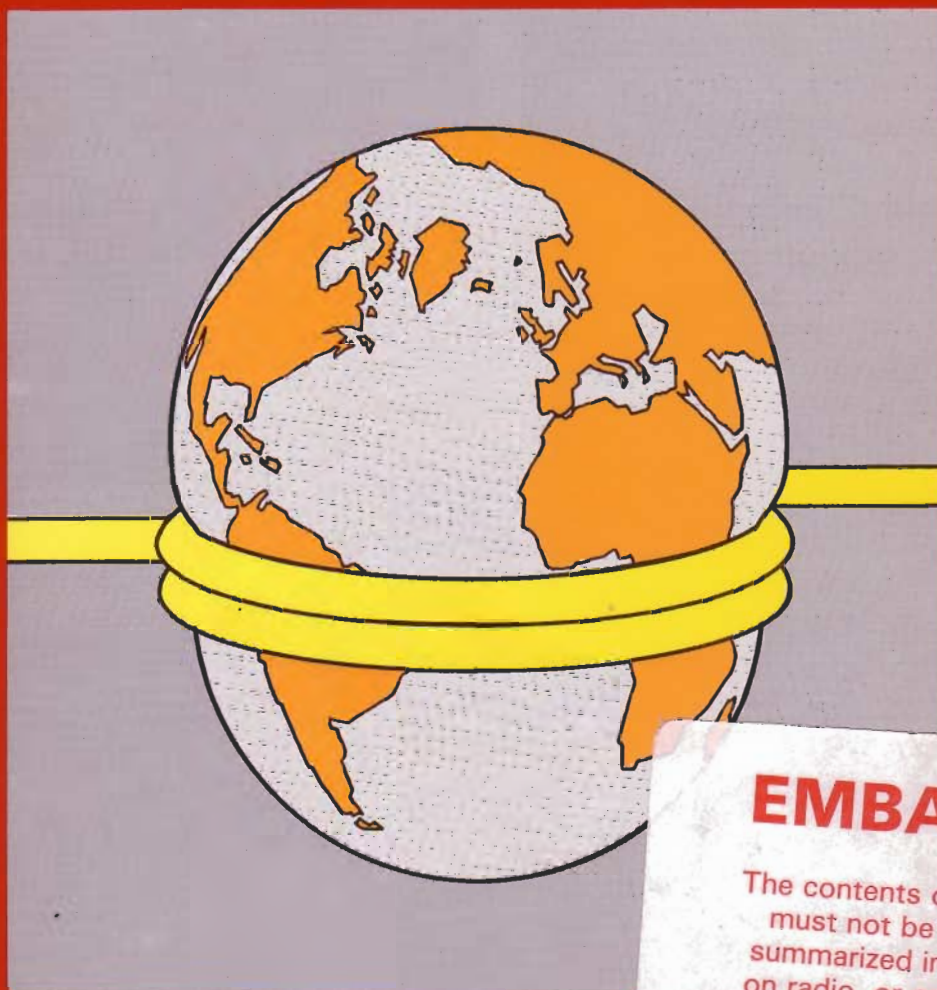


UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# **TRADE AND DEVELOPMENT REPORT, 1986**



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**UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT**

Geneva

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# **Trade and Development Report 1986**

Report by the secretariat  
of the  
United Nations Conference on Trade and Development



UNITED NATIONS  
New York, 1986

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## EXPLANATORY NOTES

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- *Classification of countries and territories*

Unless otherwise indicated, the following classification of countries and territories has been used in this Report. It has been adopted for the purposes of statistical convenience only and does not necessarily imply any judgement concerning the stage of development of a particular country or territory:

*Developed market-economy countries:* Australia; Austria; Belgium; Canada; Denmark; Faeroe Islands; Finland; France; Germany, Federal Republic of; Greece; Iceland; Ireland; Israel; Italy; Japan; Liechtenstein; Luxembourg; Netherlands; New Zealand; Norway; Portugal; South Africa; Spain; Sweden; Switzerland; United Kingdom; United States.

*Socialist countries of Eastern Europe:* Albania, Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Romania, USSR.

*Socialist countries of Asia:* China, Democratic People's Republic of Korea, Mongolia.

*Developing countries and territories:* All other countries and territories not specified above.

Generally speaking, sub-groupings within geographical regions and analytical groupings are those used in the UNCTAD *Handbook of International Trade and Development Statistics, Supplement 1985*.\*

*Latin America* corresponds to the *Handbook* grouping "Developing America" and thus includes the Caribbean countries.

*South Asia* includes Afghanistan, Bangladesh, Burma, India, Nepal, Pakistan, Sri Lanka and *East Asia* includes all other countries in *South and South-East Asia* as well as countries in *Oceania*. In general, data for the People's Republic of China exclude Taiwan Province.

*Major exporters of manufactures are:* Argentina, Brazil, Republic of Korea, Singapore, Yugoslavia, Hong Kong and Taiwan Province of China.

- *Other notes*

In the tables and in the text: references to "countries" are to countries, territories or areas as appropriate.

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

The term "billion" signifies 1,000 million.

Annual rates of growth and change refer to compound rates.

Exports are valued f.o.b. and imports c.i.f., unless otherwise specified.

Use of a hyphen (-) between dates representing years, e.g. 1965-1966, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 1980/1981, signifies a fiscal or crop year.

One dot (.) indicates that the data are not applicable.

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

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

A plus sign (+) before a figure indicates an increase; a minus sign (-) before a figure indicates a decrease. Details and percentages do not necessarily add up to totals, owing to rounding.

Except where otherwise specified, figures in brackets are estimates.

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\* United Nations publication, Sales No. E/F.85.II.D.12.

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**ABBREVIATIONS**


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<b>BIS</b>	Bank for International Settlements
<b>CCC</b>	Commodity Credit Corporation (of the United States)
<b>CCCN</b>	Customs Co-operation Council Nomenclature
<b>CEPAL</b>	Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe)
<b>c.i.f.</b>	cost, insurance and freight
<b>CMEA</b>	Council for Mutual Economic Assistance
<b>DAC</b>	Development Assistance Committee (of OECD)
<b>DMEC</b>	developed market-economy country
<b>ECAs</b>	Export credit agencies
<b>ECE</b>	Economic Commission for Europe
<b>ECU</b>	European currency unit
<b>EEC</b>	European Economic Community
<b>ESCAP</b>	Economic and Social Commission for Asia and the Pacific
<b>FAO</b>	Food and Agriculture Organization of the United Nations
<b>FCS</b>	Farm Credit System (of the United States)
<b>f.o.b.</b>	free on board
<b>GATT</b>	General Agreement on Tariffs and Trade
<b>GDP</b>	gross domestic product
<b>GNP</b>	gross national product
<b>GSP</b>	generalized system of preferences
<b>ILO</b>	International Labour Office
<b>IMF</b>	International Monetary Fund
<b>LIBOR</b>	London Inter-Bank Offered Rate
<b>MFA</b>	Multifibre Arrangement
<b>NAIRU</b>	Non-accelerating inflation rate of unemployment
<b>NGLs</b>	Natural gas liquids
<b>NIF</b>	Note Issuance Facility
<b>NMP</b>	net material product
<b>NTBs</b>	non-tariff barriers
<b>NTMs</b>	non-tariff measures
<b>ODA</b>	official development assistance
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>OPEC</b>	Organization of the Petroleum Exporting Countries
<b>PCA</b>	Production Credit Association
<b>PDE</b>	Producers' durable equipment
<b>RUF</b>	Revolving Underwriting Facility
<b>SITC</b>	Standard International Trade Classification (revision 1)
<b>UNCTAD</b>	United Nations Conference on Trade and Development
<b>UNDP</b>	United Nations Development Programme
<b>UNICEF</b>	United Nations Children's Fund (originally United Nations International Children's Emergency Fund)
<b>USDA</b>	United States Department of Agriculture
<b>VERs</b>	voluntary export restraints

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**Overview**  
**by**  
**the Secretary-General of UNCTAD**

If stagflation, plentiful liquidity and shortages of basic materials were the hallmarks of the 1970s, those of the 1980s have thus far been deflation, financial stringency and glutted markets. The process of deflation began in 1979, but did not stop with the end of the recession in 1982. It has persisted, rendering recovery weak, uneven and hesitant, and prolonging the crisis of debt and development.

The defeat of inflation is a major achievement. But there is growing realization in many quarters - in particular those involved in practical affairs - that the mixture of demand weakness and financial tightness that has characterized the past has now become a menace to stability. It is sapping the vitality of much of the world economy - the developing countries in particular - and eroding the fabric of international trade and finance, leaving in its trail widespread unemployment, slack, protectionism and insolvency. It constitutes an increasingly stubborn drag on growth, development and stability. The longer the turn towards expansion is delayed, the more structural and hence intractable will these maladjustments become.

This year's issue of the Trade and Development Report focuses on the dynamics of the deflationary process. It examines why, where and how it was set in motion, the various channels through which it has spread, the sectors of the world economy that it has permeated, its impact on trade policy and financial viability, and - above all - its consequences for development.

Its central message is that deflationary forces now constitute the single most pervasive threat to world prosperity. They are, no less, the single most important impediment standing in the way of efforts to restructure national economies and international economic relationships. It is therefore imperative that the emerging willingness to engage in policy co-ordination be strengthened and directed toward the revitalization of growth and development.

## The world economic situation and the continuing crisis of development

---

*Last year's issue of the Trade and Development Report emphasized the need to tackle the problems of the external environment of developing countries and of uneven recovery in developed market economies simultaneously. Recovery has become less uneven since then - but because growth rates have been levelled down, instead of up. This has caused the trading environment of developing countries to deteriorate further. Another notable change is the intensification of the debt-and-development crisis of many energy-exporting developing countries.*

In the developed market economies, the pace of inflation has continued to abate, and is now slower than at any time in the past two decades: in some countries, the price level is actually falling in absolute terms. Moreover, growth rates have become less uneven. However, this has come about through a decline in the overall rhythm of growth and investment: the United States economy has decelerated sharply while other developed market economies have remained sluggish.

In the socialist countries of Eastern Europe growth was also lower in 1985. In China output accelerated at an exceptionally rapid pace.

After the respite of 1984, the deflationary pressures on developing countries have once more been gaining the upper hand. The world economy slowed from a 4.2 per cent growth rate in 1984 to one of 2.9 per cent in 1985. Real non-oil commodity prices as a whole have fallen back to the lowest level since the Great Depression (despite a jump in coffee prices). Real oil prices are down to the level prevailing before their rise in December 1973. The collapses in oil and tin prices are the latest manifestation of deflation. The export volume of developing countries is stagnant. The pace of net bank lending to developing countries has picked up a little, but remains slow. Interest rates have fallen by 2 1/2 percentage points, implying a saving of some \$13 billion on debt service. This seems large, but not when compared to the over \$50 billion loss from the deterioration of the terms of trade, deceleration of export volume growth, and drop in earnings on official reserves that took place in 1985.

