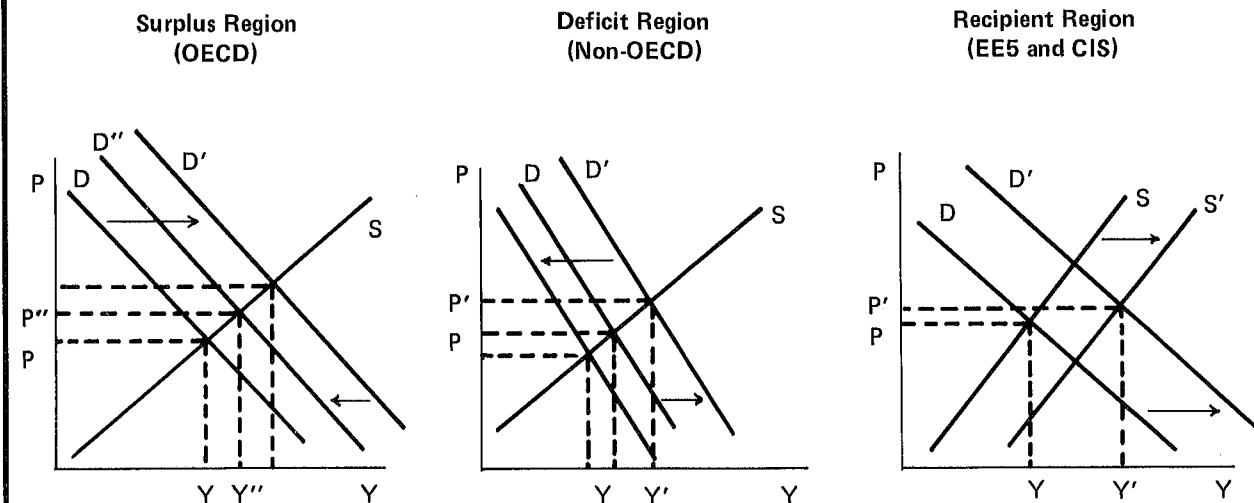
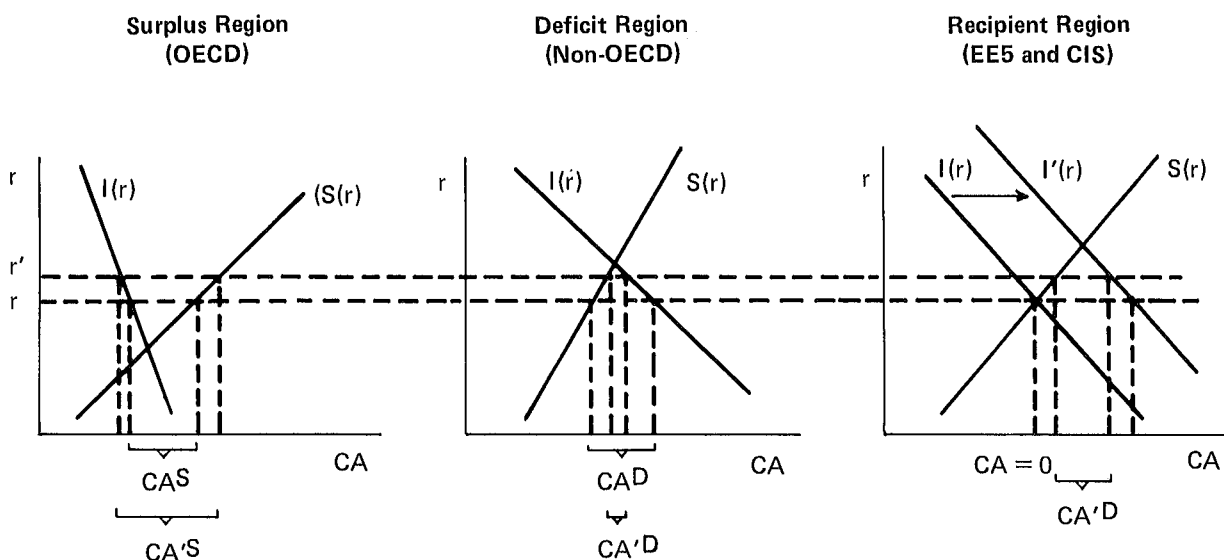


Figure A.2
REGIONAL S-I IMBALANCES AND THE WORLD REAL INTEREST RATE



SOME KEY GLOBAL ADJUSTMENT SCENARIOS AND THEIR EFFECTS ON MAJOR DEVELOPING COUNTRY REGIONS

David Vines and Chris Allen*

Executive Summary

This paper examines empirically some important medium-term adjustment issues facing the world economy. Alternative policy reactions to them are explored with concentration on their impact on three groups of developing economies. The global shocks relate to: recessionary pressures emanating from the United States, a global savings shortage emanating partly from the rebuilding of Eastern Europe, and a rise in the oil price. The groups of developing countries are (i) Latin America, (ii) the Asian NIEs (Republic of Korea, Taiwan Province of China, Singapore, and Hong Kong), and (iii) Africa. The focus of the paper is on the outcomes in these developing country blocs, although the results for the OECD economies are also discussed briefly.

1. Fiscal consolidation in the United States with money remaining "tight"

In this first exercise, the effect is examined of an attempt to bring about a reduction in the United States Government deficit by one per cent of GDP in the face of domestic financial fragility and in the shadow of substantial potential future demands on world capital markets. United States interest rates, therefore, hardly drop in face of the downturn in activity which ensues. A global Keynesian recession ensues with very damaging results for developing countries. The contraction in developing country output is between one and one and a half percentage points.

2. United States fiscal consolidation with "monetary loosening"

This shows the effect of the same United States deficit-reduction package, but in this case the Fed induces the reduction in interest rates which would naturally follow from such a fiscal consolidation in more normal circumstances. In this scenario any world recession will be only temporary, and lower interest rates will ultimately allow the reallocation of resources to other borrowers including developing countries. This would be positively, if mildly, beneficial for the third world. Third world exports become more competitive as the dollar falls. Fiscal policy can be relaxed in the net-debtor regions of Africa and Latin America, because lower world interest rates lighten the debt service burden. Interestingly, Latin America benefits the least because supply appears to be least flexible. In contrast to the previous simulation, developing country output in the long run actually rises by between one-third and two-thirds of a percentage point.

3. Additional demands on world savings

This scenario results primarily from the rebuilding of Eastern Europe. Money supplies are fixed in the rest of the world, which gives rise to large increases in interest rates, particularly in Germany, with consequential exchange rate strain. The results of this exercise are surprisingly beneficial for the third world, with the effects of increased world trade outweighing the effects of higher interest rates.

4. Additional demands on world savings with German monetary accommodation

The same "rebuilding process" is studied as in the previous simulation, but it is accompanied by monetary accommodation in Germany, so as to prevent German interest rates from rising. The consequence is a world boom and world inflationary pressure. This gives a strongly positive result for the third world, but in an environment of permanently higher world inflation. If the monetary authorities ultimately find the rise in inflation unacceptable - as is likely - then such a scenario will simply store up a future adjustment crunch.

* We are grateful to our colleagues who have developed the models used in the work reported here, in particular, T.G. Srinivasan, now at the IECAP Division, International Economics Department, the World Bank, and David Currie, of the London Business School.

5. *A rise in the price of oil of five dollars per barrel*

This hypothesis studies a permanent, sustained rise in the nominal oil price. It corresponds to what might happen if Middle Eastern and CIS supply remains constrained in the face of the present global recovery. This outcome is a bad one for LDCs, as it is for most industrialised countries: output falls by half to one percentage point across all three regions. The smallness of these numbers is highly dependent on the assumption that OPEC absorption rises rapidly and almost completely in response to increased oil revenues.

Introduction

This paper examines empirically some important medium-term adjustment issues facing the world economy. Alternative policy responses to them in the major industrial countries (the "North") are examined and the likely impact on the developing economies (the "South") is described. The main issues investigated are: recessionary pressures emanating from budgetary consolidation and from credit fragility or a liquidity trap in the United States, a global savings shortage emanating (mainly) from the rebuilding of Eastern Europe, and a rise in the oil price. All of these shocks relate to issues of current concern. Their impact is examined in detail on three groups of developing countries: (i) Latin America, (ii) the Asian NIEs (Republic of Korea, Taiwan Province of China, Singapore and Hong Kong) and (iii) non-OPEC Africa.

A. *The scenarios*

Five scenarios are examined, as follows:

1. *United States fiscal consolidation with money remaining "tight"*

The effect of a successful attempt to bring about a reduction in the United States Government deficit through a cut in government spending is portrayed in this scenario. It is assumed, in the baseline case, that this is done in the face of domestic financial fragility and in the shadow of substantial future demands on world capital markets. Specifically examined are the implications of a situation in which nominal United States interest rates hardly fall in the face of the downturn in activity which ensues. This is assumed to be caused either by a "flight into quality" or a tightening of credit availability by embattled United States financial institutions, or else by the stickiness of long-term interest rates in the face of expected future demands on world savings.

2. *United States fiscal consolidation with "monetary loosening"*

This scenario shows the effect of the same United States deficit-reduction package, but the Fed has been able to induce the reduction in interest rates which would naturally follow from such a fiscal consolidation in more normal circumstances.

3. *Additional demands on world savings*

This scenario examines the direct effects of the realization of additional demands on world capital markets, resulting primarily from the rebuilding of Eastern Europe and the CIS. For comparison, the parameters of this shock are taken precisely from a similar experiment carried out for the IMF's World Economic Outlook in October 1991.¹ Money targeting by the principal monetary authorities reduces inflationary pressures, but gives rise to large increases in interest rates, particularly in Germany, with consequent exchange rate strain. The results are similar to those obtained by the IMF, which is perhaps reassuring, and it is possible to present them in much more detail.²

¹ IMF (1991) *World Economic Outlook*.

² They are rather larger than those of Pauly (*Transfers, Real Interest Rates and Regional Development: International Economic Implications of Financial Supports for the Economies in Transition*, Studies for the Group of Twenty-Four (1992)) because of differences in their timing and because of the larger size assumed of the stock.

4. *Additional demands on world savings with German monetary accommodation*

The same "rebuilding process" as in the previous simulation is scrutinized, but it is presumed to be accompanied by monetary accommodation in Germany, so as to prevent German interest rates from rising. The consequence is a world boom and world inflationary pressure. This is a possibility which the IMF did not address, perhaps for understandable reasons.

5. *A rise in the price of oil of five dollars per barrel*

This scenario supposes a permanent sustained rise in the nominal oil price. It is postulated because it corresponds to what might happen if there were a resumption in steady moderate growth throughout the world after the present global downturn, in an environment in which Middle Eastern and CIS oil supply remained circumscribed for a long time to come. This scenario is assumed to be accompanied by "global monetary discipline"; that is, in order to prevent a persistent increase in inflation, the world monetary authorities prevent monetary aggregates from increasing, and so allow increases in interest rates to develop.

For simplicity, it is assumed that all of the shocks which follow from these five cases actually occurred from the first quarter of 1992. The focus of the paper is on the outcomes in these scenarios for the three developing country blocs, although the results for the OECD economies are also discussed briefly. It should be made clear from the outset that these exercises are not forecasts, but rather serve as scenario analysis, of the "what if" kind. If the reader wants forecasts of prospects for less developed countries, then he or she is referred to the latest *World Economic Outlook*,³ or to the latest *International Economic Outlook*.⁴ The World Bank *Short Term Outlook* pays specific attention to developing countries.⁵

B. *Outline of the paper*

The next section of this paper briefly describes the global modelling system used to perform the scenario analysis. The transmission of shocks is discussed, both among industrialized economies themselves and between industrialized countries and developing countries. Sections III to VI contain detailed analyses of each of the five shocks. The results are presented in a series of charts and tables, whose numbering corresponds to the numbering of the scenarios. Section VII presents conclusions.

I. **The international transmission of macroeconomic shocks**

For the purposes of the work, a global modelling system designed for studying North-South macroeconomic interactions is used. This system consists of two parts.

The first part is the Global Econometric Model (GEM). This is a quarterly macroeconomic model of the world economy, widely used for forecasting and simulation purposes. It was developed in the United Kingdom from the UK Treasury's World Economic Prospects model, and is now jointly maintained by the National Institute of Economic and Social Research and London Business School. GEM treats in some detail the major seven industrialized economies: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States of America. The remainder of the OECD member countries is modelled in three further blocs; and the rest of the world is disaggregated into a final six blocs. This last category consists of five groups of developing countries along with an Eastern Europe and the CIS group. GEM has been featured in a number of international discussions of global models, including the Brookings Institution Model Comparison Conference.⁶

³ *World Economic Outlook*, IMF, 1992.

⁴ *International Economic Outlook*, London Business School, 1992.

⁵ *Short-Term Outlook*, World Bank, 1992.

⁶ Bryant, *et al.*, 1988.

The second part of the modelling system consists of new detailed annual macroeconomic models of three less-developed-country regional blocs: (i) Latin America, (ii) the Asian NIEs (Republic of Korea, Taiwan Province of China, Singapore, and Hong Kong), and (iii) Africa.⁷ In these exercises, the new detailed models replace the existing small "trade" models for each of the three LDC blocs. This outcome is achieved by running these new models in tandem with the main GEM model. Detailed discussions of these models may be found in the literature.⁸

A. Industrial country regions in the GEM model

Empirical evidence suggests that, in the short-run, the major industrialized economies behave primarily in a Keynesian manner, and the GEM model is in accord with this; prices are sticky in the short run and output is therefore primarily determined by demand. Over time, inflation responds to excess demand and serves to crowd out expenditure, so that output in the longer run is determined by supply-side factors.

Interactions between countries or blocs take place through trade volumes and prices, and through exchange rate changes. Trade flows between countries and blocs depend on relative competitiveness and relative internal demand. Explicit allowance is made for differences in the direction of trade flows. Hence, for example, Japan is relatively more important than the United States for the determination of Asian NIE exports, as compared with the determination of Latin American exports.

Manufacturing export prices are determined by industrialized country domestic costs and by competitors' prices. United States domestic prices and costs have a special influence. Oil prices are assumed to be fixed by OPEC in nominal dollar terms. Non-oil commodity prices are disaggregated into four broad commodity groups. The aggregate of these commodity prices in real terms (deflated by the price of manufactured goods) depends on the strength of world output and industrial production, and on world interest rates.

The exchange rates of the yen and Deutschmark (DM) against the dollar are floating and determined in a forward-looking manner. They respond to expected future interest rate differentials. An exchange rate will initially jump downwards in response to a persistent negative interest differential, and then slowly appreciate again so that the expected returns on all currencies are equalized. By contrast, within the Exchange Rate Mechanism (ERM) of the European Monetary System, France, Italy, and the United Kingdom are assumed to have their exchange rate and monetary policy set following Germany. The monetary authorities in the United States, Japan and Germany (in the following referred to as G3) target the domestic money supply. Interest rates are therefore usually determined so that the demand for money equals the targeted supply: thus increases in income or in prices will increase interest rates in the absence of monetary "accommodation".

In the simulations, fiscal policy in the principal countries has been allowed to rely on automatic stabilizers for the first four years of the simulations. In the longer-term, to ensure intertemporal budget stability, personal tax rates are adjusted to deliver the medium-term baseline fiscal deficit.

B. Macroeconomic shocks in industrial countries

How shocks develop within individual industrial countries is best understood by means of a standard element of macroeconomic theory: the Mundell-Fleming model.⁹ The GEM model has been constructed in a manner which makes it consistent with that theory.¹⁰

⁷ A new model of the other market economies in the Far East is under development, but was not available for this work.

⁸ Allen *et al.* 1992, Srinivasan and Vines 1990, 1991a and Allen 1991.

⁹ See Dornbusch, 1980 (chapter II).

¹⁰ There are many elaborations possible of the basic Mundell-Fleming model (see McKibbin and Sachs, chapter 2). But the most basic version suffices for an understanding of our exercises.

A change in monetary policy emanating from a G3 country has a powerful effect within the country where it happens, as long as the monetary authorities there isolate the quantity of money from macroeconomic developments, and allow interest rates to be flexible and to respond to such developments. Exchange rate movements then become a central part of the process by which the economy responds to the monetary policy change. This is because exchange rates are principally determined by interest rate differentials; forward-looking market operators reinforce these effects by bringing exchange rate movements forward in response to expected future interest rate developments. In these circumstances, a monetary expansion, for instance, has the effect within the country where it happens of increasing both output and prices. However, because interest rates fall, the exchange rate depreciates, thus augmenting the upward effects on both output and prices. This is why monetary policy effects are so powerful.

A change in fiscal policy by contrast has only a small effect within the country where it happens, providing that the monetary authorities target the money supply and are willing and able to allow interest rate responses. Interest rate movements, together with the exchange rate changes which they induce, work against the direct effects of the fiscal impulse. Thus, for example, a fiscal contraction will tend to drive down both output and prices. But the resulting lower interest rates moderate these consequences. Furthermore, the exchange rate will depreciate, causing both output and prices to recover further. Only if there are significant and lasting effects on global interest rates will there remain any significant fall in domestic output. Otherwise, currency depreciation will result in a restoration of domestic output loss. If movements in interest rates are interrupted, however, fiscal policy becomes much more powerful. Without interest rate movements, exchange rate changes are much more muted, and fiscal policy will have its conventional Keynesian multiplier/accelerator effects. A fiscal contraction will then lead to a substantial and persistent domestic recession.

The transmission of the effects of macroeconomic shocks between industrial countries, and how the GEM model captures them, can also be understood using the very simplest Mundell-Fleming model.

Monetary impulses are negatively transmitted from one country to another through the exchange rate. This well-known result follows immediately from the assumption that the monetary authorities abroad as well as at home target the money supply. A monetary expansion, in the United States, say, must - because it increases the world money supply - have some downward effects on world interest rates, in the medium term. This is after international interest rate differentials have been eliminated, but before the monetary boost has been entirely exhausted through inflation. In foreign countries such lower interest rates are only consistent with monetary equilibrium if there has been a downward movement in their output and/or prices. What happens is that an appreciation of the foreign country's currency against the dollar is the vehicle by which these downward movements are engineered.

Fiscal impulses, in contrast, are transmitted positively in the short to medium term. If interest rates are variable, a fiscal contraction in the United States, for instance, will have some negative effect on world interest rates in the medium term. But in other countries such lower interest rates are only consistent with monetary equilibrium if there has been a downward movement there in output and/or prices.¹¹ What happens is that, here too, an appreciation of the foreign country's currency against the dollar is the mechanism by which these downward movements are brought about. Fiscal policy transmission will still be positive, even if interest rates are not variable following a contraction. However because interest rates have not fallen, any longer term recovery will be delayed. It will have to take place through other mechanisms, especially from real balance effects as a result of changing product prices.

To summarize, within the G3, monetary impulses are not just confined to the home economy but are actually negatively transmitted abroad. The impact of fiscal policy depends on whether or not interest rates vary. If interest rates move, fiscal impulses will quickly dissipate themselves throughout the world. If interest rates remain fixed, then fiscal policy will be both more powerful domestically and have more persistent transmission effects.

¹¹ This is positive transmission in that it is a downward movement in response to a contractionary shock in the United States.

C. Latin American, African and Asian developing country regions in the global modelling system

Empirical research suggests that it is appropriate to analyse macroeconomic developments related to developing countries, both within these countries, and between them and the advanced industrial countries, in a manner which is somewhat different from that appropriate for industrialized countries. The modelling system used here draws on a considerable amount of such research.¹² The authors' research has highlighted a number of structural differences between regions; understanding them is helpful in interpreting their different responses in the scenarios reported below.¹³

1. Demand

If prices were (unrealistically) kept constant in any of these less developed country regions, then output would be determined by demand in a normal Keynesian multiplier/accelerator manner. The consumption and investment components of this demand are determined in these regions in the normal way: crucially, global real interest rates appear to have important effects on demand through their effects on investment. Because investment determines the evolution of the capital stock, these interest rate effects will be important for supply as well.

There are distinctive differences between the regions in the trade-related parts of the demand side. The world income elasticity of demand for NIE exports appears to be much higher than that for Latin American and African exports. Also, the relevant price elasticities also appear to differ greatly between the regions: price elasticities of demand and supply for NIE exports appear to be much higher than those for Latin America, which, in turn are higher than those for Africa. Nevertheless, for all three regions a cheapening of exports through a real devaluation appears to lead to an improved trade balance, in that favourable volume effects outweigh any terms of trade loss. Overall, the relevant elasticity showing the effect on the trade balance of such an improvement in international competitiveness is 5 in the NIEs, as opposed to 2 in Latin America, and only 0.3 in Africa.

2. Supply

Making allowance for supply conditions changes the position fundamentally, in ways which differ profoundly between regions. In Latin America, any increase in demand appears to call forth very little increase in supply, and to result mainly in an increase in prices. In other words, the economy-wide supply schedule is very steep for this region. It appears to be so for three reasons. First, this region apparently has the sharpest capital constraint, in the sense that diminishing returns on capital appear to set in more rapidly in Latin America as the demand for output rises relative to the capital stock.¹⁴ Secondly, real wages appear to respond more sharply to output in this region. Thirdly, the region is the most closed, so that changes in the price of tradeable goods

¹² For the purposes of this modelling system the Latin American and African models in GEM have been replaced in the simulations which follow by fully specified macroeconomic models. The Far Eastern Model has been split into the four NIEs and the rest, and a new fully specified model of the NIEs introduced. A new model of the other market economies in the Far East is under development, but was not available for this work. Our models of the NIEs, Africa, and Latin America have a similar theoretical structure (see Srinivasan and Vines 1990, 1991a, and Allen 1991). They have been econometrically estimated using aggregate data for regions constructed from country data supplied by the World Bank. All of them are fully specified macroeconomic models, containing some 40 equations, comparable in size to those for the G7 countries in GEM. They include a fully specified income-expenditure process (i.e. a demand side), a supply-side, a foreign trade sector, and a full set of balance of payments and government accounts. Among the distinctive features of the models are the presence of real balance effects on consumption, the determination through capital accumulation and the supply side of an endogenous "natural rate" of output, the integration of the government budget deficit and foreign exchange reserves with the money supply process, and, where appropriate, the enforcement of a national intertemporal budget constraint by means of a government fiscal rule.

¹³ One of the major advantages of using directly estimated empirical models of developing economies is that estimation reveals differences in structure between economies, which may not otherwise be visible.

¹⁴ The coefficient on the capital stock in the implicit production function for Latin America is much higher than that in the NIEs. A one per cent change in the output capital ratio therefore causes more serious diminishing returns (i.e. it raises marginal costs more) in Latin America than in the NIEs. This would be consistent with relative capital scarcity in Latin America.

relative to the price of non-tradeable goods can perform less of a function in facilitating an increase in output. By contrast, as might be expected, increases in demand call forth the greatest increase in supply for the NIE region, i.e. the supply function for the NIEs is the flattest of all of the regions. This is because diminishing returns set in only slowly, because real labour costs per unit of output appear to be independent of output,¹⁵ and because of the openness of these economies.

There is another aspect to the differences between supply conditions in the three regions: the degree of money illusion differs. On the South American continent, with its inflationary experience, only an increase in the rate of acceleration of the inflation rate is sufficiently "surprising" to provoke any increase in output. Moreover the effect is small, and it is nearly all gone within a year. In contrast, in both Africa and the Asian NIEs, an increase in the inflation rate itself appears to be enough to cause surprise inflation, and roughly half of this effect persists after three years.

Three very important points may be deduced from what has just been said. Because of the steepness of the supply curves in Latin America and Africa, a permanent reduction in demand for exports reduces prices more relative to output than does a similar shock to the NIEs. A permanent supply effect, caused through, say, a reduction in the capital stock following a rise in global real interest rates may well have a much bigger impact on Africa and Latin America than on the NIEs. Finally, in response to either demand or supply shocks, prices are likely to be much more volatile in Latin America than in the other two regions. This point is reinforced by the much smaller degree of money illusion in this region, which removes one "buffering device" from the process of responding to shocks.

3. Policy

The treatment here of macroeconomic policy differs as between the three regions in a crucial way. For the NIEs, government expenditure is assumed to be exogenous. This is because the NIEs are not constrained vis-à-vis external borrowing and their Governments need not adjust spending in response to a deterioration in their current accounts. Latin America and Africa, in contrast, suffer from considerable debt overhang problems and are severely constrained in their ability to borrow abroad. To simulate this constraint, a "feed-back rule" has been implemented whereby government expenditure is reduced in response to any worsening in the current account situation, and expanded if the current account improves. The system treats tax rates in all regions as exogenous, so that budget deficits are endogenous. The money supply, however, is endogenous in order to capture an important aspect of developing-country adjustment experience, as highlighted in the "monetary approach to the balance of payments"; it is dependent on budgetary developments and on changes in foreign exchange reserves.

The modelling system treats nominal exchange rates as fixed in all three regions at baseline values, relative to the United States dollar.¹⁶

4. Other structural differences between regions

In addition to the differences between regions already discussed, there are others. The most important of these are the following:

- (a) There are differences in the outstanding stocks of debt net of foreign exchange reserves. Latin America and Africa are large debtors but the NIEs are not. A 1 per cent increase in interest rates may be estimated as worth about US\$3 billion in additional interest payments for Latin America and US\$0.9 billion for Africa.
- (b) A further difference comes from the commodity composition of NIE trade compared to that of Latin America and Africa. Unlike Latin America and Africa, the NIEs are net exporters of manufactures and net importers of commodities. A reversal in the com-

¹⁵ Because of induced productivity improvements.

¹⁶ This assumption helps to facilitate comparison of simulations. For the NIEs, however, perhaps a more realistic assumption would have been the fixing of the nominal effective exchange rate relative to a basket of currencies. Changes in the dollar would therefore be almost neutral in their effect on competitiveness. A similar remark could be made about Africa.

modity terms of trade thus improves the NIEs, terms of trade, and reduces those of Latin America and Africa.

- (c) Finally the market structure of exports differ. The NIEs' share of exports to the United States is much smaller and their trade with Japan is greater than that of the other regions. Conversely, Africa trades proportionately more with Europe.

5. *The rest of the world*

It should be noted in passing that, in contrast to what has just been described for Latin America, the Asian NIEs and Africa, the models for the remaining regions of the world are treated as in the standard version of the GEM model in the present modelling system. In these simple treatments, export volumes are determined by world import growth and the terms of trade, while import volumes merely react to "available foreign exchange". No explicit policy instruments exist in these other developing country regions. This point is of relevance for the behaviour of OPEC in the last simulation.

D. The transmission of macroeconomic shocks between developed and developing countries

The macroeconomic prospects for developing countries depend on outcomes in developed countries through three key linkages:¹⁷ the behaviour of export volumes and prices; the behaviour of the terms of trade;¹⁸ and the movements in world interest rates (which both set the terms for debt service charges and influence the accumulation of capital). The export volumes and prices of less developed countries are in turn governed by two decisive factors: real growth in the OECD countries and exchange rate movements. The fact that all three LDC regions are assumed to peg to the United States dollar is of some significance for this process.

The way in which these linkages work is best understood by again using the Mundell Flemming model. However, some care must be taken regarding exchange rate assumptions. In the interactions between the developing countries and the United States the fixed-exchange-rate variant of the theory, must be used while the floating exchange rate variant is used for other interactions.

A monetary policy shock emanating from the United States, say an expansion, is initially powerfully transmitted to all of the LDC regions, before it is eventually exhausted by inflation. This is because, with these regions having fixed exchange rates against the dollar, the positive effects of the monetary expansion on United States demand for LDC exports augment the positive effects on LDCs of lower United States interest rates. Furthermore, the depreciation of the dollar against the other G3 countries will improve the competitiveness of developing country exports in world markets. Finally, the reduction in United States interest rates reduces debt service obligations, because the overwhelming majority of debt is in dollars. There is therefore not the small or negative transmission deduced as the likely outcome in the transmission of a United States monetary shock to the other G3 countries.

A fiscal shock emanating from the United States, for instance a contraction, is however only weakly transmitted. This is because, with regions having fixed exchange rates vis-à-vis the dollar, the negative effects of the fiscal contraction on United States demand for LDC exports work against the positive effects on LDCs of lower United States interest rates. (Note again that it is interest rates in the United States which govern the interest obligations on LDC debt.) Furthermore, the depreciation of the dollar against the other G3 countries will improve the competitiveness of developing country exports in world markets, again countering the direct negative effects of the contraction on United States demand for LDC exports. There is not the strong positive transmission deduced as the likely outcome in the transmission of a United States fiscal contraction to the other G3 countries.

¹⁷ Theoretical discussion of these linkages can be found in Kanbur and Vines (1987), Currie, Muscatelli and Vines (1988), Moutos and Vines (1989), Muscatelli and Vines (1989), and Molana and Vines (1989).

¹⁸ That is, the ratio of export prices to import prices.

These contrasts, between the nature of the transmission within the G3 and the transmission to developing countries, are what might be expected from simple macroeconomic theory: transmission under fixed exchange rates differs fundamentally from that under floating rates.

The effects on developing countries of shocks coming from within the G3 but outside the United States have rather different outcomes. Monetary contraction, for instance, in Germany, would be expected to have only a weak effect on developing countries, fundamentally because of the movements of the DM against the dollar which are induced. The argument is the same as that used in section B above to describe the transmission of monetary shocks within the G3. Similarly a fiscal change, say an expansion in Germany, would be expected to have a powerfully positive effect on developing countries, again partly because of the induced exchange rate movements. The argument also mirrors the one used to discuss fiscal transmission in the same section B. Both of these points are strengthened by the fact that German interest rates do not of themselves influence debt service obligations for developing countries.

It should be noted that the outcomes of the above discussions might have been rather different if a different exchange rate policy had been assumed for developing countries. Investigating that issue creates an important agenda for future work.

II. United States fiscal consolidation with money remaining "tight"

A sustained reduction in United States Government expenditure equal to one per cent of GDP is considered in this scenario. The aim is to examine the effects of attempts to bring the burgeoning fiscal deficit under control.¹⁹ It is assumed, initially, that this is done in the face of domestic financial fragility and in the shadow of possibly substantial future demands on world capital markets. Specifically, it is represented by an outcome in which nominal interest rates hardly fall in the face of the downturn in activity which ensues.

Two factors could lead to this outcome. First, the recent chaos in the United States financial sector has left it very vulnerable to further shocks. United States financial institutions might therefore see the main effect of a fiscal deficit package as being a major reduction in future profit streams. It would thus be viewed as a potential threat to the stability of the financial system in the present circumstance of continuing debt overhangs. This would cause a "flight into quality" or a tightening of credit availability by embattled financial institutions in the country.

A second possibility is that the risk of very substantial future potential demands on world capital markets might put a floor under long interest rates. Much of the demands for capital for rebuilding Eastern Europe and the CIS have not yet been realized. Nevertheless, the threat of these future demands is reflected in current interest rates through the term structure. The effect is a sort of liquidity trap. Interest rates may therefore not be able to descend, despite current weakness of output and demand.

