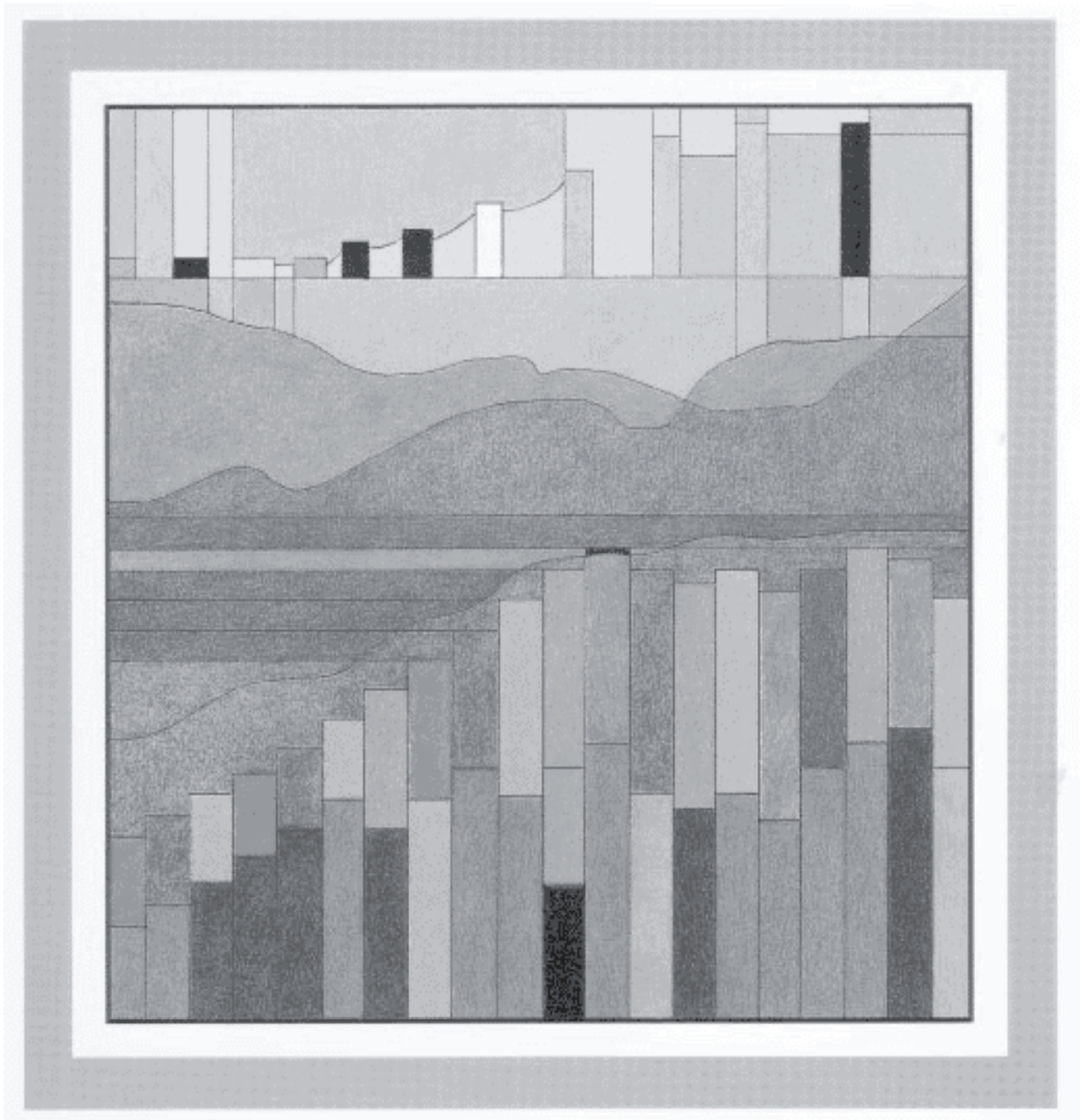


GLOBAL TRENDS



THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Overview

1. World output and trade

World output grew by 2.4 per cent in 1995, in continuation of the recovery that began in 1994 after three years of sluggish growth averaging just over 1 per cent per annum (table 1). However, this was a weaker performance than had generally been expected at the beginning of the year, following the momentum of accelerated growth in 1994 of 2.8 per cent (from 1.1 per cent in the previous year). The slowing down in the growth of the world economy which was predicted in *TDR 1995* is not expected to be reversed in 1996.

In developed countries, the expected sustained recovery gave way to widespread signs of a slowdown in economic activity in the second half of 1995, particularly in the European Union. While Japan made important progress towards the end of 1995 in recovering from a long period of stagnation, growth in the United States was modest, the lowest since 1991. Consumer confidence weakened in Western Europe on account of the uncertain employment prospects, and the net result was a significant fall in output in the developed market-economies as a whole, from 2.8 per cent in 1994 to 2.0 per cent in 1995. Despite the continued non-inflationary expansion in the United States and a stronger-than-expected recovery in Japan, there may be a further decline in 1996 if recovery is de-

layed further in Europe. The chances of such an outcome will increase unless monetary policy is eased further, so as to permit real interest rates to fall enough to offset the deflationary impact of budget cuts.

Growth of 4 per cent in developing countries as a whole (excluding China) continued to outpace that of developed countries in 1995, and the gap is likely to widen in the current year, with most regions expected to maintain or improve their growth performance. Only a relatively modest recovery is expected in Latin America, where the repercussions of the Mexican peso crisis in 1995 proved to be much deeper than anticipated by even the most pessimistic forecast, and nearly brought the expansion in the region to a halt. In contrast, growth in developing African countries in 1995 was not only broadly based but also the highest for this region since the beginning of the decade, and is expected to be higher still in 1996. Growth in developing countries in Asia continued to be outstanding throughout 1995, accelerating to 6.3 per cent (China excluded), which was triple that of the developed market-economy countries. China continued to be one of the fastest-growing countries in the world, maintaining for the fourth year in succession a rate of more than 10 per cent. Continued high growth is expected in 1996.

Finally, 1995 witnessed a notable improvement in the performance of the transition economies

Table 1

WORLD OUTPUT, 1991-1996						
<i>(Percentage change)</i>						
<i>Region/country</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995^a</i>	<i>1996^b</i>
World	0.6	1.4	1.1	2.8	2.4	2.4
Developed market-economy countries	0.9	1.6	0.7	2.8	2.0	1.9
<i>of which:</i>						
United States	-1.0	2.7	2.2	3.5	2.0	2.2
Japan	4.0	1.1	0.1	0.5	0.9	2.1
European Union	1.5	1.0	-0.6	2.8	2.5	1.3
<i>of which:</i>						
Germany	5.0	2.2	-1.2	2.9	1.9	0.5
France	0.8	1.2	-1.3	2.8	2.2	0.9
Italy	1.2	0.7	-1.2	2.2	3.0	1.5
United Kingdom	-2.0	-0.5	2.3	3.8	2.4	2.2
Central and Eastern Europe ^c	-11.7	-13.4	-8.3	-10.1	-2.6	0.3
Developing countries	2.9	3.6	3.7	4.7	4.0	4.5
<i>of which:</i>						
America	3.5	2.5	3.4	4.9	0.7	2.4
Africa	1.9	0.7	0.1	2.6	2.8	3.1
Asia	2.8	5.0	4.6	5.1	6.3	6.1
China	8.4	14.3	14.0	11.8	10.2	9.0
Memo item:						
World exports (volume)	3.0	4.5	3.1	8.9	8.0	7.3

Source: UNCTAD secretariat calculations, based on data in 1990 dollars.

a Estimate.

b Forecast.

c Including the Baltic States and the members of CIS.

of Central and Eastern Europe, where the fall in output averaged no more than 2.6 per cent, after double-digit declines in all but one of the previous years since 1990. This improvement is expected to continue throughout 1996, with the first signs of a revival of output for this group of countries as a whole. However, differences in growth performance among these economies have become even more pronounced than before.

The growth of world trade slowed down somewhat in volume terms (table 2), affecting all regions, with the major exception of exports from Latin America (where imports, on the other hand,

declined sharply). None the less, the volume of world trade expanded at twice the pace experienced during the economic slowdown at the beginning of the 1990s. In value terms the growth of exports and imports was much higher, largely because of the weakness of the dollar in the first half of the year and the continued strength of primary product prices, such as oil and non-ferrous metals.

More important, the value of world trade has continued to expand faster than world output for the sixth consecutive year. This development in the traditional relationship between trade and output growth can be explained in terms of four new

Table 2

EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS, 1993-1995

(Percentage change in volume over previous year)

Grouping/region	Exports			Imports		
	1993	1994	1995 ^a	1993	1994	1995 ^a
World	3.1	8.9	8.0	1.2	10.2	8.5
Developed market-economy countries	-1.2	9.1	8.4	-2.9	10.2	8.3
<i>of which:</i>						
United States	4.6	11.4	13.7	11.7	15.0	12.0
Japan	-1.9	1.9	4.6	3.8	13.8	13.1
France	-1.0	6.6	8.4	-3.8	7.2	5.3
Germany	-1.7	10.2	5.3	-6.3	6.0	3.1
Italy	11.6	10.5	9.4	-9.1	10.5	5.6
United Kingdom	0.2	11.7	6.1	0.4	6.4	1.5
Developing countries ^b	10.2	9.8	12.7	7.9	8.9	11.7
<i>of which</i>						
America	11.8	9.9	10.5	7.3	14.4	2.8
Africa	5.2	0.0	3.7	3.3	-4.3	4.6
West Asia	11.4	-2.3	4.8	-1.6	-5.8	5.9
Other Asia	10.3	14.1	14.0	11.4	14.9	15.0

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

^a Preliminary.

^b Including China.

aspects of world trade which are the result of greater integration of markets:

... the rise of intra-trade, trade in similar goods between similar countries; the ability of producers to slice up the value chain, breaking a production process into many geographically separated steps; the resulting emergence of supertraders, countries with extremely high ratios of trade to GDP; and the novelty that provokes the most anxiety, the emergence of large exports of manufactured goods from low-wage to high-wage nations.¹

Developing countries continue to take on increasing importance in determining the performance and patterns of world trade. Trade among developing countries has grown much more rapidly than trade among the developed ones. Furthermore,

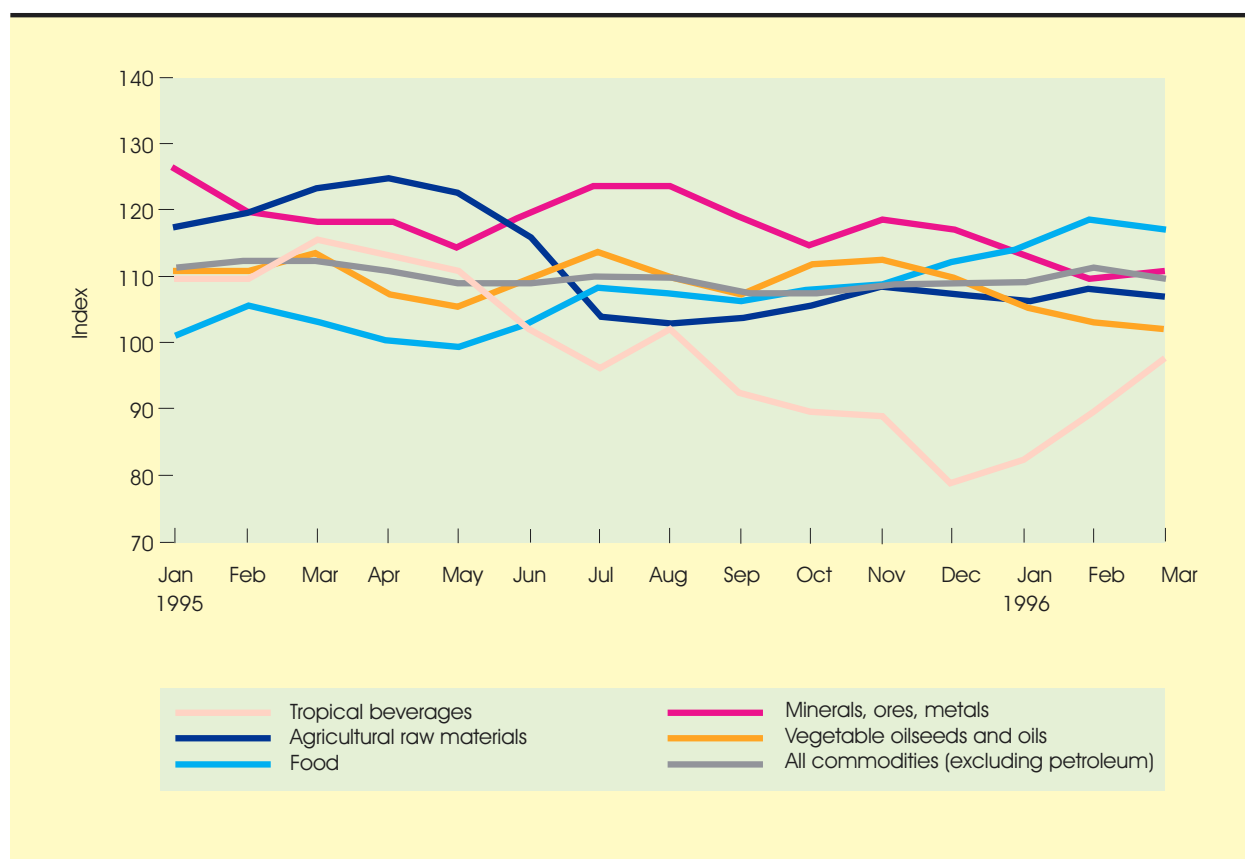
trade between developing and developed countries has been more dynamic than trade among the latter countries themselves.

As discussed in greater detail in Part Two, chapter I, the dynamism of trade in Asian developing countries is now such that these countries are able not only to maintain their own growth momentum, but also to exert a marked influence on other countries, including the developed countries, through the growing integration of world trade. The share of 10 developing Asian economies² in world trade (imports plus exports) in 1995, excluding trade among EU countries, was over 19 per cent. This is very close to the share of EU (19.5 per cent) and greater than that of the United States (17.7 per cent) or Japan (10.2 per cent). In 1994, the trade of the United States with the Asian developing countries (about \$272 billion) was greater than its

Chart 1

WORLD COMMODITY PRICES, 1995-1996

(Index numbers, 1994=100)



Source: UNCTAD, *Monthly Commodity Price Bulletin*.

trade with either EU (\$218 billion) or Japan (\$176 billion).³ Similarly, the trade of both EU and Japan with the Asian developing countries (around \$229 billion and \$283 billion, respectively) exceeded by a large margin trade between themselves (\$94 billion).

World exports of services also increased rapidly in 1995, although less so than merchandise exports.⁴ Exports of services such as insurance, banking and telecommunications rose particularly fast. While trade in services was most dynamic in Asia, it was also strong in Western Europe. Trade in primary commodities also expanded well during 1995, due to favourable price developments, especially in metals and oil. None the less, manufactures remained the most dynamic element of world trade, especially in the area of telecommunication and office equipment.

2. Commodity prices

As a result of the continuing slowdown in economic activity, especially in the developed countries, the recent surge in non-oil commodity prices, which started in 1993, showed signs of coming to an end.⁵ Many prices, including those of minerals and metals, started to decline during the first half of 1995, and by December non-oil primary commodity prices as a whole averaged 2 per cent less than in January, remaining relatively stable during the first quarter of 1996; some recovery for tropical beverages, mostly coffee, was offset by declines for other commodities, including vegetable oilseeds and oils, agricultural raw materials, mineral ores and metals (chart 1 and table 3). In particular, non-food prices appear to have peaked in recent months, not only for agricultural raw

Table 3

WORLD PRIMARY COMMODITY PRICES, 1993-1996				
<i>(Percentage change over previous year)</i>				
<i>Commodity group</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>March 1996^a</i>
All commodities^b	-3.5	17.1	10.0	0.7
Food and beverages	1.9	19.3	5.4	4.3
<i>Tropical beverages</i>	6.1	75.0	1.1	9.7
Coffee	10.3	112.3	0.7	13.7
Cocoa	1.9	24.8	2.7	-2.9
Tea	-4.9	-4.4	-10.3	-3.7
<i>Food</i>	0.7	10.1	5.9	4.7
Sugar	10.6	19.7	10.8	4.9
Beef	6.6	-10.9	-18.2	-10.4
Maize	3.7	1.3	23.5	-5.5
Wheat	1.7	4.9	30.5	13.9
Rice	-6.6	33.6	-10.1	6.2
Bananas	-7.4	-0.5	0.1	42.9
<i>Vegetable oilseeds and oils</i>	0.0	24.4	10.3	-6.8
Agricultural raw materials	-3.2	14.2	13.1	-0.7
Hides and skins	28.6	30.6	4.3	0.0
Cotton	0.0	37.5	22.3	-5.7
Tobacco	-21.7	-2.0	-1.2	0.0
Rubber	-3.8	39.3	38.6	-2.1
Tropical logs	-5.0	2.8	-5.2	-2.7
Minerals, ores and metals	-14.7	13.6	20.0	-5.4
Aluminium	-9.2	29.6	22.3	-2.7
Phosphate rock	-10.6	0.0	0.0	0.0
Iron ore	-11.0	-9.5	5.8	6.0
Tin	-15.4	5.9	13.7	-1.5
Copper	-16.2	20.6	27.2	-12.5
Nickel	-24.4	19.8	29.8	-0.9
Tungsten ore	-39.9	24.1	49.6	-0.6
Crude petroleum	-11.4	-4.1	9.3	8.1
<i>Memo item:</i>				
Manufactures^c	-5.8	2.1	8.1	..

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

a Change from December 1995.

b Excluding crude petroleum.

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

materials, such as wool, where prices have been under pressures from both low demand and sales from stockpiles, but also for metals, demand for

which has been low. Even cotton prices, which had continued to rise during early 1995, were stable for the remainder of the year.

Sharp price increases for industrial raw materials (20 per cent over the 1994 level), especially for aluminum, copper, lead, nickel, and tin, and also for agricultural raw materials (13 per cent) and vegetable oilseeds and oils (10 per cent), reflected the strength of demand. The lowest rates of price increase were for food and beverages, mainly due to supply considerations. Prices of temperate zone foodstuffs held up particularly well. World grain stocks were nearly at the lowest level for 20 years as prices approached unprecedented levels, especially in Western Europe, where production capacity had been reduced. In the United States drought and lower planting subsidies reduced supplies, especially of wheat and maize. While grain harvests were also down in Central and Eastern Europe, there was some increase in Australia. World demand, however, has been increasing rapidly, especially in East Asia, where rising living standards have led to higher consumption of grains for livestock.

In contrast, the prices of foodstuffs produced in developing countries have been weak and for tropical beverages they declined throughout most of 1995. In particular, difficulties with the stock retention programme of the Association of Coffee Producing Countries (ACPC) and lower consumption led to declines in coffee prices. While cocoa prices have been somewhat firmer, their prospects remain very uncertain, as do also those for sugar, in view of the existing surplus. An exception to this general trend for developing countries is rice, the price of which held up on account of reduced

exports from Viet Nam and China due to increased domestic demand. China became a net importer of rice for the first time in many years. It can be expected that price movements for commodities produced by developing countries will remain relatively subdued over the longer term because of productivity growth in agriculture, the declining raw material content of industrial production and low income elasticities of demand for most foodstuffs.⁶

Owing to the increase in demand on account of an unusually hard winter in the North, oil prices showed substantial recovery in 1995, but nevertheless remained at their lowest level in real terms for over 20 years. While OPEC had decided to freeze output levels for the second year running, other countries, especially suppliers of North Sea oil, Canada, and Mexico, increased their output. The difficulties in enforcing production quotas for OPEC members, for which oil revenues are of such importance to their economies, and the agreement to allow Iraq to resume limited sales under United Nations supervision, suggest a period of prolonged weakness in the oil market.

On the whole, price movements in 1995 were less favourable to the developing countries than they were in 1994. In particular, export prices for many small producers in Africa and Latin America, such as those of tropical beverages, weakened markedly in 1995; on the other hand, the increases in the prices of grain contributed to swell the import bills of many low-income, net-importing countries in Africa.

B. The world economy: erratic and uneven growth

The turning point in the current global growth cycle now appears to have been reached in 1994. In both 1994 and 1995 official expectations that the world economy was entering a new era of sustained market-driven growth in excess of 3 per cent were disappointed, and with them vanished the hope of falling unemployment in the developed countries and rising per capita incomes in the developing countries in conditions of price stability.

One of the original motives for introducing stabilization policies in a number of developed and developing countries was the expectation that lower inflation and better macroeconomic balance would provide the basic conditions for a return to high and stable growth. These policies have been generally successful in providing macroeconomic stability. For example, the hyperinflation which once plagued Latin America has been eliminated.

In the developed countries persistently high rates of inflation, which had once been thought a permanent feature of modern post-industrial economies, have been eliminated and price stability has now become the norm. Trade imbalances, in particular between the United States and Japan, and fiscal deficits in the United States, which were seen as the cause of instability in the 1980s, are not only declining rapidly, but are predicted to largely disappear. Fiscal balances have already been largely restored in many countries which had suffered from deficit-inflation-devaluation cycles, while in others, particularly in Europe, there has been increased emphasis on budget consolidation.

However, despite the success in reducing macroeconomic imbalances, most countries have not attained high and stable growth. In the major industrial countries inflation rates have been kept extremely low and stable by historical standards - at their lowest level for 30 years. By contrast, growth rates have become more erratic, around levels which are not always sufficient to allow full utilization of labour and capital. In the United States, where performance has been the best since the 1960s, quarterly fluctuations in output have caused continual uncertainty and turbulence in financial markets. In Europe, two nascent recoveries since 1991 have been reversed virtually before they had set in. In Japan, both the depth of the post-1990 recession and the speed of recovery in early 1996 were unprecedented.

This contrast between inflation and growth derives in large part from the mix and stance of macroeconomic policies. While discretionary fiscal stance has generally been contractionary, monetary policy has continued to concentrate on keeping inflation low. As discussed in greater detail in *TDR 1995*, real short-term and long-term interest rates in OECD countries have risen to unusually high levels. Furthermore, increased interest rate instability has led to greater fluctuations in effective demand and output. Economic policy has not been able to combine stable prices with sustained output growth sufficient to provide high and stable levels of employment; unemployment in OECD countries has risen to levels not experienced since the inter-war period.

The risk of deflation is real if monetary policy continues to focus solely on inflation while attempts are made to improve fiscal balances through demand restraint. Noting that "the adjustment to

fiscal restraint ... can be disinflationary", the Bank for International Settlements has argued that:⁷

In view of the inflationary experience of industrial countries over the last three decades, it is not surprising that the phrase "price stability" has been generally interpreted to mean a very low level of inflation. By this standard, price stability has been reached, or almost reached, in a large number of countries in the industrial as well as the developing world. ... This is not to deny that an inflationary threat still exists. ... Yet it remains true that the forces bearing on the price level are now more balanced than they have been for some decades. Thus, it is perhaps the right historical moment to recall the advice of Keynes and Wicksell in the early 1920s ... that it was appropriate as well as feasible for central banks to resist both inflation and deflation. At a time of rapid social and economic change, with attendant implications for social order and relative prices, it is all the more important that price stability be pursued as an anchor for rational and forward-looking decisions on all fronts.

But low and erratic growth is not restricted to developed countries. With the notable exception of Chile, and to a lesser extent, some smaller economies, it has not proved possible in Latin America to sustain the growth that was enjoyed in the early 1990s. Only Asia and Africa seem to have escaped this pattern. The reasons for the relative success of developing Asia in achieving sustainable expansion and stability are investigated in more detail in Part Two. In Africa, on the other hand, performance in recent years has been around a growth trend which has been only mildly positive.

Again, the problem of unemployment does not concern developed countries only; it is also present in a number of Latin American countries, as well as in Africa, where it often takes the form of disguised unemployment. It seems that in most countries there is still unexploited potential for higher growth without any appreciable risk of accelerating inflation.

Whatever the causes underlying unemployment in specific countries, it remains true that adjustments to rapidly changing technology and increasingly competitive international markets are made more easily when there is a strong expansion of output. Factors impeding expansion also make

adjustment to dynamic competitive market conditions more difficult. To achieve sustained expansion, Governments still have to find the right balance between stability and growth in the design of their policies so as to ensure that benefits accrue equitably among and within countries. Continued support for the market economy and the system of free trade and payments depends on their finding this balance.

1. Developed market-economy countries

Economic recovery in the industrial economies faltered in 1995, with growth falling from 2.8 per cent in 1994 to 2.0 per cent. Indeed, the current recovery has been slower than during the previous two cyclical expansions, partly because of the priority given to improving fiscal positions, and partly because of the emphasis of monetary policy on containing inflation. For EU countries, fiscal consolidation was determined by the desire to meet the targets set by the Maastricht Treaty. Only in Japan, which was going through an unusual period of prolonged economic weakness, was there a strong expansionary impetus, aimed at lifting the economy out of recession.

Also notable in the present cycle is the failure of real wages to increase in line with productivity and output. While this has been an important factor in keeping inflation low, it has also held back consumer expenditure, which has consequently provided less stimulus to growth than in the past. Profits have been on a rising trend in most countries, but private investment has lagged.

(a) United States

The current expansion of the United States economy, which started in 1991, is now its third longest in the postwar period. Although growth slowed down in 1995 and is expected to remain at moderate levels throughout 1996, economic performance has been markedly better than in most other industrial countries.

Throughout the current expansion, wage increases have remained moderate, and sustained productivity gains, particularly in manufacturing, have contained cost pressures. Price increases in the services sector have also been limited. Consequently, inflation has been well below the levels attained at comparable phases of past business

cycles, and is expected to remain below 3 per cent for the fifth year in succession. The government budget deficit has fallen to around 2 per cent of GDP, and the finally agreed budget for the current fiscal year should reduce the deficit to below 2 per cent. If the agreement is implemented in full, it is expected to produce a surplus, net of debt service, for the third year in succession, and reduce the overall deficit to zero by the year 2002.

At around 5.5 per cent, unemployment is the lowest of all the major industrial countries except Japan. In 1995 alone over 2 million new jobs were created, more than offsetting job losses through restructuring, and providing a net addition of jobs that reduced unemployment. Over 50 per cent of jobs created in the private sector during 1995 were in "high wage" industries, where average wages are above the 1993 median wage of all industry.⁸ This suggests that the United States has entered a phase of "creative destruction", with the introduction of new technology creating new jobs faster than it is destroying them through corporate restructuring and downsizing.

This adjustment has been greatly helped by the depreciation of the dollar. Despite the turnaround in its trade balance with Latin America after the Mexican currency crisis, exports rose slightly in volume in 1995. The pattern of imports has also undergone marked changes; in particular, imports of automobiles from Japan have been increasingly replaced by output from Japanese transplant factories in North America. The overall trade deficit has thus continued to shrink, reflecting declining imports from Japan and improved balances with Western Europe, China and other Asian countries.

Economic expansion has been accompanied by stronger cyclical fluctuations. After three years of acceleration, growth fell in the first quarter of 1995 by 0.5 per cent on an annual basis, owing primarily to two factors. First, there was a sharp fall in exports to Latin America following the peso crisis. Second, monetary policy continued to be tight, even though growth was slowing down as a result of the impact of inventory accumulation on production. The Federal Reserve continued its policy of what it called "pre-emptive" strike against potential inflationary pressures, raising the federal funds rate in February 1995 with the aim of bringing down the rate of expansion to its estimate of non-inflationary growth potential.⁹ However, as employment started falling, the rate was reduced in July and again in December; the economy re-

covered around mid-1995 as exports and consumer spending regained their 1994 levels. But growth in 1995 as a whole was lower than in the previous three years, on the basis of comparable figures.¹⁰ At an average 5.9 per cent, the federal funds rate in 1995 was almost twice that of 1993, while consumer price inflation was lower by about half a percentage point.

At the beginning of 1996 the economy again appeared to be poised on the threshold of a recession. Interest rates were reduced in January and in the event the economy grew by 2.3 per cent in the first quarter. The financial markets nevertheless reacted sharply at the beginning of March to the announcement of an exceptionally large number of new jobs created in February, and pushed long-term interest rates above 7 per cent, as expectations of a further reduction in official rates were quickly transformed into expectations of tight monetary policy.

The rise in long-term interest rates, together with fiscal consolidation, could exert a dampening influence on demand and taper off growth towards the end of the year. The consumer spending spree which has so far been the main expansionary factor cannot continue, as consumer debt as a proportion of personal income is at record levels. The overall outlook for the United States is for growth to remain relatively stable in 1996.

(b) Japan

After four years of stagnation, with annual growth averaging 0.5 per cent, the Japanese economy started to expand in 1995. Expansion accelerated throughout the last quarter of the year, to reach an annual rate of around 3 per cent. There was an even stronger recovery in the first quarter of 1996, to an annual rate of over 12 per cent, the fastest growth in 23 years.

A number of factors explain this faster-than-expected recovery. First, the Government introduced a series of special public spending packages, of which the latest, equivalent to 2.5 per cent of GDP, took effect in September 1995, to boost the economy through public works, land purchases and low-interest loans. Public investment is reported to have risen by 27.2 per cent during the first quarter of 1996 over the same period of 1995, and private consumption and investment by 5.1 per cent and 7.4 per cent, respectively.

A second factor was that the yen continued to decline from its earlier peaks against the dollar, thanks also to concerted intervention by the monetary authorities in both Japan and the United States. The real effective exchange rate was, in mid-1996, more than 20 per cent below the peak of April 1995. The consequence has been a substantial improvement in enterprise profits, as export prices had not been adjusted and cost reduction measures introduced in response to the 1995 appreciation have already started to take effect.

Finally, the discount rate was reduced in September 1995 from 1.75 per cent to a record low of 0.5 per cent. The policy of maintaining a low discount rate has allowed the banking system to earn large intermediation spreads, thereby contributing to removing an important part of bad loans from banks' books. Similarly, it has also helped the corporate sector to restructure its balance sheets, creating room for expansion.

However, there is considerable uncertainty over the prospects for growth in 1996-1997. The recent recovery was from a very low base; there was virtually no growth in the first quarter of 1995. More important, the recovery was based on one of the biggest fiscal and monetary boosts ever introduced in Japan. More recently, a new package was introduced, since the fiscal stimulus from the preceding one appeared to be petering out. The general government budget deficit is expected to exceed 5 per cent of GDP this year, and the Ministry of Finance has already announced that 1997 will be the year in which fiscal reconstruction commences, with measures to reduce government spending and to increase taxation.

Thus, the pace of recovery will depend on the extent to which private demand rises to offset the smaller fiscal stimulus, and that in turn depends much on monetary policy. Inflation should not be a cause for concern. Retail prices continued to fall during 1995, and although the falling value of the yen caused some increase in import prices, wholesale prices were still declining at the beginning of 1996. Real long-term interest rates have been rising since the end of 1995, and by spring 1996 they were approaching those of the United States, which is experiencing rather different domestic conditions. There is concern that tightening would be inappropriate when the prospects for continued economic expansion are so uncertain. Moreover, a rise in interest rates may encourage the reversal of international speculative positions

based on borrowing in yen to invest in higher-yielding dollar assets, thus placing upward pressure on the yen. Furthermore, since there still remains a large stock of unrecoverable loans, particularly in smaller banks and non-bank institutions, continuation of the policy of low interest rates will also be helpful for the stability of the banking system. Finally, the reduction of the trade surplus continues to dampen growth and is expected to continue to do so despite a real depreciation of the yen. In these conditions, private consumption will remain the only possible source of stimulus.

The pace of the current cyclical recovery is thus conditioned by the conflict between fiscal reconstruction, which will reduce demand, and tighter monetary policy, which risks reversing the depreciation of the yen. However, as discussed below (Part Two, chapter I), cyclical policy may not be sufficient to restore Japan to a sustainable growth path with stable employment. Indeed, despite recovery, unemployment is expected to rise in 1996. The challenges facing the country should be seen in the context of a structural adjustment required to move the economy anyway from a dependence on exports for growth that is more appropriate to a developing country toward a more balanced system characteristic of a mature industrialized economy. The Government has recognized the need for measures to shift the focus from external to internal demand, and the recent monetary and fiscal packages have certainly been helpful in addressing this problem. Since neither inflation nor the external balance is a cause for concern, it is important that monetary and fiscal policy continue to be conducted with a view not only to cyclical problems, but also to structural ones.

(c) *European Union*

Slower growth in the European Union is the primary explanation of the weak performance of developed market-economy countries in 1995. It was the result of a sharp cyclical downturn in Germany and France, and in countries with currencies that remained closely linked to the deutsche mark. This is the second time that recovery in the northern continental European economies has not followed through to sustained expansion. In 1993 expansion in Germany, led by domestic investment, was cut short when United States interest rates were raised and the international bond market collapsed. The recent recovery began with an unexpected expansion in German investment and exports during the autumn of 1994. Although conditions had al-

ready started to weaken by the third quarter of 1995, matters were compounded by the rise in interest rates transmitted from United States bond markets.

When trade was the dominant linkage between economies, asynchronous cyclical growth patterns tended to be a force for stability, with expanding economies providing export markets and additional demand for those experiencing a downturn. By contrast, now that international financial markets have become more integrated, the rising interest rates that accompany cyclical expansion are transmitted to countries that lag behind, making their recovery more difficult. This is what appears to have occurred in those continental Western European countries which have lagged behind growth in North America and the United Kingdom.

The German economy started to show signs of weakness early in 1995, and by the last quarter of the year output had flattened out. One reason therefor was that the major construction boom which had been a driving force of the economy after unification had come to an end. Many of the subsidies applied in the western *Länder* have run their course, while in the eastern *Länder* much of the necessary reconversion has been achieved.

Unexpectedly low growth produced a shortfall in government revenues in 1995 and a deficit (3.6 per cent of GDP) that was higher than projected. In order to hit the Maastricht target of 3 per cent, spending will need to be cut over and above what is already planned, and some planned tax reductions postponed. In response to the continued weakness of the economy, the Bundesbank reduced interest rates throughout 1995 and so far has continued to do so in 1996, bringing the discount rate to an unprecedentedly low level of 2.5 per cent in April. As noted, this has not prevented domestic long-term interest rates from rising alongside world interest rates; in real terms they are higher than in both the United States and Japan. Given the importance of long-term rates in the financing of investment, the impact of the action by the Bundesbank has been limited. The Bank has been reluctant to reduce rates while monetary growth remains outside the desired range, despite the fact that: output has been declining; capacity utilization is below both the long-term average and the peak experienced at the height of the reunification process; the average rate of monetary expansion over the last two years has been only 4 per cent; it is generally agreed that the buildup of

M3 does not represent potential inflationary pressure; and the inflation rate seems to have stabilized at around 1.5 per cent.

Given these policy restraints, the economy will depend on private consumption and on exports for recovery. With unemployment at 4 million, consumers are cautious and building up their savings. Export expansion will depend on movements in exchange rates and labour costs, both of which are now adjusting rapidly. While these elements of adjustment should be enough to avoid recession, further monetary relaxation will be needed in order to offset the effect of the restrictive fiscal policies and provide cyclical support to the economy.

The weak performance of the German economy has slowed down growth not only in EU countries closely tied to it through the European Monetary System, such as Austria, Belgium, Luxembourg, the Netherlands and France, but also in other countries of the Union such as Italy and the United Kingdom, which had achieved export-led growth as a result of currency depreciation when they suspended their participation in EMS in 1992.

As in Germany, slow growth in France increased the cyclical fiscal deficit, pushing it to 5 per cent of GDP. Plans have been announced to make deep budget cuts in order to meet the convergence conditions for the third stage of European monetary union, but the overall deficit is expected to remain in the region of 4 per cent. The Bank of France has followed closely the policy of the Bundesbank and been able to reduce the differential for short-term interest rates substantially, virtually eliminating it for long-term yields. This success has been interpreted in financial markets as an indication that the third stage of European monetary union will embrace at least France and Germany. Inflation has remained around 2 per cent, excess capacity is still high and there is no evident pressure on wages or demand. Thus, as in Germany, there are certainly no supply constraints on expansion.