Growth in developing countries dropped from 2.5 per cent in 1984 to 2 per cent in 1985 - i.e. less than the growth of population - as import volume contracted. Some economies (such as India and Brazil) have managed to register healthy growth rates, and output in Sub-Saharan Africa has ceased to fall, thanks to the end of the drought. But several East Asian economies that had grown rapidly in 1984 are flagging, and most other developing countries remain depressed.

The development crisis has thus been prolonged and deepened further. Large parts of the developing world are still registering regression rather than advance, with falling levels of per capita output and consumption as well as depressed levels of investment. In many countries unemployment is high, living standards are declining and social services are being cut, often at the expense of health and education. Some countries have made impressive gains on the inflation front, but financial instability remains an acute problem in many countries.

International trade and financial relations have also become increasingly strained.

Exporters are struggling to preserve their shares of shrinking markets in the face of new and often unexpected competitors. Over the past year the reliance on contingency measures of protection (such as emergency action, anti-dumping and countervailing duties) continued, with exports from developing countries being a frequent target. Preferential access for certain developing countries under the GSP has been somewhat reduced. Export-subsidy competition in agricultural trade has intensified between the European Economic Community and the United States. There is palpable lack of respect for the rules and principles of the multilateral trading system, manifested most clearly in an impatience with and lack of confidence in the dispute settlement mechanisms of the GATT. Trade retaliation has become more prevalent and more quickly applied. Although Governments have managed to avoid the passage of blatantly protectionist legislation, this has been done at the expense of convincing the electorate of their willingness to adopt a more aggressive attitude vis-à-vis the "unfair" measures of their trading partners. Reciprocity is now being applied in a much more bilateral context, with little regard to earlier commitments in favour of developing countries. At the same time, access to markets is being used to extract concessions in non-trade areas. It is against this background that discussions continue toward the initiation of a new round of multilateral trade negotiations.

Relations between certain troubled debtor countries and their creditors have also

deteriorated. A number of debtor countries have hardened their positions with regard to conditionality. A few have taken unilateral action to bring their debt service payments more closely in line with their debt servicing capacities, and the spectre of such action has come to be an ingredient in other debtor-creditor relations. Latin American countries have intensified their joint efforts to improve their bargaining position. On the other hand, the need to revive growth in debtor countries has become accepted, and creditor Governments have displayed a renewed determination to step up the level of "involuntary" lending by banks, albeit by relatively modest amounts and then only in conjunction with radical policy reforms on the part of debtors. Nevertheless, the sharp deterioration of the position of several debtors dependent on energy exports has put in question the practicality of present approaches.

The performance of numerous economies will be altered by the collapse of oil prices, and by the decline of the dollar and the United States budget cuts in prospect. However, the combined impact of these factors is unlikely to raise the momentum of growth in the world economy.

The dollar's fall is deflecting home and foreign demand on to the United States, but fiscal restraint will slow that country's pace of demand creation. The net impact on expenditure in the United States will therefore be modest. However, the degree of stimulus transmitted from the United States to other developed countries (Japan especially) will diminish considerably or turn negative: the fall of the dollar is already deflating the Japanese economy. The depreciation of the dollar is improving the price performance of other developed market economies by lowering their import costs, while the oil price fall is having that effect for all oil importers. For many developing countries the cheaper dollar would mean firmer commodity prices if the slowing of United States import demand were counter-balanced by faster import growth in other developed countries - something that is not happening.

Among the developing countries there are many more gainers than losers from the oil price decline. But, taken as a whole, developing countries are net oil exporters and will lose \$50 billion in net export revenues in 1986. Net oil-exporting developing countries will resort to some combination of reserve use, borrowing or running down asset holdings, and import reduction, while the oil-importing developing countries will build up reserves, or reduce arrears and borrowing, or increase imports. For individual countries, it is the behaviour of im-

port volume that will indicate the extent of the contractionary or expansionary impact on the home economy and on trading partners. The imports of developing countries taken as a whole will decline: indeed, they are already doing so.

The overall impact of lower oil prices on activity levels in developed countries will depend critically on (a) the extent of the import reduction by developing countries and (b) the extent of the increased expenditure by those within OECD countries that are benefiting from the lower oil price compared to the expenditure reduction of those losing from it. Inasmuch as the beneficiaries choose to lessen their borrowing, repay debt or accumulate assets, rather than increase expenditure, the growth of output will be dampened. Meanwhile, investments and other spending by energy and related sectors are being cut. Moreover, some central or local governments in energy-producing regions are seeking to compensate for falling oil (or oil-related) revenues by reducing expenditures or raising taxes. This, together with the import reduction of developing countries, is a contractionary influence.

The strengths and timing of these various expansionary and contractionary tendencies are hard to estimate. It is also difficult to foresee what the policy responses to them will be. For instance, the import behaviour of developing countries will depend partly on how they judge their own prospects and how creditworthy banks judge them to be: thus, the oil exporting countries' choices on the extent and timing of import cuts will be influenced by their views on prospects for strengthening oil prices. It is also none too clear how oil exporting developed countries will alter their monetary and fiscal policies.

There is no precedent for the precipitous decline in oil prices that has occurred, and so no forecast can command much confidence. Nevertheless, while it is clear that inflation in developed market economies will be lower in 1986, no significant increase in the tempo of growth is in sight: world economic growth is expected to remain roughly unchanged at 3 per cent.

Our estimate (made in June) is that developed market economies will grow by 2.8 per cent - the same as last year, and considerably lower than their growth potential - with some rebound in the United States but a slowing in Japan following the loss of export dynamism. Western Europe is expected to continue to grow slowly (though somewhat less slowly than at present) and without making a significant

dent in unemployment. But there is a downside risk: this estimate is based on relatively conservative assumptions regarding the contractionary tendencies stemming from the oil price fall, and on an expectation that policies in Western Europe and Japan will undergo some relaxation.

Growth in the socialist countries of Eastern Europe is forecast to rise significantly. China is expected to keep growing rapidly, but at a slower (and more sustainable) pace.

The performance of developing countries will continue to be uneven, largely reflecting the differences in the degree of external pressure upon them. Oil-exporting countries are under severe strain, with some of them encountering acute debt servicing difficulties. The terms of trade of many exporters of other primary commodities have improved in the course of this year, but are expected to deteriorate once again as non-oil commodity prices soften relative to those of manufactures; however, export volume

is expected to pick up a little. Interest rates are forecast to decline a little more; but the prospects for a strong revival of bank lending still seem poor. Oil-exporting developing countries are likely to contract and East Asian countries to resume their growth though at a much slower pace than before. Little change is expected in South Asia and in non-oil exporting African countries while growth in non-oil-exporting Latin American countries is expected to slow.

The conclusion to be drawn is that deflationary forces are the prime threat. Moreover, the financing and adjustment problems confronting energy-exporting developing countries with large debts are now extremely severe, heightening the risk of disruption of relations with creditors. Furthermore, the improvement of the external environment required to permit a revival of development in developing countries is not under way. Yet another year of the Third United Nations Development Decade is thus being lost.

### **Macro-economic policies and world economic performance**

---

*The strength of the deflationary currents moving through the world economy and depressing development can only be appreciated by beginning the story with the sea-change in the international economy that occurred at the end of the 1970s.*

#### ***The shift of policy***

Major OECD countries decided in the final years of the last decade to give top priority to combating inflation, which had reached intolerable proportions, and to reducing the role of the public sector in the economy. Strict control was henceforth to be exercised on the money supply, regardless of the impact on interest rates, while fiscal policy was to be geared towards releasing resources to the private sector by means of cuts in government civilian expenditures. Furthermore, market forces were to be given a much greater role in the allocation of real financial resources.

It was held that this approach would cause only slight and temporary damage to output and employment, while serving over the long term to accelerate non-inflationary growth by improving efficiency, strengthening confidence, and unleashing the private sector's potential for expansion.

It was also believed that, if each country's policies converged in this direction, deliberate co-ordination among them would be unnecessary: global demand would adjust itself to global supply capabilities, while exchange rates

would float in such a way as to avoid and correct imbalances. Consequently, the policy challenge was viewed as being primarily national, with global equilibrium flowing naturally from each country's "putting its house in order".

The macro-economic policies pursued by the major market economies in the 1980s have been broadly in line with the new orthodoxy. Monetary policies have on the whole been restrictive, and generally based on targeting the monetary aggregates; civilian government expenditures have also been tightly controlled, and budget deficits have been cut as a proportion of GNP. There were two conspicuous exceptions. France pursued an expansionary policy in the early years of the decade - but had to replace it with austerity, since its major trading partners did not follow suit. In the United States, budget deficits have increased extremely rapidly. However, the tax cuts that were largely responsible for these imbalances were made not to reflate the economy but to reduce tax burdens (which were expected to strengthen incentives to supply, thereby enlarging the tax base and minimizing the loss of tax revenue) and with the intention of eventually curbing any remaining deficit by means of



expenditure cuts: that process has now been initiated.

Governments have also sought to enlarge the scope for market forces in an effort to reduce distortions and rigidities. The pace of liberalization and deregulation in financial markets has quickened. Changes sought with respect to privatization and labour markets, while not absent, have naturally been slower.

### *Impact on the world economy*

The new direction given to macro-economic policy has accomplished its prime objective of bringing down the rate of price inflation in the OECD area. The rate of increase in the consumer price index has dropped from almost 13 per cent in 1980 to 4-1/2 per cent in 1985, and an even lower rate is in prospect for 1986.

However, the impact of the new policy thrust on the real side of the world economy has not been in line with expectations.

- It has triggered the steepest and longest recession of the post-war period. Recovery began in 1983, but it has on the whole been relatively slow. In many countries, recovery has not advanced sufficiently to reduce the gaps between actual and potential levels of output and employment. Moreover, the rate of growth of productive capacity has been sluggish.
- Growth in developing countries disappeared in 1982-1983, implying a sharp contraction of per capita output. Output began to recover in 1984, but for the most part growth rates remained weak. Over 1980-1984 growth averaged less than 1 per cent, compared to 5 1/2 per cent in the preceding 5 years. The number of countries experiencing stagnation or decline has more than doubled.
- The OECD slowdown was accompanied by a jump in the unemployment rate. In Western Europe the jobless rate rose even after the recovery had begun, to reach a record 11 per cent in 1985. Most developing countries have experienced an even steeper increase in unemployment. The number of open urban unemployed increased by more than 70 per cent in Latin America, and disguised unemployment also rose sharply in Africa and Latin America.
- The growth of the volume of private investment in the OECD fell steeply in the recession, and as a share of GNP has remained around 10 per cent below its 1978-1979 level. Capital accumulation has been severely damaged in developing countries. Its level grew at an annual rate of almost 3 per cent in 1978-1980, stagnated in 1981, and fell by over 3 per cent per annum during 1982 and 1983. During 1981-1983 gross domestic investment plunged by over 30 per cent in Latin American countries, and only a slight recovery was registered in 1984 and 1985. Investment in Africa fell throughout the period 1982-1985.
- The volume of exports of developing countries fell by almost 7 per cent annually during the 1980-1982 downturn, but picked up to post an increase of 3.8 per cent per year in 1983-1984, due mainly to the export growth attained by non-oil developing countries during the United States recovery. However, that recovery failed to improve their terms of trade, which had deteriorated sharply in 1980-1982. Oil-exporting developing countries experienced a sharp terms-of-trade improvement up to 1982, but it has now been more than reversed.
- The world economic downturn has triggered an international debt crisis. As export markets weakened and interest rates escalated, a precipitous decline of bank lending took place. Such lending to most developing countries has been largely "involuntary" since 1983, and has consisted in large part of rescheduling existing debts. In some countries, interest payments have come to exceed net capital inflows by sizable amounts.