This circumstance is stimulated by not allowing United States nominal interest rates to move in response to the direct effects of the fiscal shock. Effectively, the demand for money is allowed to shift so that any substantial interest rate reduction in the face of the spending fall is prevented.²⁰

¹⁹ Such circumstances could just as well be brought about by a slowdown in private sector spending. That is because in the model which we will be using, there are not the kinds of differences in import intensities or in financing consequences which could make the source of the slowdown something which matters. But at the time of writing a recovery in United States private sector seemed to be underway, making that circumstance appear less interesting.

²⁰ There is a small "second round" fall in interest rates because superimposing the monetary contraction on the fiscal contraction causes activity and prices to fall by more, and so reduces the demand for money.

A. The impact in the OECD

The result is a global Keynesian contraction, with a vengeance. Outcomes for the industrialized economies are shown in Figure 1. In the United States, the impact is a very persistent recession. The contraction in government spending reduces output by a multiplier of unity: there are accelerator-induced reductions in investment which augment the fiscal impulse, but these are offset by a severe contraction in imports. United States prices fall significantly because of the sustained demand reduction, slightly augmented by effects of currency appreciation. Ultimately the fall in prices stimulates consumption through real balance effects, and output begins to recover.

Interest rates move very little, although United States rates are deliberately allowed to respond to "second round" effects.²¹ In the absence of much movement in nominal interest rates, there is little change in nominal exchange rates, but the slow fall in United States prices causes the country's real exchange rate to depreciate gradually.

There is substantial transmission of the shock onto falling outputs abroad, as one would expect because of the much lower United States expenditures on import demands. Prices in Japan and Germany fall by much less than in the United States because transmission is only partial.

World trade falls sharply and persistently by about 1.5 per cent, most notably in Latin American markets and least in African ones, an effect predicated on the relative closeness of regional trade ties. Real commodity prices²² take a long nosedive, falling by a maximum of 2.5 per cent.

B. The effect on developing countries

These effects on the developing countries are set out in detail in table 1 and in figure 2. They can be decomposed into three components.

- (a) All of the LDC regions face straightforward contractionary pressure: the reduction in world activity and the fall in real commodity prices lead to lower export revenues. The effect is less serious in Africa than in the other regions, both because of whom Africa exports to, and because the world income elasticity of demand for African exports is less. There are also subsidiary effects of dollar appreciation on competitiveness in Latin America and the NIEs.²³
- (b) In addition, in the debt-overhung economies of Africa and Latin America, the worsening of the current account balance requires a reduction in government expenditure for reasons of external adjustment, even in the face of an already serious slump. By contrast, since the NIEs are not debt-constrained, there is no corresponding reason why they should suffer such a contraction in government spending.
- (c) Finally, in all regions, the slump in output causes a reduction in investment through the normal operation of an accelerator mechanism. But, because the stock of capital is then lower, this causes a reduction in what these economies can supply, and output falls. That induces a further reduction in investment - a kind of cumulative collapse. Although this process is not actually unstable, it certainly helps to make things much worse.

There are large falls in output in all regions. Latin America does worst, on account of its proximity to the United States. This makes Latin American export volumes fall substantially. It therefore needs to make a large fiscal adjustment; it hence suffers from a cumulative collapse. Output overall falls by 1.5 per cent.

The NIEs are also hit by the collapse in United States markets, but adjust much faster. Falling prices improves competitiveness and restores some of the loss in exports. Their permanent output loss however is still almost a full percentage point.

²¹ See footnote 20.

²² This consists of weighted non-oil commodity prices in dollars deflated by manufacturing export prices in dollars.

²³ Things might have well have been different had we not assumed that all LDC regions peg to the dollar.

Africa is in an intermediate position. Because of its trade links, it partially escapes the large fall in exports. However, it cannot escape the need for fiscal adjustment. Output falls by a little over one per cent.

C. Significance

These results suggest that a fiscal consolidation in the United States, unaccompanied by any form of monetary easing, would be damaging to the global economy, and in particular to the third world. Latin America would suffer most, but sustained falls in output would also occur in Africa and the Asian NIEs.

III. United States fiscal consolidation with "monetary loosening"

This shows the effect of the same United States deficit-reduction package as that examined above, except that the Fed induces or allows a reduction in interest rates. In particular, interest rates are presumed to fall in the manner which would naturally follow from such a consolidation if there were no shift in money demand, while, at the same time, the Government ran a "constant monetary aggregates" policy. United States interest rates would in this case fall as output fell in response to the reduction in government spending.

A. The impact in the OECD

United States output falls initially, as in the previous scenario. But now it quickly rebounds: the multiplier in the first quarter is approximately unity but all of the fall is reversed within a year. Short-term interest rates initially fall by 2.4 percentage points in nominal terms, and then rise again quite rapidly within 18 months; nevertheless, rates remain lower by a quarter of a percentage point a full five years into the simulation, thereby "pulling in" some investment expenditures, both business and housing.

The United States real exchange rate depreciates initially by 2.3 per cent, then steadily rises. This is the behaviour which one would expect since, after the initial depreciation, the dollar must appreciate to compensate for the fact that interest rates in the United States are now lower than those abroad.

After five years, interest rates everywhere are lower by between one quarter and one tenth of one per cent, so that investment in the United States remains up. Also the real exchange rate of the dollar is still depreciated by about one per cent. At this point the increase in investment and in net exports in the United States more or less exactly matches the government expenditure reduction.

United States consumer prices hardly fall at all initially, and in the end rise slightly, because the currency depreciation more than undoes the effect of the demand reduction on output prices.

There is some transmission of the shock into falling outputs abroad, because of the effect of lower United States expenditures on import demands, and because of the appreciation of foreign currencies against the dollar.²⁴ Consumer prices in Japan and Germany fall by considerably more than those in the United States because of the effects of exchange rate appreciation in these countries.²⁵

²⁴ This is a standard result from the Mundell-Fleming model. In the simplest version of that model such an outcome is only possible if interest rates fall everywhere, which is what they do.

²⁵ That does not cause a larger fall in interest rates there than the one that we actually observe, because the demand for money depends on output prices, rather than consumer prices.

Export markets initially fall sharply everywhere. Because of the closeness of trade ties Latin America suffers most and Africa least. Subsequently markets recover, in line with G3 output. Real commodity prices initially deteriorate sharply (volume and exchange rate effects dominating the effects of lower United States interest rates), but rebound upwards somewhat in later years because United States interest rates remain low (figure 3).

B. The effect on developing countries

The developing countries face contractionary pressures only in the very short run. Thereafter, they benefit from the lower interest rates and the recovery in the rest of the world economy (figure 4).

- (a) The reduction in world trade and the worsening in the commodity terms of trade lead to lower exports in the very short term. This only applies to the first year or so. Subsequently, the recovery in world trade and the expansionary effects of dollar depreciation are dominant.²⁶ The competitiveness effects most benefit the Asian NIEs, with much smaller effects in Latin America and Africa.
- (b) The improvement in the current account in the debt-overhung economies of Africa and Latin America makes possible an increase in government expenditure there. The main reason for this is that the mainly temporary reduction in United States interest rates leads to a major fall in net external interest payments; these are reduced by some US\$3 billion in the first year in Latin America and by about one-third of this in Africa. This effect is only transitory, but it is augmented by the improvement in exports just discussed; both of these factors combine to enable a considerable degree of fiscal loosening. In the NIEs, in contrast, with their outstanding positive asset balance on global financial markets, the effect of lower interest rates is to worsen the current account. However, since these countries are not debt constrained, there is no corresponding reason why this should induce a contraction in government spending.
- (c) The reduction in United States interest rates also causes an increase in investment, and so an increase in the capital stock.

These three pressure points make themselves felt on both the demand and the supply sides. On the demand side, exports rise for reasons discussed above, although overall not to a very great extent. The rise in demand is reinforced by the relaxation in government expenditure made possible by the current account improvement in Latin America and Africa. Finally, investment expenditure rises significantly because of lower interest rates. The joint effect of these three effects is to give a sustained boost to demand. On the supply side, there is a long-lasting (if not very large) boost everywhere because of the increases in capital stocks induced by lower world interest rates.

Overall output rises in all regions. The reduced form "elasticity" of the increase in LDC output with respect to United States fiscal contraction ranges between one-third and two-thirds. Also, since the rise in demand is bigger than that in supply, there is a significant rise in the price level (most of all in Latin America because of the inflexibility of supply there).

It is interesting that Latin American demand is driven by both major beneficial forces (exports more competitive and fiscal policy more relaxed) whereas the NIEs benefit from only the first effect and Africa benefits from only the second. Yet output goes up less in Latin America than in either of the other two regions. This is because supply appears to be less flexible there. The burden of ensuring this outcome falls on consumption, which rises much less in Latin America than elsewhere, prompted by the negative real balance effects caused by higher prices.

²⁶ Things might have been different here as well had we not assumed that all LDC regions peg to the dollar.

C. Significance

This exercise suggests that United States fiscal consolidation accompanied by monetary accommodation would be positively beneficial for the third world. The results intimate that allowing monetary looseness to develop in the United States in the face of a government deficit reduction package totally transforms the effects of such a package. This is because it would enable other global demands on world savings, including demands in the third world, to step in and manifest themselves on world capital markets as United States Government pressure on these markets is reduced.

These findings may seem controversial. They agree with the outcomes reported by Muscatelli and Vines,²⁷ but their paper was speculative, not being based on solid econometric investigation. However, the findings presented here differ from those of Masson and Helliwell,²⁸ who reported a mildly beneficial effect of fiscal expansion, and thus, by implication, suggested that a fiscal contraction would have negative effects. They found this even for their group of highly indebted countries; the outcome was even better for net-lender developing countries.

The point at issue is this. United States fiscal contraction reduces the value of exports. However, with lower interest rates it reduces the value of interest payments for indebted economies. The net effect is a small difference between two large numbers, and still subject to some dispute. Furthermore, in our model, the lower interest rates enable an increase in supply in less developed countries, because of the detailed way in which this is modelled. That effect is not present in the MULTIMOD model used by Masson and Helliwell. We would thus stand by our results, although it must be admitted that they are uncertain.

IV. Additional demands on world savings

This scenario is supposed to result primarily from the rebuilding of the former Soviet economy, and in particular from the additional spending required to reconstruct the eastern part of Germany. The parameters of this shock are taken precisely from a similar experiment reported in the IMF's *World Economic Outlook* in October 1991.²⁹ As described there, the Fund quantified the possible magnitude of additional demands for world savings as being of the order of US\$100 billion, made up of US\$55 billion for German reunification, US\$12 billion for reconstruction of the Middle East, and US\$33 billion for Eastern Europe and the CIS.

It is assumed that this global increase in demand for savings is maintained every year from 1992 to the end of the simulation period. In the absence of detailed explicit models of these regions, increases in resource demands are allowed to be reflected in additional net imports by the three regions: the demands have been allocated to the trading partners of the regions in exactly the same manner as was done by the IMF.³⁰

It is illustrative to compare this exercise with that of Pauly.³¹ Our shock is nearly twice the size of that considered by Pauly, and is permanent; his runs to a total of only US\$300 billion, spread over five years.³² Pauly highlights the fact that all of the resources are devoted to investment in the recipient countries. However, even in his report the import-substituting supply-side conse-

²⁷ Muscatelli and Vines (1989) "Macroeconomic Interactions between the North and the South", in Bryant *et al.* (eds.) (1989).

²⁸ Masson and Helliwell (1990) paper presented to a workshop in Rio de Janeiro.

²⁹ IMF (1991) *World Economic Outlook*.

³⁰ For Germany the expansion was simulated by increasing government consumption. For the Commonwealth of Independent States and Eastern Europe and the Middle East, data on the trade between these regions and the rest of the world were used to allocate the increase in net imports. This assumes that, although Eastern Europe and the CIS are expected to increase their trade with other regions significantly, the geographic pattern of trade will remain broadly unchanged.

³¹ *Op. cit.*, note 2 above.

³² *Ibid.*, p. 26.

quences of such activity seem to be extremely limited,³³ so the differences between us seem to boil down essentially to ones of size of shock.

What happens as a result of large increases in spending of this kind in some regions of the world depends upon the policies which are adopted elsewhere. This has been known ever since the discussion of the "transfer problem" which took place between Keynes and Ohlin in the 1920s and 1930s, concerning the effects on the world economy of the payment of reparations by Germany. It is supposed here that these increases in imports are essentially financed, to quote Pauly,³⁴ by "a consortium of major industrial countries, through institutions such as the IMF and EBRD [providing] grants, aid and soft loans...". Following both Pauly and the IMF (1991) it is supposed that all of these "grants, aid and soft loans" are bond-financed, with no adjustments in fiscal policy elsewhere: that appears to be in line with recent experience.³⁵ Crucially, money supplies in the G3 are fixed, which constrains the extra demand for world resources by giving rise to large increases in interest rates in the countries which receive extra demand for their exports. Such a policy of monetary non-accommodation represents an anti-inflationary stance by the monetary authorities in the OECD.

A. The G3 outcome

The global outcome is one in which world trade increases very markedly over the first two years, before gradually falling back. Since so much of the extra demands fall on Germany, German short-term interest rates rise in the first year by 5 1/2 percentage points. This enormous increase in German interest rates should be examined with care. First of all, the increase elsewhere is small, with the consequent financial strain being taken up by exchange rate movements. Secondly, these are short-term interest rates. In their work, the IMF found rather small movements in long-term interest rates (about one per cent), an outcome not inconsistent with the movement in short rates traced here. Other studies using short rates, cited in the *World Economic Outlook*³⁶ suggest outcomes near to our own.

Gradually interest rates come back into line worldwide. By the end of the decade world interest rates (real and nominal) are higher by about 0.25 percentage points. However, it is almost certain that such a measure also understates longer term global financial pressure. That is because after 1995 corrective tax adjustments come into play to close budget deficits. Before that time, as the figure 5 shows, there is a small global inflation tax. Thus at no time must interest rates act alone to remedy the savings shortage.

As a result of the initial interest rate movements, the DM and all the other currencies of the European Monetary System appreciate by more than 12 per cent against the dollar. Gradually exchange rates come back into line, as interest rates do. By the end of the decade, the real DM exchange rate is approximately 2 1/2 per cent higher against the dollar and up by 0.8 per cent against the yen.³⁷

As earlier simulations predicted, outputs rise in regions beyond Europe, both because of direct world trade effects, and because of positive transmission.³⁸

Consumer prices gradually inflate in the United States and Japan, ending up nearly one per cent higher, as a result both of output increases and currency depreciation. But in Germany consumer prices actually fall in the face of the pronounced exchange rate appreciation. It is thus ap-

³³ The current experience of the eastern *Länder* of Germany suggests that this is realistic.

³⁴ *Op. cit.*, note 2 above.

³⁵ *Ibid.*, p. 18.

³⁶ *World Economic Outlook* IMF (1991), footnote 36 on page 49.

³⁷ The dollar depreciates relative to the yen in order to attract a much larger share of world demand for savings to itself commensurate with its larger size, since it is necessary for United States and Japanese interest rates to remain, essentially, broadly in line. By the end of the period, the United States runs a current account surplus of about US\$30 billion compared with only about US\$10 billion for Japan. The relative exchange rate movements needed to achieve this depend on a host of parameters, not least the elasticities of trade flows with respect to competitiveness.

³⁸ Notice that by 1993 the extent of the induced boom is larger in the United States and Japan than in Germany. This is a feature which is similar to an aspect of the second simulation. It is arguably a feature of current actual experience.

parent how currency movements redistribute not just the boost to global demand, but also the resulting price pressures.

Export markets rise for Latin America and for the NIEs (after a hiccup). But Africa is heavily dependant on Europe, and, although the boom in Germany remains for some time, contractionary monetary policies throughout Europe, which must match that in Germany, drag Europe into recession³⁹ and take their toll on world expenditures. Real commodity prices increase considerably for an extended period of time, as one would expect, after an initial fall induced by high German interest rates.

B. The outcome for developing countries

There are four main ways in which the shock impacts on the third world (figure 6).

- (a) Rather diverse outcomes for export markets;⁴⁰
- (b) The behaviour of the terms of trade between commodities and manufactures - this improves the African and Latin American terms of trade because these continents are net exporters of commodities and net importers of manufactures;⁴¹
- (c) The increase in United States interest rates increases the interest payments on external debt and raises the cost of capital;
- (d) Global commodity price inflation causes some small (and transient) negative real balance effects on consumption in all regions.

This can be explained region-by-region. For Africa, the contraction in export markets causes a fall in export volumes. Consumption falls too; overall so does output in the short term. But the improved terms of trade and current account balance enable government expenditure to rise, and so output eventually recovers along with investment and the capital stock. As the global effects of the shock fade away towards the end of the decade, output returns to base.

In the NIEs, exports initially boom, and then die away, as the economy overheats. The path of output follows exports. There is no government expenditure response, and only a small effect on capital because real interest rate effects more or less compensate for output effects.

In Latin America, the impact is positive also, but much more so. The terms of trade improve more than in the NIEs, and government expenditure expands owing to the large trade balance improvement. The consequent boom causes higher prices, but also a rise in capital accumulation and an increase in supply.

C. Significance

It is often argued that an increase in demand for world savings will damage the third world. However, the results of the present exercise show surprising benefits for the third world, with the effects of increased world trade outweighing the effects of higher interest rates. This finding should be interpreted with care. First the positive result depends at least in part on timing. In fact, some of the new spending may be delayed, as certainly seems probable in Eastern Europe and the CIS. In this case, there may be negative effects in the short run as the prospect of higher future savings impacts on current interest rates through the term structure. This possibility has not been investigated in detail here.

³⁹ The contraction in the rest of Europe becomes rapidly larger than the boom in Germany.

⁴⁰ Also, the DM appreciates against the dollar and the LDC regions are assumed to peg to the dollar. But this does not have a very great bearing on the results;

⁴¹ The NIE terms-of-trade improve for the separate reason that those economies expand, driving up their export prices.

Secondly, there are channels of influence not represented here. Considerable LDC external finance in the 1980s was supplied by multilateral institutions at concessional rates. It is possible that new loans to the countries of Eastern Europe will result in the tightening of the availability of such concessional finance. If concessional loans are rationed further, then the shadow cost of capital to developing countries would rise by more than the rise in market interest rates. There would be negative effects on both demand and supply within the affected developing countries. There are unusually large uncertainties about how large this effect would be. This possibility cannot be captured at present, but it is important to remain aware of it.

V. Additional demands on world savings with German monetary accommodation

The same "rebuilding process" is studied as in the previous simulation, but it is accompanied by monetary accommodation in Germany, so as to prevent German interest rates from rising. The consequence is a world boom and world inflationary pressure. This is a possibility which the IMF did not address, perhaps for understandable reasons.

A. *The impact in the industrialized world*

This scenario results in a sustained increase in world output of 0.75 per cent and in world trade of over 4 per cent. The cost of this, however, is a permanent rise in the inflation rate in the industrialized economies of 0.25 per cent a year.

Much of the expansion again falls on Germany. With almost unchanged nominal interest rates, German interest rates in real terms are therefore reduced. The consequence is an initial real DM depreciation of a couple of percentage points against the dollar and slightly less against the yen. This initial depreciation of the DM real exchange rate is eventually reversed as German domestic prices ultimately rise further than those in other countries.⁴²

The other European economies gain directly from the expansion and also briefly from the lower real exchange rate (given that their nominal exchange rate follows the DM in the ERM). The inflationary effects are relatively slow to appear owing to lags in wage contracts. German inflation is briefly pushed as much as 1 per cent higher, a year or so after the initial impulse. The transmission effects on the rest of the OECD are strongly positive. The impact of lower real interest rates throughout the EC bloc ensures that increased demand outweighs the modest effect of lost competitiveness. These countries suffer a slow, but sustained increase in inflation.

With world trade booming, export markets rise for every group of developing countries. Real commodity prices also increase substantially (see figure 7).

B. *The outcome for developing countries*

This scenario is entirely positive for the developing world. Sustained increases in export markets benefit everyone, while the commodity producers gain from better terms of trade. The negative interest rate effects which characterized the previous scenario have of course been sterilized. The result is therefore a sustained expansion of output in each of the developing country regions. This is accompanied by higher prices (see figure 8).

The outlook for Latin America is particularly favourable. Output is permanently increased by 2.5 per cent within two years. Owing to labour shortage, real wages rise, but Latin America

⁴² The German real exchange rate ultimately appreciates by as much as in the previous scenario, as is necessary to permanently reduce net external demand.

still remains competitive owing to the substantial improvement in the terms of trade from booming commodity prices. The better current account position allows an expansion of domestic government spending.

The situation in Africa is quite similar, although the effects are slightly more muted. Output continuously rises by roughly 2 per cent.

The NIEs react in a similar way to the industrialized economies. Output is permanently increased at the cost of permanently higher inflation. Some loss of competitiveness is experienced, but this is offset by the very substantial growth in export markets.

C. Significance

This simulation creates a world boom and world inflationary pressure. As simulated, the outcome is strongly positive for the third world. But the fact that this occurs in an environment of permanently higher world inflation is significant. If the monetary authorities ultimately find the rise in inflation unacceptable - as is likely - then such a scenario will simply store up a future "adjustment crunch".

VI. A rise in the real price of oil of US\$5 per barrel

This is a permanent sustained rise in the nominal oil price by US\$5 a barrel, approximately equivalent to the achievement of the OPEC reference price of US\$21. This corresponds to what might happen if Middle Eastern and CIS supply remains constrained in the face of the global recovery. Risks clearly also exist on the downside, should oil supply turn out to be greater than expected.⁴³

A. The impact in the OECD

The oil price increase substantially raises import prices in each of the main industrialized economies. It effectively acts like an indirect tax increase. Real incomes of consumers and businesses are reduced and the relative price of energy is increased. The initial effects are seen principally on consumption, as higher prices reduce real income and financial wealth. The lagged effects on investment follow later.

With the monetary authorities following money supply targets, interest rates rise as monetary policy is tightened world wide. Notice that the resulting policy response allows for some accommodation, in that nominal income can rise somewhat as a result of the release of money balances to finance increased transactions which occurs as interest rates rise. This is broadly the policy response which was advocated by the IMF at the beginning of the Gulf crisis in 1990. It is also assumed that fiscal policy will ultimately have to be tightened to eliminate accumulated government deficits. Because interest rates change by broadly similar amounts everywhere, exchange rates remain largely unchanged.

The extent of the negative impact depends crucially on how quickly the oil producers spend their increased revenue. On the whole, the oil revenue absorption capability of the principal oil producers is probably currently fairly high as a result of the needs of Gulf reconstruction and the difficult budgetary positions of many OPEC countries in recent years. As a result it is assumed that the increase in OPEC absorption almost completely responds to increased revenues and that it would do this almost completely within a year or so. Increased OPEC imports ultimately stim-

⁴³ The results of an oil price fall would not necessarily be exactly symmetric to those shown here for an oil price rise.

ulate world trade. Even so, the effect of their increased expenditure will lag the initial impact on consumer countries (see figure 9).

Non-OPEC developing country export markets are initially depressed, but quickly recover in the aggregate as trade expands with the OPEC countries. The overall numbers clearly conceal very different experiences among countries within the blocs. The increase in oil prices improves the terms of trade of commodities with respect to manufactures prices, but this is small compensation for oil importing countries facing much more costly oil supplies.

B. The developing country impact

The impact of the oil shock on the non-OPEC developing economies is very similar to that on the main industrialized economies. The terms of trade worsen and consumption and investment is squeezed (see figure 10).

Adjustment in the Asian NIEs is achieved most quickly. Consumption and output declines sharply in the first year of the shock. Soon it begins to recover, however, partly because of recovery in export markets and also because of import compression.

Latin America gains initially from its trade with local oil producers and from some modest gain in competitiveness as a result of the negative impact on real wages of an unexpected increase in prices. This breathing space is relatively limited and output subsequently permanently falls by 1 per cent.

The impact on Africa is also negative. Output is switched from domestic demand to net exports to pay for the worsening of the terms of trade. Output falls by 0.5 to 0.75 per cent.

C. Significance

The outcome is a bad one for developing countries, as it is for most industrialized countries: the percentage drops in the LDC blocs' output range from half a per cent to one per cent of GDP across the three regions studied. These are in fact not very big numbers. But that outcome is highly dependent on the assumption that OPEC absorption rises rapidly and almost completely in response to increased oil revenues. Also, in this simulation in particular, aggregation must be treated with care since there will be a diversity of responses within the LDC blocs. For example, it should be remembered that Mexico is in the Latin American bloc.

VII. Conclusions

A. Summary of results

Three groups of medium-term adjustment scenarios have been considered along with their effects on developing economies.

The first pair of simulations investigated the implications of a substantial United States budget deficit reduction package. It was found that the impact of the package crucially depended on United States monetary policy. If either domestic financial fragility or a possible liquidity trap limits the likelihood of monetary loosening, fiscal consolidation will result in a substantial and persistent Keynesian global recession. This would be bound to be very damaging to the third world. However, if the deficit reduction package can be accompanied by monetary loosening, such

recession will be only temporary; lower interest rates will ultimately allow the reallocation of resources to other borrowers including developing countries.

The second pair of simulations examine the impact of the realization of considerable additional demands on world savings, arising principally from the reconstruction of Eastern Europe and the CIS. Again, the outcome depends crucially on monetary policy. If the Bundesbank in Germany sharply tightens monetary policy, then a sharp appreciation of the DM will export the inflationary cost to the rest of the world, while leaving the other European countries in the shadow of recession. If instead, German monetary policy is accommodating, then this will create a world-wide boom and world-wide inflationary pressure. If monetary authorities ultimately find this rise in inflation unacceptable, as is likely, then such a scenario implies a stored up future adjustment crunch.

In the final simulation, the impact of a permanent US\$5 rise in the oil price has been considered. It is a single policy response: the main monetary authorities pursue unchanged monetary targets allowing interest rates to rise world-wide. This allows some scope for the relaxation of monetary policy at the same time as avoiding the risk of a permanent rise in inflation. The outcome is a bad one for developing countries, as it is for most industrialized countries.

The simulations should not be viewed in isolation. The possibility of combining the simulations presented in this paper have not been explicitly investigated. But, broadly speaking, taking the second and third simulations together - in both of which interest rates are fully variable - it may seem that the impact of a one per cent reduction in the United States budget deficit would offset about half of the increase in interest rates from additional savings demands from Eastern Europe and the CIS were they both to happen simultaneously.

Two caveats have to be put on such a claim, however. The first is that the foci of the shocks are located in different regional economies and so short-run regional adjustment costs will still be present. The second caveat relates to the crucial question of the exact timing of these medium-term adjustments. United States budget deficit reductions are currently being discussed as a result of the "peace dividend". But, by contrast, savings demands from the investment needs of Eastern Europe have not yet been realized, except perhaps in the case of the eastern part of Germany. A clear worry is that these large anticipated future needs will overshadow the current economic situation through the term structure of interest rates. Anticipated future higher interest rates will push up long rates immediately, potentially limiting how far interest rates can fall. This is precisely the situation discussed in the first simulation of United States fiscal consolidation.

B. Three significant themes

Three major themes may be:

- (a) Monetary policy in the G3 countries is of vital importance especially in a world in which exchange rates float among the G3 countries. Monetary outcomes can make all the difference, in the case of a United States fiscal consolidation, between a global Keynesian collapse and an orderly making-way for others to take up the resources which the United States government releases. And monetary discipline can prevent the inflationary pressures resulting from the rebuilding of the eastern bloc or from an oil price shock degenerating into a global inflationary spiral.

If interest rates are able to move in response to expenditure shocks, the results are relatively short-term effects on output in those countries subject to the shock, and positive transmission through both trade volumes and exchange rates to the rest of the world. In the longer-term, changes in the level of world interest rates will equilibrate global savings and investment demands.

In contrast, if interest rate movements are disabled for any reason in the face of expenditure shocks, the effects will be much stronger and longer-lasting. Transmission will again be positive, but painful world adjustments through prices may be required to restore equilibrium.

- (b) Outcomes in the United States are particularly important for the developing economies. The majority of developing country debt is denominated in United States dollars and a large number of developing countries peg their currencies to the dollar. United States interest and exchange rates therefore have special importance for the affected economies. The United States is less important directly in trade terms: here the economies of Europe and Japan are often more important.
- (c) Finally, the impact of external demand shocks on different groups of developing countries crucially depends on their flexibility of domestic supply. Adjustment in the Asian NIEs is much easier than in the capital-constrained economies of Latin America or Africa.

C. A methodological note

Finally, from a methodological viewpoint, our results are encouraging. They suggest that there are things which can be learned from discussing regional as distinct from national developing country experience. The differences between regions in these results appear to correspond to meaningful economic divisions, rather than being the result of an arbitrary aggregation. The addition of an extra Asian region, planned in the near future, should add another facet to what can be learned from this kind of exercise. Discussions at the Earth Summit in Rio de Janeiro suggested that global North-South macroeconomic issues and their regional consequences, of the kind discussed in this paper, are going to become more and more important.