In Italy and the United Kingdom the contrast with most other EU countries reflects in part the increased competitiveness gained through their exit from EMS in 1992. Both countries managed to keep inflation stable despite very large devaluations. However, in both countries the rate started to rise in 1995 and steps were taken to tighten monetary policy. Interest rates in the United Kingdom were increased early in the year, and in Italy the increase was even greater. Demand slack-

ened quickly in the United Kingdom and inflation remained broadly in line with government targets, permitting a more expansive monetary policy by the end of the year. In Italy inflation fell back from peaks of around 6 per cent, but at mid-year was still above the 4 per cent target set by the central bank. Output growth fell in both countries to an annual rate of about 2 per cent by the end of the year. It is expected to stabilize around that level in the United Kingdom, while in Italy it is expected to continue to decline as the Government continues to generate primary budget surpluses of 2-3 per cent of GDP.

The EU member countries continue to face a challenge posed by the approaching deadline for the third stage of monetary union, which has made fiscal retrenchment the order of the day. All the major continental European countries have announced additional expenditure cuts designed to bring their deficit down to the target of 3 per cent of GDP. For most countries, however, achieving this target is rendered doubly difficult, since their current expenditures are automatically rising and their tax receipts falling as a result of the fall in their growth rates and the rise in unemployment. Simulations for France suggest that a 1 percentage point improvement in the budget deficit ratio would bring about a 1 percentage point reduction in GDP growth from the baseline forecast.¹¹ If this relationship is correct, and were to hold generally, it implies that policies aimed solely at achieving budget deficit targets would bring growth to a temporary halt. It thus provides a rough indication of the burden that would fall on other policies (in most countries primarily monetary policy) in order to ensure that growth continues.

Aside from country-specific factors, the failure to sustain recovery has been to a large extent due to the decision to use fiscal policy to assure convergence to the conditions set down for the third stage of monetary union, while not easing monetary policy sufficiently to offset the effect of fiscal reductions. When growth is sluggish, budget deficits tend to rise due to cyclical factors, and greater deficits tend in turn to act as an automatic stabilizer. Under such conditions, attempts to raise taxes or to lower spending would eliminate the normal automatic stabilizing properties of the budget, thereby depressing growth and raising budget deficits further, and necessitating additional cuts to meet the criteria. A more active use of monetary policy in support of growth would help countries avoid such dangers.

A further policy dilemma confronts member countries where very high interest rates are being used to combat inflation, but where interest payments account for a large part of the public sector deficit. In such a situation there is a potential conflict between measures needed for meeting the inflation target (high interest rates) and those that would help meet the deficit requirement (lower interest rates).

As can be seen from the above, meeting the convergence conditions in accordance with the established schedule for the third stage of monetary union constitutes a formidable challenge for EU member countries. It is consequently hardly surprising that questions have been raised in some quarters as to whether flexibility will be needed in determining whether the convergence conditions have been met and in fixing the date for the start of the third stage, or in respect of both of these questions. Success, however, depends on meeting the challenge. This in turn, requires that, within the context of national strategies for achieving the targets, all policies be geared toward supporting growth. As mentioned above, in some countries there is now a strong case for adjusting monetary policies to that end.

Conditions are likely to improve during 1996 as currency adjustment and growth in the United States sustain exports from EU and other Western European countries. But any sustained recovery will depend importantly on the response of monetary policy to the deflationary fiscal restrictions as countries attempt to qualify for the third stage of monetary union, scheduled for 1999.

2. Latin America

The impact on international financial markets of the Mexican crisis of December 1994 was speedily contained through rapid adjustment measures by the Mexican Government and an international rescue operation led by the United States and IMF which prevented the collapse of the peso from spreading into a possible major global financial crisis. In sharp contrast to the prolonged financial difficulties following the Mexican crisis of 1982, Mexico and other Latin American countries had all returned to the financial markets by the autumn of 1995, notwithstanding a sharp fall in capital flows in most instances.

However, the consequences of the crisis for the region's economic performance have been much

more serious. Net capital flows to the region fell sharply, and for the first time since the early 1990s the region as a whole ran a trade surplus and made a net resource transfer abroad; according to some preliminary estimates by ECLAC, net capital inflows in 1995 were around \$22 billion, while net payments of profits and interest were almost \$40 billion.¹² After a relatively strong upsurge in economic activity in the region which began in 1991, growth fell to 0.7 per cent in 1995 from 4.9 per cent in the preceding year (see table 1).

The financial crisis affected the countries of the region in different degrees, and variation in performance has widened significantly. In Mexico, output fell 7 per cent, exceeding even the relatively pessimistic forecast made by the UNCTAD secretariat in *TDR 1995*. Urban unemployment reached 6.4 per cent.¹³ As a result, per capita income returned to pre-1980 levels. The swing in output was equally large in Argentina, where GDP fell by 2.5 per cent, after increases of over 7 per cent in previous years, and unemployment rose to 18.6 per cent.¹⁴ Uruguay was also affected, through its close economic links with Argentina, with output declining by 1.5 per cent, after a 5.1 per cent growth in 1994.

Growth slowed down in a number of other countries not because of reduced capital inflows and a tightened payments constraint, as in Argentina and Mexico, but because the Mexican crisis laid bare the risks involved in relying on capital inflows to finance large and widening external deficits brought about by surges in consumption and imports. Since the priority given to inflation ruled out large-scale devaluations, countries such as Brazil, Colombia and Peru adopted tight monetary policies in order to moderate growth and bring external deficits to sustainable levels. Consequently, inflation was lower almost everywhere, including Brazil, which succeeded in bringing the rate down to around 20 per cent per annum in 1995 from more than 20 per cent per month in previous years; a notable exception, however, was Mexico, where the sharp devaluation resulted in a substantial increase in the price level.

Growth was lower in all the major countries except Chile, where GDP rose by 8 per cent, as its trade balance improved on account of the exceptionally favourable evolution of world prices for its exports. Chile has thus been able to sustain, over some 12 years, an average growth rate approaching that of East Asia while bringing inflation

down to single-digit rates. Central American economies, too, were able to maintain or increase their growth rates in 1995, on the basis of gains in exports and increased investment.

In both Mexico and Argentina the improvement in payments positions was due primarily to exports. The swing in the trade balance of Mexico from 1994 to 1995 of over \$25 billion resulted mainly from a 33 per cent increase in export revenue brought about by a sharp fall in the external value of the peso and in domestic demand. Exports from Argentina likewise rose substantially; while the exchange rate was fixed in nominal terms against the dollar, the real effective exchange rate fell in 1995, thanks to low inflation in Argentina relative to its trading partners, the weakness of the dollar and a large appreciation of the *real* in Brazil, its main trading partner in MERCOSUR. The higher export revenues were due to increases in both prices and volume; import demand was buoyant in some countries of the region, especially Brazil, and there was a good agricultural harvest. By contrast, for the first time in many years Brazil ran a trade deficit in 1995, in spite of a number of measures taken to deal with the worsening payments position, including reintroduction of tariffs on some consumer durables. As capital inflows revived in 1995, exerting upward pressure on the currency, a number of measures were introduced to slow them down (see Part One, chapter II). However, with the tightening of monetary policy to slow down the economy, real interest rates shot up, reaching almost 40 per cent, providing an additional stimulus to capital inflows. Consequently, net capital inflows were double those of 1994. With the continued use of the nominal exchange rate as an anchor, the result was a real appreciation of the currency and a widening of the external deficit. The balance of payments also worsened in Colombia and Peru.

The payments crises have brought into the open macroeconomic fragility in two areas extensively discussed in *TDR 1995*: fiscal balances and the financial system. In countries where the removal of external constraints in the early 1990s had made a major contribution to fiscal consolidation, budget imbalances re-emerged with the turnaround in the payments position, contraction in economic activity and/or currency devaluations. These difficulties were often aggravated by financial problems. The financial sector has been the most fragile element in Latin American adjustment, not only because of the severity of deflation and

very high real interest rates, but also because unsustainable external payments positions were closely associated with unsustainable external balance sheet positions of firms in many sectors. In Mexico, high interest rates, deflation and a sharp devaluation caused widespread financial difficulties, particularly as the exchange-rate risk passed on to bank borrowers rapidly became an increased credit risk. In Argentina, loss of dollar deposits and the rise in interest rates created serious problems for banks by bringing about a sharp reduction in domestic reserves. Government support was necessary; however, there was no formal institutional arrangement for a lender-of-last-resort role by the central bank. A series of ad hoc measures which circumvented the limitation on money creation consequently had to be introduced in order to provide short-term liquidity to the economy. The measures included creation of a private bank restructuring trust fund, financed by \$2 billion of government bonds and a \$500 million IMF loan.¹⁵ Similarly, in Brazil both financial rescue operations and the rising interest burden of government debt played an important role in the sharp deterioration of the public finances.

The short-term growth prospects for Latin America are for some improvement, with some positive growth in Mexico and Argentina and moderate growth in Brazil. In Chile there is expected to be some slowing down of growth; the recent decline in copper prices may lead to some worsening of the external payments position, since copper accounts for over 40 per cent of export earnings. Again, concern over increasing budget and payments deficits may lead to slower growth in Colombia and Peru. However, as discussed in greater detail in *TDR 1995*, the fundamental question of how to maintain both price stability and a sustainable payments position while growing steadily at rates high enough to reduce poverty and catch up with more advanced countries appears to remain unresolved in much of the region.

3. Developing Asia

At the other extreme of the growth spectrum was China. At 10.2 per cent, growth in 1995 in China was at a double-digit level for the fourth consecutive year. Nevertheless, it was significantly lower than in previous years, because of contractionary macroeconomic policies designed to maintain growth at sustainable rates, as well as to

correct internal and external imbalances. China's continuing integration into the world economy is starting to influence regional trade patterns. For example, strong domestic demand continued to draw in imports from neighbouring economies, especially Taiwan Province (via Hong Kong). As a consequence of this entrepôt trade, Hong Kong has replaced the United States as Taiwan's leading trading partner.

Strong export growth and constrained import demand, aided by the substantial depreciation of the currency, which initially was as much as 40 per cent, turned the 1994 trade deficit into a substantial surplus in 1995. The fast growth of exports was accompanied by further diversification into manufactures which, however, still consist mainly of low value-added items such as toys, textiles, footwear and apparel.¹⁶

Inflation remains high; retail prices have risen at double-digit rates since 1993, peaking at 21.7 per cent in 1994 before falling to 14.8 per cent in 1995.¹⁷ The stabilization programme, initiated in mid-1993, consisted primarily of measures to slow the growth of the money supply and of administrative controls on prices aimed at keeping the budget deficit within manageable limits and strengthening controls on investment.¹⁸

While other Asian developing countries as a whole did not match the performance of China, their 6.3 per cent average growth rate was roughly double that of the best achieved by the industrialized countries and slightly higher than the 5.1 per cent attained in 1994.¹⁹ There was, however, much variation at both the subregional and the country level. For the newly industrializing economies (first-tier NIEs), the average increase was slight, from 7.5 per cent to 7.7 per cent; only in the Republic of Korea was there any acceleration of growth (from 8.4 per cent to 9.2 per cent), mainly because of a sharp recovery in agriculture. In the other three economies there was a slight deceleration. In contrast, all countries of ASEAN-4 and most countries in South Asia were able to maintain or even accelerate their rates of growth.²⁰ The fast-growing economies of East and South-East Asia, in particular those of ASEAN-4, have succeeded in sustaining high and rising rates of domestic investment, and Hong Kong and Singapore have become net exporters of capital. In 1995, the share of gross domestic investment in GDP was around 40 per cent in Indonesia, Malaysia and Thailand, and that of domestic savings about 35

per cent.²¹ As examined in greater detail in Part Two below, for ASEAN-4 in particular, inward foreign direct investment has been accompanied by the relocation of production from Japan and the first-tier NIEs in response to the appreciation of the yen and rising wage costs in the latter countries.

Trade, especially imports, continued to be very buoyant, reflecting high investment in infrastructure and its concomitant demand for capital goods. For the fourth consecutive year not only did import growth in the region exceed that of exports, but also it generally exceeded world import growth by a wide margin. The expansion of imports slowed down during the year, reflecting in the main slower economic expansion in Indonesia and Singapore.

With the exception of Viet Nam, government budgets in most countries have remained in broad balance. Hong Kong, Singapore and Thailand, for example, have had budget surpluses for several years and a number of other countries for the past two years. The achievement of budget balance by the Philippines, despite a heavy burden of debt service, is particularly worthy of note.

In some countries, such as the Republic of Korea, Indonesia, Malaysia, Thailand, the Philippines and Viet Nam, rapid income growth has generated inflationary pressures. Widening deficits on invisibles account due to debt service and payments related to foreign direct investment have increased current-account deficits,²² which in Malaysia and Thailand reached 10 per cent and 8 per cent of GDP, respectively, raising concern about their sustainability. In Singapore, on the other hand, there was a further significant improvement in the current-account balance. Tighter monetary policies have been initiated by a number of countries to correct these growing internal and external imbalances. Monetary policies have been the primary instrument used to dampen inflationary pressures, although the levels of inflation (ranging from 4 per cent to 15 per cent) were relatively low.

Maintaining tight monetary policy became more complicated in several countries because large inflows of short-term funds attracted by high domestic interest rates relative to international rates generated excessive growth of the money supply.²³ A variety of measures, including higher reserve requirements for banks, direct restrictions on credit, and controls to limit financial inflows, were instituted in some cases. While the outcome has been

varied, the most positive results have been achieved by Malaysia. In some countries, such as the Republic of Korea, policies took the form of measures to restrict the foreign investment plans of conglomerates (*chaebols*) by requiring that 20 per cent of the financing be raised domestically.

The export competitiveness of developing countries in Asia was much enhanced by the appreciation of the yen during the first half of 1995 (subsequently reversed, however, as noted below), the effects of which were most evident in the Republic of Korea, Japan's leading trading partner. In that country total export earnings rose by almost one third in 1995, more than twice the already fast pace of increase achieved in 1994. Exports to the developing countries in the region also expanded rapidly. Exports to developing countries in Asia accounted for about 18 per cent of total exports in 1993, up from 10.4 per cent in 1980 and 11.2 per cent in 1990. Moreover, those countries were becoming important markets for exports from Japan, and not only in their capacity as production bases for Japanese firms. Rising consumption has also made those markets attractive to Japanese exporters.

In South Asia, the economic reforms being implemented by various countries succeeded in varying degrees in accelerating export growth, attracting more FDI, enhancing foreign exchange reserves and reducing inflation. Outstanding was the continuation of recovery in Pakistan from the three years of slow growth associated with the devastation of its cotton crop; growth was 4.7 per cent in 1995, after 3.8 per cent in the previous year. In most countries of the subregion, however, investment seems to have been stagnating. In India and Pakistan, where investment had stabilized at a relatively high level, large fiscal deficits continued to prevail in spite of efforts to increase revenue through major tax reforms and restrictions on government expenditure. In both countries exports rose sharply. Likewise, in Bangladesh and Sri Lanka, which rely heavily on garments exports, revenues from this source rose by 20 per cent and 35 per cent, respectively, in 1995. However, as in East Asia, the rise in the import bill in both countries was even greater. Several of the smaller countries, including South Asian LDCs, also recorded fast export growth, though generally from a low base in view of their concentration on a limited number of export commodities.

In general, the economic performance of India continued to be strong in 1995. GDP grew at

some 6 per cent as the monsoons remained favourable for the eighth successive year. The run-up to the general election of mid-1996 was accompanied by a pause in efforts to strengthen ongoing reforms as well as in the initiation of new ones. In particular, while the regime of administered prices reduced inflation, it resulted in a larger fiscal deficit. The second half of 1995 was marked by turbulence in the foreign exchange and domestic money markets which was countered through the implementation of several short-term policies.

Output in West Asia recovered in 1995, following the mild recession of the previous year. Higher oil prices and earnings helped ease fiscal and external imbalances and contributed significantly to the economic recovery. Declining oil prices in previous years had led to sharp cuts in government expenditure, prompting efforts to rationalize investment and diversify production which are now beginning to bear fruit. Some countries in the subregion, notably Iraq, Kuwait and Yemen, continued to be adversely affected by the aftermath of the 1991 Gulf War. United Nations sanctions on Iraq, and the unsettled political relations between Iraq and other countries, seriously disrupted domestic economic activity as well as trade and financial flows. On the other hand, progress in the peace process in the Middle East played a part in stimulating new investment and reconstruction. For example, as a result of its peace treaty with Israel, Jordan has witnessed an increase in private investment as well as in earnings from tourism.

4. Africa

Growth in developing countries of Africa in 1995 exceeded that of the developed countries, reaching a record for the decade of 2.8 per cent, only slightly below population growth. Most countries enjoyed high rates of expansion, which in several instances reached or exceeded 5 per cent. Contributing factors were primarily the relatively favourable external conditions and improved domestic policy environments and, in some cases, increased political stability.

Export earnings of the region are estimated to have risen by over 10 per cent, or more than double the rate recorded in 1994. While much of the increase was accounted for by higher export prices, the volume of exports also appears to have risen, after a year of stagnation. Higher prices

benefited mainly exports of petroleum, minerals, metals and agricultural raw materials. As regards tropical beverages, prices of coffee and cocoa averaged only slightly above their 1994 levels and even started to weaken noticeably during the year, while tea prices fell substantially.

The recovery of oil prices resulted in an increase of 10.5 per cent in the export earnings of oil-exporting countries of the region in 1995, reversing the decline in the previous year. Similarly, the relatively larger increase in the prices of minerals, ores and metals than those of other primary commodities stimulated mining exports in Zimbabwe, whereas Zaire and Zambia were unable to take full advantage of this price trend because of supply conditions. Revenues from tourism also increased in 1995 in a number of countries, including Egypt, Kenya, Tunisia, Uganda and Zimbabwe.

Following renewed competitiveness when the CFA franc was devalued in January 1994, recovery continued in most countries of the franc zone.²⁴ The devaluation not only led to greater flows of private and official resources, but also enabled the participating countries to take full advantage of favourable market conditions for their exports of primary commodities. In Côte d'Ivoire it also resulted in higher investment and manufacturing output. On the whole, progress in the western part of the franc zone was more rapid than in the central part.

Drought in sub-Saharan and northern Africa led to a decline in the GDP of Morocco, Zambia and Zimbabwe. The drought in Morocco, the third in four years, resulted in a widening of the budget and current account deficits as well as in higher inflation. Some countries, such as Angola and Mozambique, enjoyed relative stability after years of civil and political conflicts. GDP growth in Angola amounted to 4.0 per cent in 1995, in contrast to a decline of 5.9 per cent in the previous year.²⁵ On the other hand, social unrest, civil strife or political crises continued to disrupt production and other economic activities and impede reforms in various countries, including Algeria, Burundi, Rwanda, Sierra Leone, Somalia and Sudan. Output in Sudan, for instance, fell by 2.8 per cent in 1995, after an increase of 1.7 per cent in 1994. Political instability, more than any other factor, has been responsible for the poor economic performance of both Nigeria and Zaire in recent years. In Zaire, GDP declined by a further 2.3 per cent in 1995, having fallen by 7.4 per cent the year before.

During 1993-1995 FDI and other private capital flows to sub-Saharan Africa as a share of GDP amounted respectively to only 0.9 per cent and 0.1 per cent, compared to 1.1 per cent and 2.0 per cent for Latin America and as much as 3.1 per cent and 2.5 per cent for East Asia.²⁶ In 1995, the flow of FDI and portfolio investment to sub-Saharan Africa (excluding South Africa) declined by \$1.2 billion. In addition, such flows (which include flows to oil-producing Nigeria) remain heavily biased in favour of the energy and mining sectors in a few other countries, such as Algeria, Nigeria and Tunisia.

In many countries, import bills were swollen by higher grain prices, diverting scarce foreign exchange resources from other uses. Food shortages persisted in drought-affected areas, especially in the Sahel countries. Moreover, as noted above, recent trends in commodity prices suggest that the recent price recovery may be coming to an end for many of the commodities exported by the region.

5. Central and Eastern Europe

Economic performance generally improved in Central and Eastern Europe²⁷ in 1995, with most countries experiencing higher rates of output growth or smaller declines than in 1994. For the region as a whole output declined by 2.6 per cent, which was substantially below the 10.1 per cent decline in 1994. There was, however, greater variation among countries in 1995, reflecting differences in initial conditions and in the degree of progress achieved through the use of different strategies, economic policies and market reforms to deal with specific problems and difficulties. Particularly noteworthy was the acceleration of growth in Central Europe to 5.3 per cent from 4.0 per cent in 1994. In the Baltic States growth averaged less than 1 per cent, as in the previous year. Output in CIS continued to decline, at an average rate of only around 5 per cent, against almost 15 per cent in 1994.²⁸

Recovery is now well under way in a number of Central European economies. With the exception of Hungary, where growth fell to 2.0 per cent in 1995 from almost 3 per cent in 1994 because of demand restraints aimed at correcting large macroeconomic imbalances, output in countries members of the Central European Free Trade

Agreement (Czech Republic, Hungary, Poland and Slovakia) rose at rates varying from 5 per cent to 7 per cent, primarily on account of domestic demand expansion. With moderately accelerating rates of growth in the past two or three years, these countries constituted the core group which has been both leading and pulling ahead of other European countries in transition toward a market economy. There was a remarkable acceleration of growth in Albania and Romania, where the rate almost doubled, to reach over 13 per cent and 7.0 per cent in 1995, respectively. In Romania, however, this achievement was at the cost of excessive expansion of bank credit, rising inflation, declining external reserves and a growing current-account deficit, necessitating corrective macroeconomic policy measures. Also worth noting was the recovery in Yugoslavia following implementation of the February 1994 programme to end hyperinflation. For the other Central European countries for which data are available output declined only in Croatia and The former Yugoslav Republic of Macedonia.

Although trade among the Central European countries is beginning to revive, they still depend mainly on the major EU markets for their exports. Despite slow growth of those markets, most of the countries continued to enjoy high export growth in 1995 at an average estimated rate of 28 per cent, exceeding the growth of world trade for the third consecutive year. However, despite good export performance, both trade and current-account balances deteriorated as their increase in imports was about one third higher than that of exports. The current deficit of an estimated \$9 billion was more than offset on capital account by a net capital inflow of over \$31 billion, which was triple the net inflow (\$10 billion) of the previous year.

By contrast, intra-CIS trade has shown no tendency to rise. However, while the degree of openness of those economies is less than in Central Europe, their good export performance equalled that of the latter countries in 1995. In the Russian Federation, there was an increase in the current account surplus of some \$10 billion in the first three quarters of 1995 over the same period of 1994, due entirely to increased merchandise exports.

The transition process in the Baltic States so far has advanced more slowly than in most of Central Europe, reflecting their later start in the process of systemic transformation and the more difficult initial conditions stemming from the need to ad-

just to changes in their economic relations with the other former Soviet republics. Economic recovery continued during 1995 in Estonia and Lithuania, but at a modest pace, whereas Latvia suffered a setback partly because of a major crisis in the banking sector.

There was considerable variation in 1995 in economic performance among the CIS members. For example, whereas Armenia and Georgia had positive GDP growth rates, elsewhere output continued to fall, by as much as 10 per cent or more in Azerbaijan, Belarus and Ukraine, because of delays in policy implementation or because those policies which had been implemented have not yet had time to exert their full effect. Nevertheless, progress with stabilization during 1995 arrested the steep declines in output in a number of countries, most conspicuously in the Russian Federation, which accounts for some 70 per cent of total CIS output. After several false starts, Russian economic stabilization policy appears to be achieving some success; the decline in output was sharply reduced, from nearly 13 per cent in 1994 to only 4 per cent in 1995.

Closely associated with the economic recovery in 1995 in the majority of all these Central and Eastern European transition economies was a sharp decline in the rate of inflation. In most countries, the rise in both consumer and producer prices was smaller than in the previous year, the principal exceptions being Yugoslavia, which failed to consolidate the success of its 1994 stabilization programme, and Tajikistan, where high inflation again set in. In Hungary also the inflation rose, following the introduction of a stabilization programme in March 1995 which included a sharp currency devaluation and an import surcharge imposed to counter the effects of a high import intensity of consumption. In some countries, the fall in the inflation rate was dramatic.²⁹ Inflation was also lower in most countries of the CIS, where it had continued to accelerate in 1994. However, in most of these countries it continued to be in double, and in a number of cases even in triple, digits. Inflation also has remained high (25-40 per cent) in some of the Central European economies, but in a number of them the annual rate had fallen below 10 per cent by the end of 1995.

There were notable differences both in the policy adopted towards price stabilization and in the determinants of the process. In Hungary, Poland, Romania and the Baltic States, as well as in

some countries which have advanced further down the path of transformation and where progress has been facilitated by relatively stable nominal exchange rates and strong gains in labour productivity, it is proving difficult to bring inflation below the current annual rate of 25-40 per cent. On the other hand, in the CIS, national experience appears to be similar to that of countries which had initiated macroeconomic stabilization earlier. The results were encouraging in most cases, although price stability is still far from having been achieved. The stabilization programme introduced in the Russian Federation in 1995 has attracted considerable attention regarding both its design and the instruments used for its implementation. In order to conform to the conditionality of the standby loan of \$6.25 billion accorded by IMF and in view of the monitoring of the economy by the Fund, tight fiscal and monetary measures were taken to maintain relative stability of the rouble, including the introduction in July 1995 of a trading band of

4,300-4,900 roubles to the dollar (i.e. the exchange rate would be allowed to fluctuate within these limits). As a consequence, the pressure on import prices was considerably eased, while exports became less competitive.

Despite the progress so far achieved, output in all countries is still significantly below levels that prevailed before the breakup of the USSR. For Central and Eastern Europe as a whole in 1995 it was less than 65 per cent of the 1989 level. The extent of decline, however, varies significantly among the three groups of countries, ranging from 15.2 per cent for Central Europe to 53.4 per cent for the Baltic States. For the countries of CIS, the loss of output in 1995 amounted to nearly 44 per cent (in other words, output was some 56 per cent of its 1989 level), reflecting primarily conditions in the Russian Federation, where output was 40 per cent lower than in 1989.³⁰ Only in Poland was output in 1995 anywhere near former levels.

C. Short-term outlook

The slowing down of growth in the world economy is likely to continue during the remainder of 1996. The volume expansion of world trade growth is expected to fall to a rate of around 7 per cent for the year as a whole, compared to 8.0 per cent in 1995, but trade will thus continue to increase faster than output. The bright point in the short-term outlook is the continued resilience of developing countries to external shocks, including the stagnation in a number of industrialized economies, and their ability to maintain recent trends in the growth of both their output and their trade. However, the crisis of the Mexican peso is a reminder of the risks posed by the volatility of international capital flows.

While growth in the United States is expected to be at much the same rate as in 1995, expansion in Japan is likely to slow down after the high growth of the first quarter, and EU is unlikely to see the much-expected recovery in 1996. Growth in the developed-market economies will probably again

be smaller than in 1994 and may not even reach the 2.0 per cent achieved in the preceding year. Growth in the European Union will be more than 1 percentage point lower than in 1995, at around 1.3 per cent, on account of the halving of the rate in Italy and France and a much sharper drop in Germany; in the latter country, recovery will only arrive late in the year, keeping the annual rate for 1996 around 0.5 per cent. Inflation, which was once the constraint on faster expansion, continues to remain at historically low levels, even in those countries where growth has been faster than was considered compatible with wage and price stability.

Among the developed market economies, only the United States and the United Kingdom have been able to combine wage and price stability with falling unemployment. Elsewhere in Western Europe, levels of unemployment have surpassed those of the Great Depression and will continue to rise if the growth of the economies is no faster than is

indicated by short-term forecasts. There has consequently been a weakening of support for monetary union among those who, rightly or wrongly, attribute job losses to the implementation of policies required to achieve the convergence conditions for the third stage. As highlighted in *TDR 1995*, there is also the risk that growing imports from developing countries will likewise be blamed for job losses and lower real wages, especially in relatively low-skill occupations, where output competes directly with imports. High unemployment thus risks increasing resistance to policies directed toward achieving important objectives - monetary union in Europe and the full integration, through trade, of developing countries in the world economy.

In the developing countries as a whole there is expected to be a slight acceleration of growth in 1996. Although the expansion in Asia will be marginally lower than last year, a somewhat faster rate of recovery is expected in Latin America. As a result of strong expansion in some African countries, the African region is expected to see an increase in GDP per capita for the first time since 1985. The international environment should be favourable to such an outcome, as non-oil commodity prices are expected to remain relatively firm. In addition, good rainfall has generally returned to northern and southern Africa and good harvests are predicted for 1996 throughout the continent. In several countries efforts will continue towards reconstruction and restoration of political stability after long periods of civil and political turmoil. However, as always, for most countries the outcome will depend greatly on fluctuations in commodity prices, weather, demand in developed market economies, political stability and policy reforms.

Economic performance in Latin America is expected to improve somewhat, although growth is not likely to reach 3 per cent. Policy will focus on strengthening the financial sector and restoring capital inflows, while continuing the liberalization process. Further progress is expected in lowering inflation and in reducing trade and fiscal imbalances. Chile, Colombia and Peru should continue to grow quite rapidly, while Brazil may experience a slowdown as a result of high real interest rates. The adverse effects of the Mexican foreign exchange crisis will continue to affect performance in Argentina, Mexico, Uruguay and Venezuela. Argentina is still suffering from high unemployment despite signs of recovery and a revival of

confidence in its banking system. In Mexico itself, the severe difficulties faced by the banking system remain to be resolved and continue to constrain recovery.

Growth in Asia is expected to moderate slightly in 1996, primarily because of the need to implement anti-inflationary policies in response to overheating in several countries. Investment will continue to be an important source of growth. In addition to the continuation of the trend in the flow of FDI in recent years, greater public investment to relieve bottlenecks in infrastructure will be undertaken in several cases, notably Hong Kong, Indonesia, Malaysia, Singapore and Thailand. Despite the reversal of the yen appreciation of early 1995, exchange rates are likely to remain at competitive levels and structural reforms to promote exports will continue. However, there is increased concern over the sustainability of large current account deficits in South-East Asia, particularly with the slowdown of exports in recent months.

Early in March 1996, the Eighth National People's Congress of China approved the country's ninth five-year economic plan (1996-2000), which includes the following major targets for 1996: GDP growth of 8 per cent, an inflation rate of 10 per cent, and fixed investment corresponding to 32 per cent of GDP. The Government recognizes the need for close vigilance in macroeconomic policy in order to safeguard and extend the results of stabilization. In the external sector, further liberalization will take place as the country seeks to become a member of the World Trade Organization. It is likely that the growth target will turn out to be pessimistic, as often happened in the past. Provided that macroeconomic policy stays on course and inflation remains under control, the outcome may well be a growth rate of 9 per cent.

In Central and Eastern Europe growth is expected to be positive in 1996, after what appears to have been a bottoming out in 1995. Significant macroeconomic imbalances, however, will continue to persist in all countries. Inflation, though lower, can be expected to persist, generally at relatively high levels, since bank credit and money creation are still being used to finance a significant proportion of government expenditure. 1996 may well be the year in which output begins to revive in the Russian Federation after successive years of major declines. The convertibility of the rouble could prove to be a key element in this respect. Given

the size and importance of the Russian economy, expansion in that economy will, in turn, provide

significant support for the recovery of other countries in the group.

D. Uncertainty in short-term forecasting

With the increasing globalization of the world economy, countries have become increasingly interdependent, both within and outside their own regions, in terms of trade, investment and financial flows. Economic forecasting for a given country consequently involves making judgements with respect to the direct and immediate impact of economic variables in the country on those of economies to which it is closely linked. Moreover, the nature of these linkages appears to have undergone some change in so far as some shocks or repercussions are now apparently transmitted at a relatively greater speed than previously.

These considerations are reflected to a large extent in table 4, which compares forecasts of GDP growth for 1995 given by various international organizations and research institutions for selected OECD countries with the actual outcome. On the whole, the earlier the forecast was made, the more optimistic was the outlook. (Compare, for example, the predictions of OECD published in December 1994, or those of the United Kingdom's National Institute of Economic and Social Research in February 1995, with most of the others in the table, which were made later in 1995.) Most forecasts even failed to anticipate the slowdown of economic activity in Germany, France and other EU countries, of which there were clear indications by the second half of the year.

The actual rate of GDP growth of 2.0 per cent in the United States in 1995 is in principle not directly comparable with the predictions given in the table because of a change in the method of compu-

tation.³¹ Nevertheless, even allowing for this change, all the forecasts for the United States, except those of the UNCTAD secretariat and project LINK, proved to be too optimistic, as were also all the forecasts for the United Kingdom, Germany and France. Only for Japan and Italy was the actual outcome within the range of the forecasts.

A similar degree of uncertainty is discernible with respect to forecasts by the same institutions for 1996. As can be seen from table 5, the projections of OECD and EU, both of which were made toward the end of 1995, are distinctly more optimistic than all the others. Among the others, there is a clear convergence of forecasts only for the United States, where expectations of recovery and expansion of output are firmer, as they are also for the United Kingdom.

There is also substantial discrepancy among the later forecasts for Germany, which range from 0.5 per cent (UNCTAD) to 2.0 per cent (LINK), reflecting differing perceptions of the current economic situation with respect to likely consumer behaviour or exchange rate movements. Partly because of close ties with Germany, the forecasts for France are in a similar range (0.9-1.6 per cent), while in Japan, they range from 1.5 per cent to 2.7 per cent because of uncertainties regarding the impact of the packages of measures successively introduced to stimulate the economy. The greater interdependence and closer linkages within and among groups of countries imply that errors of prediction are likely to be highly correlated, particularly in respect of forecasts for EU countries.

Table 4

GDP GROWTH IN SELECTED OECD COUNTRIES IN 1995: COMPARISON OF ACTUAL GROWTH WITH FORECASTS BY VARIOUS INSTITUTIONS										
(Percentage)										
Country	LINK (April 95)	ECE (June 95)	OECD (Dec. 94)	OECD (June 95)	EU (April 95)	IMF (May 95)	NIESR (Feb. 95)	NRI (May 95)	UNCTAD (June 95)	Actual
United States	2.8	3.0	3.1	3.2	3.2	3.2	3.5	3.3	2.7	2.0
Japan	1.2	2.5	2.5	1.3	1.6	1.8	0.8	0.7	0.5	0.9
Germany	2.9	3.0	2.8	2.9	3.0	3.2	2.8	2.8	2.5	1.9
France	3.2	3.0	3.1	3.0	3.1	3.2	2.8	2.7	2.5	2.2
Italy	2.8	3.0	2.7	3.0	3.3	3.0	3.4	2.6	3.0	3.0
United Kingdom	3.0	3.0	3.4	3.4	3.1	3.2	3.5	2.8	2.8	2.4

Source: Table 1 for actual growth rates; TDR 1995, table 4, and OECD Economic Outlook, June 1995, for forecasts.

Table 5

ALTERNATIVE FORECASTS OF GDP GROWTH IN 1996 FOR SELECTED OECD COUNTRIES								
(Percentage)								
Country	LINK	ECE	OECD	EU	IMF	NIESR	NRI	UNCTAD
United States	2.0	2.0	2.7	2.3	1.8	2.2	2.0	2.2
Japan	2.0	2.0	2.0	2.3	2.7	2.4	1.5	2.1
Germany	2.0	1.0	2.4	2.4	1.0	1.0	0.8	0.5
France	0.9	1.5	2.2	2.4	1.3	1.6	1.2	0.9
Italy	2.2	2.0	2.5	3.0	2.4	1.4	2.1	1.5
United Kingdom	2.2	2.0	2.7	2.7	2.2	2.4	2.0	2.2
Memo item:								
Total OECD	2.0 ^a	2.0 ^b	2.8	2.6 ^a	1.8 ^a	2.1	1.9	1.9

Source: United Nations, University of Pennsylvania and University of Toronto, "Project Link World Outlook," (mimeo), post-LINK meeting forecast (May 1996); ECE, *Economic Survey of Europe in 1995-1996* (United Nations publication, Sales No. E.96.II.E.1); OECD *Economic Outlook* (December 1995); Commission of the European Communities, *European Economy, Supplement A* (December 1995); IMF, *World Economic Outlook* (April 1996); National Institute of Economic and Social Research (London), *National Institute Economic Review* (May 1996); Nomura Research Institute (NRI), *Quarterly Economic Review* (May 1996); and table 1.

^a European Union.

^b Excluding Australia, Iceland and New Zealand.