## The interdependence of countries and markets

*The practical outcome of the policies of major countries is shaped by the various mechanisms that link different countries and markets with one another, and which therefore serve to transmit changes in activity levels and monetary conditions across geographical areas and spheres of economic activity. In the 1980s countries' policies, on the whole, have been framed without regard to their international consequences. However, the structure of interdependence, both among countries and among the monetary, financial and trading systems (including the world commodity economy), has played a key role in determining the performance of individual countries and of the world economy at large.*

The world economy is now so highly integrated that national economic performance with respect to activity levels, inflation, external balances, etc. is very sensitive to changes in external conditions and exchange rates.

In most countries, a substantial share of home output is being absorbed by foreign demand, and a substantial share of home demand is being satisfied by imports. Even so, countries continue to differ considerably in the extent of their own foreign trade exposure and in the degree to which other economies are exposed to them: in particular, the United States is still both more self-reliant than others (though much less so than, say, two decades ago) and more able to affect the performance of other economies. Countries also continue to differ in the nature of their foreign trade dependence, with many developing countries being especially vulnerable because of their continued dependence on commodities.

Most countries are now also much more tightly linked than in the past through monetary and financial relations. As the main money and capital markets have become more closely integrated, capital has become highly mobile across frontiers and this has made it difficult for countries with open capital markets to both control their exchange rate and pursue autonomous monetary policies. It had been expected that, left to float, exchange rates would move in line with underlying rates of inflation and productivity. But, in practice, monetary and speculative factors rather than the "fundamentals" have often been the driving force. Instead of giving countries greater autonomy by protecting them against monetary and financial conditions abroad, floating has merely changed the channel of international transmission.

External indebtedness provides another important form of linkage. For one thing, the debt servicing capacity of developing countries is affected by the relative prices of their exports and imports. For another, those developing countries that have borrowed heavily from capital markets have become directly exposed to swings in world interest rates. Their vulnerability has been accentuated by their depend-

ence on bank lending, which has behaved in a pro-cyclical and spasmodic manner. The strength of the various financial linkages, and other factors such as the setting of oil prices in dollars, has increased the role of the dollar, and added to the importance of monetary and financial conditions in the United States.

Differences in the ways prices of different types of internationally traded goods are formed are also important. Since prices of most primary products fluctuate in response to market conditions more widely than do those of manufactures, the real incomes of primary producers are particularly vulnerable to changes in the pressure of world demand. Furthermore, since the viability of price-maintenance arrangements depends on the availability of adequate finance, the few "fix-price" primary sectors are vulnerable to prolonged cash-flow difficulties (as well as to other things such as shifting patterns of production and consumption). Finally, the fact that prices of certain goods are sticky while other prices are flexible serves to shift the burden of swings in demand onto the quantity of output where prices are sticky (e.g. manufactures and, until recently, oil), and on the real incomes of producers where prices are flexible.

Developed and developing countries are also linked in various other ways. The flow of exports from developed to developing countries (and among the latter) is vulnerable to contractions of developing countries' import capacity (for instance, as a result of falling commodity earnings and flows of bank lending, and rising interest rates). Secondly, commodity price movements represent a potential source of inflationary or disinflationary pressure on importing countries. Thirdly, the exposure of banks to developing countries makes them, and hence the international financial system, vulnerable to deteriorations in the latter's external accounts.

A domestic factor which has been little-noticed until recently but which has for some years been of potentially major international significance, is the large and chronic gap that emerged in the 1970s between the propensity to save and the willingness to invest domestically

of Japan's private sector. In any country, such a gap must be filled either domestically, via public sector borrowing and spending, or internationally, via external deficits and debt accumulation by other countries; otherwise, it removes itself by depressing home incomes and output. For a large economy, choosing between the trade-surplus and domestic-depression options has major international repercussions.

### *Deflation, convergence and transmission*

In the early years of the quinquennium, the overall fiscal stance of OECD was strongly deflationary, as was monetary policy. Convergence of policies in the direction of restrictiveness caused not only the recession and unemployment of each to be transmitted in part to other countries, but also the recession and unemployment of all to be greater than each had expected. Focusing attention narrowly on "putting one's house in order" thus resulted in the deflation being more acute than had been intended.

The impact on the export earnings of developing countries was especially harsh, for the terms of trade deteriorated sharply with the collapse of commodity prices. Since strict monetary discipline served as the cornerstone of the new direction of macro-economic policy, a very sharp rise in interest rates took place, which swelled the interest bill of developing countries indebted to capital markets. Thus, to the deterioration of the trade balance was added a deterioration of the balance on services account. Moreover, withdrawal of bank lending superimposed a deterioration on capital account upon the deterioration on current account.

The deflationary policies adopted by developing countries in an effort to curtail their external deficits served not only to depress their own output and investment, but also to accentuate the recession and unemployment of developed countries.

By amplifying the impact of the restrictive monetary and fiscal policies of the OECD countries, the pro-cyclical behaviour of commodity prices, of the interest bill and of bank lending acted as automatic destabilizers, reinforcing rather than dampening cyclical movements for both the developing countries and the world economy at large. This, too, had not been anticipated by the major market economies in charting their new course.

### *Divergence, recovery and imbalances*

The recovery in the OECD countries that began in late 1982 stemmed largely from a change of the overall fiscal stance in an expansionary direction, rather than from a spontaneous increase in private sector spending. United States fiscal policy underwent a major shift as large cuts were made in personal and corporate taxes; civilian expenditure was cut, while arms expenditures rose significantly. Although this policy was not designed with reflation in mind, it nevertheless succeeded in achieving that by injecting demand into the economy. United States monetary policy was also relaxed somewhat, but the monetary authorities failed to expand the supply of money in line with the increased demand for it stemming from recovery and from the financial deregulation that had been taking place. Real interest rates therefore strengthened. United States interest rates also rose relative to those in other major financial centres, triggering an appreciation of the dollar, which received further fuel from a speculative bandwagon.

Western Europe and Japan followed (and still follow) medium-term strategies with an overriding emphasis on financial objectives, in particular the reduction of inflation and of government spending and borrowing. In contrast to the United States, there was a sharp fall in the ratio of structural budget deficits to the national income of these countries taken together: the Federal Republic of Germany, the United Kingdom and Japan were registering structural surpluses in 1985. In many of these countries, the monetary targets set would have been compatible with output growth only in the context of extraordinarily rapid disinflation.

These two sets of policy disparities - expansionary fiscal and restrictive monetary policies pursued by the United States and the overall expansionary stance of the United States and the overall contractionary stance of other major market economies - largely governed the performance of the world economy and the external environment of the developing countries in 1983-1985.

These disparities interacted to bring about a massive deterioration of the United States trade balance. The fiscal stance of the United States was expanding demand while the stance of others was reducing it. At the same time, the stronger dollar was causing an extraordinarily high proportion of the stimulus to be transmitted to other major market economies (especially Japan), and of the demand de-

iciency of the latter (especially Japan) to be transmitted to the United States.

Consequently, United States output lagged behind demand. For Japan, whose main export outlet was the United States the opposite happened. The massive improvement of the trade balance allowed the gap between the Japanese private sector's propensity to save and its willingness to invest not to bear down on domestic activity, as it otherwise would have now that the Japanese public sector was no longer willing to absorb it as in the 1970s. The growth of the Japanese economy thus became dependent on running large trade surpluses with other countries rather than on government deficits. Indeed, the growth of net exports helped to reduce Japan's budget deficit and to maintain savings by sustaining incomes. It was possible for budget deficits to be greatly reduced without causing depression and unemployment, thanks largely to the United States policy mix and the willingness of currency markets to push up the dollar notwithstanding the growing United States trade deficit.

The worsening of the United States trade balance served to lower incomes and hence savings, and to add to the fiscal deficit. It also worsened the net asset position of the country. High interest rates also caused the interest bill of the public sector to swell: as much as 40 per cent of the cumulative structural federal budget deficits over 1980-1985 can be said to have stemmed from the rise in interest rates. The dollar appreciation put deflationary pressures on the export and import-competing manufacturing industries and prevented them from sharing in the recovery. It also depressed agricultural prices, while farmers were being hit directly by higher interest rates: acute distress, including widespread bankruptcies and foreclosures, followed. Thus, the two sets of policy disparities manifested themselves in lop-sided growth within the United States economy itself.

Unlike Japan, the restriction of domestic demand in Western Europe was not appreciably counter-balanced by a diversion of output to foreign markets: while much of the output growth that took place in 1984 stemmed, directly or indirectly, from the United States recovery, the growth was itself small. Instead, the reduction of home demand found its counterpart mostly in a rise in unemployment. But, part of it inevitably fell onto Western Europe's trading partners, including developing countries, in the form of depressed commodity prices.

The persistence of slow growth in Western Europe over so many years led firms to cease hoarding labour (as they would have done had the slowdown been short-lived), and

to undertake extensive industrial restructuring and rationalization, including the shutting down and scrapping of the less productive portions of the capital stock. The level of investment also continued to be low. Joblessness thus escalated, and since the capital stock did not expand much because demand was weak, the structural component of unemployment rose. These factors, together with the pressure on business profits stemming from slow growth and high interest rates, caused attention to be focused on the structure of labour markets. Structural factors, such as real-wage rigidities and impediments to labour mobility, were viewed as the principal causes of unemployment.

The deterioration in the United States trade balance reflected not only disparities among OECD countries in the pace of demand growth and the appreciation of the dollar, but also the sharp reduction of imports of developing countries brought about in order to cover lower export earnings and reduced net flows of financial resources. As the interest bill rose and net new lending fell, the balance between the two for capital importing developing countries deteriorated abruptly, falling from around \$50 billion in 1980 to around -\$25 billion in 1985, a swing of \$75 billion. In some debtor countries, the trade surplus rose to reach a higher figure in proportion to GDP than Japan's. The developing countries' trade balance improvement was, like Japan's, deflationary for other countries. But, unlike Japan's, it was deflationary for the domestic economy as well.

The recovery in the OECD area made it somewhat easier for developing countries to improve their trade balance. However, the overall pace of the recovery was weak: the 1979 level of manufacturing output in the OECD was not surpassed until the end of 1983 and its subsequent growth was modest. This was one reason why commodity prices remained depressed. Another was the effort of developing countries to increase (or at least maintain) the volume of traditional exports. A third was that much of the capital equipment left underutilized or scrapped in the course of the recession was relatively intensive in raw material use. The slowness of the recovery of Western Europe, which is more reliant on imports for its commodities than is the United States, and the appreciation of the dollar also made significant contributions to the weakness of commodity prices.