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Figure 1
**US FISCAL CONSOLIDATION:
 INDUSTRIALIZED ECONOMIES
 % DIFFERENCE FROM BASE**

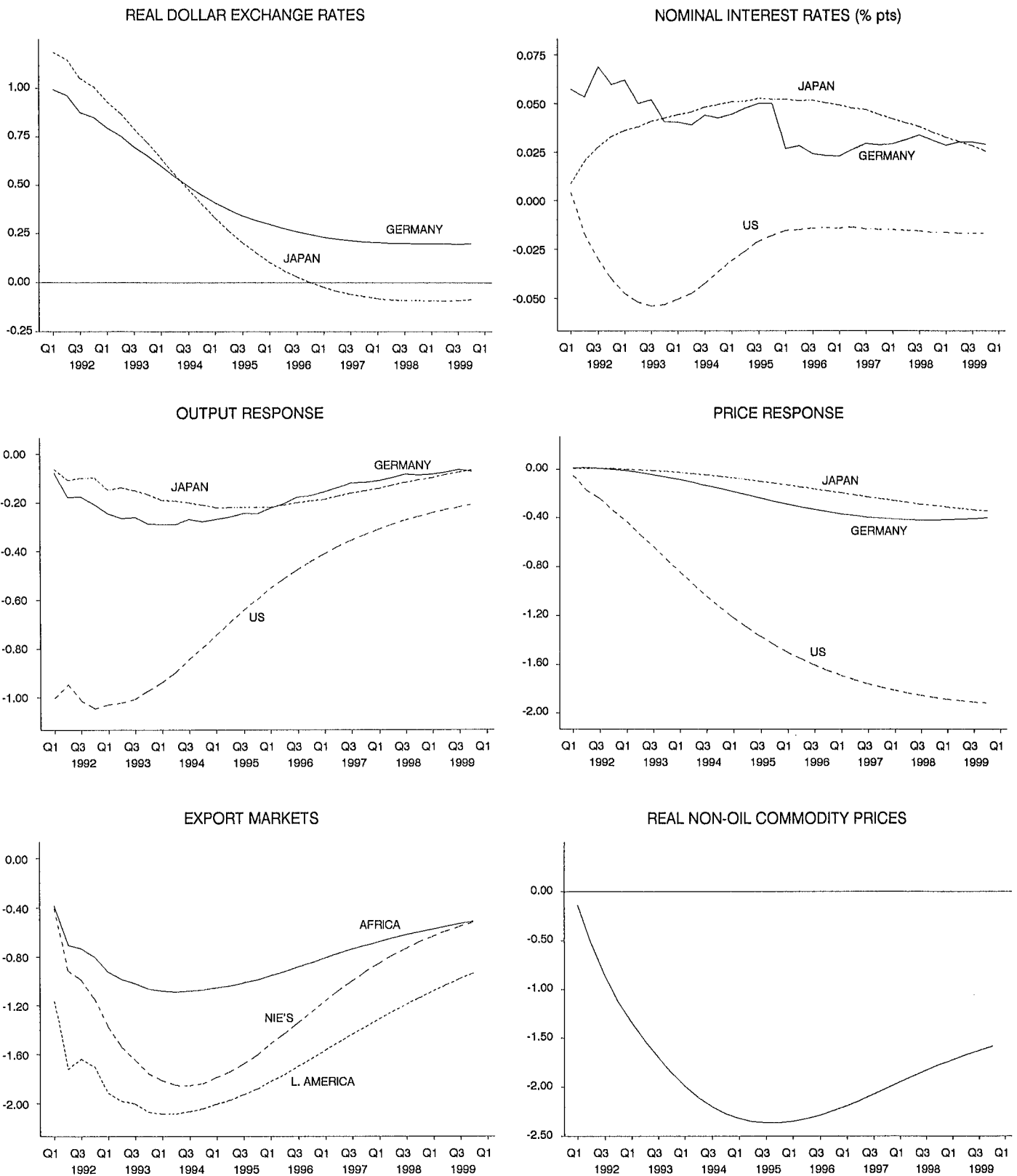


Figure 2

**US FISCAL CONSOLIDATION:
DEVELOPING ECONOMIES
% DIFFERENCE FROM BASE**

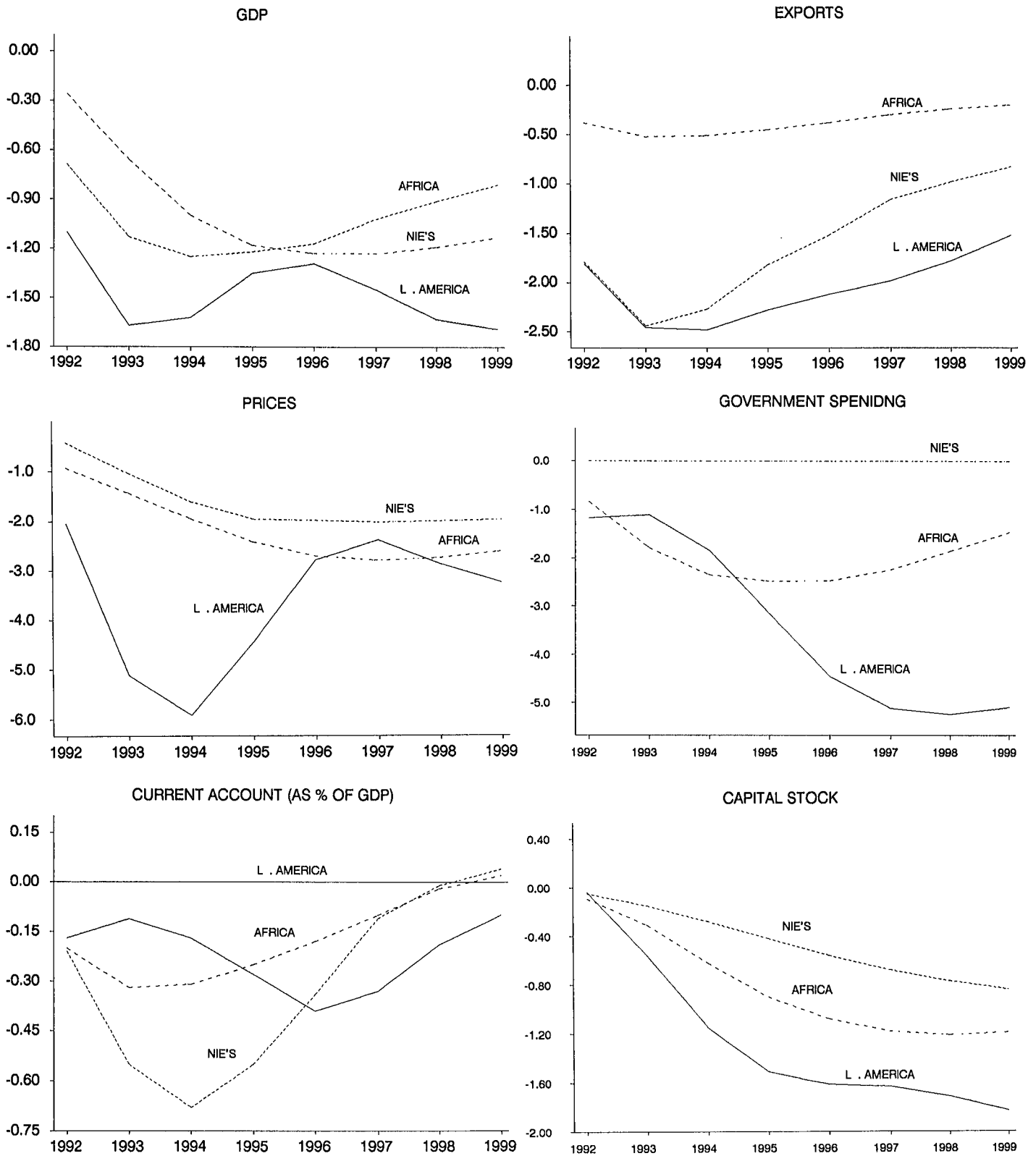
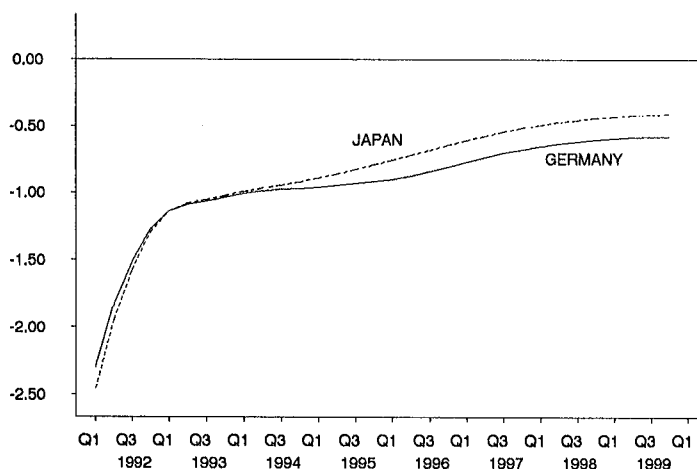


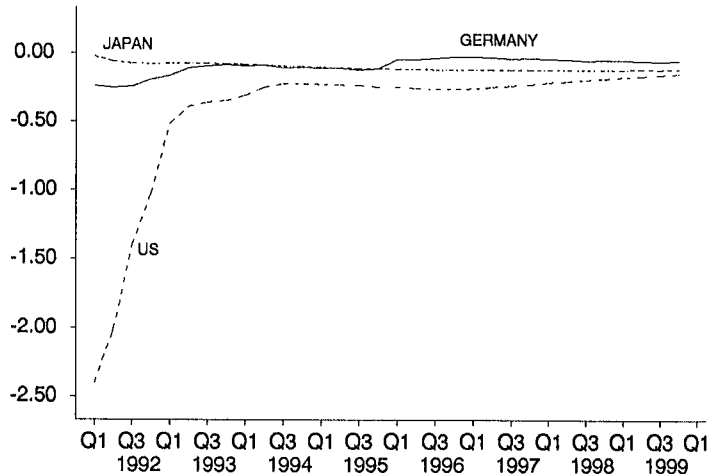
Figure 3

**US FISCAL CONSOLIDATION WITH MONETARY
LOOSENING: INDUSTRIALIZED ECONOMIES
% DIFFERENCE FROM BASE**

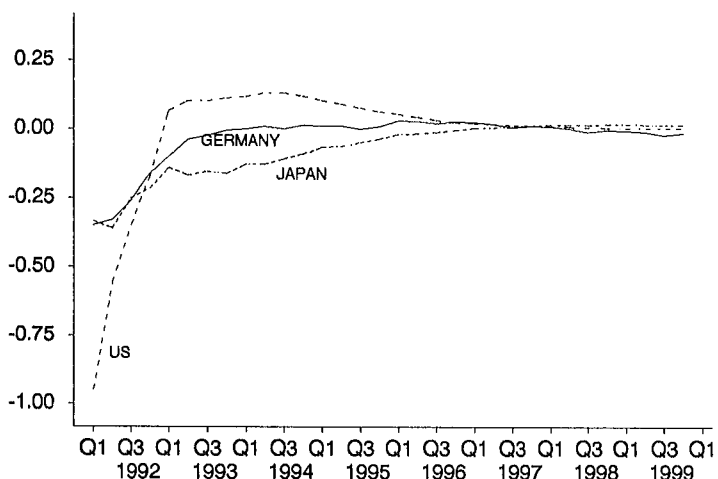
REAL DOLLAR EXCHANGE RATES



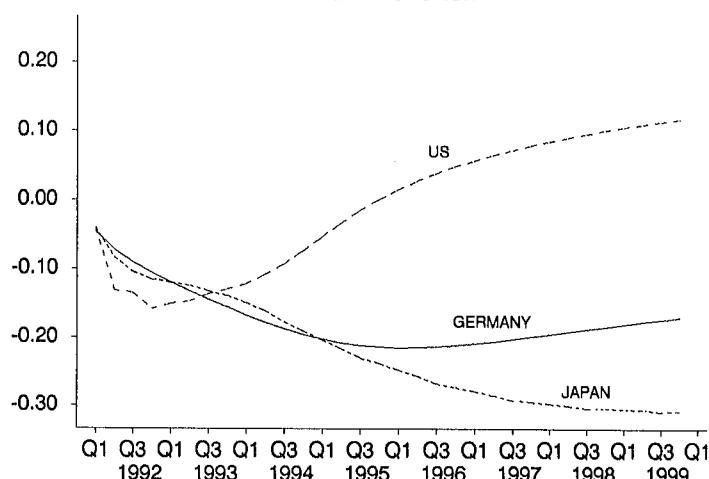
NOMINAL INTEREST RATES (% pts)



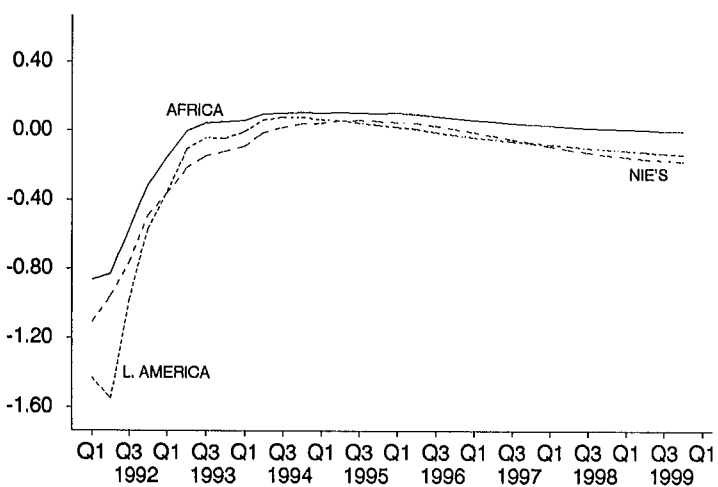
OUTPUT RESPONSE



PRICE RESPONSE



EXPORT MARKETS



REAL NON-OIL COMMODITY PRICES

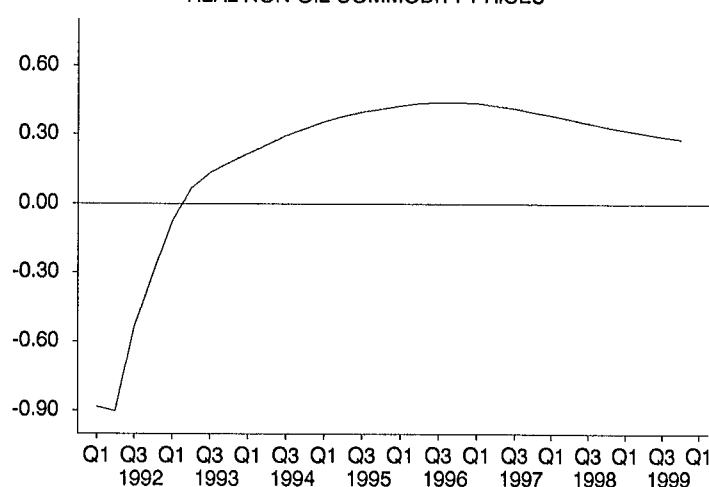


Figure 4

US FISCAL CONSOLIDATION WITH MONETARY LOOSENING: DEVELOPING ECONOMIES
% DIFFERENCE FROM BASE

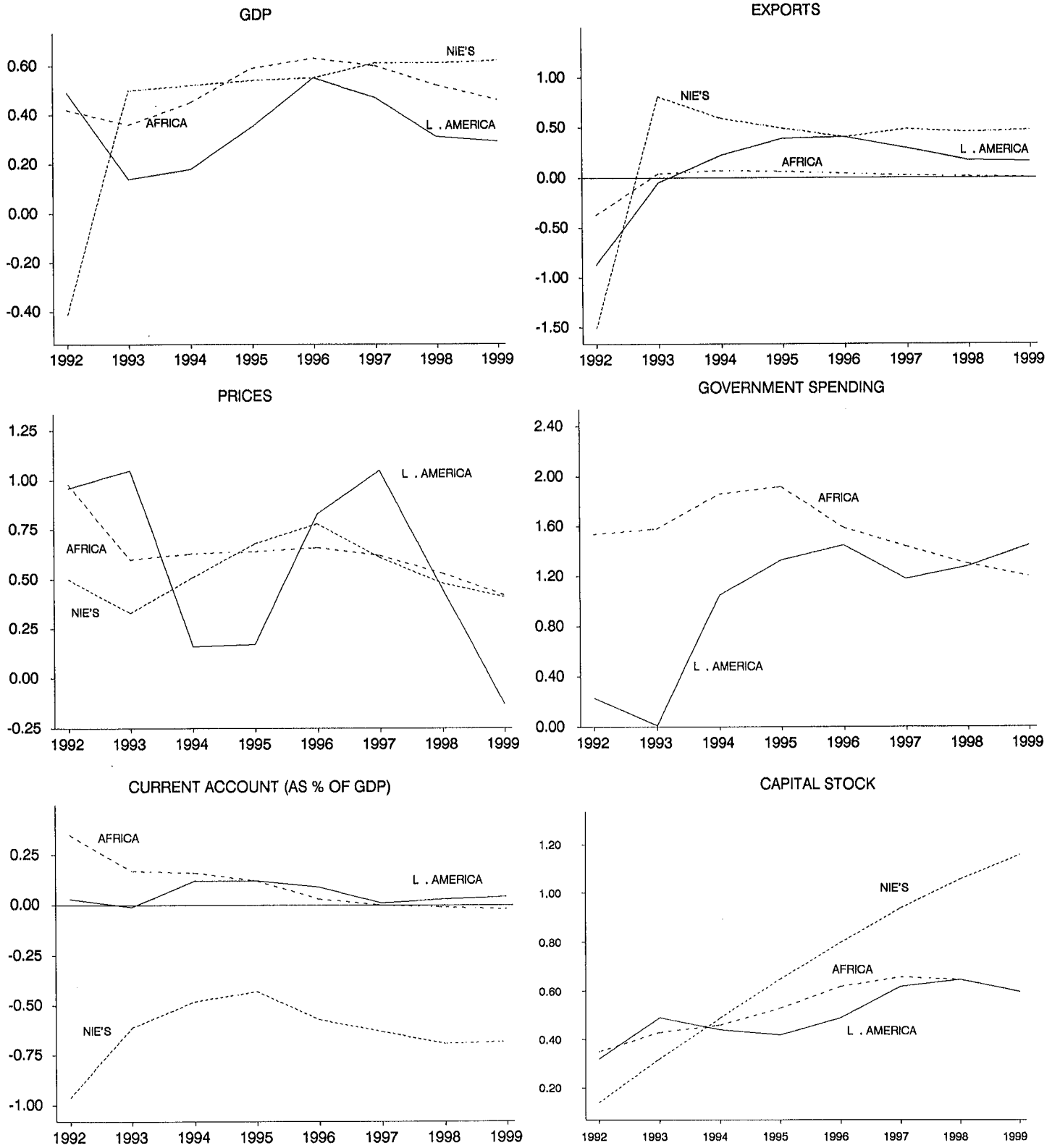
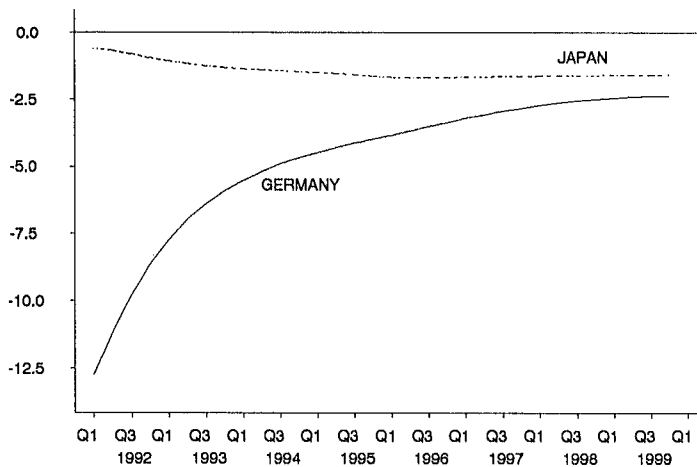


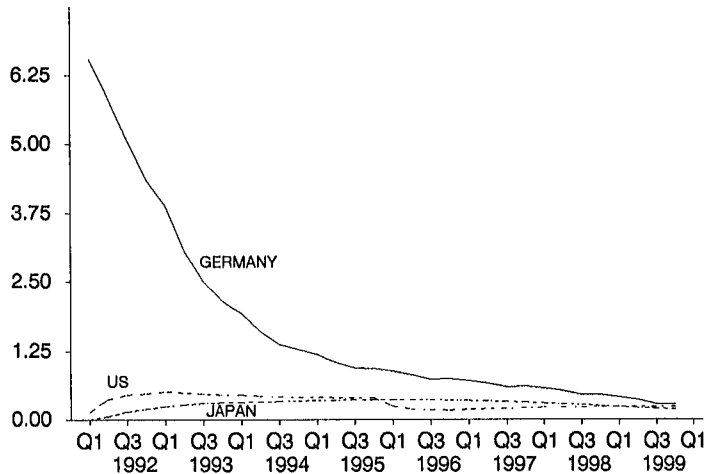
Figure 5

**ADDITIONAL DEMANDS ON WORLD SAVINGS:
INDUSTRIALIZED ECONOMIES
% DIFFERENCE FROM BASE**

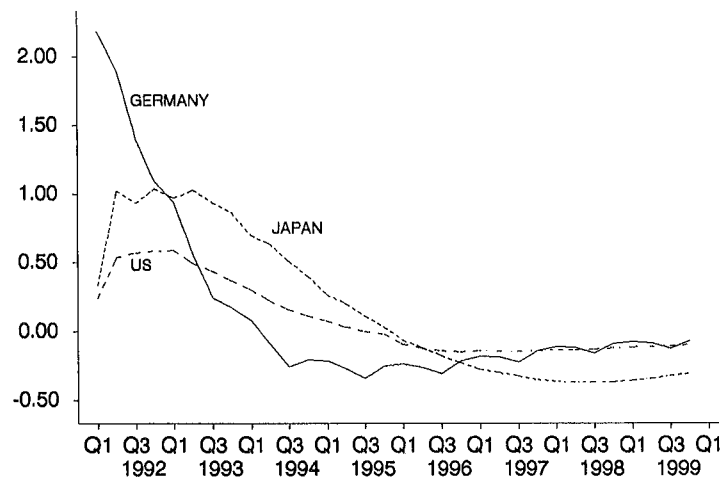
REAL DOLLAR EXCHANGE RATES



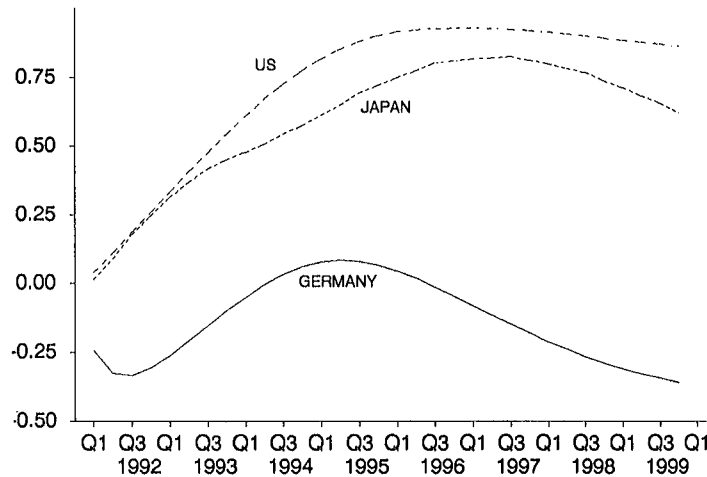
NOMINAL INTEREST RATES (% pts)



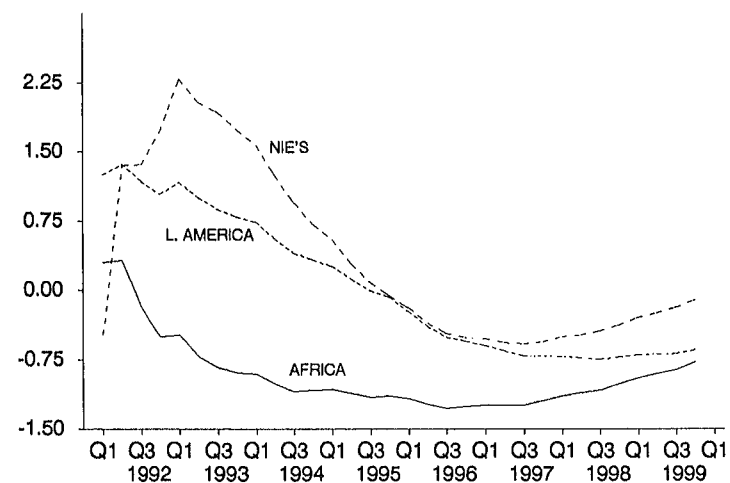
OUTPUT RESPONSE



PRICE RESPONSE



EXPORT MARKETS



REAL NON-OIL COMMODITY PRICES

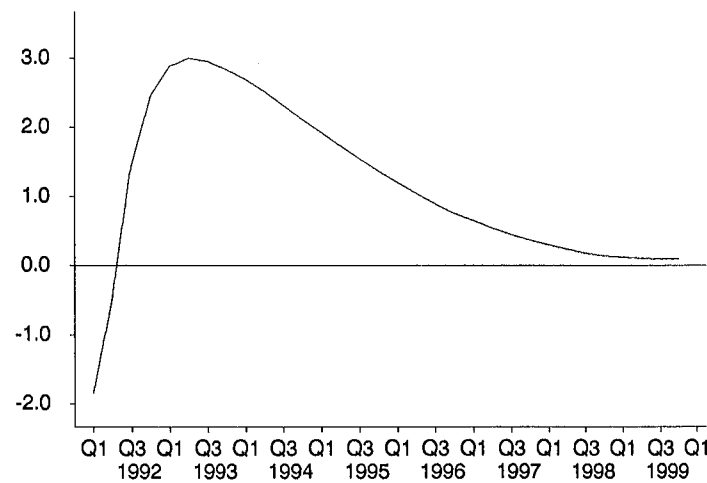


Figure 6

**ADDITIONAL DEMANDS ON WORLD SAVINGS:
DEVELOPING ECONOMIES
% DIFFERENCE FROM BASE**

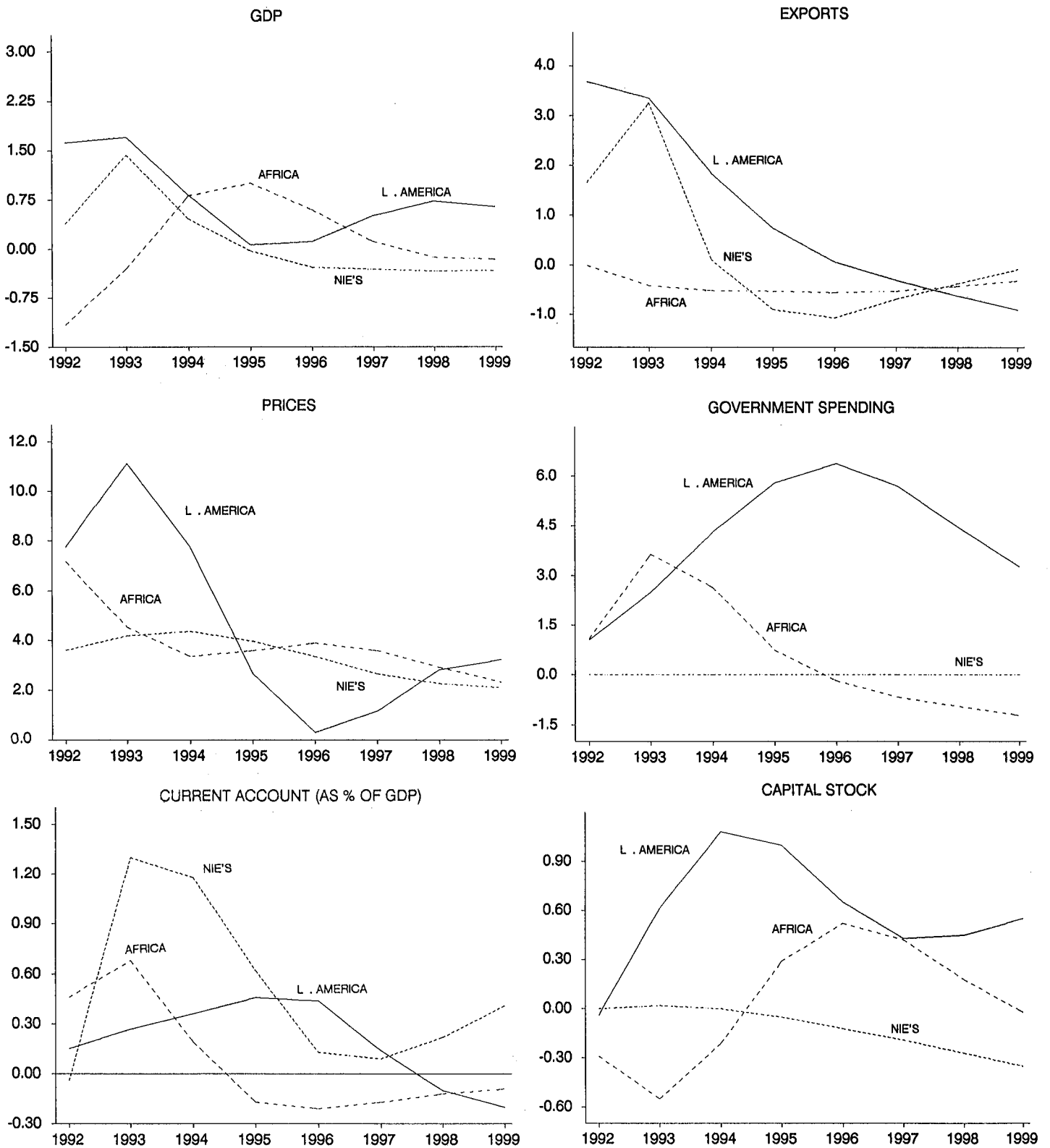
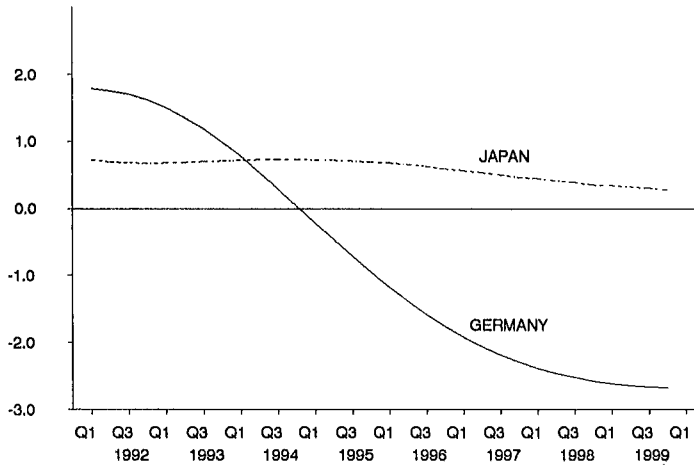


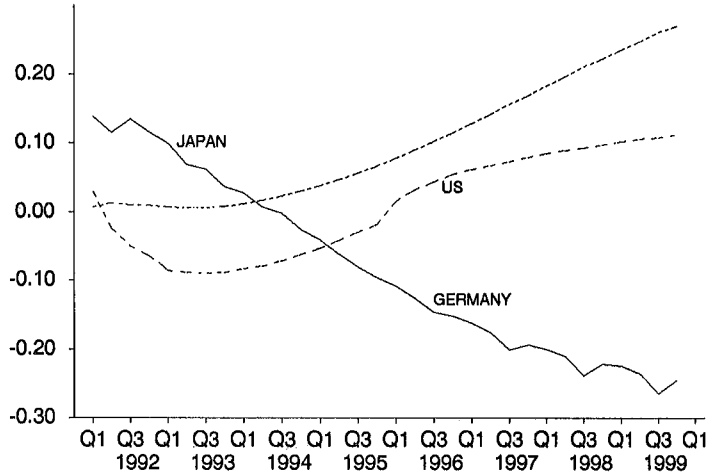
Figure 7

**ADDITIONAL DEMANDS WITH GERMAN ACCOMMODATION:
INDUSTRIALIZED ECONOMIES
% DIFFERENCE FROM BASE**

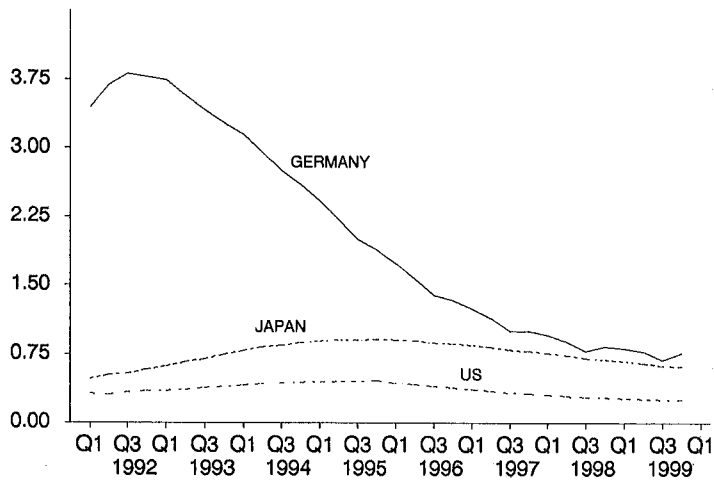
REAL DOLLAR EXCHANGE RATES



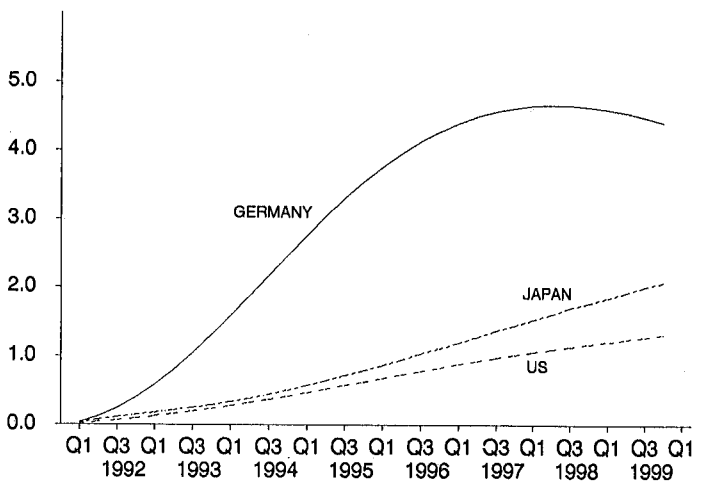
NOMINAL INTEREST RATES (% pts)