Notes

- 1 Paul Krugman, "Growing World Trade: Causes and Consequences," *Brookings Papers on Economic Activity*, No. 1, 1995, p. 332.
- 2 China, Hong Kong, India, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan Province of China and Thailand.
- 3 These figures for Asian developing countries include also Australia and New Zealand. However, trade of the United States, EU and Japan with those two countries is marginal.
- 4 See "Overview of world trade in 1995 and outlook for 1996" in *WTO Focus*, No. 10, May 1996 (table 1).
- 5 Some prices, however, have remained high during recent months because of temporary factors.
- 6 For a discussion of the prospective longer-term decline in the terms of trade of primary commodities see, for example, World Bank, *Global Economic Prospects and the Developing Countries, 1996* (Washington, D.C.: The World Bank, 1996).
- 7 Bank for International Settlements, *66th Annual Report*, Basle, June 1996, pp. 164-165.
- 8 *Economic Report of the President, 1995* (Washington, D.C.: US Government Printing Office, 1995), p. 54.
- 9 For a fuller discussion see *TDR 1995*, Part Two, chap. I, sect. B.1.
- 10 The Bureau of Economic Analysis of the Department of Commerce has recently shifted to the use of a chain-weighted procedure to measure GDP growth, in an attempt to avoid overestimation inherent in the traditional method of using the prices of a particular base year to value production during periods of substantial economic change, such as occurred with the spectacular fall in computer prices. In that instance, changing the base period to more recent years would result in a significant drop in both the share of the computer industry in real GDP and in the contribution of this rapidly expanding industry to GDP growth, and hence in a not insignificant drop in GDP growth for recent years. The new approach amounts to the computation of an index which is the geometric mean of values based on current prices and those of the preceding year. The chain-weighted procedure, however, is not without its limitations and disadvantages. For practical purposes, current prices are not so readily available and are subject to revision, so that available quarterly or monthly GDP data would not be as up-to-date and reliable as when prices of a base period are used. In addition, an error in any of the elements in the chain will remain uncorrected, so there is a tendency for such errors to cumulate over time. A more serious difficulty is the fact that components of GDP no longer add up to the total.
- 11 *ING Bank Notes, France*, 26 April 1996.
- 12 ECLAC, *Preliminary Overview of the Latin American and Caribbean Economy 1995* (United Nations publication, Sales No. E.95.II.G.18), table A.14. (For a detailed discussion of capital flows to Latin America see Part One, chap. II).
- 13 *Ibid.*, table A.4.
- 14 *Latin American Weekly Report*, No. 18, 16 May 1996, p. 212.
- 15 M. Carrizosa, D.M. Leipziger and H. Shah, "The Tequila Effect and Argentina's Banking Reform", *Finance and Development*, Vol. 33, No. 1, March 1996. However, such measures did not lead to reduction of the ratio of liquid reserves to the monetary base below the statutory minimum of 80 per cent.
- 16 Future export performance may, however, be adversely affected by the recent reduction of the rebate on the input value-added tax on goods made for export.
- 17 Nomura Research Institute (Tokyo), *Quarterly Economic Review*, May 1996, p. 51.
- 18 Major initiatives were taken in 1995 in respect of banking and the regulation of investment. A new Commercial Banking Law came into effect on 1 July 1995, which is intended to lay the foundations for the conversion of the various major specialized banks and other smaller banks into full-fledged commercial banks. New regulations governing foreign investment, listing the priority areas where foreign investors would be encouraged, were issued in June 1995. The priority areas are agriculture in general, infrastructure and power generation, mining, high technology, energy and environmental conservation. The intention is to direct investment away from luxury construction and low-technology sectors.
- 19 For a fuller discussion of the developing economies of East Asia, see Part Two.
- 20 The first-tier NIEs and ASEAN-4 are defined as in Part Two - i.e.: first-tier NIEs: Hong Kong, Republic of Korea, Singapore and Taiwan Province of China; ASEAN-4: Indonesia, Malaysia, Philippines and Thailand.
- 21 *Asian Development Outlook 1996 and 1997* (Hong Kong: Oxford University Press for the Asian Development Bank, 1996), appendix tables A.7 and A.8.
- 22 Large inflows of capital, however, have more than covered the deficits and led to an accumulation of

- foreign exchange reserves in many countries. Moreover, the large increase in Malaysia's imports in 1995, for example, was primarily accounted for by exceptional imports of aircraft and ships.
- 23 See Part One, annex I to chapter II.
- 24 For details concerning devaluation of the CFA franc, see *TDR 1995*, box 1.
- 25 Economic Commission for Africa, "Report on the Economic and Social Situation in Africa, 1995" (E/ECA/CM/21/3), Addis Ababa, March 1995, table A-2, and *ibid.*, 1996 (E/ECA/CM.22/4), Addis Ababa, April 1996, table A-2.
- 26 World Bank, *Global Economic Prospects and the Developing Countries, 1996* (Washington, D.C., 1996), table 1-1.
- 27 In the review of this region three groups of countries are distinguished: the Commonwealth of Independent States (CIS), which includes some Central Asian countries; the Baltic States (Estonia, Latvia and Lithuania); and the remaining countries of the region (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia, The former Yugoslav Republic of Macedonia, and Yugoslavia), collectively termed "Central European" countries.
- This classification broadly follows that used by the secretariat of ECE, and differs from that now used in the UNCTAD *Handbook of International Trade and Development Statistics*.
- 28 For specific country detail, see United Nations Economic Commission for Europe, *Economic Survey of Europe in 1995-1996* (United Nations publication, Sales No. E.96.II.E.1), table 3.1.1.
- 29 For instance, the rise in consumer prices fell from 97.5 per cent in 1994 to 2.0 per cent in 1995 in Croatia, from almost 5,000 per cent to 176 per cent in Armenia, and from nearly 500 per cent to 30 per cent in the Republic of Moldova (see Economic Commission for Europe, *op. cit.*, table 3.4.1).
- 30 See Economic Commission for Europe, *op. cit.*, appendix table B.1. For the Russian Federation, the loss of output from 1989 to 1994 is now officially acknowledged to be of the order of one third, rather than one half as was previously believed on the basis of production data only (see *TDR 1995*, Part One, chap. I, sect. A.4).
- 31 See note 10 above. Based on the new method, growth has been calculated to have been about 0.5 percentage points lower than previously calculated (IMF, *World Economic Outlook*, May 1996, box 2).

INTERNATIONAL FINANCIAL MARKETS AND THE EXTERNAL DEBT OF DEVELOPING COUNTRIES

A. Recent trends in private external financing

During 1995 there were substantial increases in most major categories of financing from the international financial markets, the principal exception being new international equity issues. As illustrated by table 6, these increases were accompanied by significant changes in the relative importance of the different categories. The expansion was driven principally by conditions in developed countries. For example, the large rise in syndicated bank credits reflected the impact of heavy merger and acquisition activity in the United States and the United Kingdom, greater recourse to financing in this form by companies of continental Western Europe (which appear to be reducing their traditional reliance on borrowing from domestic sources), and refinancing operations prompted by falling interest rates for major currencies (exemplified by the figures in table 7) and by lower spreads on Eurocurrency loans. The maintenance of developing countries' share of syndicated bank credits was due to borrowing by entities in South and South-East Asia. An exception to the generalization about the predominant influence on financing trends of developments in the OECD area concerns international equity issues, a category of financing for which the share of developing countries has increased in the 1990s. Issuance of equities in external markets by entities in developing countries became more difficult in the aftermath of the Mexican financial crisis, and stagnated in 1995.

The recent expansion of international financing has been accompanied by a progressive blurring of the distinction between different categories of such financing. As was noted in last year's *TDR*, this blurring has been especially evident in the case of external bonds, on the one hand, and Euro-medium-term notes (EMTNs), on the other. The former are debt instruments underwritten by syndicates of banks and issued on a one-off basis at medium- and long-term maturities. By contrast, EMTNs are "continuously issued" at intervals pursuant to a facility or "programme" agreement with the institutions responsible for distribution. Originally EMTNs carried relatively short maturities and were not underwritten, so that they did not provide a guaranteed source of funding. However, with expanding use, the maturities of EMTNs have become much longer in many cases, and they are now frequently underwritten by issuing syndicates.¹ The many advantages of EMTNs in comparison with bonds, such as their lower upfront costs and the greater flexibility of issuing procedures, help to explain the increase in their relative importance as a source of financing indicated by table 6.

The growth of the total claims of banks in the BIS-reporting area² on developing countries (including the European economies in transition) increased (after adjustment for movements of exchange rates) for the second consecutive year, as shown in table 8. The region contributing most to

Table 6

SELECTED CATEGORIES OF INTERNATIONAL FINANCING AND SHARES OF DEVELOPING COUNTRIES AND EUROPEAN TRANSITION ECONOMIES THEREIN, 1991-1995

(Billions of dollars and percentage shares)

Category	1991	1992	1993	1994	1995
External bond offerings					
Total (\$ billion)	308.7	333.7	481.0	428.6	460.6
Share of developing countries ^a	3.9	5.9	11.8	11.9	10.3
Syndicated credits					
Total (\$ billion)	116.0	117.9	136.7	236.2	368.4
Share of developing countries ^a	25.2	16.6	16.7	10.7	11.8
Eurocommercial paper programmes					
Total (\$ billion)	35.9	28.9	38.4	30.8	44.6
Share of developing countries ^a	2.8	11.8	7.8	6.5	19.1
Committed borrowing facilities^b					
Total (\$ billion)	7.7	6.7	8.2	4.9	3.1
Share of developing countries ^a	58.4	25.4	18.3	59.2	29.0
Other non-underwritten facilities^c					
Total (\$ billion)	44.3	99.0	113.6	222.1	340.6
Share of developing countries ^a	1.8	4.5	6.2	5.4	5.3
International equities^d					
Total (\$ billion)	23.4	23.5	40.7	44.9	41.0
Share of developing countries ^a	20.0	17.9	18.7	24.1	25.9

Source: OECD, *Financial Market Trends*, February 1996; UNCTAD secretariat estimates.

a Including the transition economies of Central and Eastern Europe.

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

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

d Including international placements of equity for privatizations.

this expansion was South and South-East Asia, which now accounts for almost 50 per cent of the total stock of such banks' claims on the developing world. This share reflects not only superior creditworthiness among borrowing entities in the region but also the more full-fledged participation of its new (offshore and onshore) financial centres in global financial markets. In contrast with the increases in bank claims experienced by the other regions in table 8, Africa once again registered a substantial decrease.

As shown in table 9, the vigorous growth of export credits to developing countries in 1994, which was accompanied by marked declines in the proportion of countries in different regions experiencing net outflows of such financing, was not sustained in the first half of 1995. The slower increase was strongly influenced by a substantial net outflow from Latin America, for which the number of countries experiencing such outflows almost doubled from the second half of 1994 to the first half of 1995. (Factors affect-

Table 7

SELECTED INTERNATIONAL INTEREST RATES

(Period averages in per cent per annum)

Currency	Long-term rates ^a			Short-term rates ^b		
	1994	1995	1996 (Jan-Mar)	1994	1995	1996 (Jan-Mar)
United States dollar	7.41	6.81	6.07	5.07	6.10	5.33
French franc	7.52	6.93	6.35	5.95	6.61	4.53
Deutsche mark	6.94	7.65	6.90	5.35	4.57	3.38
Japanese yen	4.50	3.37	3.30	2.36	1.26	0.72
Pound sterling	8.05	8.25	8.07	5.80	6.91	6.19

Source: IMF, *International Financial Statistics*, May 1996, and OECD, *Financial Statistics Monthly*, various issues.

a *United States*: government bonds ("composite" over 10 years); *France*: public and semi-public sector bonds; *Germany*: public sector bonds with maturities of 7 to 15 years; *Japan*: central Government bonds (10-year benchmark); *United Kingdom*: 20-year government bonds.

b London inter-bank offered rate (LIBOR) on six-month deposits.

ing the cost of export credits are discussed further in section C.)

Increasingly the availability of external financing from private sources for developing countries is affected not only by the traditional categories of international bank lending, export credits and externally issued securities but also by foreign investment in financial instruments issued on domestic financial markets and by intra-regional flows of foreign direct and portfolio investment (which are not reflected in the categories of financing included in tables 6, 8 and 9). For example, the issues of international equities by entities in developing countries and economies in transition covered by table 6 amounted to about \$10.5 billion in 1995, while preliminary estimates indicate that total external portfolio equity investment in emerging financial markets amounted to \$25 billion.³ Intra-regional financial flows have recently been expanding not only in the form of direct but also of portfolio investment. In 1994 more than 17 per cent of the figure for net external portfolio equity investment in emerging financial markets of \$39.9 billion in 1994 also originated in such markets.⁴ In the early 1990s direct purchases of securities by emerging markets mutual funds which invested in developing countries (including econo-

mies in transition) amounted to less than \$10 billion a year, but in 1993 such purchases rose to \$18 billion and in 1994 to \$64 billion.⁵

As documented in previous issues of the *TDR*, access to financing from the international financial markets continues to be concentrated among a relatively small number of developing countries and economies in transition. For example, three Latin American countries (Argentina, Brazil and Mexico) accounted for 42 per cent of net issues of international bonds by such countries, and six countries of South and South-East Asia (China, India, Republic of Korea, Malaysia, Philippines, and Thailand) for 45 per cent.⁶ Excluding the Philippines, the latter countries, together with Indonesia, were responsible for 60 per cent of borrowing in the form of international syndicated bank credits, and three countries from Latin America and South and South-East Asia (Argentina, Brazil and Republic of Korea) for more than 100 per cent of net issues of Euro-notes.⁷

The major recipients of funds were unequally affected by the aftermath of the Mexican financial crisis. As noted in last year's *TDR*, the initial effects of this crisis were felt not only by other Latin American countries but also further afield, in Asian

Table 8

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA^a VIS-A-VIS DEVELOPING COUNTRIES AND EUROPEAN TRANSITION ECONOMIES, 1993-1995

	1993	1994	1995	Stock end-1995
	<i>Percentage increase^b</i>			<i>\$ billion</i>
All developing countries^c	2.7	7.4	12.9	745
<i>of which in:</i>				
America	1.1	0.9	3.0	237
Africa	-7.7	-6.4	-7.5	41
West Asia	1.4	-2.7	4.5	91
South and South-East Asia ^d	8.9	20.5	29.7	368
Central Asia ^e	..	102.0	30.6	1
Europe ^f	-8.0	-4.6	8.0	6
Central and Eastern Europe	-4.0	-15.5	3.3	86
All borrowers ^g	5.1	4.2	9.2	7926

Source: BIS, *International Banking Statistics 1977-1991* (Basle, 1993) and *International Banking and Financial Market Developments*, various issues.

a Including certain offshore branches of United States banks.

b Based on data for end-December after adjustment for movements of exchange rates.

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

d Including Oceania.

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

f Malta and former Yugoslavia in 1993; thereafter, also Bosnia and Herzegovina, Croatia, The former Yugoslav Republic of Macedonia, and Slovenia.

g Including multilateral institutions.

emerging financial markets. However, the more lasting impact involved principally Latin American borrowers. For example, net external issues of debt securities by this group turned sharply downwards in the first quarter of 1995, becoming negative for both bonds and Euro-notes.⁸ The recovery in the second quarter was due mainly to issues by Argentina and Brazil; a revival of issues by Mexican entities began only in the third quarter. As shown by table 10, the experience in 1995 of major Latin American borrowers regarding the yield spreads on international bond issues was mixed, Argentina and Brazil witnessing some rise.

Partly as a result of more difficult conditions, since mid-1995 few countries have issued interna-

tional debt securities for the first time or after a prolonged absence from the international financial markets. Mauritius issued its first international bond in the autumn of 1995. The other main new entrants were from Central and Eastern Europe. They included Slovenia in late 1995 and Romania in the spring of 1996, the latter after achieving re-entry into the market for syndicated bank loans in early 1995. There have recently been several improvements in the credit ratings accorded by the major agencies, Moody's and Standard and Poor's, to the sovereign foreign-currency debt of developing countries and economies in transition. These improvements included the attribution of "investment grade"⁹ by Moody's to the debt of Colombia (which had already received such a

Table 9

TOTAL EXPORT CREDITS^a TO DEVELOPING COUNTRIES AND EUROPEAN TRANSITION ECONOMIES, BY REGION

A. Prevalence of negative flows									
<i>(Percentage of the number of countries in the region or grouping)^b</i>									
Country	1991		1992		1993		1994		1995
	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half
All developing countries^c	42	40	41	39	35	46	45	30	43
<i>of which in:</i>									
Africa	46	36	42	48	52	60	64	44	52
America	41	41	51	46	38	43	38	24	46
West Asia	71	36	57	36	14	50	57	36	57
South and South-East Asia ^d	24	48	17	17	30	45	27	15	36
Central Asia ^e	..	..	..	..	..	..	12	12	-
Central and Eastern Europe ^f	0	57	43	29	43	29	29	43	43

B. Net flow and stock in mid-1995						
<i>(Millions of dollars)</i>						
Country	1991	1992	1993	1994	1995 (first half)	Stocks (end-June 1995)
All developing countries^c	5900	17201	13154	18592	4658	281845
<i>of which in:</i>						
Africa	1361	2583	-444	-39	994	66833
America	3712	4641	4657	2642	-1935	72435
West Asia	2472	1687	2173	487	1140	46815
South and South-East Asia ^d	-1244	8348	6058	15560	4299	90366
Central Asia ^e	..	..	..	533	107	1316
Central and Eastern Europe ^f	10406	8015	5929	-2074	370	53493

Source: BIS and OECD, *Statistics on External Indebtedness, Bank and Trade-related Non-bank Claims on Individual Borrowing Countries and Territories*, new series, various issues.

a After adjustment for effect of movements of exchange rates.

b Excluding countries for which data are not available.

c See note **a** to table 6.

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

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

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

Table 10

**YIELD SPREADS ON INTERNATIONAL BOND ISSUES, BY TYPE OF BORROWER, FOR
SELECTED LATIN AMERICAN COUNTRIES, 1994-1996**

Country	Yield spread ^a (basis points)		
	1994	1995	1996 (Jan. - May)
Argentina			
Public	303	451	437
Private	396	419	519
Brazil			
Public	433 ^b	419	471
Private	395	435	451
Mexico			
Public	240 ^b	407 ^b	408
Private	436	397	514

Source: UNCTAD secretariat estimates.

a The yield spread is the difference between the bond yield at issue and the prevailing yield for the bonds of OECD countries denominated in the same currency and with a comparable maturity.

b Estimate based on two bond issues or a single issue.

rating from Standard and Poor's), Slovakia, Tunisia, Poland and Slovenia (the last two of which also received an "investment grade" rating from Standard and Poor's). For the three European countries mentioned the improvements are part of a rating history marked by steady progress for five economies in transition, namely

Czech Republic, Hungary, Poland, Slovakia, and Slovenia, since 1992 (when Hungary was the only one of the five to have received a rating for its debt).¹⁰ The sovereign foreign-currency debt of all these countries now carries an "investment grade" rating from at least one of the two agencies.

B. Private external financing for selected countries: similarities and contrasts

1. Introduction

As noted in section A, even among developing countries and economies in transition that were major recipients of funds from the international financial markets there was significant variation in the pattern of their major categories of financ-

ing in 1995. Such variation already existed in the earlier 1990s, as may be seen from table 11. Generally, the share of international bank lending in the total for the categories of international financing distinguished in the table was larger for the Asian than for the Latin American countries, reflecting mainly the fact that (with the exception of the Philippines, for which the share was atypically

Table 11

EXTERNAL FINANCING FOR SELECTED DEVELOPING COUNTRIES BY MAJOR CATEGORIES, 1991-1994

Country	Total (\$ billion)	of which		
		Bank loans	Internationally issued portfolio investments ^a	Foreign direct investment
		(Per cent)		
Latin America				
Argentina	31.4	8	47	45
Brazil	21.4	8	64	28
Chile	7.9	25	25	49
Colombia	4.7	9	26	65
Mexico	63.0	15	51	34
Venezuela	9.0	27	36	38
South and South-East Asia				
China	110.2	18	13	70
India	9.1	30	56	14
Indonesia	37.7	65	14	21
Malaysia	32.2	35	7	57
Philippines	7.2	13	53	35
Republic of Korea	34.0	39	52	9
Singapore	25.6	24	7	70
Thailand	39.0	62	16	22

Source: World Bank, *Financial Flows and the Developing Countries*; and IMF, *Private Market Financing for Developing Countries*, November 1995; and BIS, *International Banking and Financial Market Developments*.

^a International bonds and international equity issues.

small) the former region was much less affected by the aftermath of the debt crisis of the 1980s. Thus, if the Philippines is excluded, the share of international bank lending for the Asian countries ranges from 18 per cent to 65 per cent, while of the Latin American countries only Chile and Venezuela have shares above 20 per cent, those of the other four falling in the range of 8 per cent to 15 per cent. With respect to foreign direct investment, the range for the shares of Asian countries is wider than for those of Latin America, the figures for the latter lying between 28 per cent and 65 per cent and those for the former between 9 per cent and 70 per cent. Greater dispersion also characterizes the shares of Asian countries represented by internationally issued portfolio investments, the range being from 7 per cent to more than 50 per cent.

Available information does not make possible a fuller picture of countries' receipt of different categories of external financing, which also include investment in financial instruments issued in domestic financial markets. As noted in section A, such investment by emerging market mutual funds has recently been rising rapidly, and it is also known, for example, that a large proportion of short-term debt instruments recently issued by the Government of Mexico has been held by external investors.¹¹ Moreover, it is reasonable to assume that the progressive incorporation of several developing countries into the global network of financial markets has been accompanied by increases in holdings of domestically issued financial instruments by both financial and large non-financial firms for the purposes of both investment and

risk management. Thus, countries' vulnerability to sudden financial outflows due to external portfolio disinvestment cannot be inferred simply from the shares of categories such as those in table 11 in their total financing from international capital markets. Rather, such vulnerability is associated with perceptions of countries' creditworthiness and economic performance, the possibility of herd behaviour by international investors (such as that manifested towards not only Latin American countries other than Mexico but also other emerging financial markets at the beginning of 1995), and other imperatives of international portfolio management (which include considerations related to exchange-rate risk as well as to returns on investments denominated in their local currencies).

2. *Capital inflows and outflows: selected issues and policy responses*

In the previous sub-section attention was drawn to some broad distinctions between patterns of external financing from international financial markets for major Asian and Latin American recipients in the early 1990s. Table 12 (which also includes figures for three Central European countries) enables a preliminary review to be made of more recent trends. However, owing to the widespread lack of data concerning the net inflow of portfolio investment, an updating to 1995 of figures for the shares of major categories of external financing (such as those in table 11) was not possible at the time of writing.¹²

Three of the countries shown (China, Taiwan Province of China and Venezuela) ran surpluses on current account in at least two of the three years 1993-1995. For the other countries in the table such surpluses were relatively infrequent. In view of the traditional association of FDI with a more durable commitment by investors to the recipient economy it is notable that the proportions of balances on current account represented by such inflows fall within a wide range.¹³ At one extreme China's surpluses on current account were accompanied by large inflows of FDI. The Asian countries for which deficits on current account were associated with relatively large FDI were Indonesia, where FDI as a proportion of the deficit varied from 58 per cent to 95 per cent, and Malaysia, where it varied from 69 per cent to 179 per cent. The proportion was lower for Thailand, varying

between 1 per cent and 21 per cent. For the Latin American countries shown in table 12 there is greater variation, reflecting fluctuations in both FDI and balances on current account.¹⁴ Thus, for Chile FDI as a proportion of the current account deficit varied from 19 per cent to 767 per cent, for Argentina from 12 per cent to 118 per cent, and for Peru from 24 per cent to 100 per cent. In the case of Mexico, for the two years in which it ran substantial deficits on current account, the proportions are relatively low (19 per cent and 28 per cent). The proportions for the Central European countries shown in the table also fall within a wide range - for Hungary, for example, between 27 per cent and 140 per cent and for Poland between 29 per cent and 75 per cent.

The negative net flows of FDI of Taiwan Province of China throughout 1993-1995 and of the Republic of Korea in 1993-1994 reflect substantial outflows. The flow of FDI from firms of Taiwan Province of China to neighbouring countries, for example, was part of a rapid expansion of Asian intra-regional FDI in 1993-1995, which is estimated by Baring Securities to have increased from \$17 billion in 1992 to \$40 billion in 1993, \$52 billion in 1994, and perhaps as much as \$60 billion in 1995.¹⁵ The corresponding figures for intra-regional FDI in Latin America are much lower, only \$4 billion in 1993 and \$11 billion in 1994.¹⁶

For Latin America preliminary figures make possible a more fully articulated survey of certain major financial flows affecting the capital account in 1995. The discussion which follows focuses especially on selected countries from the region which have recently raised substantial sums of money from international financial markets.

According to initial estimates of ECLAC,¹⁷ the net flow of capital to Latin American countries in 1995 amounted to \$22.4 billion.¹⁸ The fall from the previous year's figure of \$44.9 billion was to a significant extent accounted for by the net outflow from Mexico and Venezuela of \$20.5 billion. As already mentioned in section A, flows to the major Latin American recipients of financing from the international capital markets other than Mexico were also adversely affected during 1995 by the Mexican crisis. However, for many categories of external financing the impact was concentrated mainly in the first quarter of the year, and the following nine months were characterized by a return to higher levels of lending.

Mexico's net flow on capital account (without allowance for exceptional financing, mainly in the form of the package put together in response to the crisis) was negative to the tune of \$16.9 billion, largely, it appears, on account of a contraction of foreign portfolio equity investment amounting to \$27.5 billion.¹⁹ The ECLAC estimate for Argentina is a small net capital outflow of \$0.4 billion in 1995 following the inflow of \$10.9 billion in 1994. However, this estimate has to be reconciled with more recent figures from other sources, pointing to substantial inflows for major categories of external financing for which data are available.²⁰ The apparent inconsistency between this estimate of Argentina's overall net capital inflow and those for several of its constituents seems likely to reflect underestimates by ECLAC of net issues of international debt securities (which increased to \$3.7 billion in the fourth quarter, a level more than double that of the second quarter), and possibly also of net FDI.²¹ Brazil's total balance on capital account was \$28 billion in 1995. This figure reflects large net inflows in the form not only of internationally issued securities and international bank lending but also of net purchases of domestically issued instruments.²² A substantial proportion (at least 65 per cent) of both the net issues of international debt securities and net international bank lending was accounted for by Brazilian banks. As noted in recent issues of *TDR*, this net inflow reflects the consequences of Brazilian banks' taking advantage of relatively cheap finance available from international financial markets for profitable on-lending in the local currency. The opportunities for such interest-rate arbitrage are illustrated for short-term borrowing and lending in table 13, but banks also engaged in operations of this kind through longer-term borrowing in forms such as international bonds.

The ECLAC estimate of net capital inflows into Chile in 1995 was \$0.3 billion.²³ In view of other evidence suggesting significant net portfolio investment in Chile's financial markets in 1995,²⁴ the overall figure cited above for the country's net capital inflow may be an underestimate, reflecting, *inter alia*, the unavailability of certain data at the time the estimate was made. Colombia's net balance on capital account was \$4.2 billion.²⁵ Peru's total net capital inflow in 1995 was \$4.6 billion.²⁶ This probably included substantial net purchases by foreigners of domestically issued financial instruments (probably mostly equities). Venezuela experienced a negative balance on capital account of \$3.7 billion.²⁷

As also noted in the annex to this Report, large capital inflows can create problems for macroeconomic policy, as has been the experience of countries in Latin America, Asia and (most recently) Central and Eastern Europe. Some recipient countries have adopted a largely or completely non-interventionist response, allowing the inflows to be reflected in changes in their exchange rates or money supplies (or both). More frequently, however, attempts to overcome the problems have led to shifts in macroeconomic policy (including tighter monetary policy, fiscal sterilization and higher reserve requirements for banks) and to measures bearing more directly on the capital account of the balance of payments. The latter measures have been in the form of taxes and tax-like restrictions on capital transactions designed to increase their costs and thus to reduce their profitability, the imposition of controls over such inflows, and on occasion the relaxation of controls over outflows.

Among Latin American recipients of large net capital inflows Argentina, for example, has adopted a non-interventionist stance, while others have resorted in varying degrees to offsetting measures of macroeconomic policy and to actions directed at transactions affecting the capital accounts. Actions of the latter kind in 1995 included both the introduction of new measures and the adjustment of those taken in earlier years.

For example, for the first time Peru deployed such measures in the form of adjustable reserve requirements for banks. Brazil extended the scope of its transaction taxes on foreign purchases of financial instruments to additional categories of debt and to investment in privatization funds. The minimum maturity on external bond issues by Brazilian companies was raised from two to three years, and a tax of 20 per cent was imposed on withdrawals within 18 months by foreign investors from certain types of mutual funds. Brazil also forbade purchases and sales by foreigners of financial futures and options, with the objective of preventing the construction of synthetic positions in the country's financial instruments which would make possible avoidance of transaction taxes. Chile, a country which is in the process of becoming a significant source of investment and other forms of financing for its neighbours, continued to expand the scope of measures designed to control the pace of its net capital inflows. Reserve requirements were extended to various portfolio investments, including purchases in the secondary market of American Depository Receipts (ADRs). Restriction-

Table 12

FEATURES OF THE BALANCE OF PAYMENTS AND EXTERNAL FINANCING OF SELECTED COUNTRIES IN ASIA, CENTRAL EUROPE AND LATIN AMERICA, 1993-1996

(Billions of dollars, unless otherwise specified)

	ASIA															
	China			Indonesia			Republic of Korea			Malaysia						
	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c				
Current account balance	-11.7	6.5	17.2	..	-2.1	-2.8	-7.8	..	1.0	-3.9	-9.0	-4.1	-2.8	-4.1	-8.4	..
Per cent of GDP	-2.1	1.3	2.6	..	-1.3	-1.6	-4.0	..	0.3	-1.0	-2.0	..	-4.4	-5.9	-10.0	..
Net direct investment	23.1	31.8	38.0	..	2.0	2.1	4.5	..	-0.8	-1.7	1.5	..	5.0	4.3	5.8	..
Net portfolio investment ^a	3.0	3.5	..	..	1.8	1.1	..	..	10.5	6.9	..	..	-0.7	-1.6	..	..
Securitized debt claims (per cent of total external debt)	8.8	11.0	..	..	2.3	3.6	..	..	21.0	21.3	..	..	16.9	15.5	..	..
Bank claims (per cent of total external debt) ^b	54.6	51.6	..	..	42.2	41.7	..	..	68.4	61.1	..	..	57.7	53.5	..	..
	ASIA (cont.)															
	Taiwan Province of China			Thailand			Czech Republic			Hungary						
	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c
Current account balance	6.7	6.2	5.0	1.5	-7.0	-8.4	-13.5	..	0.7	-0.1	-2.1	-0.5	-4.3	-4.1	-3.0	-0.8
Per cent of GDP	3.0	2.6	1.9	..	-5.6	-5.9	-8.3	..	2.2	-0.2	-4.6	..	-11.1	-9.8	-6.9	..
Net direct investment	-1.5	-1.1	-1.1	..	1.5	0.1	2.3	..	0.6	0.8	1.0	0.3	2.3	1.1	4.2	0.4
Net portfolio investment ^a	1.1	0.9	0.5	..	5.5	2.5	..	..	1.6	0.8	..	-0.1	3.9	2.5	..	0.2
Securitized debt claims (per cent of total external debt)	2.2	8.8	..	..	5.5	5.4	..	..	30.8	31.0	..	..	43.7	50.0	..	..
Bank claims (per cent of total external debt) ^b	90.2	84.4	..	..	66.3	71.4	..	..	58.8	67.6	..	..	32.0	29.3	..	..

Table 12 (concluded)

	CENTRAL EUROPE (cont.)						LATIN AMERICA									
	Poland			Argentina			Brazil			Chile						
	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c				
Current account balance	-5.8	-2.5	-2.4	0.1	-7.5	-10.2	-3.3	..	-	-1.2	-17.9	..	-2.1	-0.8	-0.3	..
Per cent of GDP	-6.7	-2.8	-2.1	..	-2.9	-3.6	-1.1	..	-	-0.2	-2.5	..	-4.6	-1.5	-0.5	..
Direct investment	1.7	1.8	1.8	-0.3	6.3	1.2	3.9	..	0.8	2.0	3.1	..	0.4	0.9	2.3	..
Portfolio investment ^a	-	-0.6	..	0.2	8.0	..	..	..	12.3	44.7	..	..	0.7	1.0	..	..
Securitized debt claims (per cent of total external debt)	-	-	..	..	11.5	17.4	..	..	8.7	12.8	..	..	4.5	3.5	..	..
Bank claims (per cent of total external debt) ^b	24.6	18.2	..	..	42.5	42.2	..	..	63.6	62.8	..	..	58.0	62.5	..	..
	LATIN AMERICA (cont.)															
	Colombia			Mexico			Peru			Venezuela						
	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c	1993	1994	1995	1996 ^c
Current account balance	-2.1	-3.0	-3.8	..	-23.4	-28.8	-0.2	-0.5	-1.7	-2.3	-0.9	..	-2.0	2.5	1.7	..
Per cent of GDP	-4.0	-4.9	-5.0	..	-6.4	-7.6	-0.1	..	-	-	-1.6	..	-3.3	4.2	2.2	..
Direct investment	0.9	1.0	1.2	..	4.4	8.0	4.1	..	0.4	2.3	0.6	..	-0.5	0.2	0.2	..
Portfolio investment ^a	0.1	0.3	..	..	28.4	7.6	..	..	0.2	0.6	..	..	0.6	0.3	..	..
Securitized debt claims (per cent of total external debt)	3.5	5.9	..	..	17.0	20.0	..	..	-	-	..	..	11.0	11.5	..	..
Bank claims (per cent of total external debt) ^b	46.0	48.6	..	..	62.8	61.4	..	..	19.2	21.8	..	..	61.2	57.6	..	..

Source: Data of BIS, ECLAC, IMF, World Bank, OECD, and J.P. Morgan. For more details see the text at the end of the Notes to this chapter.

^a Externally issued bonds, other securitized debt instruments and equities.

^b At end of year.

^c First quarter.

Table 13

REPRESENTATIVE EXCHANGE-RATE-ADJUSTED MONEY-MARKET RATES OF INTEREST IN BRAZIL AND DIFFERENTIAL RETURNS AS COMPARED WITH UNITED STATES RATES

(Returns, and differential returns, in percentage points after adjustment for changes in exchange rates for the dollar)^a

	1994	1995
<i>Return</i>		
Monthly average	4.69	2.43
Annualized monthly average	73.36	33.46
<i>Differential return^b</i>		
Monthly average	4.34	1.99
Annualized monthly average	66.56	26.62

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

Note: The Brazilian rates of interest relate to "hot money".

a Exchange rate adjustments on the basis of end-of-month exchange rates.

b Difference between return and that on United States Treasury bills.

tions were placed on banks' use of the formal foreign-exchange market, with the objective of reducing currency speculation. The restrictions were intended to reduce liquidity in the spot market and make it more volatile, thus increasing the risk associated with certain currency transactions. These measures were accompanied by a reduction of the minimum size of ADR issues by Chilean companies. At the same time, there was a continuation of the policy of selectively liberalizing restrictions on capital outflows. The range of permissible foreign investment options for Chilean banks and institutional investors abroad was broadened, thus facilitating international portfolio diversification and treasury management.

Examples of policy responses by Asian countries to large capital inflows since mid-1995 are provided by Thailand and Indonesia. In Thailand external capital inflows during the first quarter of 1996 were associated with an expansion of foreign assets of no less than 50 per cent of the country's monetary base. At the time of writing Thailand's response had not taken the form of measures directed specifically at the inflows but rather of credit controls, of the imposition on banks

of a shift to cash deposits with the central bank for reserve requirements hitherto held in the form of liquid assets, and of larger and more stringent capital requirements.²⁸ In Indonesia capital inflows in early 1995 led to an expansion of credit by the financial system substantially in excess of the targets of monetary policy. So far the response has been an increase in reserve requirements and a widening of the central bank's intervention band for the exchange rate. The latter measure provides additional policy flexibility to the authorities, and is also intended to increase the foreign-exchange risk associated with capital inflows.²⁹ Another Asian country which has experienced a large net capital inflow in early 1995 is the Philippines. The inflow has been reflected in a rise in reserves of 30 per cent in the first five months but has not yet brought a policy response from the Government.³⁰

An interesting recent development is that analogous problems for macroeconomic management posed by capital inflows are now being experienced for the first time by a number of Central and Eastern European economies, and in some cases have led to policy responses similar to those already tried in Latin America and Asia. At the

beginning of 1996 Slovakia increased the intervention band for the country's exchange rate from 3 per cent to 6 per cent.³¹ In February the Czech Republic increased its intervention band from 1 per cent to 15 per cent, a step taken in response to a capital inflow of \$8.4 billion in the early months of 1996.³² Net capital inflows into Poland have also recently substantially increased.³³ In the first

two months of 1996 they are estimated to have reached \$2.1 billion, of which about \$0.5 billion was FDI and about \$1 billion was short-term. The response to the resulting rise in reserves has so far taken the form of sterilization, but such a policy may eventually conflict with the Government's objective of promoting investment through low interest rates.