For these reasons, and because OECD recovery was accompanied by a rise in real interest rates and a continued low level of bank lending, both the participation of the developing countries in the world recovery and their contribution to it via import growth proved to

be very modest. The crisis triggered by the recession was thus prolonged.

### *Activity levels, exchange rate misalignment and protectionism*

The consequences of the mix and stance of macro-economic policies also made themselves felt in the trade policies pursued by Governments. Notwithstanding the increased stress placed by them on the need to remove distortions and structural rigidities, the 1980-1982 recession was accompanied by widespread and sharp increases in the number of trade restricting measures.

However, the subsequent recovery brought no general roll-back of protectionism, despite the commitments made in GATT and UNCTAD in this regard. This may be explained by the fact that the country in which the recovery was concentrated, namely the United States, experienced a sharp currency appreciation which, as already mentioned, subjected its import-competing industries to intense competition from other industrialized countries. At the same time, developing countries, in particular debtors, were intensifying their export efforts. These were naturally concentrated on the United States, whose market was growing fastest and whose currency was now worth more.

On the other hand, in Western Europe recovery remained too weak, and therefore unemployment too high, to induce a roll-back, notwithstanding the currency depreciation. Protectionism facing developing countries therefore remained high. Trade restrictions in developing countries also increased, because of balance-of-payments pressures.

In the United States, the strength of foreign competition eventually led to a mushrooming of protectionist pressures: by 1985 there were over 400 trade bills in the United States Congress. Although the United States administration provided considerable resistance to these pressures, there was, nevertheless, a proliferation of trade actions.

The persistent weaknesses of the world economy have caused sector specific and bilateral tensions to intensify. This is true of relations both among developed countries - notably among Japan, the United States, and the European Community - and between the developing and developed countries. Fundamental conflicts have arisen about the respective rights and obligations of developed and

developing countries within the multilateral trading system, for example in regard to the use of "voluntary export restraints", "equivalent market opportunity", "unfair" measures, the status of GSP commitments, the application of "safeguards" for balance-of-payments purposes and the external effects of the common agricultural policy of the European Community. The negative consequences of protectionist measures will become more evident as they begin to adversely affect the rate and allocation of new investment, and thus the pace and efficiency of economic growth in the future.

### *Commodity prices, exchange rates and disinflation*

The new direction of macro-economic policies owed much of its success in overcoming inflation to the downward pressure it put on prices of imported primary commodities (including oil). For the OECD taken as a whole, more than half of the fall in the rate of increase in consumer prices between 1980-1984 can be said to have stemmed from that source. Most of this disinflationary bonus was paid for by developing countries.

The dollar appreciation offset part of that impact on Europe and Japan, and reinforced it in the United States. So did the relative flexibility of domestically produced commodity prices in the United States, and the rigidity of domestic food prices in Europe. These factors lessened the burden of disinflation on industrial wages, employment and profits in the United States - except in the foreign-trade industries, which the currency appreciation hit hard. The story for Western Europe was the reverse. In Japan, external factors and wage moderation together made a sufficiently large contribution both to allow disinflation to take place and to prop up profit margins.

The world commodity economy took much of the brunt of the combination of weak demand and high real interest rates. The burden of adjustment within the commodity economy was not evenly spread.

Minerals production in developed countries fell, while in developing countries it remained essentially unchanged. In the farm sector, the impact was felt mostly by developing countries and other primary producing countries and the United States, and very little by the EEC. This reflected the degree of price-support given: virtually nil for the agricultural exports of developing countries; partial in the case of United States agriculture; and near-

complete for EEC agricultural production. Nevertheless, the volume of agricultural output in developing countries has risen substantially, reflecting both an upward trend in productivity and encouragement of greater export shipments to surmount balance-of-payments pressures.

### *The collapse of oil prices*

Unlike other commodity prices, oil prices had long been insulated from cyclical variations of demand. But like other commodities, oil demand was lowered by the world economic slowdown in the 1980s. However, the balance between supply and demand was also upset by the substantial conservation and substitution and increased oil supplies from non-OPEC sources that had been encouraged by the price increases of the 1970s.

The output cuts needed to balance the market became progressively harder for OPEC members to make as the expected recovery of the world economy and of oil demand failed to materialize. The swing producer role was performed by a few countries with relatively high revenues per capita and plentiful stocks of external assets since other OPEC members, in particular those with large populations and debt, were financially squeezed. At first the swing producers bore the burden willingly. But they eventually found that they were defending OPEC revenues by continuously reducing their own incomes, and sustaining a price which, judging from the rapid loss of markets by OPEC, appeared too high from the standpoint of countries such as theirs with plentiful oil reserves.

Consequently, at the end of 1985 OPEC stopped trying to manage the market on its own, and allowed prices to find their own level. As a result, they plunged from \$28 to \$12 per barrel and began to gyrate. OPEC's policy became to secure and defend for OPEC a fair share of the market consistent with the necessary income for Member Countries' development. If these two objectives are to be reconciled, it will be necessary, among other things, for non-OPEC producers, including developed countries, to participate in production management. Many of them, but not all, appear willing to consider this.

If efforts to re-stabilize the oil market fail, investment decisions in a variety of energy sectors will be adversely affected. Moreover, sharp gyrations in this key price may become the norm rather than the exception, with adverse effects on both energy producers (including those in developed countries) and energy con-

sumers (including those in developing countries).

### *Debt and trade finance*

The persistence over a number of years of deflationary pressures and other monetary and financial disturbances has diminished significantly the capacity of the international financial system to contribute to trade and development, and to foster efficiency in resource use.

Debt servicing problems of various kinds - in particular those of developing countries, farmers and the energy and energy-related industries, - have inflicted significant damage on the quality of banks' portfolios and prompted them to reduce the flow of credit to problem debtors: in some cases, new lending has been suspended altogether. Instead, banks are seeking profits through fee-earning activities. Some of these adjustments, together with improvements in capital ratios, have helped reduce banks' vulnerability to insolvency on the part of their debtors.

Nevertheless, banks remain vulnerable. Reduced lending to debtor countries has already impaired their debt servicing capacities, and a continuation of that policy would increase the risks of default. In any event, default by an individual debtor could affect many besides its own creditors. There is a potential for chain reactions spreading throughout the international financial system, not least because of the development of the inter-bank market. Financial innovation and deregulation, which have proceeded at a rapid pace, have also integrated financial markets.

Many of the structural changes taking place in financial markets are tending to make the international financial system, and hence trade and development, more vulnerable to fresh shocks such as a new wave of deflation. Monetary and regulatory authorities, as well as many observers, have recently voiced acute concern. This may indicate an inclination on their part to reassess the costs and benefits of the development of off-shore banking and deregulation of domestic banking, and perhaps even presage a willingness eventually to reconsider the thrust of policy.

The external liquidity squeezes on developing countries, which in many cases have stemmed from a sharp reduction of fresh bank lending, have tended to feed on themselves, eventually threatening the whole spectrum of the financing and payments arrangements of



the countries concerned. As a result, the day-to-day costs of international trade have been raised for a large number of developing countries.

The coincidence of external financial stringency and depressed export demand has intensified pressures to engage in countertrade. While countertrade generally entails special

costs, these may often be less for financially squeezed countries than those of alternative methods of paying for imports (or the option of forgoing trade entirely). The extent of countertrade in the future will depend importantly on the degree of financial pressure on countries, and hence on overall conditions in international markets for finance and goods.

### **Towards a revival of growth and development**

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*Unless global deflationary tendencies are surmounted, debt and development prospects will remain dim. Moreover, both the scope for and the results of domestic efforts will be meagre. The time is ripe for the major market economies to stimulate activity and reduce real interest rates by re-orienting their policies in a co-ordinated manner, and for all countries to undertake structural changes to raise their long-term growth potential.*

#### **Scenarios**

*Trade and Development Report, 1985* drew attention to the weaknesses of the recovery process in industrialized countries and of the strategy being pursued with respect to the debt problems of developing countries. It emphasized the need to place the revival of growth in debtor countries at the centre of the international debt strategy. It saw need for a co-ordinated shift of monetary and fiscal policies in the major developed market economies to bring about not only a more even but also a more rapid pace of demand and output growth, and a depreciation of the dollar. It took the view that, if the goal of policy reorientation were limited to reducing disparities in growth and current account imbalances, and did not include raising the rate of growth and lowering rates of interest, the external financial and trading environment of developing countries would remain hostile, and that consequently their debt and development prospects would remain grim.

Some elements of this reasoning have become generally accepted in recent months. The major developed market economies have engaged in more intensive consultations regarding monetary, fiscal and exchange rate policies with a view to reducing the trade imbalances among them. They have also recognized that a revival of investment and growth in developing countries is essential for the successful resolution of the debt crisis, and that this will require external financing.

However, the new approach has not advanced beyond the embryo stage. The new appreciation of the need for growth in debtor countries has the merit of addressing the debt

and growth problems of developing countries in a longer-term time frame and of emphasizing the structural character of current difficulties and of necessary solutions. However, so far the new approach has laid heavy emphasis on the role of domestic policies, perceived within a narrow framework, and has given inadequate attention to the improvement needed in financial availabilities, interest rates and trade conditions. The fruits of policy co-ordination among the Group of Five have been largely limited to dollar depreciation and possibly some accompanying attenuation of protectionism. Interest rates have also recently come down, but in the context of a further fall in real commodity prices and of stagnation of developing countries' export volume. While steps have been taken to cut the United States structural budget deficit, no provision has been made to compensate by lessening the fiscal tightening taking place elsewhere - let alone to add stimulus.

The immediate crisis in sub-Saharan Africa has abated with the end of the drought and the changed prices for oil and coffee, but it remains chronic. Its resolution will depend critically on the effective implementation by all sides of the United Nations Programme of Action for African Economic Recovery and Development recently adopted by the General Assembly.

*Trade and Development Report, 1985* contained a scenario for debt and development based on a continuation of recent trends in certain key variables. The changes that have recently taken place, particularly as regards oil, the dollar and interest rates, have made some of the assumptions of that scenario no longer indicative of "recent trends".

New estimates have therefore been made. These modify last year's results in certain respects. In particular, the prospects of oil-importing countries are brighter, whereas those of the oil exporters are much dimmer; for Africa, they reveal the potential for the emergence of an alarming debt situation. All in all, the underlying prospects for the developing world as a whole remain much the same - that is to say, highly unfavourable.

### *Domestic savings and investment, and the foreign exchange constraint*

Improvements in domestic policies unquestionably have an important role to play in enhancing over the long term the debt and development prospects of developing countries. However, to boost savings and investment performance takes time, and the scope for and effectiveness of domestic efforts depend not only on the appropriateness of domestic policies but also on the external environment.

The deterioration that has taken place in the terms of trade in the last few years has increased sharply the level of real savings that countries need to generate in order to avoid a fall in investment; so has the rise in interest rates and the decline of new borrowing. In order to compensate for the resources lost as a result of these shocks and avoid a decline in investment, the savings of developing countries would have had to rise by more than one-half.

