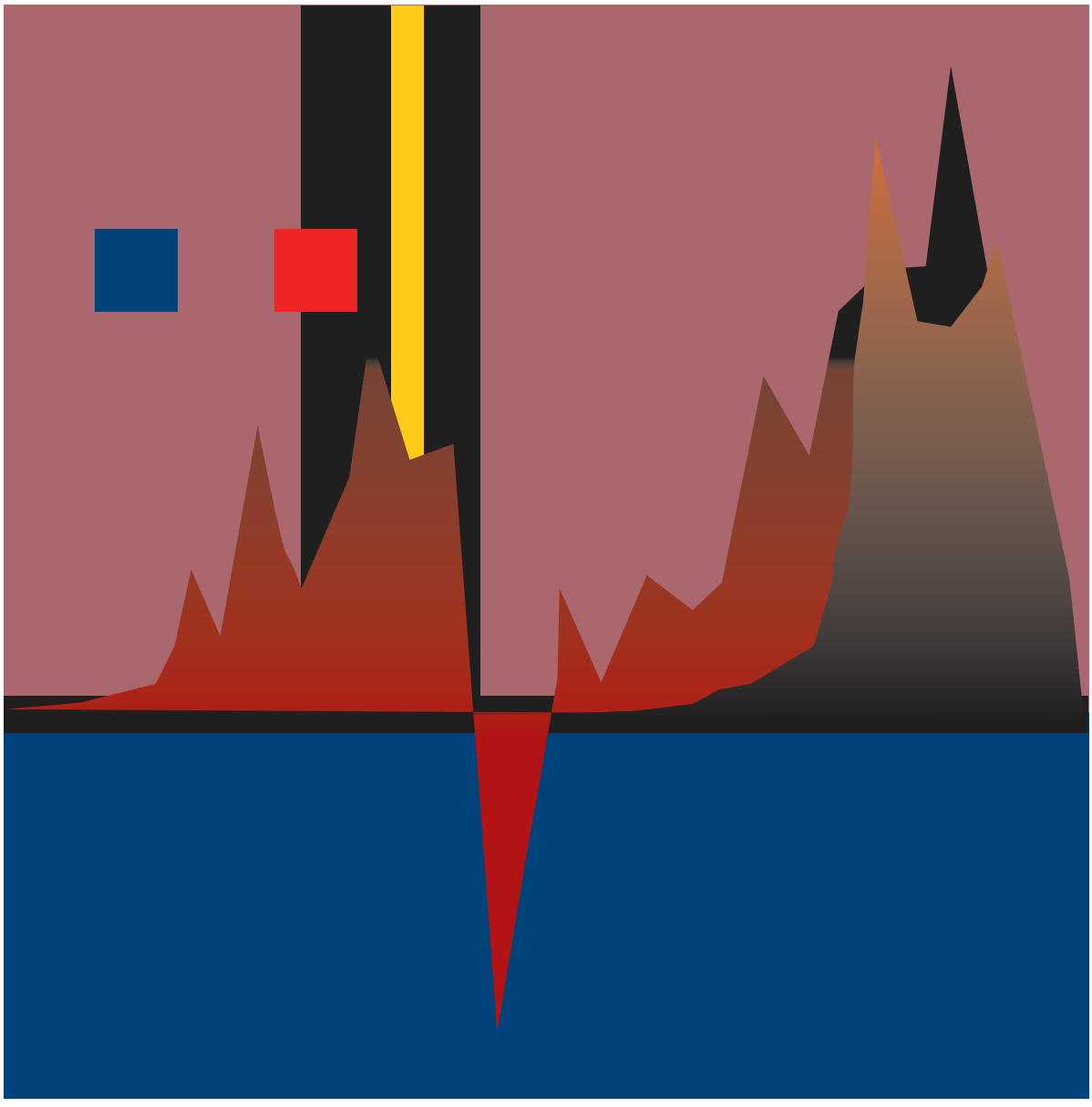
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1999

Fragile recovery and risks

Trade, finance and growth

UNITED NATIONS



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FOREWORD

Over many years, UNCTAD's *Trade and Development Report* has provided a clear and consistent analysis of trends in the international economy, with particular reference to developing countries and the policy challenges which they face. The 1999 *Report* is no exception. It offers further reflections on the Asian financial crisis, taking into account the effects of contagion on Latin America and Eastern Europe over the past year, as well as the launch of the new international currency in Europe. With a new round of multilateral trade negotiations on the horizon, it also takes a fresh look at pressing issues on the trade agenda.

For all the remarkable economic and technological progress of the past century, achieving faster economic growth with stability, particularly in the world's poorest countries, remains a prerequisite for a more peaceful and harmonious world. The growing interdependence of trade and finance means that no one country can achieve this goal on its own. A great deal has been made of the new opportunities in a globalizing world, and rightly so. But there are dangers, too. This year's *Report* examines asymmetries in the international trading and financial systems which continue to hamper growth prospects in developing countries. It provides a sobering reminder of what remains to be done if we are to build the genuine partnership and policy cooperation needed for an equitable system of global economic governance for the next century.

Kofi A. Annan
Secretary-General of the United Nations

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Classification by country or commodity group

The classification of countries in this Report has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

The major country groupings distinguished are:

- Developed or industrial(ized) countries: in general the countries members of OECD (other than the Czech Republic, Hungary, Mexico, the Republic of Korea and Turkey), Finland and Israel.
- Transition economies: the countries of Central and Eastern Europe (including the States formerly constituent republics of Yugoslavia), the Commonwealth of Independent States (CIS) and the Baltic States.
- Developing countries: all countries, territories or areas not specified above.

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

References to "Latin America" in the text or tables include the Caribbean countries unless otherwise indicated.

Unless otherwise stated, the classification by commodity group used in this Report follows generally that employed in the UNCTAD *Handbook of International Trade and Development Statistics 1996/1997*[1].

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 1998* refers to *Trade and Development Report, 1998* (United Nations publication, sales no. E.98.II.D.6).

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

The term "billion" signifies 1,000 million.

The term "tons" refers to metric tons.

Annual rates of growth and change refer to compound rates.

Exports are valued FOB and imports CIF, unless otherwise specified.

Use of a hyphen (-) between dates representing years, e.g. 1988-1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 1990/91, signifies a fiscal or crop year.

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

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

A dot (.) indicates that the item is not applicable.

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

Details and percentages do not necessarily add to totals because of rounding.

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[1] United Nations publication, sales no. E/F.98.II.D.16.

Abbreviations

ACP	African, Caribbean and Pacific (group of States)
ASEAN	Association of South-East Asian Nations
BIS	Bank for International Settlements
BoP	balance of payments
bpd	barrels per day
CEPAL	Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe)
CEPR	Centre for Economic Policy Research (London)
CFA	Communauté financière africaine (franc zone)
CIS	Commonwealth of Independent States
CIF	cost, insurance and freight
EC	European Community (or Communities)
ECA	Economic Commission for Africa
ECAs	export credit agencies
ECB	European Central Bank
ECE	Economic Commission for Europe
ECGD	Export Credits Guarantee Department (United Kingdom)
ECLAC	Economic Commission for Latin America and the Caribbean
EEC	European Economic Community
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	Economic and Monetary Union
ESCAP	Economic and Social Commission for Asia and the Pacific
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
FOB	free on board
FY	fiscal year
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	generalized system of preferences
HIPC	heavily indebted poor country
HS	Harmonized System (Harmonized Commodity Description and Coding System)
IBRD	International Bank for Reconstruction and Development (World Bank)
ICA	International Coffee Agreement
IDA	International Development Association
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IIF	Institute for International Finance
ILO	International Labour Organisation
IMF	International Monetary Fund
IPR	intellectual property rights
ISIC	International Standard Industrial Classification (of All Economic Activities)
LDC	least developed country

LIBOR	London Interbank Offered Rate
M&A	mergers and acquisitions
MERCOSUR	Southern Common Market (Mercado Común del Sur)
MFA	Multi-Fibre Arrangement
MFI	multilateral financial institution
MFN	most favoured nation
NAFTA	North American Free Trade Agreement
NBER	National Bureau of Economic Research (United States)
NGO	non-governmental organization
NIEs	newly industrializing economies
NIESR	National Institute of Economic and Social Research (London)
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
R&D	research and development
S&D	special and differential treatment
SDR	special drawing right
SITC	Standard International Trade Classification
SSA	sub-Saharan Africa
TNCs	transnational corporations
TRAINS	Trade Analysis and Information System
TRIMs	trade-related investment measures
TRIPs	trade-related intellectual property rights
UNCTAD	United Nations Conference on Trade and Development
UN/DESA	United Nations Department of Economic and Social Affairs
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
UNU	United Nations University
WIDER	World Institute for Development Economics Research
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

OVERVIEW

Since the UNCTAD secretariat made its first assessment of globalization, in TDR 1997, conditions in the developing world have deteriorated drastically. The few bright spots, mainly in East Asia and Latin America, which could light the way for others to a better future have been dimmed, and the much-hoped-for turning point in Africa has not been reached. The predicted gains to developing countries from the Uruguay Round have proved to be exaggerated and, as feared, international capital movements have been particularly disruptive. Poverty and unemployment are again on the rise in developing countries which had struggled for many years to combat them. Income and welfare gaps between and within countries have widened further.

As the twentieth century comes to an end, the world economy is deeply divided and unstable. The failure to achieve faster growth that could narrow the gap between the rich and the poor must be regarded as a defeat for the entire international community. It also raises important questions about the present approach to development issues.

Asymmetries and biases in the global system against the poor and underprivileged persist unchecked. Leaving global economic integration to markets has not helped, and that should hardly come as a surprise. Unbridled competition, particularly among unequals, has never, by itself, delivered faster growth and shared prosperity even in today's developed countries, and it has at times been destructive. There is no reason to expect a different outcome in a globalizing world.

Bold leadership, purposeful cooperation and compassion are essential ingredients if today's fragmented global economy is to give way to a century of peace and prosperity. In their absence, and if history is any guide, all will suffer.

The world economy: fragile recovery with downside risks

While the developed world suffered little from the Asian financial crisis that broke out in 1997, and even derived some benefits from it, the impact on the rest of the world has been dramatic. Virtually all developing countries and transition economies were affected. It played havoc in East Asia and Russia throughout 1998, set back the progress achieved in Latin America, and in the most seriously affected countries wiped out the fruits of decades of economic growth and poverty reduction. In its wake, growth in the developing world slowed from almost 6 per cent in 1996 to under 2 per cent in 1998, and for the first time in 10 years it was less than in industrial countries. In the transition economies the impact of the Russian crisis was to plunge the region as a whole into recession following positive growth in 1997 for the first time since the beginning of the transition process.

The two largest developing countries, China and India, have been striking exceptions in this otherwise bleak landscape. It is notable that both of these countries had resisted the temptation to pursue premature trade liberalization and rapid integration into the global financial system.

Crisis in developing countries has had serious repercussions for international trade. The substantial swing in trade balances in the Asian countries through massive import cuts has played an important role in the re-emergence of major trade imbalances in the world economy not experienced since the 1980s. It has also been a main factor in the slowdown of world trade, which suffered in value terms its strongest decline since 1982, and in the dramatic and widespread fall in commodity prices. As a result, for the first time in 50 years, the share of primary products in world trade fell below 20 per cent. This, together with the appreciation of the dollar in 1997 and most of 1998, brought about a decline in the dollar value of export earnings of developing countries for the first time since 1991.

A fall by one third in world oil prices was responsible for an estimated 86 per cent of the overall decline in the value of world trade. OPEC export revenues plummeted by over $50 billion in 1998, and oil exporters as a whole lost more than 6 per cent of their GNP. Non-oil developing countries, too, suffered terms-of-trade declines and income losses. At 12 per cent, the drop in non-oil commodity prices was unprecedented since the mid-1970s. In Latin America, declines in export prices resulted in a loss of over $10 billion in foreign-exchange earnings, and in sub-Saharan Africa the losses reached almost 2.5 per cent of GDP.

Industrial countries, by contrast, gained from the unprecedented collapse in commodity prices and cheaper manufactured imports from countries that had suffered currency devaluations. Gain from cheaper imports of oil alone amounted to some $60 billion, exceeding total official development assistance in 1998. The improvement in their terms of trade greatly helped to maintain income levels and reduce inflation.

Similarly, developed countries suffered little from the sharp declines in asset prices or increases in risk premia in global capital markets that accompanied drastically reduced capital inflows into emerging markets, especially in the months immediately following the Russian crisis in August 1998. Nor were they greatly affected by the Brazilian crisis of January 1999. On the contrary, the flight to safety which followed financial turmoil in developing and transition economies has helped to boost stock markets in the North and stimulate consumption, notably in the United States, which has enjoyed an unprecedented eighth year of expansion. Private consumption in the United States rose by over $400 billion from the second quarter of 1997 to the end of 1998, more than twice the total annual income of sub-Saharan Africa.

Prospects for the global economy have improved since the beginning of the year. The fear of contagion from the Russian crisis has proved exaggerated and the adverse impact of the Brazilian crisis has so far been confined to the region. However, as concern over a possible global recession has receded, fear has given way to complacency. This has been encouraged by a modest return of capital inflows to most emerging markets and indications that prices of certain commodities, particularly petroleum, are turning up, thanks largely to supply cuts rather than demand expansion.

On current trends the overall performance of the world economy in 1999 is unlikely to differ significantly from the previous year, although different regions are moving in different directions. Among the industrial countries growth in the United States economy is likely to moderate. While some improvement may be expected in Japan, a sustained recovery is not yet in sight. With strong recovery continuing to elude the European Union, GDP growth in developed countries is unlikely to exceed the disappointing rate of 1998.

In developing countries, excluding China, growth will be below that of population and lower than in industrial countries. The slowdown in China will continue, while contraction is expected in Latin America and growth will remain weak in Africa. Recovery in some of the crisis-stricken countries in East Asia will only be sufficient to make up for losses elsewhere. Consequently, no major improvement in the overall performance of developing countries can be expected.

Neither a return to stability in the Asian economies nor the apparent confinement of the impact of the Brazilian crisis to neighbouring countries should hide the immediate downside risks for the world economy. Stabilization of conditions in many emerging markets, including Brazil and Russia, does not mean that the underlying structural problems, including fiscal fragility, have disappeared. Yield spreads continue to be high and while private capital inflows into developing countries are expected to recover somewhat in the year 2000, they will remain far below pre-crisis levels. Even so, there is potential instability inherent in the dependence of so many developing countries on foreign capital inflows that are so volatile.

In Latin America, combining foreign and fiscal balance with an acceptable growth rate still eludes many countries. Indeed, despite poor growth performance several of the major economies, notably Argentina and Brazil, are running current-account deficits above the critical level of 4 per cent of GDP. External indebtedness and dependence on foreign capital flows are again on the increase and any loss of confidence could spark off a reversal of capital flows that could make debt-servicing problematic. The region remains vulnerable to hikes in United States interest rates.

In Asia, the speed and sustainability of the current recoveries are uncertain, and problems may emerge elsewhere in the region, notably in China with respect to maintenance of the exchange rate. The crisis has led to a slackening of exports and domestic private demand in that country, causing delay in restructuring of the financial system and of state enterprises. So far, adverse conditions in the external sector have been offset by heavy public expenditure programmes, but if the present exchange rate cannot be maintained there is a risk of currency realignments throughout the region which would jeopardize the nascent recovery in the crisis-stricken countries.

A sustained recovery in Asia and Latin America will, of necessity, be export-based and thus dependent on the pace of economic activity in industrial countries. Although rapid growth of demand in the United States has been crucial in preventing global recession, it cannot do so indefinitely. Continued rapid expansion would certainly bring about further monetary tightening, not only creating difficulties for developing countries but also putting European recovery in jeopardy. It would also lead to higher trade deficits and mounting protectionist pressures. Since domestic demand growth is increasingly dependent on stock prices and borrowing by households and firms, some slowing of the expansion must eventually take place. Will it be a "soft landing" or will growth decelerate sharply, thereby risking another equity market break and further weakening the momentum of world growth?

Recovery in Japan continues to depend on fiscal stimuli. But because of widespread excess capacity and weak balance sheets in the private sector, government outlays do not generate strong secondary expenditure effects. Once the immediate impact is absorbed, the economy tends to slither. The fiscal package announced for the autumn of 1999 thus seems to be essential if the double dip experienced in 1996 is to be avoided. Growth in the longer term will depend on structural reform.

Relatively little stimulus to world growth can be expected in the near future from the European Union, where 11 of its members face internal challenges with the adoption of a single currency. Widely heralded as a competitor to the dollar, the euro has depreciated by over 10 per cent since its introduction at the beginning of the year, giving a much-needed boost to European competitiveness but raising questions of credibility. The European Central Bank is also confronted with the dilemma of pursuing a monetary policy for economies that still exhibit considerable variation in growth rates. While many of the difficulties of the euro may be due to the cyclical asymmetry between the United States and the EU, its strength over the longer term may well depend on whether the EU countries can undertake an industrial restructuring similar to that of the United States in the early 1990s.

Should recovery in the EU and Japan be delayed for any reason, the stimulus to global growth would have to come from developing countries. However, confronted with external financial difficulties and domestic restructuring, those countries have little room to use traditional fiscal policy measures for fear of losing the confidence of capital markets, and monetary policy is constrained by the foreign-exchange market. Given the limited scope in developing countries to pursue counter-cyclical macroeconomic policies, an alternative would be the direct injection of liquidity into those countries through official channels to raise demand, imports and growth. This cannot be adequately done by multilateral financial institutions, whose resources have been drained by financial rescue operations and whose access to new resources has been curtailed by increased political resistance to such bailouts.

By contrast, Japan and EU are able to play an important role in providing direct liquidity injections by recycling part of their large current-account surpluses. Since developing countries have a higher propensity to consume and import, such schemes could prove to be superior, in their effect on global growth, to domestic fiscal expansion in the surplus countries themselves. The Miyazawa Plan offers one such model, but other means of directly increasing liquidity should also be explored. One possibility would be to remove the debt overhang of highly indebted poor countries through an immediate write-off of their unpayable official debt while extending the range of eligible countries under the HIPC Debt Initiative. Payments support to developing countries and the transition economies could also be provided through substantial SDR allocations. There are already suggestions to use such allocations on a reversible basis in order to provide liquidity to emerging markets facing a threat of financial contagion. No less valid is the case for similar action to provide additional current-account financing, particularly since much greater reserves are now needed as a protection against possible currency instability.

Trade, external financing and economic growth in developing countries

Liberalization, external constraints and growth

In recent years developing countries have striven hard, and often at considerable cost, to integrate more closely into the world economy. But, in the face of deep-seated imbalances in economic power and systemic biases in the international trading and financial systems, their expectations of the gains from such integration in terms of faster growth, greater employment opportunities and reduced levels of poverty have been disappointed. A clear example is the extravagant predictions made regarding the gains they could reap from the Uruguay Round. By contrast, the downside risks have proved far greater than was generally expected, as recently demonstrated by the experience of East Asia and Latin America. The humbling of the Asian tigers since 1997 has revealed the vulnerability of even the strongest developing economies to the powerful forces unleashed by globalization. Indeed, the twentieth century is closing on a note of crisis and a growing sense of unease about the policy advice that was proffered in the past decade.

Much of that advice was fashioned in response to the debt crisis of the early 1980s, when a reorientation of policies in the industrial countries led to considerable macroeconomic distress in many developing countries and a sharp fall in their growth rates. Severe balance-of-payments crises revealed the extent to which rapid growth in the South had come to depend on steadily rising export earnings and capital inflows and just how disruptive an interruption to these sources of foreign exchange could be. For many, the crisis was final proof that inward-oriented growth strategies and interventionist policies could not extract developing countries from the mire of poverty and underdevelopment. Thus, in the second half of the decade, a powerful consensus was forged around "getting prices right". Close integration with the world economy through rapid liberalization of trade, finance and investment was believed to be the recipe for preventing setbacks to development caused by recurrent payments crises. Trade liberalization would ensure the best allocation of resources according to comparative advantage, securing the export revenues needed to import key ingredients of faster growth. Financial liberalization would attract foreign capital seeking high returns in these capital-scarce countries, allowing them to invest more than they save without running into a payments constraint. A bigger flow of foreign direct investment would further accelerate growth not only by supplementing domestic resources for capital accumulation, but also through transfer of technology and organizational skills.

Fast integration into the world economy thus seemed to promise an alternative to stop-go growth and development through export expansion and inflows of private foreign capital, providing the inspiration for widespread reform and encouraging "big bang" liberalization. Indeed, the growth of world trade and, perhaps even more decisively, the recovery of financial flows to developing countries in the 1990s were taken as confirmation that a new era of prosperity was beginning to unfold and that it would include a growing number of developing countries.

However, few attempts have been made to examine what rapid integration has actually meant for developing countries. The analysis in this *Report* shows that the empirical record has been at odds with the promises. Inevitably, the discussion involves "nuts and bolts" economics of a technical nature, but the conclusion is a simple and striking one. It is that, after more than a decade of liberal reforms in developing countries, their payments disorders, which had earlier ushered in a rethinking of policies, remain as acute as ever, and their economies depend even more on external financial resources for the achievement of growth rates sufficient to tackle the deep-rooted problems of poverty and underdevelopment:

- Growth in developing countries has generally recovered in the 1990s from the levels of the 1980s, but it has remained well below the average of 5.7 per cent achieved during the 1970s. This recovery has been accompanied by a significant worsening of external deficits. For developing countries as a whole (excluding China), the average trade deficit in the 1990s is higher than in the 1970s by almost 3 percentage points of GDP, while the average growth rate is lower by 2 per cent per annum.

- Low prices of oil are only part of the story. In the non-oil-exporting developing countries the trade deficit in the 1990s stands at approximately the same proportion of GDP as in the 1970s, while the average growth rate is lower by 2 per cent per annum.

- The pattern is broadly similar in all developing regions. In Latin America the average growth rate is lower by 3 per cent per annum in the 1990s than in the 1970s, while trade deficits as a proportion of GDP are much the same. In sub-Saharan Africa growth fell, but deficits rose. The Asian countries managed to grow faster in the 1980s, while reducing their payments deficits, but in the 1990s they have run greater deficits without achieving faster growth.

- In almost half of the developing countries examined, which include exporters not only of commodities but also of manufactures, the trend is one of widening trade deficits, with falling or stagnant growth rates. Where trade balances have improved, there has generally been a slowdown in economic growth and imports. Among the countries which succeeded in achieving faster growth, the majority experienced a deterioration in their trade balances, financed by inflows of private capital. However, such inflows could not always be sustained and eventually led to currency crises, economic contraction and massive import cuts. Only a very small number of countries, notably China and Chile, have been able to buck this general trend by combining faster growth with improved trade performance.

The reasons why trade deficits have been increasing faster than income in developing countries are undoubtedly complex. However, the evidence shows that a combination of declining terms of trade, slow growth in industrial countries and "big bang" liberalization of trade and of the capital account in developing countries has been a decisive factor.

For developing countries as a whole the terms of trade fell by more than 5 per cent per annum during the 1980s. The more favourable trend around the mid-1990s due to a recovery in oil and non-oil commodity prices has been more than offset by large losses since 1996, when these prices declined by about 16 per cent and 34 per cent, respectively. For non-oil developing countries, the decline in the terms of trade has been steady, at about 1.5 per cent per annum, since the early 1980s. Terms-of-trade losses are no longer confined to commodity exporters. Many manufactures exported by developing countries are now beginning to behave more like primary commodities as a growing number of countries simultaneously attempt to raise their exports in the relatively stagnant and protected markets of industrial countries. For example, the prices of manufactures exported by developing countries fell relative to those exported by the European Union by 2.2 per cent per annum from 1979 to 1994.

The slower growth in industrial countries during the past two decades than in the 1970s may have added to trade deficits of developing countries perhaps by as much as 1 per cent of GDP. Rapid trade

liberalization in the latter countries has further added to their deficits; it led to a sharp increase in their import propensity, but exports failed to keep pace, particularly where liberalization was a response to the failure to establish competitive industries behind high barriers. With the notable exception of China, liberalization has resulted in a general widening of the gap between the annual growth of imports and exports in the 1990s, but the impact was particularly severe in Latin America, where the gap averaged about 4 percentage points.

Liberalization of capital flows, often prompted by the need to finance growing external deficits, has actually made matters worse. It has led to currency appreciations and instability, thereby undermining trade performance. Despite greater exposure to foreign competition, there have been serious shortcomings in exchange-rate management, even compared to the interventionist regimes of the 1970s and 1980s. An examination of exchange-rate movements in 58 developing countries shows that, after persistent appreciations, 8 of them resorted to real devaluations in the 1970s of 25 per cent or more but that there were as many as 24 in the 1980s. From 1990 until 1997, before the more recent turmoils in East Asia or Latin America, 19 countries experienced comparable reversals.

Private capital flows: solution or problem?

With today's globalized financial markets, access to foreign private capital is generally expected to greatly alleviate the external constraint on growth. Certainly, the 1990s have witnessed a rapid expansion of private capital inflows into developing countries, registering a sevenfold increase over the average for the 1970s. Portfolio flows and foreign direct investment (FDI) have shown the strongest growth, accounting for more than two thirds of total private inflows.

While such figures have received increased attention in the financial press, and seem to have had a mesmerizing effect on many policy makers in the South, a sense of proportion is called for:

- The upsurge in the 1990s represents no more than a return to trend after the blighted years of the 1980s. The annual capital inflow in the 1990s was around 5 per cent of GNP, which was roughly the level prevailing in 1975–1982. If China is excluded, the ratio is actually lower than in the earlier period by one percentage point.
- Not all trends are rising. Official development assistance has steadily declined throughout the present decade, falling in real terms in 1998 to its lowest level for many years. The share of official financing in total capital inflows fell from over 50 per cent in the 1980s to 20 per cent in the 1990s.
- As official financing took a back seat, capital inflows have increasingly been concentrated in a small group of 20 or so emerging markets which received over 90 per cent of total inflows of capital in the 1990s, compared to some 50 per cent before the outbreak of the debt crisis. As regards FDI, China, Brazil and Mexico together accounted for almost one half of the total inflow; their per capita inflow, in the range of $20–$80, and an inflow of as much as $223 per capita in Malaysia, stand in stark contrast to under $5 in many countries in sub-Saharan Africa.
- An important part of private capital inflows, notably liquid capital seeking arbitrage profits, is highly unstable and hence constitutes an unreliable source of development finance. This is particularly true for short-term loans and portfolio equity, which together reached $100 billion by the middle of the decade (about 40 per cent of all private inflows into developing countries) but fell to a mere $15 billion after the financial crises in East Asia and Russia.

Moreover, a growing proportion of net private capital inflows is absorbed by activities which add little to productive capacity in those emerging markets fortunate enough to receive them: of every

dollar brought in by non-residents 24 cents were taken out by residents, compared to 14 cents in the 1980s. No less disturbing is that more than 20 cents of every dollar of net capital inflow are put aside for the accumulation of foreign-exchange reserves, notwithstanding policy reforms designed to ensure greater exchange-rate flexibility and increased access to global capital markets. Developing countries have increasingly been advised to cover their short-term liabilities by reserves as a safeguard against speculative attacks on the currency and reversal of capital flows; the increase in reserves from 1990 to 1998 amounted to a staggering 60 per cent of the increase in their import bill during the same period.

The cost has been high, since reserves are borrowed at much higher rates than they can earn in international financial markets. The net cumulative cost over 1990–1997 may have been as much as $50 billion. Moreover, short-term capital inflows have a high rate of leakage. In the 1990s, for every dollar of short-term capital brought in by non-residents, 56 cents were taken out by residents for investment in short-term assets abroad. Thus, such capital flows provide little for current-account financing, while provoking significant instability. There is consequently an urgent need to reconsider the case for their liberalization.

Even the strong growth of FDI flows to developing countries in the 1990s should not be allowed to hide the simple fact that it largely reflects mergers and acquisitions (rather than greenfield investment), which accounted for well over half of the total FDI inflow in 1992–1997 and for almost three quarters if China is excluded. Much of this merger activity was in service sectors, and has the potential to add to payments difficulties. Attempts to meet foreign-exchange deficits of TNC-related activities by encouraging new inflows of the same kind would be self-defeating. In any case, it is not clear whether the recent momentum of FDI attracted by acquisition of existing assets can be maintained over the longer term, since there are limits to the stock of assets for sale, particularly in the public sector.

Although an important part of the capital inflow into developing countries in the present decade has allegedly been "non-debt-creating", external indebtedness is again on the rise, in both absolute and relative terms. In Latin America, for instance, for the first time in the 1990s, the ratio of debt to exports increased in 1998, reaching 203 per cent, from 191 per cent in 1997, and there was likewise an increase in the ratio of interest payments to exports. Higher interest payments add to the difficulties caused by widening trade deficits and run the risk of incurring an unsustainable debt burden. Developing countries should not heed the doctrine, popularized by the more exuberant exponents of liberal orthodoxy, that rising current-account deficits and external indebtedness generated by the private (as opposed to the public) sector are immune to the dangers that proved so destructive in the early 1980s.

In any case, on recent trends, the level and composition of net capital flows received by most developing countries are inadequate to meet their existing external financing requirements. They fall far short of those which would be needed to achieve a target growth of 6 per cent. Even under relatively optimistic assumptions regarding growth in industrial countries and the terms of trade, the external financing needs of developing countries can be estimated to exceed recent net capital inflows by more than 40 per cent. The gap would be greater if growth in industrial countries remains sluggish and the terms of trade of developing countries continue to deteriorate.

Rethinking policies: market access, not hot money

With liberal trading regimes now in place throughout much of the developing world, growth sucks in a greater volume of imports than in the past. Attempts to close the payments gap through increased exports to developed countries run up against sluggish markets, adverse movements in the terms of trade and protectionism. As a result, maintaining growth momentum increasingly relies on attracting foreign capital, of any kind. Dependence on hot money has thus become the unstable pillar

of economic growth and development in many countries. This situation contrasts with the post-war experience of liberalization in industrial countries, where the process was a gradual one and was underpinned by exceptionally strong growth.

The time has thus come for a rethinking of policies and responsibilities, which should, and indeed must, involve those of the world's richest countries as well as of the developing ones. The international community must face up to the pronounced external constraints to development and the need for exports rather than unstable capital flows to underpin a return to rapid and sustained growth in the third world.

Achieving an increase in exports requires growth in world demand, while additional foreign borrowing makes sense only if the higher export earnings are sufficient to finance the additional debt service. Thus, liberalization as a successful growth strategy in an interdependent global economy relies crucially on exports, which in turn are highly dependent on growth in industrial countries and greater access of developing countries to their markets. For their part, developing countries must promote efficient and competitive industries.

It is now time to take a long, hard look at the international trading system and identify the shortcomings of the Uruguay Round Agreements and their implementation, in order to establish the appropriate basis for new multilateral negotiations or of a "development round". Attention needs to be focused on market access. Tariff levels and the frequency of tariff peaks are still high in many areas of export interest to developing countries. For example, in agriculture excessively high rates are applied in developed countries mainly to products that offer a potential for export diversification in the South. Moreover, the subsidization of agricultural output in the North not only shuts out imports from developing countries, but also leads to unfair competition in the latter's own markets. The annual cost of support for agriculture in industrial countries in 1996–1998 was double the level of agricultural exports from developing countries during those three years. Although EU producers are among the world's highest-cost producers of dairy products, they have a 50 per cent share of the world market.

The panorama of protectionism is no better for industrial products. Footwear, clothing and textiles are well-known cases. But tariff peaks are also common in other low-technology and resource-based industries, as well as for high-technology products which involve unskilled labour in the production of components. Moreover, the threat of market penetration by southern producers is prompting new forms of protectionism within the framework of the various WTO Agreements. The abuse of anti-dumping procedures and health and safety standards against successful exporters in the South is causing major concern and there are also signs that the provisions of the Agreements are not always being properly adhered to; for example, voluntary export restraints continue to be applied.

There is strong evidence that in many product markets that are protected in the North, producers in developing countries have a competitive advantage or are able to acquire one. The potential for large overall export gains is underscored by this year's *Report*. It is estimated that an extra $700 billion of annual export earnings could be achieved in a relatively short time in a number of low-technology and resource-based industries. Agricultural exports could add considerably to this figure. All-in-all, the increase in annual foreign-exchange earnings could be at least four times the annual private foreign capital inflow in the 1990s. Moreover, unlike a large part of such flows, the resources would be devoted to productive activities, with beneficial effects on employment.

More flexibility should also be granted to developing countries in the design and implementation of policies. Building competitive industries holds the key to overcoming the external constraint not only by boosting export capacity but also by reducing the import content of growth. The scope for promoting exports through direct support has been reduced since the pioneers of export-led growth made their successful entry into world markets. However, the considerable financial resources em-

ployed by the world's richest countries to support their mature producers provides sufficient grounds to retain the infant-industry concept as an integral part of trade-policy discussion. Moreover, the success of the East Asian and other fast-growing developing economies shows that an export push often followed the build-up of domestic production capacity that replaced imports.

Advice aimed at encouraging the full use of what is still possible under the existing rules of the trading system needs to be strengthened, and further restrictions should be avoided. It is also important to secure consistency between policies regarding the current and the capital account. For instance, in view of the changing nature of the external vulnerability of developing countries, in particular to the volatility of capital flows, the conventional criteria of legitimate action need to be reviewed. Criteria based on imports or current-account deficits can no longer provide an appropriate basis for assessing reserve adequacy and hence the legitimacy of measures to safeguard the balance of payments in the context of WTO provisions. In some areas of trade policy, where review processes are, or about to get, under way, the full impact on the competitiveness of developing countries of limiting the policy options open to them needs to be reconsidered, in particular with respect to subsidies, intellectual property rights and trade-related investment measures. Special and differential treatment for developing countries, as a means of guaranteeing them adequate policy flexibility, should be made part of the contractual obligations of the rule-based system.

Developing countries need to improve the management of their exchange rates if they are to benefit from greater integration into the trading system. The advice they have received in recent years has been at best confusing and at worst misleading. Under free capital mobility, no exchange-rate regime can guarantee stable and competitive rates. Contrary to some perceptions, countries with floating rates are no less vulnerable to financial crises than those with pegged or fixed ones. Differences among pegged, floating and fixed regimes lie not so much in their capacity to prevent damage to the real economy as in the way damage is inflicted in the first place. There now appears to be a growing consensus that developing countries should target real exchange rates in combination with the control and regulation of destabilizing capital flows. This offers a viable alternative to free floating or to ceding completely monetary authority to a foreign Central Bank. Successful examples of control over inflows and outflows abound, from Chile to China, India and Malaysia, and provide a rich arsenal of tools for better management of the capital account and exchange rates.

It is essential that the autonomy of developing countries in managing capital flows and choosing whatever capital-account regime they deem appropriate should not be constrained by international agreements on capital-account convertibility or trade in financial services. Indeed, a basic objective for countries at all levels of development should be to roll back the control that financial capital has established over trade, industry and employment. It should also be recognized that private capital markets have not always been successful in replacing official development finance. Reform of the global financial architecture should focus on these issues, and include a greater role for official financing, recognize the rights as well as the obligations of debtors and provide for full debt relief for the poorest developing countries.

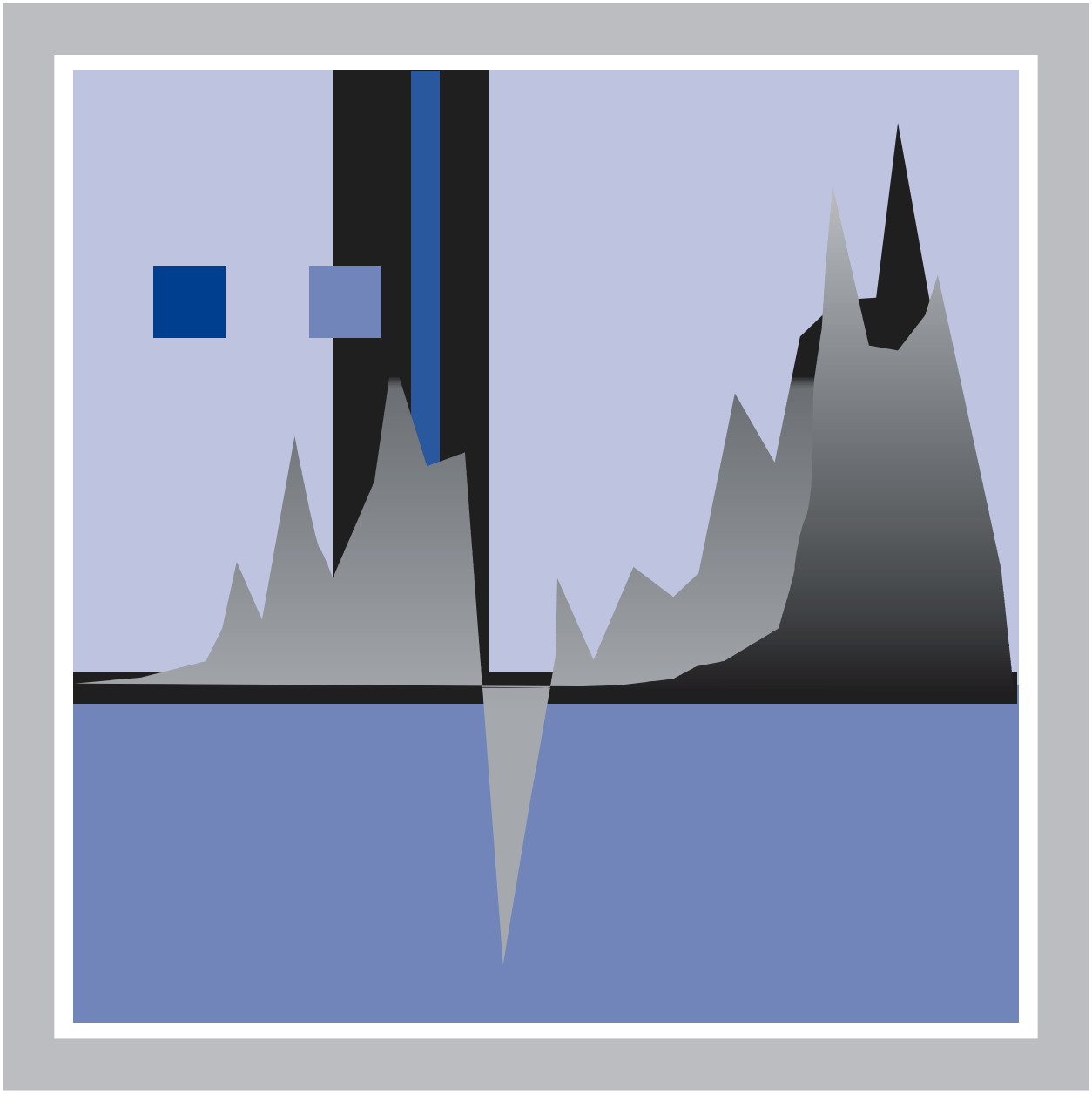
* * *

When all is said and done, progress on access to northern markets remains key to overcoming the payments constraints facing developing countries. For this to happen, industrial countries, particularly Japan and the EU, must grow more rapidly. With expansionary macroeconomic policies and targeted structural measures, they can do it. But Governments in the North should also work harder to convince a sometimes sceptical public that there are direct benefits, in terms of more jobs and rising incomes, from expanding trade with the South. They must also recognize that a more stable international financial system free from hot money and recurrent crises in emerging markets is in their longer-term interests.

A rising tide will lift all boats. However, this approach is not easy. It requires effective leadership and a spirit of cooperation. For the sake of future generations, the sooner these are in place the better.

Rubens Ricupero
Secretary-General of UNCTAD

THE WORLD ECONOMY: FRAGILE RECOVERY WITH DOWNSIDE RISKS



Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Recent developments in world output

The setback to the world economy triggered by the Asian crisis in mid-1997 had repercussions throughout 1998. World output growth fell to 2.0 per cent in 1998 from 3.3 per cent in 1997, and the slowdown affected almost all regions and economic groupings (table 1.1). Growth in developing countries was strongly influenced by the impact of the crisis on trade and commodity prices, capital inflows and financing costs, as a result of which it slowed dramatically from 5.4 per cent to 1.8 per cent. For the first time since 1988, growth in developed countries exceeded that of developing countries.