C. The terms of export credits and trade financing arrangements

As noted in section A, although net flows of export credits to developing countries increased in 1994 and the first half of 1995, the experience of different regions varied widely, those to sub-Saharan Africa being negative in 1994, as were those to Latin America in the first half of 1995. Moreover, the countries of Central and Eastern Europe registered a substantial net outflow in 1994. The relative importance of export credits as a source of external financing also differs among major regions. For example, the share of the external debt of countries of sub-Saharan Africa accounted for by export credits was 28 per cent at the end of 1994, while for Asia and Latin America it was respectively 13 per cent and 18.5 per cent.³⁴ The conditions on which this category of external financing is made available are also of more general interest as an indicator of countries' creditworthiness, and the same is true of the conditions attached to credit insurance from the private market. Thus, for example, these conditions are generally correlated with the costs of financing and payments arrangements other than credit insurance for imports, such as charges on letters of credit. The prevalence of high costs and restrictive conditions on credit insurance for developing countries serves to bring out in another way the general point already made in section A that, in spite of the recent revival of external financing for certain developing countries and economies in transition, access to such financing for the great majority of these countries remains highly restricted.

Export credits are determined by the interaction of demand and supply. Thus they respond not

only to costs but also to economic conditions in recipient countries, and in particular to the pace of investment, owing to the role of export credits in the financing of capital goods. But the discussion which follows focuses principally on the cost side and its relation to financing and payments arrangements more generally.

The costs of private export credits³⁵ consist of interest, premiums on official insurance, and various other transaction costs associated with restrictive conditions on which such insurance cover is made available. The interest rates on the financing of exports to developing countries are either commercial rates (linked to the rates at which the providers of the finance can borrow) or minimum rates for lending in different currencies under the OECD Arrangement on Guidelines for Officially Supported Export Credits, the so-called OECD Consensus.³⁶ The insurance premiums typically consist of a basic rate, which varies with characteristics of the credit such as the payments arrangement used and the maturity of the loan.³⁷ Supplementary premiums may then be added to the basic rates at levels which reflect a country's creditworthiness and recent record of making international payments.³⁸ For less creditworthy borrowers official insurance is generally provided only subject to various restrictive conditions relating to the proportion and amount of the credit for which cover is available, the limit on the amount of money below which the exporter or bank can exercise discretion in granting insured credits, the length of the period after the occurrence of non-payment before claims are met (the claims-waiting

Table 14

COMMERCIAL INTEREST REFERENCE RATES^a

Currency	1995		1996 (up to May)	
	High	Low	High	Low
Australian dollar	11.3	9.1	9.6	8.7
Austrian schilling	8.3	7.1	6.9	6.3
Belgian franc	9.3	7.8	7.7	7.2
Canadian dollar	(1) ^b 10.2	8.0	7.6	6.8
	(2) ^c 10.2	8.4	8.1	7.5
	(3) ^d 10.3	8.5	8.5	7.9
Danish krone	9.1	7.9	7.5	6.8
Finnish markka	10.6	7.9	7.8	7.1
French franc	9.0	7.8	7.5	6.9
Deutsche mark	8.3	6.7	6.6	6.0
Irish punt	9.8	8.5	8.1	7.5
Italian lira	12.3	10.3	10.8	9.4
Japanese yen	4.7	2.5	3.4	2.4
Netherlands guilder	(1) ^b 8.3	6.4	6.2	5.6
	(2) ^c 8.5	7.0	6.9	6.3
	(3) ^d 9.1	7.9	7.8	7.3
New Zealand dollar	10.0	8.2	9.9	8.1
Norwegian krone	8.7	7.4	7.0	6.7
Spanish peseta	13.1	11.5	11.6	9.6
Swedish krona	11.9	10.0	9.7	8.7
Swiss franc	6.5	5.2	5.2	4.9
Pound sterling	9.7	8.5	8.5	7.9
United States dollar	(1) ^b 8.7	6.8	7.1	6.1
	(2) ^c 8.8	6.9	7.3	6.4
	(3) ^d 8.8	7.0	7.5	6.5
ECU	8.9	7.4	7.2	6.6
SDR ^e	7.4	6.6	..	..

Source: OECD press releases and publications.

a Minimum interest rate for officially supported export credits denominated in specified currencies or weighted averages of currencies advanced by participants in the OECD Arrangement on Guidelines for Officially Supported Export Credits (the OECD Consensus).

b Maturity of less than five years.

c Maturity of from five to eight-and-a-half years.

d Maturity of more than eight-and-a-half years.

e The SDR rate was abolished from 31 August 1995.

period), and the types of security required (which may consist of a guarantee from a national public entity in the importing country or a letter of credit issued by one of its banks and confirmed by a bank in an OECD country). Although the effect on the costs of export credits may be hard to quantify, such restrictions all entail increases. If percep-

tions of a country's creditworthiness become sufficiently unfavourable, export credit insurance may cease to be available even at high premiums and with extremely restrictive conditions. However, not all export credit agencies (ECAs) necessarily cut off insurance cover for a country at the same time. It should also be emphasized that the avail-

Table 15

**TERMS^a OF INSURANCE COVER AVAILABLE TO SELECTED REGIONS
FROM SELECTED EXPORT CREDIT AGENCIES^b**

(Number of instances^c in which EXIM, ECGD or NCM applied specified terms)

Region / period	Normal terms ^a		No cover ^a		Restrictive conditions ^a	
	Short-term ^d	Medium- and long-term ^e	Short-term ^d	Medium- and long-term ^e	Short-term ^d	Medium- and long-term ^e
Africa						
Late 1994/early 1995	9	11	20	45	43	16
Late 1995/early 1996	9	11	18	45	45	16
Latin America						
Early 1995	8	13	4	18	40	21
Early 1996	8	13	5	16	39	23
South and South-East Asia^f						
Early 1995	17	18	4	15	33	21
Early 1996	17	21	4	11	33	22
Central and Eastern Europe						
Late 1994	3	3	8	13	13	8
Late 1995	3	6	8	13	13	5

Source: Exporter's regional guides and credit surveys in *Project and Trade Finance*, various issues.

- a** Normal terms apply when cover is available to a borrower subject to no restrictive conditions. Such conditions include surcharges and restrictions on the availability of insurance cover and reflect mainly the perceived riskiness of the provision of financing to the borrower in question. The number and stringency of the conditions vary. For some borrowers cover is not available on any terms.
- b** The Export-Import Bank (EXIM) of the United States, the Export Credits Guarantee Department (ECGD) of the United Kingdom, and the Nederlandsche Creditverzekering Maatschappij (NCM).
- c** Each country for which information is available corresponds to two instances for the terms available on its insurance cover for short-term credits, one for EXIM and one for NCM, and likewise to two instances for the terms available on its cover for medium- and long-term credits, one for EXIM and one for ECGD.
- d** Insurance cover for credits with maturities up to 180 days, except in the case of credits from EXIM for certain equipment goods and bulk agricultural commodities, for which maturities up to 360 days are also classified as short-term.
- e** Insurance cover for credits other than short-term.
- f** Including Oceania.

ability of official export credit insurance and interest obligations should not be regarded as independent determinants of the cost of export credits. The risk premiums included in the interest rates on trade financing, which can represent a substantial proportion of total rates, may well be significantly reduced for credits carrying official insurance or guarantees.

As is shown in table 15, for the majority of developing countries and economies in transition

credit insurance cover is available from EXIM, ECGD and NCM only on restrictive conditions or not at all. Even for the countries of South and South-East Asia cover was available on normal terms in early 1996 only in approximately one third of instances.³⁹ For countries of Latin America the proportion was about 15 per cent for short-term and 25 per cent for medium- and long-term credits, while the proportions for Africa were respectively 13 per cent and 15 per cent and for Central and Eastern Europe 13 per cent and 25 per

Table 16

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

(Number of instances)

Region	From late 1994/early 1995 to late 1995/early 1996	
	More favourable terms ^a	Less favourable terms ^a
Africa	3	0
Latin America	10	9
South and South-East Asia ^c	7	1
Central and Eastern Europe	3	0

Source: Exporter's regional guides and credit surveys in *Project and Trade Finance*, various issues.

- a** All instances in which there has been a change in the terms of export credit insurance cover available from EXIM, ECGD or NCM between the categories, "normal cover", "no cover", and "restrictive conditions". (For "instances" and these three categories see notes a and c to table 15) Such changes are recorded separately for short-term and for medium- and long-term credits.
- b** The Export-Import Bank (EXIM) of the United States, the Export Credits Guarantee Department (ECGD) of the United Kingdom, and the Nederlandsche Creditverzekering Maatschappij (NCM).
- c** Including Oceania.

cent (the latter figure having doubled since early 1995). Cover was completely unavailable much more frequently in the case of medium- and long-term credits than of short-term credits, the proportion of instances being almost two thirds for African countries (in comparison with 25 per cent for short-term credits), 54 per cent for countries of Central and Eastern Europe (33 per cent for short-term credits), 31 per cent for Latin American countries (10 per cent for short-term credits), and 20 per cent for countries of South and South-East Asia (7 per cent for short-term credits).

Generally, the conditions associated with the availability of official credit insurance are characterized by a fairly high degree of inertia. But, as shown in table 16, during 1995 there were several shifts between the three categories according to which these terms are classified. This greater vari-

ability was particularly notable for Latin America, where, for example, Brazil was accorded "normal terms" by EXIM and Venezuela experienced unfavourable shifts from both ECGD and NCM. The terms associated with the provision of private credit insurance also shift slowly, and here 1995 was no exception. The main movements in this market involved countries of Central and Eastern Europe, two of which (Bulgaria and Poland) experienced an improvement in the terms on which credit insurance was available from this source.

The prevalence of restrictive conditions for both official and private credit insurance cover reflects not only perceptions of borrowers' credit-worthiness but also restrictions on supply due to operating constraints of the institutions writing the insurance. For private insurers such constraints are not easy to document, but for ECAs they reflect partly long-term obligations to be self-supporting in their commercial operations. Widespread interruptions of debt service have been reflected in the profit performance of ECAs since the mid-1980s. But, as is shown in table 17, this performance has been improving since 1992, so that it is reasonable to assume that pressures on ECAs from this source to impose restrictive conditions have begun to diminish.

Perceptions of borrowing countries' credit-worthiness and their relation to transactions costs in their trade are also evident from data other than the conditions associated with official export credit insurance, such as the preferred payment terms in the export credit and collection surveys in the bi-weekly *Financial Times* newsletter, *International Trade Finance*. The preferred payments terms in these surveys are "open account", "sight draft" or "cash against documents (CAD)", "unconfirmed letter of credit", "confirmed letter of credit", and "cash in advance".

Under *payment on open account* an invoice is sent to the importer at the same time as the shipping of the goods, payment being specified within a predetermined period. This arrangement requires no intermediary, so that the associated transaction costs are at a minimum. However, it is also based on trust and is used mainly in trade between entities (such as inter-related companies) with a history of satisfactory transactions. The terms *sight draft* and *CAD* refer to transactions in which the documents conferring title to goods are released to the importer only against payment by sight draft or on his acceptance of a time draft. A sight draft or bill

Table 17

PROPORTION OF EXPORT CREDIT AGENCIES^a IN SELECTED OECD COUNTRIES THAT INCURRED CASH-FLOW DEFICITS, 1985-1994

(Percentage)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Proportion:	74	70	83	65	65	71	83	83	54	33

Source: Information supplied by the Berne Union.

a 1985-1989: 23 agencies in 19 countries; 1990-1991: 25 agencies in 20 countries; 1992-1994: 24 agencies in 20 countries.

of exchange is an unconditional order addressed by one party to another, requiring the latter to pay a specified sum on demand or at a fixed future date. Since such a bill is a negotiable instrument (which can be turned into cash immediately), the exporter thus obtains greater security than in the case of payment on open account. This arrangement does not require the interposition of a bank, and the associated costs are low. In the case of a time draft, payment is to be made at a specified time in the future (so that there is an additional risk that the accepted draft may not be paid at maturity). A *letter of credit* is a written undertaking by a bank in response to the instructions of the applicant (the importer) to make payment to the beneficiary (the exporter) against prescribed documents. It provides the exporter with insurance against the commercial risk of non-payment by the importer since its validity is independent of the underlying transaction. However, especially when the bank issuing the letter of credit is a local institution in the importer's country, the exporter is not protected from political risk resulting from events in the importer's country such as the unavailability of foreign exchange or the imposition of foreign-exchange controls which make fulfilment of the contractual obligation impossible. This risk can be removed by a *confirmed letter of credit* under which another bank, typically in the exporter's country, adds its commitment to pay to that of the issuing bank. Confirmation of the letter of credit results in charges by the confirming bank additional to those of an unconfirmed letter of credit (which

consist of the fees of the issuing bank and others associated with arranging for the payment to be made). In the case of *cash in advance*, delivery of the goods is authorized by the exporter only after actual receipt of money from the importer. This arrangement is used for transactions with a particularly high risk of non-payment. The first two of the preferred payment terms in the surveys of *International Trade Finance* are appropriate for transactions carrying low degrees of payments risk, and the latter three for successively greater degrees.⁴⁰

The distribution of countries of different regions by recommended payments terms is shown in table 18. It can be seen that 85 per cent of developed countries benefit from the terms associated with lowest payments risk and transaction costs, whereas for regions consisting of developing countries and economies in transition the proportions vary from 25 per cent (for South and South-East Asia) to zero. For developing countries and economies in transition the greatest concentration of preferred payments terms is to be found in the categories of confirmed and unconfirmed letters of credit. Correspondence between rankings of countries' creditworthiness on the basis of recommended payments terms in *International Trade Finance*, on the one hand, and the restrictiveness of conditions associated with official credit insurance, on the other, is imperfect. Nevertheless, the distribution of countries according to the former broadly confirms the prevalence of unfavourable perceptions evident in the latter.⁴¹

Table 18

**RECOMMENDED PAYMENTS ARRANGEMENTS FOR SELECTED DEVELOPING COUNTRIES
AND TRANSITION ECONOMIES OF CENTRAL AND EASTERN EUROPE**

(Percentage distribution)^a

<i>Region</i>	<i>Arrangement</i>	<i>Open account</i>	<i>CAD^b sight draft</i>	<i>Unconfirmed letter of credit</i>	<i>Confirmed letter of credit</i>	<i>Cash in advance</i>
Latin America		-	12	68	20	-
Africa		-	-	48	41	10
South and South-East Asia		6	19	44	31	-
Central and Eastern Europe		-	-	42	50	8
Memo item:						
Developed countries		31	54	15	-	-

Source: *International Trade Finance*, 19 January 1996.

a Data refer to the situation in early 1996.

b Cash against documents.

D. Renegotiation and reduction of bank debt

Since mid-1995 renegotiation and restructuring of debts to commercial banks have continued for countries from all regions. A number of Latin American countries and a major transition economy are at various stages of restructurings involving a spectrum of different options to creditors in accordance with the approach adopted in major renegotiations since the beginning of the 1990s. Some low-income countries have undertaken buy-back operations with multilateral and bilateral official support. Moreover, there has been progress towards an agreed distribution of liabilities associated with external debts among the new States of Central and Eastern Europe. These negotiations have covered the debts of the former USSR and the external assets, as well as liabilities, of the former republics of Yugoslavia (and in the latter case involve issues on which definitive agreement has not been reached).

In October 1995, Peru reached an agreement in principle to restructure \$4.2 billion of principal and \$3.5 billion of interest arrears. The menu of

options for creditor banks includes a buy-back and a 45 per cent discount bond. In the same month, Panama reached an agreement to restructure \$2 billion of principal and \$1.5 billion of interest arrears owed to banks. Options for creditor banks include a 45 per cent discount bond with a 30-year maturity and a par bond with an increasing interest rate (both bonds having grace periods). Expectations that the debt problems of major countries in Latin America had definitively receded were set back by the Mexican crisis which began in late 1994. As is documented above, the virtual exclusion of major countries of this region from international securities markets which followed the outbreak of this crisis proved short-lived. However, Venezuela is now thought likely to initiate negotiations on rescheduling that portion of its debt to commercial banks which was not part of the restructuring agreement in 1990.

Following completion of lengthy negotiations on the status of its commercial bank debt after the breakup of the USSR, in November 1995 the Rus-

sian Federation reached an agreement to reschedule \$25.5 billion of principal and \$7 billion of interest arrears. The principal will be repaid over 25 years, with a seven-year grace period, at a margin over the interbank lending rate. Of the interest arrears, \$500 million will be paid at closing and \$1.5 billion by the end of 1996; the balance will be exchanged for interest notes with a 20-year maturity (with the same grace period and interest rate as apply to rescheduled principal).

In June 1995 Algeria concluded an agreement with its creditors to reschedule \$3.2 billion of commercial bank debt, a figure which includes \$1.5 billion already rescheduled in February 1992. The rescheduling covers 71 per cent of the total \$4.5 billion outstanding. The rescheduled debt is to be repaid according to new maturities at a margin over the interbank lending rate.

In May 1996 Viet Nam agreed in principle with its bank advisory committee on a menu of options to restructure its \$900 million of debt to commercial banks. The options for creditors include a cash buy-back and par and discount bonds, both with 30-year maturities. Interest arrears are to be exchanged for past-due-interest bonds with 18-year maturities. The package includes debt reduction of 50 per cent.

Nicaragua, Sierra Leone and Albania completed buy-backs of commercial bank debt in 1995. In November 1995 Nicaragua bought back \$1.1 billion of its outstanding commercial bank debt, or 81 per cent of the total of \$1.4 billion, as part

of a deal also involving cancellation of some interest claims. The buy-back was funded by a grant of \$40 million from the IDA Debt Reduction Facility,⁴² a \$40 million loan from the Inter-American Development Bank, and grants from the Governments of the Netherlands, Sweden and Switzerland. The purchase price was 8 cents per dollar. In August 1995 Sierra Leone completed a buy-back of \$234 million of commercial bank debt. \$160 million was bought back in May 1995 for 15 cents on the dollar and the remaining \$74 million in August for 8 cents on the dollar. The cost of \$31.5 million was met from the IDA Debt Reduction Facility and from bilateral European donors. In July 1995, under the sponsorship of the IDA Debt Reduction Facility, Albania reached an agreement with its creditor banks which comprised conversion of the \$130 million of debt into 30-year par bonds, whose principal is collateralized by zero-coupon United States Treasury bonds of the same maturity, and the buy-back of \$370 million at 26 cents on the dollar. The debt was mostly short-term and trade-related and included interest arrears. In order to make the par bonds close in value to the buy-back option, each bondholder received the right to a pro-rata share of the distribution of an Income Fund consisting of a managed portfolio of emerging market instruments. The proceeds of the Fund will be invested with the aim of generating income comparable to the value of interest payments on the par bonds. The cost of the operation was \$97 million, of which \$55 million were provided by Albania, \$24 million by the Debt Reduction Facility, and the rest by other sources.

E. Official debt

The severe difficulties that heavily indebted poor countries (HIPC)⁴³ continue to experience in servicing their debt and the perception that the debt overhang poses a serious impediment to growth and development have thrust the multilateral debt issue into prominence. Debt owed to multilateral institutions accounts for an important and rising portion of total indebtedness and an even larger share of total debt service for these coun-

tries. It has become increasingly clear that existing debt relief mechanisms will not suffice to bring the debt burden of a significant number of these countries to a sustainable level. It is now generally agreed that a lasting solution to their debt problems requires a comprehensive and coordinated approach, involving stronger measures and a sharing of the burden among all creditors, including multilateral financial institutions (MFIs). The

framework for action to resolve the debt problems of HIPC's, which was proposed by IMF and the World Bank and welcomed by both the Interim Committee and the Development Committee at their spring 1996 meetings, is an official recognition of the need for a comprehensive debt strategy and represents a commitment to act decisively to ease the burden of multilateral debt. It addresses the concerns of the 29 debt-distressed LDCs which are categorized by IMF/World Bank as HIPC's. The proposal offers hope for LDCs and other poor countries with a proven track record of economic reform and structural adjustment to attain debt sustainability. It is in the interest of all parties concerned that growth in these countries be resumed as rapidly as possible.

1. Multilateral debt

(a) Recent developments regarding the multilateral debt of HIPC's

In 1994, the total multilateral debt of HIPC's amounted to around \$62 billion, of which almost 70 per cent was concessional. With multilateral debt accounting for the bulk of new loans, its share continued to rise, reaching over 25 per cent of the total external debt of \$241 billion in 1994. Multilateral debt service in that year amounted to over \$4 billion, representing over 46 per cent of total debt service (see table 19), or about 9 per cent of exports of goods and services.

The grave difficulties which these countries continue to encounter in servicing their debt are reflected in actual debt service payments to all creditors, amounting in 1994 to just over one third of debt service due.⁴⁴ As a result, arrears continued to mount, reaching \$74 billion by the end of that year. However, since priority has been given to the servicing of multilateral debt, the problem of arrears is relatively much greater for bilateral debt. Although practically all HIPC's registered arrears, those with protracted arrears (i.e. of six months or more) with the World Bank and IMF number only four. As shown in table 19, debt profiles vary considerably among countries, with multilateral debt accounting for over 50 per cent of total debt in 13 cases.

As for the structure of multilateral debt by source, the World Bank was the largest creditor in

1994, accounting for 55 per cent of the total; followed by the regional development banks (22 per cent) and IMF (12 per cent).⁴⁵ Net transfers from multilateral financial institutions to the group as a whole have consistently been positive and substantial, totalling over \$2 billion in 1994.

(b) Current policies affecting the burden of multilateral debt⁴⁶

Three MFIs - the World Bank, IMF and the African Development Bank - dominate the multilateral debt scene. Together, they accounted for over 82 per cent of the multilateral debt of HIPC's in 1994, so that action taken on their debt would be critical to the resolution of the multilateral debt problem. In addition to measures by MFIs, an innovative scheme entirely financed by bilateral donors was recently established in Uganda, involving the creation of a multilateral debt fund (see box 1).

(i) Increased concessionality of debt

The soft windows of MFIs were established to support the development efforts of low-income countries. The debt crisis reinforced the importance of and the need for providing financial support, on terms more closely suited to debtors' capacity to pay, not only for development projects but also for implementing policy reforms and overcoming chronic balance-of-payments difficulties. This is a good preventive approach, and for those countries already encountering serious debt-servicing problems improving the concessionality of debt has eased their burden, as it led in effect to implicit refinancing of loans contracted on near-commercial terms with funds secured on softer terms. This was the basic strategy adopted by the Bretton Woods institutions to provide debt relief.

The International Development Association (IDA), the soft window of the World Bank, is the most important channel for providing highly concessional financing to low-income countries. In 1994, it accounted for 44 per cent of the multilateral debt of HIPC's. The cessation of non-concessional IBRD lending in almost all of these countries and the sustained rise in IDA disbursements have resulted in significant positive net transfers from the Bank. Net transfers from the World Bank rose sharply (by 78 per cent) in 1994, reaching \$1.4 billion.

Table 19

DEBT STATISTICS FOR HEAVILY INDEBTED POOR COUNTRIES, 1994

(Millions of dollars and percentage shares)

Country	Debt			Debt service			Debt service due	Arrears	Net transfers on debt-creating flows	
	Total	Multilateral	Share of multilateral (Per cent)	Total	Multilateral	Share of multilateral (Per cent)			Total	Multilateral
All HIPC's	240 725	62 157	25.8	9 085	4 223	46.5	26 654	74 017	-2 370	2 174
Angola	10 609	159	1.5	74	-	-	1 085	4 747	69	33
Benin	1 619	856	52.9	41	22	53.7	52	42	86	94
Bolivia	4 749	2 539	53.5	343	215	62.7	426	137	131	128
Burkina Faso	1 126	927	82.3	44	37	84.1	43	47	100	88
Burundi	1 126	937	83.2	41	30	73.2	41	13	16	19
Cameroon	7 275	1 664	22.9	374	237	63.4	1 068	983	88	71
Central African Republic	891	632	70.9	23	20	87.0	80	65	20	38
Chad	816	633	77.6	15	11	73.3	25	49	55	60
Congo	5 275	717	13.6	555	174	31.4	1 524	1 076	-262	85
Côte d'Ivoire	18 452	3 695	20.0	1 274	606	47.6	2 144	3 646	-919	154
Equatorial Guinea	291	120	41.2	2	2	75.0	22	110	15	5
Ethiopia	5 059	2 196	43.4	92	50	54.3	414	1 022	178	216
Ghana	5 389	3 370	62.5	343	165	48.1	322	150	182	27
Guinea	3 104	1 376	44.3	97	36	37.1	244	559	77	115
Guinea-Bissau	816	369	45.2	7	4	57.1	69	222	19	9
Guyana	2 038	787	38.6	97	66	68.0	165	148	-51	-20
Honduras	4 418	2 171	49.1	433	283	65.4	468	217	36	-88
Kenya	7 273	3 159	43.4	888	251	28.3	1 356	100	-597	-62
Lao People's Dem. Rep.	2 080	576	27.7	20	7	35.0	20	-	56	59
Liberia	2 056	769	37.4	15	15	100.0	160	1 469	-14	-15
Madagascar	4 134	1 683	40.7	60	49	81.7	419	1 425	-	21
Mali	2 781	1 340	48.2	130	61	46.9	198	406	21	94
Mauritania	2 326	916	39.4	105	70	66.7	188	364	42	60
Mozambique	5 491	1 266	23.1	91	36	39.6	361	1 159	191	226
Myanmar	6 502	1 458	22.4	173	35	20.2	577	1 778	-111	-23
Nicaragua	11 019	1 363	12.4	183	70	38.3	1 463	5 816	-65	132
Niger	1 570	888	56.6	66	31	47.0	242	65	7	49
Nigeria	33 485	4 807	14.4	1 916	812	42.4	5 799	10 238	-1 818	-201
Rwanda	954	762	79.9	6	6	85.9	32	70	-18	14
Sao Tome and Principe	252	167	66.3	3	2	85.2	9	58	7	12
Senegal	3 678	2 075	56.4	197	154	78.2	465	289	-74	28
Sierra Leone	1 392	479	34.4	146	124	84.9	186	90	38	71
Somalia	2 616	938	35.9	-	-	-	171	1 519	-	-
Sudan	17 710	3 016	17.0	1	-	-	1 271	13 390	7	7
Togo	1 455	764	52.5	24	21	87.5	112	196	44	35
Uganda	3 473	2 411	69.4	152	104	68.4	173	313	186	201
United Rep. of Tanzania	7 442	2 855	38.4	174	114	65.5	548	2 472	108	91
Viet Nam	25 115	512	2.0	300	13	4.3	2 456	9 494	88	291
Yemen	5 959	1 207	20.3	145	61	42.1	360	2 550	13	53
Zaire	12 336	2 804	22.7	66	7	10.6	1 294	5 539	-201	-5
Zambia	6 573	2 794	42.5	369	223	60.4	602	1 984	-120	2

Source: UNCTAD secretariat calculations, based on *World Debt Tables 1996* (Washington, D.C., 1996), Vol. 2.

Box 1**THE UGANDA MULTILATERAL DEBT FUND**

Even after a commercial debt buy-back and a stock-of-debt operation on Naples terms, Uganda's debt situation remained unsustainable because of the heavy burden of multilateral debt, which accounted for almost 70 per cent of its total debt and debt service in 1994. With the financial support of a group of donors (Austria, Denmark, Netherlands, Sweden and Switzerland), the Uganda Multilateral Debt Fund (UMDF) was established in July 1995. The creation of UMDF involved a comprehensive assessment of debt sustainability in which the Government of Uganda played a leading role, in consultation with the donors and the Bretton Woods institutions. It was made possible by Uganda's good policy track record, and donor contributions are contingent on continued adjustment efforts. To further safeguard against moral hazard, there are specific commitments on fiscal and reserves management, as well as limits on new borrowings.

It needed only pledges in principle from three major donors of around \$30 million to launch the Fund. This had a catalytic effect in generating pledges from other donors. However, the request for contributions from IMF and the World Bank was not successful. The UMDF will pay a portion of the debt service as it falls due, with donors providing an up-front contribution, to the extent possible, at the beginning of each financial year. Allowance has been made to provide donors with flexibility with regard to payment methods and timing. The Fund is managed by the Government of Uganda. Such responsibility has encouraged improvements in debt management, as well as in fiscal and reserves management. Coordination is achieved through the annual Consultative Group meeting and local quarterly meetings called by the Government, with the participation of donors and the Bretton Woods institutions.

The UMDF is the first country fund which focuses on multilateral debt relief. Its efficient payments method has avoided even transitory arrears. As for the possible applicability of this approach to other LDCs or to other poor countries, it would require the existence of a global coordination mechanism to establish clear criteria of need and adjustment track records and, of course, willing donors. In some donor countries, such as those that have launched this fund, there is strong political support for debt relief based on the perception that the debt overhang is a key barrier to development in some poor countries, and that debt relief is more valuable than other forms of aid because removing the overhang would improve growth prospects for debtors and reimbursement prospects for creditors.

The IMF/World Bank proposed framework for action to resolve the debt problems of HIPC's includes as options the creation of a special (multi-country) trust fund and/or single-country trust funds to which multilateral development banks and bilateral donors could contribute. Thus, country funds similar to UMDF could very well fit into this scheme.

Source: M. Martin, "A Multilateral Debt Facility: Global and National", Report to the Group of 24, 31 March 1996, to be reproduced in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. VIII (forthcoming).

The Enhanced Structural Adjustment Facility (ESAF) is regarded by IMF as the centrepiece of its strategy to resolve the debt problems of HIPC's. For these countries as a whole, concessional debt to the Fund increased substantially over the past two years - by 24 per cent in 1994 and a further 41 per cent in 1995. This led to a largely enhanced share of concessional debt in total IMF debt in 1995, of 72 per cent, compared with 56 per cent in 1993. It also led to the reversal of the protracted

negative net transfers from the Fund, which had lasted for a decade (1984-1993). These countries accounted for a large proportion of total IMF concessional lending, reaching 69 per cent in 1995. Current terms for ESAF loans are an interest rate of 0.5 per cent, a maturity of 10 years and a grace period of five-and-a-half years. The concessional nature of ESAF loans is expected to be enhanced in the context of the proposed HIPC debt initiative, through extension of maturities and grace periods.

In the face of serious budgetary constraints in major donor countries, the replenishment of the soft windows of MFIs has been under threat. The process of negotiating IDA-11 replenishment, which covers fiscal years (FY) 1997-1999, proved lengthy and complex. The decision by the United States Congress to appropriate only \$700 million for FY1996 instead of the \$1.25 billion annual commitment for IDA-10 resulted in a conflict between the traditional burden-sharing formula and adequate replenishment. This led to agreement on the adoption of extraordinary measures in Tokyo in March 1996, including the creation of a one-year Emergency Trust Fund for FY1997 to which all donors, except the United States, are to contribute over SDR 2 billion, while the United States clears its outstanding IDA-10 commitments. The United States will be excluded from decision making and from procurement contracts for activities financed by the Emergency Trust Fund. Subsequently, there will be a two-year replenishment of IDA's general resources, to which all donors will contribute a total of SDR 5 billion. Another SDR 7.5 billion will come from past donor contributions, reflows and IBRD transfers, resulting in a package totalling close to SDR 14.5 billion over FY1997-1999. While less than originally hoped for, this amount will nevertheless allow a continuation of IDA activities at currently planned levels, although estimated contingency requirements are largely unfunded. However, the IDA-11 replenishment represents a significant decline from that of IDA-10 of SDR 16 billion which had been agreed to in December 1992. The drop in donors' contributions is substantial, from SDR 13 billion to SDR 7 billion. The latter amount is significantly less than what IDA is likely to require in the future, even after taking into account increasing reflows.

The Enhanced Structural Adjustment Facility, too, faces funding problems. At the October 1995 meeting of the Interim Committee, there was consensus on the establishment of a self-sustained ESAF. The Facility's existing resources are expected to last up to 1999 and it is projected that by 2005 there will be enough resources to finance lending of about SDR 0.8 billion a year on a self-sustaining basis. However, for the interim period 2000-2004, there is a need to secure financing for annual loan commitments of about SDR 1 billion and associated subsidy requirements totalling SDR 2.1 billion. Among the options proposed to finance the principal component are use of IMF's General Resources Account and further borrowing by the ESAF Trust from bilateral sources. As

for the subsidy, the following possibilities, which could be combined, were mentioned: bilateral contributions; investment income on the profits from a modest sale of IMF gold; use of resources in the Second Special Contingent Account (SCA-2), with these resources first refunded to member countries and then rechannelled to the Fund; and limited early use of amounts accumulating in the ESAF Reserve Account, which would imply a lower level of self-sustained ESAF operations.⁴⁷

The funding impasse over the seventh replenishment of the African Development Fund, the soft window of the African Development Bank (AfDB), finally ended in May 1996 with an agreed replenishment of around \$2.6 billion, which is \$400 million short of the amount requested. The impasse lasted for more than two years as donors wanted assurance of tighter credit policies and management controls. There has been no new loan approval from the African Development Fund since 1994. The payment of sums pledged was made conditional on the Bank's restructuring and continued implementation of recommended reforms. The Bank recently adopted a credit policy based on World Bank criteria, which would restrict lending to low-income countries to soft loans and have the effect that only 12 countries would be eligible for non-concessional loans. However, private sector projects assessed to have a commercial rate of return can be provided loans on non-concessional terms in any African country. The new credit policy should help reconcile the imbalance between the degree of concessionality of loans and income levels of borrowers.

(ii) Other measures

The Rights Accumulation Programme (RAP) was introduced by IMF in 1990 for countries with protracted arrears to the Fund at the end of 1989. In accordance with a phased schedule, a country can accumulate rights to future drawings of Fund resources up to the amount of arrears outstanding at the beginning of the programme, while establishing a track record on policy performance. Zambia was the third country to have successfully completed a RAP in December 1995, following Peru and Sierra Leone. Facilitated by bridging finance provided by several donors, Zambia cleared its \$1.2 billion arrears with the Fund, thereby considerably reducing the total of outstanding arrears to the Fund, since Zambia had the second largest arrears. There remain, however, four LDCs (Liberia, Somalia, Sudan and Zaire) with substantial

arrears, totalling almost \$2.8 billion in January 1996 and accounting for virtually all arrears to the Fund. Sudan's arrears amounted to \$1.6 billion, representing 55 per cent of the total. The World Bank has a similar programme, but arrears of the same four countries were much smaller, amounting to \$415 million at the end of FY1995 and comprising 17 per cent of total arrears to the Bank. Arrears with the African Development Bank, currently running at around \$800 million, remain an acute problem. In May 1996, 24 countries were in default to the Bank,⁴⁸ of which 6 countries alone - Zaire, Congo, Cameroon, Angola, Liberia and Somalia - accounted for 75 per cent of the total. In its effort to control arrears, AfDB recently approved the following measures: tightening the policy on sanctions; systematic application of directives on loan cancellation; and enhanced coordination with the Bretton Woods institutions.

It should be noted that the settlement of protracted multilateral arrears since 1990 has depended critically on bilateral financial support, through loans, grants, Paris Club reschedulings and bridge financing. This has been the case for countries with large financing requirements relative to quotas and those that have cleared arrears without recourse to the RAP. Support groups have typically been led by one or two creditor countries with particularly strong ties to the debtor. For example, a support group provided \$65 million in grants to help Haiti clear its arrears to IMF and other multilateral institutions in December 1994.⁴⁹

The Fifth Dimension facility of the World Bank, which is largely financed through IDA reflows, allocated supplemental IDA resources of \$178 million in FY1995 to 12 adjusting HIPC, in order to assist them in meeting interest payments on their outstanding IBRD debt.