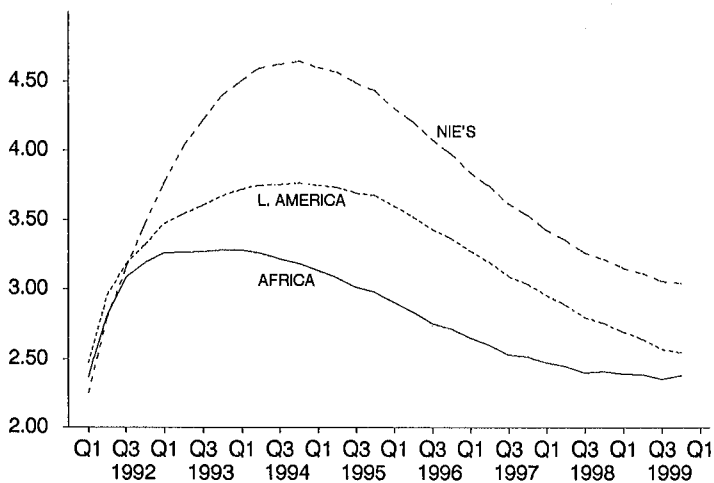
OUTPUT RESPONSE



PRICE RESPONSE



EXPORT MARKETS



REAL NON-OIL COMMODITY PRICES

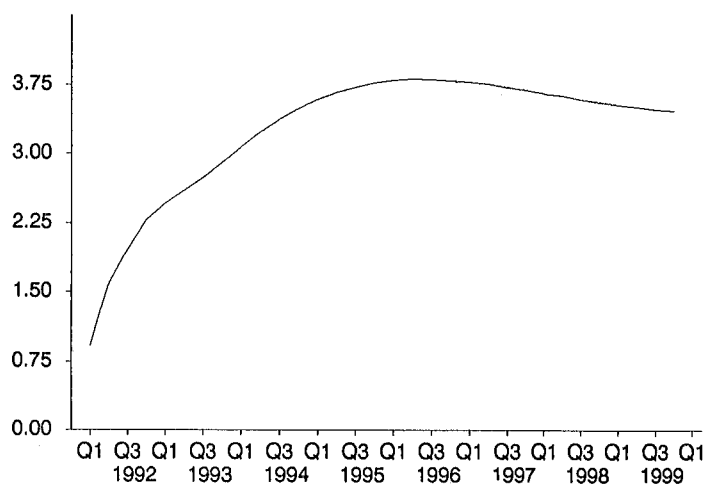


Figure 8

**ADDITIONAL DEMANDS WITH GERMAN ACCOMMODATION:
DEVELOPING ECONOMIES
% DIFFERENCE FROM BASE**

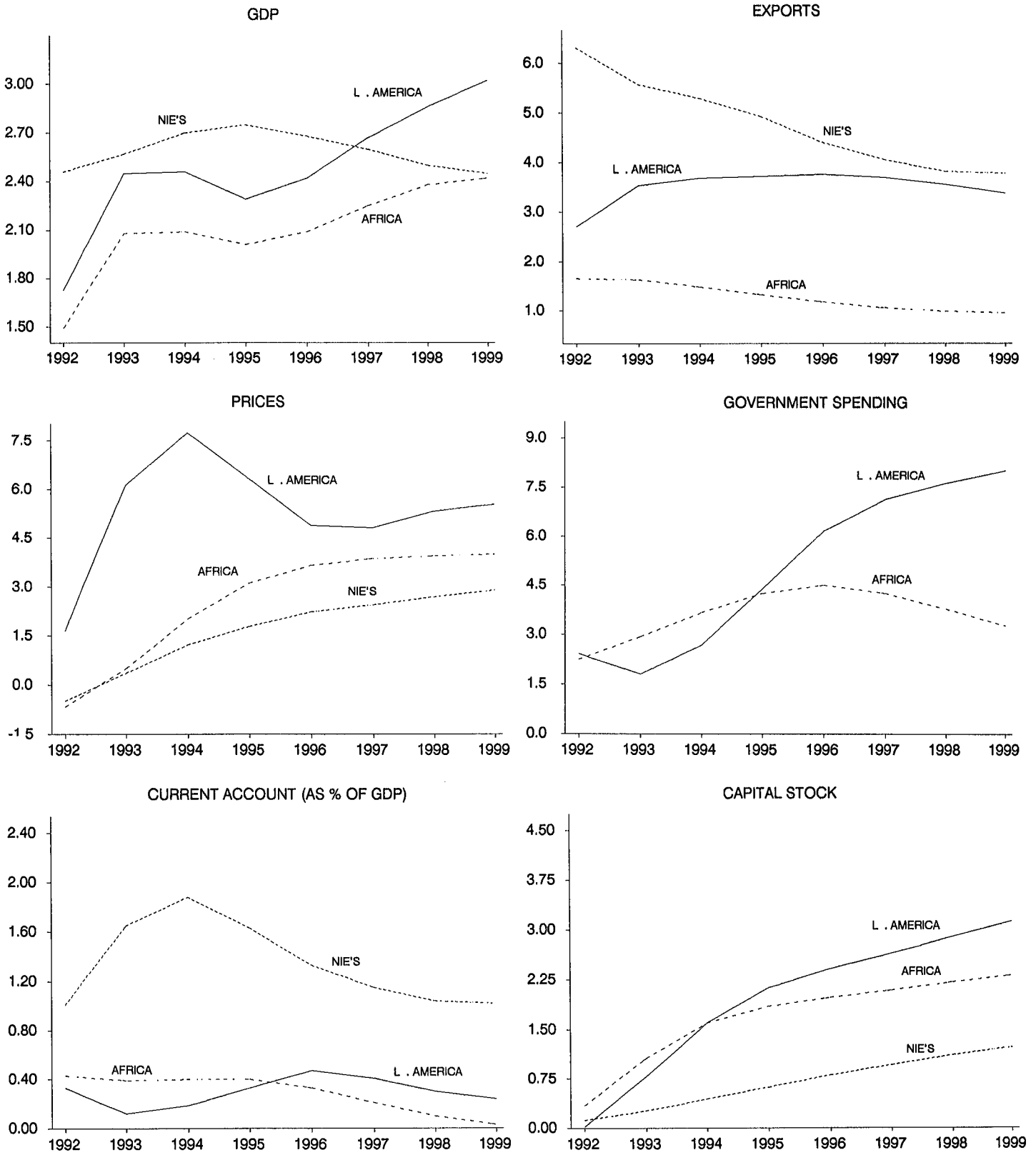
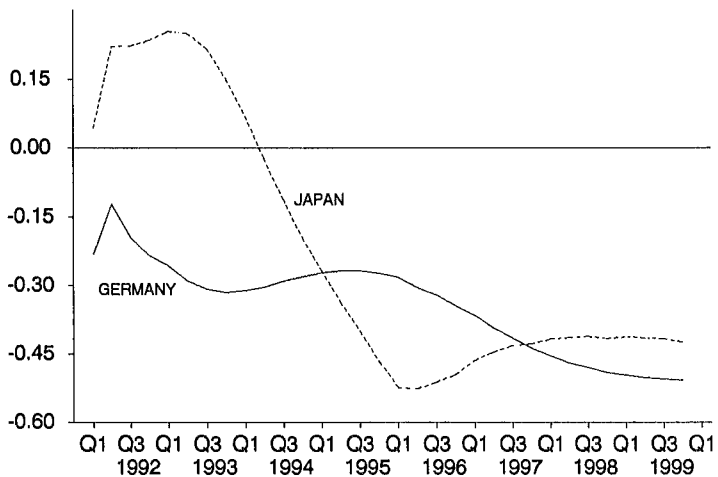


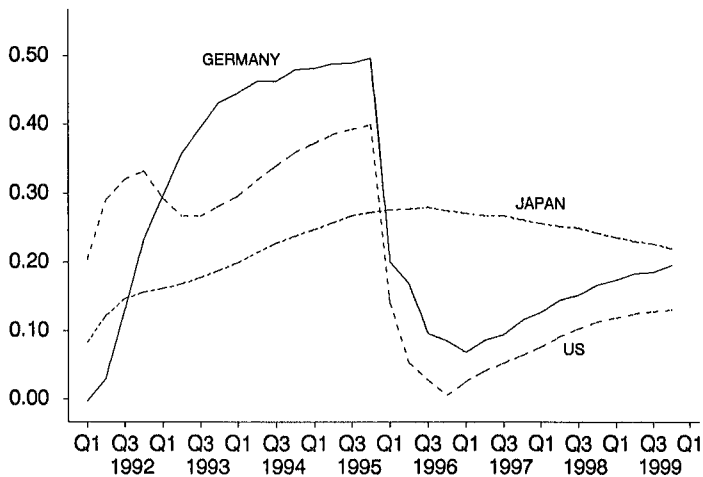
Figure 9

**RISE IN PRICE OF OIL BY \$5 PER BARREL:
INDUSTRIALIZED ECONOMIES
% DIFFERENCE FROM BASE**

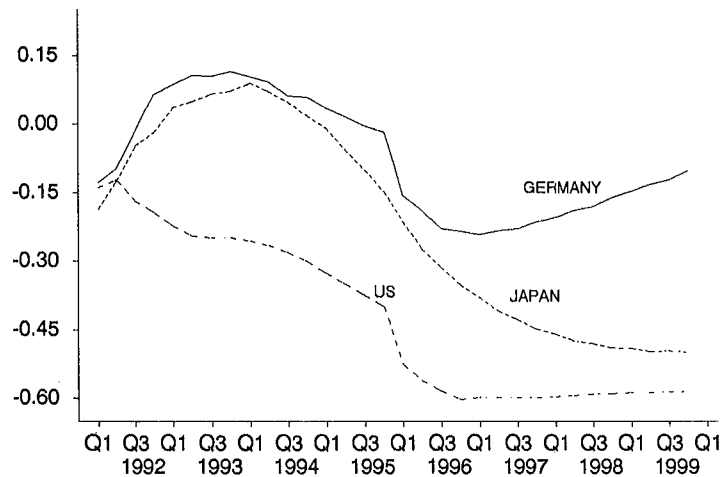
REAL DOLLAR EXCHANGE RATES



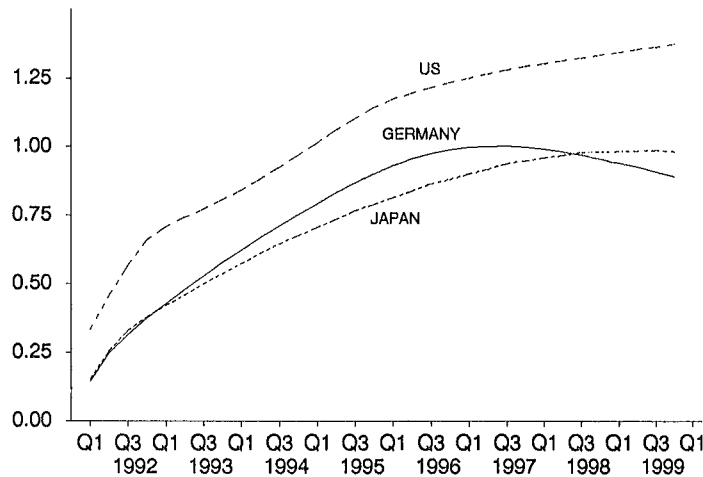
NOMINAL INTEREST RATES (% pts)



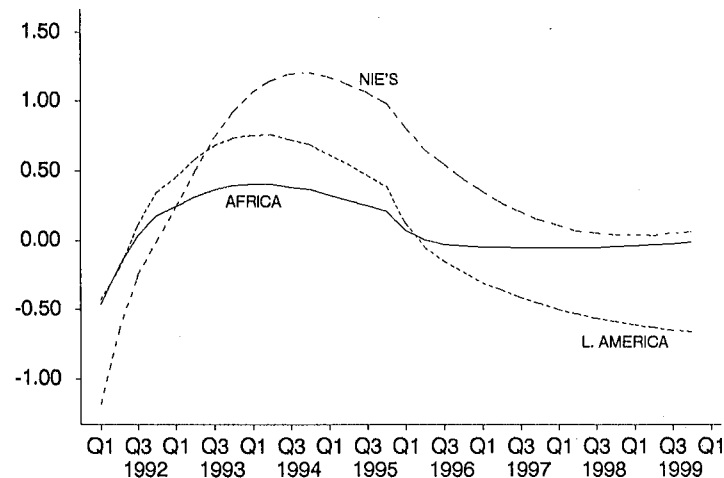
OUTPUT RESPONSE



PRICE RESPONSE



EXPORT MARKETS



REAL NON-OIL COMMODITY PRICES

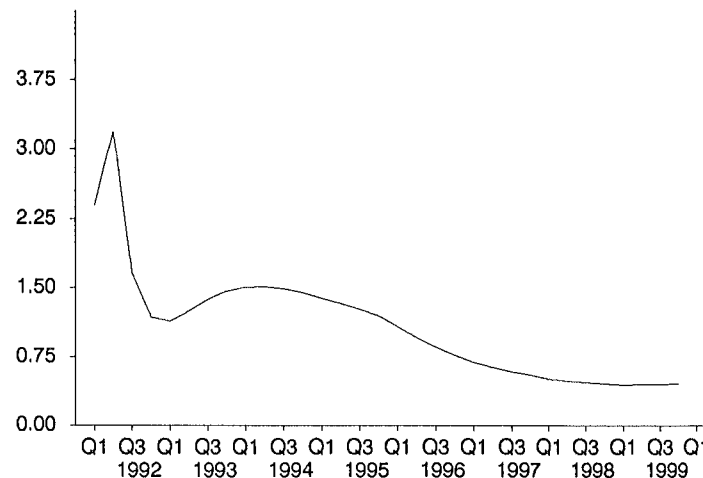


Figure 10
**RISE IN PRICE OF OIL BY \$5 PER BARREL:
 DEVELOPING ECONOMIES
 % DIFFERENCE FROM BASE**

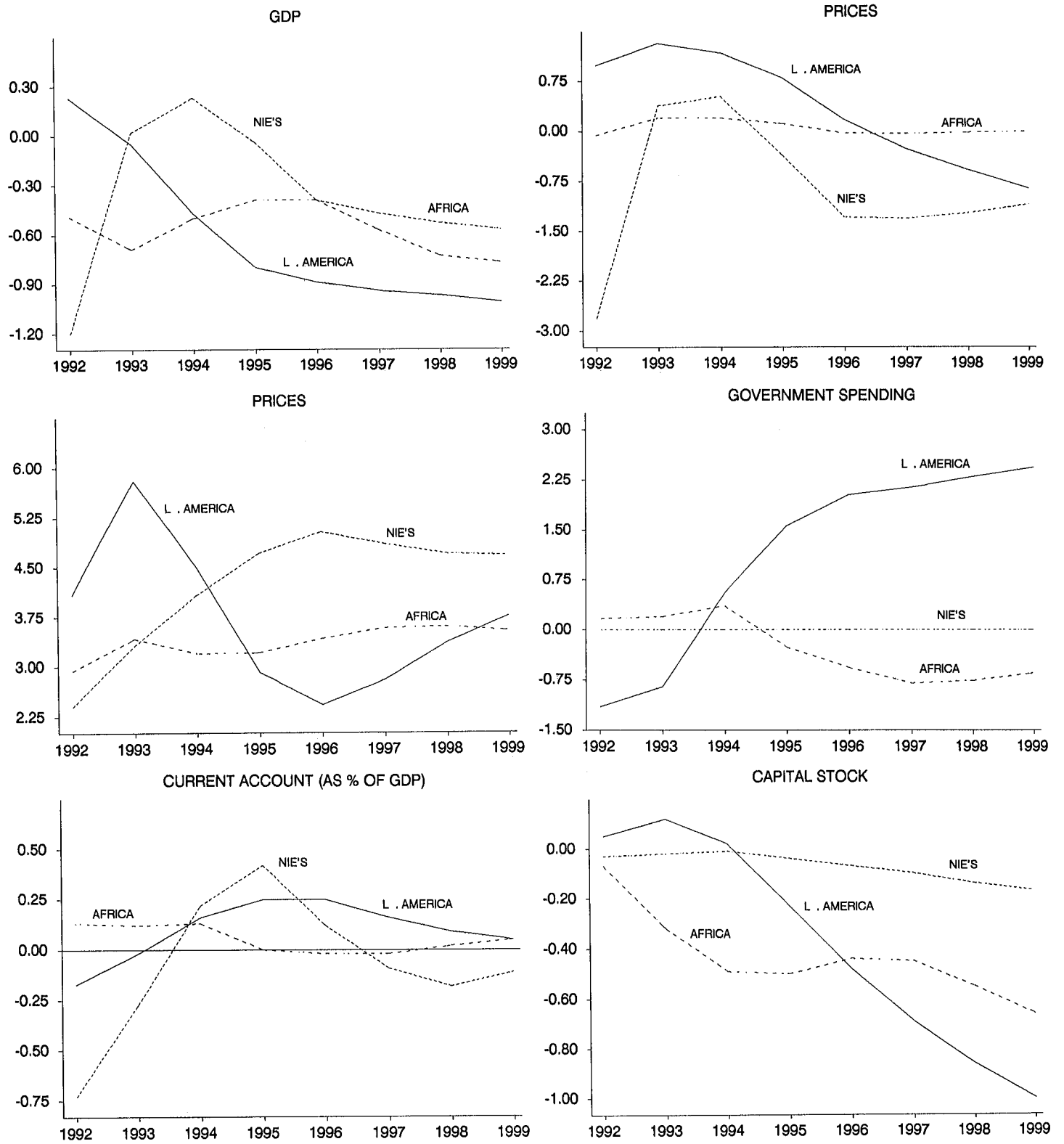


Table 1: U.S. Fiscal Consolidation with Money remaining Tight.

Africa

	Consumer Spending %s	Invest- ment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	-.05	-.51	-.83	-.38	-.30	-.26	-.09	-.93	.00	-1.46	-.93	-179	-283	-650
1993	-.39	-1.30	-1.78	-.52	-.83	-.66	-.31	-1.44	.07	-2.69	-1.37	-400	-445	-1735
1994	-.78	-2.02	-2.35	-.51	-1.32	-1.00	-.62	-1.95	.26	-3.46	-1.69	-525	-447	-2890
1995	-1.10	-2.31	-2.48	-.45	-1.65	-1.18	-.90	-2.42	.50	-3.87	-1.93	-527	-361	-3877
1996	-1.33	-2.05	-2.47	-.38	-1.80	-1.23	-1.08	-2.71	.67	-3.97	-2.07	-423	-232	-4556
1997	-1.49	-1.66	-2.24	-.30	-1.85	-1.23	-1.18	-2.80	.70	-3.85	-2.12	-247	-55	-4794
1998	-1.58	-1.35	-1.85	-.24	-1.82	-1.19	-1.21	-2.75	.63	-3.67	-2.15	-68	124	-4587
1999	-1.61	-1.10	-1.46	-.20	-1.74	-1.13	-1.19	-2.62	.50	-3.50	-2.13	98	231	-4082

Asian NIEs

	Consumer Spending %s	Invest- ment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	-.35	-.28	.00	-1.79	-1.09	-.69	-.05	-.43	-.46	-.48	-.89	433	-771	-2479
1993	-.76	-.63	.00	-2.44	-1.60	-1.13	-.15	-1.04	-.29	-1.48	-1.33	839	-1932	-8951
1994	-1.06	-.91	.00	-2.27	-1.67	-1.25	-.28	-1.61	-.01	-2.29	-1.62	1089	-2423	-17002
1995	-1.23	-1.12	.00	-1.82	-1.58	-1.22	-.42	-1.96	.12	-2.55	-1.84	1166	-1921	-23094
1996	-1.29	-1.24	.00	-1.52	-1.50	-1.17	-.56	-1.99	.17	-2.26	-1.82	1240	-1145	-26189
1997	-1.16	-1.27	.00	-1.16	-1.29	-1.02	-.68	-2.03	.00	-2.07	-2.04	1199	-175	-25644
1998	-.97	-1.27	.00	-.98	-1.11	-.91	-.77	-2.01	-.03	-1.81	-2.04	1130	410	-22951
1999	-.78	-1.24	.00	-.83	-.93	-.81	-.84	-1.98	-.05	-1.64	-2.03	1010	844	-18741

Latin America

	Consumer Spending %s	Invest- ment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	-1.12	-.26	-1.17	-1.81	-1.25	-1.10	-.04	-2.05	1.25	-.88	-.83	1529	-2076	-2169
1993	-1.56	-3.11	-1.10	-2.46	-4.03	-1.67	-.56	-5.12	4.12	-2.21	-1.21	3360	-837	-3676
1994	-1.24	-4.03	-1.84	-2.48	-4.67	-1.62	-1.15	-5.92	4.72	-3.37	-1.48	2328	-1824	-6340
1995	-.74	-3.44	-3.15	-2.28	-4.08	-1.35	-1.51	-4.45	2.89	-3.92	-1.69	-659	-3967	-13669
1996	-.64	-2.29	-4.45	-2.12	-3.26	-1.29	-1.61	-2.79	1.01	-3.91	-1.81	-2610	-5712	-27343
1997	-.92	-1.93	-5.11	-1.98	-3.19	-1.45	-1.63	-2.39	.52	-3.68	-1.88	-3021	-5135	-45036
1998	-1.25	-2.25	-5.23	-1.78	-3.57	-1.63	-1.71	-2.87	1.02	-3.52	-1.88	-2508	-3063	-62788
1999	-1.43	-2.59	-5.08	-1.52	-3.87	-1.69	-1.83	-3.25	1.40	-3.46	-1.89	-1890	-1140	-77867

Table 2: U.S. Fiscal Consolidation with "Monetary Loosening".

Africa

	Consumer Spending %	Invest- ment %	Govt. Cons. %	Exports %	Imports %	GNP %	Capital Stock %	Consumer Prices %	Real Exch Rate %	Export Prices %	Import Prices %	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	.11	2.02	1.54	-.37	.49	.42	.35	.98	.00	.43	.98	-1110	503	406
1993	.19	.78	1.58	.04	.52	.36	.43	.60	-.03	.66	.57	-235	252	777
1994	.34	.61	1.86	.07	.61	.45	.46	.63	-.02	.86	.61	-141	247	1188
1995	.54	.89	1.92	.06	.81	.59	.53	.64	.02	1.00	.65	-143	198	1500
1996	.66	1.08	1.59	.04	.90	.63	.62	.66	.00	1.04	.65	-104	15	1475
1997	.69	.88	1.44	.02	.88	.60	.66	.62	-.03	.96	.59	-149	-43	1310
1998	.66	.58	1.30	.01	.80	.52	.65	.53	.00	.84	.53	-188	-79	1055
1999	.61	.35	1.20	.00	.71	.46	.60	.42	.08	.77	.50	-201	-89	774

Asian NIEs

	Consumer Spending %	Invest- ment %	Govt. Cons. %	Exports %	Imports %	GNP %	Capital Stock %	Consumer Prices %	Real Exch Rate %	Export Prices %	Import Prices %	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	-.32	.82	.00	-1.51	-.65	-.41	.14	.50	.39	.38	.89	1194	-2600	-8616
1993	.15	1.19	.00	.81	.75	.50	.32	.33	.22	-.62	.55	149	-1641	-14692
1994	.26	1.32	.00	.59	.69	.52	.49	.51	.07	-.18	.58	107	-1364	-19735
1995	.32	1.44	.00	.49	.69	.54	.65	.68	-.06	.00	.62	52	-1360	-24827
1996	.35	1.56	.00	.40	.71	.55	.80	.78	.00	.01	.78	195	-1991	-32174
1997	.41	1.66	.00	.48	.81	.61	.94	.61	-.06	-.36	.55	225	-2399	-41023
1998	.39	1.70	.00	.45	.80	.61	1.06	.48	.02	-.57	.50	268	-2805	-51362
1999	.34	1.72	.00	.47	.79	.62	1.16	.41	.07	-.67	.48	290	-2961	-62238

Latin America

	Consumer Spending %	Invest- ment %	Govt. Cons. %	Exports %	Imports %	GNP %	Capital Stock %	Consumer Prices %	Real Exch Rate %	Export Prices %	Import Prices %	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	.50	2.18	.23	-.87	.56	.49	.32	.96	-.09	.30	.87	-4872	493	-1047
1993	.05	1.34	.01	-.05	1.06	.14	.49	1.05	-.53	.58	.51	-1681	-234	-2700
1994	.03	.22	1.05	.22	.20	.18	.44	.16	.38	.68	.55	-438	1787	-1735
1995	.22	.38	1.33	.39	.59	.35	.42	.17	.42	.72	.59	-478	1708	1022
1996	.45	.90	1.45	.40	1.03	.55	.49	.83	-.24	.82	.59	-1043	1483	4600
1997	.35	1.33	1.18	.29	1.32	.47	.62	1.05	-.53	.89	.51	-523	315	7435
1998	.18	.89	1.28	.17	.94	.31	.65	.45	.02	.83	.47	320	432	10174
1999	.19	.39	1.45	.16	.61	.29	.60	-.13	.58	.67	.45	754	655	13284

Table 3: Additional Demands on World Savings.

Africa

	Consumer Spending %	Invest- ment %	Govt. Cons. %	Exports %	Imports %	GNP %	Capital Stock %	Consumer Prices %	Real Exch Rate %	Export Prices %	Import Prices %	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	-1.97	-1.70	1.10	-.01	-1.36	-1.16	-.29	7.16	.00	7.52	7.16	826	671	1751
1993	-.74	-1.68	3.64	-.42	-.62	-.30	-.55	4.52	.35	7.55	4.89	1155	1021	4359
1994	.69	1.37	2.64	-.52	.55	.81	-.21	3.36	.53	6.12	3.90	1016	209	5301
1995	1.16	2.79	.75	-.53	1.04	1.00	.29	3.58	-.11	5.02	3.47	785	-468	4792
1996	.93	1.77	-.18	-.56	.78	.60	.52	3.89	-.78	4.03	3.08	314	-567	3841
1997	.56	-.12	-.67	-.53	.26	.11	.42	3.59	-.93	3.15	2.62	45	-499	2883
1998	.34	-1.08	-.95	-.43	-.08	-.13	.18	2.92	-.63	2.54	2.27	-121	-392	2046
1999	.24	-1.06	-1.21	-.32	-.21	-.16	-.02	2.32	-.24	2.24	2.07	-161	-314	1343

Asian NIEs

	Consumer Spending %	Invest- ment %	Govt. Cons. %	Exports %	Imports %	GNP %	Capital Stock %	Consumer Prices %	Real Exch Rate %	Export Prices %	Import Prices %	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	-.28	-.03	.00	1.66	.62	.39	.00	3.60	3.02	4.91	6.72	-908	673	1624
1993	.75	.16	.00	3.26	1.55	1.43	.02	4.18	.44	5.40	4.64	-1885	4984	18559
1994	.76	-.09	.00	.11	-.02	.46	.00	4.36	-.62	5.89	3.71	-1612	4464	33822
1995	.54	-.32	.00	-.90	-.48	-.03	-.05	3.96	-.62	4.70	3.31	-1364	2352	41351
1996	.21	-.43	.00	-1.07	-.60	-.28	-.12	3.35	-.24	3.43	3.10	-1043	461	42023
1997	-.07	-.54	.00	-.69	-.52	-.31	-.19	2.65	-.15	2.38	2.49	-955	150	41623
1998	-.31	-.66	.00	-.38	-.50	-.34	-.27	2.26	-.11	2.08	2.15	-857	548	42831
1999	-.42	-.78	.00	-.09	-.43	-.33	-.35	2.10	-.14	2.17	1.96	-811	1208	46586

Latin America

	Consumer Spending %	Invest- ment %	Govt. Cons. %	Exports %	Imports %	GNP %	Capital Stock %	Consumer Prices %	Real Exch Rate %	Export Prices %	Import Prices %	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	1.66	-.30	1.06	3.68	1.85	1.62	-.04	7.75	-1.24	4.02	6.42	-4505	2599	1817
1993	1.19	3.82	2.49	3.35	5.18	1.70	.61	11.13	-6.08	6.39	4.37	-3112	3174	6187
1994	-.16	3.41	4.31	1.84	3.71	.82	1.08	7.74	-3.96	6.72	3.48	3325	5185	17267
1995	-.99	.67	5.80	.74	1.09	.06	1.00	2.65	.43	5.71	3.09	8162	6766	36969
1996	-.63	-1.18	6.38	.06	-.37	.11	.65	.31	2.45	4.27	2.77	8156	6236	62265
1997	.20	-.69	5.69	-.31	.28	.51	.43	1.17	1.18	3.23	2.36	6347	2372	85990
1998	.71	.58	4.43	-.63	1.34	.73	.45	2.82	-.74	2.77	2.05	3867	-1825	102253
1999	.77	1.10	3.27	-.91	1.68	.64	.55	3.24	-1.33	2.63	1.87	2412	-3937	109824

Table 4: Additional Demands on World Saving with German Accommodation.