Despite this general slowdown, the fears of a global recession sparked off by a downturn in the United States economy have proved unfounded, and by the beginning of 1999 there were already signs that conditions might be stabilizing. Widely anticipated in the aftermath of the global liquidity crisis in the autumn of 1998 triggered by the financial crisis in the Russian Federation, a global recession now appears less likely in the face of rapid reduction in interest rates, first in the United States and somewhat later in Europe, continued strong expansion in the United States, recovery of global equity markets and the relatively moderate impact of the Brazilian crisis. The United States economy maintained its 1997 growth rate of some 4 per cent, and unemployment fell to nearly 4 per cent without any appreciable impact on inflation. Although the deterioration of its trade balance resulted in a leakage of demand by almost 1.5 per cent of GDP, growth remained strong thanks to a rapid expansion of domestic demand. After expanding by 5 per cent in 1997, output in developing Asia (excluding China) contracted slightly.

Declining commodity prices and a strong dollar have contributed to the sustained growth in the United States by generating higher purchasing power and easing price pressures, but these factors had the opposite effect in developing countries. Thus, the brunt of the widely forecast adverse impact of the Asian crisis on growth in developed countries has in fact been borne by developing countries, particularly in Latin America, where growth fell from 5.4 per cent in 1997 to 2.1 per cent in 1998. The combination of declining terms of trade and reduced capital inflows necessitated restrictive domestic policies at the very time when world demand conditions were weakening. Nor did the transition economies escape the fallout from the Asian crisis, with output contracting by 1.3 per cent in 1998 after an increase – the first for several years – of 1.4 per cent in 1997.

While global recession has been avoided, disparities in economic performance among major industrial countries have produced serious imbalances. Growth in EU was only slightly higher in 1998, while the Japanese economy con-

Table 1.1

WORLD OUTPUT, 1990–1998

(Percentage change over previous year)

Region/country	*1990–1995*[a]	*1996*	*1997*	*1998*[b]
World	1.9	3.3	3.3	2.0
Industrialized countries	1.7	2.9	2.9	2.2
of which:				
United States	2.3	3.4	3.9	3.9
Japan	1.4	5.0	1.4	-2.8
European Union	1.3	1.6	2.5	2.7
of which:				
Euro area	1.4	1.4	2.3	2.8
Germany	1.7	0.8	1.8	2.3
France	1.1	1.1	2.0	3.2
Italy	1.1	0.9	1.5	1.4
United Kingdom	1.2	2.6	3.5	2.1
Transition economies	-8.2	-1.5	1.4	-1.3
Developing countries	4.9	5.8	5.4	1.8
of which:				
Latin America	3.3	3.6	5.4	2.1
Africa	1.1	3.9	2.7	2.9
Asia	6.4	7.1	5.8	1.6
of which:				
China	12.4	9.6	8.8	7.8
Other countries	5.1	6.4	5.0	-0.3
Memo item:				
Developing countries, excluding China	4.0	5.2	4.8	0.8

Source: UNCTAD secretariat calculations, based on data in 1990 dollars.
a Annual average.
b Estimated.

tracted by nearly 3 per cent. High interest rates and strong demand in the United States distinguish that country as the high-growth, high-return centre of a stagnant global economy, competing with developing countries for capital and reinforcing the strength of the dollar despite the weak current-account balance. This constellation is reminiscent of the first half of the 1980s, when the dollar strengthened despite rising trade deficits and generated pressures for protectionism. The only major difference is that the United States is now enjoying a fiscal surplus, while Japan has an increasing budget deficit.

A rise in United States interest rates and a strong dollar tend to worsen the debt-servicing capacity of developing countries and reduce their capital inflows. Clearly, one of the basic problems is that demand in other industrial countries, particularly Japan and EU, is providing little by the way of additional exports from developing countries, while their capital flows favour developed markets, notably that of the United States. Global recovery will require steps to shift some of the burden from the United States to Europe and Japan, revive demand in Asia and generate a more balanced distribution of capital flows.

B. Regional economic performance

1. Developed countries

(a) United States

Economic growth in the United States has continued to surprise. The expansion that started after the 1991 recession has been sustained for what could soon be a historical record. Furthermore, at around 4 per cent, growth over the last three years has stabilized at about double what had generally been considered its longer-term potential. Nonetheless, inflationary pressures have been absent and labour costs show no signs of market tensions. Growth has been driven by consumption expenditures, although investment has been sustained at historically high rates. Moreover, until the outbreak of the Asian crisis, exports were also an expansionary factor even though the trade balance was in deficit. The deficit increased rapidly after the crisis, but its impact on aggregate domestic demand has been largely offset by the decline in import prices.

The strong performance of investment in recent years, in particular in the high-technology sectors, has generated a rapid increase in productivity (particularly in manufacturing, which was responsible for around 2 percentage points of the increase in output in 1998), preventing any re-emergence of inflationary pressures despite the high growth and low unemployment. Productive capacity has been expanding faster than demand, resulting in a decline in capacity utilization to levels not experienced since 1992, and stands at around 3 percentage points below the 83–84 per cent rate considered as a critical indicator of inflationary pressure by the Federal Reserve. This excess capacity has made it possible to accommodate peaks in demand, which in some quarters reached a roughly 6 per cent annual growth.

Higher employment accounts for about 2 percentage points of the rise in output, half of which was due to the increase in the labour force and half to higher participation rates as previously discouraged workers re-entered the labour market. Consequently, the share of long-term unemployed in total unemployment fell from over 20 per cent in 1992 to 11 per cent in April 1999. Part of this increase in the available labour force may stem from the fact that household consumption expenditure has been rising faster than income. Consequently, households have sought to supplement their incomes via the labour market.

An important factor determining consumer demand is the impact of the stock market on household wealth. The Federal Reserve estimates that around 1 percentage point of the growth of the economy has been due to the impact on private wealth of the rise in equity and real estate prices. Encouraged by their greater sense of wealth, households have increased their net indebtedness to the financial sector; consumer credit rose by 4 per cent in 1997, 5 per cent in 1998 and at an annual rate of 6 per cent thereafter (up to April 1999), although the ratio of household debt to wealth has remained generally stable. Indeed, while household savings rates according to the national accounts are negative, if capital gains on the stock market are included in household income the savings ratio is still around 6 per cent, largely unchanged over the past decade.

Business, too, has been influenced by changes in asset prices; internally generated funds are now falling short of investment expenditures so that the business sector has also become a net borrower. Much of the borrowing was used for equity purchases, offsetting the net sales of households. The purchases have thus supported market prices, increasing the returns to households. In this way, part of the financing that firms use to redeem outstanding shares indirectly finances increased consumer expenditures.

A counterpart of the net borrowing by the private sector is the net surplus of the government sector. Indeed, economic expansion has brought

a rapid improvement in the fiscal balance, which is now in surplus. Much of the surplus is due to the rising levels of employment and income, but higher yields from the capital gains tax have also been important.

There are thus two possible threats to the maintenance of recent growth performance. First, there are the questions of whether productivity growth can be maintained at rates above 2 per cent and whether the labour force can continue to expand at twice the rate of population growth. Failure on either account would quickly produce supply-side constraints and perhaps rekindle inflationary pressures. Indeed, the transitory nature of these positive supply-side factors is likely to lead the Federal Reserve to a pre-emptive tightening of monetary policy in the summer of 1999, even in the absence of any evidence of price pressures.

The second risk factor relates to the crucial role played by the rise in equity prices in the expansion of investment and household expenditures, as well as in the generation of the fiscal surplus. A major correction in equity prices would hit both business and household spending. Moreover, given the degree to which the latter is financed by borrowing against the collateral of equity values, it would also worsen the balance sheets of banks, leading to a contraction in lending. The result would be a sharp decline of private demand, a contraction of the economy and a period of deflation.

The difficulty facing the monetary authorities is that these two risk factors are not independent. Any action to increase interest rates to slow down the economy, because of the belief that the fast increases in productivity cannot be sustained or that pressures will emerge in the labour market, is likely to result in falling equity prices, lower corporate profits and falling demand, which would indeed cause productivity growth to fall off and unemployment to rise. Savings ratios would rise as households seek to repay debt and lending would be cut back, while the increase in the fiscal surplus would be partially reversed. The alternative of using tighter fiscal policy to offset overheating is not even on the policy agenda, and the political balance is pointing towards tax reduction.

The question is whether the growth rate can be cut back to 2–3 per cent through tighter monetary policy, while avoiding a drastic decline in equity prices, which would risk plunging the economy into recession. In short, there may be a discontinuity in sustainable growth rates, given the nature of the self-reinforcing factors responsible for the current positive interactions between demand and supply.

(b) Japan

In sharp contrast to continued high growth in the United States, GDP in Japan peaked at the beginning of 1997, and was in almost steady decline until the first quarter of 1999. The Government has continued its past practice of introducing new fiscal packages. In April 1998, 16 trillion yen of emergency measures were announced, and another package of more than 17 trillion was approved in November, including tax cuts worth 7 trillion yen due to come into effect in fiscal 1999.[1] Aggressive monetary easing by the central bank, as well as a policy of a weak yen, have also been part of the armoury of anti-deflation policies.

Despite the size of the fiscal packages and low interest rates, the economy showed little sign of recovery in 1998. For one thing, the low nominal interest rates are below real rates, since prices have been falling, and as in Europe lower short-term rates have not prevented long-term rates from rising, as they did towards the end of the year (see chapter III). For another, the value of the government expenditure multiplier has fallen substantially in recent years. Because of widespread excess capacity and impaired balance sheets, government spending has very little secondary impact; the impact has been principally on the restructuring of balance sheets and repayment of loans, rather than on the generation of additional private demand. Further, the rise in government bond rates depresses domestic investment and strengthens the exchange rate; that, in turn, slows exports, thereby offsetting the initial expansionary impact of public spending.

In order to broaden its policy options the Government has announced plans for a 60 trillion yen package to restructure the financial system through the Financial Revitalization Law and Bank Recapitalization Law, including deposit insurance, nationalization of banks and recapitalization, as well as a MITI proposal to guide restructuring of the real economy by reducing ex-

cess capacity, allowing labour shedding and introducing more efficient management. Among the recommendations are portable pension plans, more leeway for enterprises in wage policy, retraining schemes, better unemployment insurance, deregulation of the real estate market and revision of anti-monopoly laws. How many of these changes will be introduced, and how rapidly, is still unclear, but they represent a clear change of policy. If implemented, they are likely, on some estimates, to increase unemployment to 6 per cent, compared to the current level of some 4.5 per cent.

Public investment continued to increase at an annual rate of 50 per cent in the first quarter of 1999, and to the surprise of most forecasters consumer expenditure recovered, leading to a sharp increase in GDP over the last quarter of 1998 of an annualized 7.9 per cent. Such rapid reversals also occurred previously as a result of the cumulative effects of public expenditure packages. For example, in the first quarter of 1996 the economy surprised all forecasters by expanding by 12 per cent at an annual rate over the previous quarter, but this performance was quickly reversed. There are a number of elements that suggest a similar reaction could again occur. Bank lending continues to decline, there is still no evidence of a recovery of private investment, and manufacturing capacity utilization has fallen to a low for the decade despite a reduction of capacity by around 2 per cent in 1998. It is thus likely that once the impact of the fiscal package is worked out, the economy will return to its previous state, which would mean another series of double dips. That appears to be also the assessment of the Government; an autumn fiscal package, considered necessary to achieve the official target of 0.5 per cent growth for the current fiscal year, has already been announced.

(c) European Union

Early optimism regarding the limited impact of the Asian crisis was based in part on the expectation of economic recovery in Europe, as well as on sustained growth in Latin America. Not only was Europe considered likely to be less affected by the crisis, but also it was poised for a sustained expansion of the kind that prevailed in the United States after the 1990–1991 Gulf War. However, after a strong start in 1998, growth in the EU economies slowed towards the end of the year. By the first quarter of 1999 the annual growth rate for the 11 euro countries had fallen to 1.6 per cent, and provisional data do not suggest any significant increase in the second quarter. Thus, growth would need to accelerate in the second half of the year in order to attain an average for the year of 2 per cent.

A number of factors that had impeded recovery in the early 1990s have persisted after monetary union. As a result of the increased integration of capital markets, interest rates in all EU countries have become much more responsive to monetary conditions in the United States. Thus, their market rates have tended to move in a procyclical manner, rising in sympathy with rapid expansions in the United States, when lower rates would have been more appropriate to domestic conditions. This phenomenon was especially evident in the global bond market crash of 1994–1995, but again more recently when 10-year bond rates rose in tandem with United States bond rates, a trend which has not been reversed by the 50-basis point cut by the European Central Bank (ECB) at the beginning of April 1999. Thus, just as most EU economies risked a slowdown or even a recession at the end of 1998, domestic rates were tracking rising United States capital market rates with more or less constant spreads, suggesting that a repeat of the 1994–1995 experience is likely if the United States expansion remains strong.

It has been made clear by ECB that it does not contemplate any further reduction in interest rates unless additional action is taken to reduce fiscal deficits. Nonetheless, it appears to have opted for further monetary loosening through depreciation of the euro, the value of which against the dollar has fallen by some 10 per cent since its introduction at the beginning of 1999 (see chapter III).[2] In the major EMU countries it is intended to bring fiscal deficits down to around 1.5 per cent of GDP in 2000 and 1 per cent by 2002, thereby persisting over the next three years with fiscal tightening.

The impetus to recovery will consequently have to come from private spending. However, because of the uncertain employment situation and the slow growth of real income, consumer expenditure, which had been expected to lead the recovery in 1998, continues to be restrained, leaving exports as the major determinant of demand expansion. Even though Asia does not account for a large proportion of EU exports, the reduced demand in Asian markets had a larger-than-expected impact on income growth in the last half

of 1998 and also on investment, which fell in the second quarter of the year.

The decline in the EU growth rate appears to have come to a halt by the end of 1998, although industrial production continues to be disappointing, probably still reflecting high stock levels. Given the continued goal of fiscal consolidation, the probability of a strong recovery that would raise annual growth above 2 per cent is low, and much will depend on exports. Further, inflation remains converged at around 1 per cent, so that a policy of maintaining interest rates at 2.5 per cent can hardly be considered stimulative. The weak economic performance of the major euro area economies, in comparison with rapid growth in some of the smaller economies (such as Ireland, Finland and Portugal), also makes it difficult for ECB to reduce rates from current levels for fear of overheating in the latter countries. With sluggish aggregate demand, and the transmission from the United States of higher bond prices, the risk of deflation in EU remains. Far from leading the global economy to recovery, Europe is likely to continue to depend on recovery in other countries.

A further consideration is that restructuring in Europe has lagged behind that in the United States. The recent measures to liberalize labour markets and provide corporate tax incentives in Germany, as well as widespread corporate takeovers, have been viewed in many quarters as the start of a process similar to that in the United States in the late 1980s and early 1990s which led to sharp increases in industrial productivity and corporate profits. Should that indeed be the case, both output and employment would be affected in the short run, as the merged corporations seek to increase profits by shedding labour, especially in the recently privatized telecommunications sector.

There continues to be a division in EU between the 11 euro countries and the other four, in particular the United Kingdom, which was the first EU country to undergo substantial restructuring and to emerge from the recession of the early 1990s. The asynchronous nature of the economic cycles of the euro area and the United Kingdom that emerged at that time is still in evidence; in the fourth quarter of 1998, while the major EMU economies were skirting recession, domestic demand in the United Kingdom rose by 1 per cent. However, while the euro area receives a boost to growth from a trade surplus, the United Kingdom has a deficit on goods and services, which reached 3.8 per cent of GDP in the fourth quarter, and largely offset the benefits of strong domestic demand. Growth in the first quarter of 1999 has been stable relative to the preceding quarter, partly due to a reversal of interest-rate increases.

2. Developing countries

(a) Latin America

Growth of 5.4 per cent in 1997, the highest in a quarter of a century, created expectations that Latin America could make up for weaknesses caused by the Asian crisis in other regions. However, the region suffered a serious setback in 1998, with output rising by only just over 2 per cent, roughly the global average. Notwithstanding progress in structural reforms in recent years, including the substantial strengthening of banking regulation and supervision[3] and the change in the composition of capital inflows in favour of FDI, the region remained highly vulnerable to external shocks. On the other hand, the recently achieved reductions in inflation and fiscal deficits have dampened the adverse impact of external shocks on growth. Although exchange rates in some countries were highly unstable, the regional inflation rate for the 12 months to November of 1998 was 10.2 per cent, the lowest in nearly 50 years, with rates still falling in a number of countries. Fiscal deficits reached the peak level of the 1990s of 2.4 per cent of GDP, but they were smaller than in the 1980s. Despite these improved conditions, continued dependence on external financing made the region particularly vulnerable to any global liquidity crisis.

Initially, after the onset of the Asian crisis, Latin American countries introduced monetary and fiscal measures to preserve price stability and fiscal equilibrium. However, as the crisis produced a steep drop in capital inflows and a severe deterioration in the terms of trade, Governments had to choose between stable exchange rates and prices, on the one hand, and international competitiveness, on the other. Most countries chose to tighten monetary policy in an attempt to stem the outflow of capital and loss of international reserves.

The need for austerity was heightened by the Russian crisis, which had an immediate impact on

the region. Short-term net capital inflows quickly turned negative, especially in Brazil, Chile and Peru (see chapter III). In Brazil hikes in interest rates could not check capital outflows. Despite a brief respite after the elections in early October and the signing of an agreement with IMF for a $41 billion financial assistance package put together in November by the Fund, the World Bank and the Bank for International Settlements, outflows resumed at the end of the year, and by January 1999 reserves were no longer sufficient to allow the Central Bank to continue operating its crawling exchange-rate band; after one adjustment of the band, the currency was left to float.

The sharp decline in commodity prices also had serious effects on the Latin American economies, though with varying impact (see chapter II). The net outcome was to contribute to the absolute decline in total export earnings and so to a further worsening of the trade balance and the current-account deficit, which is currently some 4 per cent of regional GDP. Concurrently, the region's external debt rose by 5 per cent to reach $736 billion by the end of 1998. The increase was concentrated principally in Argentina, Brazil and Chile. Combined with the decline in exports, there was for the first time in the 1990s an increase in the ratio of interest payments to exports of goods and services, from 11.0 per cent in 1997 to 12.5 per cent in 1998, and a corresponding increase in the ratio of debt to exports of goods and services, from 191 per cent to 203 per cent.

Weather disasters were a further factor slowing down growth. El Niño, which started in 1997, caused extensive flooding along the coasts of Peru and Ecuador as well as in various regions of Argentina, Brazil, Chile, and Paraguay. It also brought drought to large areas of Colombia, Mexico, and other countries in Central America and the Caribbean and also South America. The overall damage is estimated to be $15 billion.[4] Towards the end of 1998, countries in Central America and the Caribbean also suffered from substantial damage caused by hurricanes, of which hurricane Mitch was one of the most destructive of this century. The extent of damage and destruction was particularly heavy in Honduras, and to a lesser extent in Nicaragua, and prompted international assistance measures. The effects of the damage will continue to be felt in the years to come.

The sharp decline in the growth of output was widespread in the region, including the larger economies of Argentina, Chile, Colombia, Mexico, Peru and Uruguay (table 1.2). In particular, output stagnated in Brazil, after the 3.8 per cent achieved in the preceding year, while it declined in Paraguay and Venezuela. The situation at the end of 1998 was in fact more serious than these annual figures suggest. In most countries, the momentum of high growth in 1997 which continued into the early months of 1998 was progressively overtaken by sharp deceleration, and in some cases contraction, during the second half of the year.

The collapse of the Brazilian real in mid-January 1999 initially led to forecasts of a sharp decline in income growth in the region for 1999. However, by the second quarter it became clear that the decline in Brazilian output would be less than the 4–6 per cent originally forecast; there will be little lasting inflationary impact, capital flows have returned and interest rates have moved down steadily. However, export earnings have so far failed to expand for the same reasons as they failed to in Asia (difficulties in financing and low export prices), while the faster-than-expected recovery in output, together with the rise in oil prices, has caused imports to fall less than originally expected. Thus, it is unlikely that there will be a large trade surplus. Difficulties also remain on the fiscal side. After a sharp increase in the primary surplus in the first quarter of 1999 above the 3.2 per cent of GDP agreed with IMF, there was a primary deficit in May, largely due to failure to control expenditure.

The GDP for the region as a whole is likely to contract in 1999 by 1 per cent. In general, the expectations are that in the absence of further external shocks the recession is unlikely to be prolonged. There are, however, considerable downside risks, including the more recent one of higher United States interest rates. Despite the weak growth performance, current-account balances in 1998 were well above the critical level of 4 per cent of GDP in Argentina, Brazil and Chile and close to that level in Mexico. Thus, external indebtedness and dependence on foreign capital inflows are again on the increase. In view of the recent realignment of exchange rates, an improvement in the current account of Argentina can only be achieved through a contraction of output, which may be unpalatable in an election year. Despite the adoption of a policy of advanced sovereign borrowing, any loss of confidence could spark off a reversal of capital flows that could make exter-

Table 1.2

GROWTH IN DEVELOPING COUNTRIES, BY REGION, 1990–1998

(Percentage change over previous year)

Region/country	*1990–1995*[a]	*1996*	*1997*	*1998*[b]
Latin America	3.3	3.6	5.4	2.1
Argentina	6.0	4.4	8.0	4.2
Bolivia	3.8	4.4	4.2	4.5
Brazil	2.7	2.9	3.8	0.2
Chile	7.4	6.8	6.4	3.3
Colombia	4.5	2.1	3.5	0.2
Mexico	1.5	5.5	7.1	4.8
Paraguay	3.2	1.1	2.4	-1.0
Peru	5.5	2.2	7.8	0.8
Uruguay	3.6	5.0	5.0	2.5
Venezuela	3.2	-0.9	5.5	-0.7
Africa	1.1	3.9	2.7	2.9
Algeria	0.4	5.5	1.1	3.4
Cameroon	-1.4	4.0	5.1	5.0
Côte d'Ivoire	1.1	5.2	6.5	5.5
Egypt	1.4	3.2	5.3	5.5
Ghana	4.3	5.0	4.3	3.8
Nigeria	2.7	3.8	3.8	2.4
South Africa	0.8	2.5	1.7	0.1
Uganda	7.5	6.0	5.5	4.0
Zimbabwe	0.8	6.6	3.2	1.0
Asia	6.4	7.1	5.8	1.6
Newly industrializing economies	6.9	6.3	6.0	-1.8
Hong Kong, China	5.5	4.5	5.3	-5.1
Republic of Korea	7.4	7.1	5.5	-5.5
Singapore	8.5	6.9	7.8	1.5
Taiwan Province of China	6.4	5.7	6.8	4.8
ASEAN-4	7.0	6.9	3.7	-9.0
Indonesia	7.1	7.8	4.9	-13.7
Malaysia	8.7	8.6	7.7	-6.2
Philippines	2.2	5.8	5.2	-0.5
Thailand	8.3	5.5	-0.4	-8.0
ASEAN-4 plus Republic of Korea	7.2	7.0	4.6	-7.3
South Asia	4.5	7.3	4.7	5.7
Bangladesh	4.1	5.4	5.9	5.7
India	4.5	7.8	5.0	5.8
Nepal	5.0	5.3	4.0	1.9
Pakistan	4.7	5.2	1.3	5.4
Sri Lanka	4.5	3.8	6.4	5.3
West Asia	2.5	5.6	4.8	2.0
China	12.4	9.6	8.8	7.8

Source: ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean 1998*, Santiago, Chile, 1998, United Nations publication, sales no. E.98.II.G.15, table A-1, and updated data provided by the ECLAC secretariat; *Asian Development Outlook 1999,* Hong Kong, China, Oxford University Press for the Asian Development Bank, 1999, table A1; ECA, *Economic Report on Africa 1999,* E/ECA/CM.24/3, Addis Ababa, 1999, Statistical Annex I, table A I.1; and IMF, *World Economic Outlook*, May 1999, tables 1.2, 1.3 and 1.4.

a Annual average.

b Estimate.

nal debt service problematic and once again exert pressure on the exchange rate and the financial system. In Brazil high primary fiscal surpluses may be politically difficult to sustain. The alternative is some form of debt restructuring, which poses a threat to stability.

(b) Asia

For most developing economies in Asia 1998 was a particularly difficult year. For developing Asia as a whole, growth slowed down considerably, from 5.8 per cent in 1997 to 1.6 per cent, and for the first time in the 1990s it was lower than in Latin America or Africa. Only China and a few countries in South Asia managed to sustain the growth rates of recent years. There are signs, however, that conditions are stabilizing and on some estimates the rate of growth will more than double in 1999.

(i) Newly industrializing economies

Aggregate GDP of the four newly industrializing economies (NIEs) contracted by 1.8 per cent in 1998, in contrast to an expansion of 6 per cent in the preceding year. Only Taiwan Province of China survived the financial turmoil relatively unscathed. Thanks to its pre-emptive devaluation and large foreign-exchange reserves built up from current-account surpluses, the decline in growth was contained at 4.8 per cent, against 6.8 per cent in 1997. Hong Kong (China) experienced its first recession in 13 years, as output declined by some 5 per cent in contrast to a growth rate of over 5 per cent in 1997, and is likely to remain in recession in 1999. In Singapore growth fell to 1.5 per cent, from nearly 8 per cent in 1997. In both economies wages and employment were allowed to fall in order to maintain external balance and competitiveness.

The recession in the Republic of Korea turned out to be worse than anticipated, due to the severe contraction of both domestic and external demand, with output falling by more than 5 per cent. Because other countries in Asia accounted for about half of the Republic's exports prior to the crisis, the fall in external demand was inevitable following the deepening of financial turmoil. On the other hand, weaknesses in the corporate and financial sectors, the emergence of a credit crunch and a reduction in household incomes resulted in a severe decline in domestic demand. Following the announcement of radical reforms in virtually all sectors of the economy, the unemployment rate rose sharply, from 2.6 per cent in 1997 to 6.8 per cent in 1998, and nominal and real wages fell by 1 per cent and 7.9 per cent, respectively. However, signs of incipient recovery in domestic demand and production were already evident in late 1998 and consumer confidence has been growing. While investment remains generally weak, it has started to recover in a number of major sectors, such as shipbuilding, machinery and automobiles. Although there are considerable downside risks associated with the external environment, the general expectation is for a restoration of growth, to reach some 4 per cent in 1999.

(ii) ASEAN-4

Income in ASEAN-4 as a group fell by 9 per cent in 1998, in contrast to an increase of 3.7 per cent in 1997. While the decline was less than 1 per cent in the Philippines, it was nearly 14 per cent in Indonesia, where the effect of El Niño on agricultural production aggravated the already drastic economic conditions. By and large, economic contraction in the four countries reflected the impact of precipitous currency depreciation and generalized debt deflation, producing widespread insolvencies in the aftermath of the massive reversal of private capital flows. The capital flight from the four countries in 1997 and 1998 is believed to have exceeded $30 billion.

The decline in output is likely to bottom out in 1999, with the exception of Indonesia, where a further, albeit greatly reduced, contraction is expected. Growth, however, will be limited. Despite greater exchange-rate stability, increased liquidity in money markets and lower interest rates, banks are reluctant to lend, owing to the rise in non-performing loans and stricter provisioning requirements. Just as for other affected countries in Asia, a sustained recovery will of necessity be export-based, and will depend much on conditions in Japan, the United States and Europe. At the end of 1998 net exports from Thailand started to expand, resulting in a nearly 1 per cent increase in GDP in the first quarter of 1999. Output recovered in Indonesia in the same quarter for the first time since the crisis, and there are indications that recovery strengthened in the second quarter. Although output declined in the first quarter in Malaysia, the economy appears to have stabilized and growth should be positive for 1999 as a whole. In the Philippines industrial production has turned up, a sign of recovery there as well.

(iii) South Asia

So far, the Asian crisis has had only a limited impact on South Asia, due largely to the sub-region's restrictions on capital-account convertibility and short-term foreign debt. For the sub-region as a whole, GDP grew by 5.7 per cent in 1998, compared to 4.7 per cent in the previous year, although there was much variation among countries. Growth accelerated in Pakistan and continued to increase slightly in India, but slowed in other countries. In spite of severe flooding during July-October 1998, Bangladesh managed to sustain a growth rate comparable to that of the previous two years.

In 1998, restrictions on trade credits to India and Pakistan associated with nuclear test sanctions reinforced the adverse impact of the Asian crisis on the amount of financing available for current-account deficits. At the same time, to safeguard the competitiveness of exports, currencies in the sub-region were allowed to depreciate. From August 1997 to December 1998, for example, the real effective exchange rate of the Indian rupee fell by 10 per cent. In Pakistan, an exchange and debt crisis emerged in May 1998 following its nuclear tests and the freezing of foreign currency accounts. The decline in reserves associated with sanctions and the accumulation of large external payments arrears led to a 20 per cent depreciation of the currency. In order to avoid a default on its external debt, Pakistan concluded an agreement with IMF in January 1999 on a $5.5 billion rescue package.

For 1999, a general slowdown in growth is likely for South Asia as a whole and for Pakistan in particular, due in part to its uncertain political climate. The outlook for Bangladesh will be dominated by recovery from the floods. In the short run, weather may also be a factor. Short-term prospects for the sub-region are also clouded by uncertainties associated with the current armed border conflict between India and Pakistan.

(iv) West Asia

Economic performance in West Asia during 1998 was dominated by developments in the international oil market. Growth in the sub-region slowed sharply, to reach only 2 per cent, against 4.8 per cent in 1997. The crisis in East and South-East Asian countries, which are major importers of oil from West Asia, produced a fall in export earnings to nearly one third of the 1997 level, or about $35 billion. The fall in oil prices worsened the sub-region's terms of trade and was also felt in currency markets. Saudi Arabia's currency, for example, which is pegged to the dollar, came under attack in the summer of 1998 and the Government had to intervene heavily in the foreign-exchange market to defend its value.

Unemployment continued to increase in most countries of West Asia. Prospects for 1999 remain highly dependent on oil prices and to a lesser extent on progress in the Middle East peace process. Notwithstanding the recent recovery in oil prices, the outlook in the short term, especially for countries members of the Gulf Cooperation Council (GCC),[5] remains challenging, given the large social and welfare programmes funded by Governments and the pressure of increasing unemployment.

(v) China

In China GDP grew by 7.8 per cent in 1998, which is a full percentage point lower than 1997 and the lowest rate since the early 1990s.[6] The performance of the Chinese economy is striking compared to that of neighbouring countries, particularly in view of the fact that the country suffered severe floods in the summer of 1998, with damage amounting to an estimated 2 per cent of GDP. Growth in output started to rebound in the second half of 1998 due to large increases in government infrastructure spending, accompanied by expansionary monetary policy. At the same time, large foreign-exchange reserves, moderate foreign debt, the control over capital flows, and prudently managed integration with international financial markets did much to insulate China from the impact of the Asian crisis.

Nevertheless, inasmuch as Asia accounted for 53 per cent and 62 per cent, respectively, of China's exports and imports in 1998, the deepening of the Asian crisis resulted in a stagnation of exports, which grew by less than 1 per cent, compared to 21 per cent in the previous year,[7] and there was also a mild contraction of imports. While the country continued to enjoy a surplus on current account for the fifth consecutive year, total capital inflows fell by about 8 per cent. The realization that the Government would not bail out foreign investors in investment trusts, such as the Guangdong International Trust and Investment Corporation (GITIC), has brought about some reassessment of risk in this area. However, FDI, which accounts

for 80 per cent of total foreign investment, remained practically unaffected, although early indications suggest that the flow may have slowed substantially in the beginning of 1999. As with exports, increased FDI flows from the EU countries and the United States compensated for the slowdown in the flow from five Asian economies (Japan; Taiwan Province of China; Hong Kong, China; Singapore; Republic of Korea), which together accounted for as much as 73 per cent of the total FDI inflow in 1997.

Pursuit of an expansionary fiscal policy to sustain output growth resulted in a significant increase in the budget deficit. While the ratios of public deficit and debt to GDP are both modest by international standards, there are grounds for concern. To begin with, money raised from bond issues are considered by the Chinese Government as budget revenues rather than borrowing. In addition, domestic bond issues in 1998, most of which were bought by the State banks, accounted for nearly 40 per cent of all government revenues, and two thirds of new issues were used for servicing existing debt. The proportion of government revenues needed for debt-servicing may have more than doubled since 1996, to reach 22 per cent in 1999.[8]

Amid weakening domestic demand and a fall in the price level, the pace of structural reforms in China has slowed down[9] and banks have increased their lending to the State sector. In particular, the reform of loss-making and highly indebted State-owned enterprises has been postponed to avoid adding substantially to the already large number of layoffs.

The Chinese authorities have repeatedly stated their firm stand not to devalue the yuan. The rationale for this stand includes the existence of large foreign-exchange reserves; the need to avoid trade tensions, especially with the United States; the impact on the debt-servicing burden; the stability of capital inflows; and the risk that devaluation may trigger a new round of competitive devaluations in neighbouring countries. However, devaluation may become inevitable if economic prospects worsen significantly. Since the price level has fallen by over 3 per cent in the 12 months ending April 1999, there must have been some real appreciation of the currency.

The slowdown in output growth is likely to continue in 1999, with the rate falling to below 7 per cent. The expansionary fiscal stance is expected to continue, with accommodating monetary policy.

(c) Africa

For the first time in the 1990s, growth in Africa exceeded that of developing countries as a whole (table 1.2). However, this was mainly due to the sharp slowdown in other regions. At 2.9 per cent, the growth of output barely kept pace with that of population.

The overall regional performance masks significant variations among sub-regions and individual countries. Growth accelerated in North Africa, while the stagnation in the Republic of South Africa had spillover effects on neighbouring Botswana, Lesotho, Namibia and Swaziland. In West Africa, growth slowed in Nigeria, Côte d'Ivoire and Ghana, while in East Africa the decline in growth was spread over a large number of countries.[10] Economic performance in some CFA countries improved considerably with the restoration of competitiveness that followed the devaluation of the CFA franc in 1994. The outbreak of hostilities in the Democratic Republic of the Congo adversely affected the economies of Angola, Chad, Namibia, Rwanda, Uganda and Zimbabwe, and political conflict and social unrest continued to undermine economic activities in Eritrea, Ethiopia, Guinea-Bissau, Lesotho and Sierra Leone.

Africa was initially relatively isolated from the impact of the Asian crisis because most countries in the region have limited access to international finance, and also have stronger trade links with EU and the United States than with Asia. Financial contagion from Asia affected primarily South Africa, the largest economy in the region; the rand, which had been sliding downwards since early 1996, came under particularly intense pressure during May–August 1998.[11]

However, the region was affected by the subsequent deepening of the Asian crisis and its repercussions on trade and commodity markets. Of 47 African countries, 39 are dependent on a mere two primary commodities for over 50 per cent of export earnings and the substantial drop in commodity prices in 1998 encompassed the entire range of African exports. The price decline was particularly dramatic for oil, which accounts

for no less than 60 per cent of the region's foreign-exchange earnings (see chapter II).

While the impact of falling commodity prices varied among countries, the overall result was a decrease of 16 per cent in export value together with a slight reduction in volume. The export earnings of 10 major or significant exporters of oil (Algeria, Angola, Cameroon, Congo, Democratic Republic of the Congo, Egypt, Equatorial Guinea, Gabon, Libyan Arab Jamahiriya, Nigeria and Tunisia), which account for 42 per cent of regional GDP, were down by 25–30 per cent.[12]

For the African region as a whole, there was a large trade deficit which, together with an increasing and substantial deficit in services, resulted in a surge in the current-account deficit from $4.9 billion in 1997 to over $16.5 billion in 1998.[13] It is estimated that net direct investment flows into Africa fell by 20 per cent in 1998, while net official flows and "other net investment" – a broad category which includes both private and official flows – fell by 56 per cent, from $1.6 billion to $0.7 billion.[14] At the same time, the global flight of capital seeking quality and liquidity made it more difficult and costly to borrow in international capital markets, in particular for Egypt, Morocco, South Africa and Tunisia.

Debt overhang continued to be a serious problem in the region and the debt burden has become unsustainable in many countries. By the end of 1998, total African debt as a percentage of GDP had reached 65.5 per cent, marginally higher than in 1997. As a percentage of exports of goods and services, however, it was 303 per cent, a substantial increase from the 1997 ratio of 284 per cent, primarily because of the decline in exports. For the same reason, debt service as a percentage of exports of goods and services rose to 30.9 per cent from 21.3 per cent in the previous year. While the debt problem is being addressed in part by the Heavily Indebted Poor Countries (HIPC) Initiative, substantial alleviation of the debt burden is yet to take place. Of the 41 countries which have been identified as HIPC-eligible, 33 are in Africa. So far, only Uganda and, more recently, Malawi, Mozambique and Zambia have been able to benefit from the initiative; Burkina Faso, Côte d'Ivoire and Mali have reached the decision point; and Ethiopia, Guinea-Bissau and Mauritania have started preliminary discussions.

The heavy burden of external debt and largely unsustainable debt-service obligations, together with continued difficulties in the external economy, pose a constraint on the growth potential of African countries, limiting their ability to address persistent structural weaknesses. Growth will continue to depend on the behaviour of commodity prices. In view of the bleak global growth prospects (see section C below), significant improvements in commodity markets are not to be expected. Output growth for the region as a whole in 1999 may well be marginally lower than last year. Besides, there are considerable downside risks, including adverse climatic conditions and continuing civil conflict.

3. *Transition economies*

Economic growth in the transition economies slowed abruptly in 1998 due to the combined effect of several factors, including the Russian crisis, the drop in global demand, and a weakening of western European import demand in the second half of the year.[15] Growth slowed in all subregions (table 1.3). In Central and Eastern Europe the increase in GDP was the smallest since 1993. While the relatively modest growth in 1997 was mostly accounted for by Albania, Bulgaria and Romania, in 1998 it reflected a more general weakening of economic activity. In particular, Romania remained in deep recession for the second consecutive year and the Czech economy, rather unexpectedly, also slipped into recession as mounting domestic and external problems offset the impact of devaluation which preceded the Asian crisis. In the Baltic States, aggregate growth in 1998 was a little over half that of 1997. In the Commonwealth of Independent States (CIS), aggregate output contracted by 2.8 per cent in 1998, nullifying the modest growth of 1 per cent in 1997, mainly because of the Russian crisis, which led to a decline in output not only in the Russian Federation, but also in Kazakhstan, the Republic of Moldova and Ukraine. Trade and output in the CIS countries were adversely affected by the devaluation of the rouble and cuts in Russian imports.

Contagion from the global financial turmoil in 1998, and especially from the Russian crisis, was responsible for the growing financial and macroeconomic turbulence in a number of transition economies, resulting in a series of currency crises involving sizeable (and in some cases repeated) currency depreciations. As a result, strong inflationary pressures re-emerged, especially in

Table 1.3

TRANSITION ECONOMIES: SELECTED ECONOMIC INDICATORS, 1996–1998

	GDP			Consumer prices			Current-account balance		
	Change over previous year[a] (Percentage)						(Percentage of GDP)		
Region/country	*1996*	*1997*	*1998*	*1996*	*1997*	*1998*	*1996*	*1997*	*1998*
Central and Eastern Europe	4.1	2.3	1.5	..	..	..	-3.7	-4.2	-4.6
of which:									
Bulgaria	-10.1	-6.9	3.5	311.1	578.7	0.9	0.2	4.2	-2.1
Croatia	6.0	6.5	2.7	3.5	4.0	5.6	-4.3	-12.1	-7.3
Czech Republic	3.9	1.0	-2.7	8.7	9.9	6.7	-7.4	-6.2	-1.9
Hungary	1.3	4.6	5.1	20.0	18.4	10.4	-3.7	-2.1	-4.8
Poland	6.0	6.9	4.8	18.7	13.2	8.5	-0.9	-3.0	-4.3
Romania	3.9	-6.9	-7.3	56.8	151.7	40.7	-7.3	-6.7	-7.9
Slovakia	6.6	6.5	4.4	5.5	6.5	5.5	-11.2	-6.9	-10.1
Slovenia	3.5	4.6	3.9	9.0	8.8	6.6	0.2	0.2	0.0
Baltic States	4.1	8.4	4.4	..	..	..	-8.2	-9.5	-11.0
Estonia	3.9	10.6	4.0	15.0	12.3	6.8	-9.7	-12.1	-8.6
Latvia	3.3	8.6	3.6	13.2	7.0	2.8	-5.4	-6.1	-11.1
Lithuania	4.7	7.3	5.1	13.1	8.5	2.4	-9.2	-10.2	-12.1
CIS	-3.4	1.1	-2.8	..	..	..	1.2	-0.4	-1.3
of which:									
Belarus	2.8	11.4	8.3	39.1	63.4	181.6	-3.8	-6.0	-7.1
Russian Federation	-3.5	0.8	-4.6	21.8	11.0	84.5	2.8	0.9	0.9
Ukraine	-10.0	-3.2	-1.7	39.7	10.1	20.0	-2.7	-2.7	-2.0

Source: ECE, *Economic Survey of Europe 1999,* No. 2, United Nations publication, sales no. E.99.II.E.3, New York and Geneva, 1999, tables 2.3.1 and 2.3.2.

a For consumer prices change from December to December.

the second half of 1998 and in early 1999, reversing to some extent the divergent but general tendency for inflation to slacken in recent years. Given the time lag in the transmission mechanisms, price movements in 1998 do not reflect the full inflationary effects of the devaluations. Indeed, inflationary pressures can be expected to increase as the exchange rate continues to weaken in a number of countries.