(c) *A comprehensive approach to the debt problems of HIPC*

At the start of the debt crisis in the early 1980s, the prevailing view among official creditors was that the problem was one of liquidity. The strategy adopted was continued financial flows in conjunction with adjustment programmes to restore growth and debt servicing capacity, together with refinancing and rescheduling provided by bilateral creditors. In time it became evident that the problem was one of solvency and that the debt overhang was hampering development efforts. The most direct means of eliminating the overhang was, of

course, debt reduction. While originally resisted by bilateral creditors, eventually debt reduction became an accepted principle of debt negotiations in the context of the Brady Plan deals for commercial bank debt and reschedulings on Toronto terms since 1988 within the framework of the Paris Club for official bilateral debt. This strategy, combined with sustained adjustment efforts, proved effective in resolving the debt problems of middle-income countries, but the situation of the heavily indebted poor countries continued to deteriorate, even in several countries pursuing policies acknowledged as sound. The low level of development in most of these countries, characterized by structural rigidities, weak institutions and administration, poorly functioning markets, and deficiencies in skills and infrastructure, prevented a rapid and strong response to reform efforts. There were other impediments to growth, such as adverse terms of trade and climatic conditions and, in some countries, poor implementation of adjustment programmes and the crippling effects of civil strife. Concern over the continuing plight of poor countries led to substantial cancellation of ODA debts by some donors and the adoption by Paris Club creditors of London terms in December 1991 and of Naples terms in December 1994 (see subsection 2(a) below on the Paris Club terms). However, studies on the impact of the Naples terms, including the assessment provided in *TDR 1995*, indicate that for a significant number of countries, even with the full implementation of the Naples terms, the debt situation would remain unsustainable mainly on account of the sheer burden of their multilateral debt as well as of non-Paris Club bilateral debt.

There has been growing pressure for stronger action from MFIs. The implicit refinancing of non-concessional debts by loans on concessional terms, while leading to some reduction in the present value of the debt, offers no exit prospect and would not resolve the overhang problem. Moreover, pressure to lend to prevent the build-up of arrears could distort lending decisions. The strategy adopted also runs the risk of an allocation pattern favouring countries with large multilateral debt and detrimental to countries that have been able to manage their debt well. The existing schemes, which involve contributions to soft windows and debt relief facilities and also the creation of support groups, absorb a large volume of bilateral resources. These resources have lately been under increasing budgetary constraints, with a risk of diverting scarce development funds for debt relief. The focus on

multilateral debt has also raised the issue of the preferred creditor status of MFIs. This status is widely acknowledged, but there are different interpretations of what it implies. For MFIs, it means exemption of multilateral debt from debt rescheduling and reduction. The application of this principle has resulted in growing arrears on bilateral debt, despite write-offs and the provision by many bilateral donors of new financing on a purely grant basis to poor countries, in order to avoid the consequences of being in arrears on multilateral debt, particularly that owed to the Bretton Woods institutions.⁵⁰

It has become evident that the solution to the debt problems of HIPCs requires bolder measures, going beyond the existing framework. The fragmented approach used so far has clearly not worked satisfactorily. An effective debt strategy needs to be comprehensive, covering all components of debt, and should involve equitable burden sharing among all creditors, including MFIs. Such an approach would require coordination among all parties concerned.

(i) Debt sustainability analysis

At their meetings in October 1995, the Interim Committee and the Development Committee requested IMF and the World Bank to continue their work on how to address the debt problems of HIPCs, including country-specific analysis of debt sustainability. In response to the request, the two institutions have recently undertaken a detailed and comprehensive analysis of debt sustainability for a number of countries. Debt sustainability implies the ability to meet fully current and future debt obligations without unduly compromising growth. The methodology employed involves the choice of a time horizon, projections of principal macroeconomic variables and capital inflows, and focusing on the evolution of two key debt indicators. Threshold ranges of 20-25 per cent for the ratio of debt service to exports and 200-250 per cent for the ratio of the present value of debt to exports were used as indicators of sustainability. These conventional thresholds served as a starting point, but other risk indicators⁵¹ were also considered, especially in borderline cases. The fiscal burden of external debt service is particularly relevant for HIPCs, as their debt is primarily public debt and past experience with debt crises indicates that, in a number of countries, the principal problem has been the fiscal burden rather than balance-of-payments difficulties.

Recent debt burden indicators for HIPCs are presented in table 20. During 1992-1994, only 5 of the 41 countries had, on average, a ratio of present value of debt to exports of less than 200 per cent, and only 6 had ratios of debt service to exports lower than the threshold range. For the fiscal indicators, 1994 scheduled debt service was greater than 50 per cent of government current expenditure in 22 countries and represented over 50 per cent of government revenue in 25 countries. In 13 countries, it even exceeded total government revenue. Current debt burdens are clearly unsustainable for most HIPCs. However, debt sustainability prospects are likely to evolve, and the question is whether with the full use of existing mechanisms the debt burden will reach sustainable levels within a reasonable period.

The preliminary results of the debt sustainability analysis indicate that the situation of eight countries has been classified as "unsustainable". These are the countries with debt indicators remaining above threshold ranges for more than 10 years despite adherence to sound policies and full use of existing debt relief mechanisms. Twelve other countries face a heavy debt and debt service burden in the medium term; for them judgment on sustainability would depend on country-specific risk factors.⁵²

(ii) A framework for action

The IMF and the World Bank proposed a framework for action to resolve the debt problems of HIPCs for discussion at the April 1996 meetings of the Interim and Development Committees. The two committees welcomed the proposed framework and endorsed the following six principles to guide such action: (1) the objective should be to target overall debt sustainability on a case-by-case basis; (2) action should be envisaged only when the debtor has shown, through a track record, the ability to put to good use whatever exceptional support is provided; (3) new measures should build, as much as possible, on existing mechanisms; (4) additional action should be coordinated among all creditors involved, with broad and equitable participation; (5) actions by multilateral creditors should preserve their financial integrity and preferred creditor status; and (6) new external finance for the countries concerned should be on appropriately concessional terms. The Committees also agreed that further action beyond existing mechanisms was needed, including contributions by MFIs from their own resources, contributions by bilat-

Table 20

DEBT BURDEN INDICATORS FOR HEAVILY INDEBTED POOR COUNTRIES, 1992-1994

(Percentage)

Country	1992-1994 ^a				Debt service to exports	1994	
	Debt to exports		Debt to GNP			Scheduled debt service to	
	Nominal value	Present value ^b	Nominal value	Present value ^b		Govt. current expenditure	Government revenue
Angola	302	278	204	188	32	63	98
Benin	272	142	82	43	11	45	46
Bolivia	457	332	85	62	46	35	31
Burkina Faso	201	104	38	20	12	24	28
Burundi	891	388	111	48	40	31	33
Cameroon	303	250	79	65	36	68	111
Central African Republic	464	243	79	41	22	39	68
Chad	400	195	70	34	13	23	48
Congo	434	370	292	249	52	47	63
Côte d'Ivoire	557	486	263	228	64	79	91
Equatorial Guinea	435	308	177	126	14	105	111
Ethiopia	608	383	77	49	38	30	31
Ghana	392	242	84	52	27	37	29
Guinea	402	255	94	59	31	82	74
Guinea-Bissau	1 934	1 280	328	217	106	123	144
Guyana	479	345	563	405	31	102	92
Honduras	347	271	134	104	41	65	54
Kenya	307	225	114	84	39	36	29
Lao People's Democratic Rep.	791	214	149	41	7	6	6
Liberia	374	339	142	128	8	..	..
Madagascar	694	495	160	114	71	100	166
Mali	523	288	115	63	31	65	75
Mauritania	469	327	226	158	60	113	87
Mozambique	1 367	1 039	444	337	95	141	183
Myanmar	600	442	38	28	32	6	7
Nicaragua	2 879	2 579	804	720	172	409	415
Niger	544	322	82	48	45	52	110
Nigeria	277	250	109	99	38	75	105
Rwanda	1 142	533	93	44	47	22	80
Sao Tome and Principe	2 082	1 101	788	418	97	78	183
Senegal	253	166	77	50	23	48	50
Sierra Leone	835	637	203	156	93	99	111
Somalia	4 711	3 745	321	254	150	..	..
Sudan	3 384	3 057	188	169	87	196	189
Togo	367	226	112	69	25	54	99
Uganda	1 285	733	99	56	89	33	31
United Republic of Tanzania	1 005	719	317	228	79	62	74
Viet Nam	638	524	198	162	44	17	15
Yemen	239	189	176	139	30	12	24
Zaire	706	594	136	114	46	624	608
Zambia	592	465	217	170	49	152	186

Source: World Bank, *World Debt Tables, 1996* (Washington, D.C., 1996), Vol. 1; IMF, *Official Financing for Developing Countries*, Washington, D.C., December 1995.

Note: Exports include goods and services.

a Average of three annual ratios.

b The present value of debt takes account of differing borrowing terms and is calculated by discounting future debt service, defined as the sum of interest payments and principal repayments over the next 40 years. The discount rates used are the interest rates charged by the OECD countries for officially supported export credits (Commercial Interest Reference Rates), except for IBRD loans and IDA credits, which are discounted using the latest IBRD lending rates, and obligations to IMF, which are discounted at the SDR lending rate.

eral donors and appropriate action by the Paris Club and by other creditors. They requested IMF and the Bank, in close collaboration with other concerned parties, to put forward specific proposals as soon as possible, with the aim of reaching a decision by the next IMF/World Bank Annual Meetings, to be held in October 1996.⁵³ At the Lyons Summit in June 1996, the G-7 also acknowledged the need for additional action, in particular to reduce debts owed to multilateral institutions and non-Paris Club bilateral creditors. Paris Club creditors were urged to go beyond the Naples terms, where they deemed appropriate. The G-7 looked forward to a concrete solution being agreed to by next autumn at the latest.⁵⁴

The proposed framework for action offers eligible countries a commitment by the international community to ease their debt burden in order to bring about debt sustainability, on the basis of an extended period of proven policy performance. It involves two stages. The first stage would build on the existing three-year track record needed to qualify for a stock-of-debt operation from the Paris Club and would involve the use of existing mechanisms for concessional financing and debt relief. At the end of the first stage, a comprehensive assessment would be made of a country's debt situation and prospects for sustainability. If the analysis suggested that the stock-of-debt operation would not produce a sustainable situation, an additional three-year track record would be needed to qualify for comprehensive treatment of the stock of debt under the HIPC initiative. A consultative group meeting would be convened to agree on a financing plan and identify required additional relief. From the beginning of the second stage, bilateral and commercial creditors, multilateral institutions and also bilateral donors could provide enhanced assistance. At the end of the second stage, the Paris Club would agree on a stock-of-debt operation with increased concessionality and the MFIs would undertake to reduce the present value of their claims to a level consistent with overall debt sustainability.

At least 8, and as many as 20, countries could qualify for additional assistance on the basis of the debt sustainability analysis described above. Once an internationally approved programme, within the proposed framework, has been adopted, potential candidates will have two years in which to participate, after which there would be a review to determine whether the programme should be extended in time, so as to include other eligible HIPCs.

An illustrative IMF/World Bank costing exercise shows that of the 19 potentially eligible countries (excluding Sudan), 13 would need additional debt relief (beyond current mechanisms) under the initiative to reduce their present value of debt-to-export ratios to below 200 per cent by their completion dates. A broad estimate of the cost of such relief is \$5.6 billion in present value terms. Should official bilateral and commercial creditors provide up to 90 per cent reduction on eligible debt, the cost to multilateral creditors would be \$2 billion. If they granted up to 80 per cent debt reduction, the cost would be \$3.2 billion. Estimated total costs would rise to \$7.7 billion with nominal export growth two percentage points lower than the baseline growth. Costs would be much higher if Liberia, Sudan and Somalia were included.

This is the first concrete proposal for multilateral debt action agreed to by both IMF and the World Bank. It represents an important change in their official position, in that they now accept that the multilateral debt problem requires measures beyond current schemes. This is a most welcome initiative. However, close attention will need to be given to the following specific features of the framework for action to ensure a lasting and rapid solution to the debt crisis.

- *Debt sustainability:* The assessment of debt sustainability is expected to play a key role in determining country eligibility and the amount of relief to be provided. A number of studies presented empirical evidence suggesting threshold levels for debt indicators lower than those used in the debt sustainability analysis of 20-25 per cent for the ratio of debt service to exports and 200-250 per cent for the ratio of the present value of the debt to exports.⁵⁵ In view of their importance in the proposed initiative, great care must be taken in establishing such thresholds so as to ensure that countries following sound policies will not revert to a crisis situation some time after the conclusion of the programme. The choice of the time horizon for reaching sustainability is also an important factor in determining eligibility. A 10-year period appears too long in view of the fact that many HIPCs have already been in an unsustainable situation for some considerable time.

The highly uncertain nature of projections of relevant economic variables and the wide margins of error to which such projections are

normally subject call for great care to be exercised in the assumptions to be made on, for example, export growth and capital flows, which have a bearing on future debt indicators.

- *Required track record and the timing of debt reduction:* A satisfactory policy track record by the debtor is clearly an essential ingredient in any new approach. However, some flexibility in the application of the requirement of a track record over a six-year period before the final debt settlement, as well as in the timing of enhanced debt relief, may be desirable as there will be gains to all from assisting eligible HIPC's in resuming growth and normal debtor/creditor relations as rapidly as possible.
- *Contributions of individual MFIs:*⁵⁶ Each multilateral institution is expected to contribute in broad proportion to the present value of its outstanding exposure to the countries involved, as of the start of the second stage. An approach indicated is for MFIs to choose from a menu of options to reduce the burden of their claims. This menu could include the provision of grants to pay a portion of the multilateral debt service as it falls due or pre-pay part of the outstanding stock at the completion date; and/or the provision of concessional funding in greater amounts and with enhanced concessionality. While there appears to be logic and equity in this proportionality, as it implies that each institution would be assuming responsibility for past lending decisions, the capacity to offer relief varies among MFIs. Some may be in a comparatively weak position and may, therefore, need support should difficulties arise in meeting their expected contributions.

(d) *Financing multilateral debt relief*

In order to avoid introducing distortions in the country allocation of development assistance, it is essential that the resources underpinning any scheme within the framework described above be additional. Additionality implies the release of funds which are not already intended to be used for development purposes. Additionality could also be achieved by creating new resources, such as through a special issue of SDRs. Alternatively, part of a general allocation of SDRs could be set aside for multilateral debt relief. However, there

is little political support for the SDR options. A special issue would require amending the IMF Articles of Agreement. Moreover, the use of SDRs carries market-related interest rates, so that there would still be a problem of financing interest subsidies.

Concerns have been raised with regard to the heavy burden imposed on bilateral donors by existing debt relief schemes, especially in the light of the fiscal constraints they confront. These restraints have led to growing demands for greater contributions from MFIs through the use of their own resources. The HIPC initiative is likely to strengthen these demands, since it calls for substantial additional efforts from bilateral creditors with respect to bilateral debt. However, any proposal concerning the use of MFIs' resources must ensure that the financial integrity of the institutions is preserved and that no prejudice to their credit rating would result. Among the various measures proposed which would meet the additionality criterion and are unlikely to affect the financial integrity of the institutions are:

- *Sale of a portion of IMF gold reserves:* IMF's contribution to reducing the debt burden of HIPC's is expected to involve ESAF, and it is therefore important that ESAF be placed on a sound financial footing. The financing of the continuation of ESAF had been under discussion even before the HIPC initiative was put forward. For this purpose, the Managing Director of IMF has proposed the sale of a minor portion, (around 5 per cent) of the IMF gold stock and investing the profits from the sale. The Fund holds more than 103 million fine ounces of gold, which are valued in its accounts at around SDR 35 per ounce. The current market price for gold is about \$380-\$390 per ounce. The investment income from the proposed gold sale would enable it to finance half of the required resources for the subsidy account needed to sustain a volume of operations of SDR 1 billion per year for the period 2000-2004. To avoid disruptions in the gold market, the sale could be phased, as was done during the previous gold sales to finance the Trust Fund.⁵⁷ To allay fears that such a gold sale might set a precedent for future sales for less legitimate purposes and in order to reach a solution, it has been proposed to formally limit the amount of gold reserves that IMF can sell by amending the Articles of Agreement. At the Lyons Summit, the G-7

called on the Fund to consider optimizing its reserves management in order to facilitate the financing of ESAF.

As for IMF's direct contribution to the HIPC initiative, various options involving ESAF are being considered to reduce the present value of its claims. This is expected to be achieved largely through greater concessionality in ESAF lending to eligible countries by extending maturities and grace periods. The proposed gold sales would provide some margin to accommodate part of the costs of the Fund's contribution to the initiative, assuming that bilateral donors provide one half of the subsidy requirement for the interim period. While in the past the subsidy account was largely financed by donors, some of them have expressed reservations in connection with financing the interim ESAF.

- *The use of net income, surplus and reserves of multilateral development banks (MDBs):* The principal mechanism for MDBs' participation in the HIPC initiative is through the creation of trust funds (multi-country and/or single-country funds), to which both MDBs and bilateral donors can contribute. The World Bank is considering the provision of grants to the trust fund from allocations of IBRD net income and/or surplus. In that event additionality would not be clear-cut. The net income of IBRD for FY1990-1995 averaged over \$1.2 billion per year. The net income for a particular year is subsequently allocated to maintaining a target reserves-to-loans ratio; making transfers to IDA and the Debt Reduction Facility⁵⁸ and transfers for similar purposes; and to surplus. The surplus consists of earnings from prior years, which are retained until a decision is made on their disposition or conditions for specified uses have been met. In FY1995, the surplus amounted to \$226 million. To ensure additionality, allocation for the HIPC trust fund needs to be associated with changes in reserves allocation or with raising net income through, for example, cutting costs. Reserves have increased significantly since 1990, particularly in the last two years, both in absolute and in relative terms. The reserves-to-loans ratio, which was 10.8 per cent in FY1990, rose to 14.3 per cent in FY1995. Reserves amounted to over \$17 billion on 30 June 1995. A number of financial analysts consider the Bank's reserve policies as excessively conservative,

especially as, in addition to reserves, it has loan-loss provisions equal to 3 per cent of total loans outstanding plus the present value of guarantees. These provisions amounted to more than \$3.7 billion at the end of FY1995. There is, therefore, considerable room for the use of reserves to finance multilateral debt relief, although such use could affect the Bank's earnings, as they are also a source of income. Among the other measures proposed by the World Bank to contribute to the HIPC initiative at the second stage are: supplemental IDA allocations over and above basic IDA allocations to ensure positive net transfers; and the selective use of IDA grants to prevent an increase in the present value of the debt due to the Bank as a percentage of exports. These measures involving the use of IDA resources would not be additional, but would certainly provide relief and programme support to beneficiaries. The management of the Bank has proposed the allocation of \$500 million in 1996 to the debt relief initiative and substantial amounts in subsequent years. It is expected that the overall contribution of the World Bank will be of the order of \$2 billion.

(e) Conclusion

A lasting solution to the debt problems of poor countries must address both long-term and immediate needs. For the long term, it is important to provide sufficient development finance on terms and levels consistent with the recipient's capacity to pay. This can be achieved through the adequate replenishment of the soft windows of MFIs, which would benefit all low-income countries. The difficulties encountered recently in connection with the replenishment of the soft windows raise concerns about the longer-term prospects of multilateral development assistance.

For a significant number of heavily indebted poor countries with an unsustainable debt burden, a special mechanism would be needed to address their debt overhang problems immediately and to ensure debt sustainability for the future, as existing schemes are clearly inadequate to deal with their critical situation. The framework for action proposed by IMF and the World Bank provides a comprehensive and coordinated approach to resolve their debt problems and is guided by sound principles. However, some flexibility in the application of certain conditions determining country eligibility, as well as in the timing of enhanced multilateral

Box 2**MEASURING CONCESSIONALITY**

In the past few years the Paris Club has adopted new terms for developing debtor countries, involving debt reductions that may be as large as 67 per cent. Since such reductions can be applied only to non-ODA debt, the definition of ODA debt is of crucial importance.

The definition of concessionality used over the years by the Paris Club has been that of OECD's Development Assistance Committee (DAC). The IMF, which had in the past also used this definition, has introduced a new one which reflects the recent evolution of interest rates.

Under the DAC definition, which was originally established in 1969, ODA loans are those (of more than one year) provided by Governments or official agencies which meet two criteria: first, they must be administered with the promotion of economic development and welfare of the developing countries as their main objective; second, they must be concessional in character, with a grant element of at least 25 per cent using a discount rate of 10 per cent.

The continued use of a fixed discount rate of 10 per cent has posed problems in recent years, due to the marked decline of interest rates in virtually all countries as compared with the early 1980s. Indeed, a loan can meet the DAC definition even if, compared with the market rate of the currency concerned, it is clearly a commercial loan. For instance, with a 10 per cent discount rate, a fixed-rate loan with a 10-year maturity and a 5-year grace period would qualify for the DAC definition of a concessional loan if its rate of interest were less than 5.2 per cent (a rate which has been above market rates in some developed countries in the past 18 months). The difference in market rates at any point in time among major developed countries also raises issues of the comparability of concessionality among donor countries.

Recognizing these problems, OECD has used since 1987, in the framework of its Arrangement on Guidelines for Officially Supported Export Credits (often referred to as "the OECD Consensus"), a formula based on individual OECD countries' market interest rates, known as Commercial Interest Reference Rates (CIRR), to assess the discount rates for calculation of the grant element.¹ Using this discount rate, a loan must have at least a 35 per cent grant element to be considered concessional; for LDCs the threshold is 50 per cent. In 1994, it was decided that for loans contracted after 31 August 1996 the discount rate used would be CIRR plus a margin reflecting the maturity of the loan. It is interesting to note that these two definitions of concessionality (that of DAC and that of the Consensus) coexist within OECD. Consequently, today a 10-year loan in yen, with five years of grace and a 4 per cent interest rate, for example, would conform to the DAC definition of concessionality but not to that of the OECD Consensus.

The IMF has moved in the direction of the OECD Consensus definition, and has applied a CIRR-based discount rate and a 35 per cent grant element from October 1995 in assessing the concessionality of loans in the context of limits on foreign borrowing in IMF arrangements.

Under the Naples terms, ODA debt - defined according to the DAC criteria - is rescheduled over 40 years, with a grace period of 16 years and at an interest rate at least as concessional as the original one. The implied reduction in net present value (NPV) terms for ODA debt - over and above its original grant element - is likely to be less than the 67 per cent applied to non-ODA debt.

Under the Naples terms, the discount rate used to calculate NPV is the "appropriate market rate", i.e. the interest rate determined bilaterally between the debtor and each individual creditor country. The appropriate market rate is usually very close to the CIRR. If the interest rate on rescheduled ODA debt equals the original rate but is not lower than the appropriate market rate, no NPV reduction can be obtained - a situation which might arise, for example, in the case of ODA loans in low-interest currencies, such as the yen. Even if the ODA debt rescheduling rate, as well as the original one, were, say, 2 per cent, as compared with a 7 per cent appropriate market rate, the effective NPV debt reduction could be as low as 30 per cent, under reasonable assumptions on the residual maturity of the original ODA debt.

Box 2 (concluded)

The adoption by the Paris Club of a new definition of ODA loans, along the lines of that used in the OECD Consensus, would better reflect the reality facing debtors and creditors. In that event, a significant portion of currently defined ODA debt, especially that denominated in low-interest currencies, would be classified as non-concessional and could thus benefit from NPV reduction of 67 per cent under the Naples terms.

¹ For the definition of CIRR and movements in the rates in 1995 and early 1996, see table 14 above.

action, may be justified to ensure a lasting and rapid solution to the debt crisis. The differences that have arisen concerning contributions of various creditors also need to be ironed out, so as to arrive at an equitable burden-sharing arrangement that is acceptable to all. Financing such contributions should be based on additionality of resources to prevent further diversion of scarce development funds for debt relief. Furthermore, it is important to define clearly the modalities of the various contributions and how coordination among all the parties concerned could best take place. The problems of some MFIs in meeting expected financial contributions must also be addressed. It is urgent to formulate a workable plan of action for decision at the Annual Meetings of IMF and the World Bank in October 1996.

The severity of the situation faced by a number of heavily indebted poor countries calls for additional efforts from all parties concerned. For eligible debtors, continued strong commitment to reform would be required, not only to safeguard against moral hazard, but also, and above all, to enable them to create the right conditions for sustained growth, thus ensuring the successful resolution of the debt crisis.

2. Bilateral debt

Following the adoption of the Naples terms in December 1994, the number of countries which went to the Paris Club in the first half of 1995 increased substantially: during that period 13 agreements were signed. Thereafter, however, activity at the Paris Club declined markedly, with 10 agreements during the ensuing 12 months, thereby

resuming a downward trend which could already be noticed in the early 1990s. A large number of countries still remain in need of debt rescheduling: as of June 1996, about half of the 36 countries which had not graduated from the Paris Club had no current agreements in effect. For more than half of them, the Paris Club agreement had expired more than one year earlier and substantial arrears were accumulating. One of the main obstacles to their achieving a new rescheduling was the difficulty encountered in reaching a new agreement with IMF.

The debt situation of many developing countries, especially the HIPC's, remains extremely difficult despite the efforts made to alleviate their debt burden through increasingly concessional rescheduling at the Paris Club and additional bilateral debt relief, as noted in the preceding sub-section. The Naples terms, while alleviating the bilateral debt burden, have at the same time revealed the extent of the multilateral debt burden for a number of developing countries, as well as of the burden of non-OECD official bilateral debt. While the international community is actively considering the multilateral debt problem, progress toward a solution of debt to non-OECD creditors is advancing very slowly and lacks a coherent framework. This is illustrated by the treatment of the debt due by countries in sub-Saharan Africa to the Russian Federation and to Arab countries, which is reviewed in the annex to this chapter.

(a) Recent developments concerning implementation of the Naples terms

Since the late 1980s, Paris Club creditors have applied increasingly concessional terms to the debt rescheduling of the heavily indebted poor countries.

These terms have evolved from a reduction of debt service payments by a third under Toronto terms agreed in 1988 to a 50 per cent reduction under the London terms (also referred to as enhanced Toronto terms) adopted in 1991. The Naples terms of December 1994 further increased the level of concessionality, to 67 per cent, in response to the enduring debt distress of HIPC. Such a reduction can be applied either to debt service payments (flow rescheduling) falling due during a relatively short consolidation period (up to three years) or to the stock of eligible Paris Club debt (stock-of-debt operation). The possibility of applying the reduction to the stock of debt, one of the major innovations of the Naples terms, was designed to provide eligible debtor countries with an exit from the debt rescheduling process as the beneficiary would no longer need to go to the Paris Club for further rescheduling.⁵⁹ The Naples terms have also added a new feature by allowing debt that has already been reduced through previous rescheduling on either Toronto or London terms to be further diminished so as to achieve a percentage reduction on the original claims of either 50 per cent or 67 per cent. This is referred to as the "topping up" principle. In the past, such claims could not be further reduced, but could, at best, be rescheduled on non-concessional terms. Only non-ODA debt is eligible for reduction under Naples terms, which raises the question of the definition of ODA debt (see box 2).

Since adoption of the Naples terms in December 1994, 19 HIPCs (roughly half of this group of countries) have rescheduled their Paris Club debt on those terms (as of 30 June 1996). Most of them received the maximum reduction, namely 67 per cent. Only three countries, (Cameroon, Guinea and Honduras), obtained the smaller reduction, of 50 per cent. Stock-of-debt treatment was granted to only five countries: Bolivia, Burkina Faso, Guyana, Mali and Uganda, the remaining 14 countries being accorded flow rescheduling.

The extent of Paris Club debt relief has continued to be determined by the balance of payments financing requirements as assessed during negotiations on IMF-supported programmes. In virtually all cases, all pre-cutoff-date debt that was never rescheduled or that was rescheduled on non-concessional terms was reduced. In flow reschedulings, the topping up principle was not always applied. Some countries benefited from it in respect of their claims restructured under Toronto terms; very few did so in the case of the debt restructured more recently under London terms.

The pace of stock-of-debt agreements, though accelerating in the first half of 1996, remained modest, largely due to the fact that only a few countries had completed the three-year probationary period required by Paris Club creditors before considering a stock-of-debt reduction under Naples terms.⁶⁰ Two such reduction agreements were signed in 1995 and three in the first half of 1996, and all involved the 67 per cent option.⁶¹ With the exception of Uganda,⁶² all of them covered not only the stock of debt that was never rescheduled, or that was already rescheduled but never reduced, but also debt restructured on Toronto and London terms; to the latter category of debt, the topping up principle was fully applied. However, none of the stock-of-debt agreements concluded to date has covered moratorium interest⁶³: such a possibility nevertheless exists under the Naples terms, whereby moratorium interest can be rescheduled or reduced, depending on the debtor country's specific circumstances. This exceptional feature was included to take account of the fact that in the early years following a stock-of-debt operation moratorium interest tends to be higher than under a flow rescheduling.

In the case of Uganda, the reduction agreement implies a reduction (in net present value terms) of 17 per cent in its total Paris Club debt, and of 3.2 per cent in its total outstanding debt. For Bolivia, the impact is greater (partly as a result of the more extensive coverage of the agreement): the reduction will amount to about 31 per cent of its total Paris Club debt and 11 per cent of its overall external debt. For Mali, Guyana and Burkina Faso the impact will be much smaller, mainly because of the level of Paris Club debt (before any debt reduction) in relation to their total external debt. It should be noted that, even after the 67 per cent stock-of-debt reduction under Naples terms, debt indicators for Bolivia, Guyana and Uganda are such that these countries are still considered as having potential debt sustainability problems, which may necessitate additional debt relief measures under the proposed HIPC debt initiative described in the preceding sub-section.

Finally, in a very few cases, the Paris Club has continued to agree to exceptional deferral of payments on arrears on post-cutoff-date debt.⁶⁴ In the past two-and-a-half-years, four countries benefited from this exceptional treatment. The period of deferral (over which the arrears have to be paid) has varied from two to three years.⁶⁵

GRADUATION FROM THE PARIS CLUB: THE CASE OF THE RUSSIAN FEDERATION

In April 1996, a five-day Paris Club meeting took place to restructure the debt contracted or guaranteed by the former Soviet Union and for which the Russian Federation had assumed responsibility. The Paris Club creditors agreed to a comprehensive rescheduling of the debt with a view to supporting Russian stabilization efforts and avoiding the need for further rescheduling. The agreement involves restructuring in two stages: a flow rescheduling, followed by a stock-of-debt operation. It is hoped that this will provide an exit strategy for the country.

The flow rescheduling covers 100 per cent of the principal and interest payments due from January 1996 to 31 March 1999 on debt that was never rescheduled, as well as on that resulting from the three previous Paris Club agreements (of 1993, 1994 and 1995).¹ This debt is rescheduled over an unusually long period of 21½ years, including 3 years of grace. As in the three previous agreements, part of the debt contracted after the cutoff date (determined to be 1 January 1991) was also rescheduled; payments on such debt due over the period 1996-1998 were rescheduled, though with a somewhat shorter maturity, of about 17 years. Furthermore, the moratorium interest and short-term debt that were rescheduled in the previous agreements were also rescheduled, on the same terms as those granted on post-cutoff-date debt.

In the second stage, principal payments falling due on or after 1 April 1999 are to be rescheduled, also with a maturity of 21½ years, including 3 years of grace. This restructuring covers only the debt resulting from the three previous agreements and excludes all post-cutoff-date debt. For this stock-of-debt operation to be implemented, a number of conditions have to be met, including, for instance, the approval by IMF of the review of the 1997 and 1998 programmes, as well as of the final quarterly review scheduled under the Fund's extended arrangement, and the fulfilment of financial obligations due up to 31 March 1999.

The agreement with the Russian Federation is exceptional for two reasons. The first is the substantial amount involved (about \$40 billion), the largest in the Paris Club's history. The second is that it is a stock-of-debt operation on non-concessional terms, the first of its kind in the Club's 40 years of existence. This agreement is along the lines of London Club restructuring of commercial bank debt outside the Brady Plan framework. The other stock-of-debt restructurings which took place within the Paris Club, either on Naples terms or those agreed to in 1991 for Poland and Egypt, included a reduction in the present value of debt.²

¹ For the last three months of the consolidation period, the percentage of debt rescheduled falls to 40 per cent for debt that was never rescheduled.

² For the terms accorded Poland and Egypt see *TDR 1992*, box 2.