However, the capacity to save has itself been depressed, by the reduction of incomes and output stemming from the import cuts made in order to "adjust". In many countries, the savings capacity of firms has been impaired by the fall in profitability resulting from higher external and domestic interest rates, contraction of the domestic market, and devaluation. The savings capacity of Governments has been reduced by such factors as contractions of the tax base resulting from domestic recession, decline of tariff revenues stemming from the fall in imports, and reduction of royalties and taxes resulting from the depression of commodity prices. In several countries, capital flight has taken place on a large scale, and the capacity of financial institutions to mobilize savings has been damaged.

For these and other reasons, it is not surprising to find that domestic savings have fallen relative to GDP, especially in debtor countries; that national savings (which makes allowance for the loss resulting from interest payments abroad) have fallen even more - for debtor countries as a group by no less than 5

per cent and in some by as much as 10 per cent of GDP - and that investment has also fallen as a percentage of GDP. A number of countries have managed to increase domestic savings, but most of them have not been able to do so sufficiently to prevent investment from falling.

It is therefore unrealistic to suppose that under current conditions it would be possible to push up savings and thereby increase significantly output, investment and exports. Rather, one must look to an improvement in the external environment to trigger a rise in output, investment, income - and hence savings. It is after such a process begins to gather force - not before - that increased thriftiness can reasonably be expected to accelerate growth and development.

In many developing countries, reduced consumption - public or private - cannot be easily translated into increased investment. In economies with relatively advanced production structures devaluation can serve to induce output to be redirected to foreign markets and demand to be redirected to domestic output. The impact of devaluation is much greater at high levels of investment since the flow of new investment (and hence the pattern of output from such investment) is easier to restructure than output from capital stock installed in the past. For many countries with a relatively small industrial sector and a depressed level of investment, devaluation tends to be 'stagflationary' rather than an instrument for revitalizing growth.

If OECD growth and capital flows remain unchanged, the changes in export penetration and/or decreases in import requirements that developing countries would need to make in order to attain an acceptable growth rate are much too large to be feasible. For growth in major debtor countries to reach 5 per cent, it would be necessary either for their penetration of OECD import markets to rise by 20 per cent (if the import requirements of growth remains unchanged) or for the import requirements of growth to fall by one third (if their penetration of OECD markets remains unchanged). There are few historical precedents for movements of this magnitude. For least developed countries, neither improved export performance nor effective import substitution would be feasible without substantial inflows of external resources.

Thus, while there is no substitute for strengthening domestic efforts and policies, at the present juncture the key to unleashing the development potential of developing countries lies in improving the global trading and financial environment.



### *Macroeconomic policies in OECD countries*

Prospects for improving that environment depend critically on the policy choices of the major market economies. Although these countries have come to recognize the need for policy co-ordination in order to reduce imbalances in trade and the tensions in commercial relations that go with them, they have not all accepted that there is need to re-orient policies to stimulate growth and reduce real interest rates.

The policy adjustments needed are by no means the same for all countries. For the United States, whose fiscal stance is set to tighten, the main requirement is a loosening of monetary policy. In Western Europe and Japan there is need for greater fiscal and monetary stimulus combined with appropriate structural policies. Structural policies in Western Europe would need to be directed at improving wage and price behaviour to improve the trade-off between inflation and unemployment, whereas in Japan they would need to be designed to alter the propensity to save and the willingness to invest.

Over the longer term the scope for non-inflationary growth will depend critically on an increase in the rate of growth of capacity. The growth of productive capacity would naturally be pushed up as the narrowing of the gap between actual and potential output elicits a higher level of new investment. But it could be raised further if rigidities in labour and goods markets were progressively lessened. The two lines of attack could reinforce each other to strengthen long-term growth prospects. But it is difficult to see how the much-awaited revival of investment can take place unless monetary and fiscal policies are first relaxed to raise the demand for output. It must therefore be emphasized that the adoption of more expansionary policies in Western Europe and Japan does not need to await progress on the structural front: there already exists sufficient scope to expand domestic demand.

Paradoxically the need for expansionary policies in Western Europe and Japan may have been increased rather than lessened by the collapse of oil prices. Oil-exporting countries are important markets for their exports, especially in the case of Europe, and these markets will be greatly reduced. Moreover the oil price drop has worked to offset the impact on the United States price level of the dollar depreciation. As such, it may have allowed a larger depreciation of the dollar (and consequent shrinkage of European and Japanese export markets) than would otherwise have been

sought by United States authorities. The stagnation of Japanese and European export volumes observed in early 1986 undoubtedly reflected these forces. There is a possibility that, if growth in its trading partners does not improve, the United States may choose to bring down the dollar further, or alternately to resort to trade measures in order to bring down its trade deficit. Either way Western Europe and Japan would get a deflationary shock from the United States rather than the expansionary stimulus which they have been receiving until recently, though in neither case would the United States be able to "export" the entirety of the demand reductions stemming from its budget cuts. In order for growth in the United States to accelerate, it would be necessary both for interest rates in that country to come down and growth in its trading partners, developed and developing, to revive.

A further danger is that Japan will seek to make up for the competitiveness it has lost to the United States by capturing a larger share of Western European markets. An attempt by Japan to shift its trade surpluses in this way would likely be met with stiff resistance, particularly since Western European countries are now also less competitive vis-à-vis the United States and, as already mentioned, have lost part of their market in oil-exporting countries.

For these reasons, there is a danger of an accentuation of policy conflicts among the developed market economies. In order to avoid a process of unilateral policy initiatives and reactions and the accompanying danger to the international trading system, Governments would need to advance much further along the path of policy co-ordination.

The central goal of such co-ordination would need to be significantly faster growth with much lower real interest rates. Otherwise, conflicts among developed countries could remain unresolved, and the improvements required in the external environment of developing countries, including a strengthening of commodity prices, could fail to materialize. As long as strict monetary discipline and reduction of fiscal deficits remain overriding objectives in the major market economies, the risk of such failure will be high - and the prospects of revitalizing the development process, lessening trade conflicts, and returning to normalcy on the debt front will remain dim.

Higher growth and lower interest rates alone will not, however, be sufficient. An enlarged flow of financing will also be required, especially from the multilateral development finance institutions, whose net lending must be stepped up. Many countries, especially least

developed and sub-Saharan African countries, must receive substantially higher amounts of highly concessional aid, as well as debt relief. For others, lending on commercial terms will be called for, together with more flexible and innovative approaches to debt, including achieving a more equitable distribution of its burden among creditors and debtors. In this connection, financial instruments that would establish a link between debt service and export prices could be in the interests of both debtors and creditors.

However, it is essential to bear in mind that small amounts of financing on stiff terms and tough conditions are not likely to work. For reasons already explained, it is essential that the combined impact of enlarged financing and an improved trading environment should be sufficiently stimulative. Moreover, unless interest rates come down and the terms of trade improve, additional borrowing would in many cases eventually prove too onerous.

In short, in order to succeed, efforts of developing countries to adjust through development must go hand-in-hand with policy changes in the developed market-economy countries as well.

### *Turning to growth*

*The situation is ripe for Governments to raise their sights, and to take bold steps for growth and development. The Governments of the major developed countries are now much more conscious of the need for policy consistency, and the accentuation of deflationary pressures is making it all the more necessary for their policies to be oriented towards growth. The successes achieved in regard to inflation have enlarged the scope for expansionary policies.*

It is also to be noted that the United States, which is itself a major debtor country with a large deficit wishing to grow rapidly, is now actively seeking an expansion of the economies of its principal trading partners, both in order to reduce its own current account imbalance without imposing trade restrictions and/or undergoing a further currency depreciation, and in order to lessen the burden on indebted developing countries and the attendant risks for banks.

Discussions are now proceeding towards the initiation of a new round of multilateral trade negotiations with the stated objective of strengthening the trading system. The danger inherent in any such new trade negotiations in present economic conditions is that the major trading countries may press for modifications in the trading system which will legitimize rather than eliminate the current tendencies towards managed trade and discrimination. As many examples of the past indicate, once such mechanisms are legitimized, even on a sectoral basis, they are extremely difficult to contain let alone eliminate, even when the economic conditions which brought them about are radically changed. For this reason it would be desirable that the launching of a new round of multilateral trade negotiations should proceed in tandem with a strategy for the revival of growth and development and for the attainment of greater stability in the world's financial system.

The present situation may mark a new turning point. The major market economies can choose to adhere strictly to restrictive policies, and risk a future of limping growth, recurrent crisis, endemic instability, massive unemployment, and arrested development. But now that the risks of inflation are minimal there is an alternative - to adopt collectively agreed policies that would revive growth and create an environment in which developing countries could adjust through development. ■



K.K.S Dadzie

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## CHAPTER I

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### THE DEPRESSION OF THE 1980S AND THE SETBACK TO ECONOMIC AND SOCIAL DEVELOPMENT

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#### Introduction

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The 1980s have been marked by the widespread collapse of the development process. This collapse has been characterized by financial disorder and extended periods of negative or negligible growth in most developing countries, entailing high costs in terms of social stagnation and, in some cases, regression. Moreover, the effects on investment in productive capacity, infrastructure and social services call into question the future ability of many countries to respond to the needs of their populations and to bring about the changes in the structure of production necessary to restore growth and development.

This chapter illustrates the impact of the development crisis by the discussion of recent trends in output and investment in developing countries (section A) and of the widespread falls in living standards and social welfare which have accompanied them (section B). It is emphasized in section C that the collapse of development did not happen in isolation, but was an integral part of the broader depression in the world economy. Different aspects of the global context of this collapse are then taken up in the remainder of this Report.

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#### A. Output and investment in developing countries

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Large parts of the developing world experienced depression in 1982-1983. As a result, the annual average growth of GDP for developing countries as a whole during 1980-1984 fell to little less than 1 per cent from the figure of 5.5 per cent during the preceding five years (see annex table 1).

In many countries there was a stagnation or even a decline in output, evident from annex table 1 and brought out more fully in annex table 3. The number of developing countries experiencing stagnation or decline (that is to say, growth of less than 0.5 per cent) more than doubled between the periods 1975-1979 and 1980-1984. Moreover, there was almost a doubling of the number whose growth of output, though positive, was less than 3.5 per cent. Annex table 3 makes clear the pervasiveness of the declines or low growth of GDP in the countries of Africa and Latin America. Thirty-five of the 46 countries of "Other Africa" covered by the table experienced growth rates of less than 3.5 per cent in 1980-1984, including 18 countries for which there was stagnation or a decline. Twenty-four of the 25 countries in Latin America and the Caribbean also experienced growth rates of less than 3.5 per cent in the same period, including 14 in which there was stagnation or a decline.