The impact of a worsening external environment has varied among countries. Exporters of primary commodities and semi-processed goods, particularly to South-East Asia, suffered most. By contrast, exports of final consumption goods destined for Western Europe or products marketed through the distribution networks of TNCs were not affected to the same extent by weak external demand; indeed, these exports, mostly from Central Europe and the Baltic States, tended to grow quite strongly.

The current-account deficit of the Central and Eastern European countries of some 4.6 per cent of GDP in 1998 was larger than in 1997 (4.2 per cent). In the Baltic States, large and growing deficits appear to have given way to a surplus in 1998 in Estonia, resulting in a more favourable performance than was achieved in Latvia and Lithuania. The fall in world commodity prices was a major factor explaining the conversion of the Russian current-account surplus into a deficit in the first

half of 1998, but there was a surplus for the year as a whole due to the collapse of imports following devaluation.

For many transition economies access to international financial markets was greatly reduced following the Russian debt moratorium in August 1998, and was virtually impossible after the Brazilian devaluation of January 1999. Initially, the conflict in Yugoslavia also disrupted debt issuance by the transition economies, but conditions have eased for some of the better credit risks. Indeed, there is a growing differentiation among the transition economies in their access to international capital markets. Some (e.g. Hungary and Poland) do not appear to have had problems in financing their current-account deficits in 1998, and the inflow of FDI to these countries was also largely unaffected by the financial turmoil. FDI inflows into the Central and Eastern European countries also rose, while they fell sharply in the Russian Federation, due to a worsening investment climate.

The short-term outlook for the transition economies has deteriorated since the beginning of 1999. Because of the general tightening of conditions on international financial markets, balance-of-payments constraints may be the decisive factor. The conflict in Kosovo has also added to the uncertainty and undermined prospects for a number of countries, especially in those neighbouring on Yugoslavia. Between March and June 1999, several countries (Albania, Bulgaria, Hungary, Poland, The former Yugoslav Republic of Macedonia, all three Baltic States, Azerbaijan, Belarus, Georgia, Kazakhstan, Republic of Moldova) lowered their forecasts for growth in 1999. It is also likely that other CIS countries will end the year in recession. According to the official forecasts available in mid-June, Governments in 3 of the 12 Central and Eastern European countries (Czech Republic, Romania and The former Yugoslav Republic of Macedonia) expect GDP to fall for 1999 as a whole. Without an improvement in the current economic situation, this number may well increase in the second half of the year, taking in also the Baltic States. Even where some positive growth is forecast, the general expectation is that it will be less than in 1998.

Although considerable uncertainty surrounds the future of the Russian economy, short-term prospects have improved somewhat in recent months. At the beginning of the year, the official forecasts for 1999 were for a contraction in GDP ranging from 2 per cent to 10 per cent. By June, however, the expectation was of a decline of no more than 1 per cent.

C. Prospects and downside risks

Developments in the first half of 1999 suggest that economic activity is moving in different directions in different regions. However, the balance of expansionary and deflationary forces is such that the overall performance of the world economy is unlikely to differ significantly from the previous year. While growth in the United States and EU is expected to be slower than in 1998, in Japan there should be an improvement in the economic situation even though sustained recovery may not yet be in sight; growth in industrial countries as a whole can be expected to remain somewhat below the level of 1998. Disparate movements are also probable among developing countries: while Latin America is expected to experience a contraction, in Asia growth will most likely be considerably higher than in 1998. For developing countries as a whole, however, no significant increase over the 1998 growth rate is likely.

There are, however, considerable differences in the perception of current economic trends, reflected in the baseline projections for 1999 made by various international organizations and other institutions. As can be seen from table 1.4, the expected growth in global output ranges from 1.6 per cent to 2.4 per cent. Also discernible are significant discrepancies at the regional and subregional levels, as well as for certain countries.

Table 1.4

BASELINE FORECASTS OF GDP GROWTH IN 1999 BY REGION AND FOR SELECTED COUNTRIES, BY VARIOUS INSTITUTIONS

(Percentage change over 1998[a])

	IMF	World Bank	OECD	UN/DESA	JP Morgan	UNCTAD
World	2.3	1.8	2.4	2.0	1.6	1.9
Industrialized countries	2.0	1.8[b]	2.2[b]	1.8	1.7[b]	1.9
G-7	1.9	1.7	2.1	.	1.6	.
United States	3.3	.	3.6	3.5	3.2	3.4
Japan	-1.4	.	-0.9	-1.5	-0.5	-1.3
Germany	1.5	.	1.7	2.0	1.3	1.5
France	2.2	.	2.3	2.3	1.9	2.2
Italy	1.5	.	1.4	1.5	1.4	1.4
United Kingdom	0.7	.	0.7	0.5	-0.1	0.6
European Union	1.8	.	1.9	2.0	.	1.8
Euro area	2.0	.	2.1	2.3	1.7	2.0
Transition economies	-0.9	-1.5	.	-0.5	1.8[c]	0.6
Central and Eastern Europe	2.0	2.3	.	1.5	.	.
Russian Federation	-7.0	.	-1.0	-4.0	0.9	-1.0
Developing countries	3.1	1.5	.	2.5	.	2.1
Africa	3.2	.	.	3.0	3.8	2.6
Sub-Saharan Africa	.	2.5	.	2.9	.	.
Asia	4.7	4.1	.	4.8[d]	3.2[e]	3.3
Newly industrializing economies	.	2.0	.	2.5[f]	.	3.1
Hong Kong, China	-1.3	.	0.0	-0.5	-1.5	-1.0
Republic of Korea	2.0	.	4.5	4.5	4.0	4.0
Singapore	0.5	.	.	1.0	1.0	0.7
Taiwan Province of China	3.9	.	.	4.8	3.7	4.1
ASEAN-4	-1.1	-1.1	.	.	0.0[g]	-0.7
Indonesia	-4.0	.	-3.0	-2.5	-3.5	-4.0
Malaysia	0.9	.	0.5	1.5	0.0	0.7
Philippines	2.0	.	2.5	2.5	2.6	2.2
Thailand	1.0	.	1.0	1.3	2.5	1.0
ASEAN-4 plus Republic of Korea	.	0.3	.	.	.	0.6
South Asia	.	4.4	.	5.5	.	4.9
China	6.6	.	7.2	7.5	6.5	6.6
Latin America	-0.5	-0.8	.	0.0	-2.3	-0.8
Argentina	-1.5	.	-3.0	-1.5	-2.5	-2.0
Brazil	-3.8	.	-3.0	-2.5	-5.5	-3.2
Mexico	2.0	.	3.2	3.0	1.9	2.5

Source: IMF, *World Economic Outlook,* May 1999; World Bank, *Global Development Finance*, April 1999; OECD, *OECD Economic Outlook*, May 1999; UN/DESA, *World Economic and Social Survey 1999,* United Nations publication, sales no. E.99.II.C.1, New York and Geneva, 1999; and JP Morgan, *World Financial Markets*, New York, 2 April 1999.

a Based on weights in terms of purchasing power parity for IMF, World Bank and OECD, and in terms of exchange rates for UN/DESA and JP Morgan.

b Including also Mexico and the Republic of Korea, now members of OECD.

c Bulgaria, Czech Republic, Greece, Hungary, Poland, Russian Federation and Turkey.

d South and East Asia.

e China, Hong Kong (China), India, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan Province of China, and Thailand.

f East Asia.

g Including also Singapore.

For developing countries the discrepancies are even greater than for industrial countries, reflecting in large part differences of view about the speed of recovery in East Asia and the extent of economic difficulties in Latin America.

While the world has so far avoided recession and medium-term prospects may look less bleak than a year ago, there is no ground for complacency, since the systemic forces responsible for the recent financial turmoils are still present. There is potential instability inherent in the dependence of so many developing countries on so much volatile foreign capital. Indeed, the rapidity with which capital inflows have resumed is itself a cause for concern, as the stabilization of conditions in many emerging markets does not mean that the underlying structural problems have disappeared. In particular, the restructuring of the public finances in the Russian Federation is still on the political agenda, and in Latin America combining foreign and fiscal balance with an acceptable growth of per capita incomes still eludes many economies. Even in Asia, the speed and sustainability of the current recovery are highly uncertain, and problems may emerge elsewhere in the region, notably in China with respect to the sustainability of the exchange rate. The vulnerability of these countries to financial instability increases the uncertainties associated with any assessment of world economic prospects. Moreover, there are major question marks concerning the ability of the United States economy to achieve an orderly adjustment towards a more sustainable rate of growth, and of EU to achieve stable recovery. The pace at which restructuring in Japan takes place, and its impact on the economy, are further elements of uncertainty.

These downside risks are generally recognized, and baseline projections of the various international organizations made at the beginning of the year were accompanied by alternative scenarios depicting the likely impact of various possible adverse developments.[16] Some of these risks may now have been reduced, but not eliminated, and others, such as higher United States interest rates, have emerged.

A combination of a sharp correction in equity prices, a decline in the dollar triggered by mounting trade deficits, and retrenchment of consumer spending designed to reduce household indebtedness in the United States appears to be one of the most serious downside risks facing the world economy. The consequences of such an eventuality cannot be predicted with accuracy since they depend, inter alia, on the response of policy makers and global financial markets. The earlier IMF downside simulation designed along these lines suggested that such a development would subtract more than one percentage point from global growth. Again, the World Bank downside scenario, which combined instability in the United States financial markets with worsening economic and financial conditions elsewhere, including the emerging markets, showed that the world economy could come to the brink of recession. These results are also confirmed by UNCTAD simulatons,[17] which indicate that a fall in private consumption expenditure following a 25 per cent correction in equity prices would depress United States GDP by 1 per cent both in 1999 and in 2000. If that were combined with declines in other developed equity markets and a 20 per cent reduction in capital flows to developing countries, world output would be reduced by half a percentage point in both years.

As for the developing world, the weakening of economic conditions in China, resulting in part from its structural problems and in part from external shocks associated with the recent bouts of crisis in emerging markets, is often considered as a new potential source of world economic instability. A further slowdown in growth, accompanied by a sharp decline in capital flows, could indeed lead to a devaluation of the yuan. That alone would scarcely cause a major disruption of the world economy. However, its global impact could well be amplified by competitive devaluations elsewhere in the region, as well as by the adverse reaction of international financial markets.

Indeed, according to the UNCTAD simulations mentioned above, a 20 per cent devaluation in China alone would have little impact on either China or the global economy. Although it would have some adverse trade effects on neighbouring countries, the gain in output growth for China would be marginal. According to a simulation by OECD, simultaneous devaluation of the yuan and the Hong Kong dollar would have little impact on growth in the OECD as a whole and most of its member countries.[18] However, if it triggered devaluations in the major ASEAN countries, the negative impact on the current-account balances and the growth rates in the major industrial countries would more than double.

D. Policy challenges

Despite the rapid return of many emerging-market borrowers to international capital markets after the Brazilian crisis, the sustainability of the current recovery that appears to be taking place in Asia and Latin America remains crucially dependent on the pace of economic activity in industrial countries. Continued expansion of the United States economy is essential, but the inevitable slowdown there will need to be compensated by a strong recovery in Western Europe and the emergence of Japan from its decade-long stagnation. This redistribution of global demand is crucial if the global economy is to avoid the kind of imbalances that plagued recovery in the 1980s. Since neither Japan nor Europe appears more assured of recovery than two years ago, there is the risk that the recent resurgence of financial flows to emerging markets, some of which are still in the throes of crisis, could be rapidly reversed. Another bout of global financial instability generated by a weakening of economic conditions in developed countries, in particular the United States, could still push the world economy into recession. Avoiding such an outcome will require vigilance by policy makers, particularly in industrial countries, where there remains considerable scope and freedom for implementing expansionary policies.

In designing effective policy responses to the threat of a reversal in what appears to be the turning point in global economic activity, it is important to diagnose correctly the underlying forces responsible for the recent difficulties. It should be recalled that the present downturn is different from typical cyclical contractions following expansions. The conditions prevailing in the world economy in 1998 were not induced by policy actions designed to deal with overheating or to counter the risk of a rekindling of inflation due to a spree of profligate government spending or excessive wage demands. Inflation rates are at historical lows in industrial countries, and have fallen below pre-crisis levels even in most of the crisis-stricken Asian and Latin American economies that have undergone large devaluations and terms-of-trade losses. Budgets are in surplus in some countries, while in others deficits are at low levels thanks in large part to primary surpluses (the main exceptions being Japan and the Russian Federation).

The slowdown has thus been occurring in conditions of stable or even falling prices, rising productivity and improved fiscal balances. Despite expansionary monetary policy introduced to counter the liquidity crisis in the autumn of 1998, the cost of private finance has been high and rising as a result of falling inflation and the increase in risk premia. Spreads remain substantially higher than before the liquidity crisis. In the United States the federal funds rate is about 150 basis points above its 40-year average in real terms,[19] and the clear intention of the Federal Reserve to reverse the 75 basis-points reductions introduced in response to the crisis will aggravate this difference. To the extent that risk premia continue to govern borrowing rates and that borrowers remain reluctant to increase already high levels of indebtedness, the current tendency to bring the stance of monetary policy back to the position before the Russian crisis can only increase the risks of a reversal of the incipient recovery.

In contrast to previous cyclical downturns, in the 1970s and 1980s, most Governments now do have substantial leeway to allow public spending to play its traditional role as an automatic stabilizer of aggregate demand. The United States has considerable room to use fiscal policy should the risk of recession increase. In Japan the recent volatility in bond prices has raised questions about the sustainability of its fiscal stance, and the decision of the Bank of Japan to keep policy rates at zero until the risk of recession is clearly past is to be welcomed. The possibility of amending EU's Stability and Growth Pact in order to exclude public investment expenditures from the calculation of the 3-per-cent limit on budget deficits is currently under review, and the recent decision to allow Italy a small rise in its deficit in the face of its weak internal situation is a move in the right direction. While these steps will provide only a small stimulus to global demand, they constitute

a recognition of the need to make policy more flexible if a highly fragile recovery is not to be thwarted.

As noted above, developing countries facing external financial difficulties have little room to use monetary policy for recovery. Moreover, the use of traditional fiscal measures tends to be inhibited by fear of their impact on market confidence. Countries where fiscal revenues depend on commodity earnings have introduced expenditure cuts for fear that failure to do so would jeopardize capital inflows and exchange-rate stability. Despite some recovery in oil prices, Governments of oil-exporting countries have maintained their restrictive measures, preferring to use the unanticipated revenues to reduce deficits even further. In other countries fears that increased government borrowing may increase interest rates and public debt and deficits have acted to reduce public expenditures, reinforcing the downward cyclical trend in demand.

Given the limited scope in developing countries to pursue counter-cyclical macroeconomic policies, a possible response could be the direct injection of liquidity into these countries through official channels to raise demand, imports and growth. This cannot be adequately done by drawing on the resources of multilateral financial institutions, which have been drained by financial rescue operations and by growing political resistance to continued bail-outs. By contrast, Japan and EU are able to play an important role in providing a direct liquidity injection by recycling part of their large current-account surpluses. Since developing countries have higher propensities to consume and to import, such schemes could prove to be superior, in their effect on global growth, to domestic fiscal expansion in the surplus countries themselves.

Indeed, the greater overall impact of such surplus-recycling schemes is confirmed by simulations undertaken in UNCTAD prior to the announcement of the Miyazawa Initiative to explore the potential role of Japan in the recovery of East Asian economies.[20] These simulations suggest that the regional and global growth impact of an additional Japanese aid package of $100 billion for the crisis-ridden East Asian countries is considerably stronger than that of a domestic fiscal stimulus of an equal magnitude. Gains in growth resulting from an aid package could be considerable not only for the countries in crisis, but also for most other regions and countries, including the United States and EU.[21] Moreover, while the direct, short-term impact of fiscal stimulus is greater on the level of activity in Japan itself than an equivalent increase in aid to Asia, the medium-term impact is less clear after allowing for the effects of action needed subsequently to restore fiscal balance. Since the underlying cause of the decline in the trend growth rate in Japan lies in its structural problems, purely domestic stimulus packages are unlikely to permanently restore growth in Japan. Indeed, an appropriate strategy could combine action on three fronts: a temporary fiscal stimulus to promote cyclical recovery, aid to the Asian countries in crisis, and structural reforms. Thus, the recent policy initiatives in Japan, including the stimulus packages, efforts to tackle structural deficiencies in the financial sector and the extension of the Miyazawa Initiative to the second phase, are to be welcomed. The second phase of that plan could play a particularly useful role. It aims at increasing investor confidence in the Asian economies through additional guarantees of up to 2 trillion yen, helping them to return to the bond market and to proceed with corporate restructuring. The idea behind the plan seems to be to design an efficient means of inducing the private sector to "bail in" rather than providing funds to allow it to "bail out". Thus it constitutes a major break from official interventions in the recent crises in emerging markets.

Other means of providing liquidity to developing countries should also be explored. One avenue worthy of consideration would be to remove the debt overhang of the heavily indebted poor countries (HIPCs) through a rapid write-off of their unpayable official and multilateral debt. In this respect, the decisions recently taken at the G-7 summit in Cologne are to be welcomed. While such action has its merits on its own, pursuing it under current conditions would enhance its impact. Similarly, a substantial SDR allocation could also provide payments support to developing countries and the transition economies. There are already suggestions to use such an allocation on a reversible basis in order to provide liquidity to emerging markets facing a threat of contagion.[22] No less valid is the case for similar action to provide additional current-account financing, particularly at a time like the present, when reserve needs are no longer adequately met by international capital markets even for the middle-income emerging markets which normally have access to international capital. ■

Notes

1 Previously, between August 1992 and September 1995, six packages had been introduced, amounting to around 66 trillion yen, and tax measures worth about 16.6 trillion yen over three years were introduced in fiscal 1994. (The term "trillion" in this context signifies 1,000 billion.)

2 According to estimates made by JP Morgan, a 10 per cent devaluation can be expected to add about 1 per cent to GDP of the euro area in 1999 (*European Economic Outlook, July/August 1999*, 25 June 1999: 6).

3 Although Colombia, Ecuador and Peru are all currently facing difficulties in their banking sectors, Ecuador's problems have been aggravated by weakness in its supervisory system. The cost to the Government of the bailout of the banking system in Ecuador is likely to be one of the highest on record, at around one third of GDP.

4 ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean, 1998*, United Nations publication, sales no. E.98.II.G.15, Santiago, Chile, 1998, box 2.

5 The member countries of GCC are: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates.

6 Official data for GDP may overstate the true extent of growth. See The true pace of China's real GDP growth, in JP Morgan, *Asian Financial Markets*, *Second Quarter 1999*, 30 April 1999: 11.

7 Exports to the Republic of Korea contracted by 34 per cent; to Hong Kong (China) by 12 per cent; to Indonesia by 36 per cent; to Japan by 7 per cent; to Malaysia by 17 per cent; to Singapore by 9 per cent; and to Thailand by 24 per cent. See *China's Customs Statistics*, December 1998, Series no. 112. For a discussion of the repercussions of the Asian crisis on the trade of developing regions see chapter II.

8 *The Economist*, 29 May 1999.

9 See OECD, *OECD Economic Outlook*, May 1999, box III.l.

10 For details see ECA, *Economic Report on Africa 1999*, Addis Ababa, 1999 (E/ECA/CM.24/3), Statistical Annex I, table AI.1.

11 The correlation coefficient of share prices in South Africa and IFC's Asian index has a value of 0.60. See International Finance Corporation, *Monthly Review of Emerging Stock Markets*, Washington, DC, July 1998: 106–107.

12 African Development Bank, *African Development Report 1999*, Oxford and New York, Oxford University Press for the African Development Bank, 1999: 4.

13 ECA, op. cit., table 1.8. Alternative estimates of the current-account deficit are $4.2 billion in 1997 and $19 billion in 1998. See African Development Bank, op. cit., table 1.4.

14 IMF, *World Economic Outlook*, Oct. 1998, table 2.9.

15 This sub-section draws on Economic Commission for Europe, *Economic Survey of Europe, 1999, No. 1*, United Nations publication, sales no. E.99.II.E.2, New York and Geneva, 1999; and ibid., *No. 2*, sales no. E.99.II.E.3.

16 For a brief summary of earlier baseline projections and the associated downside risks, see *Global Economic Conditions and Prospects*, paper prepared for ASEAN by the UNCTAD secretariat, Geneva, Feb. 1999 (UNCTAD/GDS/MDPB/4).

17 The simulations were carried out for UNCTAD by Akira Onishi, based on the operations of the Futures of Global Interdependence (FUGI) Model M80. For a detailed description of the model, including its historical background, methodology, as well as scope and structure, see *Economic & Financial Computing*, 3(1), spring 1993; also Onishi A, *Global Model Simulation: A New Frontier of Economics and Systems Science*, Soka University, Institute of Systems Science, Tokyo, 17 Sept. 1994.

18 *OECD Economic Outlook*, May 1999, box I.4.

19 See Merrill Lynch, *Weekly Economic and Financial Commentary*, 4 Jan. 1999.

20 See The potential contribution of Japan to Asian recovery: External aid versus domestic fiscal stimulus, paper prepared by the UNCTAD secretariat, Geneva, Oct. 1998.

21 This is also shown by simulations of Onishi referred to in the preceding sub-section, examining the implications of a consumption tax from 5 per cent to 3 per cent, together with tax exemption on land and housing transactions for a five-year period starting in mid-1999. While the direct impact on the Japanese economy is quite significant in 1999, it is less so in 2002. On the other hand, the effect on the global economy in 1999 is positive, but very small. The impact in subsequent years is marginal, and in fact negative in 2004 and 2005.

22 See Ezekiel H, The role of special drawing rights in the international monetary system, in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. IX, United Nations publication, sales no. E.98.II.D.3, New York and Geneva, 1998. See also Towards a new international financial architecture, Report of the Task Force of the Executive Committee on Economic and Social Affairs of the United Nations (ECLAC document LC/G.2054), Santiago, Chile, March 1999 (on the Internet at http://www.eclac.cl).

Chapter II

INTERNATIONAL TRADE AND THE TRADING SYSTEM

A. The slowdown in world trade

Growth in the volume of world trade, which began to slow with the onset of the Asian crisis in mid-1997, decelerated abruptly in 1998, along with a significant slowing of world output growth. Trade performance differed widely among regions, reflecting the changing pattern of demand and output growth and the impact of the decline in most commodity prices. Sustained output growth in the United States and the European Union in 1998 was a key factor offsetting the slowdown in other regions, notably the severe contraction in Asia.

Growth in the volume of imports slowed down in all regions, with the exception of the European Union, but was particularly sharp in developing regions, and in Asia there was an absolute decline (table 2.1). Among the developed countries, import growth was particularly strong in the United States, in continuation, at a slightly slower rate, of the expansion of the previous year, whereas in Japan there was also an absolute decline.

Differences in regional export performance were far less pronounced than for imports. The volume of exports rose most in the transition economies and the expansion was above the world average in the European Union and the United States. In Asia export volume growth was substantially below the world average, especially with respect to intra-regional trade, and in Japan there was even a small absolute contraction.

In value terms world trade not only failed to grow; it underwent its strongest decline since 1982, with exports falling by 2 per cent (FOB) and imports by 1 per cent (CIF). And, for the first time in the post-war period, the share of primary products in world trade fell below 20 per cent, due to a continued increase in the value of trade in manufactures and a decline of trade in agricultural products, metals and fuels. The European Union was the only major region to record an increase in the value of exports (3 per cent), while in Japan there was a decrease of 8 per cent. The appreciation of the dollar in 1997 and most of 1998, together with the decline in prices of commodities (including oil), contributed to a decline in the dollar value of export earnings of developing countries for the first time since 1991. The decline was particularly severe in the Middle East (21 per cent) and Africa (16 per cent). While the value of imports rose in the European Union, North America and Latin America by around 5 per cent, there was a steep fall in Asia.[1]

Table 2.1

EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS, 1990–1998

(Percentage change in volume over previous year)

	1990–1995[a]	*1996*	*1997*	*1998*
		Exports		
World	6.0	5.5	10.5	3.5
Developed market-economy countries	5.3	5.2	10.2	3.4
of which:				
Japan	1.5	1.0	12.0	-1.5
United States	6.4	6.3	11.8	2.4
European Union	5.5	5.5	9.5	5.0
Transition economies	5.0	6.5	12.5	10.0
Developing countries	9.0	6.9	12.3	3.4
of which:				
Africa	0.6	6.4	4.9	-1.3
Latin America	8.0	11.0	11.0	6.5
Asia	12.6	6.2	12.4	1.4
of which:				
Newly industrializing economies[b]	12.5	9.1	11.5	3.3
ASEAN-4[c]	14.8	5.9	13.2	0.8
China	17.2	-0.8	20.5	3.6
Memo item:				
ASEAN-4 plus Republic of Korea	13.9	11.5	18.3	8.6
		Imports		
World	6.5	6.0	9.5	4.0
Developed market-economy countries	5.6	5.4	8.5	7.4
of which:				
Japan	6.5	5.5	1.5	-5.5
United States	6.9	5.6	12.1	10.9
European Union	4.5	5.0	7.0	7.5
Transition economies	2.5	16.0	17.0	10.0
Developing countries	10.1	6.6	10.8	-4.5
of which:				
Africa	3.5	0.8	9.0	0.6
Latin America	12.0	8.5	22.0	9.5
Asia	13.7	5.8	7.0	-10.1
of which:				
Newly industrializing economies[b]	13.2	6.4	7.7	-11.5
ASEAN-4[c]	14.9	4.2	4.7	-21.9
China	17.9	6.5	5.1	3.6
Memo item:				
ASEAN-4 plus Republic of Korea	14.3	7.6	3.4	-22.0

Source: UNCTAD secretariat calculations, based on statistics of WTO.

a Annual average.

b Hong Kong (China), Republic of Korea, Singapore and Taiwan Province of China.

c Indonesia, Malaysia, Philippines and Thailand.

B. Impact of the Asian crisis on developing regions

Developing countries have been much more affected than developed countries by movements in commodity prices, resulting in most cases in slower growth or a contraction of output and reduced export earnings. Overall, the terms of trade of the developed countries rose by 1.4 per cent in 1998, while those of the developing countries fell by 3.9 per cent. These and other developments were largely due to the collapse in the imports of the East Asian economies, including Japan.

The net impact of the changes in trade flows and declines in commodity prices in 1998 varied significantly among different groups of countries. Oil exporters suffered the most, together losing as much as 18 per cent in their terms of trade and 6.3 per cent in income.[2] For non-fuel primary commodity exporters, the corresponding losses were much more moderate, amounting respectively to 3.2 per cent and 0.5 per cent, since lower export prices were offset by lower import prices. In contrast, the group of net commodity importers, which includes most industrial countries, experienced a gain of 1.8 per cent in the terms of trade and of 0.3 per cent in output.

1. Asia

Contrary to expectations stemming from the substantial decline of the real effective exchange rate of their currencies, export earnings fell in the most affected Asian economies in 1998 (table 2.2); only the Philippines registered a sharp increase. For developing Asia as a whole the decline in export earnings amounted to 5.2 per cent, largely because of a fall in the dollar prices of exports. While export volume declined in Hong Kong (China), Taiwan Province of China, Thailand and Malaysia, there were strong increases in the Republic of Korea and Philippines and a more modest increase in China.

Of the world's major economic regions, developing Asia recorded the strongest import contraction in both volume and value terms in 1998. The value of imports fell by an unprecedented 17 per cent, and by as much as 31 per cent for the five most affected Asian countries (ASEAN-4 and the Republic of Korea). In volume terms the fall amounted to 22 per cent for those five countries, compared to 10 per cent for developing Asia as a whole. Imports rose in only a few countries, such as India, Sri Lanka and China (table 2.2). The high degree of interdependence of trade and investment among the economies of East Asia (including Japan), once a source of strength, was a major factor responsible for the poor export performance of countries in the region inasmuch as intra-regional trade accounts for about one half of the region's exports. The drastic contraction of Japanese imports (17 per cent in value and some 6 per cent in volume) was particularly critical. As a consequence, balance-of-payments adjustment by countries in the region had to take the form mainly of import compression rather than export expansion. The swing from payments surplus to payments deficit was as large as 20 per cent of GDP in Malaysia and over 14 per cent in the Republic of Korea and Thailand (table 2.5).

Despite the decline in export prices, which was particularly sharp in the Republic of Korea, there was in general no serious deterioration in the terms of trade, on account of an equally sharp drop in import prices. Indeed, in Thailand, Philippines and, to a lesser extent, China the terms of trade improved markedly (table 2.2).

Although the strong currency devaluations had raised the competitiveness of enterprises in the affected Asian countries, these countries did not significantly increase their market share in the major developed country markets. China, by contrast, was able to compensate losses in exports to other Asian countries[3] – more than half of its exports go to the region – by higher exports to other regions. Despite the competitive pressure from other Asian countries, Chinese exports to both Latin America and the United States expanded by

Table 2.2

FOREIGN TRADE AND THE TERMS OF TRADE OF SELECTED DEVELOPING ASIAN ECONOMIES, 1997 AND 1998

(Percentage change over previous year)

	Exports						*Imports*						*Terms of trade*		
	Value		*Unit value*		*Volume*		*Value*		*Unit value*		*Volume*				
Economy	*1997*	*1998*	*1997*	*1998*	*1997*	*1998*	*1997*	*1998*	*1997*	*1998*	*1997*	*1998*	*1996*	*1997*	*1998*
Hong Kong, China	4.0	-7.5	-2.0	-3.6	6.1	-4.0	6.0	-11.5	-1.2	-5.0	7.2	-6.9	0.9	-0.8	1.5
Republic of Korea	5.0	-2.2	-16.0	-17.0	24.9	17.9	-3.8	-35.5	-5.3	-17.2	1.5	-22.0	-12.4	-11.3	0.2
Singapore	0.0	-12.1	-6.4	-11.5	6.8	-0.7	0.8	-23.4	-6.7	-12.3	8.1	-12.6	-0.8	0.4	0.9
Taiwan Province of China	4.8	-9.4	-2.0	-5.7	7.0	-3.9	12.5	-8.5	-5.8	-5.1	19.3	-3.6	2.0	3.9	-0.6
Indonesia	7.3	-8.6	-6.4	-8.7	14.6	0.1	-2.9	-34.2	-5.9	-8.7	3.2	-28.0	-0.7	-0.5	-0.0
Malaysia	0.7	-7.1	-7.1	-4.7	8.4	-2.6	0.8	-25.9	-8.1	-6.3	9.7	-21.0	-0.7	1.1	1.7
Philippines	22.9	16.9	-6.4	-3.1	31.3	20.6	12.2	-16.5	-6.0	-7.3	19.3	-9.9	-3.5	-0.4	4.5
Thailand	3.3	-6.9	-7.6	-4.1	11.0	-2.9	-13.1	-33.5	-6.1	-8.8	-7.5	-27.1	1.1	-1.6	5.2
India	3.6	-3.0	-4.9	-3.4	8.9	0.4	9.7	4.5	-5.6	-6.4	16.3	11.6	-5.3	0.7	3.2
China	21.0	0.5	0.4	-3.0	20.5	3.6	2.5	-1.5	-2.4	-5.0	5.1	3.6	3.6	2.9	2.1

Source: UNCTAD secretariat calculations, based on statistics of WTO and national sources.

some 16 per cent, to the European Union by 18 per cent and to Africa by 27 per cent.[4]

2. Latin America

The contagion from the Asian financial crisis, together with a series of weather disasters, led to a widening of current-account deficits in the majority of Latin American countries (see table 2.5).[5] The deficit in Argentina, Brazil and Mexico, the three largest economies, was close to the regional average of 4 per cent of GDP, but it exceeded 6 per cent in Chile and was even higher for Bolivia and some other countries. The region's balance on factor services was unchanged, the increase in the deficit being entirely due to the trade balance which, in contrast to previous years, resulted from weak exports rather than a surge in imports (table 2.3).

Indeed, the value of exports from the region fell for the first time in 12 years. This was primarily due to a decline in export unit value, brought about by the sharp drop in the prices for primary commodities of particular relevance to the region, such as oil, agricultural raw materials, minerals and metals. The drastic fall in oil prices alone explains the decline in unit value for Venezuela, while Ecuador, Chile and Peru were hard hit by the falling prices of metals, particularly copper. In Costa Rica, the sharp upturn in exports (and also imports) was due to the activity of the leading manufacturer of micro-processors, Intel.[6]

In most countries the drop in prices was alongside an expansion of export volumes. However, the increase for the region as a whole was substantially less than in the two previous years, reflecting mainly the contraction in intra-regional trade caused by a slowdown in the Brazilian economy. Brazil accounts for 26 per cent of the overall exports and imports of Argentina, one third of the exports of Uruguay and nearly half of those of Paraguay.[7] Thanks to its membership of NAFTA, exports from Mexico held up well, sustained by strong import growth in the United States.

The slowdown in the growth of import volume in 1998 was associated with a weakening of domestic demand. Moreover, in many Latin American countries, for the first time in several years there was a depreciation in the real effective exchange rate. In Brazil import volume did not rise at all in 1998 (table 2.3). For the region as a whole, the slowdown of import growth was more pronounced in value than in volume, as unit values declined not only for imported commodities, but also for manufactures. An important role was played by the reduced inflow of external finance and a relatively small increase in the purchasing power of exports. The latter expanded by only a little over 3 per cent for the region as a whole, owing to a combination of weak export growth volumes and declining terms of trade.

Because Latin America is a net exporter of oil, the terms of trade declined by around 4 per cent in 1998, amounting to a loss of over $10 billion or 0.5 per cent of regional GDP.[8] The decline affected roughly half of the countries, while for the other half lower export prices were more than offset by lower import prices. For Uruguay and the Dominican Republic, the gain was equivalent to around 1 per cent of GDP, and for Honduras and Nicaragua it was 3 per cent and 4 per cent, respectively. The chief losers were the exporters of petroleum (Ecuador, Trinidad and Tobago and, above all, Venezuela) and metals (Chile, Jamaica, Guyana). The losses exceeded 5 per cent of GDP in Venezuela and 2 per cent in Chile and Ecuador. In Brazil, a large net importer of oil, the positive and negative effects were mutually offsetting.

3. Africa

Despite a modest growth of output, mainly due to the recovery in agricultural production, Africa's trade remained sluggish in 1998 (table 2.1). Exports fell by 1.3 per cent in volume, after three years of expansion, and the volume of imports remained virtually unchanged after the rise of 9 per cent in the previous year. Because of its relative export dependence on European markets and the United States, where demand was well sustained in 1998, most countries of the region were partly insulated from the effects of the slowdown in world trade. But owing to the recent decline in commodity prices the region's export earnings fell sharply by 16 per cent, against an increase of 2 per cent in the previous year. For the region as a whole, the loss in terms of trade represented 2.6 per cent of real income (table 2.4).

Oil-exporting African countries lost 13 per cent of GDP on account of the terms of trade. Because oil revenues finance more than 50 per cent of government expenditure (except in Cameroon

Table 2.3

FOREIGN TRADE AND THE TERMS OF TRADE OF SELECTED LATIN AMERICAN COUNTRIES, 1997 AND 1998

(Percentage change over previous year)

	Exports						Imports						Terms of trade		
	Value		Unit value		Volume		Value		Unit value		Volume				
Country	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1996	1997	1998
Argentina	7.2	-1.1	-1.0	-8.8	8.2	8.4	27.7	3.5	-2.0	-4.5	30.3	8.4	8.8	1.0	-4.5
Bolivia	2.6	-5.5	-1.5	-9.3	4.2	4.2	13.2	7.1	-3.0	-5.0	16.7	12.8	-10.5	1.5	-4.5
Brazil	10.5	-3.3	1.5	-6.0	8.8	2.8	14.2	-6.2	-4.0	-6.0	18.9	-0.2	-1.8	5.8	0.0
Chile	9.9	-12.0	1.0	-14.0	8.8	2.3	10.3	-4.2	-4.5	-3.9	15.5	-0.4	-17.0	5.8	-10.5
Colombia	8.8	-5.5	3.5	-10.0	5.1	5.0	12.4	3.0	-3.5	-4.0	16.5	7.3	0.8	7.3	-6.2
Costa Rica	8.9	23.9	4.0	-1.7	4.6	26.1	12.6	19.3	-2.0	-5.4	14.9	26.2	-0.3	6.1	3.9
Dominican Republic	8.0	2.4	3.0	-6.2	4.8	9.1	11.8	14.5	-1.0	-7.0	13.0	23.1	-3.9	4.1	0.9
Ecuador	7.4	-21.5	3.0	-13.0	4.3	-9.7	25.9	10.9	-2.0	-5.0	28.5	16.8	9.1	5.1	-8.5
El Salvador	32.7	-7.1	8.0	-2.0	22.9	-5.1	11.3	4.7	-3.0	-4.4	14.8	9.4	-2.5	11.3	2.4
Guatemala	15.4	8.8	4.0	-0.5	11.0	9.3	22.4	19.9	-3.0	-5.5	26.2	26.9	-5.3	7.2	5.3
Honduras	9.5	9.2	8.0	0.4	1.4	8.8	11.4	18.0	-2.5	-6.7	14.2	26.5	-3.1	10.8	7.6
Mexico	15.0	6.4	-3.7	-5.4	19.4	12.5	23.4	14.0	-2.2	-2.7	26.1	17.1	-0.9	-1.5	-2.8
Nicaragua	4.9	-13.4	5.0	-0.2	-0.1	-13.1	34.3	1.4	-2.5	-6.2	37.7	8.1	-7.6	7.7	6.3
Paraguay	4.3	-6.2	2.0	-10.0	2.3	4.2	9.6	-13.1	-1.0	-5.5	10.7	-8.1	-1.1	3.0	-4.8
Peru	15.6	-18.6	2.5	-14.0	12.7	-5.3	8.3	-2.1	-4.0	-5.7	12.8	3.8	-0.5	6.7	-8.8
Uruguay	13.7	4.5	-1.0	-1.0	14.9	5.5	11.8	3.4	-4.5	-5.6	17.1	9.6	-2.9	3.6	4.9
Venezuela	0.0	-25.4	-5.0	-25.5	5.3	0.0	47.8	6.8	-3.0	-3.5	52.4	10.7	18.6	-2.0	-22.7

Source: As for table 2.2.

and Egypt), oil exporters face difficult budget decisions as a result of the substantial drop in export earnings. Oil-importing countries also suffered from the commodity price decline, depending on their individual export structure (see chart 2.1). Their losses were generally much smaller than that of oil-exporting countries as lower oil import bills partly offset lower export earnings.

Among the oil importers, export earnings are estimated to have declined by more than 10 per cent in Burundi, Ethiopia and Uganda (mainly on account of coffee), Rwanda (coffee and gold),

Table 2.4

AFRICA: CHANGES IN THE TERMS OF TRADE AND THEIR IMPACT ON REAL INCOME, 1996–1998

	1996	1997	1998
	Change in terms of trade *(Percentage change over previous year)*		
All Africa	5.9	-0.2	-9.9
of which:			
Sub-Saharan Africa	5.0	-0.6	-9.1
Oil-exporters [a]	22.6	1.9	-28.8
Non-fuel exporters	-1.1	-0.3	-1.3
CFA countries [b]	-1.6	-1.5	-4.3
	Terms-of-trade impact on real income [c] *(Percentage of GDP)*		
All Africa	1.4	-0.1	-2.6
of which:			
Sub-Saharan Africa	1.2	-0.3	-2.4
Oil-exporters [a]	9.9	-1.3	-13.3
Non-fuel exporters	-0.2	-	-0.2
CFA countries [b]	-0.5	-0.8	-1.6

Source: IMF, *World Economic Outlook*, May 1999, table 2.10.

a Algeria, Angola, Cameroon, Congo, Gabon, Libyan Arab Jamahiriya, Nigeria.