Africa														
	Consumer Spending %s	Invest- ment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	1.25	1.99	2.25	1.65	1.75	1.49	.34	-.67	.00	.71	-.67	201	629	1341
1993	1.78	4.16	2.94	1.63	2.79	2.08	1.06	.50	-.46	2.21	.04	443	573	2697
1994	1.88	4.06	3.67	1.48	3.12	2.09	1.60	2.01	-1.22	3.47	.77	635	610	4228
1995	2.01	3.15	4.26	1.32	3.20	2.01	1.85	3.11	-1.54	4.58	1.52	709	665	5905
1996	2.31	2.60	4.51	1.17	3.34	2.09	1.98	3.65	-1.46	5.30	2.13	647	544	7310
1997	2.69	2.64	4.26	1.05	3.54	2.25	2.09	3.86	-1.24	5.68	2.56	496	247	8054
1998	3.00	2.80	3.78	.98	3.70	2.38	2.21	3.94	-1.08	5.86	2.82	292	-49	8109
1999	3.17	2.81	3.28	.95	3.75	2.42	2.31	3.99	-.97	5.93	2.98	81	-252	7654
Asian NIEs														
	Consumer Spending %s	Invest- ment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	1.52	.67	.00	6.31	3.93	2.46	.12	-.49	-.06	-.91	-.55	-1278	3186	10750
1993	2.12	.97	.00	5.57	3.85	2.57	.26	.36	-.28	1.62	.08	-1672	5466	29726
1994	2.58	1.27	.00	5.29	3.93	2.70	.44	1.22	-.46	3.04	.76	-2232	6548	52253
1995	2.93	1.52	.00	4.93	3.95	2.75	.62	1.78	-.30	3.59	1.48	-2589	5880	71866
1996	3.01	1.69	.00	4.41	3.74	2.68	.80	2.22	.00	3.81	2.22	-2997	4805	87005
1997	2.93	1.81	.00	4.06	3.49	2.60	.96	2.44	.01	3.68	2.46	-3241	4023	98966
1998	2.74	1.87	.00	3.82	3.23	2.50	1.11	2.68	.03	3.63	2.71	-3363	3380	108348
1999	2.57	1.91	.00	3.79	3.11	2.45	1.23	2.89	-.03	3.60	2.85	-3413	2899	115872
Latin America														
	Consumer Spending %s	Invest- ment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	1.77	.12	2.42	2.71	1.97	1.73	.02	1.64	-2.21	.49	-.61	-1468	4040	4742
1993	2.40	4.52	1.81	3.54	6.45	2.45	.78	6.13	-5.78	1.96	-.01	-4604	1095	8027
1994	2.10	5.58	2.69	3.69	7.28	2.46	1.60	7.74	-6.60	3.55	.63	-3611	2371	12251
1995	1.64	5.02	4.40	3.73	6.82	2.29	2.13	6.32	-4.72	4.65	1.30	115	5339	22311
1996	1.68	4.11	6.17	3.76	6.20	2.42	2.41	4.88	-2.89	5.16	1.84	2378	7948	40800
1997	2.00	4.08	7.13	3.70	6.43	2.67	2.64	4.82	-2.48	5.40	2.22	2988	7449	64999
1998	2.29	4.39	7.64	3.56	6.90	2.86	2.89	5.32	-2.72	5.60	2.46	3044	5439	90766
1999	2.55	4.60	8.03	3.38	7.19	3.02	3.12	5.53	-2.78	5.75	2.59	2959	3743	115441

Table 5: Rise in Oil Price by five dollars per barrel.

Africa

	Consumer Spending %s	Investment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	-.83	-.42	.17	-.06	-.58	-.49	-.07	2.94	.00	3.15	2.94	445	185	595
1993	-1.05	-1.41	.20	.20	-.92	-.69	-.32	3.42	.17	3.16	3.60	394	120	1038
1994	-.85	-1.24	.36	.20	-.88	-.50	-.49	3.20	.45	3.43	3.67	469	140	1558
1995	-.70	-.58	-.26	.11	-.82	-.39	-.50	3.21	.50	3.36	3.73	496	-82	1655
1996	-.71	-.09	-.57	-.03	-.82	-.39	-.44	3.42	.35	3.09	3.78	164	-128	1487
1997	-.89	-.52	-.80	-.04	-1.02	-.57	-.45	3.58	.21	2.86	3.79	61	-155	1213
1998	-1.06	-1.06	-.76	-.02	-1.23	-.73	-.55	3.60	.19	2.77	3.80	18	-86	1051
1999	-1.13	-1.23	-.65	-.01	-1.33	-.77	-.66	3.54	.27	2.76	3.81	4	-33	986

Asian NIEs

	Consumer Spending %s	Investment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	-1.05	-.17	.00	-2.81	-1.90	-1.20	-.03	2.40	1.82	3.34	4.27	243	-1785	-6499
1993	-.56	.05	.00	.38	-.26	.02	-.02	3.32	1.42	3.35	4.79	-546	-255	-8027
1994	-.19	-.01	.00	.52	-.16	.23	-.01	4.08	.71	4.47	4.82	-875	1260	-4154
1995	-.15	-.19	.00	-.36	-.62	-.04	-.04	4.71	.13	5.33	4.85	-967	1717	1380
1996	-.28	-.22	.00	-1.29	-1.04	-.39	-.07	5.03	.00	5.45	5.04	-600	426	2375
1997	-.36	-.24	.00	-1.31	-1.00	-.47	-.10	4.85	.00	4.75	4.85	-553	-646	-631
1998	-.51	-.30	.00	-1.23	-.97	-.53	-.14	4.70	.15	4.37	4.86	-491	-1358	-6270
1999	-.67	-.37	.00	-1.10	-.98	-.57	-.17	4.67	.18	4.33	4.86	-414	-1477	-12271

Latin America

	Consumer Spending %s	Investment %s	Govt. Cons. %s	Exports %s	Imports %s	GNP %s	Capital Stock %s	Consumer Prices %s	Real Exch Rate %s	Export Prices %s	Import Prices %s	Govt. Deficit \$m diff	Current Account \$m diff	Money Supply \$m diff
1992	.24	.32	-1.15	.99	.27	.23	.05	4.09	.36	1.80	4.46	-2510	-1575	-2919
1993	-.37	.50	-.85	1.32	.31	-.05	.12	5.80	-.77	2.92	4.99	-2858	-752	-7017
1994	-1.13	-.45	.56	1.18	-.86	-.47	.02	4.50	.49	3.53	5.01	351	2112	-7137
1995	-1.62	-1.52	1.56	.80	-1.96	-.80	-.23	2.91	2.07	3.51	5.04	3097	3639	-1420
1996	-1.71	-1.85	2.03	.17	-2.61	-.89	-.48	2.42	2.60	3.24	5.08	3234	3779	8780
1997	-1.69	-1.88	2.14	-.27	-2.70	-.94	-.69	2.80	2.20	3.02	5.05	3309	2607	20753
1998	-1.66	-1.83	2.30	-.58	-2.69	-.97	-.86	3.36	1.65	2.99	5.06	3382	1533	32646
1999	-1.65	-1.77	2.44	-.86	-2.64	-1.01	-1.00	3.76	1.25	3.06	5.06	3393	708	43413

BANK AND FUND APPROACHES TOWARDS ENVIRONMENTAL ISSUES: THE CONCERNS OF DEVELOPING COUNTRIES

C. Nurul Islam

Introduction

It is increasingly recognized that environmental issues are important to developing and developed countries. Both share a common environmental future. This realization has spread in the face of the conspicuous evidence of soil erosion, deforestation, desertification, pollution of air and water, deterioration of health and sanitary conditions, loss of biodiversity, climatic change and threats to indigenous people, etc. There is, however, a wide variation in the relative importance of environmental stress among countries, depending upon their stage of development and their industrial or agricultural base. Soil erosion and deforestation are acute problems in tropical areas which are more fragile and complicated than temperate zones. Deforestation and devegetation caused by overgrazing, land-clearing, commercial logging, and slash-and-burn agriculture all deplete the soil cover, while reducing soil fertility and agricultural yield. They also contribute to flooding, sedimentation and the silting up of dams and reservoirs and threaten water supply. Soil erosion in India removes nutrients worth \$6 billion a year in chemical fertilizer replacements.¹ Because of scarcity of fuel, an estimated 400 million tons of dung are burned each year in developing countries; not only does this detract from fertility of the soil but erosion is accelerated.

One aspect of the environmental problem - unsanitary living conditions owing to inadequate water supply and waste disposal - occurs predominantly in the poor countries. In the developing world, water is also polluted by pesticides and by municipal and industrial wastes. A poor water supply is frequently linked to diseases and malnutrition. Even though industrial pollution is worse in industrial countries than in developing ones, it is beginning to be a major problem in many cities in the latter as well.

Population growth increases the demand for goods and services. With unchanged practices, this increased demand leads to environmental damage. According to some projections, the consumption of almost all goods will double in two generations on account of population growth alone and rising incomes will further raise three-fold the overall demand on agriculture. The corresponding increase for energy, water and manufactured goods will be four- to six-fold.² Population growth also increases the need for employment in order to earn a livelihood which, in turn, especially in rural areas, puts additional pressure on natural resources. Agricultural intensification under the pressure of rapid population growth in many cases has taken place through shorter fallow periods, and without the use of better inputs or techniques that permit yields to be maintained.

With a rise in income per head, the consumption per person of meat and meat products tends to grow, leading to an increase in livestock herds per hectare. They may cause severe problems of over-grazing during the process of transition from the traditional methods of livestock farming to more intensive methods. Similarly, energy consumption increases substantially, requiring measures to contain its environmental effects. Industrial pollution in developing countries will increase, especially with the growth of such environmentally damaging industries as paper and pulp, chemicals, petroleum products, non-metallic minerals, iron and steel and nonferrous metals. Environmental problems associated with increased urban transportation and vehicles include pollution and congestion in large cities, especially in heavily populated countries. Exposure to industrial pollution tends to increase with a rise in income per head up to a maximum, after which

¹ Development Committee (1987).

² World Bank (1992b).

it tends to fall with further economic growth. Income per head in most developing countries places them in the rising phase of this process.

Economic growth without regard for the environment is neither feasible nor desirable. In any case it can be self-defeating. The adverse impact of environmental spillovers on human health and natural resources undermines the inputs required for growth. At the same time, exclusive emphasis on the environment seems unjustified; in the absence of growth, such an emphasis would only aggravate the conflicts between competing claims over limited resources. At the same time, there are trade-offs between growth and environment because of the prevailing state of acute poverty. In poor countries it is not easy in the short-run to find alternative fuels to prevent the rapid depletion of fuelwood stocks or to stop the burning of dung for fuel. High levels of water pollution persist in developing countries because the costs of abatement are deemed to outweigh the extent of improvement in health and quality of life resulting from such investments.

Poverty and environment are closely interrelated. The poor are both the victims and the agents of environmental damage. A large number, maybe about half, of the world's poor live in rural areas that are environmentally fragile; they frequently depend on the exploitation of natural resources that are being degraded. Others live in crowded urban squatter settlements, often exposed to environmentally adverse circumstances such as unsafe water and sanitation, industrial accidents and emissions, and transport-related air pollution, etc. Farmers seeking land extend cultivation onto steep slopes and erosion-prone hillsides; they move to semi-arid areas, where soil degradation is rapid, and to tropical forest areas, where crop yields on deforested land fall drastically after a short period of cultivation.

Poor families lack the resources necessary to avoid degradation of their environment or to preserve environmental quality. They have little access to credit or insurance markets; their access to natural resources, land or water is often governed by poorly defined property rights. Hence, they are seldom able or willing to invest in environmental protection. Even if they were able to make investments, they would need quick results. Only with increased incomes will there be security and opportunity to invest in environmental protection, provided it is profitable.

I. Environmental impacts of development policies

Environmental degradation takes place whenever there are systematic differences between social interests and the motives of individuals, especially those who make decisions about the use of natural resources. This divergence between social welfare and an individual's interests takes place owing both to policy distortions and to market failures.

Examples of policy distortions which cause environmental degradation include subsidies for agriculture and energy inputs. These include: subsidies to natural resource-based activities such as logging and cattle-ranching in South-east Asia and Brazil, respectively; protection or subsidies to highly polluting and energy-intensive industries, such as chemicals, mining, pulp and paper; public utilities and government departments that provide such services as electric power, water and sanitation at subsidized prices; government agencies charged with managing public lands and forests but unable to regulate access or effectively balance multiple claims through an appropriate system of fees and charges.

Price policies regarding agricultural outputs and inputs have important effects on the conservation of natural resources and the degradation of the environment. For example, with lower agricultural land prices, the incentive is reduced to invest in farm land development or in conservation. This reduces a farmer's ability and incentive to invest in levelling, terracing, drainage, irrigation, or other land improvements. Conversely, higher agricultural prices may have adverse long-term implications if they lead to the extension of production onto marginal lands and/or excessive use of yield-increasing but environmentally damaging chemical inputs.³

Crops differ in terms of their demands on soil nutrients, water uptake and in their response to, or suitability for, diverse agro-ecological conditions. Sometimes discrimination against export crops may have adverse environmental implications, since crops such as coffee, cocoa, rubber,

³ K. Miranda, T. Muzondo and Bovenberg (1990); Development Committee (1987).

bananas, spices and so on, grow on trees and bushes that provide continuous root structure and canopy cover. Suitable for the hilly terrain where they are usually grown, they leave soil much less susceptible to erosion than such crops as yams, maize, sorghum, millet and cassava.

A variety of input subsidies, including tax and tariff concessions and low-interest loans, tends to encourage excessive use of chemical inputs or mechanical equipment in agriculture, with their adverse environmental effects.⁴ Over-use of pesticides, encouraged by subsidies, not only increases people's exposure to toxic substances but also leads to the development of more resistant mosquitos and other insects. Pesticides poison fish in ponds and irrigation channels. Similarly, subsidized irrigation schemes may entrain environmental degradation through an excessive or wasteful use of water, which in turn creates the need for more dams, leading to downstream shortages. In many countries, land concessions, tax holidays and low-interest loans encourage the stocking rates of livestock to climb well above the carrying-capacity of the land in years of low rainfall. The increased need for grazing land leads to forest clearing, soil erosion and loss of agricultural productivity.

A. Removing price distortions to improve environmental quality

Eliminating subsidies on energy inputs would help improve the air quality of many cities. It could also reduce environmental damage associated with mining and production of energy and improve the fiscal position of government. Pricing to cover the costs of irrigation water and its delivery will reduce salinization and render water available for unserved agriculture and urban users. Eliminating subsidies on pesticides and fertilizers will not only curtail a rise in pest resistance but also prevent health damage and water pollution caused by pesticides and fertilizers. Reducing rents on timber harvests by raising stumping fees and instituting competitive auctions of forest concessions could prevent excessive deforestation. These are some of the measures which would improve both environmental quality and economic growth.⁵

Despite improvements some environmental resources will remain susceptible to over-exploitation and abuse. This is because markets fail to reflect environmental costs accurately in a variety of ways. Air pollution, soil degradation, and deforestation will pose significant challenges even in the absence of subsidies for high-sulphur context coal, irrigation water, and logging. For example, the negative health impact on nearby residents of industrial emissions is not communicated through prices. Those who make decisions about using resources tend to ignore or underestimate the cost to society. The benefits from environmental conservation are seldom reflected in the current market; they accrue to many people and even to those not yet born. Conversely, the benefits from exploiting such resources are often narrowly concentrated and can be captured through markets.

Where there are environmental spillovers, Governments have the responsibility to ensure that market prices reflect the full social costs of private action. Thus, prices of natural resources should reflect their scarcity within an environmental context or in environmental terms. Stumpage fees, irrigation charges, and pesticides prices are all examples of market instruments designed to protect the rural environment. Similarly, pollution charges, tradeable permits, and deposit fund schemes play the same role for industrial activities.

As seen above, when markets are allowed to operate totally free, environmental degradation may follow because prices do not fully take into account the social costs and benefits. Problems can arise when it is difficult to specify clearly or effectively the rights to own or use environmental resources. For example, if there is open access to natural resources, this could exacerbate the pressure on the environment by encouraging more intensive exploitation, because when ownership rights are ill-defined the benefits from conservation of such resources as soils or forests do not clearly accrue to those who would farm them. For instance, more open trade policies for logs and timber products would lead to an increase in deforestation if stumpage fees and royalties were set so low as to create large rents from logging on public lands and if the duration of concessionary arrangements was so short that it encouraged a very fast rate of timber extraction or logging. For example, by making it more profitable to expand cassava cultivation in sub-Saharan Africa, foreign

⁴ Schram and Warford (1989); Repetto (1985); Development Committee (1987).

⁵ K. Miranda and T. Muzondo (1991).

exchange reforms have intensified pressures for deforestation in areas where ownership of the forest was not well defined. Clarification of property rights will help reduce excessive exploitation of open access pasture lands, forest and fishing grounds.⁶ As land becomes scarce, there is a need to adopt various productivity-enhancing technologies which require investment of capital and effort; inducements are needed for the cultivators to make such an investment. Such incentives are strengthened when property rights - i.e. the right to cultivate, sell or transfer land - are secured not only by social custom but also by an effective legal system.

B. Environmental consequences of development projects

Examples of projects which have positive economic benefits but at the same time have indirect adverse environmental effects are numerous. A municipal water-supply project where waste water flows are not matched by provisions for the treatment and disposal of waste would have environmentally adverse effects. Similarly, irrigation projects can lead to salinization, water-logging of soils and depletion of ground water reserves. Large-scale irrigation and power projects may involve the destruction of forests, the erosion of stream beds, drying of downstream lakes, threats to wildlife, reduction in the quality of water in reservoirs and increases in the incidence of human diseases, etc.⁷

Happily, there are also cases where the economic and environmental objectives of projects may coincide. For example, the improvement of water supply and sanitation projects may lead to improvements in health as well as in labour productivity and can be economically justified on the basis of consumers' willingness to pay for their services.

In projects which cause adverse external effects, the financial cost tends to be lower than the total economic cost including the environmental cost. Whether the incorporation of the cost of environmental safeguards or countervailing measures significantly affects the economic viability of a project often depends on the ratio of such costs to total project costs. In cases of negative environmental externalities, public intervention to raise prices beyond those required to meet the financial objectives of the projects will improve the efficiency of resource use and increase support for environmental objectives. Developing countries almost invariably implicitly subsidize industrial pollution in that polluters typically do not have to pay for the damages caused. In some cases, the economic benefits of pollution control are difficult to demonstrate in economic terms, and sometimes even in physical terms. Long-term health and environmental effects are particularly hard to predict; likewise indirect benefits are hard to quantify.

There are two sets of policies available to Governments to reflect environmental costs where markets do not do so. One is to incorporate investment costs and benefits into the expenditure and management decisions of public agencies and departments. A second is to design the policy to change the behaviour of resource users and polluters in the private sector, in order to compensate for the failure of market prices to include environmental effects.

In order to facilitate the inclusion of environmental impacts in the design and appraisal of public-sector projects, such as infrastructure projects, it is necessary to improve the cost/benefit analysis of projects. In an extended cost/benefit analysis, market prices can be adjusted for distortion by assigning shadow prices that take into account both non-environmental and environmental external benefits and costs. For example, in calculating the economic rate of return of a forestry project, the benefits of expanded timber production should take into account the value of reduced soil erosion, higher crop yields and more fodder and forest products. The inclusion of these benefits is more likely to make such an investment attractive. However, uncertainties associated with environmental impact limits the use of such extended cost/benefit analysis. Uncertainties surround the long-term consequences of air and water pollution for example, and they are quite inadequately understood. Losses from the extinction of species, i.e. reduced bio-diversity, may never be known. In addition, the attitude towards risks also varies greatly among individuals and communities.

⁶ World Bank (1991), *The World Bank and the Environment: A Progress Report*.

⁷ The World Bank, *World Bank Support for the Environment: A Progress Report*, Development Committee, No. 22, September 1989.

II. Global commons and developing countries

As illustrated in the foregoing, a large number of environmental issues involve situations where the consequences are localized or confined within the boundaries of an individual country. There are other types of environmental issues where the consequences spill over to other countries. Examples include air and water pollution on an international scale through acid rain, global warming, ozone layer depletion, and pollution of the seas. The interlinkage reflects the growing physical and economic interdependence of countries.

Although the industrial countries have been predominantly responsible in the past for global environmental degradation, developing countries contribute increasingly, for example, through (a) deforestation and (b) emission of industrial pollutants. A question arises as to the extent to which developing countries may be expected to sacrifice current growth for the sake of preservation of the global environment? It is argued that the developed countries must assume the burden of global environmental adjustment since they are mainly responsible. If the developing countries are to adopt environmentally friendly patterns of growth and to benefit from new technologies and accumulated experience, they can do so only through economic growth and development.⁸

The costs and benefits from actions affecting the global environment vary among countries. Some countries expect a larger net benefit from a proposed course of action than others; some may even lose. The losers need compensation. Even if all countries gain, it may be beneficial for some countries to refrain from cooperating in an international agreement. If the rest of the world reduces emissions, it may pay for some countries not to do so themselves and thus to be free-riders. It may be possible to punish the defecting countries. One way would be for cooperating countries to threaten to break the agreement unless the defector decides to cooperate. Another way would be to impose sanctions on the non-cooperating countries, e.g. trade sanctions and credit restrictions, etc.

In the context of a convention on climatic change, the developing countries would like to regulate the use of the atmosphere on an equitable basis, i.e. the right of each human being to have equal access to the world's atmospheric resources. As latecomers to industrialization, they have used only a small proportion of their entitlements. Therefore, they argue that the cutback in the emissions of greenhouse gases by the developed countries should be proportionately much larger than that applicable to developing countries: the long-term objective should be to seek a convergence of per capita energy consumption and emissions by all countries.⁹

The proposed international agreement on biodiversity gives rise to a similar set of issues. The value (either economic, agricultural, or pharmaceutical) which many of the tropical plants and animal species provide are derived from the centuries-old knowledge of the subsistence farmers and forest-dwelling people. While the developed countries have benefitted from these resources and knowledge - treated as global commons with free access to all - the farmers and forest-dwellers in developing countries have not been compensated for their contributions. The developing countries argue - and appropriately so - that an international agreement on intellectual property rights to confer private property rights on and permit private companies to patent new technologies (biotechnology) based on genetic resources transferred from the developing countries should include provision for access to technology on the part of developing countries.

⁸ "Environment and Development: Towards a Common Strategy of the South in the UNCED Negotiations and Beyond", South Centre (1991).

⁹ *Ibid.*

A. Policy reform, macro and sectoral: approaches of the Bank and the Fund

The World Bank and the International Monetary Fund (IMF) are heavily involved in policy dialogue with, and policy reforms in, developing countries. The latter range from macroeconomic policies, e.g. trade, exchange rate, fiscal and monetary policies, in the case of the IMF, to sectoral policies, in the case of the Bank, including output and input price policies in different sectors, such as agriculture, transport and energy. The policy reforms also cover institutional arrangements for ownership and management of natural resources, including individual property rights.

Macroeconomic and sectoral policies influence the pricing of outputs and inputs in various sectors of the economy and, therefore, they have a significant impact on the environment, as elaborated in the foregoing section. For example, if an exchange-rate adjustment gives rise to excessive exploitation of natural resources, such as forestry products, the country concerned suffers from environmental damage. At the same time, exchange rate adjustment could, through higher export earnings, provide resources to finance environmentally sound practices, reduce rural to urban migration and, hence, lower the environmental stress associated with urban congestion. Conversely, a reduction in the fiscal deficit may have a negative impact if it reduces expenditures on environmental protection services. On the other hand, a major reduction in subsidies to pollution-generating activities may have a favourable impact on the environment.

Various fiscal and non-fiscal measures have been devised for environmental protection. Environmentally oriented fiscal measures include taxes on effluents or emissions from leaded gasoline or on sulphur or carbon, etc. They also include subsidies for installation of solar-generating capacity, for planting trees or for taking marginal land out of cultivation. Public investment in water purification and in urban sewerage treatment improve environment. Such environmental policies have macroeconomic implications as they affect output, prices and employment, not to mention fiscal monetary and trade balances. A reduction of subsidies on energy improves the fiscal balance through reduced outlays. This promotes efficient energy use and improves the balance of payments as imports fall. The introduction of environmental taxes might damage some export and import competing activities, especially if other countries do not impose similar taxes. Taxes which internalize externalities can increase the cost of production and prices of relevant goods and services. This may lead to a rise in domestic prices and adversely affect economic growth. A limit on the rate of exploitation of natural resources which constitute a major source of exports may yield environmental gains but, at the same time, reduce exports and prospects of economic growth. Similarly, a poor developing country with abundant coal can only avoid a coal-based energy policy and related pollution at the cost of a slowdown in its rate of industrialization.¹⁰

The IMF Board decided that the IMF should develop a "greater understanding of the interplay between economic policies, economic activity, and environmental change." The Fund should avoid recommending "policies that could have undesirable environmental consequences, while ensuring that the thrust of its action - promoting sustainable growth and reducing poverty - also helps mitigate environmental concerns". "The IMF's work on environmental issues should be evenhanded and universal in scope, giving appropriate attention to problems in countries within each region and at all stages of development."¹¹

The Fund is concerned with the implications, firstly, of environmental degradation for sustainable economic growth and, secondly, of macroeconomic policies for the environment.¹² It intends to undertake an assessment of significant price distortions including subsidies on energy, irrigation, fertilizer, pesticides, as well as tax and credit policies, which result in pricing natural resources below their scarcity value. Removal of these distortions promotes efficiency and strengthens the capacity to address environmental problems. Furthermore, the Fund is expected to take into account on a selective basis major adverse environmental implications of its macroeconomic policy advice. In the event that its policies are found to have adverse environmental consequences, it would examine alternative policies which address adverse environmental concerns without significantly sacrificing macroeconomic objectives.

Environmental issues can be incorporated into the design of the Fund's macroeconomic adjustment programmes. For example, in Papua New Guinea, in the context of the standby ar-

¹⁰ K. Miranda and T. Muzondo (1991).

¹¹ "IMF reviews its approach to environmental issues", *IMF Survey* (1991).

¹² *IMF Survey* (1990 and 1991).

rangement with the Fund in 1990, a fiscal deficit reduction was an important element of the programme and expenditure priorities were carefully assessed. At the same time, when overall public expenditures were reduced in the interest of macroeconomic stability, public expenditure on environment was maintained and certain environment-preserving projects were not eliminated.¹³

The Bank's structural adjustment lending programme is also concerned with policies, both sectoral and macroeconomic, that have an impact on the environment. The Bank's advice on structural reforms, including sectoral price policies, are complementary to the advice of the IMF on macroeconomic, trade, and fiscal policies. The impact of Structural Adjustment Loans on the environment depends partly on the extent to which such loans incorporate measures which directly or indirectly protect or enhance conservation.¹⁴ At the same time, however, austerity programmes linked to Structural Adjustment Loans may lead to the aggravation of poverty in the short run, if no safety net is provided for the poor. The accentuation of poverty intensifies pressure on natural resources. The policy conditions under the structural adjustment programmes indeed, provide a good opportunity to address environmental issues explicitly. It is, therefore, necessary that the implementation of structural adjustment programmes be closely monitored, with a view to examining their consequences not only with respect to poverty but also to environmental degradation.

B. The World Bank's project and sector lending and the environment

The Bank either finances a number of free-standing loans for environmental projects or incorporates environmental components into loans in various sectors, e.g. agriculture, forestry, energy, industry, urban development, water development, etc. The former has the primary objectives of addressing environmental problems as such and may be distinguished from loans whose main objectives are income generation and/or poverty-alleviation, while incorporating environmental components. Some of the recurrent environmental elements in agricultural projects are soil conservation, irrigation efficiency, improved land-use patterns, agro-ecological zoning, land tilling, flood control and drainage, agro-forestry and rangeland and wildlife management. Energy-development projects include hydro-electric power generation projects as well as projects for the sustainable use of fuel wood; they raise issues of water and air pollution and the emission of gases related to the greenhouse effect. Environmental elements in the industrial sector range from facilities for treating effluents to those for reducing the emissions of air pollutants, controlling industrial pollution and providing for industrial safety. Water-supply and sewerage projects address the need for waste-water treatment, sewerage management, and various other measures to protect water quality. Urban projects contain such environmental components as urban infrastructure, water-waste disposal sites, garbage collection, and drainage maintenance.¹⁵

The procedures of the Bank, in order to ensure that the project and sector lending duly considers the environmental implications, include the preparation of environmental assessment impact for all major projects. The Bank subsidizes the cost of these assessments to be undertaken by the borrowing countries and encourages the latter to create and maintain their long-run capacity for environmental assessment.

The World Bank's projects have been classified into four different categories from the point of view of their environmental impact. Category A projects contain diverse and significant envi-

¹³ IMF (1987).

¹⁴ Structural adjustment loans sometimes make reference to environmental issues such as erosion control, deforestation, pesticide use, desertification, etc. In some cases, they involve measures which have implications for sustainability. For example, the forestry component of a Côte d'Ivoire Structural Adjustment Loan explicitly addressed guidelines for conservation, incentives for replanting, promotion of agroforestry, soil conservation and land-tenure reform (World Bank, 12 May 1986).

¹⁵ In the past, the Bank did not often take into account environmental consequences of development projects. For example, the World Bank's past financing for the establishment of plantations for oil palms and rubber in Malaysia would not have been acceptable today if sufficient consideration for biological diversity were taken into account. At the time this project was approved and implemented, the tradeoffs were judged in favour of the project, given the information at that stage. This project, on the other hand, did in fact lead to significant agricultural growth and poverty alleviation. Similarly, in the Mexican irrigation projects financed by the World Bank, the adverse environmental consequences could have been avoided if components designed for preventing environmental degradation had been assigned high priorities and completed in time. Even then such projects often did result in permanent improvement of economic welfare of the target populations through long-run agricultural growth (Petit, *et al* 1991).

ronmental impacts. Hence, they require full, detailed environmental assessments. Category B project have specific environmental impacts for which a more limited analysis is considered appropriate. Category C projects do not have a direct environmental impact and therefore no environmental analysis is required. Category D projects are those with an environmental focus and thus do not require a separate environmental assessment.¹⁶

The Bank's forestry projects have both national and global environmental implications. The impact of deforestation on soil erosion, flooding, loss of fuelwood and desertification, etc. is localized or confined to national boundaries. Deforestation, however, also contributes to global warming and loss of biodiversity and thus has international dimensions. The Bank distinguishes between two broad types of projects: one refers to clearly environmentally protective projects, such as reforestation to protect a watershed or degraded land, and small holdings farm land and social forestry projects; the second refers to commercial plantations inside intact forests in the temperate zone as well as tropical dryland forests. Bank loans to commercial plantations require a government commitment to sustainable, conservation-oriented forestry as reflected in, among others, a forestry conservation and development plan; likewise there must be a social, economic and environmental assessment of the commercial utilization of forests and adequate compensatory preservation of forests so as to maintain biodiversity and to safeguard the interests of the forest dwellers.¹⁷

However, with regard to the utilization of tropical moist forests, the Bank has decided not to undertake, under any circumstances, financing of commercial logging in a primary tropical moist forest. Three reasons are cited for this decision: considerable uncertainties regarding the full evaluation of environmental services of such forests; inadequate knowledge regarding sustainable management systems for them; irreversibilities associated with their loss.¹⁸

In assessing the Bank's approach to environmental issues, it is important to remember that traditional areas of the Bank's concern are also important for environmental sustainability. Its emphasis in recent years on equity and popular participation has environmentally beneficial side-effects. In this context, emphasis needs to be continued on the Bank's activities in such areas as women in development, population control, health and sanitation. In view of the impact of pressure of population on natural resources, especially land resources, policies and investment programmes which promote population control and planning will have beneficial effects on the environment. As major producers of food, cash crops, and livestock and as agents for procuring water and fuel for the household, women play a significant role as managers of natural resources. Their knowledge of, and access to, technology, advice, inputs and services are often limited and far from commensurate with their role as economic agents or resource managers. Similarly, the Bank's work in the field of health and nutrition has implications for the environment. There are health-related problems in water and irrigation projects and in the use of agricultural chemicals. Reductions in mortality are not primarily due to improved water supply and sanitation; rather, they occur as an integral part of an overall improvement in living standards, which involve better water supply, sanitation, housing, medical services, education, and so forth.