(b) Middle-income countries

Over the past 18 months, only 5 of the 23 rescheduling countries belonged to the middle-income category, among which were Croatia and The Former Yugoslav Republic of Macedonia, which signed their first agreements with the Paris Club in 1995. One of the most notable features of the treatment applied to the debt of this group of countries has been the increasing use of graduated repayment schedules whereby, following a short

grace period, payments take place with a progressively increasing amortization schedule.⁶⁶ The most interesting new development was the treatment granted to the Russian Federation for its debt restructuring in April 1996. The Paris Club had hitherto retained the flow approach to deal with the debt of middle-income countries. In contrast, the agreement with Russia allows for the rescheduling of the stock of debt as of 1 April 1999 (see box 3). Some other middle-income debtor countries would also like to benefit from a com-

prehensive rescheduling through a stock-of-debt operation. It remains to be seen, however, whether the Russian agreement signals a change in the Paris Club practices regarding middle-income countries, or whether it is truly an “exceptional” rescheduling, as were those for Poland and Egypt five years

ago. If it does indeed signal a change, other middle-income countries (not eligible for Paris Club debt reduction) might be able to benefit from a comprehensive debt approach similar to that applied to the Russian Federation. ■

Notes

- 1 K. Clifton, “MTNs: a vision of the future”, *Euromoney*, March 1996.
- 2 The claims of BIS-reporting banks include not only loans but also in most cases various categories of international securities among the assets in the institutions’ portfolios.
- 3 Baring Securities, *The Financial Silk Road ... A Fifth Wave of Global Money. Cross Border Equity Flows*, Vol. I (London, September 1995), p. 9.
- 4 *Ibid.*, p. 24.
- 5 D. Folkerts-Landau, T. Ito *et al.*, *International Capital Markets: Developments, Prospects, and Policy Issues*, World Economic and Financial Surveys (Washington, D.C.: IMF, August 1995), p. 51. An emerging markets mutual fund is defined as one that holds at least 60 per cent of its assets in securities of developing countries.
- 6 BIS, *International Banking and Financial Market Developments* (Basle, February 1996), table 12B. (Figures for net issues include adjustments in the form of deduction of scheduled and early repayments, and of addition of implied interest accruals in the case of zero-coupon bonds.)
- 7 *Ibid.*, tables 8 and 12A. A number of developing countries recorded negative net issues in 1995. Euro-notes in this source comprise but are not necessarily identical to EMTNs.
- 8 *Ibid.*, tables 10A, 12A and 12B.
- 9 Debt instruments of less than “investment grade” are often not permitted to be held by certain institutional investors under their regulatory regimes.
- 10 J.P. Morgan, *Emerging Markets Data Watch*, 10 May 1996, p. 31.
- 11 According to an estimate quoted by the Mexican Minister of Finance, approximately two thirds of the *tesobonos* maturing in 1995 were held by foreigners. (*Latin American Economy and Business*, March 1995, p. 11.)
- 12 Figures for the net inflow of portfolio investment in 1993-1994 from IMF, *Balance of Payments Yearbook*, Part I, 1995 (Washington, D.C.: IMF, 1995), which are used for most of the countries in table 12, are those of the analytic presentation, which facilitates comparisons among countries and through time. These figures sometimes differ from those of the standard presentation, which attributes to portfolio investment net inflows included under other headings in the analytic presentation. The differences between the figures in the two presentations are substantial for some countries, those of the standard presentation, for example, being higher for some Latin American countries.
- 13 With the progressive liberalization of regulatory regimes in emerging financial markets there has been some blurring of the distinction between direct and portfolio investment, since purchases not only of tangible assets but also of shares on stock markets can serve as vehicles for the achievement of management control.
- 14 In the interests of comparability with the Asian countries, only the World Bank’s estimates of net FDI in the Latin American countries are shown in table 13 (which generally differ from those of ECLAC mentioned below).
- 15 Baring Securities, *op. cit.*, pp. 40-41.
- 16 *Ibid.*, p. 42.
- 17 ECLAC, *Preliminary Overview of the Latin American Economy and Caribbean Economy 1995* (United Nations publication, Sales No. E.95.II.G.18), table A.13, which is also the source of the total net capital inflows (balance on capital account) for the individual Latin American countries discussed in this sub-section.
- 18 This figure may well be an underestimate due to the scale of inflows, according to the most recent statistics, in the last quarter of 1995, of which the ECLAC secretariat would not have been able to take proper account. See the remarks concerning Argentina and Chile below.
- 19 The figure for the net outflow of portfolio equity investment is from *Latin American Economy and Business*, February 1996, p. 5. Mexico’s net FDI was in the range of \$4-6 billion as indicated by estimates of ECLAC (*op. cit.*, p. 40) and the World

- Bank (*World Debt Tables 1996. External Finance for Developing Countries* (Washington, D.C.: The World Bank, 1996), Vol. 1, table 1.4, one or both of which are also sources for the FDI figures for other Latin American countries discussed below. Net issues of international debt securities, which include both bonds and EMTNs (an instrument with an increasing resemblance to bonds, as explained in section A), amounted to \$0.9 billion. The change in the exposure to the country of BIS-reporting banks (after adjustment for the effects of movements of exchange rates) was a diminution of \$6.5 billion, reflecting large negative figures in the first nine months of the year. Figures for net issues of international debt securities and the change in the exposure of BIS-reporting banks for Latin American countries discussed in this sub-section are taken from BIS, *International Banking and Financial Market Developments*, tables 5A and 10.
- 20 The net inflow of FDI was in the range of \$2-4 billion. Net issues of international debt securities amounted to \$7.8 billion, constituting a rise from the 1994 total of \$5.3 billion and a strong recovery in the last three quarters of the year after a negative figure for the first quarter. The increase in BIS-reporting banks' exposure to Argentina (after adjustment for movements of exchange rates) was \$2.3 billion.
- 21 Official Argentine sources indicate a rise in the net inflow on capital and financial account during the fourth quarter of 1995 to a figure almost 2.5 times that of the second and third quarter combined. These sources also point to a substantial positive net capital inflow for the year as a whole, though a lower one than in 1994.
- 22 The net inflow of FDI amounted to a little more than \$3 billion. Net issues of international debt securities were \$6.2 billion, reflecting a recovery after a net outflow in the first quarter; and the increase in the (exchange-rate adjusted) exposure of BIS-reporting banks to Brazil was \$6.8 billion.
- 23 Figures for major categories of external financing were as follows: a net flow of FDI in the range of \$1.4-2.3 billion, a net increase in international debt securities of \$0.1 billion, and a net increase in (exchange-rate-adjusted) exposure of BIS-reporting banks of \$1.9 billion.
- 24 *Latin American Economy and Business* (February 1996, p. 8) cites an estimate of \$500 million for (presumably) net foreign portfolio investment in Chile in 1995.
- 25 This total incorporates a net inflow of FDI of \$2.2 billion, net issues of international debt securities of \$0.7 billion, and a net increase in (exchange-rate-adjusted) exposure of BIS-reporting banks to the country of \$1.8 billion.
- 26 An estimate of the country's net receipt of FDI was not available at the time of writing, though it is thought to be not much less than the previous year's figure of \$2.4 billion. There were no issues by Peru of international debt securities, and the increase in (exchange-rate-adjusted) exposure to it of BIS-reporting banks was \$1.2 billion
- 27 The country's net inflow of FDI amounted to \$0.6 billion, while its net issue of international debt securities was a negative \$0.4 billion and the (exchange-rate-adjusted) decrease in BIS-reporting banks' exposure to it was \$1.6 billion.
- 28 J. P. Morgan, *Emerging Markets Data Watch*, 26 January 1996, p. 20, and 19 April 1996, pp. 4 and 36. The inflow did lead to discussion in Thailand of the possibility of imposing a transaction tax on currency swaps between the baht and the dollar. See G. Baker, "It's tough to be cool", *Euromoney*, April 1996.
- 29 J.P. Morgan, *Emerging Markets Data Watch*, 10 May and 14 June 1996.
- 30 *Ibid.*, 14 June 1996, p. 22.
- 31 *Ibid.*, 26 January 1996, p. 23.
- 32 *Central Banking*, Vol. 6, No. 4, Spring 1996, p. 7; and V. Boland, "Czech currency: greater flexibility in exchange rate policy", *Financial Times*, 26 April 1996.
- 33 J.P. Morgan, *Emerging Markets Data Watch*, 10 May 1996, pp. 7-10.
- 34 OECD, *External Debt Statistics: the Debt of Developing Countries and the CEE/NIS at end-December 1994 and end-December 1993* (Paris: OECD, 1995), table A.
- 35 The export credits in table 9 include not only the private lending carrying insurance or guarantees from an export credit agency (ECA), which is discussed in the present section, but also direct lending by OECD Governments, the determinants of which are not discussed here. It is customary to define credits carrying "official" insurance or guarantees as "private export credits". "Official" insurance in this context is in some cases provided by privately owned institutions with officially recognized mandates. However, the sale of the short-term credit insurance operations of the United Kingdom's Export Credits Guarantee Department (ECGD) to the Nederlandsche Credietverzekering Maatschappij (NCM), the consortium of banks and insurance companies which serves as the vehicle for providing export credits in the Netherlands, has led to the omission of new short-term export credits extended by United Kingdom sources from the statistics in table 9. Nevertheless, owing to the availability of data concerning NCM's short-term operations which complement those for medium- and long-term cover from ECGD, the conditions associated with NCM's short-term insurance cover are included in the analysis of this section alongside of those attached to insurance cover from the Export-Import Bank of the United States (EXIM).
- 36 Maximum and minimum levels for these so-called Commercial Interest Reference Rates for different currencies in 1995 and the first five months of 1996 are shown in table 14.
- 37 For example, under the short-term "whole turnover" policy of NCM for cash payments against docu-

- ments, basic premiums vary between 0.2 and 0.3 per cent of the value of contracts for developed countries, and between 0.6 and 0.7 per cent for developing ones; for repayment periods up to 30 days premiums vary between 0.4 and 0.8 per cent of the value of contracts for developed, and between 0.9 and 1.2 per cent for developing, countries; and for repayment periods between 30 and 90 days they vary between 0.7 and 1.1 per cent for developed, and between 1 and 1.4 per cent for developing ones. See OECD, *Export Credit Financing Systems in OECD Member and Non-Member Countries* (Paris: OECD, 1995).
- 38 In the case of NCM these supplementary premiums are called "market rate additions" (MRA).
- 39 The concept, "instance", is explained in note c to table 15.
- 40 For such a ranking see, for example, D. Briggs and B. Edwards, *Credit Insurance: How to Reduce the Risks of Trade Credit* (New York, etc.: Woodhead-Faulkner, 1988), pp. 25-26.
- 41 The regional samples of countries for which preferred payments terms are available are significantly smaller than those underlying the analysis of conditions associated with official credit insurance cover, this shortcoming being especially marked for South and South-East Asia.
- 42 Under the IDA Debt Reduction Facility (established in 1989) money is made available to low-income countries for reduction of their external debt in the form of obligations to commercial banks and suppliers through buy-backs at large discounts on face value. Support is contingent on programmes acceptable to IDA for medium-term adjustment and the management of external debt. Other donors may provide cofinancing in the form of grants in support of individual debt-reduction operations under the Facility.
- 43 The group comprises 41 countries: the 32 countries classified as severely indebted low income countries (SILICs) in *World Debt Tables 1994-95, External Finance for Developing Countries* (Washington, D.C.: The World Bank, 1994); an additional 7 countries that have received concessional treatment from the Paris Club; and 2 lower middle-income countries that have recently become IDA-only countries. For a listing of the countries see table 19.
- 44 See *TDR 1995*, Part One, chap. II, sect. E.2, for a discussion of the debt problems of these countries since the emergence of the debt crisis.
- 45 International Monetary Fund, *Official Financing for Developing Countries*, Washington D.C., December 1995, table 21.
- 46 For a detailed discussion of schemes adopted by MFIs to alleviate the debt burden of poor countries, see *TDR 1995*, Part One, chap. I, sect. E.
- 47 See the excerpts from the press conference held jointly by the Chairman of the Interim Committee and the Managing Director of IMF, on 23 April 1996 (*IMF Survey*, Vol. No. 25, 6 May 1996). Resources held in the ESAF Reserve Account are meant to be used to make payments of principal and interest for the Loan Account, should actual debt service payments (including interest subsidy) by the debtor be insufficient to cover the amount due. SCA-2 was created in 1990 to safeguard against potential losses arising from purchases made under a successor arrangement after the successful completion of a Rights Accumulation Programme, and to provide additional liquidity to finance such purchases. As of 31 January 1996, holdings in the ESAF Reserve Account amounted to SDR 1364 million and in SCA-2 to SDR 898 million.
- 48 *Financial Times*, 23 May 1996 (reporting a statement by the President of the Bank).
- 49 IMF, *Annual Report 1995* (Washington D.C., 1995), p.147.
- 50 See T. Killick, "Solving the Multilateral Debt Problem: Reconciling Relief with Acceptability" (London: Commonwealth Secretariat, forthcoming).
- 51 Among the risk indicators considered were the fiscal burden, reserve coverage, aid dependence, export diversity, sensitivity to export shortfalls, resource gap and policy track record.
- 52 The eight "unsustainable" cases are Burundi, Guinea-Bissau, Mozambique, Nicaragua, Sao Tome and Principe, Sudan, Zaire and Zambia. The 12 other countries with potential debt sustainability problems are: Bolivia, Cameroon, Congo, Côte d'Ivoire, Ethiopia, Guyana, Madagascar, Myanmar, Niger, Rwanda, United Republic of Tanzania and Uganda.
- 53 See the Communiqués of the Interim Committee (22 April 1996), Development Committee (23 April 1996), and the Group of 24 (21 April 1996), reproduced in *IMF Survey*, 6 May 1996.
- 54 G-7 Lyons Summit, Economic Communiqué, 28 June 1996.
- 55 A number of studies, which used different approaches, arrived at consistent results, indicating a critical level of 200 per cent for the ratio of the present value of debt to exports. According to *World Debt Tables 1994-95*, Vol.1 (p. 40), debt profiles and track records of selected SILICs suggested that debt service ratios that consistently exceeded 15 per cent were high and that debt-to-export ratios greater than 200 per cent had generally proven unsustainable over the medium term. In *TDR 1995* (Part One, chap. II, sect. E.1), a benchmark debt service ratio of 20 per cent was used because, over the period 1983-1994, countries in the sample were actually able to make debt service payments equivalent on average to 22 per cent, but only after debt reschedulings and accumulation of large arrears. It must be emphasized that debt sustainability implies the ability to meet debt obligations without resorting to debt relief, rescheduling or accumulating arrears.
- 56 In addition to the World Bank, IMF and regional development banks, MFIs include other multilateral and intergovernmental agencies, such as the International Fund for Agricultural Development

- (IFAD), a number of Arab funds and the multilateral institutions of the European Union.
- 57 The sales, involving a much larger volume than that currently proposed (50 million ounces), were carried out over a four-year period (1976-1980) and had little discernible depressing effect on the market price.
- 58 This facility, which is co-financed by donors, provides grants to IDA-only countries for commercial debt buy-backs at a sharp discount.
- 59 To be eligible for a stock-of-debt operation, a country must fulfil three main conditions: (1) it must establish a good track record with IMF-supported programmes; (2) it must comply with Paris Club bilateral agreements, and (3) Paris Club creditors must be confident that the country will be able to fulfil its obligations under the stock reduction agreement. For details of the Naples terms, see *TDR 1995*, box 3.
- 60 Debtor countries restructuring their Paris Club debt for the first time under the Naples terms initially receive a flow rescheduling. The agreement signed includes a clause whereby a three-year or, in some cases, a four-year probationary period is required during which a good track record of relations with IMF and with Paris Club creditors has to be established before a stock-of-debt operation can be considered.
- 61 As noted above, the reduction applies only to non-concessional debt.
- 62 The Uganda agreement signed in February 1995 reduces only previously rescheduled debt (as there was hardly any eligible debt which had not been rescheduled). It excludes debt restructured in 1992 on London terms.
- 63 Moratorium interest refers to interest payments on amounts deferred or rescheduled under the rescheduling agreement.
- 64 The cutoff date is the date prior to which loans must be contracted in order for their debt service to be eligible for rescheduling. Loans contracted after the cutoff date are expected to be serviced in full. The cutoff date is determined at the first Paris Club rescheduling and typically remains fixed in all subsequent reschedulings.
- 65 Guinea-Bissau obtained particularly generous treatment in 1995, with the rescheduling over 10 years of arrears on post-cutoff-date debt.
- 66 Graduated payment schedules enable debtor countries to avoid the bunching of debt service obligations which takes place at the end of the grace period in conventional reschedulings.

Sources for table 13

Current account balance and GDP: 1993-1994 were taken from IMF, *International Financial Statistics* and 1995-1996 from J.P. Morgan, *Emerging Markets Data Watch*, except for Argentina, where the current account balance in 1994 was taken from ECLAC, *Preliminary Overview of the Latin American and Caribbean Economy 1995*, December 1995, and for Taiwan Province of China, where both items in 1993-1995 were taken from Central Bank of China (Taipei), *Financial Statistics*. **Direct investment:** 1993-1994 was taken from IMF, *Balance of Payments Yearbook*, Vol. 46, Part I, 1995, and 1995 from World Bank, *World Debt Tables*. *External Finance for Developing Countries 1996*, Vol. 1 (table 1.4), except for Argentina in 1994-1995 and Colombia in 1993-1994, where it was taken from World Bank, *op. cit.*, and for Taiwan Province of China in 1993-1995, where it was taken from Central Bank of China (Tapei), *op. cit.* **Portfolio investment:** 1993-1994 was taken from IMF, *Balance of Payments Yearbook*, Vol. 46, Part I, 1995, and 1996 from J.P. Morgan, *Emerging Markets Data Watch*, except for Colombia in 1993-1994, where it was estimated from World Bank data and BIS, *International Banking and Financial Market Developments*, and for Taiwan Province of China in 1993-1995, where it was taken from Central Bank of China (Tapei), *op. cit.* **Securitized debt claims** were taken from BIS, *op. cit.* **Bank claims** were taken from OECD/BIS, *Statistics on External Indebtedness Bank and Trade-related Non-bank External Claims on Individual Borrowing Countries and Territories*. **Total external debt** was taken from OECD, *External Debt Statistics, 1995 Edition* (Paris, 1995).

SUB-SAHARAN AFRICA'S DEBT TO NON-OECD OFFICIAL CREDITORS

A. Nature of the problem

Developing country debt to non-OECD official creditors¹ is a category of debt for which there has been surprisingly little analysis to date. Possibly, this is because it is generally considered that such debt does not account for a substantial proportion of the total debt of developing countries or that it is mostly in arrears, with little prospect of repayment. In a report on the subject shortly to be published² the UNCTAD secretariat dispels these beliefs. There is no comprehensive source of data on this type of debt, but such data as are available indicate that it amounts to at least \$245 billion, which represents 12 per cent of total developing country debt and more than 15 per cent of their medium- and long-term debt. If arrears are taken into account, non-OECD creditors accounted in 1995 for almost 20 per cent of scheduled total debt service and for 42 per cent of scheduled bilateral debt service. In addition, although part of this debt to non-OECD creditors is not being paid, the debt nevertheless contributes to the debt overhang of the countries concerned. Uncertainty as to how this debt will be treated does pose a problem, especially nowadays: in the context of a comprehensive approach, where solutions have and are being sought on commercial bank, Paris Club and multilateral debt, the problem of debt to non-OECD creditors cannot be ignored.

Non-OECD creditors have indeed taken a certain number of measures to deal with the debt servicing problems of developing countries. These

efforts include tolerating accumulation of arrears and arranging reschedulings, debt cancellations, conversions and buy-backs. To date, however, there has been no formal framework for discussion of non-OECD debt and no consistent implementation of measures to alleviate payments difficulties and reduce the relatively high transaction costs associated with monitoring and negotiating debt bilaterally on a case-by-case basis.

The UNCTAD study mentioned above focuses on sub-Saharan Africa (SSA)³ for two main reasons. First, non-OECD debt presents a relatively greater problem for SSA than for developing countries in general. It amounted to an estimated \$35 billion, or 17 per cent of their total debt. Indeed, non-OECD scheduled debt service in 1995 represented about 19 per cent of total debt service; if arrears are taken into account, the share rises to more than one third. Second, the study emanates from a specific request put forward by African representatives at a seminar organized by UNCTAD in 1994 on strategies for Africa's debt negotiations.

As SSA's non-OECD debt is predominantly to two groups of creditors, the Russian Federation and Arab financial institutions and Governments (which together account for about 85 per cent of both non-OECD debt and debt service of SSA in 1995), the study concentrates on these two categories.⁴

B. Debt to the Russian Federation

Debt owed to the Russian Federation, the single largest non-OECD creditor, accounted for \$16.8 billion,⁵ i.e. 8 per cent of SSA's total external debt, but for almost half of its total non-OECD debt in 1994.⁶ From the point of view of the creditor, however, the picture is different, as claims on SSA represent less than 10 per cent of total developing country debt to the Federation. Such debt, according to the Russian authorities, amounts to \$173 billion.⁷ Russian claims on SSA are particularly concentrated on three countries - Angola, Ethiopia and Mozambique. In these three countries, the Russian Federation is the major creditor. In two other countries (Guinea and United Republic of Tanzania) such debt also represents a significant share of total external debt. A high proportion of SSA's debt to the Russian Federation - perhaps as much as 90 per cent - is related to purchases of military supplies, and carries highly variable terms. The repayment record of SSA has generally been poor, and arrears have accumulated quickly.

A crucial issue is the exchange rate to be used in placing a dollar value on the debt. Around 80 per cent is denominated in roubles but repayable in hard currencies at the rate of R 0.5854=\$1. Since the official exchange rate became market-determined in 1992 it has fallen sharply, reaching R 5,069=\$1 as at 12 June 1996. Many debtors have argued that the debt should be revalued according to the current exchange rate, but the Russian Federation has insisted that the old rate continue to apply. It is estimated that revaluing SSA debt at the market rate would cost the Federation over \$14 billion and reduce outstanding debt to a marginal sum. The Government has, however, displayed a willingness to adjust the rate in several cases for non-African countries for a variety of reasons, including trade and investment prospects in the debtor country. There have also been difficulties between debtor countries and the creditor country associated with reconciling data on outstanding debt, reflecting the inadequacy of the statistics.

The Russian Federation has utilized a number of methods to deal with the problem of its claims on SSA:

- Rescheduling was a preferred method for all bilateral loans until 1990, by which time more than 150 agreements had been signed with developing countries (most of them during the 1980s). Over 65 of the agreements were with countries in SSA. During 1980-1993, such agreements covered over \$20 billion in outstanding debt. Rescheduling terms broadly matched those of the Paris Club at the beginning of the decade, but fell behind after 1988, when Paris Club terms became progressively softer. Rescheduling is now rarely applied to low-income countries.
- Payment of debt via exports of goods was also widely resorted to in the 1980s, and the practice continues for larger developing country debtors. Difficulties arose, however, with regard to the non-transparency of valuation of goods, the quality of goods provided in payment, and the trend toward trade liberalization in both debtor countries and the creditor country. These problems have led to the virtual cessation of such deals with SSA, and this method is unlikely to be much used in future.
- Conversion of debt into local currency payments has been attempted, but much less frequently in recent years as trade links have dwindled. Debt-for-equity swaps were sometimes resorted to in the early 1990s, but due to a number of difficulties there have been few such deals with SSA. These difficulties include finding appropriate partners and projects, and differing expectations between local and Russian partners.
- The sale of debt to foreign intermediaries for either hard currency or goods has also suffered from serious drawbacks, including

disputes over debt valuation, lack of transferable titles, Russian insistence on debt prices which are considered too high by the debtor countries (especially in view of the low prices of their debt on secondary markets), debtors' lack of resources with which to pay intermediaries, and the non-transparency of such operations. The sale of debt to Russian banks and other companies via a system of tenders has similarly encountered adverse circumstances which limit its usefulness.

- Discounted buy-backs by debtor countries of debt to Russian trading organizations have become increasingly popular, because they are more transparent, are based on the international secondary market price, and guarantee immediate foreign exchange receipts. Agreements have been hampered by debtors' lack of foreign exchange, but in recent years increasing amounts of debt to the Russian Federation have been classified as commercial and included in IDA buy-backs, and bilateral donors have been willing to provide grant funding.

The UNCTAD study examines the costs and benefits of the three main options which appear to be most practicable for dealing with the outstanding Russian claims on SSA countries: buy-backs, conversions, and rescheduling on Paris Club comparable terms:

- Further debt buy-backs could be envisaged where the Russian Federation sells its loans at secondary market prices, with debtor payments funded by donor grants, preferably through a non-OECD buy-back facility similar to the IDA-financed Debt Reduction

Facility for commercial bank loans. These operations might be particularly interesting in respect of concessionality for the debtor, certainty of payment for the creditor, and transparency and lower transaction costs for both debtors and creditor. They would also allow immediate relief from the debt overhang in participating debtor countries. However, the funding of such operations would present a problem, especially in view of the various existing and potential demands on donor funds to finance other debt reduction facilities. Nevertheless, for a number of small debtors, a relatively small sum would provide tremendous benefit. As an example, in a buy-back operation, \$318 million would clear the debt to the Federation of 15 SSA countries, utilizing discount rates equivalent to the secondary market price of the debt, which ranges from 65 per cent to 98 per cent.

- On the basis of a case-by-case analysis of those countries offering the best prospects for joint ventures, conversions could also be considered, provided that the difficulties mentioned above have been overcome.
- Finally, for a number of debtor countries, membership of the Russian Federation as a creditor in the Paris Club would most likely result in the reduction of their debt to that country under the Naples terms. The degree of concessionality which might be provided under this option is clouded by, *inter alia*, the exchange rate issue and the potential classification of a large portion of the debt as concessional.⁸ Discussions have taken place on the issue of Russian membership in the Paris Club in recent months, but as yet with no result.

C. Debt to Arab financial institutions and Governments⁹

Total SSA debt to Arab financial institutions (AFIs) and Governments amounts to \$12 billion, or 45 per cent of SSA debt to non-OECD creditors.¹⁰ Most of this debt is concessional. Debt to the AFIs is particularly important for six Sahel countries (Mali, Mauritania, Niger, Senegal, Somalia and Sudan); it also represents a significant

part of the total loan portfolios of the AFIs. Arrears on such debt have been rising steadily since the mid-1980s, especially as disbursements began to slow down as a result of falling oil prices and growing debt difficulties in many SSA countries during this period. In recent years, growing SSA arrears have become an increasingly serious finan-

cial constraint on some of the AFIs, which have begun to record relatively high arrears relative to capital, reserves and total loans. In absolute terms, of \$6.6 billion in total arrears to the AFIs at end-1994, SSA was responsible for \$5.1 billion. There is hence a clear need for enhanced debt relief as both creditors and debtors are burdened by the effects of debt overhang, liquidity shortfalls and arrears.

There are precedents for debt relief by Arab creditors. First, AFIs have tolerated arrears in a number of cases; indeed, while according to loan contracts arrears lead to immediate suspension of disbursements, most institutions are more flexible in practice. Several of them allow three to six months of arrears before suspending disbursements. In addition, in spite of public arguments against rescheduling and cancellation, Arab institutions have increasingly refinanced or deferred arrears and current service informally (for instance, through refinancing with new quick-disbursing loans). A few Governments have also bilaterally cancelled large amounts of debt and arrears. Arab creditors have, however, avoided sales on secondary markets, buy-backs or conversions, largely due to the transaction costs involved (staff time and training) and concern regarding the complexities of negotiations and the risk of non-transparency.

As regards the prospects for increased relief, given that most loans from AFIs and Governments are already concessional, there are three main possibilities:

- Rescheduling of arrears and current service over an extended period on terms comparable to those of the Paris Club (40-year maturity and 16-year grace period);

- Debt cancellation by Governments which is extended to the stock of debt instead of being confined mainly to arrears;
- Debt conversion. In spite of the reluctance of Arab creditors regarding conversions, there might nevertheless be projects in which Arab investors could provide valuable expertise, and where Arab NGOs could be involved. A coordinated conversion fund could be established, which would reduce transaction costs by concentrating activities in one institution.

The first two of these proposals may not be significantly more costly to the creditors than the informal procedures applied so far, but would be more orderly and transparent.

Regarding more specifically the problem of debt owed to Arab multilateral institutions, the integration of this debt into wider proposals for multilateral debt relief could be a solution. Indeed, if a multilateral debt facility is established, one might consider whether its resources should not also cover payments due to multilateral Arab institutions.

Finally, the problems faced in trying to deal with the debt to AFIs have been accentuated by poor communication between creditors and debtors, the decision-making procedures in the institutions and, until recently, poor coordination among them. An organized framework for negotiations could reduce transaction costs. The steps recently been taken by the Coordination Secretariat of Arab National and Regional Development Institutions to overcome these problems should be encouraged, together with the enhanced participation by the AFIs on debt issues at Consultative Group and Round Table meetings, especially in view of the new initiative for HIPC's.

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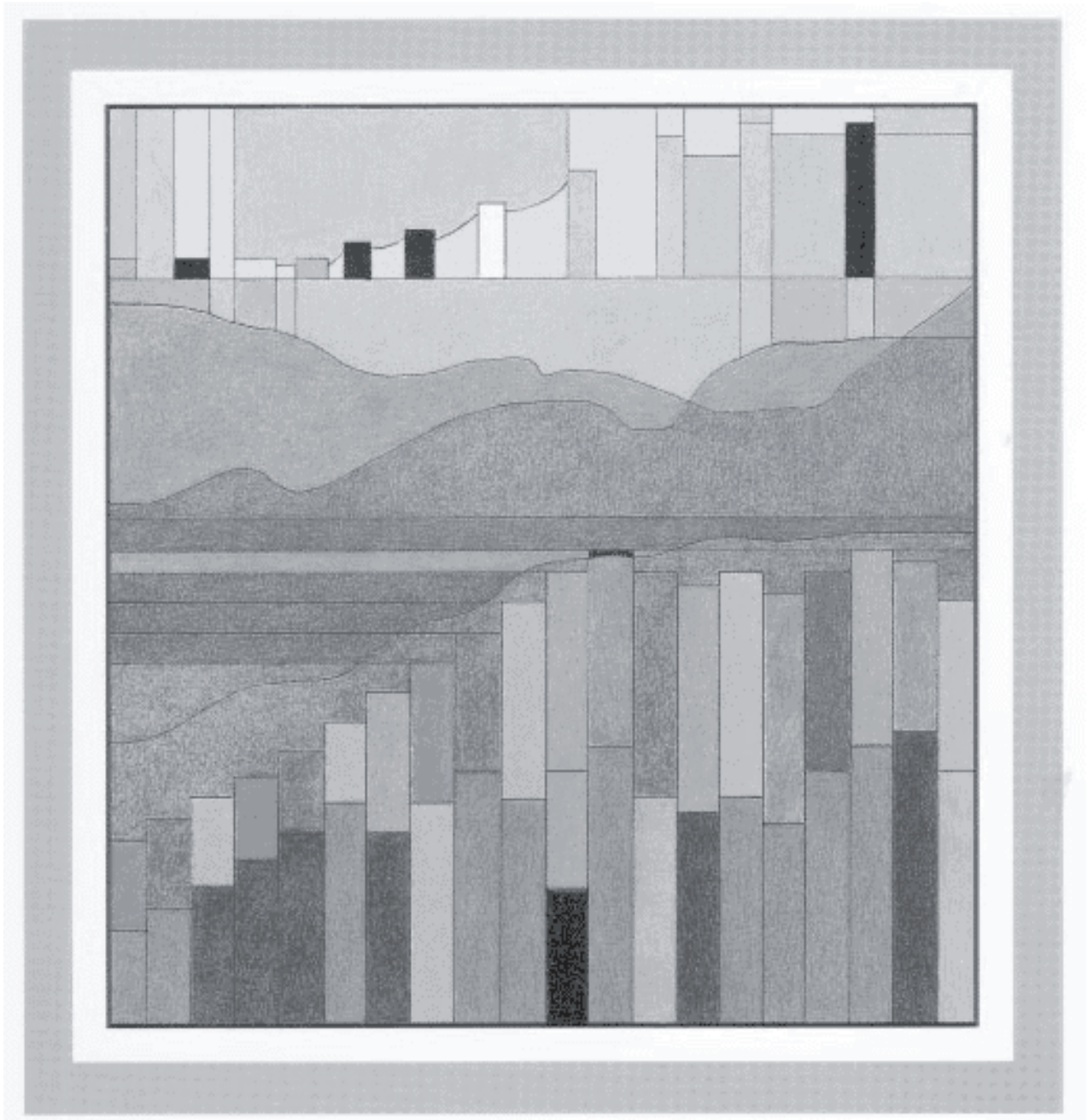
Although the UNCTAD report focuses on the two major non-OECD official creditors, it should be noted that for specific countries other such creditors may be relatively more important. For SSA as a whole, however, it is clear that significant improvement is possible in terms of communication and coordination between debtors and creditors, and in the case of debt to Arab financial institutions and bilateral government debt, among the relevant credi-

tors themselves. It is vital that the issue of non-OECD debt be placed within a comprehensive context in which this category of debt can be considered alongside other types of debt and the need for a sustainable debt position overall. In this regard, increased use of Consultative Groups and Round Tables would prove useful while the Paris Club continues with its present role of generating a consensus among OECD bilateral creditors. ■

Notes

- 1 The term “*non-OECD official creditors*” is defined here to include all non-OECD official bilateral creditors, together with multilateral financial institutions that have as members only non-OECD countries.
- 2 *Reducing Sub-Saharan Africa's Debt to Non-OECD Official Creditors: Sharing the Burden.*
- 3 “Sub-Saharan Africa” in the study excludes South Africa and Namibia.
- 4 Twelve debtor countries (Angola, Ethiopia, Guinea, Guinea-Bissau, Mauritania, Mozambique, Niger, Sao Tome and Principe, Senegal, Uganda, United Republic of Tanzania and Zambia) are studied in detail in the report; they were chosen for the high share of non-OECD debt in their total debt and their large share of the total non-OECD debt of sub-Saharan Africa.
- 5 All data related to Russian claims reflect a valuation of rouble-denominated claims at the official exchange rate of R 0.5854=\$1. This does not constitute an endorsement by the UNCTAD secretariat or by the debtor countries surveyed of the appropriateness of this exchange rate.
- 6 Russian claims represented 46 per cent of its total non-OECD debt and 55 per cent of its total non-OECD bilateral debt in 1994.
- 7 It is noteworthy, however, that HIPCs do account for a substantial portion of the total debt because this group includes large non-SSA debtors such as Nicaragua, Viet Nam and Yemen.
- 8 This classification could lead to pressure for cancellations similar to those provided bilaterally by many OECD countries. On the other hand, under the Naples terms, concessional debt is not reduced.
- 9 The debt examined here consists of: debt to multilateral development funds (AFESD, AMF, BADEA, the Islamic Development Bank and the OPEC Fund) and to bilateral development funds (such as the Algerian Development Bank, the Abu Dhabi Fund, the Iraqi Fund, the Libyan Arab Bank, the Libyan Arab Foreign Investment Company, the Kuwait Fund, and the Saudi Fund) as well as Government-to-Government loans (especially those granted by Algeria, Iraq, Kuwait, Libyan Arab Jamahiriya, Saudi Arabia, and the United Arab Emirates).
- 10 Arab bilateral debt represents 33 per cent of the non-OECD bilateral debt of SSA, and Arab multilateral debt about 88 per cent of the region's non-OECD multilateral debt.

**RETHINKING DEVELOPMENT STRATEGIES: SOME
LESSONS FROM EAST ASIAN EXPERIENCE**



Introduction

Rapid growth, rising living standards and increased international competitiveness in the economies of East Asia have caught the attention of policymakers and researchers in other developing regions, as well as in the developed world. A broad debate has consequently opened up on the lessons that can be drawn for meeting the wider challenges of economic development. The region's performance relative to other regions can no longer be regarded as a passing phenomenon. But how such high and sustained rates of growth have been achieved among a large group of economies is still the subject of debate. To date opinion has been divided. On one view, the experience confirms the case for "getting prices right" through the free play of market forces. On another, it points to the limits of price signals as a guide to the process of capital accumulation and technological catching-up, and confirms the benefits to be drawn from appropriate forms of government intervention. Both these interpretations have tended to pose stark choices for other developing countries seeking to emulate the East Asian example: the market versus the State; inward- versus outward-oriented development; investment or exports as the engine of growth.

This issue of *TDR* pursues a different line. In *TDR 1994* the analysis focused on the links between capital accumulation, technological progress and economic growth in the first-tier East Asian newly industrializing economies (NIEs) - Hong Kong, Republic of Korea, Singapore and Taiwan Province of China. It examined possible conflicts as well as complementarities between the State and the market in evolving government-business relations built around a profit-investment nexus animated by strategic policy interventions and appropriate institutions. Building on that research, this year's Report emphasizes the interdependence of exports and investment and its role in accelerating structural change and industrial growth. In particular, it considers the extent to which mutually reinforcing regional trade and investment

linkages have added a distinct dimension to the East Asian growth experience. Following the lead of the earlier Report, it also examines the role of policies in linking exports to investment, as well as in upgrading and diversifying export structures. In this context, the complementarity between effective export promotion measures and import substitution policies is examined. Differences among countries in the choice and effectiveness of policies are explored, as well as those within the region between the first-tier NIEs and the second-tier ones (Indonesia, Malaysia and Thailand).

From this perspective the issue of replicating East Asian success outside the region comes into sharper focus. Broadly speaking, outward-oriented development is a dynamic process where investment, imports, exports and industrial upgrading are closely intertwined. Such a process is consistent with varying degrees of import substitution and export orientation, and with concentration on different products and markets. There is thus considerable room for manoeuvre in a pragmatic approach to development policy in a globalizing world, which can accommodate differences in levels of industrial development, natural resource endowments and macroeconomic constraints.

Replication by a large number of countries not only requires the successful pursuit of trade, industrial and technology policies by developing countries, but also open markets in the North. This in turn will depend upon finding solutions to the severe labour market problems which continue to beset many advanced industrial economies. As last year, this year's Report rejects the claim, which has become louder over the past year, that growing import penetration by developing countries of their domestic markets is to blame for these problems, assesses the scope for increased North-South trade, and argues that outward-oriented development in the South and expansionary policies in the North provide the basis for a new global policy dialogue.

However, there are also new challenges confronting policymakers in developing countries seeking to emulate the East Asian type of export-oriented industrialization. In the first place, compared to the first-tier NIEs, they can certainly expect closer surveillance of their domestic trade and investment policies, which will be subject to WTO disciplines. The Report assesses from this standpoint the new trading environment and the scope for permissible policy alternatives for promoting industrialization in the South. Moreover, given the uncertain economic prospects in the advanced industrial economies, the regional success of East Asia not only encourages a fresh look at the potential gains from South-South economic cooperation, but also widens the opportunities for such cooperation.

Chapter I examines the regional dimension of East Asian industrialization and growth, concentrating on trade and investment links among countries. Particular attention is paid to macro-economic pressures and government policies in

shaping the regional integration process. The chapter also assesses the implications of recent shifts in competitiveness for growth and employment in Japan, as well as for industrialization and development of the developing countries of the region. Chapter II seeks to account for the success of the East Asian economies in linking a rapid pace of investment and industrial upgrading to exports. The role of trade and industrial policies in animating an investment-export nexus is emphasized, and differences in export performance among economies in the region are related to differences in policy orientation, including policies relating to FDI and TNCs. The final chapter examines the issue of replicating the East Asian export performance on a large scale. In particular, the danger of a “fallacy of composition” that may arise from widespread efforts to promote low-skill manufactured exports is examined, as well as the potential problems such exports might pose for advanced economies. An assessment is also made of whether the post-Uruguay Round trading regime precludes the policies that underpinned export success in East Asia. ■

INTEGRATION AND INDUSTRIALIZATION IN EAST ASIA

A. The flying geese paradigm

During the past two decades, the economic performance of Japan and a small group of rapidly growing East Asian countries, including the Republic of Korea, Taiwan Province of China, Hong Kong and Singapore (collectively identified as the first-tier newly industrializing economies, NIEs) has attracted considerable attention. More recently, strong growth in a second tier of (South-East) Asian industrializing countries (Indonesia, Malaysia and Thailand) and the re-emergence of China in the world economy have added weight to the idea of a wave of industrial development spreading across a much wider region and focused attention on East Asia¹ as a new growth pole in the world economy.

This regional pattern of industrialization, which has not only proceeded in waves but also progressively involved a regional division of labour based on an industrial and locational hierarchy, has been dubbed as a “flying geese development paradigm.”² This paradigm provides a description of the life-cycles of various industries in the course of economic development and of the relocation of industries from one country to another through trade and foreign direct investment (FDI) in response to shifts in competitiveness.³ However, there is more at stake in the flying geese paradigm than pure description. The significance of the paradigm lies in its analysis of the linkages between the different countries in a regional hierarchy, the mechanisms by which development is transmitted from one country to another, the re-

spective roles of policy and markets in this process, and the stability and sustainability of the process itself.