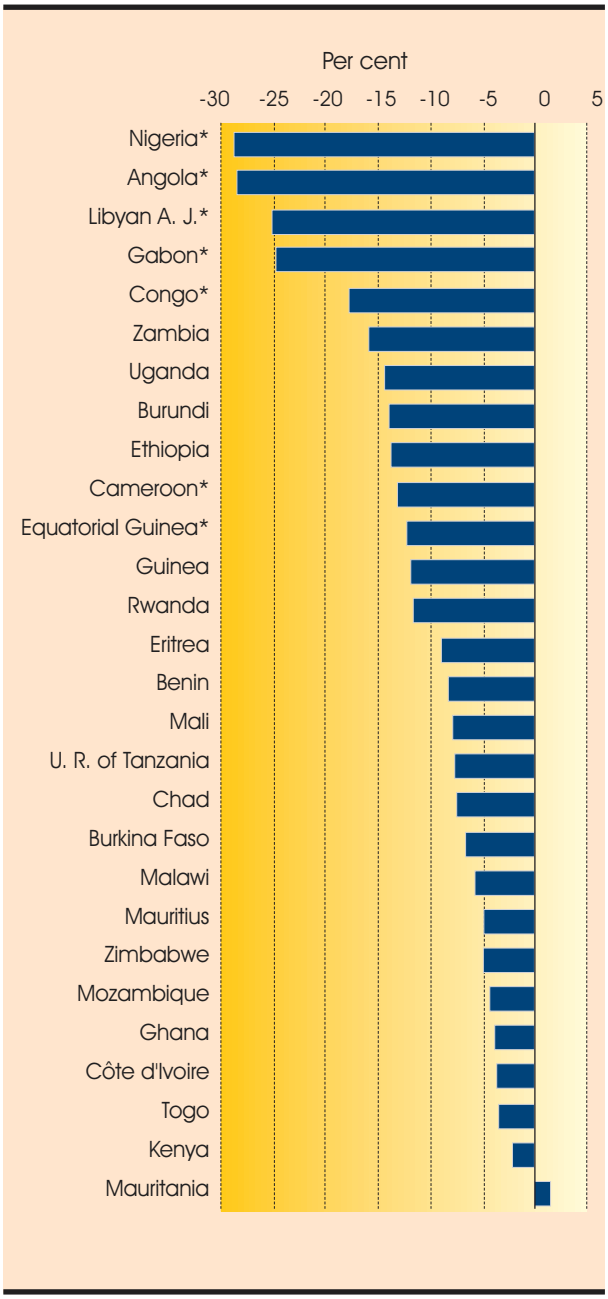
b Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comoros, Congo, Côte d'Ivoire, Equatorial Guinea, Gabon, Mali, Niger, Senegal and Togo.

c Change in trade balance in current prices due to change in the terms of trade.

Chart 2.1

LOSS OF EXPORT EARNINGS IN 1998 OF SELECTED AFRICAN COUNTRIES DUE TO PRICE MOVEMENTS FOR PRINCIPAL COMMODITY EXPORTS

(Percentage of total export earnings)



Source: UNCTAD secretariat estimates, assuming 1997 export volumes, based on UNCTAD, *Monthly Commodity Price Bulletin.*

Note: Export structure was calculated on the basis of import statistics of partner countries from the ITC Trademap database (on the Internet at www.intracen.org/services/trademap). The commodities included in the analysis are: sugar, coffee (ICA composite price index), cocoa, tea, tobacco, hides and skins, natural rubber, tropical logs, sawnwood, cotton, phosphate rock, aluminium, crude petroleum, copper, iron ore, nickel and gold. Oil-exporting countries are marked with an asterisk.

Zambia (copper) and Guinea (bauxite). However, for oil importers whose exports are concentrated on commodities for which price declines were moderate, or for which prices even rose, the export revenue loss was smaller and in varying degrees they enjoyed an improvement in their terms of trade. Such was the case in 1998 for exporters of cocoa (Ghana and Côte d'Ivoire), tea and tobacco (Malawi), and iron ore (Mauritania).

Falling commodity prices also affected the more diversified economies in the region, including Kenya (coffee), Mauritius (sugar), and Zimbabwe (nickel). In addition, these countries are likely to have experienced increased competition from Asia in their exports of manufactures to third countries. In the first quarter of 1999 major cocoa exporters have also been affected by the drop in prices for that commodity.

C. Short-term outlook and uncertainties

The uneven distribution of global demand has led to increases in trade imbalances, and so in substantial swings in current-account balances in relation to GDP (table 2.5). The current-account deficit of the United States widened from $155 billion in 1997 to $233 in 1998, and in Latin America from $65 billion to $90 billion.[9] The counterpart is to be found in the increased surpluses of Japan (to $122 billion), the euro area ($90 billion), and the developing countries of Asia ($98 billion, of which the NIEs account for $63 billion).[10] During 1998, there were also shifts in such balances at the intra-regional level. In the second half of 1998 the improvement in the Russian Federation, for example, was at the cost of the rest of Europe.

For 1999, Latin America is expected to have a much reduced current-account deficit, while the surpluses of Japan and the Russian Federation should again increase considerably. A sharp reduction in the surpluses of developing Asian economies (particularly China and the Republic of Korea) can be expected. The deficit of the United States is likely to widen further, to over $300 billion, or about 3.5 per cent of GDP. Thus, having already absorbed most of the counterpart to the swing into surplus of the affected Asian countries in 1997 and 1998, the United States economy is now expected to absorb most of the counterpart to the improvement in Latin America and the Russian Federation. There is concern not only over how long the United States can continue to sustain such a high deficit, but also over the likelihood of its inducing increasing instability in currency markets and tensions in the world trading system.

Prospects for world trade in 1999 are fraught with considerable uncertainties and downside risks (associated with the current global economic situation as discussed above in terms of output growth). Although the sharp contraction of output and trade of the affected Asian countries appears to have bottomed out, and a moderate recovery is expected in 1999, these economies remain vulnerable to both internal and external disturbances. A sharp slowdown in Brazil can be expected to have significant effects on neighbouring economies with which it has extensive trade ties, adding to the adverse effects of the depreciation of its currency. The same goes for the Russian Federation in relation to its European neighbours.

For the world as a whole, trade expansion is not expected to differ significantly from the rate registered in 1998. If the slowdown in output growth in the United States and Western Europe turns out to be more pronounced than presently expected, and if the anticipated recovery in Asia (including Japan) is delayed, the final outcome could well be a lower volume rate of trade growth than in 1998.

Table 2.5

CURRENT-ACCOUNT BALANCE OF SELECTED ECONOMIES, 1996–1998

(Percentage of GDP)

Economy	*1996*	*1997*	*1998*
United States	-1.8	-1.9	-2.7
Japan	1.4	2.2	3.2
European Union	1.0	1.7	1.4
Germany	-0.6	-0.2	-0.4
France	1.3	2.8	2.7
Italy	3.3	3.0	2.3
United Kingdom	-0.2	0.6	-0.8
Australia	-4.0	-3.1	-5.0
New Zealand	-3.9	-7.1	-6.0
Hong Kong, China[a]	-1.1	-3.2	0.6
Republic of Korea	-4.7	-1.8	13.1
Singapore	15.9	15.8	20.9
Taiwan Province of China	4.0	2.7	1.3
Indonesia	-3.3	-3.0	3.4
Malaysia	-4.9	-5.1	15.7
Philippines	-4.7	-5.2	2.0
Thailand	-7.9	-1.9	12.2
China	0.9	3.3	2.4
India	-1.4	-1.4	-1.7
Pakistan	-7.1	-5.8	-2.9
Saudi Arabia	0.2	0.2	-10.4
Argentina	-1.9	-3.7	-4.4
Brazil	-3.0	-4.1	-4.5
Chile	-5.4	-5.3	-6.3
Mexico	-0.7	-1.9	-3.7
Hungary	-3.8	-2.2	-4.1
Poland[b]	-1.0	-3.1	-4.5
Russian Federation	0.6	-1.3	0.3
Côte d'Ivoire	-4.8	-4.5	-4.9
Egypt	-0.3	0.2	-3.0
Nigeria	11.9	4.8	-8.4
South Africa	-1.3	-1.5	-2.1

Source: IMF, *World Economic Outlook and International Capital Markets, Interim Assessment,* December 1998, table 4.10; and IMF, *World Economic Outlook*, May 1999, table 2.6.

a Data include only goods and non-factor services.

b IMF estimates.

D. Non-oil commodity markets

Commodity markets have weakened considerably since the outbreak of the Asian crisis. The more than 12 per cent price decline in 1998 for non-oil commodities as a whole was the largest since the mid-1970s, and embraced most commodities (table 2.6) and all major commodity groups. Declines were particularly pronounced for commodities such as coffee, sugar, maize and wheat; hides and skins, and rubber; and aluminum, copper, nickel, lead, and zinc, some of which had already suffered substantial declines in 1997. In early 1999 the price decline continued, affecting also cocoa.

Although many of the fast-growing economies in Asia are major suppliers of commodities to world markets, it is the decline in their consumption of commodities, either directly (in the case of foodstuffs) or indirectly (in the case of industrial inputs and construction materials) that is the main channel through which the impact of the Asian crisis has been felt, and will continue to be felt, in commodity markets. The ASEAN-4 countries, together with the Republic of Korea and Japan, account for a substantial share of world consumption of most commodities.[11] On the other hand, prices of natural rubber, rice and timber – commodities exported primarily by countries in South-East Asia – were especially hard hit by increases in supply associated with sharp currency devaluations and by slower demand growth in the region. Devaluation raised prices in local currency and stimulated production even as world (dollar) prices declined.

Since developing countries as a whole are highly dependent on primary commodities for their export earnings, they suffered losses of real income in varying degrees on account of worsened terms of trade. Many sub-Saharan African countries nevertheless fared relatively well in 1998, since their major exports were of products such as cocoa and tea, the prices of which actually increased in both 1997 and 1998.

The collapse in Asian demand reinforced the cyclical decline in commodity prices following a mini-boom in 1994–1996. The decline reflects a combination of supply and demand factors, including reduced raw material and energy intensity of production, substitution by other materials and the fall in production costs of commodities themselves. Technological changes in production and economies of scale have brought about major productivity increases in metal mining, smelting and refining. At the same time, advances in agronomic and genetic research have increased yields in agriculture.

For many agricultural commodities large price declines since mid-1997 were also a reflection more of record world production than of reduced consumption. From 1995 to 1997, for example, world production of grain grew by 10.5 per cent, compared to a long-term trend growth of only 1.4 per cent. Similarly, over the same period, soybean production expanded by an annual 13.2 per cent, well above its trend rate of 3.6 per cent.[12]

World supplies of metals and minerals have risen in lagged response to the high prices of 1994–1996, and also as a result of substantial investments in mining and refining over the past decade. From 1995 to 1997, for example, aluminium production increased by more than 10 per cent, while consumption grew by only 5.6 per cent. Over the same period, copper production grew by 12 per cent, but consumption by 7.6 per cent. Similarly, output of nickel expanded by 11.4 per cent, whereas consumption fell slightly.

Prices of most non-oil commodities continued to decline up to March 1999, due in part to the continued effects of the Brazilian devaluation on the markets for coffee, soybeans (soybean oil) and sugar – commodities for which Brazil accounts for some 20 per cent of world exports. However, prices of urea fertilizer rose 11 per cent during March 1999 due to rumours of an agreement between the Russian Federation and Ukraine to curtail exports. On average, metals and minerals prices have stabilized in early 1999, with higher nickel and silver prices offsetting the continued decline in those of aluminium and copper.

Table 2.6

WORLD PRIMARY COMMODITY PRICES, 1995–1999

(Percentage change over previous year)

Commodity group	*1996*	*1997*	*1998*	*April 1999*[a]
All commodities[b]	**-4.2**	**0.0**	**-12.3**	**-8.0**
Food and tropical beverages	**2.1**	**2.8**	**-13.6**	**-12.1**
Tropical beverages	-15.2	33.3	-17.3	-10.5
Coffee	-19.1	54.7	-28.5	-13.0
Cocoa	1.2	11.2	3.7	-21.7
Tea	9.9	35.1	4.3	16.7
Food	6.8	-3.5	-12.6	-12.7
Sugar	-9.9	-4.9	-21.2	-32.9
Beef	-6.4	4.0	-7.0	3.7
Maize	25.0	-25.3	-13.4	-0.4
Wheat	16.2	-22.6	-19.9	-9.3
Rice	5.0	-10.7	1.3	-16.6
Bananas	7.5	4.3	-3.1	7.3
Vegetable oilseeds and oils	**-4.2**	**-0.9**	**7.1**	**-15.8**
Agricultural raw materials	**-9.9**	**-10.3**	**-10.8**	**-4.5**
Hides and skins	-23.7	-19.8	-22.7	-3.6
Cotton	-14.8	-8.9	-8.3	-4.1
Tobacco	15.6	15.6	-5.5	2.2
Rubber	-11.9	-28.3	-29.8	-9.3
Tropical logs	-20.1	-5.5	-1.2	-9.5
Minerals, ores and metals	**-12.1**	**0.0**	**-16.0**	**1.0**
Aluminium	-16.6	6.2	-15.1	2.3
Phosphate rock	8.6	7.9	2.4	2.3
Iron ore	6.0	1.1	2.8	-9.2
Tin	-0.8	-8.4	-1.9	2.6
Copper	-21.8	-0.8	-27.3	-0.5
Nickel	-8.8	-7.6	-33.2	31.6
Tungsten ore	-17.9	-9.3	-6.4	4.1
Lead	22.7	-19.4	-15.3	3.6
Zinc	-0.6	28.4	-22.2	6.2

Source: UNCTAD, *Monthly Commodity Price Bulletin,* various issues.
a Change from December 1998.
b Excluding crude petroleum.

Producers of particular commodities have in general been reluctant to reduce output in an attempt to limit or reverse the fall in prices. Rather, they have preferred to let stocks accumulate, leading to a large overhang. For example, grain stockpiles held by the world's major exporters more than doubled, to 140 million tons, in the last three years, and sugar harvests have exceeded production for the fourth year consecutively. Similarly, stocks of metals such as copper and aluminium are near record levels.

With recovery in the affected Asian economies, food and raw material prices may bottom out in 1999. However, the overall weakness of

commodity prices can be expected to continue, reflecting the continuation of sluggish world demand, overcapacity in almost all commodity markets, and the delayed effects of recent devaluations in important producing countries, such as Brazil and the Russian Federation.

E. Recent developments and emerging trends in oil markets

Of all the primary commodities, oil is by far the most important to both developed and developing countries alike. In recent years international trade in oil has been almost as large as that in all other primary commodities taken together. Since 1986, as a result of growing demand in industrialized countries, together with a fall in production in the United States, world trade in crude oil and products has increased to reach some 42 billion barrels per day (bpd) in 1998, which was slightly more than half of world consumption. The largest oil importers in that year were the United States, Japan, France, Germany, Italy, Republic of Korea and Spain. (Prior to the Asian crisis, the Republic of Korea was the world's fourth largest importer.) Together, these seven countries accounted for about 60 per cent of world oil imports. United States net oil imports met only about 51 per cent of domestic consumption requirements, whereas dependence on imports was nearly 100 per cent in the others. Exports of crude oil by members of OPEC have increased steadily since 1986, reaching about 24 million bpd in 1998. Those from other producers have also grown since the mid-1970s, to over 14 million bpd in 1998; nearly two thirds of these non-OPEC exports are accounted for by Mexico, Norway, Oman, the Russian Federation and the United Kingdom.

The world oil market was highly unstable in 1998. There was a large build-up of crude oil inventories on account of low demand in Asia and an unseasonably warm winter in the northern hemisphere, combined with an abundance of supply resulting from buoyant OPEC production, increased exports from Iraq, and relatively resilient net exports from the CIS economies.

World oil prices had already dropped sharply in late 1997, and the stock overhang was the main reason why prices remained depressed during much of 1998 and early 1999 (see chart 2.2). In 1998, the average price of crude oil was $12.3 a barrel, or 40 per cent lower than in 1996.[13] Expressed in dollars of 1974, when the price for a barrel of oil was $10.4, the average price of the OPEC basket in 1998 was an estimated $4.0 a barrel, which is one fifth of the average price in 1980 of $20.4 (likewise in 1974 prices).

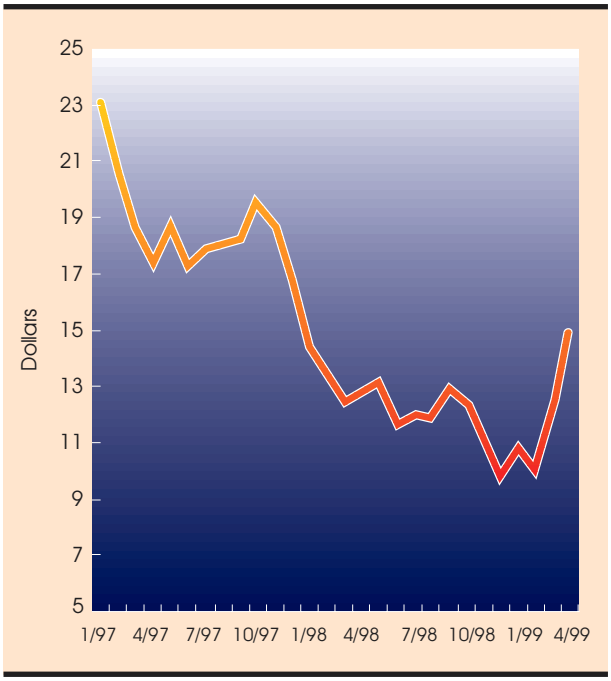
At the prevailing price, output in some of those countries, such as the United States, has become less profitable, resulting in a slower growth of output. Moreover, the major non-OPEC producers have cooperated with OPEC in efforts to share some of the burden of defending prices by restricting output. An agreement was reached whereby OPEC members and key non-OPEC producers (Mexico, Norway, Oman and the Russian Federation) would contribute to a cut in global oil output by 2.1 million bpd.[14] This new commitment to cut production, combined with the pledge of a cut of about 2.6 million bpd by OPEC in 1998, has done much to reduce most of the excess in world oil stocks and thus to balance supply with demand and push prices higher. Since the ratification of the agreement, oil prices have rebounded sharply, rising by about $4 per barrel in the second quarter of 1999.

Whether the higher price level can be sustained, however, will depend to a large extent on the ability of OPEC to restrain output in the face of rising prices as well as on the timing and strength of economic recovery in Asia. Overall, prices are likely to remain volatile and cyclical: higher oil prices will induce an increased supply, which in turn will put pressure on prices, necessitating further cuts in production by members of OPEC.

Chart 2.2

AVERAGE SPOT PRICES OF AN OPEC BASKET OF SEVEN CRUDE OILS, JANUARY 1997–APRIL 1999

(Dollars per barrel)



Source: OPEC.

1. Changes in the oil industry and pricing policy

The evolution of oil prices in recent years is a reflection of the major changes which have taken place in the industry since the 1970s. From 1973 until the mid-1980s, oil prices were determined by OPEC. Higher prices during that period led to lower demand and increased output by non-OPEC suppliers, which in turn led to reduced demand for OPEC oil. When OPEC could not stop the gradual erosion of its market share, it abandoned its policy of restricting supplies, and oil prices fell by more than one half in 1986.

The consequences of the oil price collapse were more far-reaching for the structure of the oil industry than for the oil pricing system itself. After 1986 the industry went through a period of intense restructuring as a result of which only the efficient and technologically sophisticated have survived. Most oil companies have succeeded in reducing capital and operating expenditures, driven down fixed and overhead costs and introduced more streamlined operations. Rapid advances in petroleum technologies have reduced the cost of exploration and production by nearly one half in 10 years. Non-OPEC producers have consequently increased output at substantially higher profits. Privatization and deregulation in a number of countries, such as Argentina, Malaysia and Venezuela, have transformed state-owned oil companies into giant TNCs. The key underlying factors that have shaped the oil industry throughout much of the 1990s, namely technological innovation, deregulation and privatization, the lowering of trade and investment barriers and the pursuit of security of supply, are still in full play and are likely to remain so in the medium and longer term.

With the reluctance of OPEC after the 1986 oil price collapse to preserve its traditional role as the world's swing producer, lowering or raising output to set prices, a new pricing system, dominated by futures markets, has emerged. Under this system, traders set up key futures prices based mainly on expectations of market conditions. Transaction prices have become closely linked to prices established in the organized trading markets. The large influence and the functioning of futures trading have resulted in more transparency in the petroleum market, enabling not only consumers but also speculators to react to shifts in supply or demand more rapidly.

While it is often said that the new pricing system relies more on market forces than on OPEC policies, recent experience shows that even when prices fall supply still expands. Reluctant to play the role of residual supplier and unwilling to give up its market share, OPEC members have at times continued to produce at levels that contributed to oversupply when demand slackened due to factors such as abnormal weather or a sudden rise in supply by other producers. The decline in prices and earnings because of oversupply stimulated even greater production in an attempt to resist an erosion of revenues, thus exacerbating the oversupply and exerting further pressure on prices. Ultimately, the downward trend in prices can be reversed only if OPEC members collectively cut output significantly or if demand for their oil rises considerably. Although OPEC now has less control over prices than before, it still exerts a major influence, as vividly demonstrated by the upturn in prices in early 1999 noted above.

Persistent low oil prices have encouraged many oil-producing countries to seek international oil companies' capital, technology and expertise. Reduced oil revenues made it difficult to provide the investment required to expand or even maintain oil production capacities, let alone to explore and develop new oil fields. For these reasons, a number of countries, such as Algeria, the Islamic Republic of Iran and Venezuela, which had previously nationalized their oil industry and closed their doors to foreign investment therein, are now offering upstream opportunities for exploration and development to TNCs. Others, such as Kuwait and Saudi Arabia, are now willing to allow foreign oil companies to invest in their low-cost oil reserves.

The pressure created by price volatility has also led to a new wave of consolidations in the oil industry, involving some of the largest mergers ever witnessed. The merger of British Petroleum (BP) with Amoco and of Exxon with Mobil marked the beginning of a trend towards re-grouping in the oil industry. These mega-mergers are expected to change the shape of the industry through the exercise of considerable market power, and through reductions in production and other costs. They are also expected to reduce the cost of doing business. The merger of BP and Amoco is expected to save $3 billion in administrative costs, while Shell International plans to reduce costs by $2.5 billion per year over the next few years. These development are likely to have a major influence on the oil industry and markets.

2. Demand and supply conditions

The demand for oil, which accounts for about 39 per cent of world commercial energy needs, notably transportation, has been growing at 1.3 per cent per year since the mid-1980s (table 2.7). Consumption in developing countries has been rising consistently faster than in the industrialized countries owing to their high rate of population growth and of motorization, rapid urbanization and increasing industrialization. As a consequence, the share of developing countries in global oil demand has grown from 25 per cent in 1986 to over 35 per cent in 1998. Among the developing regions, oil consumption in South and East Asia more than doubled over the same period, compared to an increase of 46 per cent for all other developing countries and 18 per cent for developed economies.

Table 2.7

WORLD OIL DEMAND BY REGION, 1986–1998 [a]

(Millions of barrels per day)

	1986	*1990*	*1995*	*1998 [b]*
Developed countries	36.3	38.0	40.4	42.2
North America	18.5	18.9	19.8	21.0
Western Europe	12.5	13.0	13.9	14.7
Pacific [c]	5.3	6.1	6.7	6.5
Transition economies	10.8	10.1	6.1	5.7
Central and Eastern Europe	1.8	1.7	1.4	1.4
Former Soviet Union [d]	9.0	8.4	4.7	4.3
Developing countries	16.1	18.3	23.7	26.1
Latin America	5.0	5.2	6.1	6.6
Africa	1.8	2.0	2.2	2.4
West Asia	3.1	3.3	4.1	4.2
South and East Asia	4.2	5.0	8.0	8.7
China [d]	2.1	2.3	3.3	4.2
World	63.3	66.4	70.2	73.8

Source: UNCTAD secretariat estimates, based on International Energy Agency, *Monthly Oil Market Report*, various issues.

a Including deliveries from refineries/primary stocks and marine bunkers, and refinery fuel and non-conventional oils.

b Estimated.

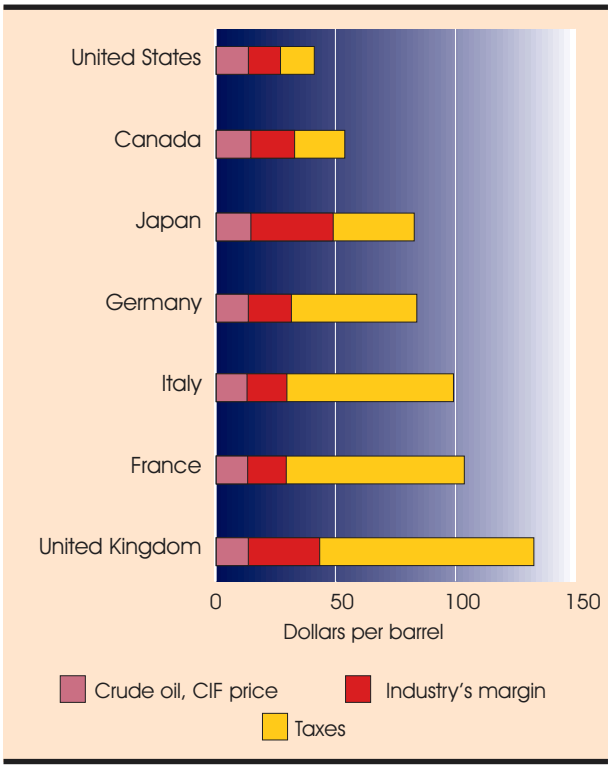
c Australia, Japan and New Zealand.

d Based on estimates of apparent domestic demand derived from data on official production and trade.

In 1998, world oil demand amounted to some 74 million bpd, roughly the same as in 1997. In Japan consumption fell by 3 per cent, but it was buoyant in North America (especially the United States) and Western Europe. In general, the decline in world prices did not stimulate consumption since, with the exception of the United States, taxes on oil products in all OECD countries account for so much of the price to end-users that the latter scarcely benefit from any fall in international crude oil prices. In Western Europe, for example, over 70 per cent of the end-user price is constituted by taxes (see chart 2.3). Consequently,

Chart 2.3

COMPONENTS OF THE END-USER PRICE OF OIL IN SELECTED INDUSTRIAL COUNTRIES, 1998



Source: *Middle East Economic Survey*, 26 April 1999.

even a prolonged period of low oil prices is not likely to increase demand in the developed countries by more than 1–2 per cent per year.

In the transition economies, demand for oil has stagnated at 5.7 million bpd in recent years compared to the peak of 10.8 million bpd reached in 1986. The demand also stagnated in most developing regions in 1998, but fell in South and East Asia. Indeed, the dramatic contraction of 15 per cent in the Republic of Korea, together with the decline in Japan, was a major reason for the slowdown in world oil demand in 1998.

World oil production in 1998 continued the upward trend of the 1990s (table 2.8), and for the third consecutive year exceeded demand. For the first time since 1990, there was a decline in OECD output as production continued to fall in the United States and stagnated in North Sea sources of supply. Most of the increase in world production in crude oil was accounted for by OPEC members, where production exceeded by far the quota of 25.2 million bpd set at the end of 1997.

During 1986–1992 there was a steady decline in non-OPEC oil production. A remarkable expansion by North Sea producers and in a number of non-OPEC developing countries was more than offset by a progressive decline elsewhere, particularly in the United States and CIS, because of lower oil prices combined with a mature and depleting reserve base. Accordingly, world demand for oil became increasingly dependent on OPEC sources of supply during that period, and the OPEC share in world output rose from 30 per cent to 39 per cent.

By contrast, from 1993 to 1996 non-OPEC supply increased markedly, especially from North Sea producers and developing countries (Angola, Argentina, Brazil, China, Colombia, Ecuador, India, Malaysia, Mexico, Oman and Yemen). The growing relative importance of non-OPEC supply is likely to continue as expanded production in the Russian Federation and Caspian Sea sources adds further to non-OPEC supplies.

Table 2.8

WORLD OIL PRODUCTION BY REGION[a], 1987–1998

(Millions of barrels per day)

	1987	*1990*	*1995*	*1998[b]*
Developed countries	16.8	15.9	18.0	18.9
Transition economies	13.0	11.8	7.4	7.5
Developing countries	31.4	38.0	43.1	47.4
OPEC[c]	19.7	25.1	27.7	30.7
Other developing countries[d]	11.7	12.9	15.3	16.7
Processing gains[e]	1.2	1.3	1.5	1.6
World	62.4	67.0	70.0	75.3

Source: As for table 2.7.
a Crude oil, condensates, natural gas liquids and oil from non-conventional sources and other sources of supply.
b Estimated.
c Including Ecuador up to 1992 and Gabon up to 1994.
d Including Ecuador from 1993 and Gabon from 1995.
e Net volumetric gains and losses in refining process (excluding net gain/loss in the transition economies and China) and marine transportation losses.

Table 2.9

WORLD EXPORTS OF OIL AND OTHER MERCHANDISE, 1996–1998

(Billions of dollars and percentage change)

	Value			Percentage change		
	1996	1997	1998	1996	1997	1998
All merchandise	5 150	5 325	5 225	4.5	3.4	-1.9
Oil	290	278	192	18.2	-4.1	-30.9
Non-oil	4 860	5 047	5 033	3.6	3.8	-0.3

Source: UNCTAD secretariat calculations, based on WTO data.

3. The impact of falling oil prices

The one-third drop in oil price in 1998 reduced the value of international oil trade by about $86 billion and accounted for an estimated 86 per cent of the decline in the value of world trade (table 2.9). It also contributed significantly to the 7 per cent fall in the total export revenue of developing countries. As a group, oil exporters suffered a deterioration of nearly 20 per cent in their terms of trade[15] and a dramatic swing in their current-account balance from a surplus of about $23 billion in 1997 to a deficit of over $22 billion in 1998, resulting in a transfer of real income of over $80 billion from oil exporters to oil importers.

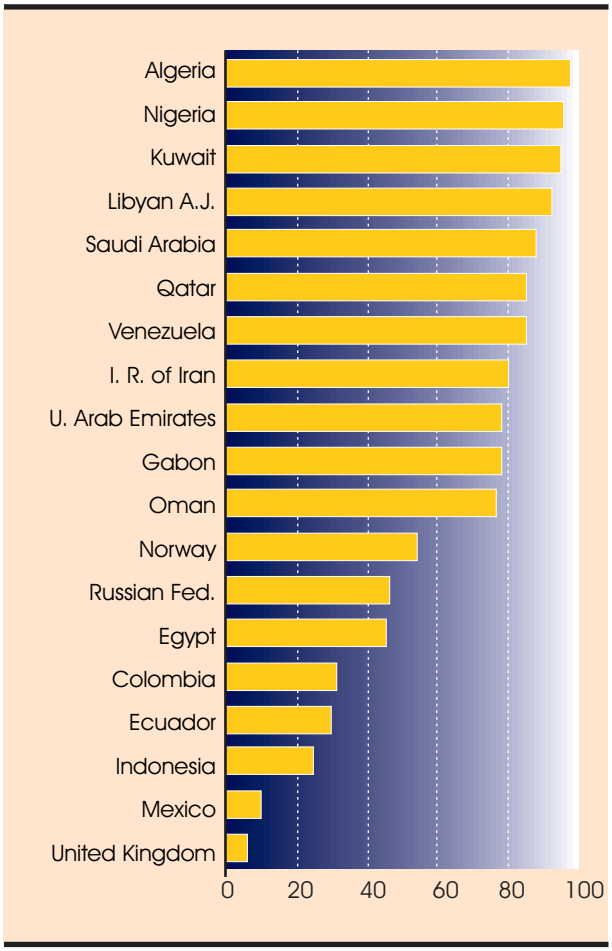
While OPEC oil export revenues plummeted by $54 billion to just over $100 billion in 1998, the lowest level in real terms since 1973, industrial countries gained about $60 billion through lower prices of oil imports, a gain which exceeded their total official development assistance (ODA) in that year. In 1998, the Governments of member countries of the European Union collected over $250 billion in oil taxes; in three of those countries alone (France, Germany and Italy) the tax revenue exceeded the value of oil exports from members of OPEC.

Lower oil prices have also helped to moderate inflation in oil-importing countries. In the United States every $1 change in the price of oil translates into a 1 per cent change in the consumer price index (CPI) for energy.[16] Since energy has a weight of 6.3 per cent in the index, the $6.2 per

Chart 2.4

SHARE OF OIL IN TOTAL EXPORT REVENUE OF SELECTED OIL-EXPORTING COUNTRIES, 1997

(Percentage)



Source: Economist Intelligence Unit, various country reports.

Table 2.10

IMPACT ON EXPORT EARNINGS[a] OF A FALL IN OIL PRICES ON SELECTED OIL-EXPORTING COUNTRIES, 1998

	$1 per barrel price drop causes export revenue shortfall[a] of		1998 actual price drop[b] caused shortfall in export revenue of	
	($ million)	*(Per cent of GDP)*	*($ billion)*	*(Per cent of GDP)*
Algeria	450	0.9	2.9	6.0
Indonesia	220	0.1	1.4	0.6
Iran (Islamic Republic of)	900	1.0	5.8	6.3
Kuwait	710	2.4	4.5	15.0
Libyan Arab Jamahiriya	485	2.2	3.1	13.0
Nigeria	750	1.9	4.8	12.2
Qatar	245	2.4	1.6	15.7
Saudi Arabia	2 800	2.0	17.9	12.8
United Arab Emirates	850	2.2	5.4	13.0
Venezuela	1 075	1.2	6.9	8.0
Total OPEC[c]	*8 485*	*1.0*	*54.3*	*6.4*
Colombia	140	0.1	0.9	0.9
Ecuador	90	0.5	0.6	3.0
Egypt	125	0.2	0.8	1.0
Gabon	120	2.3	0.8	15.0
Mexico	630	0.2	4.0	1.0
Norway	1 150	0.8	7.4	5.1
Russian Federation	1 330	0.3	8.5	1.8

Source: UNCTAD secretariat calculations.
a Assuming 1998 export volumes.
b $6.4 per barrel for OPEC basket.
c Excluding Iraq.

barrel drop in oil prices in 1998 contributed to a drop of about 0.4 per cent in the CPI.

In general, with the major exceptions of the United Kingdom and Mexico, most of the world's oil exporters are highly dependent on such exports for foreign exchange, the share of oil in their total exports in 1997 ranging from 25 per cent in Indonesia to 97 per cent in Algeria (see chart 2.4). Estimates of the loss in export revenues, both in absolute terms and as a share of GDP, due to the fall in oil prices in 1998 for selected oil-exporting countries are presented in table 2.10, together with the corresponding impact of a drop of $1 in the price of oil per barrel. For OPEC members (excluding Iraq), the loss in revenues is equivalent to 6 per cent of their combined GDP. In Saudi Arabia, the world's largest oil exporter, every $1 drop in the price of oil translates into a reduction of $2.8 billion in annual export revenues and a loss of 2 per cent in GDP. In 1998, the export loss amounted to $18 billion, by far the largest of any oil exporter, generating a fiscal deficit of $12 billion and a rise in the current-account deficit to nearly 10 per cent of GDP. In the Islamic Republic of Iran, the result was a swing in the current-account balance from a surplus of 3 per cent of GDP in 1997 to a deficit of 3 per cent in 1998, along with strong pressure on the domestic currency, prompting the Government to allow a 24 per cent fall in the market-based exchange rate since March 1998.[17]

In Venezuela, the largest oil exporter in Latin America, the export revenue loss in 1998 amounted to $6.9 billion, the second highest among OPEC members; it eliminated the traditional trade surplus and led to a current-account deficit of about

1.6 per cent of GDP. The impact was particularly severe on public finances, since oil normally accounts for nearly 60 per cent of fiscal revenue.[18] For other OPEC countries, the loss in oil revenue was much less in value terms, but considerably more important relative to GDP.

For many non-OPEC exporters, foreign exchange revenues in 1998 also fell significantly, particularly in the Russian Federation, Norway and Mexico; in Gabon, Norway and Ecuador revenue also fell in relation to GDP. In Mexico, where the oil sector is nationalized, oil-related revenues accounted for nearly 37 per cent of the budget in 1997, in contrast to around 10 per cent of total exports. In consequence, the Government was obliged to cut its budget three times in 1998 to make up for the shortfall in revenue from oil, estimated at about $4 billion.[19] In the Russian Federation, revenues from oil exports are estimated to have fallen by 25 per cent in spite of higher export volumes, contributing to a severe deterioration in the country's trade balance. Norway, the world's third largest oil exporter, experienced its first current-account deficit in many years.

Lower oil prices have thus benefited oil-importing countries, but have had a wide-ranging impact on oil exporters. In the latter countries, they have necessitated tighter monetary and fiscal policies, resulting in slower growth and a compression of imports. The reduced import capacity of oil-exporting countries as a whole, in turn, has adversely affected exports in oil-importing countries. All this has certainly played a significant role in the weakening of the world economy in 1998.

F. The international trade agenda for 1999 and beyond

1. *The Third WTO Ministerial Conference and a new "Trade Round"*

A consensus seems to be gradually emerging on launching a new round of multilateral trade negotiations at the Seattle Ministerial Conference of WTO, to be held at the end of 1999, but there remain substantial differences among countries over the content of any such negotiations. On the one hand, developed countries are pressing for a broad-based agenda and for negotiations to be concluded within three years so as to maintain the momentum of trade liberalization.[20] On the other hand, a large number of developing countries consider that negotiations should concentrate on problems of implementing the Agreements reached in the Uruguay Round and on its "built-in agenda", which provided for new negotiations only in agriculture and services.[21]

The position of the developing countries reflects three immediate concerns. First, the Uruguay Round and its implementation process has done little to improve market access for their exports of goods and services. Second, WTO rules have been unbalanced in several important development-related areas such as the protection of intellectual property rights and the use of industrial subsidies, while the special and differential treatment which the Uruguay Round accorded them has been inadequate. Third, insufficient human and financial resources and weak institutional capacities have restricted the ability of many developing countries to exploit the opportunities open to them under the WTO system, particularly in respect of its dispute settlement mechanism, as well as the ability to comply fully with their multilateral obligations.

Underlying these concerns is the more basic question of whether it is in the interest of developing countries to enter into negotiations with wealthier trading partners from a position of chronic weakness not only in terms of economic power but also in terms of research, analytical and intellectual support and negotiating skills. The effective participation of developing countries in any new round of multilateral trade negotiations will require them to formulate and effectively

pursue proposals in each agreed area of the negotiations, and to link these to their wider development objectives and policy goals. It will also require the political will and understanding of their developed partners to treat all issues of interest to developing countries on a priority basis.

2. A "positive trade agenda" for developing countries

Future multilateral trade negotiations will take place against the backdrop of the increasing polarization of rich and poor nations, the greater vulnerability of developing countries to financial shocks and crises and growing doubts about simple policy responses to the opportunities of a globalizing world.[22] It would thus only seem right that all agreed issues and subjects for negotiations be couched in terms of development priorities.[23] Although setting priorities will be an integral part of any negotiating process, access to northern markets for developing country exports remains the single most important theme around which to build any such "positive agenda".

(a) Market access

Even after all Uruguay Round concessions are fully implemented by the industrialized countries, significant trade barriers in the form of high tariff peaks (exceeding 12 per cent but in some cases reaching or exceeding 300 per cent) and tariff escalation will continue to affect many exports from developing countries (see chap. VI). The removal of such protection should be given priority so as to ensure the credibility and broad-based political support of any negotiations. In addition, duty-free access should be extended to all products exported by least developed countries (LDCs), including their main food and food industry exports, textiles and clothing, leather products and footwear. Most LDCs have no other exports, and their export capacities are limited even in these sectors. Restraining the use of anti-dumping actions and other trade contingency measures by developed countries in specific sectors of export interest to developing countries is another key area where a new round needs to make considerable progress.[24]

In agriculture, exports from developing countries remain severely hampered by massive domestic support and export subsidy programmes in developed countries, by peak tariffs and by difficulties in the implementation of the tariff quota system.[25] Significant reductions in tariffs, domestic support and export subsidies in this sector should be the firm goal of any negotiations. On the other hand, the continued reform of agricultural trade will have to take account of non-trade concerns such as food security, the specific problems faced by net food-importing developing countries and the varying social impact of agricultural trade liberalization. The general direction of negotiations should be towards integrating agricultural trade into the framework of "normal" WTO rules, while ensuring that developing countries, particularly those with predominantly rural agrarian economies, maintain adequate flexibility, so that concerns such as food security and rural employment can be addressed.