Appropriate technologies are essential for reconciling the claims of growth with environmental sustenance. Governments pressed for fiscal resources to address short-term challenges often deprive research institutions of adequate resources. The World Bank has a vital interest in strengthening national and international research systems.¹⁹

Poverty for most developing countries remains at the heart of the problem of environmental degradation. Substantial synergies exist between alleviating poverty and protecting the environment. With safety nets to sustain their consumption levels, the poor are less obliged to mine natural resources in times of crisis. Extension and credit programmes and the allocation of property

¹⁶ *World Bank Support for the Environment: A Progress Report*, Development Committee 1989. During the fiscal year 1991, of the 229 projects approved by the Bank, 11 were designated as A, and 102 were rated as B. More than 40 per cent of the projects in these two categories fell into one of the following sectors: energy, agriculture, rural development and transportation. Within category A, five projects were energy related, three were for agriculture and rural development, two were in transportation and one was for industrial development. Out of 108 projects in category C, almost half supported education, health or population activities. Eight loans were placed into category D, including three for agriculture and rural development, one for industrial development, two for urban development, one for energy and one for water supply and sewerage (World Bank 1991).

¹⁷ World Bank, *Forestry Policy Paper*, Washington, D.C. (July 1991).

¹⁸ *Ibid.*

¹⁹ Michel Petit and Suzanne Gnaegy (1991).

rights strengthen their ability to make environmental investments and manage risks. Similarly, public investment in water and sanitation as well as in pollution abatement benefits the poor. In many of the world's degraded ecological areas, environmental regeneration activities such as control of soil erosion, deforestation, soil and water conservation measures, will not only improve the land but are also highly labour-intensive, and thus provide income and employment opportunities for the poor. Similar labour-intensive or employment-generating programmes can also play a role in dealing with problems such as global warming and conservation of biodiversity.²⁰

In sum, in respect of analytical work and policy advice as well as project and sector lending, the Bank has recently given increasing attention to environmental considerations. This reflects a heightened concern in the member countries regarding environmental problems - more so in the developed, donor countries than in the developing, recipient countries. This emphasis is also evidenced by the recent deliberations of the OECD/DAC.²¹ Most bilateral donor agencies have put in place guidelines for the introduction of environmental considerations into their lending operations.

The Bank has a fund of knowledge which properly analysed would provide a basis for exploring the interrelationship between development and projects, on the one hand, and environmental stress and consequences, on the other. This should serve as a reasonable guide for future action for the incorporation of environmental considerations into its project and policy lending.

It is necessary to ensure that the World Bank responds to the concerns and interests of not only the donor countries but also the developing, recipient countries. It should encourage, in the development community, debate and dialogue on environmental issues. On highly controversial environmental issues, it should take into account consensus reached in such forums as the United Nations Conference on Environment and Development (UNCED); it should also contribute to the development of such a consensus in the international community.

In this context, the issue of Bank lending for the exploitation of tropical moist forests is an important one. The developing countries, which are dependent on commercial logging and exports from tropical rain forests, are concerned that they are being asked by the donor community to forego an important resource for financing development. In the absence of an international consensus on this issue, a unilateral action by the Bank to stop all lending for commercial logging appears arbitrary. A more appropriate policy would be to recommend that if the developing countries are to preserve tropical forests for the services they provide to the global community, they should be compensated by a commensurate transfer of resources from the developed countries.²² It is important to emphasize that there are many opportunities for policy reforms and investments which meet both economic and environmental criteria. The Bank should seek to give priority to projects and policies which satisfy both objectives.

In order to generate a consensus at the country level on the environmental issues and policies, the Bank's recent undertaking to prepare environmental issue papers as well as action plans for individual borrowing countries is a welcome step in the right direction. They are especially important because priorities in respect of environmental issues differ among countries, depending, among others, on the agro-ecological characteristics, composition of natural resources, and stages of development. They should promote a greater awareness and provide an occasion for public debate and discussion, including the participation of nongovernmental organizations (NGOs), on priority environmental issues of a country and thus help build a national consensus. Such papers will, in addition, concentrate attention on the need for multisectoral and interministerial coordination and consultation at the country level.

While seeking to incorporate environmental considerations into policy advice and lending, it is important to remember that a great deal of uncertainty surrounds the measurement of environmental benefits or consequences of projects. While environmental impact assessment is a desirable tool it must be remembered that it is a qualitative tool. It forces recognition of the risks to the environment of development projects but at this stage of knowledge it cannot yield a precise quantitative measurement. A comparison of the costs of environmental damage with the costs of

²⁰ Development Committee (1987); South Centre (1991).

²¹ Organization for Economic Cooperation and Development, *Development Cooperation in the 1990s*, Paris (December 1989).

²² General Agreement on Tariffs and Trade, *Trade and the Environment*, Geneva (1992).

measures needed to mitigate the damage or a decision as to whether economic benefits of a project exceed its environmental damage, leaves room for judgment.

The use of discount rates in the cost-benefit analysis results in low weight being given to the benefits of conservation measures which accrue to future generations. Within a reasonable range of rates of discount, the discounted values after 10 years or so for most projects become very small so that a project that has benefits accruing in the long-run tends to be necessarily neglected. This does not, however, obviate the necessity of a decision as to how one can achieve inter-generation equity under these conditions.

It is also important to note that some environmental consequences are reversible while others are not. Certain types of degradation such as soil erosion or deforestation (possibly not of the tropical rain forest) or urban pollution are reversible. A certain amount of reversible degradable/pollution can be sustained in the short-run for the sake of urgently needed growth, and as resources expand and technology becomes available the degradation can be reversed. The broader the range of "reversibility" in terms of environmental stress, the wider the range of options available to the developing countries. It may, however, be argued that the costs of combating future environmental degradation, accumulated owing to inaction at the present time, will be higher than if countermeasures had been taken from the outset. At the same time, the ability of developing countries to bear the costs will also be greater, if a higher growth rate is attained in the intervening period. The "reversibility" criterion is relevant to the choice of priority areas for action "today" by the developing countries as contrasted with problems which can be postponed until "tomorrow".

When prescribing environmental standards for projects in developing countries, for example, for industrial pollution, it is worth emphasizing that the degree and type of environmental degradation which developing countries suffer today differ from those experienced in developed countries. The actual demand for environmental quality on the part of the developing countries relative to that for other objectives has to be evaluated when considering environmental measures; however, it is nonetheless true that demand can be modified through information, analysis and exchange of ideas weighing the pros and the cons of environmental degradation and the policies needed to combat it.

The Bank may find itself in a difficult position when a Government intends to proceed with a given project, with or without the Bank, but seeks its financial support. The Bank may not avoid participation in a project just because it is potentially controversial provided that the Bank's participation can reduce the damage but albeit not eliminate it entirely. The net gain from the Bank's participation might still be positive.²³

Finally, the implementation of the environmental components in projects increases not only the cost of administration on the part of the Bank, but also, more importantly, the costs incurred by the developing countries for making environmental impact assessments. This raises a significant problem as to the funding requirements for environmental assessment to be undertaken by the borrowing countries.

III. Resource requirements for environment-friendly development

High-income countries in the OECD have committed between 1 per cent and 3 per cent of their income over almost two decades to funding environmental improvement.²⁴ There is concern that costs on the same scale are too high to be borne by the developing countries with their low incomes and great demands on investment resources. It may be argued, however, that the current environmental expenditures in developed countries are high because in the past they did not follow efficient practices for protecting the environment; consequently their current expenditures have been partly devoted to rectifying the consequences of past decisions instead of avoiding environmental damage from the outset. This interpretation emphasizes the need for developing countries

²³ The World Bank, *World Bank Support for the Environment: A Progress Report*, Development Committee, No. 22 (September 1989).

²⁴ The World Bank, "Markets, Government and the Environment (unpublished 1992).

to follow efficient policies right from the start.²⁵

Nevertheless, there will be a need for substantial public and private investment for environmental protection in developing countries. Some of these investments such as soil conservation, improvement in health, sanitation and water supply and pollution control will pay relatively high returns even in the short run, both nationally and locally. There are other investments, such as those aimed at the reduction of carbon emissions, whose benefits will accrue in the long term, uncertain future. Others, like those for the preservation of biodiversity, will benefit the whole world. The resource gap of developing countries will be greatly widened if they are to undertake additional investment in order to avoid or reduce environmental damage. The need for additional resources arises not only from the additional costs involved in incorporating environmental dimensions into specific national projects, but also as a result of the costs of adopting internationally agreed environmental measures to preserve and protect the global commons.

An aggregate estimate of additional expenditures or investments required in developing countries in the decade between 1990 and 2000 to combat environmental problems confined within their national frontiers has been made. The figure amounts to \$20 billion for 1990, rising to \$82 billion by the year 2000.²⁶ This excludes the costs of measures to deal with global environmental problems. The components of expenditure are as follows:

- (a) Raising energy efficiency - \$1 billion in 1990, rising to \$11 billion in 2000; this should be seen in the context of investment in electricity which is expected to be about \$200 million per year during the 1990s; in most countries an additional capital cost of 1 to 2 per cent will be needed for environmental protection; in some countries in the absence of low sulphur coals or natural gas, the additional cost may rise from 5 per cent to 15 per cent of capital costs;
- (b) Developing renewable energy-starting with \$1 billion in 1990 rising to \$15 billion in 2000;
- (c) Reforesting the earth - \$2 billion in 1990 rising to \$7 billion in 2000;
- (d) Protecting top soil and crop land - \$3 billion in 1990, rising to \$16 billion in the year 2000; since part of the commitment of time and resources to reduce soil erosion will come from the farmers themselves, it is difficult to estimate the required public investment. Annual investment costs for protecting soil come to between \$10 to \$100 per hectare depending on cultivation practices, topography and severity of the problem. Improved practices may cost up to 2 per cent of capital expenditure in the agricultural sector which is equivalent to \$6 billion a year during the 1990s;
- (e) Slowing population growth - \$13 billion in 1990 rising to \$33 billion in the year 2000. These additional requirements will amount to a 20 per cent increase on the flow of external resources for development in 1991.

In addition, investments will be needed in such areas as water protection, sanitation and control of industrial pollution. The investment in water and sanitation is currently estimated at \$15 to \$20 billion per year. The required amount of investment will increase with economic growth and, more importantly, will be related to policies that permit greater efficiency, cost effectiveness, and less waste in the provision of services. An amount of 2 per cent of capital expenditures may be necessary to control pollution in the manufacturing sector, i.e. roughly about \$8 billion a year in developing countries.²⁷ These estimates represent enormous costs. As most of these costs have to be met from domestic resources, incomes of developing countries must grow apace.

The costs to fund the conventions and protocols which may be negotiated in connection with the protection of the global commons under the auspices of the UNCED Conference in June 1992 must be added to the above estimates. Estimates of the incremental costs to the developing countries for carrying out the Montreal Protocol have ranged between \$3 billion to \$6 billion

²⁵ *Ibid.*

²⁶ World Institute for Development Economics Research, "The Environmental and Emerging Development Issues", WIDER (1992).

²⁷ World Bank (1992b). Additional costs for the control of industrial pollution are expected to be financed partly through commercial markets, including foreign direct investment. This is related to the policies which the developing countries follow vis-à-vis foreign investment and the response of the latter to such policies.

spread over the years 1990 to 2008.²⁸ Estimates of financial needs for protecting biodiversity or natural habitats in the developing countries range from \$2.4 billion to \$4.8 billion annually.²⁹ Expenditures on research, development and market expansion for the technologies needed to reduce "greenhouse" emissions have been estimated at \$5 billion a year for developing countries.³⁰

External financing of global environmental measures should be distinguished from financing of environmental projects with a more direct and immediate impact on the local population, such as measures to correct urban air pollution, contamination of rivers, and soil erosion. In the case of global environmental measures, it needs to be emphasized that the developing countries' social rate of discount may be so high that the benefits accruing to the international community greatly exceed those perceived by the population of the developing countries. If the primary interests of the international community are served by the protection of biodiversity or a slowdown of global warming, the degree of externalities involved justify a straightforward donation that avoids fiscal costs for the debtor country. This transfer is not to be considered as development assistance in the usual sense. On the contrary, this is an investment by the world community to meet global problems shared between developing and developed countries, in accordance with their respective perception of benefits, relative past contribution to the degradation of the global environment and ability to pay.

The question arises of how to finance such additional resources for environmentally friendly investments. Some of the current ideas in this respect include (a) debt relief related to environmental investment; (b) charges for the use of the commons, as had been articulated at the time of negotiations on the Law of the Seas; (c) earth stamps (suggested by a group of more than 100 NGOs from some 30 countries); (d) a tax on non-renewable energy or a tax on carbon.³¹

Debt-for-nature transactions capture, for conservation purposes, some of the secondary market discount on the liability of the debtor countries. This would operate as follows. An international donor such as a donor Government or an international environmental organization (non-governmental) uses foreign exchange to buy up government loans in the secondary market. Once purchased, the debt is exchanged with the debtor government authorities for locally denominated currency or bonds. The Government may or may not share in the discount captured by the donor. The local resources are invested in environmental conservation projects which are agreed upon between the Government and the donor, usually in collaboration with local environmental groups.³²

Most swap projects have focused on the protection of land containing exotic flora and fauna, including endangered species, and have provided for the strengthening of local education, training, and research programmes related to conservation.³³ The Enterprise for the Americas Initiative, proposed by the United States Government, provides that a part of Latin America's concessional debt to the United States will be reduced and the corresponding interest payments placed in local currency trust funds to finance mutually agreed environmental projects. Likewise, nonconcessional debt with the United States could also be sold at a discount to organizations willing to negotiate swaps with different countries. The World Resources Institute has proposed a multilateral authority to purchase the developing country external debt at a discount and to negotiate for its forgiveness in response to adoption and implementation by the borrowing countries of sustainable development programmes.³⁴

The swap transactions are not without some costs. A swap has inflationary monetary effects which are not always easy to neutralize. A swap is basically a pre-payment of debt and has an initial impact in raising fiscal outlays. The inflationary impact needs to be counteracted by the central bank; this sets a limit on the magnitude of swap programmes involving debt. If swaps involving debt became large enough to create a wide impact, this could become excessively inflationary. Moreover, so far, the swaps have tended to finance internationally prestigious

²⁸ UNCED (1991), Montreal Protocol on Substances that Deplete the Ozone Layer, 1987.

²⁹ World Bank (1992b).

³⁰ *Ibid.*

³¹ UNCED (1992).

³² Up until early 1991, swaps of this type retired \$100 million in debt in Latin America. Donors paid, on average, 17 cents on the dollar and exchanged the loan papers with the Latin American Governments for local resources at the equivalent to 60 cents on the dollar.

³³ Institute for International Economics, 1991.

³⁴ UNCED (1991).

environmental projects, with emphasis on preserving biodiversity, in which a considerable part of the returns is externalized to the rest of the world. The major impact is felt in the long run. "Debt for nature" swap transactions should preferably be combined with the mobilization of resources, both external and internal, in a non-inflationary way. They should finance both global and national environmental measures and should also cover both public and private debts.

Charges for the use of the global commons may be illustrated by charges for the use of seabed resources, ocean fishing, use of the high seas by shipping, use of the atmosphere and stratosphere for air transport, and communication facilities which utilize the global commons. Funds could be raised by asking national Governments to permit their postal systems to sell earth stamps which would then be added to regular postage. Another possibility would be the selling of stamps outside the postal system. This is already widely used as a fund-raising device by various organizations. The success of this method will depend on the willingness of individuals and Governments to purchase such stamps, and their desire to support the uses to which the funds should be devoted.

It is estimated that a tax on non-renewable energy or a carbon tax, equivalent to a 10 per cent tax on coal, would produce revenues of more than \$20 billion annually in the industrial countries. A phased-in tax on each ton of carbon beginning at \$11 in 1991 and going up to \$110 would yield by the year 2000 revenues of up to \$120 billion. Such a tax is projected to lead to a 37 per cent reduction in carbon emissions and a 20 per cent improvement in energy efficiency.³⁵

These special funds could be raised by Governments. Implementation could be carried out by international organizations which would handle the financing of agreed environmental measures, both global and national, to be undertaken by the developing countries. It would be advisable to have several or diverse international organizations administer these resources, depending on the regional or subject matter expertise of the respective organizations.

There is a growing interest in the concept of "critical environmental loads", with loads being apportioned by an agreed formula and then made available for trading. The overall critical load would relate to an environmentally effective unit, which in the case of global warming is the whole earth, and, in the case of acid rain, a region or a group of countries. The overall load would be apportioned in accordance with agreed criteria among countries which would be allowed to trade allocations among themselves. This could create the potential of substantial transfers from one country to another. In the case of gases contributing to the greenhouse effect, it is argued that industrial countries have room to substantially reduce the amount of emissions, while many developing countries will need to maintain or increase emissions in order to achieve their development objectives. If the allocations to the developing countries were larger than needed in the short-run, they might then sell their rights to "over quota" industrial countries, giving the latter time to adjust to agreed lower levels over a longer period of time.

The question has been raised as to whether there should be independent funding arrangements for each international convention designed to deal with global environmental problems such as climate or biodiversity. One alternative would be to expand the mandate of the existing funding institutions to deal with these problems. This would obviate the need for the creation of new financing mechanisms for the implementation of new conventions. In this context, it is important to examine the current experience with the Global Environmental Facility (GEF) and its future possibilities. The GEF has been conceived as a pilot scheme for helping developing countries to contribute to the solution of global environmental problems. The four main areas of activities are: reduction of global warming, protection of international waters, preservation of biological diversity, and prevention of further depletion of stratospheric ozone layers. Responsibility for implementing the facility is shared by the World Bank, UNEP and UNDP. UNEP provides scientific and technical guidance with the help of a Scientific and Technical Advisory Panel made up of 14 international environmental experts. UNDP has responsibility for technical assistance activities and helps to identify projects at the country level. The World Bank administers the GEF Trust Fund and is responsible for investment projects as distinct from those of technical assistance. The GEF is an administrative umbrella for three types of funds: (a) contributions to the global environmental trust fund (this is the core fund); (b) associated co-financing arrangements; (c) contributions to the Montreal Protocol's interim, multi-lateral fund.³⁶

³⁵ *Ibid.*

³⁶ Together these three funds constituted, as of mid-1991, \$1.3 billion. Core funds consist of \$800 million; the co-financing arrangement provides a total of \$300 million; \$200 million is available through the interim, multilateral fund

Three types of investment projects with global environmental effects have been distinguished. The Type 1 project is economically viable on the basis of domestic cost and benefits to the country itself. It is not eligible for GEF financing unless the participants agree in advance by consensus that a compelling case has been made, despite the attractive rate of return, that the project in question would not proceed without GEF involvement. The Type 2 project is one which would not be justified in a country context if the full costs were borne by the implementing country; however if part of the costs can be offset by concessional assistance from the GEF, then the overall project can be made attractive to the implementing country and substantial global environmental benefits would be realized. The Type 3 project is justified in the country context, but the country would need to incur additional costs in order to bring about additional global benefits. The additional costs of accommodating global concerns would be eligible for funding.³⁷

A number of outstanding issues require examination in the context of the future of the GEF, as shown below:

- (a) Should it include issues covered by an existing global convention and even one under discussion, such as global warming or biodiversity, and should it also cover other environmental issues discussed in a global or regional context whose impacts extend beyond national borders, such as desertification and the management of hazardous materials?
- (b) To what extent should the GEF provide concessionary and additional funding for the "incremental costs" to achieve global environmental benefits. How should "incremental costs" be defined? There are cases where a distinction between global and national benefits is difficult, if not impossible, to make.
- (c) The cost of incremental action needed to protect the global environment is strongly influenced by existing national policies. Distinctions between national and global activities could become blurred in the case where a convention, on climate change, has specified government obligations such as targets and timetables; (d) What should be the structure of governance of the GEF? Should it be dominated by the donor countries, with votes distributed according to the size of their contributions? Should there not be provision for a broad representation of countries, developed and developing, in the governance of the fund?

In sum, a considerable increase in investment resources will be needed to finance both national and global environmental measures in developing countries. This will require an increase in the flow of external resources, additional to those traditional development objectives. The external resources needed for global environmental measures should not be treated on a par with development assistance. Such investments will be made in developed countries because this is the most effective way to deal with global problems. Accordingly, the governance of the international funds for financing global problems should not be based on the principle of the donor-recipient relationship. Moreover, in view of the relative scarcity of resources in relation to development needs in the conventional sense, including the need of the Commonwealth of Independent States and eastern Europe, additional resources for environmental measures need to be raised or mobilized through novel and innovative ways.

of the Montreal Protocol. This latter fund is administered by UNEP under the auspices of a 14-country executive committee. Approved projects are implemented by either UNEP and UNDP or the World Bank. The investment projects originating from the Bank and UNDP are initially reviewed by them depending on the nature of the project. They submit their rough project proposals to the Scientific and Technical Advisory Panel for review prior to the transmission of the complete set of projects to the Implementation Committee. The Implementation Committee, consisting of three agencies, reviews the programmes and policy issues and selects projects eligible for GEF funding for submission to the meeting of the participating countries. The group of participating Governments, currently made up of 31 countries and balanced fairly evenly between developed and developing countries, are those which contribute to the GEF. They approve the work programme, but the appraisal and approval of projects is left to the relevant implementing agency. Each agency follows its own decision-making procedures. The three implementing agencies have committed themselves to working with NGOs. About 20 NGOs are involved in identifying, appraising, and preparing the projects (World Bank 1991a).

³⁷ The 26 projects submitted to the participating parties for review in May 1991 consisted of 15 investment projects worth \$214 million; 11 of these addressed biodiversity, three related to global warming and one treated pollution of international waters. Eleven technical assistance projects amounted to \$59 million; seven were for biodiversity preservation, three were related to reducing global warming and one was for protecting international waters.

IV. Conclusions

It is now recognized that policy failures, market failures, poverty, and population growth - all in a complex and interdependent way - lead to environmental degradation. Macroeconomic and sectoral policies affect the composition of output, whether overall or sectoral. These along with the intensity and the pattern of resource use have environmental implications. Output and input price distortions cause environmental degradation: e.g. soil erosion, water and air pollution through overuse of soil and water or of chemical inputs, etc.

The activities and operations of the Bank and the Fund impinge on the various aspects of environmental problems in developing countries. They are heavily involved in policy dialogues and policy reforms in developing countries. Both agencies provide quick-disbursing non-project loans under what are variously called stabilization or structural adjustment programmes linked to macroeconomic and sectoral policy reforms. The Bank provides both project and sector loans. Lately the Bank has become involved with UNDP and UNEP in administering the Global Environmental Facility dealing with "transborder" environmental projects.

The developing countries in general have now embraced, sometimes as a part of an agreement with the Bank and the Fund and sometimes on their own, the need for significant macroeconomic and sectoral policy reforms, including fiscal monetary reforms and as well as those on sectoral output and input price policies, which increase growth and the efficiency of resource use in the short run. Many of these policy reforms, like reduction or elimination of output and input subsidies, also preserve the environment by preventing excessive use of environmentally damaging inputs and resources as well as inappropriate patterns of output in such areas as energy, agriculture, forestry, etc.

Problems arise when increases or adjustments in prices are recommended not so much to correct government interventions or distortions in the market but to correct externalities, i.e. divergence between private and social costs. Since quantification of externalities is difficult and considerable uncertainties exist in this respect, the correction, for environmental reasons, of prices of inputs/outputs by means of taxes and subsidies poses problems and involves risks. Appropriate action in this regard calls for further knowledge of country-specific situations gained through research and analysis of the externalities which arise in such activities as irrigation, energy use, and agricultural intensification, etc. Meanwhile, gradualism in policy reforms and/or changes in incentive structures is advisable; likewise, monitoring of the consequences of policy changes on the environment is urgently required.

The setting of environmental standards in various sectors of the economy and their enforcement through either regulations or price incentives would raise the relative costs of some economic activities and affect the competitive positions of related exports from developing countries. The extent to which relative costs are affected depends on the costs of implementing environmental standards relative to the costs of production in different activities. It is not yet known whether the costs of pollution control or of environmentally friendly technologies for different activities are the same in the developed as in developing countries. More empirical analysis is needed.

The developing countries face a dilemma in respect of implementation of environmental standards and the associated costs. If they do not adopt and enforce environmental standards comparable to those of developed countries, they face the prospects of trade restrictions by the developed countries. The latter threatens to impose restrictions not only on the exports of industries that do not apply comparable environmental standards but also on other exports in order to pressure the developing countries to adopt or raise environmental standards in all activities, be they domestic market-oriented or non-tradeable. Conversely, if they assume the additional costs of enforcing environmental standards, the competitive advantage they now enjoy in some economic activities would be partially modified.

This issue cannot be divorced from two other related considerations. One is the question of actual demand for environmental quality in developing countries. Given the low current level of environmental pollution and the extent of prevailing poverty, many developing countries assign greater weight to expansion in current output than to improvement of environmental quality. There is no apparent reason why environmental standards desired in developed countries that have both higher standards of living and higher levels of environmental degradation should be imposed on the developing countries.

Moreover, certain types of pollution or degradation of air, water or soil are reversible in the future. As developing countries attain higher levels of income and expand their access to resources or technology over time, they will be able to reverse the degradation which occurs now. In other words, for certain types of degradation urgent action may be postponed in the interest of an increase in output and income today. It is necessary to identify various types of "reversible" degradation in order to determine the appropriate course of action.

Both policy changes and investment in projects have a role to play in preventing or alleviating environmental degradation. In respect of policies to deal with environmental problems, there is the question of the right mix of prices and incentives, on the one hand, and regulations and controls, on the other. An appropriate set of policies which prevents the inefficient or wasteful use of natural resources obviates the need for additional investment to alleviate the degradation resulting from policy distortions.

The role played by the Fund and the Bank vis-à-vis developing countries is very different from the one they play vis-à-vis developed countries. Both the Bank and the Fund depend on the developed countries as the predominant source of financial resources. Furthermore, the developed countries are not their borrowers. Even though the Fund, in theory, has the function of monitoring and surveillance of the macroeconomic policies of developed countries in relation to their impact on the world economy, they have, in fact, with very little influence. While, they do have leverage and can influence policy reforms in developing countries with an impact on the environment, they have no such leverage on the policies of developed countries. They cannot protect the developing countries from the actions, retaliatory or otherwise, which developed countries might take in respect of their trade and aid policies, in order to impose environmental standards on the former. The Bank and the Fund, therefore, have a special responsibility, in cooperation with other international organizations, to analyse the environmental problems, both national and global, which the poor countries face, keeping in view of their development imperatives. At the same time, they must seek to warn against the resulting adverse consequences for growth and development in the poor countries from the actions of developed countries in the name of environmental protection.

The Bank, more than before, is now particularly involved in promoting private investment in developing countries; the International Finance Corporation, as a World Bank affiliate, has been engaged for quite some time in encouraging direct foreign investment through co-financing arrangements. The policies which foreign investors implement in respect of environmental standards in developing countries are critical; they largely determine not only developing countries' access to environmentally friendly technologies but also the exports of hazardous materials, including chemicals and other dangerous wastes, with potentially adverse environmental consequences in developing countries.

In view of the close interrelationship between poverty and environment, environmental considerations justify a renewed emphasis on the Bank's earlier focus on poverty alleviation. The greater the extent of poverty alleviation, the lower the environmental stress because the pressure on the poor to discount the future is reduced when the resources at their disposal to preserve or protect the environment are greater. Poverty-alleviating measures include income- or employment-generating projects oriented towards the poor; increased access of the poor to technology, credit, education and training as well as safety-net measures for the poorest either through direct transfers of income or consumption subsidies or through special public-employment schemes.

Enhanced awareness of environmental considerations should give added impetus to the Bank's involvement in such sectors as health, nutrition, water supply, sanitation, and agricultural sustainability. Women are both important users and polluters of resources. The Bank's investment in expanding women's access to knowledge resources, and technology, so that they can adopt environmentally friendly measures, should be strengthened. Also, programmes and policies relating to population control have an important impact on the environment.

Environmental priorities in terms of sectors and activities vary by country depending on the stage of economic development, including degree of industrialization; they are also related to agro-ecological characteristics which determine the relation between environmental stress, on the one hand, and the rate and pattern of agricultural development, including that of forestry and fisheries, on the other hand. In this context, the preparation of an environmental issues paper and of an action plan based upon the issues paper, which the Bank is encouraging, are appropriate steps in the right direction for determining national priorities. For most developing countries, the

problems of soil erosion and resource degradation, including deforestation, water pollution and sanitation, deserve high priority in the near future.

From the point of view of developing countries, the level of domestic capacity to undertake environmental analyses and impact assessments is a matter of considerable importance. Their institutional capacity is limited; the shortage of trained personnel is acute. The additional burden of analytical and administrative work must be seen against the background of what is already required of them in terms of carrying out macroeconomic and sectoral policy analyses and planning; the analytical work required for monitoring issues of special concern to donor developed (as well as developing) countries, such as women's role in development, the impact of development programmes on poverty and, of late, environmental consequences of development projects, is growing while the supply of analytical skills has never been commensurate with demand. Associated with this is the need for appropriate institutions or organizational and decision-making structures which may enable the analytical work to influence policies and their implementation. External financial and technical assistance to build up institutions as well as trained manpower to perform increasingly sophisticated and specialized jobs has not been available to the degree required. The role of the Bank and the Fund in building up and strengthening national capacity in this regard can hardly be over-emphasized.

The Bank's financial investment in environmental improvement is carried out either by integrating environmental components into development projects or by designing "free-standing" projects to meet a particular environmental problem. The incremental costs consequent to incorporation of environmental considerations into projects impose a burden on the developing countries. Unless this component involves a new technology, process of production, or product pattern which increases the efficiency of production, i.e. reduces costs per unit of goods or services output, there will be diversion of resources away from directly output-increasing investments.

There is indeed a trade-off between an increase in output and in environmental benefits. The developing countries can pay for the environment benefits. The developing countries can pay for the environmental measures only at the expense of additional output - which they cannot afford to lose or surrender. The additional costs will be incurred partly by the private sector and partly by public sector. Private investment in environmental protection will only be made if it is found profitable in terms of benefits over costs. In some instances, it may require public subsidies or complementary investment to render profitable private investment in environmental measures. For example, the private investments by farmers in terracing on hillsides or similar such soil- and water-conservation measures will depend upon incentives and resources at their disposal, i.e. price policy for inputs and outputs as well as access to credit; this in turn depends partly on the rate of return on the alternative investment opportunities in non-farm activities.

Since in many cases uncertainty exists as to the benefits of environmental measures, either as "free-standing" projects or as "components" in development projects, it is necessary to ensure that there is wide public participation in the examination of the nature and magnitude of environmental costs and benefits. "Environmental" conditionality becomes effective if there is a strong awareness among the policy-makers, the public and the various interest groups in developing countries of the urgent need for environmental protection.