In this process, trade is the most important vehicle for transferring new goods and technology across countries. Imports from the more advanced countries (*senshinkoku*) would allow new goods to be introduced into the “follower” countries (*koshinkoku*). They would also allow the transfer of technology and capital goods needed for their subsequent production in the “follower” economy and, eventually, for their export to other countries. Finally, when a country loses competitiveness in a particular product, its domestic production is phased out and replaced by imports from the “followers”, which have succeeded in building up a competitive industry in that product. Thus, this sequence combines the life-cycle of a particular product with a dynamic process of shifting comparative advantage. The outcome is a constantly evolving regional division of labour within a group of economies all striving for the common goal of industrialization.

More recently emphasis has been placed on FDI as an additional channel for “recycling comparative advantage”. On this view, FDI both shapes and is shaped by the evolution of comparative advantage between the follower countries and the lead country. Domestic investment withdraws from those sectors suffering from loss of competitiveness (e.g. labour-intensive sectors such as textiles

Box 4**THEORIES OF TRADE AND FOREIGN DIRECT INVESTMENT**

There has never been a happy marriage between the theory of international trade and the analysis of the determinants of FDI. Although trade and FDI are often linked through their balance-of-payments effects, such a relationship is a simple accounting one, and does not provide an integrated theory of overall competitiveness. While the standard theory of international trade seeks to explain comparative advantage in terms of inter-country differences, such as in factor endowments, most of the literature on the determinants of FDI concentrates on firm-specific, microeconomic factors. The two approaches are not always consistent; the theory of comparative advantage is based on the assumption of perfect competition, whereas FDI is often explained in terms of market imperfections or failures. Even where a more interactive approach to FDI has been attempted, analysis has concentrated narrowly on corporate strategy; thus, it provides little insight into how macroeconomic factors interact in the decisions on locating production globally.

On the other hand, the neoclassical theory of capital movements based on international differences in thrift and productivity makes no explicit reference to the theory of comparative advantage. Nor does it contribute to the understanding of the determinants of FDI because it leaves open the allocation of excess savings between portfolio and productive investment. Finally, the link between a country's domestic investment and its FDI is not clear. The conventional approach to international capital flows sees no trade-off between the two since it treats thrift and productivity as independent variables. By contrast, where FDI is treated as a substitute for exports, there is an implicit trade-off between domestic capital formation and FDI.

One way of combining the theory of trade with the theory of FDI is to view trade and FDI as alternative ways for a firm to supply foreign markets. In deciding between the two, the firm would naturally compare the costs of investing and operating at home with those of investing and operating abroad. Thanks to the seminal contribution by Hymer¹, it is now generally recognized that foreign firms face certain disadvantages compared to local firms and that in order to be able to compete with the latter they consequently need to enjoy certain comparative advantages based on unmarketable, owner-specific assets such as superior technology and product design and managerial, marketing and distributional skills. In the absence of a market to price these knowledge- and information-based assets, or when market solutions such as licensing suffer from inefficiencies, the production process will need to be organized through subsidiaries in order to capture the rents from firm-specific assets.²

Certainly, in order for a firm to invest abroad and compete with local firms, the comparative advantages arising from such firm-specific factors need to exceed the additional costs of operating abroad. However, this is not a sufficient basis for determining whether it is in the interest of the firm to supply foreign markets from its plants abroad rather than at home. The basis for such a decision is provided by the product-cycle hypothesis³, which sees trade and FDI as successive stages in production for foreign markets. First, the firm innovates and develops a new product within the market, to satisfy domestic demand. Then output of the product is increased as conditions in export markets become favourable for the product concerned. Eventually, the firm is forced to invest abroad as the knowledge embodied in the goods produced is increasingly absorbed by foreign producers. In other words, the firm will decide to invest abroad when trade no longer allows it to capture the rents from its intrinsic assets.

However, none of these intra-firm considerations can explain the evolution of trade and FDI at the aggregate level. Different firms and industries will reach different stages of production at different times, and there is no reason to expect them to move simultaneously from the domestic market to exports, and from exports to FDI. In other words, these theories do not provide much insight into the behaviour of trade and FDI throughout the industrialization process. By the same token, any generalization about the overall pattern and evolution of trade and FDI in industrial societies needs to rely on common, macroeconomic factors that generate more or less uniform influences across the industry. Both the flying geese paradigm and the "four stages" model of Roemer discussed in section C of this chapter aim at such a generalization.

Box 4 (concluded)

Such macroeconomic influences may arise from a number of factors, including a sustained rise in labour costs relative to competitors and/or a permanent appreciation of the currency. Perhaps an equally important factor is the restrictions faced in exporting to foreign markets. Clearly, both tariff and non-tariff barriers to trade will open up the potential for FDI as a means of circumventing the barriers. If a country faces greater barriers to its exports as its share in world trade increases, it is to be expected that the pace of its exports will slow down and that of FDI will take off. Such an outcome is probable when the rising trade share is associated with a balance-of-payments surplus and when the major trading partners suffer from chronic demand deficiency and high and rising unemployment. While historically this situation has not always prevailed, the post-1980 increase in Japan's share in world exports has certainly taken place in the context of slow growth and increased unemployment in its major trading partners in Europe and elsewhere. Under these conditions the factors that tend to restrict exports also provide additional incentives for FDI; from the trading partners' point of view, while imports tend to reduce employment, FDI creates additional jobs.

It should, however, be pointed out that, even when an inverse correlation is observed between exports and FDI at the industry or the aggregate level, it is not always possible to conclude that the latter replaces the former. Exports may simply be constrained by rising costs, currency appreciation or increased protectionism, while firms respond by investing abroad. Thus, the choice is not between exporting and investing abroad, but between FDI and losing an important part of the market. Moreover, investment abroad could prevent further deterioration in the external position of the country if it allows the firm to develop and become more competitive in the home market or third markets vis-à-vis other foreign firms.⁴ Finally, FDI may even help improve the exports of the home country through the provision of, first, capital goods and, then, intermediate inputs to foreign subsidiaries of parent companies. In such cases, one may or may not observe an inverse relationship between FDI and trade, but in any case such a relationship does not necessarily indicate causality. This may also explain why empirical studies on the relation between FDI and trade are inconclusive.⁵

¹ S. H. Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investment* (Cambridge, MA: M.I.T., 1976), Monographs in Economics, No. 14.

² These considerations are also broadly valid for the so-called "complex FDI strategies", whereby the production process is "sliced up" among different locations and intra-firm trade is of growing importance. Even ignoring the empirical question of how far this slicing up has actually progressed, the focus on corporate strategies is no more successful in providing an integrated theory of trade and FDI in the sense discussed here.

³ R. Vernon, "International Investment and International Trade in the Product Cycle", *The Quarterly Journal of Economics*, Vol. 80, May 1966.

⁴ See R. E. Lipsey and M.Y. Weiss, "Foreign Production and Exports in Manufacturing Industries", *The Review of Economics and Statistics*, Vol. 63, No. 4, November 1981.

⁵ See J. P. Agarwal, "Determinants of Foreign Direct Investment: A Survey", *Weltwirtschaftliches Archiv*, Vol. 116, No. 4, 1980, for an earlier, and G.C. Hufbauer, D. Lakdawalla and A. Malani, "Determinants of Direct Foreign Investment and its Connection to Trade", *UNCTAD Review, 1994* (United Nations publication, Sales No. E.94.II.D.19), for a more recent survey of these studies. The studies do not always, however, distinguish among manufacturing, services and natural-resource-oriented flows of FDI. Certainly, FDI in natural resources does not replace trade and domestic investment; and in ancillary services, such as sale and service networks, it is often complementary to trade.

and footwear), and production is relocated where labour is cheaper in order to supply both foreign and home markets. However, aggregate investment does not diminish in the advanced economy because its industry is constantly being restructured and upgraded, and resources are reallocated to higher-skill, higher-technology products, where it now enjoys comparative advantage. In this model,

therefore, there is no trade-off between aggregate domestic investment and FDI; global investment continuously increases, promoting trade flows. In the host country, FDI raises living standards and provides employment for those displaced by the migration of older activities to the "follower" countries. On this account, FDI is trade-oriented and benignly complementary to the host country's economy. The flying

geese pattern of FDI is governed by shifts in competitiveness brought about, in part, by macroeconomic factors, and is often contrasted with alternative patterns where FDI is governed by the "microeconomic" interests of transnational corporations (TNCs) to defend oligopolistic advantage.⁴ Thus, this paradigm offers an integrated analysis of trade and FDI at the aggregate level which a firm-based approach cannot provide (see box 4).

This chapter makes a critical assessment of this paradigm as applied to the East Asian experience. It examines trade and investment linkages among countries in East Asia at different levels of industrialization, the role played by the more advanced countries in the hierarchy, particularly Japan, and the macroeconomic factors underlying the changes in trade and investment flows within the region. The chapter also explores the extent to which government policy has been central to the flying geese pattern of development, and discusses whether this pattern always generates a mutually reinforcing, harmonious process of industrialization, or also contains some conflictual elements.

A main lesson that emerges from the assessment is that there is considerable scope for developing countries at different levels of industrialization to benefit mutually from the flying geese pattern of trade and FDI. As long as they pursue

appropriate industrial and technology policies, these countries can move up the industrial hierarchy through accelerated capital accumulation and the adaptation of advanced technology in such a way that shifts competitiveness to the mutual advantage of all countries and does not lead to unmanageable domestic dislocations and adjustment problems, or to trade frictions. Consequently, there is considerably more scope for South-South cooperation in industrial development than is generally believed.

However, with economic maturity the speed of upgrading slows down considerably, since moving up in the technology scale increasingly depends on innovation. This poses different policy challenges for the lead economy from those faced by developing countries further down the industrial hierarchy. Focusing on these concerns brings into sharper perspective the regional role of Japan, which has become much greater in recent years and has been associated with serious regional imbalances in trade and FDI flows. The response of Japan not only will determine whether or not the Japanese economy will enter a new post-industrial stage with low growth and high unemployment typical of other major industrial countries, but also will affect the fortunes of the developing countries of the region, and, indeed, prospects for the wider regional integration process.

B. Role of policy and markets in the flying geese process

The first important issue is whether or not industrial development in line with the flying geese paradigm has been a market-driven process. There can be little doubt that it implies a more outward-oriented development strategy. However, this does not mean that a mutually beneficial flying geese pattern of investment, trade and industrialization emerges spontaneously. Policy intervention would be needed if markets fail to generate signals about the possible evolution of comparative advantage so as to allow producers and investors to anticipate difficulties that existing industries may face, or if producers and investors fail to respond to market signals because of a number of impediments and imperfections, including problems of informa-

tion and coordination and of adjustment costs, or because firms' responses to price signals do not generate a mutually reinforcing process of industrialization for all the countries concerned.

Policy intervention has indeed taken place, at two levels. For the more advanced economies, notably Japan, phasing out obsolescent industries and supporting "sunrise" industries have often required considerable government intervention to help private enterprises to relocate production abroad through FDI and/or to move to different products, where they could create new comparative advantages. As examined in greater detail in *TDR 1994*, these interventions were formulated in the context

of a consistent, overall industrial policy designed to tackle a series of closely interrelated and mutually reinforcing market failures which typically held back the process of investment and innovation, and the type of industrial policy used worked through the interaction of government policy and the competitive strategies of private firms. The need for policy intervention did not lessen with the progress of industrialization in Japan. Indeed, as discussed in section H below, the response of domestic firms to recent shifts in competitiveness poses serious policy challenges.

From the Japanese perspective, outward FDI, government support and regional integration strategies have been closely interrelated. There is indeed substantial empirical evidence that corporations in Japan continue to work closely with the Government, even after they have moved abroad.⁵ Often, the Government has also worked with Governments of other countries to support an orderly, sequential transfer of industries in response to changing comparative advantage among the ranks of developing countries in Asia. In this context, the flying geese paradigm has served partly as a rationale for the country's official development assistance (ODA) and economic cooperation programmes to support the activities of Japanese firms in South-East Asia. In particular, ODA for the development of infrastructure has been seen as preparing the recipient countries elsewhere in the region for FDI and as a means of promoting their export industries.⁶ This factor also helped Japan to extend its national concepts of industrial policy to other countries of the region. It has, for instance, been suggested that officials of

the Ministry of International Trade and Industry (MITI) have tried to reproduce in South-East Asia some of the instruments of industrial policy used in Japan.⁷ Similar conclusions can also be reached from the more recent wave of regional FDI from first-tier NIEs. Thus many of the positive international spillovers within East Asia have been ultimately generated because of the success of the industrial policies of the lead economies, rather than through a purely market-generated process.

The evolution of an export-oriented industrial sector is no more spontaneous and no less difficult for developing than for developed countries. As discussed in greater detail in chapter II below, even the promotion of industries which enjoy comparative advantage arising from existing resource endowments, including labour, require considerable policy effort. The process of industrial upgrading poses even greater policy challenges. Thus, the "followers" need to employ industrial policy, in the form of infant industry protection and export promotion, in order to even the competitive playing field with the more advanced economies. The effective use of FDI in facilitating upgrading and technological catching-up and in promoting exports has also depended on a series of policy initiatives on the part of host Governments. While such policies have often been prompted by the need to respond to market pressures, they were also designed to deal with missing markets or market failures. In this sense, the flying geese paradigm of a mutually beneficial process of industrialization is best described as a market-compatible, rather than a market-driven, process.

C. Harmony, competition and conflict in the flying geese process

Most of the recent accounts of the flying geese paradigm paint a harmonious picture in which East Asian development is presented almost in entirely cooperative terms, while the potentially conflictual and competitive aspects of this process are virtually ignored. Such a harmonious vision is notable particularly with respect to the role of TNCs and FDI. As noted above, there are certainly many instances in which the interests of TNCs and the

Governments of the more advanced and the "follower" countries coincide, leading to close collaboration with little or no conflict. Again, there are many instances where the interests of producers and consumers within countries are compatible. However, it would be misleading to assume that no conflict of interest is involved either within or among countries, or between countries and TNCs in the flying geese process. Indeed, as already

noted, an important objective of policy has been to avert potential problems and conflicts by facilitating adjustment to changed conditions of competitiveness, or to bring about desired outcomes by inducing domestic and foreign investors to undertake activities they would not otherwise envisage.

In the original formulation of the flying geese paradigm by Akamatsu, conflicts among and within countries associated with trade were clearly recognized. Thus, it was recognized that the initial penetration of imports into a "follower" country would benefit local consumers but hurt producers. When local firms eventually develop and successfully compete with imports, the follower country as a whole may benefit, while the leading country as a whole may suffer. These dangers are scarcely recognized in more recent versions of the paradigm, which ignore or seriously downplay the costs and difficulties of restructuring. In the course of time both follower and lead countries may be better off as they move up in the industrial hierarchy, but the management of conflicts arising from the immediate impoverishment of producers, and adjustment to new circumstances pose serious challenges to policymakers.⁸

Conflict between countries and TNCs can take many forms. The latter seek to maximize profits from their global operations, rather than those of each and every affiliate separately. Consequently, their interests do not always coincide with those of the host country. The likelihood of conflict is greater when TNCs pursue "complex integration strategies", whereby the production process is "sliced up" among different locations and intra-firm trade is of growing importance. With such strategies the scope for transfer pricing, for example, increases considerably. As noted in another UNCTAD report, "no single country ... in which a part of a TNC system is located can be assured of capturing (or capturing to the same extent as others) the benefits" that are expected to flow from the global activities of TNCs. Although "it can reasonably be assumed that attempts by a TNC to improve its competitiveness would have favourable repercussions on at least some of the national economies within which it is operating",⁹ there is no presumption that these national economies are less advanced ones. A host developing country may wish to maximize the local content of TNC production, or to induce TNCs to locate high value-added activities within its borders and maximize spin-offs to the domestic economy by encouraging the local firms to enter the industry.

It may also wish to lock TNCs into the national economy and induce them to upgrade their technology in line with the changing needs of national development. Such objectives may conflict with the natural desire of TNCs to safeguard their technological advantages and maximize their flexibility to relocate production in line with their shifting global priorities. Transnational corporations can be a powerful engine for "recycling comparative advantage", but the extent and terms of this recycling are variable, and the more leverage a host country can exert over TNCs, the better the bargain it can strike.¹⁰ Indeed, as discussed in chapter II below, national policies towards TNCs and FDI have played an important role in shaping their contribution to the attainment of development objectives in the East Asian NIEs, and will continue to exert a major influence on the future course of industrialization and development.

What is even less appreciated is the possible conflict of interests between TNCs and the home country. The flying geese paradigm assumes that the lead country can always upgrade its industrial structure and introduce new methods of production and new products as rapidly as other countries catch up. Moreover, the markets for the new products introduced are seen as extensive as those for the products displaced. While these assumptions may be correct at earlier stages of industrialization, they become less valid with maturity. Indeed, it appears that the innovation-imitation lag between the mature economies and the NIEs has shortened considerably over the past two decades, thanks not only to greater flexibility and divisibility in production technology, but also to a rapid pace of accumulation of physical and human capital in the NIEs which has allowed them to introduce rapidly new technologies embodied in capital goods and accelerated the learning and catching-up process.¹¹ Thus, the lead countries may no longer maintain a pace of technological progress and productivity growth that would allow them to expand simultaneously FDI, trade and domestic investment.

These considerations are indeed consistent with the observed postwar development of the major industrial countries. In this experience, four distinct stages have been identified in the internationalization of manufactured activity.¹² In the first stage the country relies on exports, and its share in world manufactured exports tends to increase. The second stage is the transition "from trade reliance to investment reliance" - i.e. its share in world trade stabilizes while that of FDI starts rising. In the

third stage FDI becomes the main source for supplying foreign markets and the share of the country in world trade declines. In the final stage “neither trade nor investment can save the competitive position” of the country, whose share in global FDI also declines.¹³ The transition to industrial maturity in the latter stages has often been associated with a slowdown in growth, loss of manufacturing employment and a shift into services - i.e. de-industrialization.¹⁴

At the time when this analysis was formulated, i.e. the mid-1970s, Japan, the Federal Republic of

Germany, the United States and the United Kingdom were described as being in the first, second, third and fourth stages, respectively. The increased role of Japan in the flying geese process in the past decade appears to be associated with a shift to the third stage, where Japanese outward FDI is no longer generating but replacing exports, and no longer complementing but substituting for domestic investment. These tendencies highlight the kind of conflicts that may arise between the interests of TNCs and the home country, and underlie the recent concern over the “hollowing-out” of Japanese industry discussed in section G below.

D. FDI and regional integration

As noted above, the recent versions of the flying geese paradigm assign an important role to outward FDI by the more advanced countries, notably Japan, as a way of “recycling comparative advantage” to less developed countries. This section describes the intra-regional investment flows and their role in regional integration and industrialization. While the evidence suggests that the pattern of intra-regional FDI is broadly consistent with the flying geese paradigm, until recently such FDI was relatively small compared to the flow of FDI to the region from the United States and Europe, as well as in relation to the overall rate of regional capital accumulation. Indeed, as discussed in chapter II below, there are several important countries in East Asia, including Japan itself, which have developed rapidly without relying heavily on FDI from any source.

In assessing the role of Japanese FDI in the region, it should be noted that Japan has emerged as a major international investor only during the past decade. Ten years ago, in 1985, the outstanding stock (cumulative value) of its global FDI was around \$84 billion, equivalent to about one half of the country’s total exports in that year. During the second half of the 1980s, however, such investment increased rapidly and steadily, reaching an annual average of \$45 billion (table 21).¹⁵ The outflow somewhat decelerated in the early 1990s, but still remained high, at an average annual rate

of \$38 billion. Consequently, the share of Japan in the world stock of FDI rose rapidly, reaching 12 per cent in 1994, against less than 4 per cent in 1980 (chart 2).

This rapid increase in Japanese FDI has been accompanied by significant changes in its sectoral distribution. Before the 1980s, resource-based investment, particularly in mining and energy, was a major element, accounting for 25 per cent of total outflows. Such investment stagnated throughout the 1980s, and has constituted no more than 3 per cent since 1985. The share of manufacturing investment in total Japanese FDI was higher in the 1970s (35 per cent) than the 1980s (25 per cent), but the decline slowed down towards the end of the 1980s. There was a strong recovery in the 1990s, and in 1994 the share exceeded one third. The tertiary sector has always accounted for an important part of FDI from Japan. Much of it has been in wholesale and retail trade, designed to facilitate access of domestic producers to foreign markets. The Japanese trading companies have been instrumental in this process, handling a wide range of goods and helping exporters to overcome problems of entry, as well as providing them with information on developments in foreign markets. Originally, the establishment and operations of such companies helped obviate the need for producers to locate production facilities abroad. However, they have also played an important role in promot-

Table 21

SECTORAL AND REGIONAL DISTRIBUTION OF FOREIGN DIRECT INVESTMENT BY JAPAN

	<i>Cumulative outflow</i>					<i>Stock^a</i>			
	1951- 1970	1971- 1980	1981- 1985	1986- 1990	1991- 1994	1980	1985	1990	1994
Total FDI (\$ million)^b	3577 (179)	32920 (3292)	47152 (9430)	227157 (45431)	152798 (38200)	36497	83649	310806	463604
<i>of which to (per cent):</i>									
North America	25.5	27.0	36.4	48.1	43.5	26.8	32.2	43.8	43.7
Europe	17.9	11.6	13.9	21.2	20.0	12.3	13.2	19.1	19.4
Asia	21.0	27.6	20.4	12.4	18.8	26.9	23.3	15.3	16.4
Latin America	15.9	17.0	20.1	10.9	9.6	16.9	18.7	13.0	11.9
Other regions	19.8	16.8	9.2	7.4	8.1	17.1	12.7	8.8	8.6
Primary sector (\$ million)^b	886 (44)	7094 (709)	4995 (999)	5659 (1132)	4769 (1192)	7980	12975	18634	23403
<i>of which to (per cent):</i>									
North America	20.8	9.1	13.5	21.5	12.4	10.4	11.6	14.6	14.2
Europe	0.7	12.0	0.1	12.9	13.0	10.8	6.7	8.6	9.5
Asia	35.6	42.2	64.8	23.6	30.0	41.5	50.5	42.3	39.8
Latin America	12.4	18.0	6.1	5.1	10.8	17.4	13.0	10.6	10.6
Other regions	30.6	18.7	15.4	36.9	33.9	20.0	18.2	23.9	25.9
Manufacturing (\$ million)^b	928 (46)	11645 (1164)	11826 (2365)	57213 (11443)	47284 (11821)	12573	24399	81612	128896
<i>of which to (per cent):</i>									
North America	23.4	19.0	44.6	57.0	40.1	19.3	31.6	49.4	46.0
Europe	3.9	6.9	10.5	18.3	18.4	6.7	8.6	15.4	16.5
Asia	34.5	36.6	24.9	19.5	31.5	36.4	30.8	22.9	26.0
Latin America	29.6	21.5	15.0	3.0	4.6	22.1	18.7	7.7	6.5
Other regions	8.6	16.0	4.9	2.2	5.5	15.5	10.3	4.7	5.0
Services (\$ million)^b	1763 (88)	14181 (1418)	30331 (6066)	164284 (32857)	100638 (25160)	15944	46275	210559	311197
<i>of which to (per cent):</i>									
North America	29.0	42.5	37.0	45.9	46.7	41.0	38.4	44.2	45.0
Europe	33.9	15.3	17.4	22.6	21.2	17.4	17.4	21.4	21.3
Asia	6.6	13.0	11.4	9.5	12.3	12.2	11.7	10.0	10.7
Latin America	10.3	12.8	24.3	13.9	11.9	12.6	20.3	15.3	14.2
Other regions	20.2	16.4	9.9	8.2	7.9	16.8	12.3	9.1	8.7

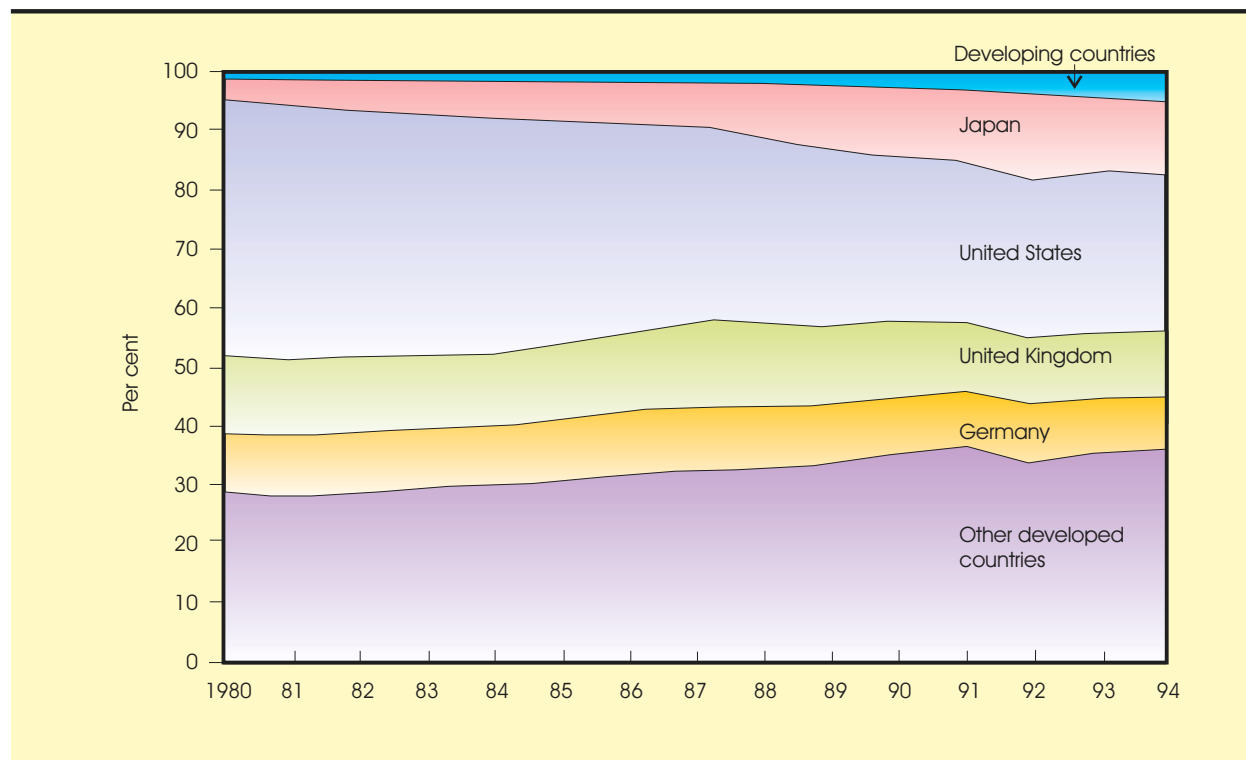
Source: Ministry of International Trade and Industry, *Statistics on Foreign Investment and Overseas Activities of Japanese Enterprises* (in Japanese), various issues.

a Cumulative annual outflows valued at historical cost (i.e. cumulation of the flows shown in the first part of the table).

b Figures in parentheses are annual averages.

GEOGRAPHICAL DISTRIBUTION OF WORLD FDI STOCKS, BY ORIGIN, 1980-1994

(Per cent)



Source: UNCTAD data base.

ing Japanese investment abroad, particularly for small investors, when they started relocating production through FDI.

Developing countries have always accounted for a very large proportion of Japanese FDI in the primary sector. At the beginning of the 1980s they also accounted for about 70 per cent of the stock of Japanese FDI in manufacturing. Although there was an important shift in the 1980s in the direction of the flow, from developing countries to the North, this was subsequently reversed, due in particular to a reduction in the flow to North America and increased flows to East Asia, which received about one third of Japanese manufacturing FDI in 1989-1994.

In 1985 almost half of the total flow of Japanese FDI to East Asia was to Indonesia, mostly in natural resource industries and labour-intensive manufacturing.¹⁶ Singapore was also a significant recipient, with a flow of about \$2 billion, mostly

in manufacturing. Corresponding investment in Hong Kong was somewhat larger, and almost entirely in non-manufacturing. For the rest of East Asia the amounts involved were modest. It is striking that, on the whole, Japanese manufacturing investment in East Asia in 1985 was small, exceeding \$1 billion only in Singapore and Indonesia. Since that year, the stock of total Japanese FDI in East Asia has more than quadrupled and much of the new investment has been in manufacturing. It first went to the first-tier NIEs and then to the ASEAN-4, but in the 1990s attention was switched to China (see chart 3).

Until the last few years Japan was the only country in East Asia with significant FDI in the neighbouring countries. In the late 1980s it was joined by the first-tier NIEs, which started shifting some labour-intensive production to less developed countries, including China.¹⁷ Between them, the first-tier NIEs now have a greater stock of FDI in ASEAN-4 than Japan. Indeed, Taiwan

Chart 3

TRENDS IN JAPANESE FOREIGN DIRECT INVESTMENT IN ASIA



Source: Ministry of International Trade and Industry, *White Paper on International Trade 1995 (Summary)*, Tokyo, July 1996.

Note: Figures for 1994 are estimates.

Province of China alone has more FDI in Malaysia than Japan (table 22). Again, a very large proportion of FDI in China originates from Chinese residents in Hong Kong and Macau, as well as from Taiwan Province. It has been argued that

much of this apparent FDI is a recycling of funds which originate in the People's Republic of China itself. Domestic firms with money to invest are said to team up with Chinese residents abroad, who invest the money back in China, where it receives

Table 22

**COMPOSITION OF THE STOCK OF FOREIGN DIRECT INVESTMENT IN CHINA AND
ASEAN-4 IN 1992, BY ORIGIN^a**

(Percentage)

Origin	ASEAN-4 ^b				China ^c
	Total	Indonesia	Malaysia	Thailand	
Hong Kong	..	7.4	3.0	6.6	62.0 ^d
Republic of Korea	..	5.7	2.9	1.5	0.9
Singapore	..	4.1	6.7	6.3	..
Taiwan Province of China	..	7.7	22.8	9.2	8.2
<i>Total first-tier NIEs</i>	<i>25.8</i>	<i>24.9</i>	<i>35.4</i>	<i>23.6</i>	<i>71.1^e</i>
Japan	26.1	15.7	22.7	38.1	8.4
United States	9.5	6.5	7.0	11.9	8.5
Other countries	38.6	52.9	35.0	26.4	12.0 ^f

Source: Ministry of International Trade and Industry, *White Paper on International Trade 1994*, Tokyo, 1994.

a Share of home countries listed in rows in total FDI stock in host countries listed in columns.

b Indonesia, Malaysia, Thailand and the Philippines.

c 1993.

d Including also FDI from Macau.

e Excluding FDI from Singapore, for which no separate data were available.

f Including FDI from Singapore.

the privileges and protection accorded to foreign investors. According to some estimates, 25 per cent of the total flow of FDI to China in 1992 was of this variety.¹⁸

There appears to have been a strong parallel between FDI from Japan and from the first-tier NIEs in the region, with the latter generally being a stage behind the former, as implied by the flying geese paradigm. This is particularly notable with respect to the Republic of Korea, where, as in the early years in Japan, FDI was initially concentrated in resource-extracting activities aimed at ensuring continued expansion of industrial production. Since the late 1980s, however, manufacturing FDI by the Republic of Korea has surpassed resource-oriented FDI in terms of both numbers of projects and value. It appears that large Korean conglomerates have begun developing global and regional production networks, emulating their Japanese predecessors.

Similarly, from the late 1980s onward the authorities in Taiwan Province of China adopted

an active policy of moving labour-intensive industries abroad. An industrial upgrading regulation provided certain incentives, including compensation for losses incurred by investors abroad. In 1993, the Province started to pursue what came to be popularly referred to as the “southbound” policy of investment. Unlike Japan and the Republic of Korea, where FDI is undertaken mainly by large firms, it is the small- and medium-sized enterprises (SMEs) that have accounted for an important part of outward FDI.¹⁹

Thus, in terms of the sequencing of FDI among sectors and countries, the intra-regional pattern is consistent with the flying geese paradigm. Japan was the first major regional investor, first in primary sectors and then in manufacturing. Its FDI in manufacturing gradually moved from more to less industrialized countries of the region. The sectoral pattern of FDI seems to have continued when, following Japan, the second-tier NIEs also emerged as international investors. However, the evidence does not suggest that the flying geese pat-

tern of regional industrialization has depended entirely or even to a large extent on intra-regional investment. As discussed in chapter II below, FDI did not play a very important role in the industrialization of Japan and the majority of the first-tier

NIEs. It has been more important for the second-tier NIEs and China, but, as shown in table 3, FDI inflows from outside the region have been equally or even more important.

E. Intra-regional trade

The flying geese paradigm predicts a certain pattern of trade among countries in the "formation" at different levels of industrialization. Primary commodities (food, raw materials and fuels) make up the bulk of exports of countries at the bottom of the industrialization hierarchy, while their imports consist of all kinds of manufactures. As industrialization proceeds, labour-intensive manufactures account for an important part of exports, while capital goods and other skill- and capital-intensive manufactures constitute a high proportion of imports. As industrial upgrading progresses, capital goods imports continue to be important, but intra-industry trade also emerges in a number of skill- and capital-intensive products. Another implication of the paradigm is that developing countries participating in the process typically run overall trade deficits with the more advanced economies, and capital flows from the latter to the former, including FDI, help to close the external gap. In what follows the evidence on intra-regional trade is examined with a view to assessing the validity of these predictions of the flying geese paradigm.

1. Japanese trade

Table 23 shows the evolution of the trade of Japan since 1985 in selected items with the first-tier NIEs, ASEAN-4 and China. A number of features are worth noting. First, as the flying geese paradigm predicts, Japan has run trade deficits with all three areas in food, raw materials and fuel. The deficit is greater in trade with ASEAN-4 than with the first-tier NIEs, on account of both greater resource endowments of the former countries and their greater reliance on primary exports. Second, there has also been a deficit in clothing and foot-

wear with all three areas. While in absolute terms it is greatest with the first-tier NIEs, the deficit has risen fastest with China, followed by ASEAN-4.

For most other manufactures Japan has a very large and growing surplus with each of the three areas, notwithstanding the fact that generally imports have been growing faster than exports, as indicated by the declines in the export/import ratios in the table. The increase in the trade surplus in these products is explained by the fact that the volume of East Asian goods purchased by Japan was initially very small, when the period of rapid growth in the region began, particularly as regards imports of the ASEAN-4. In 1985, Japan exported manufactures to those countries worth about \$7 billion, but imported from them only some \$800 million (table 24), yielding a surplus of more than \$6 billion. In 1994, the corresponding figures were about \$39 billion and \$12 billion, giving a surplus of about \$27 billion. Thus, exports increased by a multiple of 4.6 but imports by one of 14, yet at the same time the trade surplus more than quadrupled. Clearly, if such trade trends persist, the Japanese surplus with these countries will eventually diminish in absolute value.