Given the growing importance of trade in services, and the export potential in this area for some developing countries, it is important to ensure that the architecture of the General Agreement on Trade in Services (GATS) remains intact. The Agreement not only provides flexibility to developing countries in the timing and choice of sectors to be opened up, but also, by enabling them to attach market access conditions aimed at achieving the objectives of its article IV, acknowledges the use of performance requirements and other measures, such as joint ventures, as legitimate tools of development policy. It also recognizes, in the same article, that the increasing participation of developing countries in trade in services should be facilitated through negotiated specific commitments and better access to information networks, distribution channels and new technologies. There is still, however, and as recognized in GATS article XIX, need for further work to improve data on trade in services as well as the analytical and policy framework for pursuing liberalization in this area.

In the light of imbalances in the process of global economic integration, effective implementation of GATS article IV should be among the priority objectives in the next round of negotiations. Trade in services of developing countries continues to be hampered by restrictions imposed on the movement of natural persons, coupled with other barriers. Commitments relating to mode of supply and movement of natural persons need to be specified by sector and category and economic needs tests should be removed or else specific cri-

teria scheduled for their use. Mutual recognition agreements concluded among developed countries concerning professional qualifications and any other agreement facilitating the movement of persons among developed countries should be extended to developing countries.

(b) Outstanding and new issues

A number of aspects of the Uruguay Round Agreements are already or will soon be subject to review. Those on TRIPs and TRIMs are of greatest interest to developing countries.

Since there is growing concern that the cost of the TRIPs Agreement to developing countries is outweighing its benefits, and in view of the major difficulties they have experienced in its implementation,[26] the following matters require consideration:

- A comprehensive empirical assessment of the links between intellectual property rights (IPRs) and economic development;
- Elevating the objectives relating to the promotion of technological innovation and to the transfer and dissemination of technology to a central place in new disciplines governing IPRs;[27]
- Measures geared to providing incentives to enterprises and institutions for promoting and encouraging technology transfer to LDCs;
- Extension of the transition period so as to provide additional time for domestic industries to adjust, given the broadness and complexity of the reforms required;
- Technical and financial support to formulate IPR rules adapted to a country's domestic circumstances and stage of development and to establish the necessary institutional infrastructure;
- Adoption of specific measures facilitating the use of compulsory licensing as a means of ensuring the transfer of technology (including "environmentally sound" technologies) and of meeting public health concerns (e.g. a compulsory licensing regime for WHO-listed essential drugs);
- Measures to bring the TRIPs Agreement into line with the Convention on Biodiversity;
- Inclusion of new provisions relating to the protection of traditional and indigenous knowledge and works of folklore; provisions to prevent any restriction on parallel imports; clarification aimed at explicitly prohibiting any rules and practices that amount to unilateral retaliation.

As regards the TRIMs Agreement, the scheduled review must determine whether it should be supplemented by provisions on investment and competition policy. However, emphasis should be on whether or not the Agreement has helped build up strong developing-country enterprises able to compete in world markets for both goods and services. Accordingly, there should be some reconsideration of certain parts of the Agreement in the light of developing-country experience.

An extension of disciplines on the use of certain trade-related investment measures currently permitted by the WTO rules, such as export performance requirements, could constrain the use of policy instruments still available to developing countries to promote sectors and industries with an export potential. Equally, the importance of investment performance requirements for their development programmes and their right to impose such requirements should be recognized and respected. The possibility that in some areas, such as domestic content, existing rules are harmful to their interests should be considered. The investment incentive programmes of developed countries have also had a trade-distorting impact on developing countries and should be examined. Given these outstanding concerns, many countries remain sceptical about including full-fledged negotiations on investment issues in the next round. Broader aspects of investment policy could relate to consideration of GATS-style market access commitments and/or negotiating disciplines on investment in the context of other WTO Agreements.

While competition policy is considered a "new theme" for the Third WTO Ministerial Conference, rules dealing with competition can already be found in the existing WTO Agreements, including those dealing with TRIMs, TRIPs and services, and in the Annex to the more recently concluded Telecommunications Agreement. In the Uruguay negotiations on TRIMs, developing

countries were successful in maintaining a symmetry between future work on investment policy and competition policy. The "merger mania" which continues to sweep across the world economy strengthens the position taken by developing countries on this issue.

However, any multilateral agreement on competition policy would have to take fully into account the special and differential treatment of developing countries that was unanimously agreed upon in the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices adopted by the United Nations. Such treatment could encompass the right to exempt sectors from national competition rules for development reasons. Exceptions and exemptions still exist in most developed countries.

Increased public pressure in the North is leading to greater proliferation of standards, technical regulations and sanitary and phytosanitary measures with the potential for increased trade barriers against those developing countries whose products are not able to conform to them. Developing countries have repeatedly expressed their concern about how international standards are formulated and approved, pointing out how limited their participation is from the point of view of both number and effectiveness. International standards are consequently often inappropriate as a basis for framing technical regulations in developing countries, and those countries also face problems when they have to comply with regulations in the importing markets that were drawn up on the basis of international standards. These "scientific barriers" have already been subject to dispute in WTO. Ways should be found to enable developing countries to participate more effectively in the formulation of international standards, which is a very costly process, to gain access to mutual recognition agreements concluded progressively among developed countries (which discriminate against developing countries), as well as to meet sanitary and phytosanitary regulations. As in services, developing countries need extended and much more focused financial and technical assistance in order to build their own effective capacities.

Developing countries have, with good reason, strongly resisted linking labour standards to WTO trading rules.[28] International agreements on labour standards are best left to the appropriate international bodies responsible for these matters.

(c) Systemic priorities

In view of the increasing polarization of the global economy and the concerns of developing countries noted above, future negotiations should provide for greater flexibility, including special and differential treatment (S&D) for developing countries. As the pressure to extend the "frontiers" of the trading system continues, it remains essential to preserve the right of developing countries to take certain measures as part of their overall development strategy. Rather than relying on artificial and arbitrary time-frames unrelated to need or performance, S&D should be linked to specific economic and social criteria, which would involve examination of such broad policy questions as:

- The basic rights of developing countries under article XVIII and the Enabling Clause of GATT 1994;
- Extension of the Enabling Clause to cover the provision by developing countries of non-reciprocal preferences to LDCs;
- The adequacy of transition periods in some WTO Agreements that terminate in 2005 or earlier;
- Revision and improvement of S&D provisions in WTO Agreements on the basis of experience accumulated in their implementation (for example, establishment of higher thresholds in application of anti-dumping measures to safeguard developing countries' export interests);
- Elaboration of additional S&D provisions, providing emphasis on supply-side measures in order to foster the development of internationally competitive export supply capabilities and to encourage product diversification;
- Linkage of further trade liberalization to transfer of technology requirements;
- Definition of S&D aspects for LDCs, small and vulnerable economies so as to overcome their marginalization.

Another systemic issue relates to the problems faced by developing countries, especially LDCs, seeking accession to WTO. Achieving the

universality of the multilateral trading system should be a major objective of the new negotiations. However, current applicants are facing substantial difficulties in their attempt to benefit from some of the S&D provisions in the WTO Agreements. The negotiation of transition periods, for example, is being strongly resisted by major developed countries. The acceding countries are also being required to accept obligations going beyond those of the original WTO members or incorporated in the Agreements themselves – for example, in such areas as agriculture, privatization, export tariffs and the acceptance of optional plurilateral trade agreements. Moreover, they are being requested to liberalize market access in goods, and especially in services, to an extent which may not be consistent with their present development needs. The approach to acceding countries is often motivated by geopolitical strategies and a concern not to establish precedents. These imbalances should be corrected so as to avoid fragmentation of the trading system in terms of different rights and obligations for founder members and for new members.

Developing countries have weak institutional capabilities and lack resources for sustaining effective trade policy formulation and coordination mechanisms. Experience has demonstrated that without financial assistance many developing countries will be unable to fully meet their obligations and effectively exercize their rights. The grant of such assistance will therefore be of key importance in order to strengthen the credibility of a rules-based multilateral trading system, and an attempt should be made during new negotiations to assess the administrative and financial burden of fulfilling multilateral trade obligations. For example, where new multilateral disciplines are accepted, there should be an "implementation audit" to estimate the financial and administrative cost to developing countries of their implementation. ■

Notes

1 See *WTO Focus* no. 39, April 1999.

2 IMF, *World Economic Outlook*, May 1999, table 2.11. The impact of the decline in oil prices in 1998 on oil-exporting countries is discussed in section C below.

3 Exports to the Asian countries fell by 10 per cent, to Japan alone by 7 per cent, to ASEAN by 14 per cent and to the Republic of Korea by as much as 34 per cent.

4 *China's Customs Statistics,* Series no. 112, Dec. 1998.

5 This outcome reflects the lower dollar values of GDP resulting from currency devaluations in many countries. ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean 1998*, United Nations publication, sales no. E.98.II.G.15, Santiago, Chile, 1999: 19.

6 In the first nine months of 1998 exports from the export-processing zones (EPZs), including Intel's external sales, were 80 per cent higher than in the same period of the previous year.

7 In 1997, exports to Brazil corresponded to 2.4 per cent of GDP in Argentina, but 6.1 per cent and 4.7 per cent, respectively, in Paraguay and Uruguay. In both Chile and Venezuela, the proportion was 1.2 per cent. For a discussion of Brazil as a transmission channel of macroeconomic shocks to other MERCOSUR countries and trade linkages in Latin America see, respectively, ECLAC, op. cit., box 3, and IMF, op. cit., chap. II.

8 ECLAC, op. cit.: 22.

9 IMF, op. cit., Statistical Appendix, table 27.

10 The past two years have also seen significant gains in export market shares by Asian exporters, notably China, Indonesia, Republic of Korea and Philippines (JP Morgan, *World Financial Markets*, 8 January 1999).

11 For further details see UNCTAD, *Global Economic Conditions and Prospects*, UNCTAD/GDS/MDPB/4, Geneva, February 1999 (especially table 11).

12 World Bank, *Global Development Finance, 1999,* Washington, DC, 1999: 18.

13 The price indicator employed here is the average spot price of the basket of seven crude oils produced by members of OPEC.

14 Under the agreement, which came into force on 1 April 1999, OPEC members are to cut their total production by 1.7 million bpd, while Mexico, Norway, Oman and the Russian Federation will effect a cut of 0.4 million bpd.

15 IMF, op. cit., table 2.11.

16 JP Morgan, *Global Inflation Outlook*, 2 April 1999.

17 IMF, op. cit.: 56–57.

18 *OECD Economic Outlook*, Nov. 1998, box I.5.

19 United States Energy Information Administration, OPEC Revenues Fact Sheet, Washington, DC, May 1999.

20 See the Chair's statement at the 33rd Quadrilateral Trade Ministers Meeting, Tokyo, 11–12 May 1999 (on the Internet at http://www.miti.go.jp/topic-e-menu-e.html); Communiqué of the OECD Council meeting at Ministerial level, 27 May 1999; "The contribution of the WTO Millennium Round to globalization: an EU view", speech by Sir Leon Brittan, Vice President of the European Commission, First Herbert Batliner Symposium: Europe in the Era of Globalization – Economic Order and Economic Law, Vienna, 29 April 1999 (on the Internet at http://europa.eu.int/comm/dg01/slb3004.htm); *Global Trade Reform: Maintaining Momentum*, Department of Foreign Affairs and Trade, Commonwealth of Australia, 1999.

21 See the various statements made at the Ninth Summit of the Heads of State and Government of the Group of 15, held in Jamaica on 10 February 1999, excerpts from which are published in *South Letter*, vols. 1 and 2, 1999.

22 For in-depth analysis of these issues, see *TDR 1997* and *TDR 1998*.

23 See in this connection the speech by the Rt. Hon. Clare Short, Secretary of State for International Development, United Kingdom (Future Multilateral Trade Negotiations: A development round?) to the special session of the Trade and Development Board, held on 2 March 1999 (excerpts from which are published in *UNCTAD News*, 1[1], 1999).

24 See the report by the secretariats of UNCTAD and WTO, Market access: Developments since the Uruguay Round, implications opportunities and challenges, in particular for the developing countries and the least developed countries among them, in the context of globalization and liberalization, E/1998/55, prepared for the substantive (July) 1998 session of the Economic and Social Council; Finger JM and Schuknecht L, Market access advances and retreats since the Uruguay Round Agreement, paper presented at the Annual World Bank Conference on Development Economics, Washington, DC, April 1999.

25 See UNCTAD, Examining trade in the agricultural sector, with a view to expanding the agricultural exports of the developing countries, and to assisting them in better understanding the issues at stake in the upcoming agricultural negotiations, TD/B/COM.1/EM.8/2, Geneva, Feb. 1999.

26 See Rodrik D, *The New Global Economy and Developing Countries: Making Openness Work*, Washington, DC, Overseas Development Council, 1999: 148; South Centre, *The TRIPs Agreement: A Guide for the South*, Geneva, South Centre, 1999; UNDP, *Human Development Report 1999*, New York, Oxford University Press, 1999, Chapter Two.

27 Article 7 of the Agreement states that "The protection and enforcement of IPRs should contribute to the promotion of technological innovation and to the transfer and dissemination of technology, to the mutual advantage of producers and users of technological knowledge and in a manner conducive to social and economic welfare, and to a balance of rights and obligations".

28 For a discussion of labour standards, see *TDR 1995*, Part Two, chap. IV.

Chapter III

INTERNATIONAL FINANCIAL MARKETS: INSTABILITY, TRENDS AND PROSPECTS

A. Volatility and contagion in the aftermath of the East Asian crisis

The depth and global ramifications of the East Asian financial crisis which broke out in 1997 have confounded analysts and forecasters, and have been a major cause of more recent periods of extreme volatility in international financial markets. Expectations that the crisis would be confined to the region and that recovery would be relatively rapid have been repeatedly belied by events. By the middle of 1998 it was clear that it was sharply reducing growth rates not only in the directly affected countries but also in most other developing and transition economies. The international liquidity crisis set off by the currency collapse and debt default in the Russian Federation raised the possibility that the full global implications might not yet have been realized. On the other hand, the relatively benign response of financial markets to the later Brazilian currency crisis and the continued rapid growth of some major industrial countries suggest that the repercussions may still be restricted largely to developing countries.

The successful negotiations in early 1998 between the Republic of Korea and its major overseas creditor banks to reschedule the country's outstanding short-term debt were accompanied by a stabilization of asset prices and a strengthening of exchange rates throughout East Asia during the early spring of that year. The recovery of equity markets after the sharp fall in world stock markets in October 1997, the continued absence of any apparent adverse impact of the crisis on the United States, and signs of recovery in Europe and of improving conditions in Latin America raised expectations that the crisis would be contained within the Asian region, with little impact on the rest of the world. The modest inflation produced by large currency depreciations in the Asian crisis countries, along with rapidly improving payments balances in the Republic of Korea and Thailand, led to expectations of a relatively rapid, V-shaped adjustment similar to that experienced in Mexico after the 1994–1995 crisis.

Optimism was quickly reversed by the political unrest in Indonesia, which provoked large capital outflows and focused attention on the political risks inherent in the policies introduced in a number of emerging markets in response to the Asian crisis. The rise of international tensions and the application of trade sanctions that followed the nuclear tests in India and Pakistan also contributed to heightened investor awareness of risks in emerging markets. In addition, the fall in the prices of oil and non-oil primary commodities appeared to impede rapid recovery and to spread the crisis to other, seemingly unrelated, regions. Even exporters of manufactures in the South faced falling prices due to excess supply in most of the global markets in which they competed.

As noted in chapter II (section C), the decline in commodity prices reduced not only

foreign-exchange earnings needed to finance imports and debt servicing, but also fiscal revenues in countries where commodity earnings constitute an important source of government income through direct ownership in the commodity sector (e.g. petroleum in Mexico) or taxation (e.g. the Russian Federation). The typical response was to introduce expenditure cuts for fear that failure to do so would jeopardize capital inflows and currency stability, thereby multiplying the negative impact on income and employment of the declining terms of trade. This was one of the main, and initially unanticipated, channels by which the impact of the Asian crisis spread rapidly to other developing countries.

The problems in Indonesia touched off an outbreak of financial turbulence at the beginning of the summer of 1998 that spread rapidly first from Asia to the Russian Federation and then to South Africa and Latin America.[1] It initially produced a flight towards the safety of the dollar, which appreciated rapidly against the yen; that in turn raised the possibility of an adjustment of the renminbi, given the slower growth and falling exports of the Chinese economy. But the greatest impact was in Russian financial markets, where overnight interest rates were raised to 200 per cent to avoid a collapse of the currency. This response of international financial markets to a resurgence in Asian risk challenged the prevailing view that the impact of the crisis on the rest of the world would be minimal.

Less than a year after the global stock-market break of October 1997 financial markets experienced another episode of extreme turbulence when the Russian Federation announced in August the first long-term bond default by a major sovereign debtor in the post-war period.[2] The value of the Russian bonds used as the collateral for the dollar funds borrowed by investors in these bonds dropped suddenly to zero. As international banks started to call for additional security, and to withdraw credit lines for their most highly leveraged borrowers, a number of institutions became insolvent and many major international banks suffered large losses. In an effort to forestall the disruption that would have resulted if one of the largest and most successful investment funds (Long-Term Capital Management, or LTCM) had been forced to sell assets in order to meet margin calls, the United States Federal Reserve organized a private-sector recapitalization and lowered interest rates three times to support the international financial system. The move was soon followed by similar monetary relaxation in Europe.

The effects of the financial turbulence of 1998 are also evident from other indicators. In the United States there was a more than doubling of long-term corporate debt defaults, and global stock markets went into a violent decline in the summer. The Dow Jones Industrial Average, which had set a record high on 20 July of 9,367, fell to a low of 7,400 by September. Many other markets fell by much more. In the aftermath of the Russian crisis investors sought refuge in only the most liquid and safest securities. This caused sales to be made not only in the emerging-market and high-yield sectors, but also in less liquid treasury obligations, such as "on the run" government debt.[3] Thus, investors were not only seeking higher remuneration for credit risk; they were also seeking a higher liquidity premium. As a result, new issues of both bonds and equity virtually ground to a halt not only for emerging markets but even for United States entities.

This massive malfunctioning in the global capital market resulting from the difficulties of the relatively small and underdeveloped Russian financial market is an indication not only of the degree of integration attained among the world's major financial markets, but also of the high degree of leverage maintained by the major financial institutions operating as intermediaries in these markets.[4] Correlated responses of asset prices in the markets of countries lacking close trading or political ties are often described as constituting contagion based on the irrational extrapolation by investors of particular conditions, or conditions in particular countries, to whole classes of investments or to whole regions.[5] However, given modern leveraged investment strategies in integrated global capital markets, these interrelationships are often the result of sophisticated risk-management techniques and highly-geared investment strategies rather than irrational investor behaviour.

The Russian moratorium not only produced large losses for major Western financial institutions, but also led them to sell assets to raise funds to cover their losses. Many of these sales were in emerging markets, thus creating an outflow of capital. A second impact involved the banks, which increased their collateral requirements and cut back lending to emerging markets. Both ac-

tions had a self-reinforcing impact on the downward movement of prices in the latter.

Strategies which involved covering losses on investments and arbitrage also help to explain why one of the first economies to feel the impact of the Russian crisis was Brazil. The markets for Brazilian equities and Brady bonds are among the largest and most liquid of emerging markets, and played important roles in global arbitrage strategies. The equities were sold both to close arbitrage positions and to cover losses linked to Russian investment positions. Brazilian equities fell by nearly 40 per cent between the outbreak of the Russian crisis in August 1998 and the beginning of September, and Brazilian Brady bonds fell by nearly 50 per cent. The effects of the search for liquidity was reinforced by the perception that the Brazilian economy had features similar to that of the Russian Federation: a large and growing public-sector deficit, an exchange-based stabilization policy, real appreciation and rising foreign deficits sustained by large short-term capital inflows based on interest-rate differentials, and vulnerability to commodity price declines. If such problems had created instability of the rouble and then default on loans, it was felt that a similar turn of events was possible in Brazil, too.

Even though, unlike the Russian Federation, Brazil had large foreign-exchange reserves which were used to provide for an orderly exit of foreign investors, the country was forced to allow its currency to float in January 1999, when it became evident that foreign lenders would not return until the exchange rate had been adjusted. The currency depreciated by around 40 per cent to around 2.20 real to the dollar before returning to the range of 1.65–1.75. However, additional effects on global financial markets were more limited, and emerging-market borrowers returned to international capital markets in the early spring. Thus, some two years after the outbreak of the Asian crisis international capital markets have come full circle, and there are again predictions of relatively rapid recovery.

B. A comparative analysis of the East Asian, Russian and Brazilian crises

A number of explanations have been put forward to explain the Asian crisis. Given its intensity and extension throughout the region to economies considered to possess sound economic fundamentals, most explanations rely on the identification of some form of peculiar weakness inherent in the Asian model of development. In contrast, *TDR 1998* viewed the crisis as being only the latest in a series of increasingly frequent and virulent systemic breakdowns in the operation of international financial markets. The subsequent occurrence of the Russian and then the Brazilian crisis in increasingly rapid succession appears to fit this pattern.

The financial and currency crises that have occurred since the liberalization and deregulation of domestic and international capital markets have all been characterized by capital inflows which were excessive relative to developing countries' ability to employ them efficiently and profitably, followed by periods in which these flows were reversed and resources were transferred from developing countries back to developed countries, usually leaving financial systems in the former in ruins and their economies in depression.

An important part of the initial inflows in this pattern of events is normally due to the attempt of domestic financial and non-financial firms to reduce their financing costs by borrowing funds from cheaper foreign markets, thus accumulating foreign-currency liabilities that are not balanced by foreign-currency assets. Foreign arbitrage funds, seeking to profit from the interest-rate differential, are another potential source of the capital inflows. Moreover, developed-country investors may respond to "yield famine" resulting from falling interest rates in their domestic markets, and

banks may respond to falling returns on equity in domestic markets by seeking to expand investments and loans in higher-yielding emerging markets.[6] Thus, when some external event reduces the interest-rate differential or increases the risk premium, not only does the current account become unsustainable, but also the exchange rate becomes highly vulnerable on account of a reversal of capital flows, since the capital outflow may well quickly exceed the foreign-exchange reserves available to maintain exchange-rate stability. The inevitable collapse of the currency is likely to produce widespread financial difficulties. The credit crunch makes it very difficult for firms to finance the import of inputs and the exports required to exploit the newly-gained competitive advantage. This situation generally leads to a deep recession, with drastic cuts in imports.

The three recent crises all appear to conform to this basic pattern, though to varying degrees. Yet there are important peculiarities in the way each unfolded and influenced conditions in the global economy. These arise from differences in the types of financial flows and the nature (or origin) of borrowers and lenders.

In all three cases attempts to change the intervention band of the exchange-rate regime quickly led to loss of confidence and a collapse of the currency. In East Asia and the Russian Federation the impact on unhedged foreign-currency liabilities caused a breakdown of the banking and financial systems as well as widespread bankruptcies in the private sector. This was not the pattern in Brazil, where there were only isolated banking insolvencies[7] and no major corporate failures. As a result of the country's previous history of hyperinflation, the market for long-term capital was not well developed, while banks had earned income from inflation arbitrage and treasury operations,[8] but not from lending to the private sector. Thus the corporate sector was not highly indebted to the banking system (although many banks held corporate equity as an inflation hedge); in 1997 the average debt of the corporate sector was only 30 per cent of equity.[9] Corporations relied on internal funding or had direct access to capital markets and so had no large foreign-currency exposures.

Loans represent less than half of bank assets in Brazil, and an increasing proportion of lending was to households to finance consumption expenditures, much of which was in foreign currency and created a threat of bankruptcy among households not seen in either East Asia or the Russian Federation. However, private banks in June 1997 are estimated to have had only 15 billion real in foreign-exchange denominated lending (only 21 per cent of total loans). Only 19 per cent of their liabilities was foreign-currency denominated, although the figure may have been as high as 50 per cent for foreign-owned banks. Thus, banks did not, and do not, have the kind of currency mismatches that characterized other recent crises.[10]

Furthermore, Brazil had just emerged from a major restructuring of the banking sector following the banking crisis that started in 1994–1995.[11] From July 1994 to December 1998 the Central Bank intervened on many occasions, liquidating a large number of public and private banks. Strict supervisory and regulatory provisions were also introduced, with capital adequacy requirements stricter than those in the Basle Capital Accord. Over 20 per cent of the Government's outstanding debt was created as part of this process of restructuring. Thus, unlike in East Asia, it was the Government and the Central Bank which were most exposed in foreign currencies through the issue of dollar-linked debt to both foreigners and residents, in particular to banks which used it to hedge their exposure when providing forward cover to commercial clients.

Both the Russian Federation and Brazil, before their respective crises, had recently undergone highly successful stabilization plans using the exchange-rate anchor, thereby generating expectations of economic recovery and attracting large capital inflows. While some of the inflows into Brazil were for direct investment, in the Russian Federation they were almost all arbitrage funds. However, even when the inflows financed Brazilian imports of capital goods, they were used to increase capacity to serve the large internal market. They thus generated little in the way of increased export earnings for the service of external debt, in stark contrast to East Asia. Indeed, the difficulties started in many Asian countries when returns on such investments fell and the continuing capital inflows were invested in financial engineering and real estate.

In East Asia the process of economic collapse was one of debt deflation, as the private sector sold domestic currency to repay foreign loans, and sold domestic stocks and even equipment to repay debt because of the extremely high internal

interest rates. In Brazil, on the other hand, assets were also sold in an attempt to forestall the crisis, but the sales took the form of the privatization of large portions of the public sector which covered a substantial proportion of the current-account financing needs and had, if anything, a positive impact on the balance sheets of the entities involved.

The Brazilian experience also differs from that of the Russian Federation in that, although in both cases sovereign debt was involved, the exchange-rate risk for the rouble was borne by foreign investors as well as by domestic intermediaries engaged in international arbitrage. As a result, losses were incurred primarily by the private sector, both at home and abroad. These losses, and the re-assessment of risks in emerging markets that was provoked by the Russian moratorium, explain why the Russian crisis created greater turmoil in international financial markets.

In Brazil the major damage to the private productive sector was due to the impact on demand and capital costs of the attempt to avoid crisis by defending the exchange rate. Industry suffered from penal interest rates from the autumn of 1997, that peaked at monthly rates of 4.5 per cent on working capital loans at the end of that year and never fell below 3.3 per cent during 1998, even though inflation had virtually fallen to zero. On the other hand, the principal focus of government policy was on improving the fiscal balance, through, inter alia, a reduction of expenditure by 3 per cent of GDP. The depreciation of the currency improved competitiveness without producing large losses on the balance sheets of private enterprises, but since the outbreak of the crisis Brazil (like East Asia before it) has been plagued by the disappearance of trade credits, and the improvements that have taken place in the foreign account have been primarily due to import cuts. Moreover, although the stabilization of the currency has allowed the Central Bank to reduce interest rates, to around 22 per cent by the beginning of the summer, these reductions have not yet fed through to private-sector lending rates.[12]

On the other hand, the crisis had also a number of positive aspects for the private sector. Banks had been large holders of dollar-linked government debt, and a number of investment banks reported record profits as the result of futures positions taken in anticipation of the depreciation of the currency. This is another reason for the relatively benign character of the crisis. Since Brazil was one of the first countries to have been hit by contagion from other regions, there was clear advance warning of possible difficulties. Further, it was widely accepted that the currency was overvalued. Thus foreign and domestic investors were given adequate time to make an orderly withdrawal of capital and arrange for necessary hedging, as well as to unravel complicated derivative strategies, well before the country ran out of reserves. Indeed, the devaluation had been so widely anticipated that several investment banks incorporated the impact of a possible devaluation in their growth forecasts for 1999 as early as the last quarter of 1998. Many private banks returned to the international capital markets at the end of the first quarter before the Government launched a Brady swap issue in April.

After the East Asian crisis it became widely recognized that target levels of fiscal surpluses agreed with IMF had contributed to the depth of the recession. Thus they were revised to allow Governments the possibility of running fiscal deficits. However, in Brazil this has not been the case, and even larger primary surpluses to offset the increased costs of debt service have been part of the conditions for the provision of multilateral lending. Even though the entire fiscal deficit is due to interest payments and the effects of higher obligations on foreign-currency debt brought about by the collapse of the currency, Brazil is aiming for a primary surplus of 3.2 per cent of GDP in 1999. One reason for this may be fear that the devaluation would rekindle hyperinflation. But after a one-off rise in prices the inflation rate has come down to levels similar to that before the crisis.

While the crisis in Brazil has had a relatively limited contagion effect, its domestic implications are similar to those for the Russian economy. In the run up to the devaluation, forecasts of the impact on the real economy of the high interest rates and of austerity measures necessary to defend the exchange rate were for a contraction of 4–6 per cent in 1999. However, the key to reducing the government deficit and debt is unlikely to lie in raising the primary surplus, since reduced spending or increased taxes would squeeze the private sector and prove counter-productive. Rather, interest rates need to be reduced below the growth rate of the economy, failing which there is a risk of prolonged economic stagnation; restrictive policies, while intended to reduce the debt, have the opposite effect, by increasing the deficit and out-

standing debt. Resolving the fiscal problem in a climate of economic expansion appears to be the only viable option. The floating of the currency should indeed reduce the need for restrictive measures to manage the exchange rate. This, together with the better-than-expected growth performance in the first quarter of 1999, has been the main reason for renewed optimism in Brazil.

C. Capital flows, currency markets and policy responses

1. Industrial countries

As noted above, the uncertainty concerning the global impact of the Asian crisis has produced periodic turbulence in international financial markets and considerable volatility of the exchange rates of the major currencies (including the euro, whose introduction is discussed at greater length in section E). Given Japan's trade and financial linkages to the rest of Asia, the yen was especially hard-hit by the crisis. Continued economic stagnation despite fiscal stimulus packages led to the view that Japan would be forced to devalue in order to stimulate exports to non-Asian markets. By the late spring of 1998 what appeared to be a total collapse of confidence rapidly pushed the yen towards 150 to the dollar. This depreciation was halted only by a combined intervention in support of the yen in the early summer. As the Russian crisis and the uncertainty surrounding the possible collapse of LTCM (see above) raised expectations of interest-rate reductions by the United States Federal Reserve, the yen recovered to around 130 in early September, and in the first week of October jumped by over 10 per cent in just two days' trading. This abrupt reversal of fortunes to a range of 110–125 to the dollar was due to technical factors rather than to any improved outlook for the economy or to a tightening of Japanese monetary policy.

An important factor in the appreciation of the yen was the reversal of the "yen carry trade". Expectations of rising interest rates in Japan and of falling rates in the United States reinforced the downward movement of the dollar as investors unwound positions in which they had borrowed yen to invest in other currencies, especially the dollar.

The yen's continued strength in autumn 1998 was associated with the announcement by Japan's Trust Fund Bureau (TFB) that it did not intend to increase its holdings of government bonds.[13] In addition, from March 2001 postal deposits and pension contributions will no longer be required to be placed in the TFB. This created expectations that the announced 5.9 per cent increase in spending under the second budget (explained in note 13) would be financed primarily by the issue of new bonds, producing a sharp increase in the slope of the yield curve. In fact, long-term interest rates shot up to over 2.25 per cent by the end of 1998 from less than 1 per cent three months earlier. Subsequently, it was announced that the publicly-controlled funds would take up only 10,000 billion yen of the required bond issue for fiscal 1999, down from over 25,000 billion in fiscal 1998. In the event, this has involved maturities of less than one year, further increasing the slope of the yield curve.

Various other factors also contributed to the strength of the yen. The decision by the Bank of Japan to reduce risk-adjusted capital requirements for domestic banks without international operations to 4 per cent has encouraged a large number of banks with foreign offices to close them and repatriate funds. Finally, the impact of rising interest rates and the steepening of the yield curve has produced substantial losses on bank bond portfolios, again leading to repatriation of dollar assets to offset them.

Despite large injections of liquidity by the Bank of Japan, the reduction of the overnight call rate to virtually zero and an expected fall of long-term rates to around 1.5 per cent by the summer of 1999, the yen has remained at around 120 to

the dollar. The strength of the currency and stagnant exports stimulated substantial intervention by the Bank of Japan in foreign-exchange markets.

Instability in financial markets has produced large swings in the value of the dollar vis-à-vis European currencies (and in the euro since its introduction in January 1999). Since the Russian crisis was initially considered as a threat to the Central and Eastern European economies, and since the German banking system was a major lender to the entire area, initial reactions to these difficulties brought a weakening of the deutsche mark relative to the dollar. This tendency was soon reversed as the risks to the United States' financial stability from the losses of some large hedge funds on their Russian positions became known and led to the expectation that the Federal Reserve would respond with lower interest rates.[14] The dollar thus fell against the deutsche mark in late August and again in October, taking the rate from around 1.80 to 1.63.

However, while the dollar has remained weaker against the yen, its weakness relative to European currencies has been reversed in 1999. Since its introduction the euro has suffered a sustained depreciation relative to the dollar exceeding 10 per cent. The continuing expansion of the United States economy at a pace of around 4 per cent and failure of the expected recovery to take root in the major European economies have led to expectations of higher interest rates in the United States and of continued reductions in Europe, thus reducing the relative attractiveness of the new currency. Furthermore, unemployment has again started to increase in the euro area, reinforcing expectations that the limits of the Stability and Growth Pact may be tested or even revised to allow more positive fiscal action. However, the European Central Bank (ECB) has insisted that monetary support for economic activity will be forthcoming only if the conditions of the pact are strictly respected. The positive impact of the depreciation of the euro on economic activity allows ECB to maintain its credibility as an advocate of tight monetary and responsible fiscal policy, but the euro's depreciation nonetheless leads to an erosion of its role as a credible international store of value.

By contrast, the dollar has been supported by continuing effects of the global liquidity shortage that followed the Russian crisis and prompted most emerging-market countries to take action to generate current-account surpluses. Central banks in these countries will no longer be required to sell their dollar reserves in support of their currencies but rather to buy them to prevent excessive appreciation.[15] The expectation of increasingly favourable dollar interest-rate differentials and the continued strong performance of the United States equity market make it likely that much of the surpluses generated by the adjustment policies of the East Asian crisis economies and in Latin America will be invested in the United States, offsetting its rising trade deficit.

2. *Emerging markets*

Exchange rates and domestic financial conditions in emerging markets were affected in varying degrees by the credit squeeze and the closely associated deterioration in the economic outlook following the Russian crisis. As discussed in greater detail below, some Governments felt constrained to take measures to restore capital inflows and to support the currency, whilst others were concerned mainly to shield their domestic economies from the impact of volatile capital flows or managed to keep the overall thrust of their macroeconomic policies largely unchanged. The Hong Kong dollar, the Argentine peso and the Chinese renminbi were kept stable, though in each of these economies maintenance of the currency peg was associated with policy measures designed to prevent financial instability or excessive deterioration of the trade balance. In some cases exchange rates were defended at a high cost in terms of output and employment. Countries which avoided serious macroeconomic disruption after the Russian crisis included several in East Asia and certain transition economies. More severely affected were emerging markets in Latin America and, as explained in detail above, Brazil entered a period of financial crisis late in the year.

China has been prepared to accept a contraction of its trade surplus as the price for maintaining a fixed dollar exchange rate for the renminbi, while nonetheless easing the resulting pressures on exporters through such measures as raising rebates of export taxes for several goods, allowing private companies to export directly rather than through foreign-trade enterprises, and steps to ensure exporters' access to bank credit.