What is needed is intensive public debate in developing countries on environmental issues. Although objections to an irrigation project, for example, may be raised by an international NGO or an environmental lobby because some rare species of fish is threatened or an indigenous tribe is adversely affected, the cause of environmental protection would be much better served in the long run if at the time of design and formulation of projects presented for consideration by the Bank for funding all the affected parties at the local and national levels had been able to reach a consensus. "Conditionality", as experience has shown, can be subverted in actual implementation if the borrowing country is not convinced of the need for environmental protection measures. For instance, rather than stopping all loans for commercial logging in tropical rain forests, as the Bank has decided to do, it might be preferable to devise and finance alternative sources of income and employment or other means of foreign-exchange earnings for countries heavily dependent on tropical rain forests. There may be even a case for the international community to pay the poor countries to preserve their rain forests for the contribution they make to the global environment.

In view of the controversy surrounding the degree of priority to be attached to environmental issues in developing countries for the debate to advance, it is necessary that the Bank and the Fund make an independent empirical analysis and thus help build up consensus on major environmental issues. A considerable degree of uncertainty relates to the measurement of costs and benefits of

environmental actions or the comparison between output, growth and environmental degradation. The important role of judgement in this case cannot be denied. The Bank must take careful note of the inherent uncertainties and demonstrate an adequate flexibility in action at the country level. After all, the qualitative nature of any environmental impact assessment should always be kept in mind.

Given the wide gap between investment requirements and resource availability in the developing countries - a gap which is increased by the inclusion of the costs of environmental protection - the case for additional flows of external resources cannot be over-emphasized. It has been recently suggested by the Secretary-General of the United Nations Conference on Environment and Development (UNCED) that IDA at the World Bank should have additional resources of \$1 to \$2 billion a year for environmental purposes. Likewise, the GEF should be provided \$5-6 billion for financing global environmental measures.³⁸

It is necessary to ensure that "additionality" in the external resource flow is real and not imaginary. A special account or a "separate window" in the bilateral and multilateral lending agencies is needed in order to ear-mark additional and distinct resources for environmental purposes. Given the stagnation in recent years in the flow of external resources and competing claims from the Commonwealth of Independent States and eastern Europe, innovative and non-conventional approaches are needed in order to raise resources under international auspices to finance environmental preservation. Taxes for the use of the global commons or for the use of resources which are environmentally damaging, such as carbon, merit serious consideration. To devise new sources of revenue is a daunting task and the UNCED meeting in June 1992 will test the will and ability of the international community in this regard. The first stage will be to reach the necessary degree of consensus on how to deal with major environmental problems; the next question will be how to raise resources for financing agreed measures. To assist developing countries to address global externalities is more a matter of mutual interests than of aid, but to convince citizens of rich countries to meet the costs of such transfers may be difficult.

There are important obstacles such as political and social constraints, faced by policy-makers in addressing environmental challenges, nationally and internationally. Perceptions of the urgency of environmental problems differ among societies; People often err in their choices of conservation policies. There is usually the opposition of vested interests: environmental policies preempt people's rights to pollute and damage the environment. Those with a vested interest will resist strongly sometimes aligning themselves with forces which oppose an open trading system or international cooperation for development. A strong capacity in developing countries to monitor and enforce environmental policies is needed. Without strong political commitment and a willingness to invest in an enforcement capacity, policies are likely to be ineffective. In addition, the uncertainties must be addressed; many environmental problems are not fully understood. This is especially relevant in relation to the ecological aspects of natural habitats or the speed and consequences of climatic change.

³⁸ *New York Times*, 1992.

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THE GROUP OF TWENTY-FOUR: TWO DECADES OF MONETARY AND FINANCIAL COOPERATION AMONG DEVELOPING COUNTRIES

C. Randall Henning*

Executive Summary

The Group of Twenty-Four has successfully placed before the world a developing-country agenda for reform of the international monetary system, including the mechanisms and facilities of the IMF and the World Bank. The G-24 has not become the forum, however, through which the developing countries conduct hard-headed negotiations with their advanced-country counterparts.

Evolving from developing-country cooperation during negotiations in the 1960s over the creation of Special Drawing Rights (SDRs), the G-24 became the principal coordinating vehicle for the developing countries in bargaining on international monetary reform in the early 1970s. The Group continued to develop common positions and provide technically sound studies and advice both for the preparations for global negotiations and the separate agenda within the Bretton Woods institutions during the late 1970s and early 1980s. Its 1985 report on the world monetary system was prescient, widely acknowledged and represents a high point for the Group.

The G-24 has faced a number of institutional challenges. The diversity of its membership and the principle of non-exclusion creates common positions comprised of long lists of policy items which are not prioritized. There has also been a frustrating tendency for the G-24 ministers to retreat from the common position, or press that position less vigorously, in meetings with their advanced-country counterparts in the Interim Committee.

Introduction

The transformation of world politics and economics at the beginning of the 1990s presents new challenges for developing-country cooperation in the Group of Twenty-Four (G-24). The dissolution of the Soviet Union, liberalization and reforms in the successor States and in Eastern Europe, the easing of the international debt problem, and the apparent ideological victory of liberal, market-oriented capitalism around the world, create both new economic and financial problems as well as new problems of coalition formation among the developing countries. The time has come for the Group to reassess its role and approach vis-à-vis the developed countries and the international financial institutions in this new environment.

The G-24 is now two decades old. Since becoming the primary institutional mechanism for the coordination of developing country positions on international monetary affairs, the G-24 has accumulated significant achievements. It has developed a common position among developing countries, and given voice to that position in the International Monetary Fund (IMF) and World Bank bodies. The G-24 has achieved moderate but notable programmatic successes in these

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international financial institutions, and has been remarkably prescient in recommending international cooperation on exchange rates and macroeconomic policy coordination among the industrialized countries during the second half of the 1980s.

As the Group re-evaluates its mission and its approach, the moment is opportune for reflecting on the history and achievements of the G-24 as an institution. The present paper offers a summary and overview of the evolution of the G-24, its objectives, constraints and mechanisms. The paper does not diagnose the present challenges facing the Group nor propose specific tactics for addressing them. The observations and lessons drawn from the experience of the Group presented here are meant to serve rather as an antecedent to that exercise.

The paper begins with a description of the origins of developing-country cooperation on international monetary issues in the IMF during the creation of the SDR. The succeeding sections chronicle the creation of the G-24 during the Committee of Twenty (C-20) negotiations of the early 1970s, and its role in them; the two-pronged approach to international monetary activism later in the 1970s, through "global negotiations" on the one hand and the Bretton Woods institutions on the other; G-24 work on the transformed agenda of the 1980s, with an important study and the debt crisis. The paper concludes with some observations about the work of the G-24 and its organization.

I. Early cooperation among developing countries

International monetary issues were not originally high on the agendas of the developing countries. The first concerns of the newly independent former colonies were trade, commerce and finance, rather than the structure and institutions of the international monetary system. The United Nations system of economic and social organizations dominated by the developing countries, which has included the United Nations Conference on Trade and Development (UNCTAD), focused mostly on this agenda. Money and finance, in any case, were the province mainly of the Bretton Woods institutions, formally affiliated with the United Nations system but in fact quite separate.

Beginning in the 1960s, the developing countries began to make their voices heard in the advanced-country-dominated IMF and World Bank. The first significant reform of the Bretton Woods system, the creation of the General Agreements to Borrow (GAB), was negotiated among the Group of Ten (G-10).¹ Since the GAB provided for an infusion of funds into the IMF, in the event of a shortage of convertible currencies, there was little overt opposition from the countries excluded from the decision-making process. The creation of Special Drawing Rights (SDRs) later in the 1960s, in contrast, raised distributional questions that affected the developing countries. At this point, before the creation of the G-24 itself, developing countries directly asserted their interests in monetary matters.

The international monetary system of the 1960s relied for liquidity on U.S. current account deficits, which simultaneously eroded confidence in the United States currency, a phenomenon identified by and associated with the work of Robert Triffin. The advanced countries first tried to resolve the so-called "Triffin Dilemma" by negotiating among themselves, outside the governing bodies of the IMF, just as they had created the GAB. They considered creating a new international reserve asset to replace the dollar in the foreign reserve portfolios of major reserve holders. The overwhelming majority of international reserves were held by the G-10 countries at that time. As the G-10 deputies chairman, Otmar Emminger, explained, the envisioned development of the world reserve system meant that a group of countries would take on responsibility which had up to now been vested in the United States alone. The initial proposals, consequently, provided for the distribution of SDRs among the G-10 or a limited group excluding the developing countries.

The Europeans were concerned that the United States of America and the small industrial and developing countries might overwhelm them in the management of the new reserve scheme if

¹ The G-10 is composed of Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom and United States of America. Switzerland also participates in its discussions.

that arrangement were made universal.² The United States of America was much more supportive of universal distribution of SDRs. Because the developing countries could be expected to be net users of the new asset, as could the United States, rather than holders of it, officials of the United States might have anticipated common interests in the management of the reserve system.³ The Managing Director, Pierre-Paul Schweitzer, and IMF staff, as might be expected, strongly favoured the creation of the new asset within the organization, with universal distribution and decisions on allocations taken by the regular bodies.

During 1964-1965, the G-10 deputies undertook a major study of proposals on reform of the reserve system. The appointed subgroup, chaired by Rinaldo Ossola (Italy), left many of the most important issues unsettled, including the issue of the scope of distribution of the new asset. The G-10 deputies and ministers themselves proceeded to settle these largely political issues during the following two years. However, despite the initial United States position and the support for universal distribution from the IMF staff, the former seemed to be moving toward a complex compromise position whereby a limited group would be responsible for the creation of the reserve asset, while it would also be distributed more broadly.

The developing countries responded to these initiatives, in lieu of the G-24, through three institutional mechanisms: the United Nations Organization; regional organizations such as those in Latin America; and Executive Directors in the IMF from developing country constituencies. The developing countries had been making more progress advancing their special interests within the United Nations system than in the Bretton Woods institutions. On economic and social questions considered by the United Nations General Assembly, they were favoured by the principle of one vote per country. Through the United Nations General Assembly, which they controlled when voting as a block, the developing countries created a system of institutions more responsive to their particular economic needs than the IMF or the World Bank. In the early 1960s, the African and Asian representatives to the United Nations General Assembly had joined with the Latin American countries in passing a resolution to convene a special conference - the United Nations Conference on Trade and Development (UNCTAD), held in Geneva in 1964. At this meeting, UNCTAD I, the Group of Seventy-seven (G-77) was formally established as the mechanism through which the developing countries would organize on international economic and social issues.⁴ The G-77 became the ideological and political centre of developing country international collaboration.

In 1965, UNCTAD convened a prestigious expert group to consider the reserve issues being considered in the G-10.⁵ The experts argued that the international liquidity needs of the developing countries were greater relative to imports than those of the developed countries, and could be expected to increase. Developing countries could also be expected to hold rather than spend a large share of newly issued reserves. Their report also argued that a link between the provision of international liquidity and development finance could be profitably established, and that reform of the international monetary system should include the developing countries in process and substance.⁶ The report was considered and endorsed by UNCTAD's Committee on Invisibles and Financing Related to Trade, which stressed that the developing countries should be eligible to participate in reserve asset creation.

The Latin Americans - always the best organized regional grouping of developing countries - also endorsed the experts' report through their own Inter-American Committee on the Alliance for Progress, in early 1966. They reinforced the recommendation to consider seriously the linking

² Robert Solomon, *The International Monetary System, 1945-1981* (New York: Harper and Row, 1982), chaps. 4 and 8.

³ See, John S. Odell, *U.S. International Monetary Policy: Markets, Power and Ideas as Sources of Change* (Princeton: Princeton University Press, 1982), chap. 2.

⁴ For a succinct history of developing country coordination of international economic positions in world bodies, see Robert F. Meagher, *An International Redistribution of Wealth and Power: A Study of the Chapter of Economic Rights and Duties of States* (New York: Pergamon, 1979), chap. 2.

⁵ *International Monetary Issues and the Developing Countries*, UN document TD/B/32 and TD/B/C.3/6, New York, 1965.

⁶ In 1960, Maxwell Stamp had proposed that the IMF issue certificates representing claims on currencies held by the Fund to the International Development Association (IDA) of the World Bank. IDA would then distribute them to developing countries, who could in turn purchase goods from the industrial countries. He argued that this could satisfy both the needs of the developing countries for capital goods and development assistance and the need of the industrial countries for greater liquidity, as they would be left holding the IMF certificate.

of reserve creation to development finance.⁷ This was seconded by a meeting of Latin American central bank governors in Jamaica shortly thereafter. The governors affirmed that the IMF should remain the central institution of the international monetary system. This endorsement was a significant departure from previous Latin American positions.⁸ In May, cognizant that the G-10 was meeting in Rome at ministerial level to consider the reserve question without them, 31 developing countries issued a joint statement reiterating their opposition to limited-group proposals.⁹

Owing largely to these pressures, the G-10 accepted the principle of universal distribution of the reserve asset by mid- 1966. They agreed that units would not be allocated without another explicit decision. The debate then shifted to the nature and characteristics of the asset that would be created. The ordeal of the developing countries was not yet over.¹⁰

Despite agreement on universal distribution of the new reserves, the G-10 was unwilling to negotiate the rules, rights and obligations governing their use entirely within the IMF. Agreement was finally reached on holding joint meetings of the Executive Board of the Fund and the G-10 deputies to discuss these issues - a formula that gave the G-10 countries double representation. In preparation for these meetings, the nine Executive Directors elected from exclusively developing countries held informal caucuses to coordinate their positions on the forthcoming issues, creating the "Group of Nine" - the third institutional mechanism through which developing countries coordinated their positions.

The four joint meetings reached basic agreement on the specific qualities of the SDR. With this accord, the Articles of Agreement were amended for the first time in July 1969. The first allocations were approved within months of the entry into force of the first amendment, and the first distribution of a three-part dispersal of SDRs began in January 1970.

During these negotiations, the developing countries proposed that the SDR be linked to development finance - a position that would become a central position of the G-24. The design of the SDR was very complex indeed, without injecting the issue of the development link. The developing countries reserved their full advocacy of the concept until after the nature of the asset had been determined and SDRs created and allocated.

With the advent of the 1970s, the developing countries had good reason to be proud of their accomplishments in the realm of international monetary affairs. They had succeeded in getting the industrialized countries to agree to the principle of universality in distribution of the SDR. While from a later perspective this may not seem such a great achievement, the SDR was expected by many in the early 1970s to evolve into a full-fledged currency, perhaps replacing the United States dollar at the centre of the world monetary system. That the developing countries were full participants in the distribution and management of this new international asset, the potentially most important reform of the system to date, was a formidable victory. Capping this victory, an allocation for SDRs had been approved and was being distributed.

However, the developing countries continued to be circumvented, in their view, in international monetary diplomacy by the activities of the G-10. Used by the industrialized countries in advance of discussions in the IMF when they considered broader participation to inhibit progress on reform issues, the G-10 had become increasingly active with each major monetary crisis in the late 1960s. So, while the developing countries had won a substantive victory, they continued to be excluded in large measure from the inner group of developed countries that had formed half outside of the Fund. The joint meetings of the Executive Board and G-10 deputies did not resolve this exclusion to their satisfaction. However, the newly independent, newly organizing States of the third world held high hopes for the future.

7 Margaret Garritsen De Vries, *International Monetary Fund, 1966-1971: The System Under Stress. Volume 1: Narrative* (Washington, D.C.: International Monetary Fund, 1977), pp. 84-5. The Committee suggested that the Latin American countries place their additional owned reserves in a collective fund. See the report of the Inter-American Committee on the Alliance for Progress, *International Monetary Reform and Latin America*, March 1966.

8 De Vries, *International Monetary Fund, 1966-1971*, p. 85. They also recommended that quotas be increased, access enlarged, and the CFF expanded.

9 The developing countries were not alone. Opposition to the limited-group approach was voiced as well by the smaller industrialized countries excluded from the G-10, *ibid.*, p. 81.

10 *Ibid.*

II. The creation of the G-24

A. Genesis

With the unravelling of the international monetary system at the beginning of the 1970s, the developing countries were confronted with a major challenge. Frustrated by the inability to reach an agreement within the G-10 on evolutionary reforms of the international regime, the former American president Richard Nixon officially suspended gold convertibility and unilaterally imposed a surcharge on imports into the United States in August 1971. He and his Treasury Secretary, John Connally, then proceeded to negotiate a realignment of exchange rates with the other members of the G-10. The developing country Executive Directors at the IMF wrote to the Managing Director, Pierre-Paul Schweitzer, insisting that a way be found for them formally to express their positions on the issues being considered and decided by the G-10. In response, the joint meetings of the Executive Board and the deputies of the G-10 were resurrected. Such a meeting was convened the day before the G-10 Ministers met in Washington, D.C. at the Smithsonian Institution to agree on the new exchange rates among their currencies.¹¹

The Smithsonian negotiations established the anticipated realignment of G-10 currencies, principally by devaluing the dollar and revaluing the European currencies and Japanese yen. The Ministers also took two other decisions of importance. First, they agreed that broader discussions regarding "reform of the international monetary system in the longer run" should begin promptly. Secondly, they agreed that these discussions should be undertaken in the framework of the IMF.¹²

These decisions were welcomed by the developing countries, which had resented the joint meetings of the Executive Board and the G-10 deputies for their double representation of industrialized countries. The small industrialized countries were also relieved that the G-10 had at least nominally agreed to negotiate reform in the full bodies of the IMF. Both the developing and small industrialized countries remained concerned, however, that with the G-10 having monopolized realignment bargaining, there could be subsequent backsliding on exclusion, with the G-10 capturing a preponderant role in later discussions on overall reform.

With these concerns in mind, the developing countries had already begun to organize outside the framework of the IMF. The G-77, at its Second Ministerial Meeting in Lima, Peru, in November 1971, sharply criticized the approach of the advanced countries to monetary reform:

It is entirely unacceptable that vital decisions about the future of the international monetary system which are of concern to the entire world community are sought to be taken by a limited group of countries outside the framework of the IMF.¹³

Frustrated at their lack of access to reform discussions, the G-77 ministers created a special group to consider monetary issues in light of upcoming reforms.¹⁴ This step had been originally proposed by the Latin American countries at their regional-level meeting in October.¹⁵

¹¹ De Vries, *The International Monetary Fund: 1966-1971* pp. 552-53.

¹² Ministerial Meeting of the Group of Ten, communiqué, Washington, D.C., 17 to 18 December 1971.

¹³ Second Ministerial Meeting of the Group of 77, "The Declaration and Principles of the Action Programme of Lima".

¹⁴ See, Eduardo A. Zalduendo, "Brief History of the Group of Twenty-Four", in *Intergovernmental Group of Twenty-Four on International Monetary Affairs: Documents of the G-24, 1972-1986* (Washington, D.C.: March 1986). See as well, Karl P. Sauvant, *The Group of 77: Evolution, Structure, Organization* (New York: Oceana Press), pp. 60-62.

¹⁵ Their statement, which also contains a draft of the terms of reference of the new group, appeared as Resolution 27/XII of "The Consensus of Lima", adopted by the Twelfth Meeting of the Special Committee on Latin America Coordination (CECLA); cited by Sauvant, *The Group of 77*, No. 95, p. 93.

Specifically, the conference asked the Peruvian Government to consult with others on the formation of an intergovernmental group to perform the following tasks: (a) review progress on international monetary reform and keep the G-77 informed on discussions within the IMF; (b) evaluate the effects of international monetary decisions taken by the advanced countries on the interests of the developing countries; (c) recommend coordinated positions to the developing countries, at UNCTAD III in particular (to be held in Santiago, Chile, in the spring of 1972) and future action, including the convening of a world monetary conference within the framework of the United Nations.¹⁶ However, despite this reference to working within the United Nations system, the communiqué stated explicitly that the G-77's goal was to strengthen the institution of the IMF, not weaken it. The scope of the new group was strictly monetary and financial, as its purpose was to fill a substantive lacuna in the trade-oriented UNCTAD and G-77.

In addition to these terms of reference, the G-77 meeting in Lima, Peru, also enunciated the principles of organization and the structure of the new intergovernmental group. It was originally conceived as having 15 members, ministers or senior monetary or financial officials, five from each continent: Latin America, Asia and Africa. Paralleling the structure of the G-10, a deputies group was set up. Included at the deputy level would be the Executive Directors of developing countries at the IMF, the G-9. Though actual membership would be limited, all members of the G-77 were given the right to participate in any of the meetings of the Group.

Over the following two months, coordinators from each of the three regions met to discuss the details of formal establishment of the group. The points of discussion were the membership, its size, the level of representation, invitations to international officials and the preparation of an action programme. As agreement on which countries should have formal membership in the Group became a contentious issue; the size of the Group was raised first to 21, then to 24, eight from each region, selected by each region independently.

At the end of January 1972, a preparatory meeting of deputies was convened in Geneva, Switzerland, to draft a work programme on substantive and organizational issues for consideration by the first full meeting of ministers of the new Group and UNCTAD III. To the meeting came the Executive Directors of the Fund from Washington, many of them from Latin American countries, and many ambassadors in Geneva from the African and Asian countries. The deputies appointed Manuel Moreyra Lorado of Peru, chairman, Rachid Bouraoui of Algeria, deputy chairman, and Lal Jayawardena of Sri Lanka, rapporteur.

The meeting has been described by some participants as "frantic and messy", with considerable dissension between regional groups. Countries held regional caucuses, then tried to merge their positions with those of the other two groups, in keeping with the practices of the G-77. The African countries tended to favour broad political statements, while the countries of Latin America felt it was against their interest to jostle or alienate the financial markets in their communiqué. This divergence partly reflected the different inclinations of officials from foreign affairs ministries and financial technicians.

The directness of the SDR link became a major issue at the outset, with those countries having large quotas in the Fund standing to gain by a direct link and those with smaller quotas or disproportionate influence with the management of Fund resources standing to lose. The African countries were very interested in emphasizing commodities, and schemes for commodity price stabilization, the Latin American countries were more interested in manufactures, while the Asian countries took various sides of the issue. The Latin American representatives were so frustrated that they pledged never to meet again in Geneva. Even so, the fledgling Group nonetheless managed to hammer out an agreement on substance and procedure.

The deputies refined the organizational structure set by the UNCTAD conference. The frequency of meetings was a decision of the chairman (who would later be given a one-year term only). Meetings could also be called at the request of any member. When the deputies deemed it useful, working groups could be established to address specific issues or tasks.

The agreement, made public a few months later at UNCTAD III, in Santiago, endorsed the creation of the Committee of Twenty (C-20) as the forum in which to discuss international monetary reform. The deputies agreed that a new allocation of SDRs should be made, but declined to specify an amount. They accepted the important principle that SDRs should be created in

¹⁶ Second Ministerial Meeting of the Group of 77, "The Declaration and Principles of the Action Programme of Lima", cited by Zalduendo, "Brief history of the Group of Twenty-Four", p. vii.

amounts consistent with the need for international liquidity. They also agreed on the need for a link of some kind between SDR allocations and development aid, but did not specify whether a direct or indirect link was necessary.¹⁷

Inaugural meetings of the G-24 were held in Caracas, Venezuela: first of the Deputies, then of the Ministers, in April 1972. It was formally christened, the "Intergovernmental Group of Twenty-Four on International Monetary Affairs".¹⁸ Three weeks later, at its meeting in Santiago, UNCTAD III endorsed the short report of the G-24 ministers and issued the G-24 communiqué. The developing countries were, thus, organized for the subsequent negotiations on international monetary reform, even if they had not yet agreed on the substance of their platform.

B. Purpose and prospects

The G-24 was created by the poorest and most vulnerable States in the world economic system. These Governments created the new Group when it became clear that the United States, Japan and Europe would not automatically or altruistically take the interests of the third world into consideration when restructuring the international monetary system. By coordinating their actions and promoting common positions, they hoped to have an important influence on the outcome, whereas otherwise they would have none. They pursued, in other words, a strategy of the weak in world politics.

The genesis of the G-24 introduces continuing themes in the history of international monetary cooperation among the developing countries, the Group's strengths and weaknesses, its character and effectiveness. Even at birth, first of all, the G-24 responded to the agenda set by the developed countries. The developing countries surely could not remake the international monetary system by themselves. Nor could they force the developed countries to change it against their will. However, the developing countries might affect the evolution of that system when the industrialized countries recognized the need for change but were undecided on a course of action or were divided among themselves. In other words, the G-24 might have a significant impact on the margin. However, the broad parameters of these reform deliberations were set by the industrialized countries in the early 1970s, and continue to be.

Secondly, the structure of the economies of the members of the G-24 and the other Governments participating in its meetings span a vast range - a much greater diversity than within the G-10: e.g. Brazil and Lebanon, Guatemala and India, Ethiopia and the Philippines. These diverse countries were charged with writing a platform to promote common interests. Aggregating these varied interests would prove to be a difficult task.

Thirdly, the important operational result of this diversity and weakness was the necessity to open the Group to participation by all interested developing countries, as well as the initial decision to expand the Group to 24 members. Moreover, since a major grievance was exclusion from the reform discussion, it would have been deemed hypocritical to exclude Governments from participation for efficiency's sake, particularly since efficiency was the argument of the advanced countries. The diversity of the economic interests of the countries involved made the appointment of representatives difficult. Broad participation meant that consensus-building would be a slow, communiqué-intensive process, accentuated by the rule that the G-24 would operate on the basis of consensus, not majority voting.

The first meetings of the G-24 were organized around regional caucuses, the organizing principle of the G-77. This process was disbanded soon after the creation of the Group, and was not formally resurrected. However, the divergence of interests among these countries along regional lines has surfaced periodically as a major feature of intra-group decision-making.

¹⁷ Group of Twenty-Four, communiqué, April 7, 1972, issued at Caracas, Venezuela, as reproduced in *Intergovernmental Group of Twenty-Four*, pp. 1-2.

¹⁸ The 24 members of the group are: Algeria, Argentina, Brazil, Colombia, Côte d'Ivoire, Egypt, Ethiopia, Gabon, Ghana, Guatemala, India, Iran, Islamic Republic of Lebanon, Mexico, Nigeria, Pakistan, Peru, Philippines, Sri Lanka, Syrian Arab Republic, Trinidad-Tobago, Venezuela, Yugoslavia and Zaire. The composition of the group has not changed since its inception. Several officials of the World Bank, the IMF, UNCTAD, UNDP and the Governments of developing countries non-members, such as the Peoples' Republic of China, attend as observers.

Fourthly, the broad participation of diverse countries has predisposed the G-24 toward aggregating every member's first priority into one long list when building a consensus platform. Group organizers have drawn upon this "log rolling" technique periodically over the years, although it has by no means dominated all internal decision-making. At times, particularly during the C-20 period, the G-24 was quite capable of assigning priorities to its list of reforms and promoting them vis-à-vis the G-10 Governments.

Fifthly, the Ministers meeting at Caracas, Venezuela decided not to create a permanent secretariat - an issue that would resurface periodically over the life of the Group. Schweitzer, the Managing Director, attended the ministerial meeting, along with officials from the World Bank and UNCTAD, and offered administrative and logistical support for meetings held in Washington, D.C. All other support would be provided by group members themselves. This meant that the larger members - Brazil, Argentina, India, the Philippines, Mexico - would be relatively influential in the work of the Group. Also, there would be no repository for a long-term institutional memory, given the turnover among Group leaders. The Group would develop a dual reliance on the IMF staff, for logistical support, and for the most up-to-date reports of world economic conditions and forecasts, and, later, on UNCTAD and the United Nations Development Programme (UNDP) for background analysis on the reform measures which it would endorse.

Sixthly, the G-24 would thus have ambivalent relations with UNCTAD. Whereas it was originally the creature of the G-77, it had sought to distance itself somewhat, partly through the efforts of the developing country Executive Directors at the IMF. The latter, however, did not command sufficient staff resources to backstop the new Group, so that input from UNCTAD remained vital. While sometimes caught in a difficult position, the G-24 helped to keep the positions of the developing countries in the Fund and in the United Nations from diverging too far from one another.

Seventhly, the G-24 was an important effort to put together a technically sound platform which could serve as the basis of negotiations with the G-10 over the following few years. (Notably, at that time the G-24 was not expected to continue indefinitely.) Finance ministers, central bankers and their deputies would play a dominant role within the group, and would resist the influence of foreign, labour and agricultural ministries from their own Governments. This tendency could be seen in the initial, preparatory meeting of the deputies in Geneva. One commentator observed:¹⁹

The Deputies felt that the Group should evolve a distinctive character of its own which would carry with it an aura of specialized competence and mature thinking among hard-headed financial experts, focusing on specific issues rather than generalities.

The predominance of financial experts and finance ministers in the G-24 has distinguished it from other major international economic organs of the developing countries.

III. Negotiations over international monetary reform

The developing countries emerged with a fairly strong position in the institutional structure of the reform negotiations, with the support of the United States of America and IMF staff. Indonesia's Minister of Finance, Ali Wardhana, was elected chairman of the C-20. Two of the four vice-chairmen of the deputies were chosen from developing countries: Jonathan Frimpong-Ansah, former governor of the central bank of Ghana, and Alexandre Kafka, a Brazilian and Executive Director for Brazil's constituency at the IMF. They sat on the "bureau", the secretariat of the C-20.

The issues of the adjustment process, international liquidity, asset settlement and convertibility, and the disposition of gold confronted the would-be architects of monetary reform. The developing countries, in general, preferred a loose adjustment system and a loose system of asset settlement, at least as applied to them. As a group, their position was most salient on the issues of the SDR link, access to capital markets and a reapportionment of Fund quotas - those

¹⁹ Zalduendo, "Brief History of the Group of Twenty-Four", p. ix.

raised in the first G-24 communiqué - with the SDR link heading the list. The G-24 strategy in approaching these negotiations was laid out in an internal report prepared by Carlos Massad, Sidney Dell and others.

The developing countries had succeeded in having their special concerns placed on the agenda of the C-20 and deputies. This subject was addressed directly at the fifth meeting of the deputies, held in Washington in late May 1973. There, the developing country deputies spoke with one voice on the need for an SDR link. Their arguments were prepared to counter the objections of the industrialized countries. The G-24 had set up a working group on the link to prepare the position.

Alone among the industrialized countries, the representative of Italy supported the link. While some other delegations expressed sympathy, the industrialized countries, on the whole, opposed the concept. The United States of America and the Federal Republic of Germany took firm positions in opposition, arguing that the link would impair the development of the use of the SDR and that it would inevitably result in an over-allocation of SDRs beyond the true liquidity needs of the system. But, as the representatives of France and the United Kingdom were more inclined to favour the link, a technical group on the link was established to study the issue further. This group carried out its work over the next several weeks. The main industrialized-country opponents of the link, however, remained unmoved. While general agreement was reached that the amount of SDR allocations should continue to be determined solely by global monetary requirements, with or without the link, the United States successfully resisted the scheme.²⁰

The C-20 deputies also discussed other special concerns of the developing countries at their fifth meeting - mainly their access to capital markets and the relative size of developing-country quotas in the IMF. From this discussion emerged a general sentiment that the access to IMF resources should be increased in ways that were likely to favour developing countries. Financing could be made available for longer periods, perhaps for buffer stocks, and access to the Compensatory Financing Facility (CFF) might be eased. The deputies thus encouraged further consideration of a proposal developed a few months earlier by the IMF staff for an extended facility.²¹ The final outline for reform approved by C-20 in 1974 "envisaged" its creation to provide developing countries with longer-term balance of payments finance.²² The facility was established later that year.