However, GDP growth was not subject to adverse movements of this kind in all developing countries. A continuation of rapid growth was achieved by many countries in both South and East Asia, although a slowdown took place in the latter region in 1985. The countries responsible for this performance show considerable variation in both the major characteristics of their economies and in the economic strategies which they have pursued. On the one hand the group includes countries such as India, with large economies, where there are large populations but low levels of per capita income. Such countries are relatively insulated from the international economy and thus protected against external economic shocks. On the other hand, the group includes a number of economies with higher levels of per capita income which have pursued more outward-oriented policies (though there is considerable variation in the extent and type of government intervention in support of manufacturing industry).

Declines in the growth of GDP have been widely accompanied by still greater falls in that of investment, as is evident from annex table 4. But as for GDP growth, there is much variation among countries. There were sharp decreases in 1982-1983 in the share of gross capital formation in GDP for the developing countries of Latin America and "Other Africa",

two of the regions most affected by the depression. For developing countries in the former region there was a fall in volume of over 30 per cent in gross domestic investment between 1981 and 1983. Only two of a group of 23 countries in this region for which figures are available achieved an increase in volume during this period. According to estimates of the Inter-American Development Bank, for a group of six countries in this region which includes the largest economies, by 1984 the ratio of total investment to GNP had fallen in comparison with its average level in 1980-1981 by figures varying from 17 per cent to 37 per cent.

Such falls in investment are likely to inflict serious damage on the longer-term development prospects of the countries affected. Moreover, in the case of debtor countries experiencing difficulties with respect to their external payments, they are capable of hindering changes in structures of production that would enhance capacities to supply exportable goods and import substitutes. Such changes are essential to the adjustments which these countries must make if they are to be able to service their external debts and to achieve sustainable positions for their current accounts. However, several features of the present situation of the many developing countries experiencing external financial stringency remain unfavourable to widespread revivals of investment.

The reductions in the availability of external financing implied by such stringency have typically been substantial. Indeed, for some of these countries, among them many of the larger borrowers from private capital markets, inflows of financing have recently fallen short of outflows due to payments of interest and principal on their external debts. The reduced availability of external financing has coincided with a period of weak demand for most of the exports of developing countries. This has led to widespread falls in the prices of primary commodities and to associated adverse movements in the terms of trade for most developing countries since 1982.

The policies of deflation and austerity adopted in response to this situation have

interacted in various ways with external conditions to depress investment. For example, reduced levels of activity and falls in the prices of exports have had adverse effects on the cash flows and profitability of enterprises, leading not only to cut-backs in investment but in many cases also to insolvencies. For many enterprises such consequences have been aggravated by unfavourable shifts in the cost and availability of domestic borrowing, and by the impact of devaluation on the cost in domestic currency of servicing debts denominated in foreign currencies (though, as discussed in more detail in chapter VI, section A, the latter phenomenon was partly or wholly offset in some cases by the favourable effects of the new level of the exchange rate). As also discussed in chapter VI, lower levels of activity and export prices have also decreased government revenues in the form of both taxes and other receipts, thus intensifying the pressures for reductions in government expenditures and for the curtailment of public sector investment.

Moreover, for a country experiencing an increased burden of external debt service in relation to the availability of new financing (that is to say, a reduced net transfer from abroad), the efforts to achieve a given objective with respect to its balance on current account lead to an increased drain on domestic savings, as is explained in more detail in chapter VI, section A. Such an effect is exacerbated if the country also suffers an unfavourable movement in its terms of trade. The extensive incidence of such movements and of reduced net financial transfers suggests that these mechanisms have contributed to reducing resources available for investment in many developing countries.

The increased scarcity of foreign exchange is also a factor capable of holding down investment owing to its impact on the availability of inputs and equipment that have to be purchased abroad. The disruption of such supplies is likely to lead to reductions in capacity utilization, thus adding to downward pressures on cash flows and profits, and to cause difficulties for productive activities generally, including investment. Effects of this kind have recently been widely felt.

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## B. Employment and the human condition

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The declines in output described in the preceding section have been accompanied by widespread, and in many cases substantial, falls in living standards. These falls are implicit in the pervasiveness of negative growth of GDP per capita since 1981 for the different economic

groups of developing countries distinguished in annex table 2. The experience by geographical regions is shown in table 1. Year by year, the number of countries in Latin America and the Caribbean which experienced stagnation or decline in the growth of GDP per capita from

1981 to 1984 was: 13 in 1981, 24 in 1982, 19 in 1983 and 14 in 1984. For "Other Africa" the corresponding totals were 29, 27, 31 and 31 respectively. In many cases the negative growth rates were quite large.

The difficulties of measuring several of the dimensions of variations in living standards are well known and are compounded for the majority of developing countries by the absence of many of the relevant statistics. In the case of most of these countries, comparable figures are available only for GDP per capita, a very incomplete indicator, so that the rest of the discussion in this section cannot be systematic. Nevertheless, its survey of various data concerning such topics as unemployment, social services and incomes in a number of countries does bring out some of the implications of the recent setback to development for the welfare of individuals and families.

Few developing countries have unemployment statistics with a coverage analogous to those of developed market-economy countries (which in any case are usually not comprehensive for various reasons), and the figures available typically understate the magnitude of the phenomenon. Such understatement is a characteristic of the figures in table 2 for rates of (open) urban unemployment in various Latin American countries. For all the countries except three covered in this table there were rises between 1980 and 1984, and for some countries the increases were substantial. According to estimates of the secretariat of the Inter-American Development Bank, during this period the absolute number of open urban unemployed in Latin America increased by more than 70 per cent. Annex table 17 gives figures for the number of unemployed calculated on various bases for selected countries or regions within countries. Here, too, the direction of change since the late 1970s, where the data make such comparisons possible, is mostly upwards.

A major distortion in figures of this kind is their failure to include underemployment and employment in the informal sector. Various estimates suggest that outside those parts of the economies of developing countries for which figures for open unemployment are recorded, as much as 30-40 per cent of the economically active population is frequently unemployed or underemployed. Moreover, on the basis of a definition of underemployment which covers all workers earning too little to provide themselves and their families with an adequate standard of living (whether in the formal or in the informal sectors), it has recently been estimated that in 1982 52 per cent of the labour force in developing countries was underemployed, and that there had been a 6 per cent increase in under-

employment (corresponding to 27 million people) since 1974. A large part of the increase was concentrated in Africa. A recent report of UNICEF draws attention to the fact that in Africa the informal sector has become increasingly important as a result of internal migration and the stagnation of opportunities for wage employment. The size of the urban informal sector in many African towns is estimated to amount to 50-60 per cent of the urban labour force, and in several Latin American countries to between 30 and 40 per cent.

These rises in unemployment took place in countries where there are no safety nets of the kind provided by the systems of social welfare in developed market-economy countries. Consequently, their implications for the people concerned were often desperate. Moreover, the alternative of obtaining employment through emigration became less easily available during this period. The contraction of opportunities in this respect was due to the widespread increase in unemployment, especially in certain Western European countries, and to the decline in the export revenues of various oil-exporting countries which had earlier been substantial sources of demand for expatriate labour.

The austerity in developing countries experiencing external financial stringency has, in general, not only resulted in rises in unemployment and decreases in private consumption but has also had an adverse impact on the provision of social services in fields such as health and education. Such developments are frequently due to the failure of balance-of-payments-adjustment programmes to take sufficient account of longer-term objectives or of objectives which are not of a narrowly economic nature. Thus efforts to combat infectious and parasitic diseases have been curtailed in many countries and programmes designed to check the resurgence of malaria have also been adversely affected.

Annex table 15 enables a comparison to be made of the share of education and health in the expenditure by central governments in various developing regions. The figures for Latin America show a fall in 1980-1983 compared with 1977-1979 (while those for South and East Asia show a rise). Information for various African countries points to a sharper deterioration. For example, in the cases of Nigeria, the United Republic of Tanzania and Zambia, the inputs into social services (for example, drugs, paper, textbooks, water pipes, pumps, etc.) have decreased sharply, by as much as 50 per cent in some cases.

Recent declines in living standards have been most dramatic in a number of African

Table 1

**DISTRIBUTION OF DEVELOPING COUNTRIES BY RATES OF GROWTH OF GDP PER CAPITA, 1960-1984**  
(Number of countries)

<i>Growth of GDP per capita</i>	1960-1969	1970-1974	1975-1979	1980-1984
<i>2 per cent and above</i>				
Total	64	54	56	21
Latin America	19	17	15	1
North Africa	3	3	6	1
Other Africa	25	18	16	5
West Asia	8	6	7	4
South Asia	2	1	5	4
East Asia	7	9	7	6
<i>0.1 per cent to 1.9 per cent</i>				
Total	23	25	15	15
Latin America	5	8	6	1
North Africa	2	2	-	2
Other Africa	10	13	6	7
West Asia	-	1	1	1
South Asia	3	1	2	3
East Asia	3	-	-	1
<i>0 per cent and below</i>				
Total	19	27	35	70
Latin America	2	1	5	24
North Africa	1	1	-	3
Other Africa	12	16	25	35
West Asia	2	3	2	5
South Asia	2	5	-	-
East Asia	-	1	3	3

*Source:* UNCTAD secretariat calculations, based on official national and international sources, for 106 countries for which data are available.

countries, and in certain cases were associated with widespread starvation. Indeed, according to some estimates, in 1984 more than 30 million people were threatened by starvation. It has been argued that famine was often due not so much to the non-availability of food supplies as to lack of income to buy them. Since the crisis first became apparent, there have been efforts to alleviate its impact, and recently more favourable weather has led to rises in food production. Nevertheless, the international community was unable to organize relief before millions had been exposed to hunger and malnutrition. For many relief, when it did come, was too late.

There have also been widespread and often substantial falls in living standards in Latin America. These have been due not only to the

increases in unemployment but also to the behaviour of real wages, which in many cases have decreased owing to the failure of money wages to keep pace with inflation. Annex table 16 shows that in only three of a sample of seven Latin American countries were average real wages higher in 1985 than in 1980. Even in these three there were substantial decreases in some years during this period. Moreover, in four of the countries average real wages were lower in 1985 than they had been in 1975 (in three of them substantially lower).