In a series of measures starting in mid-August, the authorities in Hong Kong (China), which has

Chart 3.1

EXCHANGE RATES AND MONEY-MARKET RATES IN SELECTED EMERGING-MARKET ECONOMIES, 1998–1999

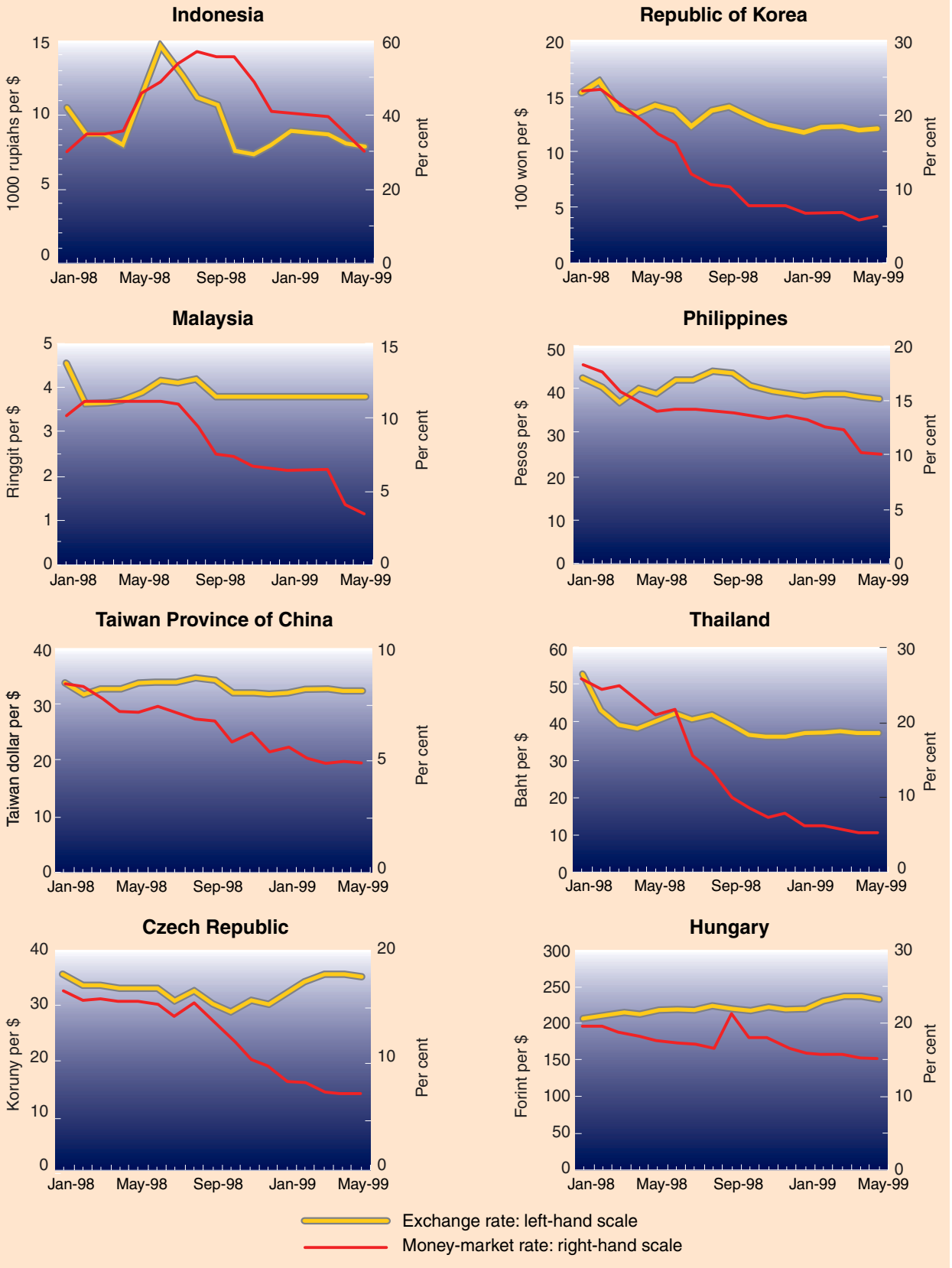


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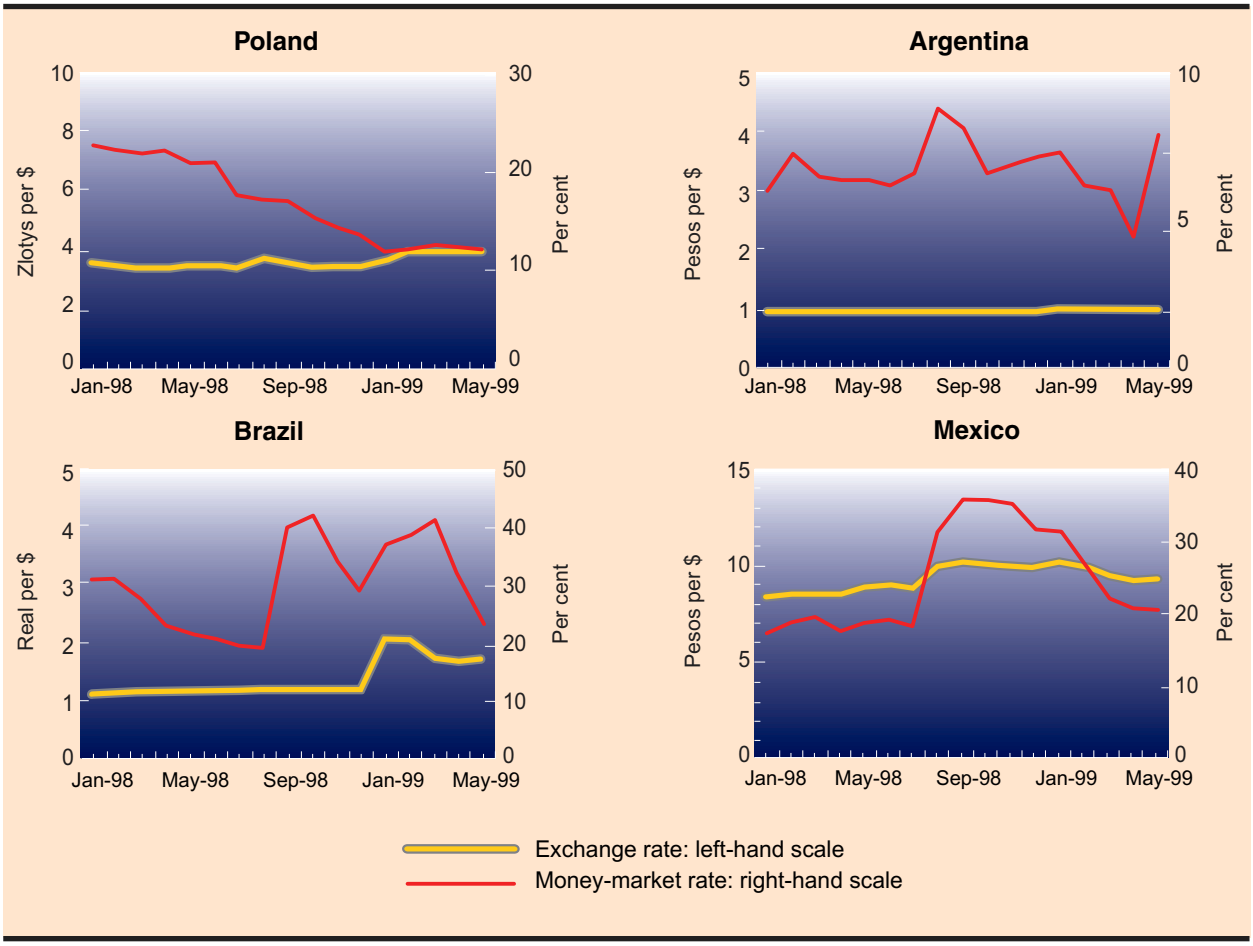
Chart 3.1 (concluded)

EXCHANGE RATES AND MONEY-MARKET RATES IN SELECTED EMERGING-MARKET ECONOMIES, 1998–1999



Source: Datastream; JP Morgan, *Global Data Watch*, various issues.
Note: Exchange rates at the end of the month; money-market rates on various dates in the second half of the month.

one of the world's freest financial markets, acted to squeeze or restrict short selling of equities and thus limit speculative strains on its currency and on share prices. A major target of this intervention was the so-called "double play", in which speculators combined short sales of stock (or stock futures)[16] with the purchase of United States dollars against Hong Kong dollars. Under Hong Kong's currency board system, the purchase of United States dollars automatically reduces domestic liquidity and puts upward pressure on interest rates, increasing the costs of financing long stock positions and thus producing pressure to sell shares and causing prices to fall.[17] This creates the possibility of making a profit by closing the prior short sales of stock at the lower prices. Hedge funds in particular had taken positions intended to enable them to profit from such a possibility: principally through currency swaps[18] with borrowers in Hong Kong dollars during the first part of the year they had accumulated positions in the currency of about HK$30 billion, while also holding short positions in stock futures amounting to 80,000 contracts, which would have produced profits of HK$4 billion for every fall of 1,000 points in the index of stock prices. To diminish the profitability of such transactions the Hong Kong Monetary Authority (HKMA) purchased stock (estimated at about US$15 billion) to prevent the fall in stock prices and create losses for short sellers forced to close positions at higher prices. Other steps taken to curb speculation were margin surcharges on large positions in the stock futures market and a temporary moratorium on short selling of three of the most important shares traded. The shareholdings of HKMA and its as-

sociated operations in futures and options markets proved highly profitable in 1998, earnings from these sources amounting to more than HK$35 billion.

The Malaysian ringgit fell steadily throughout 1998 until the introduction of exchange controls in September, when the rate was fixed at 3.80 to the dollar. These controls had the objectives of keeping interest rates low to counter deteriorating prospects for growth and of lessening the pressure of non-performing loans on the country's banking sector. They covered current as well as capital transactions and were designed to restrict trading outside Malaysia in financial assets denominated in ringgit. Official approval was required for most cross-border capital flows and some current transactions, and ringgit deposits held offshore were to be repatriated within a month of the announcement of the measures. In February 1999 the controls were relaxed with the introduction of a system of exit taxes. At the time of writing, the relaxation of capital controls had not led to a large outflow of foreign funds, and the improvement in the current account has been accompanied by a substantial increase in foreign-exchange reserves. However, the real test is likely to come in September 1999, when repatriation will no longer be subject to the levy.

Several East Asian currencies continued to fluctuate during the first three quarters of 1998, though around a generally improving trend (chart 3.1). Both the Indonesian rupiah and the Korean won experienced considerable volatility early in 1998, the former currency depreciating particularly sharply at the height of the country's political crisis; and both currencies subsequently stabilized. Interest rates in both cases have also fallen sharply. The Thai baht has experienced substantial appreciation since early 1998 (though the pace has slowed since the middle of the year), together with sharp declines in interest rates. The Philippines and Taiwan Province of China have both witnessed more limited movements in their exchange rates.

The spillover effects of the Russian crisis in East Asia were manifest mainly in sharp falls in equity prices and unfavourable conditions for external borrowing from banks or through external bond issues; yield spreads in secondary-market trading of bonds issued by countries in the region rose sharply (chart 3.2). The spillover effects of the Brazilian crisis were more limited: following the float of the Brazilian currency, speculative selling led to reduction of the forward rates of both the Chinese renminbi and the Hong Kong dollar, and there was a brief rise in short-term interest rates in Singapore.

As in East Asia, the effects of the Russian crisis on exchange and interest rates in Central and Eastern Europe were limited, though there, too, stock prices fell sharply. The currencies of the Czech Republic, Hungary and Poland all depreciated in the immediate aftermath of the crisis, but then stabilized in the last quarter of 1998 (chart 3.1). Whereas the Czech Republic had abandoned the fluctuation band for the koruna in May 1997, both Hungary and Poland continued to manage their exchange rates within fluctuation bands around a central rate, adjusted under a policy involving a crawling peg at pre-announced rates. Hungary has maintained a constant fluctuation band for the forint since the beginning of 1998, but that of the Polish zloty was widened twice in 1998 and again in March 1999. All three currencies have gradually depreciated since the beginning of 1999.

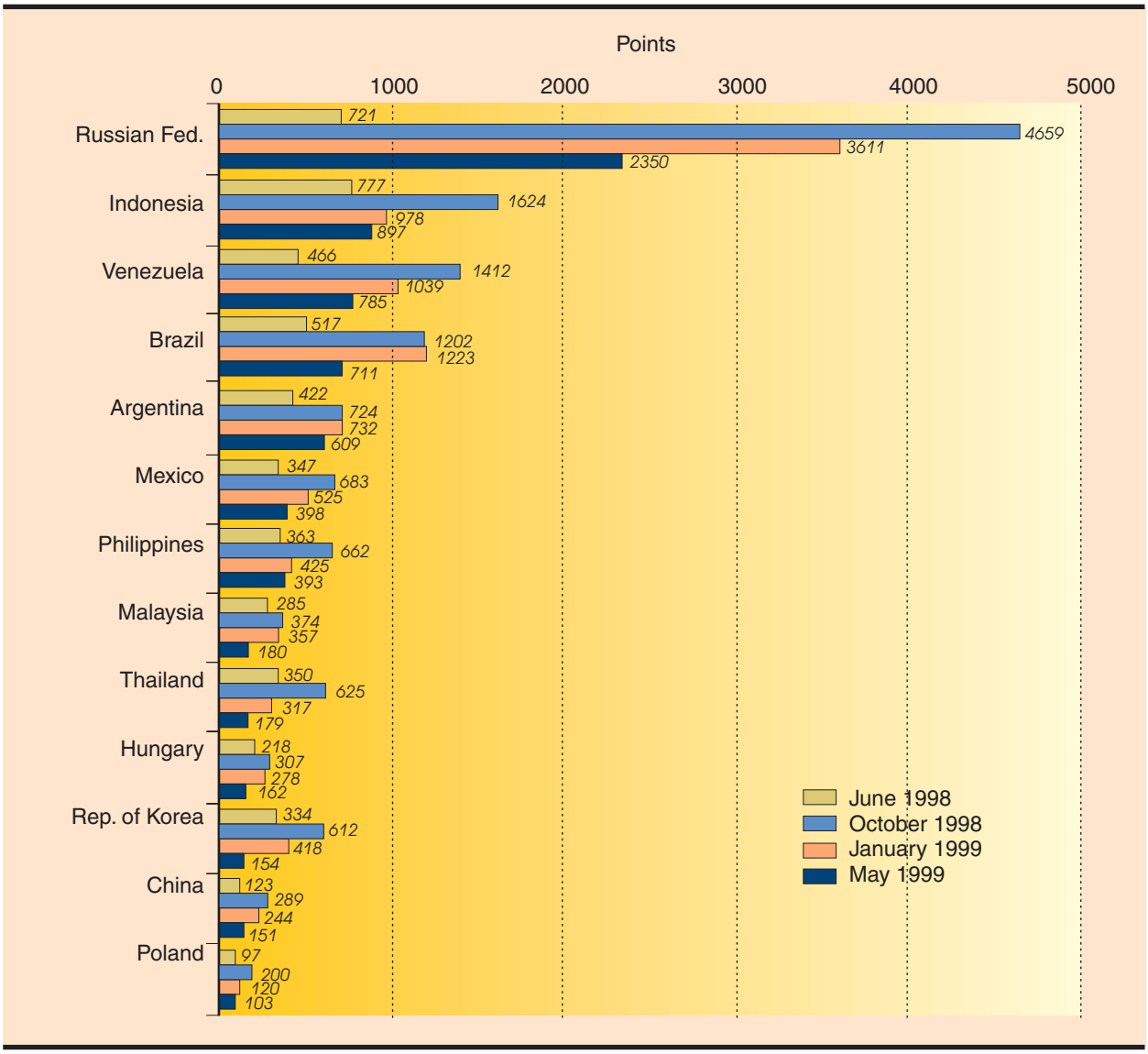
South Africa largely escaped the spillover effects of the Russian and Brazilian crises. Sentiment regarding the economy had already taken an unfavourable turn, as early as May 1998, leading to sustained selling by foreigners of government paper and a reduction of the pace of the net inflow of external investment in equities. The resulting selling pressure led to a substantial depreciation of the rand and rising interest rates. However, since August 1998 the currency has stabilized and interest rates have fallen.

In Latin America the impact of the Russian crisis included sharp falls in stock prices,[19] but more serious was the marked slowing of capital inflows that was closely linked to a worsening of the macroeconomic outlook. The sustained attacks on the Brazilian currency and their consequences were described above. To provide help in coping with global financial turmoil, Argentina sought and obtained agreements for lending facilities from multilateral financial institutions. In the event, it was the first country in the region to return to the international bond markets, in October. The crisis and currency devaluation in Brazil, with which Argentina has close trade links through MERCOSUR, led to a sharp rise in interest rates and another decline in stock prices. The country's access to international bond markets has nonetheless been maintained, but only at a sub-

Chart 3.2

YIELD SPREAD OF SELECTED INTERNATIONALLY ISSUED EMERGING-MARKETS BONDS[a]

(Basis points[b])



Source: UNCTAD secretariat calculations, based on data compiled from Datastream/ICV.

a Differential between the yield on bonds issued by the borrowing country and those of the same maturity issued by the Government of the country in whose currency the borrower's bonds are denominated.

b One basis point equals 0.01 per cent.

stantial risk premium comparable to that of many other emerging markets without a link, or with a much weaker one, to the dollar. The Mexican peso depreciated sharply after the Russian crisis, and there followed a tightening of monetary policy. By contrast, the collapse of the Brazilian real in January 1999 had only a brief effect on the peso, and was associated with only a brief fluctuation in short-term interest rates.[20] Since the beginning of the year the peso has appreciated slightly, while short-term interest rates have fallen. Conscious of the economy's vulnerability to capital outflows during the period preceding a Presidential election, Mexico recently negotiated loans and credit lines amounting to more than $20 billion from multilateral financial institutions and fellow members of NAFTA.

In Chile pressures on the currency following the Russian crisis led to the raising of interest rates

to emergency levels and the relaxation of reserve requirements on capital inflows. The fluctuation band for the peso/dollar exchange rate, which had been tightened only three months earlier, was widened again. Since depreciating slightly in the middle of 1998 the peso has moved in a narrow range (being little influenced by the Brazilian crisis), and the authorities have substantially eased monetary policy. In Colombia, the Russian crisis was followed by a tightening of monetary policy and a change in the fluctuation band for the peso/dollar exchange rate corresponding to a 9 per cent depreciation of the central rate, followed by stabilization. In Venezuela, where the effects of weak oil prices have been accompanied by considerable political uncertainty, the bolivar stabilized in the autumn of 1998 after depreciating at the time of the Russian crisis, and the fluctuation band around the crawling bolivar/dollar rate has been maintained. Though little affected by the Brazilian crisis, the bolivar has recently resumed a gradual depreciation against the dollar.

The developments since mid-1998 described in this section (and illustrated in chart 3.1) have involved substantial shifts in the relative levels of the exchange rates of emerging-market economies. The period July 1997–July 1998, for example, witnessed significantly larger and more widespread depreciations in East Asia than in Latin America: of the group from the latter region consisting of Brazil, Chile, Colombia, Mexico and Venezuela, only Colombia experienced a depreciation of its currency greater than that of Singapore which (at 18 per cent) was the smallest recorded by the group of East Asian countries (consisting of Malaysia, Philippines, Republic of Korea, Singapore, Taiwan Province of China and Thailand). Since July 1998 all the countries in the East Asian group have experienced currency appreciation, whilst all those in the Latin American group have experienced currency depreciation. Such movements of relative exchange rates illustrate the rapid changes of different countries' competitiveness in export markets due to upheavals in financial markets since the outbreak of the Asian crisis.

D. Private capital flows to developing and transition economies: recent trends and prospects

Since 1996 there has been a huge contraction of private capital flows to developing and transition economies, the flow in 1998 being well under one half that of the peak reached in 1996.[21] Forecasts for such flows have followed a similar pattern, with some particularly large downward revisions in the aftermath of the Russian crisis in the summer of 1998 and the credit crunch which followed. The most recent forecasts are for at best stabilization in 1999, followed by a modest recovery in 2000. They reflect the modest improvement in conditions in international financial markets since the autumn of 1998, evident from renewed access to international bond markets for a few emerging markets, falls in yield spreads on the bonds of such countries traded in secondary markets (see chart 3.2), a continuation of the more favourable trends in interest and exchange rates in East Asia, and the relatively limited disruption of international financial markets consequent on the Brazilian crisis.

Nonetheless, the events of 1998 provide a stark demonstration of how still only partly understood linkages between different financial markets are capable of transmitting shocks between industrial and developing and transition economies. The downside risks in the present situation are closely linked to those of the macroeconomic outlook: if there were financial turbulence in the United States, there could be spillovers on asset prices and risk premia elsewhere, and there remains the possibility of further outbreaks of instability in the asset markets and exchange rates of emerging markets triggered by events in these markets themselves.

1. Recent trends in private external financing

The extent of the fall in private capital flows to developing and transition economies since 1996

Table 3.1

ESTIMATES BY THREE INSTITUTIONS OF NET CAPITAL FLOWS TO DEVELOPING AND TRANSITION ECONOMIES, 1996–2000

(Billions of dollars)

Type of flow/region	*1996*	*1997*	*1998*	*1999*[a]	*2000*[a]
			Estimates of JP Morgan		
Net private capital inflows					
Total	333	292	153	111	159
Net debt inflows	201	157	41	-2	20
Medium- and long-term	129	182	98	22	12
Short-term	72	-25	-58	-25	7
Net equity inflows	132	135	112	114	139
Net portfolio investment	20	-8	-15	20	28
Net direct investment	112	143	127	93	111
Asia	177	108	16	22	48
Europe and Africa	65	83	39	44	50
Latin America	91	101	99	46	61
			Estimates of the Institute for International Finance		
Net private capital inflows					
Total	328	263	143	141	..
Private creditors	199	121	20	16	..
Commercial banks	120	32	-29	-12	..
Non-bank private creditors	79	89	49	28	..
Equity investment	129	142	123	125	..
Direct equity	93	116	120	103	..
Portfolio equity	36	26	2	22	..
Africa/Middle East	6	16	8	10	..
Asia/Pacific	170	71	8	29	..
Europe	48	69	42	36	..
Latin America	104	106	85	66	..
			Estimates of the International Monetary Fund		
Net private capital flows[b]					
Total	212	149	64	67	145
Net direct investment	116	143	131	117	123
Net portfolio investment	81	67	37	8	44
Other net investment	15	-60	-103	-58	-22
Africa	8	16	10	12	17
Net direct investment	6	8	7	8	8
Net portfolio investment	0	3	4	1	2
Other net investment	2	6	0	3	6
Asia	101	3	-55	-32	3
Net direct investment	55	63	50	41	46
Net portfolio investment	13	1	-15	-17	-2
Other net investment	33	-60	-89	-57	-41
Middle East and Europe	7	17	27	26	21
Net direct investment	2	3	3	5	6
Net portfolio investment	4	4	9	8	10
Other net investment	0	9	15	13	4
Western hemisphere	82	87	69	38	83
Net direct investment	39	51	54	46	44
Net portfolio investment	40	40	33	2	23
Other net investment	3	-3	-18	-9	16
Transition economies	15	26	14	23	23
New direct investment	14	19	17	18	19
Net portfolio investment	24	19	7	14	11
Other net investment	-23	-12	-11	-8	-8

Source: JP Morgan, *World Financial Markets*; Institute for International Finance, *Capital Flows to Emerging Market Economies*, 25 April 1999; IMF, *World Economic Outlook*, May 1999, table 2.5.

a Forecast.

b Other net investment comprises trade credits, loans, currency and deposits, and other assets and liabilities. For further explanations see note 23.

Table 3.2

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA[a] VIS-À-VIS DEVELOPING AND TRANSITION ECONOMIES, 1996–1998

	1996	1997	1998	Stock in Dec. 1998
	(Percentage increase[b])			($ billion)
Total[c]	14.5	8.2	-5.3	978
of which in:				
Latin America	11.5	12.4	0.2	309
Africa	-5.3	-0.01	1.6	44
West Asia	5.4	17.9	24.8	137
East and South Asia	21.5	1.7	-18.5	369
Central Asia	38.9	33.9	16.1	3
Eastern Europe	11.8	19.3	-0.8	106
Other Europe[d]	25.0	28.8	12.6	10
Memo item:				
All borrowers[e]	6.6	13.7	3.7	9 665

Source: BIS, *International Banking and Financial Market Developments*, various issues.
a Including certain offshore branches of United States banks.
b Based on end-year data after adjustment for movements of exchange rates.
c Excluding offshore banking centres, i.e. in Latin America: Bahamas, Barbados, Bermuda, Netherlands Antilles, Cayman Islands and Panama; in Africa: Liberia; in West Asia: Bahrain and Lebanon; and in East Asia: Hong Kong (China), Singapore and Vanuatu.
d Malta, Bosnia and Herzegovina, Croatia, Slovenia, The former Yugoslav Republic of Macedonia, and Yugoslavia.
e Including multilateral institutions.

is evident from table 3.1. Estimates by IMF of the net flow of private capital to such economies show a fall of 70 per cent from 1996 to 1998, while the estimates of the two private-sector institutions[22] show falls of about 55 per cent.[23] The incidence and scale of the declines in that period vary significantly among regions: the declines for Asian economies, for example, have been larger than elsewhere and began the earliest, while those for Latin America have been more moderate but a recovery is expected to begin later.[24] Net inflows of FDI have been relatively little affected by recent financial crises: the 1998 figure was buoyed by high inflows for Brazil (about one third of which was accounted for by receipts from privatization) and for the Republic of Korea (where it reflected the effects of liberalization of the regulatory regime and corporate restructuring), and the net inflow is likely to have been sustained in East Asia by the effects of falls in the local-currency prices of assets and currency depreciations.[25] By contrast, net debt inflows have fallen very sharply, the declines in bank lending being particularly drastic.

As shown in table 3.2, the exposure of banks in the BIS reporting area to developing and transition economies contracted by 5 per cent in 1998. This decrease reflected principally the impact of a particularly sharp fall (of more than 18 per cent) for the countries of East and South Asia (other than offshore financial centres[26]), most of which was due to contraction in the banks' exposure to China, Indonesia, Malaysia, Philippines, Republic of Korea and Thailand.[27] Movements in banks' total exposure were parallelled by a decline in international syndicated facilities to developing and transition economies from $131 billion in 1997 to $73 billion in 1998, $35 billion of this fall being accounted for by East and South Asia.[28] There was a further contraction in the first quarter of 1999. The economies of this region even experi-

Table 3.3

TOTAL EXPORT CREDITS[a] TO DEVELOPING AND TRANSITION ECONOMIES, BY REGION

(Millions of dollars)

Region	Net flow					Stock
	1994	1995	1996	1997	1998 (first half)	1998 (end-June)
Total	17 653	9 083	13 492	9 703	2 149	287 175
of which to:						
Africa	-65	-580	3 852	-3 703	-1 493	53 049
Latin America	1 741	-3 964	-1 043	-2 428	474	50 016
West Asia	2 042	1 214	1 290	1 975	638	40 434
East and South Asia[b]	16 404	11 697	4 178	16 226	-1 818	90 977
Central Asia[c]	532	355	615	803	541	3 028
Eastern Europe[d]	-2 450	-36	5 416	-3 511	3 004	45 847

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

a After adjustment for movements of exchange rates.

b Including Oceania.

c Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgystan, Tajikistan, Turkmenistan and Uzbekistan.

d Albania, Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, the Baltic States and countries members of CIS (excluding those listed in note c).

enced a negative inflow of export credits in the first half of 1998: positive inflows in the form of officially insured bank loans for trade financing fell to less than one quarter of their level in the first half of 1997 and other net inflows in the form of export credits fell to a negative level (table 3.3).

1998 was also notable for a sharp contraction in issues of international debt securities by developing and transition economies, accompanied by fluctuations in their access to the markets for such instruments during the year.[29] Net issues, for example, to such economies other than offshore financial centres declined from more than $80 billion in 1997 to about $37 billion in 1998. The latter figure was largely accounted for by issues during the first two quarters, while net issues in the last two quarters actually turned negative and those for the first quarter of 1999 showed only a modest recovery. The experience of the second half of the year reflected a complete cessation of new issues during the credit crunch after the Russian crisis, followed by a limited revival which initially consisted mainly of issues by Latin American countries and more recently also by those of East Asian countries.[30]

Yield spreads in secondary-market trading of the international bonds of developing countries rose very sharply in the aftermath of the Russian crisis (chart 3.2), and then declined before rising again at the end of the year owing to concerns over Brazil. The period since the levels of spreads began to moderate as the effects of the Russian crisis wore off has been marked by investors' more discriminating evaluation of different borrowers: the yield spreads on issues of certain East Asian countries, for example, were little affected by Brazilian developments and returned at the end of 1998 to levels similar to those prevailing at the beginning of the year, in contrast to the spreads for certain Latin American borrowers, which remained significantly higher.

The relative stability of net FDI was not matched by net inflows of portfolio equity which, according to the estimates of IIF and JP Morgan, dried up or (for several emerging financial markets) actually turned negative in 1998, an outcome reflecting principally a significant net outflow from Latin America. Most of these equity flows involved shares issued in the stock markets of the recipient countries but part also consisted of new

shares in external markets in the form of primary and secondary placements. For developing and transition economies such placements fell from $27 billion in 1997 to $10 billion in 1998, most of the 1998 issues taking place in the first half of the year (as in the case of international bond issues).[31]

2. Outlook

Forecasting private financial flows to developing and transition economies is a hazardous task. A certain amount of data is available for many countries concerning licensed or planned FDI, but the timing of the realization of the investments involved is often uncertain. Other information concerning existing commitments makes it possible to project a recipient country's stock of medium- and long-term debt. However, to an important extent forecasts of capital flows are linked to those for external payments balances, and thus reflect major macroeconomic influences on both the supply and the demand sides. Moreover, forecasters are typically also influenced by current perceptions of creditworthiness as indicated, for example, by prevailing risk premia.

Forecasts for private capital flows to developing and transition economies for the second half of 1998 and for 1999 were revised sharply downwards during the summer of 1998 in the aftermath of the Russian crisis, in response to the ensuing credit crunch and increases in risk premia as well as to what was judged to be a less favourable world economic outlook. No recovery is expected before 2000. Of the three institutions whose forecasts for 1999 are shown in table 3.1, only JP Morgan foresees a substantial further decline, while IIF and IMF forecast a continuation of 1998 levels. As in the case of flows actually realized since 1996, forecasts of net FDI have been less affected by developments since mid-1998, although both JP Morgan and IMF continue to expect smaller flows in 1999.[32] The region for which forecasts have been most sharply marked down by recent revisions is Latin America. The pessimism reflects reduced confidence in the sustainability of earlier forecast levels of current-account deficits, a worsening economic outlook, and spillover effects from Brazil's external financial problems. The emerging markets of East and South Asia, by contrast, are expected to experience a moderate recovery in their net private capital inflows in 1999.

E. The euro and the international financial system

At the beginning of 1999, 11 of the 15 member countries of the European Union took the historic step of irrevocably fixing their exchange rates through the creation of a common European currency, the euro.[33] Representing the completion of the project launched in 1985, the euro will be the currency of a single market that is some 20 million persons larger than that of the United States. While the combined GDP of the 11 countries is three quarters that of the United States, at 16 per cent their share in world exports (excluding exports to each other) is higher than that of the United States (around 12 per cent) or Japan (some 8 per cent). Furthermore, the euro area traditionally runs payments surpluses, making it an important international creditor and potential lender to developing countries. It is thus the importance of euro countries in world trade and as an international creditor that makes the introduction of the euro highly relevant in the global context.

Discussions of possible repercussions of the single currency have generally concentrated on its implications for the international monetary and financial system, and for trade and growth. In the first respect attention has focused on its impact on the role of the dollar as the dominant international trade and reserve currency, the role of the European securities markets in the global financial system, and the stability of international currency and financial markets. Clearly, the impact of the euro on international financial flows and stability will also have implications for trade and growth.

However, quite independently of these implications, the abandonment of their national currencies is also claimed to generate some additional benefits for the countries concerned, with positive spillovers for their trading partners, including developing countries.

1. Background

The introduction of the euro is certainly the most significant change in international monetary arrangements since the creation in 1968 of the special drawing right (SDR). Like the SDR, the euro is not the liability of a sovereign Government. Nonetheless, it is legal tender and a unit of account in 11 sovereign countries and will be used by those countries in their international trade and investment transactions. It could thus also serve as an investment vehicle for third countries and as a transaction currency in their international trade. The supply of euros will reflect the monetary policy of the European Central Bank (ECB).

As with the SDR, many of the economic conditions which eventually led to the creation of the euro have subsequently declined in importance. During the latter part of the period of the Bretton Woods system of fixed exchange rates, accumulation of dollars outside the United States due to its external payments deficits was a major concern to Europe because of its potential inflationary effects. After the de facto introduction of flexible exchange rates in 1973, there was a tendency for speculative flows out of the dollar to go into the deutsche mark, thus creating fluctuations in intra-European exchange rates that were unrelated to economic fundamentals. The eventual response was the creation of the European Monetary System (EMS), which was designed to preserve stable exchange rates among its members and to pool member country reserves to protect the deutsche mark from speculative surges.

The attempt to complete the process of integration of the European Community quickly led to the recognition that full integration of goods and capital markets would require either irrevocably fixed exchange rates or a single currency. However, a single currency also implied a single European monetary policy, which could not be achieved if there were substantial differences among countries in monetary conditions such as inflation rates, interest rates, and government debt and deficits. Thus, the prerequisite to the introduction of the euro was a process of convergence of monetary and financial variables, which, as examined in past *TDRs*, entailed large costs in terms of growth and employment in the countries concerned. Moreover, in order to ensure that a single currency would not produce a highest common denominator in terms of money creation and inflation, care was taken to pattern the new system on the monetary institutions of the country with the best record of price stability, namely Germany.

2. Exchange-rate stability

While ECB has responsibility for the monetary policy of those countries participating in the single currency, decisions regarding exchange-rate policy belong to the European Council of Ministers. Although the day-to-day responsibility for managing the exchange rate is left to ECB, the Bank's legal responsibility to stabilize the value of the euro extends only to the currency's internal value, and its external value in real and nominal terms will be free to fluctuate within limits that are considered as compatible with price stability. Since ECB faces the problems of gaining market credibility and experience in formulating a uniform monetary policy for its members' still rather diverse economies, it is expected to proceed with prudence.

The introduction of the euro is often seen as a major step towards the division of the global economy into three currency blocs organized around the currencies of the three major economic powers, namely the United States, Japan and the European Union. Such an arrangement has often been suggested as a means of providing greater stability in global foreign exchange markets. However, although the European countries involved have eliminated currency fluctuations among themselves, there is no guarantee that the creation of the euro will provide greater exchange-rate stability among the three major currencies.

It is sometimes suggested that the euro will make it easier to achieve policy coordination among the major industrial countries in order to attain greater exchange-rate stability. One proposal that has been made is to establish target zones among the three major currencies. However, it is unlikely that the United States, Europe

and Japan could achieve the kind of convergence and monetary cooperation needed for such an arrangement to work; difficulties among the EU member countries during the 1992–1993 EMS crisis hold valuable lessons in this respect. Indeed, the immediate point at issue is not the exchange-rate regime but the international financial system. In a regime of largely uncontrolled currency trading no exchange-rate system can guarantee stability.

Since the strength of the euro has important implications for growth and inflation, it cannot be ignored by ECB in determining monetary policy. However, both the Maastricht Treaty and the subsequent (June 1997) Stability and Growth Pact strongly favour price stability as opposed to exchange-rate stability. Once the credibility of the euro is established, its external strength is unlikely to play a major role in the design of monetary policy within EMU. The countries which have adopted the euro all have very high shares of trade in GDP. However, with the introduction of the euro, trade among them no longer involves international settlements. Thus, 11 very open economies have been transformed into a single relatively closed economy and the exchange rate has become consequently a much less important variable than it was previously for the 11 individual central banks, since its influence on domestic prices will be much weaker.

The politics of the euro could also discourage pursuit of an active exchange-rate policy. Since it may be difficult to decide on a single exchange rate that is suitable to each and every member, there may be a tendency to leave it to the market. Moreover, at times of serious market pressures, restoring exchange-rate stability often requires reorientation of fiscal policy, which remains a national responsibility. At present there is no mechanism other than the Stability and Growth Pact to coordinate national fiscal policies.

The single currency eliminates for EMU investors the benefits of diversification from investing in other European countries. Thus, the search for non-correlated assets within EMU to create portfolio diversification will have to take place in other directions, such as assets issued by different economic sectors or at different maturities. Investments in such assets are typically accompanied by a higher degree of financial sophistication, the use of more complex financial strategies and greater leverage. They are accordingly likely to be associated with increased volatility in financial markets, which in turn may also increase the volatility of the external value of the euro.

Both the strength and the stability of the euro will have significant repercussions for countries which have traditionally used European currencies as a peg, most notably the CFA countries. The 14 sub-Saharan African countries comprising CFA participate in two separate monetary areas with two separate currencies, each issued by a regional central bank. Both currencies had been convertible into the French franc at the same fixed rate, but as a consequence of EMU they are now pegged to the euro. While a strong euro could become a major reserve currency, it could create problems for the CFA countries, necessitating a devaluation. On the other hand, pegging of the CFA franc to the euro should be of some benefit to those countries in their economic and trade relations with the members of the euro area, while, to the extent that the euro fluctuates vis-à-vis other major currencies, the CFA countries may experience greater instability in their international trading relations.

All other CFA arrangements remain unchanged. Since the convertibility of the CFA franc into the French franc or the euro is guaranteed by the French Treasury, rather than the Bank of France, there is no conflict either with the obligation of the Bank of France not to finance Governments directly or with the Bank's lack of legal authority to fix the external value of the euro. The only restraint would then be that on the French Government to respect the 3 per cent limit on budget deficits.

3. The euro versus the dollar

As happened with the introduction of the SDR, there has been a great deal of speculation concerning the impact of the euro on the role of the dollar as the dominant reserve currency. Although there are good reasons for adjustment of the composition of central bank reserves in favour of the euro by Latin American and Asian central banks seeking to distance themselves from the volatility of the dollar, as well as by countries seeking accession to EU, for various reasons the dollar is nonetheless likely to retain its predominant role in the medium term.

The euro reduces the need of the central banks in the euro area for foreign-exchange reserves. There will no longer be reserve holdings of what were formerly national currencies of the member countries. On the other hand, while the dollar reserve needs of ECB will be less than the total dollar reserves held previously by the EMU countries, the decline in the total dollar reserves of the euro area (which will continue to include the holdings of national central banks) is likely to be less than that for European currencies, which cease to exist as a result of the introduction of the euro.[34]

The persistence of the dollar as a reserve currency is partly explained by the level of outstanding external indebtedness of the United States and by the aim of central banks of maximizing returns on their holdings of foreign exchange. Thus, the relative cyclical positions of the United States and Europe, return differentials, and interest-rate expectations will play an important role. It is estimated that if Asian central banks were to convert 10 per cent of their dollar holdings over a five-year horizon, some $8 billion per annum would be involved. However, average private capital inflows into the United States are currently roughly 12 times that amount.

Paradoxically, the biggest impact thus far of the euro is serious consideration by a number of Latin American countries of the adoption of the United States dollar as their domestic currency. Following the logic of the single currency, adopting the dollar is seen as a way of eliminating the exchange-rate instability that has proved so persistent and damaging to sustained expansion in Latin America since the onset of the debt crisis. Equally, the high interest rates in the region maintained to attract foreign capital and to stabilize exchange rates have been damaging to growth prospects. The adoption of the euro by EU countries brought about a convergence of their interest rates to a low level. It is thus thought that if Latin American countries adopted the dollar, interest rates could be brought down to levels near those in the United States and thus improve growth prospects.

Such considerations appear to be the motivation behind the desire expressed in Argentina to replace the national currency with the dollar. Indeed, as noted above, and despite the presence of a currency board which effectively links the peso to the dollar, Argentina continues to experience a substantial risk premium in interest rates on its international borrowing, and this premium continues to behave in periods of crisis in a way similar to that of other emerging markets.[35] Moreover, it exists even though Argentina has substantially strengthened its banking system. Adoption of the dollar and convergence of interest rates to United States levels are thus expected to insulate the economy from financial contagion.

Clearly, if the euro were to become a stable international investment and transactions currency, it would find a place in suitably diversified reserve portfolios of central banks. However, the present tendency in Latin America to strengthen linkages to the dollar or to move to regional currency arrangements is unlikely to involve a large diversification of reserves away from the dollar. A number of Eastern European countries are preparing for entry into EU; concerned to keep exchange rates stable vis-à-vis the euro, they may increase their reserve holdings of the single currency. Again, some Middle Eastern or North African countries with traditional links to Europe may also diversify their holdings away from the dollar. But the size of such movements is unlikely to have any significant impact on the value of the euro or its status as a reserve currency. Asia has a substantial amount of trade with EU but even more with Japan, which is also a major investor in and creditor of the region, as well as with the United States, which is a major market for its exports. While there has been some increase in euro reserves held by Asian countries, it has so far been on a fairly small scale and limited to countries without payments difficulties.

During recent bouts of financial crisis a number of developing countries used substantial amounts of their reserves to stabilize exchange rates or to pay down debt. As these countries recover, their response is likely to be a decline in their dollar sales or even an accumulation of dollars to replenish reserves. Only after this process is completed will it be possible to identify any pronounced trend of substitution of the euro for the dollar.

There may also be a possible role for the euro in the global market for hard currency, particularly in developing and transition economies. At present, this market is estimated to be around some $400 billion, of which about two thirds is in dollar bills. An important part of such holdings is linked to illicit activities. Large currency denominations are usually attractive in such markets. The

decision to issue large euro denominations (notes of 500 euros, worth about $550, against the largest United States bill of $100) may shift some of the seigniorage to Europe.

4. The euro and capital markets

The role of the euro as a reserve currency will also depend greatly on the strength, depth and efficiency of capital markets and the range of instruments available for the investment of reserves. One reason for the attractiveness of the dollar is the size and liquidity of the United States capital market. Although EMU will create a market that should rival that of the United States in size, there are a number of factors which will slow this process. The first is the fact that European integration has been based on the principles of home-country regulation and subsidiarity, essentially implying the preservation of national institutions and practices wherever possible. The creation of a single currency does not mean the creation of a single, uniform capital market. Indeed, no formal steps have been taken to bring this about, and there are substantial impediments such as the maintenance of national supervision and prudential regulations, which will be slow to converge.

The changes needed to create a single, unified capital market for EMU are made more difficult by the fact that the larger economies involved have had financial systems organized around universal banks. They do not have highly developed private bond markets, and the tradition of running fiscal surpluses has meant that government bond markets are relatively underdeveloped. In these systems individuals have held bank-intermediated rather than market-intermediated assets, thereby impeding the development of equity and markets. The changes are only likely to occur as a result of market forces for integration. Once they are achieved, they can be expected to provide for a large flow of European capital to emerging markets as private investors increase the market-intermediated assets in their portfolios. If "yield famine" operates in Europe as in the United States, the rapid decline in interest rates that has occurred in a number of countries of the euro area may also lead to an increased flow of investment funds to emerging markets. But the impact that such a movement might have on the composition of reserves and the strength of the euro is uncertain.

The euro eliminates the need for domestic investors to diversify within EMU to hedge currency risks. Since the primary hedge currency was the deutsche mark, there should be a reduction in the holdings of deutsche mark/euros in private sector portfolios, which can only be offset by a rise in returns due to the reduced costs and increased ease of European cross-border investing. Portfolio diversification will now require extra-EMU investments, and since these will in all probability be in the United States, such diversification will also help the dollar to retain its relative position.

Expectations that the euro would rival the dollar as a currency of issue in capital markets have been fulfilled to a certain extent: the increase in issuance of euro-denominated paper has led to rough equality with that denominated in dollars, at around 40 per cent of the market for each (after eliminating United States and European borrowers who issue in their own currencies). Corporate issues increased sharply in the first two months of 1999, and almost a quarter of the new issues were for amounts of 2 billion euros or more, compared with only 7 per cent in 1997. Much of the new issuance has been due to low interest rates for the euro relative to the dollar – a form of currency arbitrage – or was designed to establish euro benchmark rates for borrowing.[36] However, the potential development of the market for euro-denominated debt instruments will also depend on the creation of a market for interest-rate and currency swaps that will provide the basis for a full panoply of derivatives products. Recent experience in this respect is extremely disappointing, with very little interest-rate swap activity and an extremely unbalanced dollar/euro swap market.