Japan accounts for about one half of all external exports of food, raw materials and fuel from the NIEs and China (i.e. excluding trade among the latter countries). In labour-intensive manufactures, Japan does not appear to have been a leading market for the first-tier NIEs during their initial stages of development. For instance, the share of Japan in total clothing exports from the Republic of Korea was quite low (around 15 per cent) in the 1970s, when the latter country was in an early stage of industrialization. Only during the 1980s, when the economy was already rather developed, did Korean clothing exports to Japan really take off; it

Table 23

TRADE OF JAPAN WITH FIRST-TIER NIEs, ASEAN-4 AND CHINA, 1985, 1990 AND 1994

Product group	Trade with first-tier NIEs						Trade with ASEAN-4						Trade with China					
	Trade balance (\$ billion)		Export/import ratio		Trade balance (\$ billion)		Export/import ratio		Trade balance (\$ billion)		Export/import ratio		Trade balance (\$ billion)		Export/import ratio			
	1985	1990	1994	1985	1990	1994	1985	1990	1994	1985	1990	1994	1985	1990	1994	1985	1990	1994
Manufactures	15.7	34.2	63.2	4.0	2.9	3.8	6.2	16.1	26.4	10.0	4.2	3.1	10.4	0.0	-1.5	8.0	1.0	0.9
Of which:																		
Chemicals	1.7	4.5	7.2	4.9	5.4	6.2	0.6	1.5	2.3	5.2	5.6	4.8	0.4	0.2	0.4	2.6	1.3	1.5
Computers and office equipment	0.7	1.7	1.9	7.4	3.2	1.7	0.1	0.1	-0.3	131.4	1.2	0.7	0.2	0.1	0.0	1254.8	2.9	1.2
Electrical machinery	4.7	12.0	22.1	7.7	5.2	5.0	1.1	3.0	7.0	17.4	5.0	3.1	2.3	1.0	2.0	186.6	4.3	2.2
Non-electrical machinery	3.9	10.4	17.2	17.0	10.8	16.3	1.6	6.2	10.4	26.8	22.3	15.6	2.5	1.0	4.7	839.9	8.6	11.6
Road motor vehicles	1.1	2.7	5.0	63.0	12.6	13.0	1.1	3.9	5.6	81.3	148.1	60.2	1.8	0.2	1.4	9241.1	25.3	18.4
Clothing and footwear	-1.3	-4.0	-2.9	0.1	0.0	0.1	-0.0	-0.5	-1.2	0.2	0.0	0.0	-0.5	-2.5	-9.1	0.0	0.0	0.0
Manufactures classified by material ^a	3.6	4.9	8.0	3.5	2.2	2.8	1.5	1.8	2.4	5.7	1.9	1.7	3.4	0.4	1.1	7.1	1.3	1.3
Other manufactures	1.4	1.9	4.7	2.6	1.6	2.2	0.3	0.3	0.2	6.9	1.4	1.1	0.4	-0.3	-2.1	3.6	0.5	0.3
Food, materials & fuels ^b	-2.9	-4.0	-2.4	0.3	0.5	0.7	-15.6	-18.4	-17.7	0.0	0.0	0.1	-4.4	-5.9	-7.4	0.1	0.1	0.1
Unspecified	-0.1	0.4	1.6	0.9	1.6	2.9	0.0	-0.0	-0.2	1.1	0.9	0.7	-0.0	0.0	0.1	0.9	1.4	1.7
Total merchandise trade	12.8	30.7	62.4	2.3	2.2	3.0	-9.4	-2.2	8.6	0.4	0.9	1.3	6.0	-5.9	-8.8	1.9	0.5	0.7

Source: United Nations, Commodity Trade Statistics tapes.

^a Excluding non-ferrous metals.^b Including non-ferrous metals.

Table 24

**EXPORTS OF MANUFACTURES FROM SELECTED EAST ASIAN COUNTRIES,
BY MAJOR DESTINATION, 1985 AND 1994**

(Billions of dollars)

Exports to	from	Developing East Asia									
		Total		First-tier NIEs		ASEAN-4		China		Japan	
		1985	1994	1985	1994	1985	1994	1985	1994	1985	1994
World		102.2	483.8	82.7	281.7	10.2	102.5	9.3	99.6	169.4	377.8
Developing East Asia		19.1	173.2	13.1	101.9	2.9	34.3	3.1	37.0	39.7	142.3
First-tier NIEs		11.9	114.8	6.6	51.9	2.4	28.4	2.9	34.5	20.9	86.0
ASEAN-4		5.1	42.9	4.5	36.2	0.4	4.2	0.2	2.5	6.9	38.8
China		2.0	15.5	1.9	13.8	0.1	1.7	.	.	11.9	17.5
Japan		7.8	50.3	5.9	23.9	0.8	11.7	1.1	14.7	.	.
Other developed market economies		61.7	105.8	53.1	122.0	5.7	46.3	2.9	37.5	100.5	196.4
Rest of world		13.5	54.5	10.5	33.9	0.8	10.2	2.2	10.4	29.2	39.1

Source: UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.

absorbed between 20 and 50 per cent of total Korean clothing exports in 1990, depending on the item concerned. Similarly, in the late 1980s, only a small share of labour-intensive exports (10 per cent or less, according to the item concerned) from ASEAN-4 went to Japan. However, such exports appear to have risen rapidly during the present decade.

Despite the rapid growth of imports, the Japanese market is still of secondary importance for most other manufactured products from East Asia. Per head of population, Japan imports roughly the same amount of manufactured goods from East Asia as does the United States or Western Europe. However, because of their much larger populations, the total manufactured imports of these areas from East Asia are much greater than those of Japan (table 24). Around 10 per cent of total exports of manufactures from developing East Asia currently go to Japan, but the vast bulk of exports is still to other developed market economies, principally in Europe and North America. In recent years, there has been an upsurge in Japanese imports of elec-

tronic goods from other East Asian countries, such as telecommunication and sound equipment from Malaysia, electronic micro-circuits from the Republic of Korea, and automatic data processing equipment from Singapore and Taiwan Province of China. This development has received considerable attention, but in fact the scale of such trade is still quite small. In 1993 only some 7-11 per cent of all external exports from China and NIEs of machinery and transport equipment, office machinery, electrical goods and other machinery went to Japan.

A related feature of the trade between Japan and the East Asian developing countries is significant trade imbalances. The latter countries have become of growing importance as a market for Japan, now absorbing more than a third of all its exports (table 25). But since Japan buys comparatively little in return, the result has been an unusual trading asymmetry, with Japan enjoying a large trade surplus with developing East Asia and the latter region enjoying a large trade surplus with industrial countries other than Japan. Nor is this

Table 25

**TOTAL EXPORTS OF SELECTED EAST ASIAN COUNTRIES,
BY MAJOR DESTINATION, 1980-1994**

(Billions of dollars)

Exports to	from		Developing East Asia				Japan	World ^a
			Total	First-tier NIEs	ASEAN-4	China		
World		1980	117.3 ^b	70.3	47.0	..	129.5	..
		1985	146.2 ^b	100.3	45.9	39.4 ^c	175.8	..
		1990	361.7	213.5	86.1	62.1	286.8	..
		1994	591.6	313.8	156.8	121.0	395.3	..
Developing East Asia		1980	23.2 ^b	13.3	9.9	..	33.3	127.3
		1985	52.9 ^b	17.8	11.9	16.1 ^c	42.4	144.5
		1990	110.5	54.5	24.1	31.9	84.8	415.2
		1994	213.2	116.2	51.6	45.4	152.4	648.1
First-tier NIEs		1980	14.4 ^b	6.4	8.0	..	19.1	88.0
		1985	17.7 ^b	8.5	9.2	15.1 ^c	22.6	107.0
		1990	76.7	27.8	18.7	30.2	56.5	266.1
		1994	139.9	58.4	39.9	41.6	93.2	365.8
ASEAN-4		1980	7.8 ^b	6.3	1.5	..	9.1	39.3
		1985	9.1 ^b	7.0	2.1	1.0 ^c	7.3	37.5
		1990	25.1	19.8	3.6	1.7	22.2	95.8
		1994	52.8	41.6	7.4	3.8	40.5	166.7
China		1980	1.0 ^b	0.6	0.4	.	5.1	..
		1985	2.9 ^b	2.3	0.6	.	12.5	..
		1990	8.7	6.9	1.8	.	6.1	53.3
		1994	20.5	16.2	4.3	.	18.7	115.6
Japan		1980	23.4 ^b	7.2	16.2	..	.	139.9
		1985	24.8 ^b	10.7	14.1	6.4 ^c	.	127.5
		1990	57.1	27.0	21.1	9.0	.	231.2
		1994	81.0	31.8	27.6	21.6	.	272.3
North America		1980	28.7 ^b	19.7	9.0	..	34.1	308.0
		1985	50.1 ^b	40.7	9.4	3.4 ^c	70.6	434.1
		1990	88.5	65.4	17.5	5.6	97.6	632.3
		1994	132.6	75.1	34.6	22.9	124.6	834.3
Western Europe ^d		1980	20.3 ^b	13.6	6.7	..	21.5	902.4
		1985	19.5 ^b	13.6	5.9	4.5 ^c	25.3	779.9
		1990	53.4	38.5	14.9	6.2	63.2	1655.3
		1994	84.4	43.7	24.6	16.1	65.6	1692.8

Source: UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.

a Owing to lack of data, figures for exports from "world" to the countries listed are imports (c.i.f.) as reported by those countries.

b Excluding China, for which no data were available before 1987.

c 1987.

d Including the eastern *Länder* of Germany from 1991.

an example of “triangular trade”, since Japan does not use its surplus with developing East Asia to finance imports from the rest of the world. On the contrary, it runs a surplus with both regions. However, as discussed below, present trends suggest that the situation is changing rapidly and that the Japanese trade surpluses with countries both within and outside the region are likely to shrink in the coming years, particularly as outward FDI continues to replace exports.

To sum up, although Japan did not constitute an important market for the first-tier NIEs for their labour-intensive products in their earlier stages of development, it has been playing a greater role vis-à-vis the second-tier NIEs. This is largely because Japan had not yet phased out an important part of its labour-intensive industries in the former instance. Thus, both the pattern and the evolution of trade between Japan and East Asian developing countries are broadly consistent with the flying geese paradigm. On the other hand, while trade imbalances continue to be large, they are likely, as discussed below, to diminish over time if the recent patterns of trade and FDI continue.

2. Trade among developing East Asian countries

The first-tier NIEs have emerged not only as major investors in the less developed countries of East Asia, but have also become important trading partners for them. Like Japan, they supply manufactures on a large scale to these countries, but unlike Japan they also purchase manufactures from them on a large scale. In 1994, exports of manufactures from ASEAN-4 to the first-tier NIEs amounted to \$28 billion and to Japan to less than \$12 billion. Chinese exports of manufactures to the same destinations were about \$35 billion and \$15 billion, respectively (table 24). Thus, the first-tier NIEs were more than twice as important as Japan as outlets for the manufactured exports of their less developed neighbours. It is interesting to note that the same is also true for trade among the first-tier NIEs, which export far more to each other than they do to Japan (tables 24 and 25).

The evidence thus suggests that there is a rapid process of integration taking place within the smaller countries of East Asia, a process in which even China is becoming involved to some extent. Trade among the countries of East Asia (exclud-

ing Japan) has been rising much faster than trade with the outside world, accounting for around one third of their total imports and exports. Although Japan has a huge trade surplus with the rest of East Asia, the latter countries on average now import more manufactures from each other than they do from Japan (table 24). Japan remains the dominant supplier of road vehicles and other machinery, but it has been overtaken in chemicals, electrical equipment and office machinery, where trade among other East Asian countries is now greater than their trade with Japan.

The pattern and evolution of trade among the developing East Asian countries (see table 26) are also broadly consistent with the predictions of the flying geese paradigm. The resource-rich ASEAN-4 have trade surpluses with both China and the first-tier NIEs in food, materials and fuels, while China has a surplus in the same categories with the first-tier NIEs. China also has a surplus with these countries in labour-intensive manufactures, such as clothing and footwear, which has been increasing over the past decade. Its trade deficits with these countries are mostly in technology- and skill-intensive products. A similar pattern is observed in trade between the first-tier NIEs and ASEAN-4. On the other hand, China's trade with ASEAN-4 does not show any clear pattern in labour- or skill- and technology-intensive manufactures.

At present all three areas (first-tier NIEs, ASEAN-4 and China) run large surpluses in manufacturing trade with the developed market-economy countries of Europe and America. For China and ASEAN-4, this surplus reflects their rising exports of labour-intensive items, which now exceed their imports of more sophisticated items such as chemicals, machinery and transport equipment. The picture is more complex for the first-tier NIEs. These countries still have a large trade surplus with Europe and North America in labour-intensive products, but this surplus is diminishing as they develop and shift to more sophisticated products. There has been a spectacular growth in exports of machinery and transport equipment from the first-tier NIEs over the past decade, and these countries now have a large trade surplus in such products with those regions.

These trends in trade thus provide strong support for the flying geese paradigm so far as trade among the NIEs is concerned. While the role of Japan as the lead goose is open to question, among

Table 26

TRADE AMONG CHINA, THE FIRST-TIER NIEs AND ASEAN-4

Product group	Trade of China with:																	
	First-tier NIEs					ASEAN-4					Trade of ASEAN-4 with first-tier NIEs							
	Trade balance (\$ billion)		Export/import ratio			Trade balance (\$ billion)		Export/import ratio			Trade balance (\$ billion)		Export/import ratio					
1985	1990	1994	1985	1990	1994	1985	1990	1994	1985	1990	1994	1985	1990	1994	1985	1990	1994	
Manufactures	0.5	8.7	4.8	1.2	1.5	1.2	-0.2	0.2	0.7	0.5	1.2	1.4	-1.2	-3.9	1.0	0.7	0.7	1.0
Of which:																		
Chemicals	0.1	0.3	-2.9	1.6	1.3	0.4	0.0	0.0	0.2	1.3	1.4	2.1	-0.6	-1.2	-2.2	0.2	0.4	0.4
Computer and office equipment	-0.1	0.0	0.2	0.1	1.1	1.3	0.0	0.0	0.0	21.0	2.1	1.7	-0.1	0.3	2.2	0.2	1.3	2.4
Electrical machinery	-0.5	0.8	0.4	0.2	1.3	1.1	0.0	0.0	0.2	7.6	2.5	2.4	0.1	0.0	1.7	1.2	1.0	1.2
Other machinery	-0.4	-1.2	-4.6	0.2	0.5	0.2	0.0	0.2	0.3	8.0	11.6	3.6	-0.5	-1.9	-2.5	0.4	0.3	0.4
Road motor vehicles	0.0	0.6	0.2	1.0	1.3	1.5	0.0	-0.1	0.0	20.3	0.5	3.7	-0.0	-0.0	0.3	0.4	0.6	1.9
Clothing and footwear	0.3	5.5	8.6	39.6	119.1	24.9	0.0	0.0	0.3	111.2	60.1	139.2	0.0	0.3	1.0	2.1	5.1	8.8
Manufactures classified by material ^a	1.1	0.5	-1.1	3.0	1.1	0.9	-0.2	-0.0	-0.5	0.2	0.9	0.6	-0.1	-1.5	-0.6	0.9	0.6	0.9
Other manufactures	0.0	2.1	4.0	1.1	2.1	2.7	0.0	0.0	0.2	3.2	2.0	6.3	-0.1	0.1	1.2	0.7	1.1	1.6
Food, materials & fuels ^b	3.4	3.6	3.6	12.1	3.5	2.0	0.0	-0.5	-1.3	1.1	0.5	0.5	4.1	4.1	5.3	2.7	2.0	2.0
Unspecified	0.0	0.0	-0.1	1.0	0.2	0.2	-0.0	-0.0	0.0	0.1	0.8	14.7	0.0	-0.6	-0.5	1.1	0.4	0.7
Total merchandise trade	4.0	12.3	8.2	1.8	1.7	1.2	-0.1	-0.4	-0.5	0.8	0.8	0.9	3.0	-0.5	5.9	1.5	1.0	1.2

Source: United Nations, *Commodity Trade Statistics* tapes.

Note: Import and export figures for the trade of China used for the compilation of this table are those reported by that country. They can differ substantially from those reported by the partner countries, due to re-exports from Hong Kong.

^a Excluding non-ferrous metals.

^b Including non-ferrous metals.

the remaining countries it does seem to be the case that industrialization is being transmitted from one

wave of developing countries to the next wave by the mechanisms postulated in this paradigm.

F. Macroeconomic influences on East Asian trade and FDI

The evolution of trade and FDI in East Asia has been greatly influenced by a number of macroeconomic developments in Japan, its major trading partners in the West, and the NIEs of the region. In the first half of the 1980s, disparities in the growth of major markets and the appreciation of the dollar gave a major boost to Japanese exports to major industrialized countries. From the early 1980s the dollar rose rapidly, exceeding 260 yen in 1985. Although it appreciated against some other currencies, the real effective exchange rate of the yen fell from 1981 to 1985. Thus, the increase in the share of Japan in world exports of manufactures, which had already begun in the 1960s, continued with greater force in the first half of the 1980s (table 27). As a result, the Japanese trade surplus, which had peaked at \$23 billion in 1978 but disappeared in 1979-1980 under the impact of the second oil price shock, started to rise again rapidly, and exceeded \$50 billion by the mid-1980s.

As noted above, the surge in exports in the first half of the 1980s was also associated with a sharp increase in Japanese manufacturing FDI in the United States and, to a lesser extent, in Europe, which appears to have been a response to increased protectionism in those markets. In the United States, despite a strong recovery from the 1980-1982 recession, unemployment remained high, and this, together with a mounting trade deficit, gave rise to renewed pressures for protectionism. In Western Europe, on the other hand, despite the external demand stimulus from the United States and improvements in trade balances, recovery remained weak and unemployment continued to rise. There was a widespread resort to non-tariff measures (NTMs) such as voluntary export restraints and anti-dumping and countervailing measures in both regions.²⁰

In the second half of the 1980s continuing protectionism, the appreciation of the yen, and increased competition from low-wage, high-

productivity producers in East Asia played a crucial role in the switch by Japanese firms from reliance on exports to reliance on investment and production abroad in supplying foreign markets. These pressures accentuated in the 1990s and, together with shifts in competitiveness among the East Asian NIEs, exerted a strong influence on trade and investment.

The Plaza Accord of September 1985 to lower the exchange rate of the dollar was in part a consequence of the threat posed by mounting protection in the United States. The nominal effective exchange rate of the yen rose by more than 50 per cent from 1985 to 1988, and the real effective exchange rate by 40 per cent. The initial reaction of Japanese firms was to resort to what is known as "pricing to market", namely to reduce yen export prices and to take cuts in profit margins on exports.²¹ High profits that had been earned while the dollar was appreciating made it easier to accept lower profit margins rather than lose market shares.²² Japanese firms were also greatly helped by the terms-of-trade gains and by the declines in the prices of imported inputs brought about by the appreciation of the yen, and, even more so, by the collapse of oil prices from their earlier peaks.²³ However, these did not prevent substantial declines in profits from exports.²⁴

Exports from Japan fell in volume in 1986 and stagnated in 1987, but the trade surplus rose in dollar terms due to the valuation effect, reaching almost \$100 billion in 1987. "Pricing to market" slowed down the adjustment of the United States trade deficit, which rose to \$160 billion in the same year. Thus, the decline of the dollar did not bring about a reversal of the protectionist actions that had proliferated in the first half of the 1980s. Instead, new non-tariff measures were put in place.²⁵

Japanese producers saw the post-Plaza appreciation of the yen as a permanent shift rather than

Table 27

SHARES IN WORLD EXPORTS OF MANUFACTURES^a OF FIRST-TIER NIEs AND MAJOR INDUSTRIAL COUNTRIES, 1965-1993

(Percentage)

<i>Period</i>	<i>United States^b</i>	<i>United Kingdom</i>	<i>Germany</i>	<i>Japan</i>	<i>First-tier NIEs</i>
1965-1969	19.1	10.6	17.1	8.5	2.0
1970-1974	15.4	8.3	17.7	10.3	3.4
1975-1979	14.4	7.9	16.9	11.1	4.8
1980-1985	14.6	6.8	14.8	13.4	6.8
1986-1990	11.9	6.2	15.6	13.3	8.6
1991-1993	13.0	5.9	14.2 ^c	12.9	9.0

Source: UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.

a SITC 5-8 less 67 and 68.

b Including Puerto Rico for 1965-1980 and also US Virgin Islands for 1981-1993.

c Including the eastern *Länder* after 1991.

a temporary surge, and responded in three ways. First, they invested heavily at home in order to enhance productivity and cut costs and to upgrade and expand in a number of areas to improve competitiveness. The share of capital formation in GDP rose from about 27 per cent in 1987 to 32 per cent in 1990, reaching the previous high achieved immediately after the first oil crisis, and investment in machinery and equipment alone grew at an unprecedented rate of 15 per cent per annum.

Second, as noted above, they invested heavily in the United States and, to a lesser extent, in Europe in order to supply these markets directly from local plants, and so side-step protectionism and protect profits. Alongside a sharply increased investment in manufacturing in the United States there was also a surge in investment in financing and insurance, and real estate.

Finally, they relocated production to low-cost countries in East Asia with a view to exporting both to third markets and back to Japan, as well as to supplying local markets. The rise of the yen at first benefited more the first-tier NIEs, which received a larger proportion of Japanese FDI than the rest of East Asia. Initially, such investment concentrated in labour-intensive manufactures, but subsequently shifted to technology-intensive sectors as wages rose and the currencies of these

countries appreciated against the dollar after 1987, in part as a result of their strong export performance, but also under the pressure from the United States to revalue. Currency appreciation and rising wages in the first-tier NIEs, as well as rising protectionist sentiments against these countries explain why Japanese FDI, particularly in labour-intensive manufactures, has moved away gradually to ASEAN-4 and China.²⁶ In the latter case it was also easier to enter the domestic market in many products through FDI than through exports.

Japanese firms were greatly helped in this period by government policies (noted in section B above) in phasing out and restructuring non-competitive industries and supporting investment in new areas. New investment was also greatly facilitated by the relaxation of monetary policy as part of the Louvre Agreement, which reduced significantly the cost of financing capital investment by producing a sharp escalation of prices in the stock market. Indeed, an important objective of the Bank of Japan was to facilitate the adjustment of industry to yen appreciation.

The appreciation of the yen and the resiting of production abroad had a major impact on the volume, composition, origin and destination of Japanese imports and exports as well as those of its main trading partners.²⁷ There was a surge in

Japanese imports, which rose by more than 80 per cent from 1985 to 1990 (table 25), partly stimulated by the expansion of aggregate domestic demand led by the investment boom. As noted above, much of these additional imports, particularly in labour-intensive manufactures, came from the first-tier NIEs, ASEAN-4 and China. Following the investment boom, Japanese exports picked up, increasing in volume by about 4.5 per cent per annum from 1988 to 1990. Moreover, the structure of exports underwent a significant change, from labour- to technology-intensive products. Exports to the three areas rose sharply, particularly in capital goods, associated with the increase in FDI; in 1990 exports to these countries were double their 1985 volume.

Trade and investment among the developing countries of the region have also been influenced by changes in exchange rates and competitiveness. With the exception of Hong Kong, where the currency had been pegged to the dollar since the early 1980s, the currencies of the first-tier NIEs appreciated rapidly against the dollar throughout the second half of the 1980s; the appreciation was around 20 per cent for the Republic of Korea and Singapore and 48 per cent for Taiwan Province of China. Their exports to the United States decelerated as a result of this appreciation, while Europe and Asia became more important markets for these countries. The first-tier NIEs responded to currency realignments and the emergence of strong competition from ASEAN-4 in much the same way

as Japan - by upgrading through investment, relocating labour-intensive industries and subcontracting in the less developed neighbouring countries.

As noted above, Taiwan Province of China emerged as the second most important investor in the region. Various surveys suggest that the prime motivations for investment abroad were lower wage costs, utilization of host-country GSP benefits, and access to host countries' domestic markets.²⁸ Similarly, according to a survey conducted in the late 1980s, the single most important motivation for FDI from the Republic of Korea in ASEAN-4 was the availability of low-cost labour (47.1 per cent), while other factors were their utility as export platforms to industrialized countries (21.6 per cent), and penetration of local markets (13.9 per cent). Accordingly, Korean FDI in South-East Asia was primarily to Indonesia, which has the lowest wage levels in the ASEAN region.²⁹

There can be little doubt that the trade and investment patterns in East Asia in the past decade have been the product of corporate strategies and decisions. These have, in turn, been strongly influenced by macroeconomic changes and expectations regarding their permanence. However, government policies have been crucial in this process not only through actions at the sectoral or firm level, but also by influencing overall macroeconomic conditions so as to facilitate adjustment to changes in competitiveness.

G. "Hollowing out" in Japan?

Just as it was adjusting to the post-Plaza exchange rates and competitiveness, Japan faced a new situation at the beginning of the 1990s, namely, a "debt deflation-cum-recession" process brought about by the burst of the speculative bubble.³⁰ The situation was aggravated by another appreciation of the yen, beginning in late 1992. By the end of 1995 the yen had risen against the dollar by two-and-a-half times within a decade, and its nominal effective exchange rate was up by more than two times.³¹

The sharp rise in the yen coincided with considerable improvements in productivity and declines in unit labour costs in the United States and, to a lesser extent, in Western Europe, brought about by industrial restructuring. As after the Plaza Accord, Japanese firms first responded to the erosion of competitiveness by cutting profits; during the first half of the 1990s the dollar price of Japanese exports rose 15 per cent compared to the price of United States exports, while the yen appreciated against the dollar by 40 per cent.³²

They also shifted to high-value export products. However, unlike post-Plaza, they cut down sharply on domestic investment in order to reduce excess capacity; real gross private non-residential fixed investment fell by 20 per cent from 1991 to 1995, a contraction which is unprecedented in the postwar cyclical behaviour of the Japanese economy.

Japan has found the recent adjustments far more difficult to make than previous ones (the oil crises and the Plaza Accord). Whereas on those occasions the growth of the economy never fell below 2 per cent, real GDP grew by only 1 per cent in 1992, fell in 1993 and has virtually stagnated in 1994 and 1995. For the first time for many years, employment has followed variations in output, and the unemployment rate passed the psychological barrier of 3 per cent in 1995.

During the initial stage of the downturn, there was a clear slowdown in outward FDI, partly due to the recession in the United States and Western Europe and partly to the need for funds for corporate restructuring, further aggravated by the collapse of stock prices in Japan. However, from 1993 onwards, when the dollar declined below 100 yen, Japanese firms increasingly responded to the crisis by relocating production to countries with lower labour costs, mainly ASEAN-4 and (even more) China, and by increasing their procurement from affiliates abroad.³³ These investments made a major contribution to the sharp turnaround in the Japanese trade balance. Import volumes rose sharply, in 1994-1995, by an annual average of over 13 per cent, while exports remained sluggish. Thus, Japan's share in world exports started to decline, while its share in world FDI stock continued to rise. Accordingly, after exceeding \$140 billion in 1994, the trade surplus fell sharply, to less than \$110 billion in 1995, the first drop in five years.

These developments suggest that a major structural transformation has taken place in Japanese trade and FDI over the past decade. In the first half of the 1980s, Japan continued to rely on exports to supply foreign markets, even though it began to emerge as a leading international investor. During that period FDI was trade-oriented in the way described by the recent formulations of the flying geese paradigm, complementing rather than substituting for domestic accumulation. Thus, Japan's shares in both world exports of manufactures and world FDI increased throughout that period (chart 2 and table 27).

The second half of the decade marks a transition from trade reliance to investment reliance, i.e. to the second stage in industrial development described in section C; Japan's share in world manufactured exports stabilized, while its share in FDI stock continued to rise rapidly. During that period, the complementarity of FDI with exports and domestic investment is less evident. The 1990s mark a gradual transition to the third stage, with FDI becoming the principal means of supplying global markets, competing with, rather than complementing, exports and domestic investment. The combination of currency appreciation, heightened foreign competition, external pressures to reduce the trade surplus and sluggish domestic demand has been forcing Japanese producers to relocate production abroad at the expense of domestic investment and exports. Thus, Japan seems to have entered the mature stage of industrialization, where its share in world exports can be expected to diminish steadily, while its share in world FDI stabilizes, accompanied by a decline in the pace of domestic capital accumulation and the potential growth rate. These developments underlie the recent concern over "hollowing out" of the industrial base in Japan, exemplified by the convening in February 1995 in Tokyo by the Ministry of Foreign Affairs of an International Seminar on Hollowing Out and Internationalization.

Few studies have been made of the effect of FDI on Japan's exports and balance of payments. Estimates by the Economic Planning Agency of Japan suggest that during 1985-1990 the flow of FDI to North America had a large export-inducing effect - albeit one reduced by the increased pressure for greater local procurement in that country - but the export substitution effect was even greater. Moreover, the reverse-import effect also appears to be very small; over 90 per cent of the goods produced in the United States and Europe by subsidiaries of Japanese enterprises are sold locally.³⁴ These estimates are thus consistent with the above observation that Japanese manufacturing FDI in the United States was largely triggered by a combination of protectionism in that country and loss of competitiveness by Japanese firms after Plaza.

The overall effect on the trade balance of Japanese FDI flows to Asia was also negative. However, unlike that flows to North America, the export-inducing effect was greater than the export-substituting effect, and the overall negative impact on the trade balance was due to a strong reverse-import effect, particularly in electronics and

Box 5**FDI BY JAPAN AND DOMESTIC INVESTMENT**

Rather than formulating a theoretical relationship between FDI and gross fixed capital formation (GFCF), an exploratory study is made of the relationship between them by using an auxiliary regression, where the choice of the explained or explanatory variable is arbitrary. The equation first estimated is:

$$FDI_t = \alpha + \beta GFCF_t + \epsilon_t \quad (1)$$

This equation has been estimated for both total and manufacturing investment, using ordinary least squares (OLS). Since time series on GFCF in manufacturing are not consistently available, GFCF in machinery and equipment is used as a proxy. A separate equation for FDI and GFCF in machinery and equipment has also been estimated. The estimates using the logarithms of the nominal values of the variables are reported in the table below. Estimates using the nominal levels of the variables, not reported here, were similar, as were also those using real variables.

While these estimates give a positive long-term relation between the two, they also suggest a structural break.¹ Indeed, the break-point Chow tests reject the hypothesis of the stability of the equation in all its specifications, and the series of recursive coefficients indicate structural breaks in the late 1980s for all the estimates.

Next, two dummies are introduced, one for the intercept and one for the slope of the equation, to determine the structural break. The rationale for using an intercept dummy (as well as a slope dummy) is to capture the effect of changes in competitiveness on FDI (GFCF) that occur independently of their effect on GFCF (FDI). The following equation is estimated:

$$FDI_t = \alpha + \delta \text{ Dummy} + \beta GFCF_t + \gamma \text{ Dummy} * GFCF_t + \epsilon_t \quad (2)$$

where the intercept and slope are given by α and β , respectively, before the break, and by $\alpha+\delta$ and $\beta+\gamma$ after. Estimation results in the table below indicate that there is a shift in both the slope and the intercept. According to the Akaike Information Criterion (AIC), this break is in 1988 for the relation between total FDI and GFCF, and in 1988 or 1989 between manufacturing FDI and GFCF; that is, both dummy variables are equal to zero for 1970-1987 (1988) and unity afterwards. Thus, in all these cases the relationship between domestic and foreign investment is one of complementarity in the former period (as indicated by the positive values of β), and substitutability in the latter (negative value of $(\beta+\gamma)$). It is also noteworthy that the break is much sharper for manufacturing investment than for total investment.

In order to test if the estimated slope for the period after the break ($\beta+\gamma$) was significant, additional tests were applied. First, joint tests (Wald tests) indicated that the coefficient is significant at the 5 per cent level for the equation using FDI and GFCF in machinery and equipment, but not for the others. Second, the same equation was estimated by changing the definition of the dummy variable, setting it at zero after the break and unity before the break, so that the slope is now given by β and $\beta+\gamma$, respectively. Results indicated that β is negative for all specifications of the equation and again significant at the 5 per cent level for the specification using investment in machinery and equipment.

¹ Unit root tests (Augmented Dickey-Fuller tests) indicate that these series are all non-stationary, but cointegration tests give a cointegration between the domestic investment and FDI for all the definitions and specifications used in estimating equation (1) above.

Box 5 (concluded)

RELATIONSHIP BETWEEN FDI AND GFCF: OLS RESULTS

Explained variable	Explanatory variable	Dummy = 1 for the period	α	β	δ	γ	R^2	F	D.W.	AIC
log(FDI)	log(GFCF)	-	-6.325* (-13.234)	1.452* (18.046)			0.934	325.7*	0.658	-2.064
log(FDI _{man})	log(GFCF _{mach})	-	-5.291* (-18.316)	1.355* (21.844)			0.956	477.2*	1.069	0.256
log(FDI _{mach})	log(GFCF _{mach})	-	-7.772* (-22.462)	1.678* (22.583)			0.959	510.0*	0.938	0.616
log(FDI)	log(GFCF)	1988-1994	-6.402* (-10.807)	1.464* (13.575)	1.802* (3.679)	-2.585* (-3.658)	0.960	168.4*	1.124	-2.406
log(FDI _{man})	log(GFCF _{mach})	1988-1993	-5.057* (-13.922)	1.294* (15.069)	15.428* (2.880)	-2.651** (-2.841)	0.970	217.4*	1.588	0.029
log(FDI _{mach})	log(GFCF _{mach})	1989-1993	-8.248* (-23.614)	1.797* (22.192)	27.613* (3.765)	-4.835* (-3.807)	0.980	295.6*	1.501	0.154

Notes: Figures in parentheses are t-coefficients.

* Significant at the 1 per cent level.

** Significant at the 5 per cent level.

electrical machinery; around 25 per cent of Japanese imports of these products from Asia are from the subsidiaries of Japanese firms. Again these features are consistent with the view that Japanese FDI in Asia during 1985 to 1990 was largely of the cost-reducing variety. Indeed, according to figures given by the Nomura Research Institute (NRI), operating profit margins for plants established through Japanese FDI have been consistently higher in Asia than elsewhere.³⁵

The effect of Japanese FDI on trade has not been identical for all manufactured products, since changes in competitiveness have not been uniform.

The estimates given by NRI, based on trade specialization coefficients (defined as the ratio of the trade balance in each product to the volume of trade in that product) show that since 1985 Japan has maintained its competitiveness in capital goods, suggesting that the FDI has induced exports for such industries.³⁶ By contrast, loss of competitiveness has been particularly severe in durable and non-durable consumer goods, where most of the reverse imports have been taking place.

However, the positive effect of increased capital good exports associated with FDI is expected to weaken over time while the reverse-import ef-

Table 28

**SALES AND PURCHASES BY JAPANESE OFFSHORE MANUFACTURING SUBSIDIARIES,
1993-1995, AND PROJECTIONS UP TO 2000**

(Percentage of total sales and purchases)

Subsidiaries in	Sales to Japan					Purchases from Japan				
	1993	1994	1995	1998	2000	1993	1994	1995	1998	2000
North America	3.0	3.0	3.0	4.0	5.0	40.0	40.0	40.0	30.0	20.0
Asia	15.0	15.0	15.0	22.5	25.0	40.0	40.0	40.0	35.0	30.0
Europe	1.0	1.0	1.0	1.8	2.0	45.0	45.0	45.0	40.0	35.0
Total, three regions	6.7	6.9	7.0	11.1	13.0	41.1	41.1	41.1	34.1	27.3

Source: Y. Takao and N. Nemoto, "Long-term outlook: Japan's economy in an era of structural change", *Nomura Research Institute Quarterly*, Summer, Vol. 4, No. 2, 1995.

Note: Figures relate to fiscal years beginning in April of the year shown.

fect is strengthened. According to projections by NRI, manufacturing subsidiaries' exports to Japan will increase sharply during the remainder of the decade, while their purchases from Japan will decline (table 28). The projected increase in sales to Japan is particularly notable for Asian subsidiaries. Purchases from Japan by North American affiliates will decline rapidly as a result of increased local procurement, whereas in Asia the decline is not as significant, because of the continued export of capital goods associated with Japanese FDI in the region. Overall, whereas in 1993 foreign subsidiaries of Japanese firms made around 40 per cent of the total purchases in Japan and sold around 7 per cent of their total output to Japan (a ratio of roughly 6:1), by the end of the present decade, this ratio is projected to fall to around 2:1. As a result, Japan's net trade with overseas subsidiaries, which was in the positive in 1992, is expected to be balanced in 1998 and register a deficit there after.

There have been few studies that systematically look at the relationship between Japanese domestic investment and FDI. However, it has been observed that "the decline in domestic nominal capital expenditure since 1992 has been accompanied by a decline in direct investments in North America

and Europe, but a continued increase in Asia. ... The data thus suggest that Japanese direct investments into Asia have acted very much as a substitute for investment in Japan, and are likely to continue at a strong pace, even as domestic economic growth is constrained by the yen's appreciation".³⁷

This conclusion finds some support in econometric estimates of the relationship between FDI and domestic investment in Japan. As described more fully in box 5, regression analysis suggests a structural break in this relationship in the 1980s. The estimates show that, until the late 1980s, total Japanese FDI was positively correlated with total gross fixed capital formation and that the correlation was even stronger in manufacturing. The correlation was reversed by 1988 in both cases. As would be expected, the break was much more pronounced for manufacturing than for total fixed investment, since the latter includes the secondary and tertiary sectors, which are much less affected by changes in exchange rates and relative prices. Thus, whereas during 1970-1988 each dollar of Japanese FDI in manufacturing was associated with about 3 cents of additional investment in domestic manufacturing, from 1988 onwards it was associated with a reduction of almost 6 cents.