One study, which attempts to analyse the impact of depression on social conditions on the basis of household surveys for Chile, Colombia, Costa Rica, Panama and Venezuela, concludes that not only have those at the bottom of the social pyramid been severely af-

Table 2

RATES OF URBAN UNEMPLOYMENT IN SELECTED LATIN AMERICAN COUNTRIES, 1975-1985  
(Average annual percentage rates)

Country	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Argentina <sup>a</sup>	3.7	4.9	3.3	2.5	2.6	4.7	5.3	4.6	4.6	4.6	6.6
Bolivia <sup>b</sup>	..	..	7.9	4.5	7.6	7.5	9.7	9.4	12.1	12.6	..
Brazil <sup>c</sup>	..	..	..	6.8	6.4	7.2	7.9	6.3	6.7	7.1	6.0
Colombia <sup>d</sup>	11.0	10.6	9.0	9.0	8.9	9.7	8.2	9.3	11.8	13.5	14.2
Costa Rica <sup>e</sup>	..	5.4	5.1	5.8	5.3	6.0	9.1	9.9	8.6	6.6	6.7
Chile <sup>f</sup>	15.0	16.3	13.9	13.3	13.4	11.7	9.0	20.0	19.0	18.5	17.7
Mexico <sup>g</sup>	7.2	6.8	8.3	6.9	5.7	4.5	4.2	4.1	6.7	6.0	5.7
Nicaragua <sup>h</sup>	..	..	..	..	..	18.3	15.8	19.9	15.2	16.3	..
Panama <sup>i</sup>	8.6	9.0	..	9.6	11.6	9.8	11.8	10.3	11.4	11.1	11.5
Paraguay <sup>j</sup>	..	6.7	5.4	4.1	5.9	4.1	2.2	5.6	8.4	7.4	..
Peru <sup>k</sup>	..	8.4	9.4	10.4	11.2	10.9	10.4	10.6	13.9	16.4	..
Uruguay <sup>l</sup>	..	12.7	11.8	10.1	8.3	7.4	6.7	11.9	15.5	14.0	13.5
Venezuela <sup>m</sup>	8.3	6.8	5.5	5.1	5.8	6.6	6.8	7.8	10.5	14.3	14.0

Source: CEPAL, "Preliminary overview of the Latin American economy 1985", *Notas sobre la economía y desarrollo*, No. 424/425, Santiago, December 1985.

<sup>a</sup> National urban. Average April-October; 1985: April.

<sup>b</sup> La Paz, 1977, 1978 and 1979: second semester; 1980: average May-October, second semester.

<sup>c</sup> Metropolitan areas of Rio de Janeiro, Sao Paulo, Belo Horizonte, Porto Alegre, Salvador and Recife (average for 12 months); 1980: average June-December; 1985: average January-August.

<sup>d</sup> Bogota, Barranquilla, McJellin and Cali; average for March, June, September and December; 1985: average for March, July and September.

<sup>e</sup> National urban. Average for March, July and November; 1984: average March and November; 1985: average March and July.

<sup>f</sup> Greater Santiago. Average for four quarters. As from August 1983 data relate to the metropolitan area of Santiago; 1985: average January-September.

<sup>g</sup> Metropolitan areas of Mexico City, Guadalajara and Monterrey (average for four quarters); 1985: average for January and February.

<sup>h</sup> Non-agricultural activities.

<sup>i</sup> National urban. 1980 corresponds to urban unemployment recorded in the population census taken in that year. 1981, 1982 and 1985: metropolitan area.

<sup>j</sup> Asuncion, Fernando de la Mora, Lambare and urban areas of Luque and San Lorenzo (annual average); 1981: first semester; 1983: average September, October and November; 1984: average August and September.

<sup>k</sup> Non-agricultural activities.

<sup>l</sup> Montevideo (average for two semesters); 1985: average January-September.

<sup>m</sup> National urban (average for two semesters); 1985: first semester.

affected but middle-income strata have also suffered. In Chile the proportion of those with living standards classified as corresponding to absolute poverty increased from 12 per cent in 1981 to 16 per cent in 1982, and in Costa Rica from 17 per cent in 1979 to 19 per cent in 1982.

The incidence of poverty is affected by family size so that, for example, in the Los Andes region of Venezuela, where overall poverty has declined, the situation of large families has worsened. However, in Colombia overall pov-

erty decreased, and the largest families benefited most from this improvement.

This brief survey has stressed the human impact of the depression of the 1980s in developing countries. However, the consequences are not limited to social hardship and deprivation. For example, cutbacks in government expenditure on health and education, like reductions in capital formation, can be expected to harm long-term development prospects through their adverse effects on the quality of the labour force. Good health is a prerequisite

of satisfactory labour performance, and levels of education are crucially related to the capacity for acquiring labour skills. Moreover, as living standards fall, governments in the countries affected tend progressively to lose their freedom of manoeuvre in major areas of policy. Eventually their positions may be threatened by outbreaks of political instability. The disruptive consequences of such situations will not necessarily be limited to the domestic scene. Indeed, they may well spill over into several areas of international economic relations.

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### C. The global economic context of the setback to development

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The setback to development needs to be understood as part of the world depression of the 1980s (although it should be noted that in some cases, especially those of many African countries, economic decline had begun much earlier). At the centre of this depression stands the poorer growth performance of developed market-economy countries. Several factors have contributed to the poor growth performance of these countries during the 1980s, some of which may be of a long-run character, but it is also due to the stance and mix of the macro-economic policies followed in developed market-economy countries.

The thrust and rationale of these policies, as well as many of their effects within these countries, are reviewed in detail in chapter II of this Report. Chapter III takes up various questions related to how the effects of these policies are transmitted to other countries. The main focus of the chapter is their effects on the markets for commodities, including oil. Chapter IV is concerned with the impact of depression on important parts of the financial and trading systems of particular significance to developing countries. The difficulties of many

of these countries and of several major economic sectors in meeting debt service payments have widely weakened the portfolios of financial institutions, leaving them vulnerable to unfavourable shocks or future economic downturns. Moreover, external financial stringency and deflation are unfavourably affecting international trade in ways that go beyond its direct interactions with levels of activity. For example, through their impact on the cost and availability of financing and payments arrangements, they have substantially increased the charges associated with developing countries' trade. Furthermore, the evidence suggests that deflation, misaligned exchange rates and the consequent imbalances in trade among the developed market-economy countries have given a significant stimulus to protectionist trends. After a review of major features of recent developments and the outlook for the near future for activity, prices, financing and trade in the world economy in chapter V, the Report concludes, in chapter VI, with an examination of the medium-term outlook for the world economy and of policy changes required to bring about rapid and sustained growth and development. ■



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## Chapter I: Notes and references

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### Page

- 1 The figures for the growth in gross domestic investment in countries of Latin America were taken from Inter-American Development Bank, *Economic and Social Progress in Latin America External Debt: Crisis and Adjustment. 1985 Report* (Washington, D.C., 1985, Statistical Appendix table 5), and those for the ratio of investment to GNP for six countries in that region from the same source, table II.2.
- 2 On relationships among investment, structural adjustment and external payments positions see, for example, *The international monetary system and financial markets: recent developments and the policy challenge*, Report by the UNCTAD secretariat (TD/B/C.3/194/Rev.1), United Nations publications, Sales No. E.85.II.D.5, and the *Trade and Development Report, 1985* (UNCTAD/TDR/5), United Nations publication, Sales No. E.85.II.D.16, part two, chapter II, section D.
- 2 Concerning the reductions in net financial transfers to developing countries see the World Bank, *World Debt Tables. External Debt of Developing Countries 1985-1986 Edition* (Washington, D.C., 1986), p. xii.
- 3 For the increase in the absolute number of open unemployed see Inter-American Development Bank, *op. cit.*, p. 169.
- 3 Concerning the scale of unemployment and underemployment outside the formal sectors of developing countries see, for example, United Nations Economic and Social Commission for Asia and the Pacific, *Economic and Social Survey of Asia and the Pacific 1985* (ST/ESCAP/405), United Nations publication, Sales No. E.86.II.F.1, pp. 96-97. The estimates of underemployment in the formal and informal sectors of developing countries are from a study by M. Hopkins, "Employment trends in developing countries, 1960-1980 and beyond", *International Labour Review*, vol 122, No. 4, 1983.
- For the growth of the informal sector in Africa see UNICEF, *Within Human Reach - A future for Africa's children* (1985), p. 22. On its size in towns in Africa and Latin America see ILO/JASPA, *Informal Sector in Africa* (Addis Ababa, 1985) and Inter-American Development Bank, *op. cit.*, p. 169.
- 3 The failures of programmes of balance-of-payments adjustment to take proper account of long-term and non-economic objectives is analysed in UNICEF, *op. cit.*
- 3 Concerning deteriorations of social services in various African countries see R.H. Green and H.W. Singer, "Sub-Saharan Africa in depression: the impact on the welfare of children", *World Development*, vol. 12, No. 3, March 1984.
- 3 On the relationship between inadequate incomes and starvation see S. Reutlinger, "Food security and poverty in LDCs", *Finance and Development*, December 1985, and World Bank, *Poverty and Hunger. Issues and Options for Food Security in Developing Countries* (Washington, D.C., 1986), p. 19.
- 4 The study based on household surveys in certain Latin American countries is described in O. Altimir, "Poverty, income distribution and child welfare in Latin America", *World Development*, vol. 12, No. 3, March 1984.

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## CHAPTER II

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### THE MACROECONOMIC SETTING: INTERACTION OF POLICIES IN THE MAJOR DEVELOPED MARKET ECONOMIES

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#### A. Policies and performance in the 1980s

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The 1980s have witnessed a drastic slowdown in the pace of economic growth in major developed market-economy countries (see table 3). After a deep and prolonged recession during 1980-1982, economic activity recovered somewhat, largely owing to the stimulus given by the United States, but overall performance has remained extremely poor, with the GNP growth rate of seven major OECD countries during 1980-1985 averaging about 2.2 per cent per annum as against 5.7 per cent in the 1960s and 3.5 per cent in the 1970s. Moreover, expansion has been principally concentrated in Japan and the United States; in the major European countries the rate of growth has on average barely exceeded 1 per cent.

Slower growth has been associated with a deceleration in the underlying potential growth rates of the economies concerned. Indeed, the statistical evidence shows that the potential output, conventionally defined as the maximum production capability consistent with stable inflation, and measured in terms of the observed rate of GNP growth from one peak of the business cycle to the next, has displayed a decelerating trend since the mid-1970s. The growth rate of potential output of the OECD countries taken together slowed to about 3 per cent during the first half of the 1980s from about 5 per cent in the early 1970s; the slowdown has been more marked in Western Europe and Japan than in the United States.

Many observers have sought to explain the decline in the underlying growth of potential output in terms of a sharp slowdown in labour productivity growth and continuous rise in the level of unemployment compatible with stable inflation, brought about by increased rigidities in the structure of labour and product markets. Among the factors usually mentioned are "the major shift in income distribution in favour of wage earners, . . . the increased tax

burden required to finance government activity, . . . subsidizing declining industries at the cost of an increase in the public sector deficit, {and} improvement and extension of unemployment compensation benefits."<sup>1</sup> It has also been suggested that the rise in energy costs reduced the economically viable capital stock and weakened potential output growth, particularly in countries where investment in capital equipment more suited to the new structure of relative prices and patterns of demand could not be undertaken. Moreover, "the continuing forces of technological change, along with the growing importance of the newly-industrializing countries as suppliers of competitive manufactured goods on world markets, necessitated a progressive adaptation of the economic structure of OECD countries {which} did not always take place smoothly, particularly in Europe."<sup>2</sup>

While structural problems may well have increased over time and reduced the degree of flexibility of economies, it is no coincidence that the sharp slowdown in output growth has been associated with a sharp restriction of aggregate demand. Slow productivity growth generally accompanies high rates of unemployment, and it has been found that the slower rise in productivity that took place in manufacturing industries after 1973 was associated with widespread falls in output in these industries. Again, productivity growth is largely brought about by investment, which depends on the expectations of future sales at sufficient profits, and hence on the adequacy of demand as well as on relative prices.