5. Impact on trade and growth

In the discussions of the European Single Market Act to complete the economic common market it was estimated that the gains from the removal of internal barriers to trade such as border controls, the liberalization of financial services, the opening of public procurement to competitive bidding and associated supply-side effects would add around 4.5 per cent to GDP of the European Union in the medium term, starting with the introduction of the single market in 1993.[37] These estimates were made before the

decision to introduce a common currency, and thus did not make provision for the elimination of transactions costs associated with the use of multiple currencies – savings which have subsequently been estimated to add another 0.5 per cent to GDP.

In addition to these static or microeconomic effects, there are some more dynamic macroeconomic effects that might influence growth in Europe. If members of EMU are no longer required to use monetary policy to keep their exchange rates stable as they were within EMS, then interest rates could be substantially lower in the euro area. It is difficult to estimate the impact of lower interest rates on income growth, but Europe has traditionally had higher capital costs than the United States or Japan, so that the impact should be positive. The necessity to maintain stable exchange rates in a world of floating rates appears to have converted Europe into a low-inflation, low-growth area with a virtually permanent current-account surplus. Higher growth with a smaller share of external trade in GDP might bring about a decline in the current-account surplus, with positive effects on global trade and demand.

Most studies of customs unions show that reducing internal tariffs leads to an increase in internal trade at the expense of external suppliers (i.e. trade diversion). The adoption of the euro can also be viewed in that light, for the elimination of exchange-rate spreads and commissions on currency trading has an impact similar to a reduction in tariffs on internally traded goods, while the possible increase in the volatility of the euro would have an impact similar to an increase in the common tariff on goods coming from outside the area. There is no doubt that the potential magnitude of the second effect is much less than the first. But even if there is no increase in exchange-rate volatility, internal trade should grow at the expense of international trade, making Europe a more closed economy.

Thus, any benefit to trade for third parties must come from the dynamic or income effects of the introduction of the euro (i.e. trade creation). A study by IMF indicates that even on the most favourable hypothesis of an increase in EU incomes of 3 per cent by 2010, the increase in output in developing countries would be only 0.3 per cent,[38] and it would be largely concentrated in the Mediterranean basin, Eastern Europe and CFA countries.

These potential benefits are small compared with the costs in terms of lower output that have resulted from convergence among the EU countries. Moreover, they do not take into account costs that may be incurred in terms of output and employment forgone as a result of the loss of fiscal flexibility under the Stability and Growth Pact, costs which on many estimates could more than offset the potential benefits.[39]

For developing countries, the most important considerations are interest rates, export markets and capital flows. From the observations above, it is possible to conclude that the euro will bring about a reduction in international interest rates. Although the currency's impact on the growth of European import demand is uncertain, it holds out more promise than the pre-euro process of economic convergence if Governments are willing to relax the constraints on fiscal policy imposed by the Stability and Growth Pact. Finally, the impact on the stability of capital flows will depend on the evolution of European securities markets: even if they should develop in a way similar to those in the United States, there is no guarantee that investments in emerging markets from this source will be any less volatile than they have been since 1980. ■

Notes

1 The spreads on speculative grade seven-year maturity bonds began to widen significantly in May 1998; see Historical Default Rates of Corporate Bond Issuers, 1920–1998, Moody's Investment Services, Special Comment, New York, Jan. 1999.

2 Moody's, op. cit. For a more detailed discussion of the Russian crisis see UNCTAD, *Global Economic Conditions and Prospects*, UNCTAD/GDS/MDPB/4, Geneva, Feb. 1999.

3 "On the run" and "off the run" are closely linked to the level of trading (and thus the liquidity) of different United States Government bills and bonds, the first category being more actively traded, while a higher proportion of the second is generally held in

the portfolios of large institutions and is consequently less actively traded.

4 As BIS recently put it, the unfolding of the Russian crisis "can be seen as part of a series of mutually reinforcing events which have highlighted a number of deficiencies in the world financial system. For instance, the massive unwinding of leveraged positions has served as a painful reminder that linkages between markets have become highly complex and opaque. Recent events have also ... provided another illustration of the increasing convergence in the behaviour of banks and other categories of market participants", BIS**,** *International Banking and Financial Market Developments*, Nov. 1998: 4.

5 Usually, a distinction is made among three types of the contagion. First, there is the contagion due to common causes, such as declines in commodity prices triggering attacks on currencies of commodity exporters. Second, there is the so-called fundamental-based contagion which arises from interdependence among countries through trade and finance (e.g. a currency collapse in a country can cause pressure on the currencies of its trading partners or competitors in third markets). The third category is the so-called pure contagion, which arises in the absence of such interdependence; see Masson P, Contagion: Monsoonal effects, spillovers and jumps between multiple equilibria, IMF working paper WP/98/142, Sept. 1998; and Calvo GA and Reinhart C, Capital flows to Latin America: Is there evidence of contagion effect?, in Calvo GA, Goldstein M and Hochreiter E, eds., *Private Capital Flows to Emerging Markets after the Mexican Crisis,* Washington, DC, Institute for International Economics, 1996.

6 There is some statistical evidence to support the relationship between low returns in developed countries and inflows into emerging markets; see e.g. Eichengreen B and Mody A, Interest rates in the North and capital flows in the South: Is there a missing link?, *International Finance*, 1998, 1(1): 35–58.

7 The Central Bank provided emergency dollar credits at below-market rates to Banco Fonte Cidam (which was subsequently sold to Banque Nationale de Paris) and to Banco Marka, both of which had taken derivative positions based on maintenance of the exchange-rate regime. Banco Boavista was sold to France's Crédit Agricole, and Grupo Espirito Santo of Portugal made large capital injections into its Brazilian investment banking operations.

8 Inflationary transfers of income are estimated at some 4 per cent of national income and provided some 40 per cent of bank earnings.

9 For the evolution of corporate indebtedness in Brazil during the *Plan Real* see Nessi Zonenschain C, Estrutura de capital das empresas no Brasil, *Revista do BNDES*, 1998, 5(10), tables 3 and 5.

10 See in this connection IMF, Brazil: Recent economic developments, IMF Staff Country Report, no. 98/24, Washington, DC, April 1998.

11 As part of the liberalization of trade and finance in the late 1980s, Brazil liberalized the licensing of new banks by domestic (but not foreign) entities. Many of the entities founded since the late 1980s came to grief with the rise in interest rates that took place at the time of the Mexican crisis and during the attempt to calm the boom generated by the introduction of the *Plan Real*. Eighty per cent of all interventions took place after the introduction of the Plan. See Sáinz P and Calcagno A, *La economía brasileña ante el Plan Real y su crisis*, Temas de Coyuntura, no. 4, ECLAC, United Nations publication, sales no. S.99.II.G.13, Santiago, Chile, 1999.

12 From October 1998 to May 1999 consumer credit rates increased by 21 per cent, while the Central Bank's base rate fell by 46 per cent. Rates on commercial lending fell by only 4 per cent. In May 1999 the interest rate for consumer credit was more than 12 times and the rate for business loans 5.5 times the base rate; see Study by the National Association of Financial Executives, reported in *O Globo*, 16 May 1999: 38.

13 The TFB is the investment agent for the Postal Savings System and other government agencies, such as pension funds, and typically places funds in government bonds, thus facilitating the financing of fiscal stimulus programmes. Such fiscal stimulus packages are financed by the so-called "second budget", covering the Fiscal Investment and Loan Programme. See *TDR 1995*, Part Three, chap. IV, sect. B.2.

14 Hedge funds are private investment pools which originally acquired their name because they used a form of spread trading in which long positions in investments expected to increase in value were balanced by short positions in the same type of assets that were expected to decline in value. These funds now typically follow more aggressive strategies based on high levels of leverage and remuneration of managers, consisting primarily of participation in investment profits. The most widely discussed case of recent difficulties among such funds is that of LTCM, for which (as discussed above) the United States Federal Reserve organized a consortium of creditors and investors for the purpose of injecting emergency financing so as to prevent the fund from becoming insolvent owing to losses on highly leveraged positions in such instruments as United States government bonds, the shares of companies involved in takeover activity, and Russian securities. Difficulties were also experienced by a number of other hedge funds, often owing to the movements in asset prices following the Russian financial crisis.

15 Concerning policies regarding foreign-exchange reserves in response to volatility in international financial markets see chap. V, sect. C.2.

16 A stock index future is an exchange-traded contract to buy or sell the face value of an underlying stock index, where the face value is defined as the value of the index multiplied by a specified monetary amount. It serves as a vehicle alternative to buying and selling large baskets of shares for taking positions designed to profit from movements in the general level of stock prices.

17 For a detailed account (and defence) of the actions taken by the Hong Kong Monetary Authority (HKMA) see the speech by its Chief Executive, Joseph Yam, in Singapore on 14 October 1998 (reproduced in *BIS Review*, 23 Oct. 1998).

18 Currency swaps are contracts through which interest payments in different currencies are exchanged for an agreed period of time and the underlying principal amounts are exchanged at a pre-arranged exchange rate at maturity. Currency swaps enable the counterparties to alter the currency and interest-rate exposures associated with their liabilities as part of their hedging, arbitrage or speculation.

19 In August 1998 the fall was at least 30 per cent in Argentina, Brazil, Mexico and Venezuela; there were smaller falls in Colombia (more than 15 per cent) and Chile (a little under 10 per cent).

20 The initial widening of the fluctuation band for the Brazilian real was followed by a sharp rise in Mexican short-term interest rates, but the subsequent decision to float the currency was followed by a still larger decline. See JP Morgan, *Global Data Watch*, 15 Jan. 1999: 25.

21 For the terminology used in this Report relating to capital flows see box 5.1.

22 The Washington-based Institute for International Finance (IIF) is a grouping of major banks whose objectives include the provision of information and of a forum for debate and the development of positions on policy issues of importance to the Institute's membership.

23 There are differences between the estimates of IMF and those of the two other institutions regarding country coverage and method of estimation. The group of emerging markets distinguished by IIF in its *Capital Flows to Emerging Market Economies* consists of 29 developing and transition economies. That of JP Morgan (*World Financial Markets)* can be assumed to be similar but not identical. The number of countries included in the IMF groupings is more comprehensive, and the figures are obtained after subtraction of net lending by residents of the recipient economy (which helps to explain why they are lower than those of IIF even though they are based on larger groupings). Since the figures of IIF and JP Morgan are much the same, it is reasonable to assume that their bases of estimate are also broadly similar. (For an account of the approach of JP Morgan see *World Financial Markets*, 2 April 1999: 13.) On the other hand, because of differences in coverage both sets of figures on inflows differ from those of the World Bank (in its *Global Development Finance),* which are used in chapter V below.

24 Much of the fluctuation for East- and South-Asian economies is due to net private capital flows to Indonesia, Malaysia, Philippines, Republic of Korea and Thailand. For example, for these countries IIF estimates of April 1999 show a fall from $102 billion in 1996 to approximately zero in 1997 and -$28 billion in 1998.

25 For a more detailed discussion of FDI linked to privatization and to cross-border merger and acquisitions linked to falls in asset prices see chap. V, sect. E.2.

26 For the identity of the offshore financial centres see note c to table 3.2.

27 BIS, *International Banking and Financial Market Developments*, June 1999, table 6A. The contraction in exposure to the five countries amounted to $62.5 billion in the first three quarters of 1998.

28 Ibid., table 10.

29 Ibid., table 11. The figures in this table include money-market instruments, bonds and notes.

30 Developing and transition economies for the entities of which international bond issues were announced between September 1998 and the end of the year included Argentina, Brazil, Mexico, Uruguay, Venezuela, Lebanon, Turkey, China, Malaysia, Republic of Korea and Sri Lanka. Several of these bond issues included "sweeteners" intended to enhance their marketability (such as warrants, backing by collateral or official guarantees of various kinds). BIS, op. cit., March 1999: 19.

31 BIS, op. cit., June 1999, table 18. At $2.4 billion, such issues continued at a similar pace in the first quarter of 1999.

32 The reasons for JP Morgan's less sanguine expectations are summarized as follows: "There are limits to how much should be expected from direct investment flows .... First, the return on emerging market equity has been very poor in recent years ... Direct investors may not have done much better. Second, direct investment in many emerging economies is concentrated in goods (and commodity) industries, where global excess capacity is high, pricing is weak and profits are low" *(World Financial Markets*, 2 April 1999: 16).

33 The remaining four countries retain the option of joining the others as long as they meet the convergence criteria set out in the Maastricht Treaty.

34 For possible effects of the euro on reserves see McCauley RN, The euro and the dollar, *Princeton Essays in International Finance*, no. 205, Princeton, NJ, Nov. 1997.

35 Although Argentina's Currency Board should reduce credit and foreign-exchange risks, by the time the effects of the tequila crisis had subsided in 1996 spreads on international issues by Brazil, which operated a crawling peg, and Mexico, which operated a floating-exchange-rate regime, were smaller than those of Argentina. See Aronovich S, O custo de captação externa por meio de bonds: considerações sobre as recentes experiências de Argentina, Brasil e México, *Revista do BNDES*, 1997, 4(7): 37–62

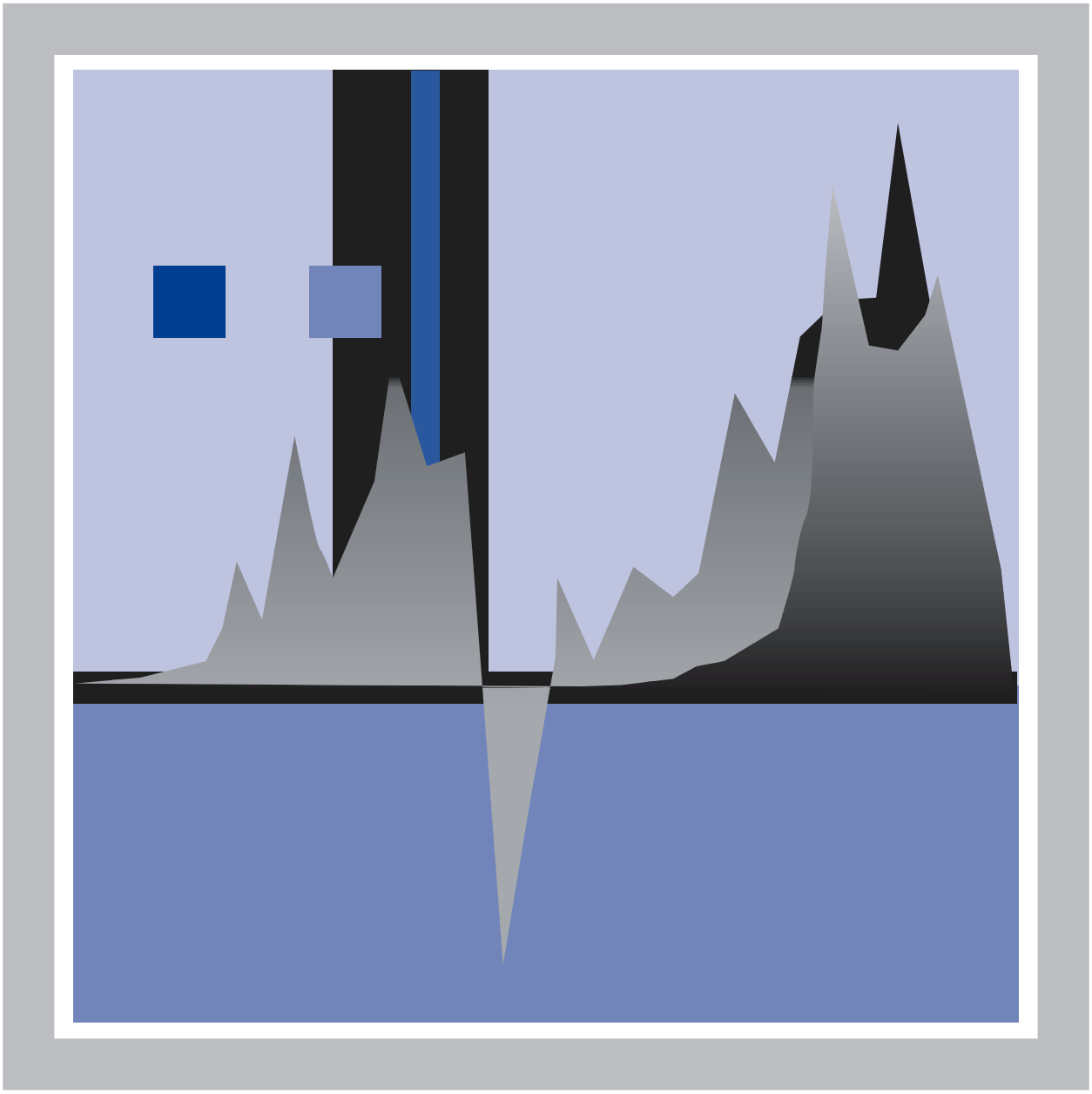
36 Any strengthening of the euro and/or an increase in European interest rates can thus cause problems for developing-country borrowers in the euro market. A similar situation was observed in the 1970s, when a weak dollar and low dollar interest rates encouraged borrowing in dollars, but debtors faced serious problems subsequently, when the dollar appreciated and United States interest rates went up.

37 *The European Challenge, 1992* (Cecchini report), Aldershot, United Kingdom, Wildwood House, 1988.

38 IMF, *World Economic Outlook*, Oct. 1997, chap. III and Annex II. See also Bekx P, The implications of the introduction of the euro for non-EU countries, Euro Paper no. 26, European Commission, Brussels, July 1998; and Feldman R et al., *Impact of EMU on Selected Non-European Union Countries*, IMF Occasional Paper no. 174, Washington, DC, 1998.

39 See, for example, Eichengreen B and Wyplosz C, The Stability Pact: more than a minor nuisance?, *Economic Policy*, no. 26, April 1998.

TRADE, EXTERNAL FINANCING AND ECONOMIC GROWTH IN DEVELOPING COUNTRIES



Introduction

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

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

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

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

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

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

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

Chapter IV

PAYMENTS DEFICITS, LIBERALIZATION AND GROWTH IN DEVELOPING COUNTRIES

A. Introduction

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

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

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

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

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

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

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

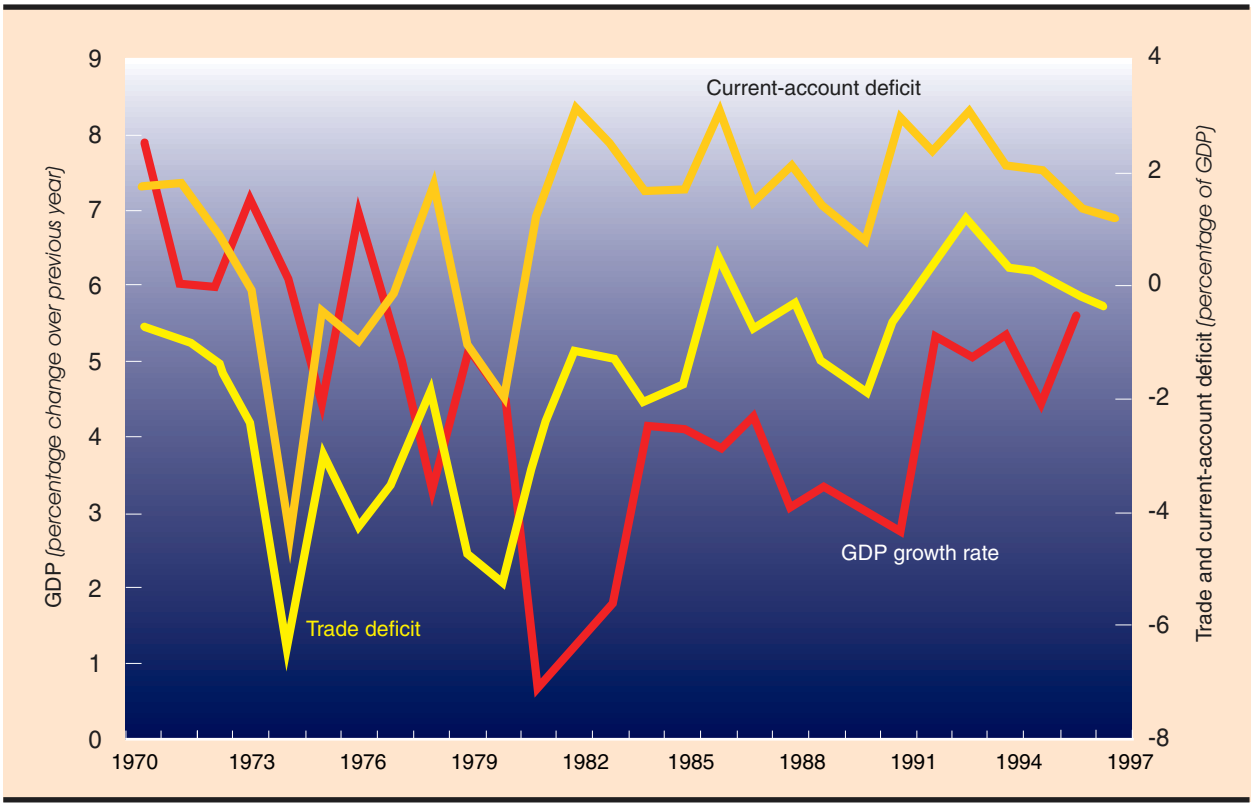
One of the crucial external factors influencing the trade performance of developing countries is the size and growth of markets in major industrial countries, which are the most important outlets for their exports. Slow growth of these markets, continued restrictions on access in areas of export interest,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

B. A review of long-term trends

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

Chart 4.1

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



Source: IMF, *World Economic Outlook* database; UNCTAD, *Handbook of International Trade and Development Statistics*, table 6.2 (various issues).
Note: Positive values for trade and current-account balance indicate a deficit, negative values a surplus.
a Excluding Hong Kong (China), Republic of Korea, Singapore and Taiwan Province of China.

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

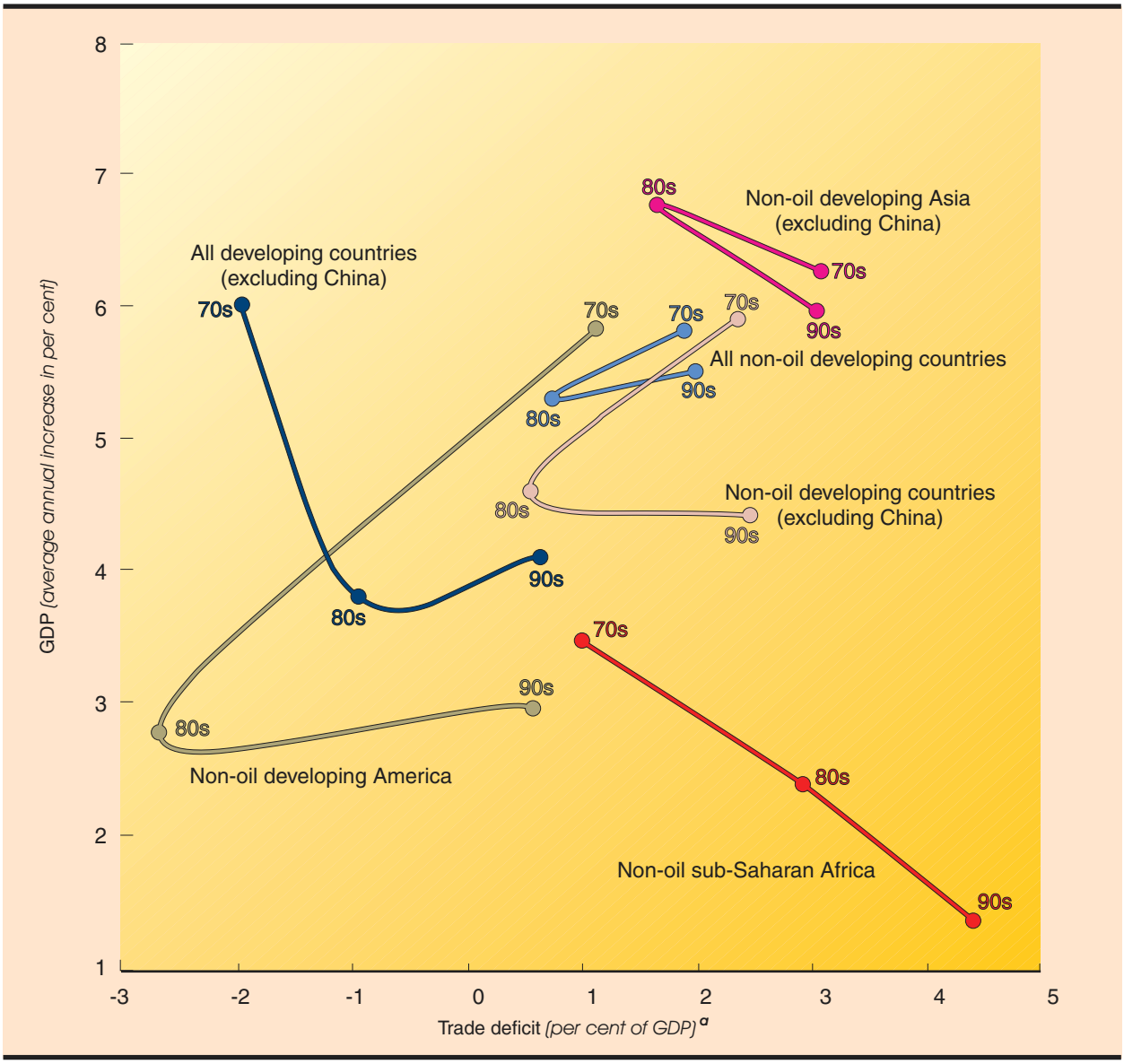
Growth in developing countries has also shown large swings over the past three decades. While fluctuating sharply throughout the 1970s, it averaged 5.7 per cent per annum and never fell below 3 per cent. There was a dramatic slowdown in the early 1980s due to a deep global recession and the resulting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

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

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

Chart 4.2

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



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

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

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

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

1. Trade deficits and growth

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

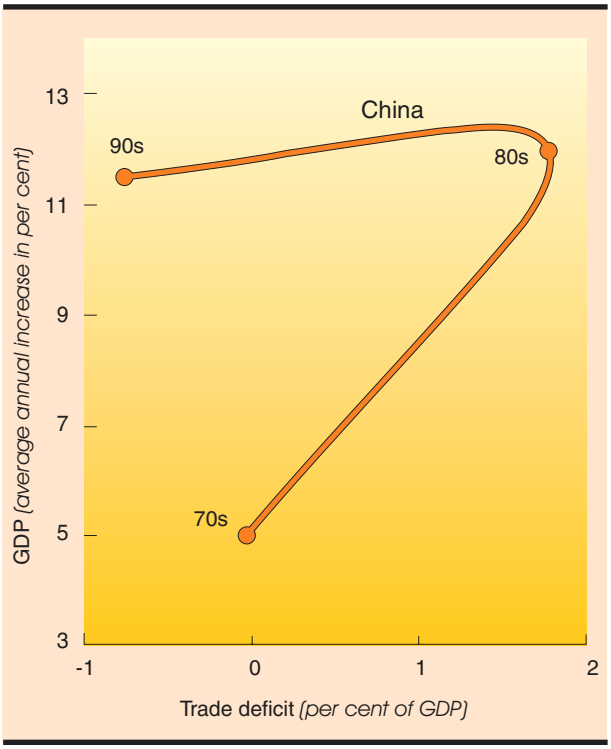
First of all, for developing countries as a whole (excluding China), with or without oil-exporters, there has been a considerable change for the worse in the relationship between economic growth and trade balances. Growth was lower in the 1980s than in the previous decade. While this fall was associated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

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

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

Chart 4.3

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



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

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

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

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

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

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

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

2. Imports and exports

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

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

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

Table 4.1

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

(Average annual percentage increase in value)

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

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

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

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

3. The experience of different countries

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

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

Table 4.2

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

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

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

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

a Change from 1982–1988 to 1989–1995.

Table 4.3

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

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

Source: See table 4.2.
Note: See table 4.2.
a Excluding 1974 and 1975, which were exceptional years due to the sharp rise in oil prices.
b Change from 1970–1979 to 1989–1995.

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

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

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

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

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

C. Factors influencing trade performance

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

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

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

Table 4.4

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

(Average annual percentage change)

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

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

1. Terms-of-trade losses

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Liberalization and trade performance

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

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

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

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

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

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

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

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

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

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

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

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

Table 4.5

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

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

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

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

b Annual average growth of value in per cent.

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

d Real effective exchange rate.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table 4.6

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

(Per cent)

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

Source: UNCTAD secretariat calculations.
Note: The 16 countries are Argentina, Brazil, Chile, Colombia, Ghana, Indonesia, Kenya, Malaysia, Mexico, Morocco, Philippines, Republic of Korea, Thailand, Tunisia, Uganda and Venezuela. For further explanations see text and the annex to this chapter.
a Annual percentage increase.
b Percentage of GDP.

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

Notes

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

16 Maizels A et al., op. cit.

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

18 See Kaplinsky R, op. cit.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Annex to chapter IV

TRADE DEFICITS, LIBERALIZATION AND GROWTH IN DEVELOPING COUNTRIES: SOME ECONOMETRIC ESTIMATES

This annex presents the results of some econometric exercises designed to estimate the relation between economic growth and the trade balance in developing countries and the effect thereon of trade liberalization. These results are also used in constructing scenarios to estimate deficits on current account that could be associated with faster growth in developing countries than has so far been achieved, and hence to assess their external financing requirements.

The model is specified by taking the ratio of trade balance (TB) to GDP as the dependent variable. The explanatory variables are the growth rate (GROWTH) and the purchasing power of exports (PPX) of developing countries and the growth rate of industrial countries (GRIND). Income, rather than barter, terms of trade are used, in order to capture the effects of both relative prices and export volumes and to assess the impact of liberalization on import propensity.[1] Liberalization (LIB) is used as a dummy variable. On the basis of the discussion in chapter IV, this variable is expected to capture the joint effects of currency appreciations and instability resulting from capital-account liberalization as well as the impact of import liberalization.

The countries studied are the 15 listed in table 4.5, other than Turkey, and also include the Republic of Korea and Venezuela. The regression equations are obtained on the basis of panel data estimation techniques using the information for the 16 countries over 26 years, i.e. from 1970 to 1995. The equations are estimated alternatively as a random-effects and a fixed-effects model. The Hausman test supports the random-effects model, implying that the intercepts are uncorrelated with the explanatory variables.[2]

As a first hypothesis, LIB is used as an intercept shift – i.e. it adds to trade deficits by a constant amount independent of the values of the explanatory variables. Estimates of the random-effects and fixed-effects model are given below, where the figures in brackets are the t-ratios:

Random-effects model

$$\begin{aligned} TB/GDP = &- 3.78 \;(2.27) \;-\; 0.24\ GROWTH\ (4.35) \;+\; 0.02\ PPX\ (4.60) \\ &- 2.68\ LIB\ (4.92) \;+\; 0.75\ GRIND\ (4.94) \end{aligned} \qquad \textbf{(1A)}$$

R-square = 0.04; Standard error of estimate = 7.64; N = 416; Chi-square Hausman test = 2.13

Fixed-effects model

$$\begin{aligned} TB/GDP = &- 0.24\ GROWTH\ (4.30) \;+\; 0.02\ PPX\ (4.69) \\ &- 2.71\ LIB\ (4.97) \;+\; 0.75\ GRIND\ (4.94) \end{aligned} \qquad \textbf{(1B)}$$

R-square = 0.68;
Standard error of regression = 4.46; N = 416

The fixed-effects model has a different intercept for each country, estimated as a country dummy.

Both models are consistent with the analysis given in the chapter and generate comparable estimates. All the structural parameters have the expected signs and pass the significance test at the 1 per cent level. Acceleration of growth in developing countries adds to trade deficits by a similar amount in both estimates. Better terms of trade and faster growth in industrial countries improve the trade balance, while liberalization worsens it significantly. The strong impact of growth in industrial countries on trade balances is particularly notable. The estimates suggest that the decline in the average growth rate of industrial countries from around 3 per cent in the 1970s to less than 2 per cent in the past decade may have added as much as 1 per cent of GDP to the trade deficits of developing countries.

A more satisfactory treatment of the effect of liberalization should allow for the possibility that relaxation of controls over trade and financial flows could lead to structural changes in the economy. It can indeed be expected that in a liberalized economy the impact of changes in the growth rate or terms of trade on external payments is likely to be different from the impact in an economy where international trade and capital flows are subject to control. In the models used here, such effects can be incorporated by using LIB as a slope dummy for the explanatory variables. The results, based on the same data, are given below, where the variables LIBGROWTH, LIBPPX and LIBGRIND denote the interaction of liberalization with the variable for growth and the terms of trade in developing countries and for growth in industrial countries.

Random-effects model

TB/GDP = - 5.37 - 0.16 GROWTH
(3.21) (2.47)

+ 0.65 GRIND + 0.03 PPX
(4.25) (6.96)

- 0.20 LIBGROWTH - 0.02 LIBPPX
(1.7) (5.23)

+ 0.72 LIBGRIND
(2.48) **(2A)**

R-square = 0.04; N = 416;
Chi-square Hausman test = 4.62

Fixed-effects model

TB/GDP = - 0.15 GROWTH + 0.03 PPX
(2.38) (7.05)

+ 0.65 GRIND - 0.21 LIBGROWTH
(4.23) (1.81)

- 0.03 LIBPPX + 0.73 LIBGRIND
(5.24) (2.52) **(2B)**

R-square = 0.70; N = 416

The values of the coefficients in a liberalized economy are given by the sum total of the individual and interaction coefficients (GROWTH and LIBGROWTH, etc.), whereas in a non-liberalized economy the interaction terms are zero. Again, there is very little difference between the two sets of estimators and the Hausman test supports the random-effects model. Accordingly, equation (2A) with a common (random) intercept can be used for forecasting the trade balance.

In these estimations, too, the signs of the parameters of GROWTH, PPX and GRIND are as expected. However, unlike the specification in (1A) and (1B), these estimates show that the overall impact of liberalization on the trade balance varies with the values of GROWTH, PPX and GRIND, and may be positive or negative depending on the particular configuration of these variables. As expected, growth in a liberalized developing economy is associated with greater trade deficits than in a non-liberalized economy. On the other hand, increases in the purchasing power of exports continue to improve the trade balance in a liberalized economy, but less than before liberalization. This suggests that liberalization tends to raise the import propensity, and is indeed consistent with the rise in the share of imports in GDP in developing countries as a whole from 21.5 per cent in 1990 to over 27 per cent in 1996.

By contrast, the results show that faster growth in industrial countries improves the trade balance in a liberalized developing economy more than in a non-liberalized economy. A possible explanation for this result is that in an open economy emphasizing trade, business is generally more prepared to exploit market opportunities abroad than in an inward-oriented economy.[3] In other words, this result could be due to a positive impact of liberalization on export growth associated with a given growth rate of industrial countries.

Accordingly, if industrial countries grow sufficiently rapidly, acceleration of exports in developing countries could lead to an improvement in their trade balance, even though it may bring in more imports than in a non-liberalized economy.

A possible shortcoming of the above specifications is the treatment of GDP growth as an exogenous variable. Indeed, in a simultaneous equations country model, GDP growth and the trade balance are both expected to be endogenous, with the trade balance influencing the growth rate at least from the demand side. Given the difficulties of constructing such a model with panel data, an alternative procedure has been adopted here in order to correct some of the biases of the least squares estimates by using instrumental variables. Thus, the endogeneity of the growth variable is accounted for by using GRIND, PPX and LIB as the instruments. Since there is a lack of sufficient instruments, interaction terms among the three variables are not used. Consequently, in this specification, the effect of liberalization on the trade balance operates through economic growth. The results obtained with two-stages least squares are as follows:

$$\begin{aligned} TB/GDP = & -0.96\ GROWTH + 1.28\ GRIND \\ & (2.45) \qquad\quad (4.45) \\ & + 0.01\ PPX \\ & (2.90) \end{aligned} \qquad \textbf{(3)}$$

R-square = 0.57; Standard error of estimate = 5.41; N = 416

Compared to the previous estimates, the impact of developing-country growth on the trade balance is much stronger; that is, in a liberalized economy, a one-percentage point increase in the growth rate creates an additional trade deficit of almost 1 per cent of GDP. But equally significant is the increased impact of GRIND on trade balances in developing countries, suggesting that rapid growth in industrial countries has an important influence on the trade deficits of developing countries.

Finally, the equations above have also been estimated using the Sachs-Warner index of openness as a proxy for liberalization.[4] This allows a broadening of the sample to cover 52 developing countries (27 in Africa, 19 in Latin America and 6 in Asia) over 26 years (1970–1995). The estimate of equation (2A) using this index is given by:

$$\begin{aligned} TB/GDP = & -15.00 - 0.10\ GROWTH \\ & (10.58) \quad (2.83) \\ & + 0.66\ GRIND + 0.07\ PPX \\ & (5.51) \qquad\quad (13.90) \\ & - 0.23\ LIBGROWTH - 0.05\ LIBPPX \\ & (2.99) \qquad\qquad\quad (9.64) \\ & + 0.80\ LIBGRIND \\ & (3.60) \end{aligned} \qquad \textbf{(2A-SW)}$$

These estimates are very similar to the ones obtained with a sample of 16 countries as given in (2A); all coefficients have the correct signs and are significant. Similar results have also been obtained for most of the other equations using the Sachs-Warner index. However, since, as noted above (see note 19 of the main text), this index of openness is controversial, estimates given by (2A) rather than (2A-SW) have been used in designing the scenarios discussed in section C.3 of this chapter. ■

Notes

1 Since the TB/GDP ratio incorporates the barter terms of trade and the export volume, in this formulation the impact of income terms of trade on the trade balance works through import volumes. The model has also been estimated using the net barter terms of trade. The latter had a positive and significant impact on the trade balance, and the effects of other explanatory variables were broadly similar to those obtained with the income terms of trade. However, unlike the estimates in equations (2A) and (2B) below, liberalization had no effect on the relation between barter terms of trade and the TB/GDP ratio.

2 These models using panel data analysis differ according to whether they treat intercept parameters as random or fixed across the sample. The estimators in the random-effects model are the generalized

least squares estimators, and they combine the within- and between-country estimators, using the corresponding residual variances as weights. For elementary panel data techniques see Johnston J, *Econometric Methods*, New York, McGraw Hill, 1996.

3 This could also be true in an economy which is not very open but export-oriented, such as contemporary China (not included in the sample) or the East Asian NIEs until the past decade.

4 See Sachs J and Warner A, Economic reform and the process of global integration, *Brookings Papers on Economic Activity*, 1995, 1: 1–118. The index has been extended to 1995 by taking for each country the same value for that year as for 1994.