The C-20 also commissioned a working group on the transfer of real resources to the developing countries, which was to examine specific action proposals other than the link and EFF. While it addressed reserve management and exchange rate arrangements, it focused mainly on the issue of access to international capital markets, particularly in light of the oil price increases of late 1973 and early 1974. The group's report concluded by recommending that these issues be studied further and that specific agreements might be best carried out by a ministerial group. From these suggestions, the Development Committee was eventually created.²³

Many of the fundamental presuppositions of the discussions of the C-20 were shattered by the first oil shock, especially with respect to the developing countries. The control that OPEC exercised over the world oil market and the opportunities that this seemed to offer other commodity exporters dominated the North-South debate over the next decade. The first oil shock also obscured the interests of the industrialized countries in international monetary reform; and for that reason alone pulled the rug out from under any tentative agreements reached among them in the C-20. That unique attempt at regime transformation and reconstruction thus ended in failure. The ministers could agree only that the regime should evolve through continued negotiations over the next several years.

While largely only codifying *de facto* exchange practices of members, subsequent reform discussions did bring the developing countries concrete concessions. These include the EFF, Special Oil Facility, enlarged access policy generally, the creation of the Development Committee,

²⁰ "Report of Technical Group on the SDR/Aid Link and Related Proposals, 9 July 1973", *International Monetary Reform: Documents of the Committee of Twenty* (Washington, D.C.: IMF, 1974), pp. 95-111.

²¹ Margaret G. de Vries, *The International Monetary Fund, 1972-1978: Cooperation on Trial*, Volume II (Washington, D.C.: IMF, 1985), pp. 206, 209.

²² "Report to Board of Governors by Committee of Twenty and Outline of Reform with Annexes, June 14, 1974", *International Monetary Reform: Documents of the Committee of Twenty* (Washington, D.C.: IMF, 1974), p. 18.

²³ "Report of Technical Group on the Transfer of Real Resources, April 30, 1974", *International Monetary Reform*, pp. 183-210.

and establishment of the Trust Fund. Some of these gains were won, it is generally acknowledged, through the power of the developing countries to block formal incorporation of the reforms agreed among the industrialized countries into the IMF articles of Agreement. Negotiations over the disposition of gold provide a good example of the exercise of this "blocking position" on the part of the developing countries collectively.

The Interim Committee, the institutional remnant of the Committee of Twenty, continued negotiations over the disposition of the IMF's gold stock in 1975 and 1976. The United States and most members of the G-10 wanted to reduce the role of gold in the monetary system, while France in particular pushed for its return to members. All proposed solutions required an amendment of the Fund's Articles, but no amendment could be passed without more than half of the votes of the developing countries.

The G-24 firmly stated the principles of the kind of arrangement that it would accept: (a) national gold policies would not be unilateral; (b) these policies would be consistent with the Articles and the gradual reduction in the role of gold and strengthening of the role of the SDR; (c) new arrangements would substantially raise the flow of financial resources to developing countries without imposing a loss on any one of them; and (d) arrangements would not accentuate the concentration of international liquidity in the hands of the advanced countries. Aware that they possessed a blocking position, the ministers worded their pronouncements on gold strongly: such that, "no arrangements" which failed to meet the third criterion "would be acceptable".

In Jamaica, where the Interim Committee agreed on the Second Amendment to the Articles, the G-24 expressed "strong dissatisfaction" with the distributional implications of the arrangements under consideration.²⁴ A compromise agreement was reached whereby one-third of the Fund's gold would be sold, one-sixth of it would be restituted to member countries in proportion to the quota, and an additional one-sixth would be made available to developing countries alone, through a combination of an additional restitution (according to quota) and lending through a new institution, the Trust Fund. The Trust Fund took the profits realized through the sale of part of the IMF's gold and lent them to the poorest of the developing countries on favourable terms. The agreements on gold became part of the Second Amendment to the Articles of Agreement of the Fund, which entered into force in April 1978. In the 1980s, the resources of the Trust Fund were transferred to other facilities, including the SAF.

The decisions on gold also showed that the G-24 could be relatively influential when the industrialized countries were themselves divided. The United States and France were opposed on the issue of the role of gold in the system. The developing countries sided with the Americans, favouring a displacement of gold by SDRs.²⁵ This ran counter to the preference of France for restitution of IMF gold holdings. In both cases, the united position taken by the developing countries was decisive on the margin in settling an issue among the industrialized countries. Albeit modestly, the developing countries were able to exploit divisions within the G-10 to advance their own interests.

IV. Preparations for global negotiations

The oil price increases of 1973 and 1974 dramatically changed the conditions and agenda of international economic discussions. In OPEC's control over the oil market, developing countries sensed increased collective bargaining power with the North on a broad range of commodities. If they could harness OPEC's bargaining leverage, the developing countries believed, they might find the industrialized countries considerably more forthcoming on issues of trade, finance, and monetary affairs. Negotiating advantages thus argued for linking discussions across the breadth of the issue spectrum, a position earlier adopted on substantive grounds.

Beyond the areas of development and finance, the World Bank and IMF were ill-suited as a forum for serious negotiations, for developing country purposes. Developing countries favoured

²⁴ Group of Twenty-Four, communiqués, 9 June and 30 August 1975, and 6 January 1976.

²⁵ Interestingly, the Trust Fund was first broached not by the G-24 but by Henry Kissinger in 1974 when advocating an expansion of international lending facilities to the advanced countries as well, in the wake of the oil crisis.

instead the United Nations, a forum where they were dominant on economic and social issues, and in which cross-issue linkages exploiting their commodity power might be more easily pursued. Given impetus by UNCTAD and the Brandt Commission, global negotiations were advanced. The G-24 became the international monetary agent of the G-77 and UNCTAD in preparing for these prospective negotiations. Though these "global negotiations" never became a reality, torpedoed by the industrialized countries, notably the United States, they did become the focus of the international economic diplomatic efforts of the developing countries in the late 1970s. As such, they dominated the work of the G-24 and altered its relationship with the G-77, G-9 and foreign ministries within developing countries. This section focuses on that topic; the following section discusses the continuing work of the G-24 within the framework of the Bretton Woods institutions.

The oil price increases of the late 1970s, also deeply divided the interests of the developing countries. As OPEC current account surpluses soared, peaking at \$116 billion in 1980, the deficits of the non-oil developing countries rose accordingly, registering \$59 billion in 1979, \$86 billion in 1980, and \$100 billion in 1981.²⁶ These deficits required financing. The IMF and multilateral development banks (MDBs) provided some of this financing, as mentioned above. The largest share came from funds invested from OPEC surpluses in Western international commercial banks and relented to the developing countries mainly through syndicated lending on the Eurocurrency markets.

The ballooning of the Eurocurrency markets placed enormous quantities of finance at the disposal of creditworthy developing countries. For them, access to capital markets ceased to be a problem. For higher-risk developing countries, however, access to capital markets was still blocked and augmented official financing was all the more necessary. Secondly, many of the largest borrowers were themselves oil exporters, borrowing on the strength of their oil reserves. Thirdly, external borrowing dramatically raised the indebtedness of oil and non-oil developing countries alike, setting the stage for the debt crisis of the 1980s and the associated issues which would then dominate the G-24 agenda.

When the G-24 was founded in the early 1970s to prepare the developing countries for the upcoming reform negotiations in the C-20, it was not created as a permanent group. But, as the C-20 exercise left important work unfinished and reform deliberations continued into the mid-1970s, there was a continuing need for a forum in which the developing countries could coordinate their views. Moreover, the Development Committee was a new body for which the G-24 could coordinate the positions of its developing country members. Accordingly, in 1976, the G-24 was given a mandate to continue its work by the G-77 at its ministerial meeting in Manila.²⁷ Thus, when in the late 1970s the developing countries needed to aggregate and coordinate their views on monetary matters associated with global negotiations - all the more important in light of greater potential conflicts of interest among oil and non-oil countries - the institutional mechanisms were already in place. Indeed, technical support for the Group had matured in the meantime.

A. Technical support

Once it became clear that the G-24 would continue, several members raised the question of administrative, technical, and manpower support for the Group. Participating officials in the early days often had very little advance preparation for G-24 meetings. The deputies would rendezvous in their hotel rooms on the eve of the conference to gather agenda items for the following day. To lend more structure and planning to their work, many advocated that a permanent secretariat be created to fulfil these functions. This proposal immediately ran afoul of the practical problems of financial support, assessment of national contributions to the group, selection of the secretariat chief, his powers and relationship to the G-24 chairman and members. In general, the smaller countries tended to favour the creation of a secretariat, while the larger countries believed that these functions could be staffed by people from their own, larger ministries and central banks.

An alternative of having UNCTAD provide this support, as it does for the G-77, was considered. UNCTAD's funding, however, is provided mainly by the industrialized countries. In the mid-and late 1970s, the industrialized countries were quite aware that this portion of their con-

²⁶ IMF, *Annual Report for 1982*, table 7, p. 20.

²⁷ Third Ministerial Meeting of the Group of 77, "Organizational and Other Matters", cited by Sauvart, *The Group of 77*, No. 110, p. 94.

tribution to the United Nations system was going to the study of and development of international coalitions supporting proposals and principles to which they were strongly opposed. Group B, as the industrialized countries were known in UNCTAD, would not countenance the extension of UNCTAD's activities beyond trade and development into international monetary and financial affairs, which they regarded as the province of the World Bank and the IMF in any case. Using UNCTAD as a G-24 secretariat would jeopardize existing Group B support for UNCTAD's existing functions.

UNCTAD's Secretary-General subsequently approached UNDP to ask whether it could support the work of the G-24 under a technical assistance grant. Provided that this grant extended only technical assistance and not the administrative capacity for coalition building, this arrangement would have the approval of the industrialized countries. UNDP agreed in 1975 to provide funds for a series of technical studies overseen by Sidney Dell of the United Nations secretariat. These studies, conducted by inside and outside experts, were designed to advise the G-24 deputies and ministers on issues of importance before the World Bank and the IMF. They supported the development of G-24 communiqués and, more importantly, reports of the Group.

A report issued in 1979, dubbed the "Blue Book" by its authors, became the G-24's manifesto for the 1980s and the prospective global negotiations. The Blue Book was the most comprehensive statement to date by the Group, and represented its coming of age among the fraternity of international economic "groups". With this report, the G-24 demonstrated that it would be a continuing feature of international monetary diplomacy.

B. The Blue Book

With serious discussion on international monetary reform having been concluded, and the prospect of important negotiations between the developed and developing countries looming on the horizon, the G-24 was pulled strongly in the direction of closer association with the G-77.²⁸ Furthermore, the G-77 became more directly involved in the monetary issues that they had previously left completely up to the G-24 alone. They would seem to have had two motives for doing so. First, they suspected that the G-24 had been co-opted by the Bank and IMF, and unduly influenced by the Executive Directors there. Secondly, ministries excluded from international discussions in the monetary realm - foreign ministries in particular - asserted their bureaucratic interests. The G-77 has included ministers from foreign, trade, planning, industry and agriculture, in addition to officials from finance ministries and central banks.

At Arusha, Tanzania, the Fourth Ministerial Meeting of the G-77 in February 1979 adopted a truly radical set of international monetary proposals. They jettisoned inhibitions they viewed as merely technical to promote a political agenda in the monetary realm. The G-77 ministers were highly critical of the IMF, in particular, declaring that it tended to "reproduce colonial relationships". Elaborating, they said, "Its orientation is fundamentally incompatible with an equitable conception of structural change, self-reliance and endogenous development". They advocated a "United Nations Conference on International Money and Finance", at which a new international monetary authority could be created. They put forth the principles on which the new organization and monetary system would be based: universality, democratic management and control, an international currency unit, automaticity in transfers of resources through reserve asset creation.²⁹

There was virtually no possibility that the creation of a new monetary authority dominated by developing countries and supplanting the IMF would be accepted by the developed countries. The G-77 ministers apparently believed that by pushing a radical set of reforms, with the vague threat of restricting the supply of important commodities such as oil, they might induce the developed countries to make moderate concessions. Leaving the door open to compromise, the ministers recommended a list of "transitional measures" to be undertaken by the IMF, which closely coincided with the reforms recommended by the developing countries' representatives to the IMF. It was this list, not the radical set of reforms, on which the G-24 focussed in its manifesto for global negotiations.

²⁸ For a discussion of the relations between the G-24 and G-77, see, Karl P. Sauvart, *The Group of 77: Evolution, Structure, and Organization* (New York: Oceans, 1981), pp. 65-9.

²⁹ *Development Dialogue* 1980:2.

Taking encouragement from the Brandt Report,³⁰ the G-24 mounted a special effort to prepare a comprehensive statement on the issue of monetary and financial interest relevant to global negotiations. Sidney Dell and Roger Lawrence of UNCTAD directed a thorough study of international monetary and financial issues affecting developing countries.³¹ They benefitted from inputs of experts' papers funded by the UNDP programme as well as a large number of country studies conducted by developing country officials and academics. Their paper was perhaps the most thoroughly researched and carefully reasoned document up to then produced for the G-24. Presented to the Group in March 1979, at the onset of the second oil shock, it provided the expert foundation for the reform agenda proposed in the G-24 ministerial report.

In the above mentioned report, the G-24 lamented the failure of world monetary reforms under the C-20, and reiterated the positions it had taken earlier.³² A viable system, according to the report, would be characterized by (a) symmetrical adjustment, requiring sufficient access to official credit and private goods and capital markets on the part of developing countries; (b) a flexible, but stable, exchange rate regime; (c) evenhanded IMF surveillance of deficit and surplus countries, with a distribution of the burden of adjustment between them that preserved high levels of economic growth; (d) collective creation of international liquidity, with the SDR becoming the principal reserve asset of the system; (e) the SDR link; (f) a greater role for developing countries in the decision-making process surrounding the monetary system.

The G-24 ministers also endorsed a "Programme of Immediate Action" for measures relating to the broader concerns of the developing countries in global negotiations, including the transfer of real resources, increases in IMF resources, balance-of-payments support, and trade. On the much-debated issue of establishing a substitution account for disposing of the "dollar overhang", the G-24 remained noncommittal. This menu of proposals included far-reaching reforms, although strictly within the framework of the existing institutions of the Bank and IMF. While the G-24 ministers cited the G-77 Arusha statement as giving a "sense of direction to their efforts to achieve a New International Economic Order", the G-24 conspicuously omitted the ideological language and proposals for a replacement for the Bank and IMF.

Nevertheless, meeting in Belgrade, Yugoslavia, shortly before the Bank/Fund annual meetings, the G-77 ministers endorsed the G-24 report. Organized on the initiative of Yugoslavia, this endorsement was the first and only such formal ratification by the G-77 of the G-24's position. Thought to be necessary to show solidarity among developing countries during the important approach to global negotiations, the endorsement left no doubt that the report represented the united view of all developing countries.

At the outset of the 1980s, therefore, the G-24 had positioned itself closely to the G-77. While it retained both the G-77 mandate to coordinate developing country efforts and policies regarding international monetary reform and considerable independence from its parent, the G-24 operated within the context of impending global negotiations, which were to be dominated by the United Nations organization, as far as developing countries were concerned. The influence of the Executive Directors from the IMF was correspondingly reduced to a certain extent, particularly as technical and research support was being provided by UNCTAD/UNDP. As prospective global negotiations captured attention in developing country capitals, decision-making on national positions tended to be centralized, often giving foreign ministries greater say. Thus, the G-24 was in the position of promoting proposals that it thought technically and financially feasible within a highly charged, ideological negotiating environment.

Despite closer association with the programme of UNCTAD, the broadening of the substantive coverage of the G-24 ministers was relatively limited in the late 1970s and early 1980s. The G-24 meetings focused on the agendas of the Interim and Development Committees. Two major exceptions were the ministers' persistent pleas for greater official development assistance (ODA) from the industrialized countries, and their promotion of the Common Fund for UNCTAD's Integrated Programme for Commodities, beginning in 1976. Despite somewhat greater attention to debt, trade, and the transfer of real resources in the 1979 report, the continuity

³⁰ *North-South: A Program for Survival*, the Report of the Independent Commission on International Development Issues (Cambridge: MIT Press, 1980), chap. 13.

³¹ This Study was later published as, Sidney Dell and Roger Lawrence, *The Balance of Payments Adjustment Process of Developing Countries* (New York: Pergamon, 1980).

³² Group of Twenty-Four, "Outline for a program of Action on International Monetary Reform", press release, Belgrade, Yugoslavia, September 29, 1979.

of the G-24's focus on the Bank and IMF agendas was the most striking aspect of the communiqués issued during preparations for global negotiations, and a source of friction with officials promoting the New International Economic Order (NIEO).

When the industrialized countries rejected global negotiations in the early 1980s, the G-24 gained renewed independence from the broader concerns of the developing countries. The Group pursued its own objectives separately from the agenda being promoted by the G-77 as a whole. However, the G-24 did not return to the limited objectives of the early 1970s, but rather maintained a broad offensive vis-à-vis the developed countries across a much larger spectrum of issues. Further, with global negotiations looking hopeless, the G-24 became all the more important as the venue for monetary cooperation among the developing countries. It was clear that monetary reform would not be achieved through any other body but the governing units of the IMF, and the Bank. Furthermore, despite the strong opposition of the Reagan administration to suggestions of reform, dissatisfaction with the workings of the international monetary system was widespread within the United States of America and among the other industrialized countries as well. The G-24 thus emerged from the early 1980s with independence, enhanced stature, and nurturing the hope that reform might still be accomplished.

V. Return to the Bank and Fund agenda

While global negotiations waxed and waned, business within the World Bank and IMF continued. Three economic developments served as the backdrop to the economic discussions during the few years after entry into force of the Second Amendment in April 1978. First, the American dollar exhibited continued weakness on the foreign exchange markets. Secondly, the oil price increases of early 1979 following the Iranian Revolution promised very large current account surpluses for OPEC and formidable adjustment problems for the non-oil countries, again. Thirdly, world inflation reached double digits, posting an all-time high of 12.9 per cent in the OECD in 1980.³³ These circumstances kept at the forefront several long-simmering issues: a "substitution account" for the dollar "overhang"; quota increases and adequacy of IMF resources; access to those resources; conditionality; and surveillance of the members' anti-inflation policies.

The G-24 consistently argued for increased IMF and Bank resources (through large quota increases, general capital increases for the Bank, and generous IDA replenishments) and access to them, loosened conditionality, and consideration by the industrialized countries of the deflationary effects of anti-inflation policy on the developing countries. Correctly calculating that the outcome of negotiations over the substitution account hinged on agreements among the industrialized countries themselves, the Group wisely refrained from investing political capital in the proposal.

The debt crisis arising from the worldwide recession of 1982 overwhelmed all other items on the agenda. Among other things, it transformed the role of the IMF in the monetary system and world economy. The Fund staff sought to preserve international financial stability. The management of the crisis involved applying conditionality to debtor countries, but also assuring the continued flow of financial resources from the industrialized countries. With the Fund's resources insufficient to the task, the Managing Director sought "involuntary lending" from the large commercial banks, with the support of the Chairman of the United States Federal Reserve and other concerned central bankers around the world. In 1984, the G-24 adopted a revised programme of action - intended to update the 1979 programme - which gave sustained attention to the debt issue.³⁴

³³ *OECD Economic Outlook* 30 (December 1981): table 22, The aggregated consumer price index, p. 47.

³⁴ Group of Twenty-Four, "Revised Program of Action Towards Reform of the International Monetary and Financial System", press release, Washington, D.C., 21 September 1984. The ministers stressed the need for cooperation among all concerned with the debt problem, continued flow of commercial financing, improvement in rescheduling procedures so that arrangements "did not claim an unreasonable proportion of export earnings", and intensified cooperation among developing countries, including sharing information and experience on "various aspects" of the debt issue. They advocated the creation of a development committee task force on the debt problem, and that it consider an interest subsidy facility in the Bank or IMF.

A. The G-24 1985 Report

For the 1985 economic summit meeting of the largest industrialized countries, held in Bonn, the G-10 deputies prepared their report on the international monetary system. Delayed by instability in the exchange market, the report was presented instead to the Fund Executive Board in June. It concluded, among other things, that a system of target zones for exchange rates would be neither desirable nor feasible. While acknowledging that multilateral surveillance of macroeconomic and international monetary policies had not been "as effective as desirable", the report argued that no major institutional changes were required. Governments should use the mechanisms in place to greater effect.³⁵

The Executive Directors from developing countries believed that a number of important views and issues affecting their constituencies had been excluded from the G-10's study and proposed that a second report be prepared for consideration by the Executive Board and the Interim Committee. To prepare this report, the Argentine Chairman of the G-24 appointed a working group under the chairmanship of the Executive Director, Dr. Arjun Sengupta (India). The report addressed the same issues of the international monetary system and reforms as the G-10 deputies study, but added problems of international debt and the transfer of real resources to the developing countries.

The working group represented a new mechanism within the G-24. It solicited papers and suggestions from the rest of the Group and from experts but was alone responsible for the output. UNCTAD/UNDP assisted the group through the provision of papers on specific items. Writing a report that was technically sound and economically well argued, the group members offered expert input to the more political process of writing the communiqué at the deputies and ministerial level. By employing a working group, the G-24 could prepare a technically complex set of proposals in a short period of time to serve as the basis for arguments of the deputies and ministers in dealing with their counterparts in industrialized countries.

In August, the report was submitted to the chairman of the G-24 and considered by the G-24 deputies in drawing up the ministerial communiqué. It was also considered by the Executive Board and placed on the agenda of the Interim Committee. The report was widely acknowledged to confront more openly key economic problems than the report of the developed countries had and it represented a high-point in the visibility and prestige of the G-24.

The 1985 report contained more than 150 paragraphs of separate recommendations relating to international liquidity, the role of the IMF, debt and the transfer of real resources. In the field of exchange rates and surveillance, the group had recommended the adoption of target zones and tighter policy coordination among the developed countries. They recommended a two-stage surveillance procedure wherein the major industrialized countries would first negotiate a mutually consistent set of objectives and policies among themselves, and then compare actual outcomes to original targets, "setting off discussions of appropriate measures when the two deviate".

The IMF, according to the G-24 blueprint, would have an integral role in these discussions, with staff reports on recommended policies and performance indicators being deliberated by the Executive Board. The IMF would also "exercise pressure" on industrialized countries to undertake policy measures to correct deviations, both in multilateral surveillance and bilateral surveillance meetings, thus making IMF influence over the policies of industrial and developing countries more "symmetrical". IMF surveillance would be supportive of growth, "particularly of developing countries".³⁶

The working group effectively tapped widespread discontent within developed and developing countries alike at policy coordination failure among the United States, Japan and Europe. The shortcomings in developed-country cooperation were dramatically corrected with the Plaza Accord of September 1985, the Tokyo summit of 1986 and the Louvre Accord of February 1987. At these meetings, the Group of Five, then the Group of Seven (G-7), agreed to a currency realignment and then stabilization through a secretly agreed set of target ranges for exchange rates. The developing countries were left outside of the process of G-7 coordination. However, those developments did

³⁵ "Report of the G-10 Deputies on the Functioning of the International Monetary System", *IMF Survey*, July 1985, pp. 2-14.

³⁶ *IMF Survey*, September 1985, Supplement on the Group of 24 Deputies' Report.

demonstrate that the G-24 had correctly diagnosed the fundamental problem of the world economy and been remarkably prescient in its recommendations.

VI. Lessons and observations

A. Accomplishments

The G-24 has been successful in placing before the world a developing-country agenda for reform of the international monetary system, including the mechanisms and facilities of the IMF and the World Bank. They thereby have addressed the criticism from the developed countries that they speak with many different voices. However, the G-24 has not become the forum through which the developing countries conduct hard-headed negotiations with their advanced-country counterparts.

The G-24 and developing countries had had a number of tangible successes during the early and mid-1970s: (a) universal distribution of SDRs; (b) the Spécial Oil Facility; (c) Extended Fund Facility; (d) Compensatory Financing Facility; (e) general policy of enlarged access to IMF resources; (f) creation of the Trust Fund; (g) creation of the Development Committee; and (h) the Supplemental Financing Facility. Later, the G-24 was instrumental in preventing backsliding from earlier accomplishments: (a) preventing dissolution of the Development Committee; (b) maintaining access to IMF facilities above a threshold where it might otherwise have dropped; (c) preventing even tighter conditionality being applied to the CFF or a diminution in its resources. The G-24's analysis of international monetary affairs in the mid-1980s received public consideration on a par with that of the G-10. In contrast to its early years, the G-24 no longer simply responded to items on an agenda set by developed countries.

Conversely, perhaps the least fruitful of the G-24's campaigns, has been the SDR link. In the mid- and late 1970s, the world was awash with international liquidity, though access to it was denied to a large number of least developed countries. This, the high-inflation environment, and additional oil price increases and OPEC surpluses, vitiated support within the advanced countries for realizing the previously stated common goal of making the SDR the basis of the monetary system, and the issuance of sizable SDR allocations, not to mention linking the SDR to development assistance. When the SDR held the possibility of becoming the principal reserve currency, promotion of the link concept was a worthwhile investment of energy and attention on the part of the G-24. Once such plans for the SDR had been effectively jettisoned, the link concept was less likely to be accepted and would have been less profitable for the developing countries. Global negotiations seemed to hold the prospect of further reform, and given this environment, the G-24 continued to push the proposal. In reality, however, the SDR link was a moribund proposal, and was dealt a *coup de grâce* by the Interim Committee in the spring of 1986.³⁷

Nor has the G-24 been effective in realizing broader objectives of systemic reform and gaining greater political influence over international decisions on monetary affairs. The developing countries have not been able to raise substantially their quotas in the IMF and, consequently, their voting power on Fund decisions. While they were able to block ratification of the Second Amendment to the Articles, the developing countries were not able to initiate or force further formal changes in the monetary system. Exchange arrangements and macroeconomic coordination have been the province of the largest industrialized countries entirely. Many debtor countries were able to extract favourable bargains from creditor countries and banks in the late 1980s and early 1990s; but the G-24 as a group was not at the forefront on the debt issue. Broader questions of world economic management and macroeconomic coordination have been addressed exclusively by a small group of industrialized countries in the G-7.

In sum, while the G-24 has been successful in creating new financial facilities, maintaining

³⁷ The Interim Committee stated clearly that the SDR "should not be a means of transferring resources". See the Interim Committee communiqué, 10 April 1986, Washington, D.C., item 7.

an enlarged access policy in the IMF, and keeping its own agenda on the table, it has not achieved the political objectives of more far-reaching proposals for restructuring economic relations between developing and developed countries.

B. Platform and coalition building

The single, most common criticism levelled at the G-24 is that its statements represent an aggregated "wish list" of demands compiled by log rolling among members. This is a function of the diversity of its membership, a reflection of the different primary concerns of creditor and debtor, oil and non-oil, poor and middle income, large and small countries. Indeed, officials involved in the work of the G-24 acknowledge that the balance of considerations argue for inclusion rather than exclusion of strongly felt national positions. Given the principles of broad participation and consensus within the group, there is an inevitable tendency to add each country's priority to the list.

G-24 officials defend the practice, however, by saying that the result nonetheless has the support of all members, their proposals have technical justification, and that progress should be made on all fronts, as long as demands are not mutually inconsistent. While serious negotiations with the developed countries are not in prospect, it would not make sense for the G-24 to alienate member States by designating proposals of merit as low or medium priorities. Critics argue that the G-24 is nonetheless ill-equipped to act as a negotiating agent for the developing countries as it is institutionally incapable of assigning priorities to its list of demands in the event that comprehensive negotiations were held with developed countries.

Developing countries have, however, worked effectively together to achieve reforms that might otherwise not have passed through the World Bank and the IMF. The use of their "block position" in the process of ratification of the Second Amendment and the creation of the Trust Fund is a case in point. Further, during the C-20 negotiations, the G-24 was united on a small number of reforms: the direct link, access to capital markets, and increasing developing country quotas in the IMF. If the G-24 were to enter into a set of serious negotiations with the developed countries at some indefinite point in the future, however, some mechanism to economize the efforts of its members by identifying particular priorities would be beneficial.

C. Dealing with advanced countries

Developing country cooperation in monetary affairs vis-à-vis advanced countries confronts a fundamental problem. Ministers of finance are constrained to give priority to their overall economic relations with industrialized countries in the fields of finance, trade, labour migration, technology transfer, direct investment, and foreign assistance. When developing country ministers fear that the industrialized countries may link relations on this broad array of issues to positions taken in the field of monetary affairs - or even security and foreign policy concerns - they will often not press developing country positions strongly in, for example, the Interim Committee. International organizations, relatively strong secretariats, and groups such as the G-24 help to shield ministers in their dealings with industrialized countries. Through these groups, ministers can push indirectly for changes that might alienate developed country ministers if promoted face-to-face. Thus, it should not be surprising if there was considerable "slippage" between the positions adopted by the G-24 ministers in their meetings and communiqués and the views they represent directly to industrialized-country ministers in the Interim Committee. To accommodate such slippage is one of the functions of the G-24; the Group remains hostage to the willingness and capability of its ministers to contend with their counterparts from industrialized advanced countries.

The developed countries are often divided among themselves on reforms which the developing countries propose. Indeed, it has been on these issues that the latter countries have made progress in the past, and can probably hope to make the more progress in the future. The developing countries have often found allies in small industrialized countries, sometimes among European countries, sometimes in the United States and sometimes in influential groups within

industrialized countries. On the universality of distribution of SDRs, the disposition of gold, and symmetry of adjustment obligations among deficit and surplus countries, the developing countries found an ally in the United States. On the need for greater exchange-rate stability, the developing countries have allied with European countries, notably France. On multilateral surveillance and macroeconomic management, and conditionality, the developing countries have taken encouragement from the renewed emphasis on growth in the United States. Indeed, the developing countries can only make progress on issues on which they have support from the industrialized countries. The requirement of developed-country support explains why the developing countries have not advanced their cause on the issues of power and control in the World Bank and IMF, and in the cases, when the reform debate has been ideologically and politically charged. There remains, however, a significant number of issues on which developing countries can find common cause with at least some of the developed countries.

The new global political economy might well enable the finance ministers to press their case with developed-country Governments, despite the challenges which this changed atmosphere present. The passing of the Cold War might reduce the tendency for developed countries to link monetary and financial issues to security and foreign policy matters. The elevation of environmental issues to the global agenda, and their infusion into the work of the Bretton Woods institutions, has placed the advanced countries in the position of *demandeur* vis-à-vis developing countries. Finally, both population and income growth can be expected to be substantially higher in the developing countries compared to the industrialized countries over the next several decades. Through the increased weight and importance of the developing countries in the world economy, their Governments can take moral encouragement from these very long-term trends.

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