Chapter V

CAPITAL FLOWS TO DEVELOPING COUNTRIES

A. Introduction

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

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

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

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

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

Box 5.1

DEFINITION OF DIFFERENT TYPES OF CAPITAL FLOWS

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

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

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

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

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

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

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

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

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

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

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

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

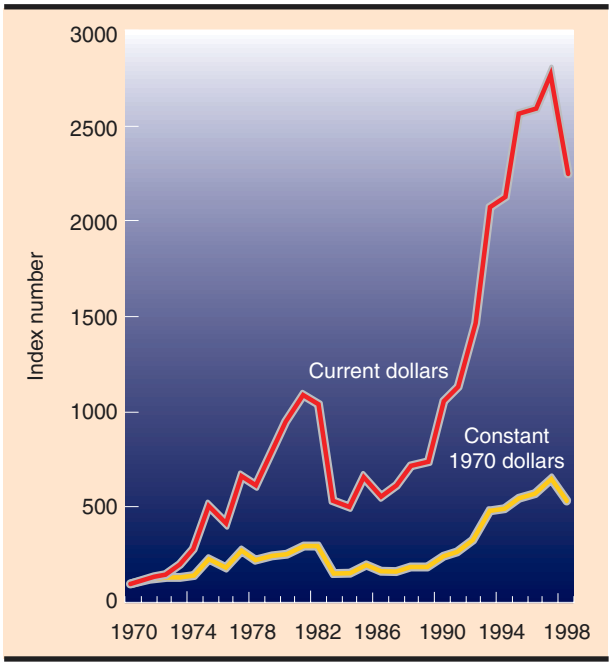
Net capital inflows into developing countries have risen more than 20-fold in nominal terms since 1970 (chart 5.1), reaching an estimated $255 billion in 1998, down from a record level of almost $312 billion in the previous year. In real terms, however, the increase is much less impressive. If the import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

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

Chart 5.1

DEVELOPING COUNTRIES: AGGREGATE NET CAPITAL INFLOW, 1970–1998

(Index numbers, 1970 = 100)



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

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

Table 5.1

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

(Percentage of GNP)

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

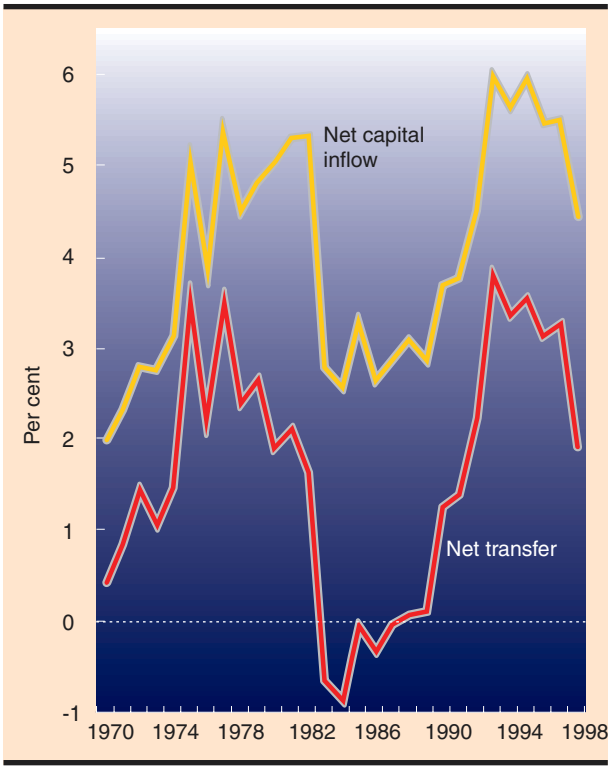
Source: As for chart 5.1.
Note: For definitions see box 5.1.

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

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

Chart 5.2

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

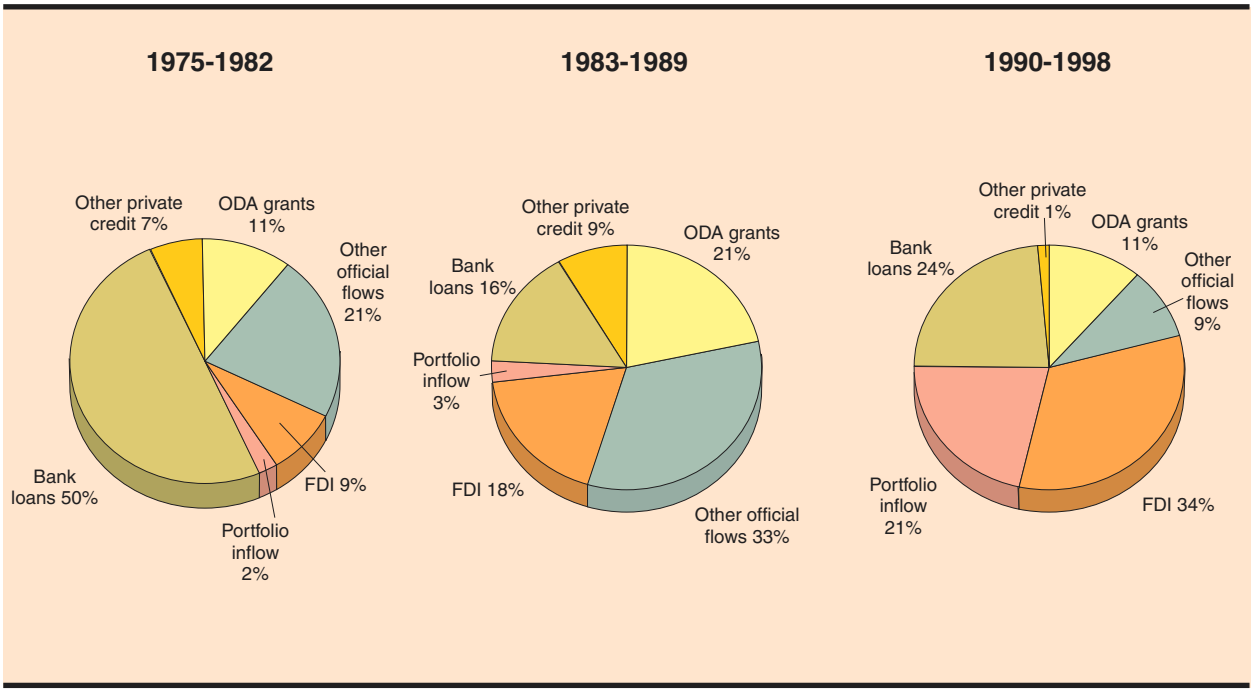


Source and definitions: See chart 5.1.

Chart 5.3

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

(Percentage of aggregate net inflow)



Source and definitions: See chart 5.1.

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

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

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

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

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

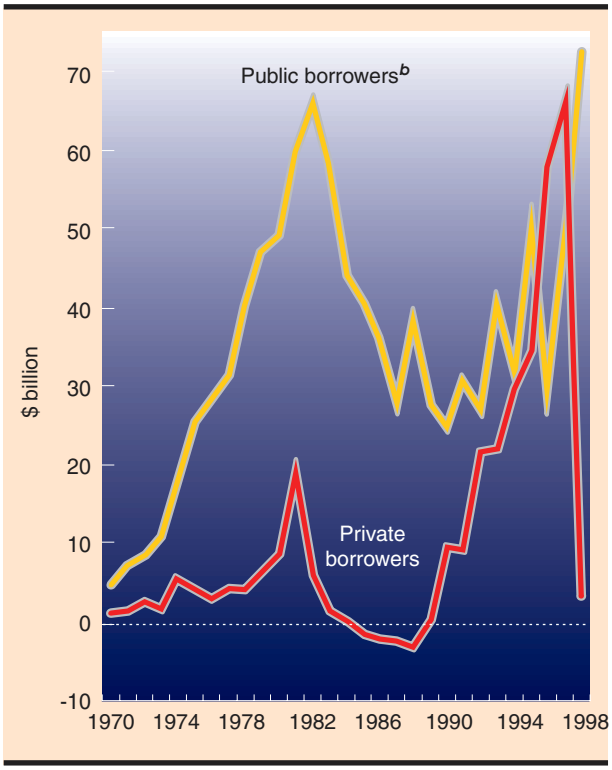
Finally, these changes in the composition of net capital inflows have been accompanied by shifts in their distribution among developing countries and regions. In particular, since official flows tend to favour poorer developing countries and regions, their movement relative to that of private capital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

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

Chart 5.4

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

(Billions of dollars)



Source and definitions: See chart 5.1.

a Excluding short-term credit.

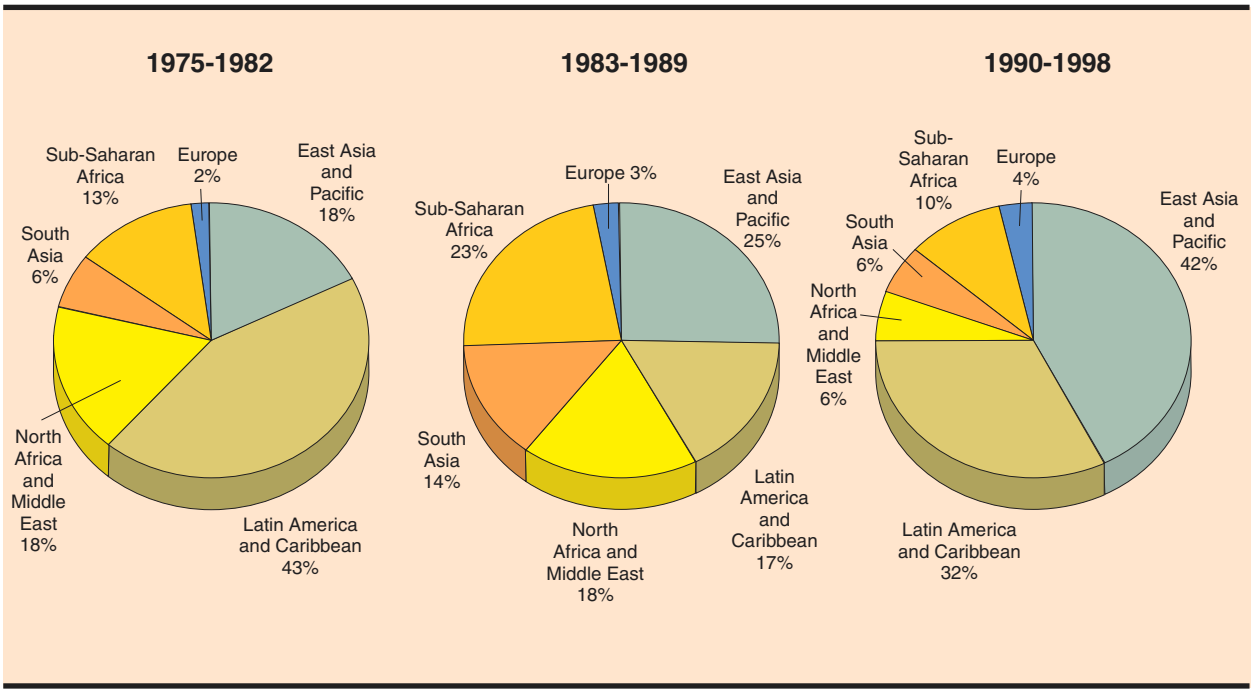
b Including publicly-guaranteed credit to private borrowers and IMF lending.

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

Chart 5.5

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

(Percentage of aggregate net capital inflow)



Source and definitions: See chart 5.1.

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

C. Capital flows and the current account

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

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

Table 5.2

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

(Billions of dollars and per cent)

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

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

Note: For definitions see box 5.1.

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

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

c A minus sign indicates an increase in reserves.

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

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

1. Capital outflows

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

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

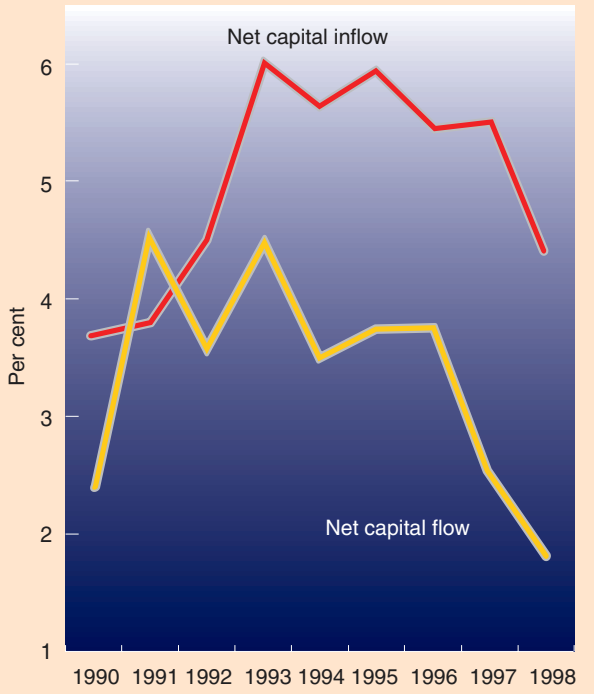
The evolution of unrecorded capital outflows as given by the errors-and-omissions item is particularly noteworthy. With the loosening or dismantling of exchange controls, improved recording of external transactions and standardization of data collection, this item could be expected to decline in importance.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

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

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

Chart 5.6

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



Source and definitions: See chart 5.1.

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

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

2. Reserve accumulation

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

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

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

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

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

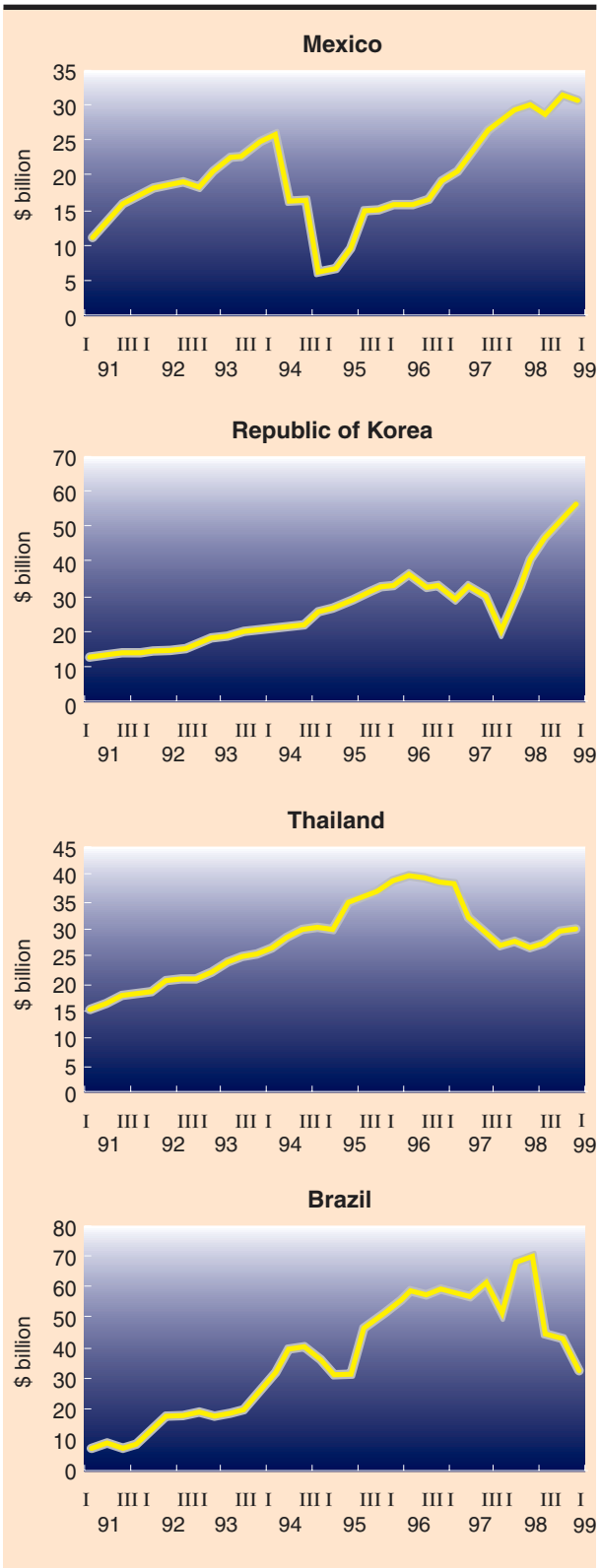
Since the early 1990s such boom-bust cycles in emerging markets have been observed with increasing frequency, first in Mexico, then in East Asia and Brazil (chart 5.7). In Mexico, after a sharp increase in the early 1990s reserves collapsed in 1994 and early 1995, when the currency came under attack.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

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

Chart 5.7

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

(Billions of dollars)



Source: Datastream/ICV.

Box 5.2

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

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

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

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

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

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

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

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

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

Box 5.2 (concluded)

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

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

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

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

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

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

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

3. Current-account financing

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

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

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

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

D. Short-term capital flows

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

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

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

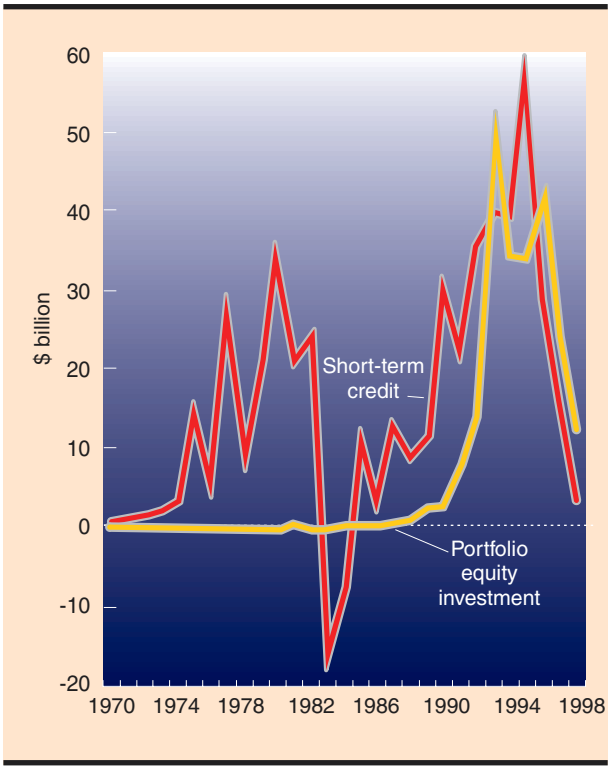
In analysing financial instability a distinction should also be made between short-term inflows and outflows, as done in the previous section for total capital flows. One of the areas of controversy during the recent bouts of crisis in emerging markets was whether it was residents or non-residents who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

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

Chart 5.8

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

(Billions of dollars)



Source and definitions: See chart 5.1.

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

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

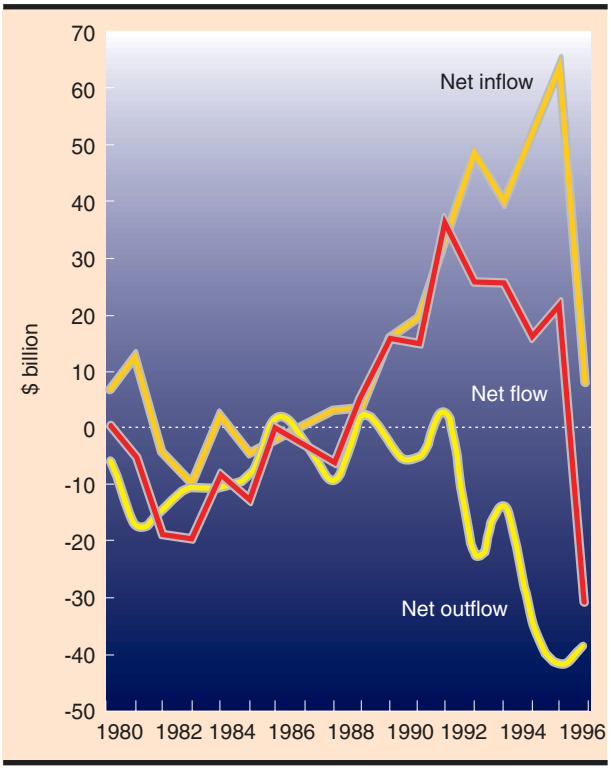
A more comprehensive picture of the evolution of short-term arbitrage flows can be derived from balance-of-payments statistics of IMF, which include both inflows and outflows and cover a wider range of capital flows but exclude short-term trade credits. Analysis of this data for 13 emerging markets (chart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

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

Chart 5.9

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

(Billions of dollars)



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

Table 5.3

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

(Cumulative totals, in billions of dollars)

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

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

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

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

b 1986–1989.

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

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

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

Table 5.4

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

(Billions of dollars)

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

Source: As for table 5.3.

Note: For definitions see box 5.1.

a Malaysia, Philippines, Republic of Korea and Thailand.

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

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

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

E. Foreign direct investment

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

1. Recent trends

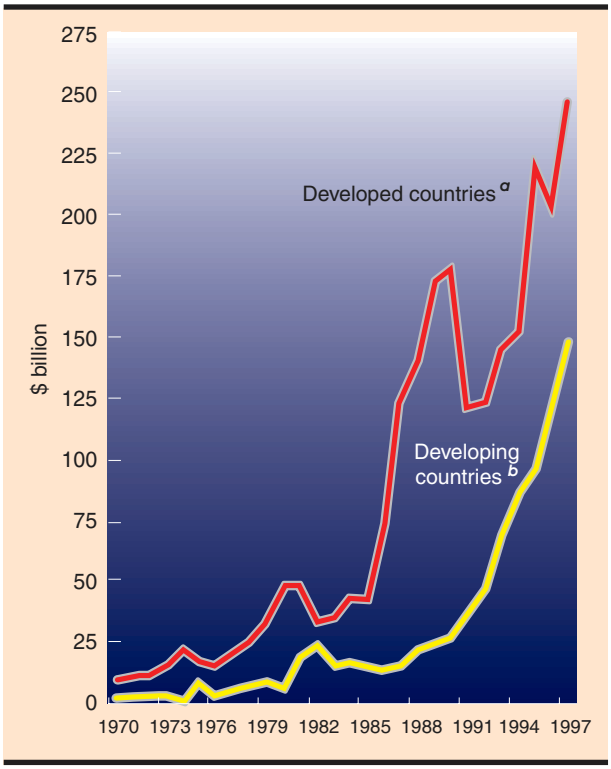
Of about $2,000 billion of net capital inflow in developing countries during 1990–1998, more than $700 billion have been direct investment. The inflow during the 1980s had lagged behind the global surge of FDI which followed the emergence of Japan as a significant source of such investments and the consolidation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

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

Chart 5.10

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

(Billions of dollars)



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

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

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

2. Sources and utilization

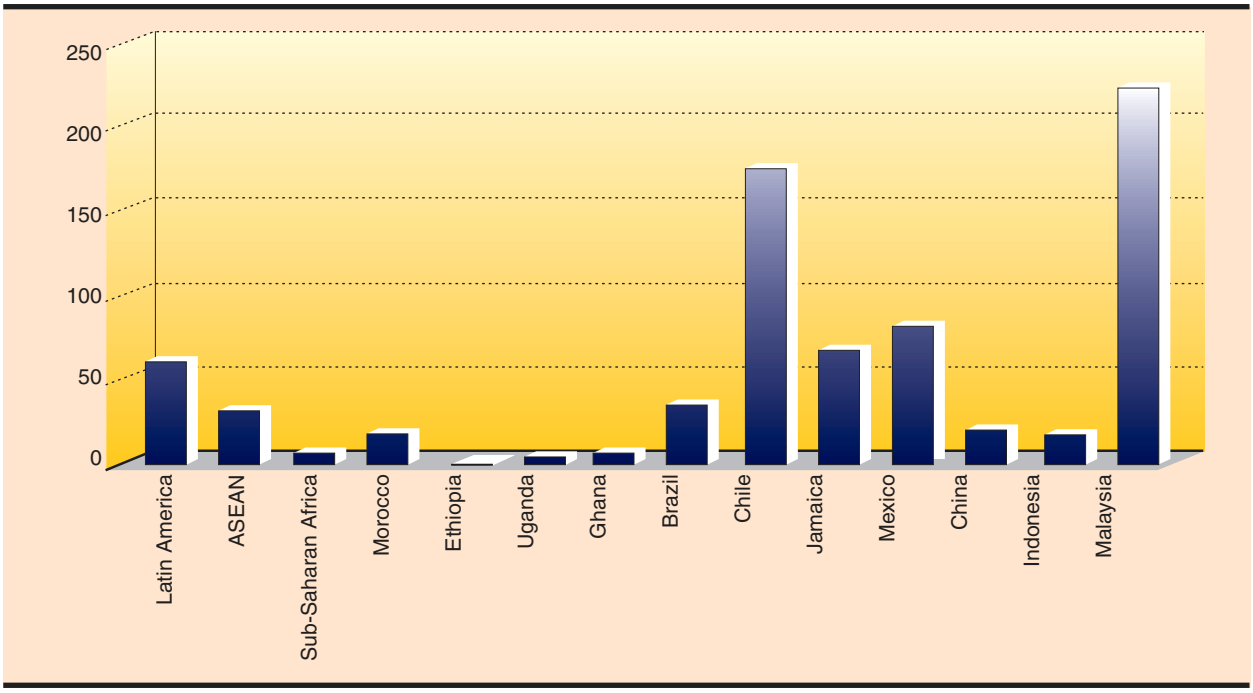
The sources of FDI flows and their utilization have important implications for their stability and sustainability and their contribution to the balance of payments. A distinction is usually made among three different sources of FDI flows: equity capital, undistributed profits, and loans from parent companies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

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

Chart 5.11

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

(Annual average, in dollars)



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

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

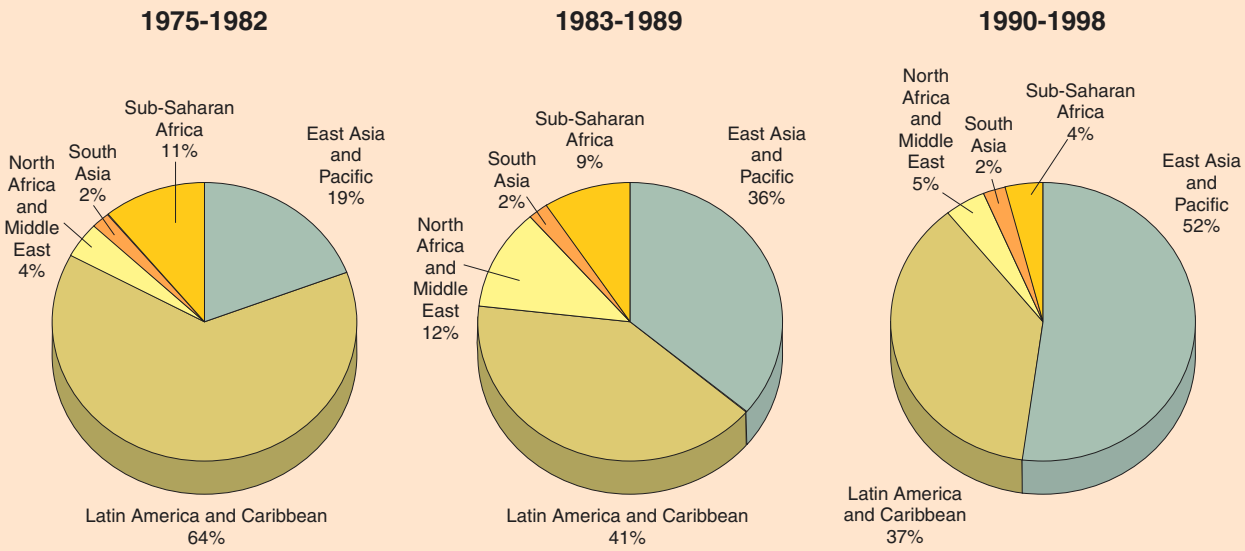
Whether FDI inflows are utilized for mergers and acquisitions (M&A) or for so-called greenfield investment also has an important bearing on their stability and sustainability, and on their balance-of-payments impact. While from a corporate perspective both are additions to productive assets, this is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

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

Chart 5.12

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

(Per cent)



Source and definitions: As for chart 5.1.

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

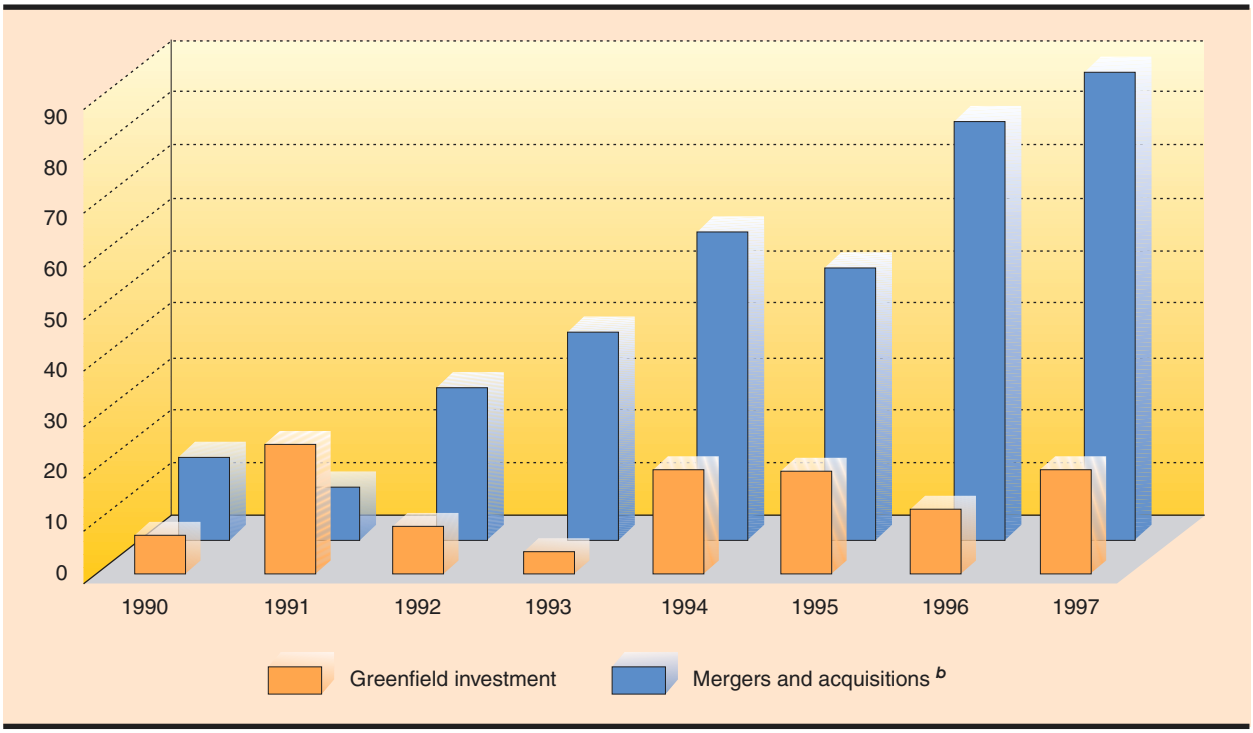
The surge in M&A, especially in the services sector, is closely linked to privatization programmes adopted during the 1990s in which TNCs have often played a prominent role.[27] It can be estimated from World Bank data that during 1990–1997 privatization via foreign investors amounted to 12 per cent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

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

Chart 5.13

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

(Billions of dollars)



Source: UNCTAD, FDI/TNC database.

a Excluding China.

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

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

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

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

Table 5.5

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

(Billions of dollars)[b]

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

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

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

3. Balance-of-payments impact

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

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

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

Table 5.6

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

(Millions of ringgit)

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

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

a Profits and dividends plus rents and royalties.

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

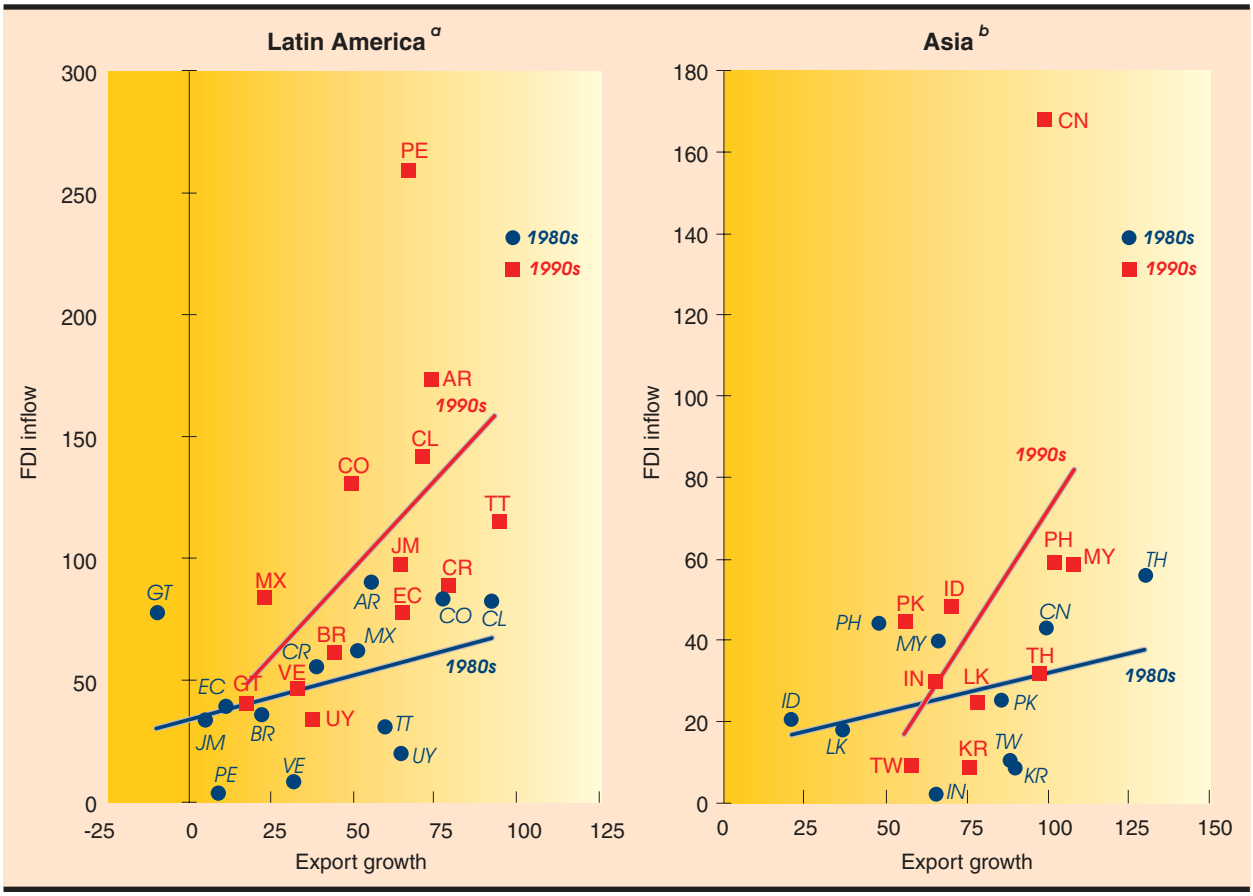
A few country studies are available on the overall payments impact of FDI. They consider export earnings, spending on imports and income payments abroad resulting from the utilization of the existing stock of foreign-owned capital as well as current inflows of FDI and imports of capital goods associated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

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

Chart 5.14

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

(Percentage)



Source: UNCTAD databases.

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

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

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

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

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

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

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

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

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

Notes

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

23 Op. cit.: 2.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Chapter VI

RETHINKING POLICIES FOR DEVELOPMENT

A. Introduction

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

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

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

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

B. Developing countries: managing integration

1. Exchange-rate management

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Establishing competitive industries

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

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

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

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

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

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

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

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

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

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

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

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

3. Fallacies of composition

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

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

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

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

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

1. Beyond the playing-field metaphor

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

(a) Tariffs

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

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

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

Table 6.1

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

(Percentage of tariff lines within each group)

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

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

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

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

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

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

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

(b) Non-tariff measures

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

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

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

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

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

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

2. *Trading opportunities for developing countries*

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

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

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

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

Table 6.2

UNIT LABOUR COSTS IN SELECTED DEVELOPING ECONOMIES AND INDUSTRIES, 1995

(Ratio to the United States level)

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

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

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

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

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

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

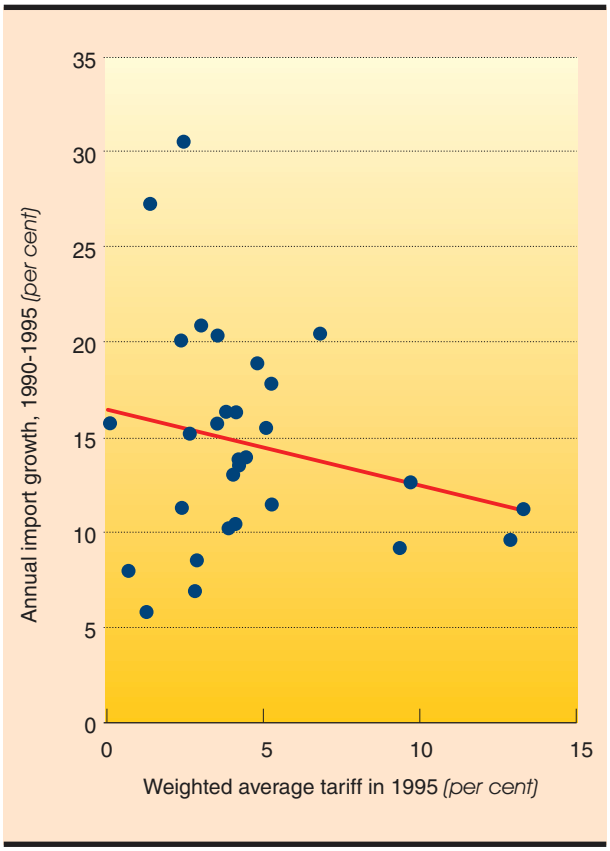
provides a summary of consumption, production and trade data for a number of other low- and medium-skill industries. For most of these industries the share of imports from developing countries in apparent consumption in the North is still very small even though, as shown in table 6.2, developing countries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

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

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

Chart 6.1

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



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

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

Table 6.3

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

(Billions of dollars and per cent)

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

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

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

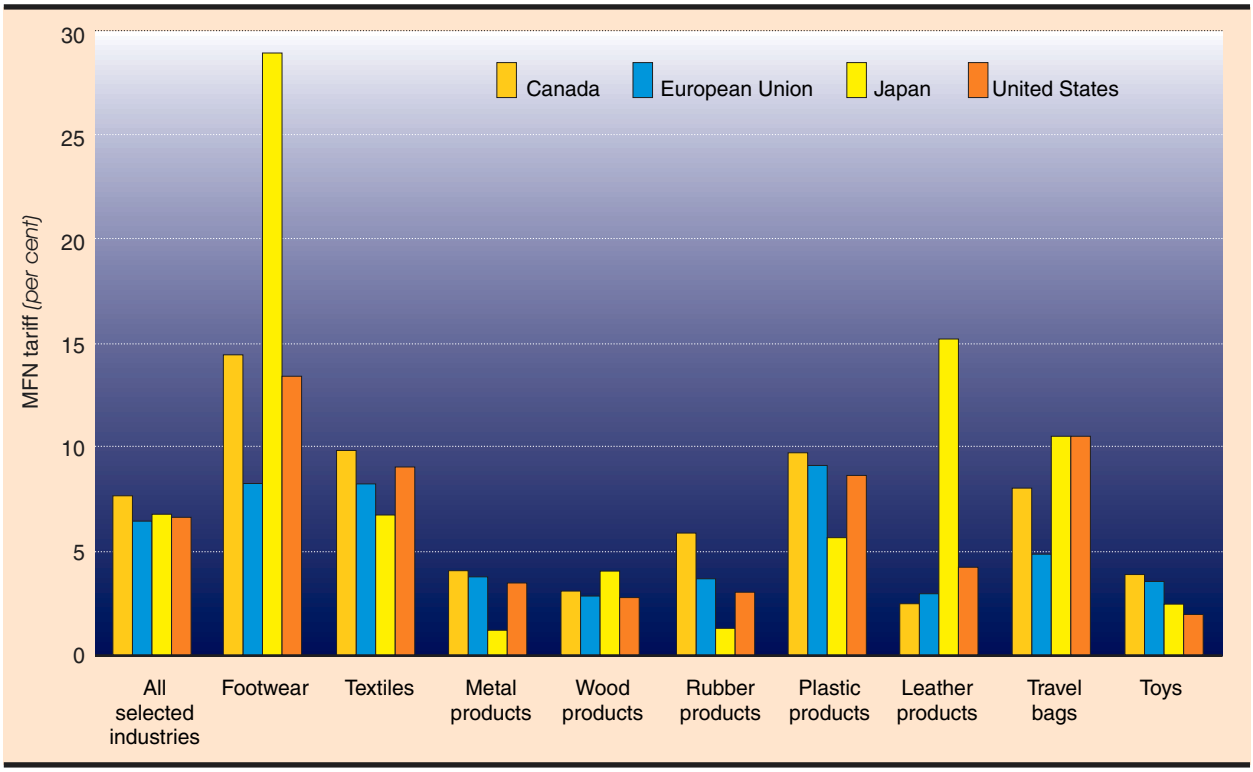
Comparable consumption and production data are not available for leather goods, travel goods and toys and sportswear, but in those sectors, too, a doubling or tripling of exports could be expected, generating increases in annual export earnings of $20–60 billion by the year 2005.

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

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

Chart 6.2

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



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

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

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

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

Table 6.4

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

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

Source: As for table 6.3.

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

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

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

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

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

e 1995–2005.

f Gain over export-value projection in baseline scenario.

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

Table 6.5

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

(Percentage of apparent consumption)

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

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

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

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

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

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

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

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

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

3. Adjustments in the North

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

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

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

Notes

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

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

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

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

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

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

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

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

8 Eichengreen B, op. cit.: 109.

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

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

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

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

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

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

15 Helleiner GK, op. cit.

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

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

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

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

20 Whalley J, op. cit.: 40–44.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

37 Fokker R and Klugkist J, op. cit.

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

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

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

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

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

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

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

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

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

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