The slow pace of demand since the mid-1970s has not been conducive to capital formation and technological innovation. Much of the decline in potential growth has thus itself been the result of the slowdown in the level of activity.<sup>3</sup> It has, for instance, been recognized that "a protracted period of slow growth could

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<sup>1</sup> IMF, *World Economic Outlook* (Occasional Paper No. 4, Washington, D.C., June 1981), pp. 7-8.

<sup>2</sup> *OECD Economic Outlook*, No. 31, July 1982, p. 7.

<sup>3</sup> This is particularly true for the estimates given by the peak-to-peak method, since it ignores such key considerations as capacity utilization or employment rates associated with the trend. Indeed, estimates of potential output in the 1980s calculated on the basis of the growth in labour and capital inputs and of productivity show higher rates of potential output growth than the peak-to-peak method.

Table 3

**GROWTH, OUTPUT GAP AND UNEMPLOYMENT IN MAJOR DEVELOPED  
MARKET-ECONOMY COUNTRIES, 1970-1985**

	1970- 1979	1980- 1985	1979	1982	1985
<b>Real GNP growth (per cent per annum)</b>					
United States	3.0	2.1	2.8	-2.1	2.2
Japan	5.4	4.3	5.3	3.1	4.6
Germany, Federal Republic of	3.2	1.2	4.0	-1.0	2.4
France	4.1	1.2	3.3	1.8	1.2
United Kingdom	2.2	1.1	2.2	1.5	3.2
Italy	3.3	1.4	4.9	-0.5	2.3
Canada	4.3	1.9	3.2	-4.4	4.5
Total, 7 major countries	3.5	2.2	3.0	-0.5	2.7
<b>Output gap (per cent per annum) <sup>a</sup></b>					
United States	2.4	6.3	1.5	10.1	5.4
Japan	2.7	2.7	2.5	3.9	3.6
Germany, Federal Republic of	2.1	6.2	1.1	7.4	8.2
France	0.5	3.6	-0.1	3.4	6.8
United Kingdom	0.6	6.3	0.0	8.3	5.8
Italy	1.8	2.4	-0.5	2.8	5.4
Canada	-0.3	4.8	0.6	8.8	5.0
Total, 7 major countries	2.0	5.1	1.2	7.7	5.5
<b>Unemployment (percentage of total labour force)</b>					
United States	6.1	8.0	5.8	9.7	7.2
Japan	1.7	2.4	2.1	2.4	2.6
Germany, Federal Republic of	2.3	6.4	3.2	6.1	8.6
France	3.8	8.3	5.9	8.1	10.1
United Kingdom	4.4	11.1	5.1	11.4	13.2
Italy	6.3	9.2	7.6	9.0	10.5
Canada	6.6	9.9	7.4	10.9	10.4
Total, 7 major countries	4.4	7.2	4.9	7.8	7.6

*Source: OECD Economic Outlook; IMF, International Financial Statistics; Federal Reserve Bulletin; P. Muller and R.W.R. Price, "Structural budget deficits and fiscal stance" (OECD Working Paper No. 15), Paris, July 1984; Morgan Guaranty Trust Company of New York, World Financial Markets, December 1985.*

<sup>a</sup> The difference between potential and actual output expressed as a proportion of actual output (see text).

seriously damage OECD economies; slow growth tends to engender slow growth. It harms productive potential, through weak investment and a degradation of labour skills."<sup>4</sup>

It is noteworthy that, even after allowing for the decline in potential output growth, the recent slowdown in activity has enlarged the gap between actual and potential output, as well as between actual and potential employment. In other words, this drastic slowdown has taken place not in the context of exhaustion of production and technological capabilities and increased pressure on supply, but,

on the contrary, of increased slack. In short, the developed market economies have been operating far below their potential trend level, which itself has been falling in large part because of the persistent gap between actual and potential output. While the average unemployment rate in the seven major OECD countries listed in table 3 remained below 4.5 per cent in the 1970s, it averaged over 7 per cent in the first half of the 1980s. Similarly, the gap between potential (peak-to-peak) and actual output expressed as a proportion of actual output has more than doubled, entailing a cumulative loss of output of some \$2,000 billion

<sup>4</sup> OECD, *op. cit.*, p. 10.

at 1980 prices for these seven countries alone. Two-thirds of this, i.e., \$1,300 billion, could have been avoided had the average rates of unemployment and output gap of the 1970s been held constant.

The recovery process has not closed the output and employment gaps which, for the seven countries as a whole, are still substantially above their 1979 levels. With the exception of the United States and Canada, unemployment rates remain above the peak rates registered in 1982, and in some countries the output gap is also wider. It has been estimated that in order to close the output gap by 1988 these countries would need to achieve an average growth rate of about 4 per cent per annum from 1983 to that year - a figure well above the recent average. In the light of the present slowdown, the output gap is very likely to persist throughout the rest of the decade.

Although these considerations suggest that there is substantial scope for expansionary policies, the slowdown has, in fact, been the result of restrictive policy stances. Overall, macroeconomic policies have been geared primarily towards reducing inflation, which had reached very high levels at the end of the 1970s and introduced important economic distortions. Monetary restriction has been adopted as the main tool of anti-inflation policy while reduction in the size of the public sector has been seen as a prerequisite for growth through increased private initiative. This thinking has held sway even in the United States where, contrary to the original intentions, sizeable fiscal deficits have emerged. However, the private sector expenditure has not risen spontaneously, and its trend has been governed by the degree of stimulus applied or withdrawn by the public and/or external sectors.

For the seven major OECD countries taken together, the average ratio of *actual* budget deficits to GNP was around 3.5 per cent during 1980-1985. However, this ratio is not an appropriate measure of fiscal stance, since actual deficits are not independent of the level of activity: a high ratio may result from a low level of activity rather than an expansionary fiscal stance. *Structural* deficits, i.e., those that would emerge if the economy were to grow in line with potential output, provide a more appropriate measure of fiscal stance. But it is the change in the fiscal balance that determines whether or not fiscal stance is expansionary. On that measure, fiscal policy has not, on average, been stimulative (see table 4). The United States expansion has been largely offset by contraction in Japan, the Federal Republic of Germany and the United Kingdom, with the result that there was practically no change in the ratio of structural fiscal balance to potential

GNP during the first half of the 1980s; it moved to surplus by about 0.5 percentage points over 1979-1982, and to deficit by the same amount in the subsequent period due to the United States tax cuts. While all seven major countries have actual deficits at present, the Federal Republic of Germany and the United Kingdom have structural surpluses whereas, in Japan and France, the budget is more or less structurally balanced.

There is no comparable measure of the degree of tightness of monetary policy. In general, monetary aggregates have tended to grow more slowly throughout the 1980s; the demand for money has also undergone major shifts because of changes in the conduct of monetary policy and the impact of financial deregulation and innovation. Nevertheless, the generalized rise in real interest rates to exceptionally high, and in some cases unprecedented, levels provides evidence for the stance of monetary policy. The rise in real interest rates started before the United States structural budget balance had begun to deteriorate. It is sometimes argued that since capital is mobile internationally, the fiscal pressure on interest rates ought to be measured globally. As indicated earlier, the overall fiscal stance has barely changed in the 1980s. This suggests that the rise in real interest rates in all major industrial countries reflected primarily restrictive monetary policies.

Real interest rates were only one of the key set of prices that were drastically changed as a result of the policy mix and stance in the major countries. Exchange rates of the major currencies were another. The value of the dollar, as measured by the effective exchange rate, rose by more than 50 per cent in nominal terms and by just under 50 per cent in real terms between 1980 and early 1985, and, despite its recent fall, remains above the level of the early 1980s. Both interest and exchange rates have shown substantial short-term instability. The Eurodollar rate reached about 19 per cent during Spring 1980, dropping to about 9 per cent in mid-summer, climbing back to 20 per cent towards the end of the same year and returning to about 9 per cent, after various ups and downs, at the end of 1982. Exchange rates have varied by 5-10 per cent within a matter of a few days, and there has been a marked upward shift in the short-term volatility of exchange rates even as compared to the turbulence of the early days of floating.

The terms of trade between goods that are flexible in price and those whose prices are more closely related to costs and are therefore sticky (i.e., fix-price goods) have also undergone major changes. Nominal prices of non-oil commodities fell sharply when the recession

Table 4

ACTUAL AND STRUCTURAL FISCAL BALANCES  
IN SEVEN MAJOR DEVELOPED MARKET-ECONOMY COUNTRIES <sup>a</sup>

Country	1985 ratio <sup>b</sup> of		Change from 1979 to 1985 in the ratio <sup>c</sup> of	
	Actual fiscal balance to actual GNP	Structural fiscal balance to potential GNP	Actual fiscal balance to actual GNP	Structural fiscal balance to potential GNP
	Per cent		Percentage points	
United States	-3.5	-1.9	-4.1	-3.1
Japan	-1.3	-0.5	3.5	3.8
Germany, Federal Republic of	-1.1	1.2	1.5	3.5
France	-2.6	-0.2	-1.9	0.6
United Kingdom	-3.1	2.4	0.4	5.6
Italy	-14.0	-10.7	-4.5	-1.0
Canada	-6.1	-2.6	-4.3	-1.0
Total, 7 countries	-3.5	-1.4	-1.8	-0.1

Source: OECD Economic Outlook (various issues); Morgan Guaranty Trust Company, *World Financial Markets*, December 1985.

<sup>a</sup> General government basis.

<sup>b</sup> A negative sign indicates a deficit.

<sup>c</sup> A negative sign indicates a move towards fiscal expansion.

deepened in 1982. Their subsequent recovery from mid-1983 to mid-1984 made up for less than 15 per cent of the previous decline, and they fell again after mid-1984. Since prices of manufactured products were relatively stable, the terms of trade turned sharply against primary commodities.

Movements in interest and exchange rates and in the commodity terms of trade have

had a major influence on the performance of the world economy during the 1980s by transmitting the expansionary and contractionary impulses through the channels of trade and finance. The significance of the macroeconomic policies of the major industrial countries has thus been much greater than would be indicated by these countries' shares in world output, trade and finance.

## B. Recession and recovery in the United States

### 1. Shift in the monetary stance and the 1980-1982 recession

At the end of the 1970s the United States economy was characterized by double-digit inflation, a cheap dollar and a modest growth of output (see annex table 18). The unemployment rate (around 6 per cent) was widely con-

sidered to be compatible with a stable rate of inflation. Nevertheless, inflation was accelerating. It was widely held that this was due not only to the rise in oil prices but also, and more importantly, to the failure of monetary aggregates to slow down, and to a buildup in inflationary expectations resulting from greater "erosion in the credibility of the Federal Re-

serve's will and capacity to control the situation."<sup>5</sup>

It was against this background that in October 1979 a major shift occurred in the approach of the Federal Reserve Board. The new approach was to target some monetary aggregates in order to reduce inflation, and to let the market determine the interest rates as an outcome of the balance between demand for and supply of liquidity. An equally important element of this approach was to secure the confidence of the public in the fulfilment of monetary targets, in order to restore credibility and influence favourably the expectations regarding future inflation. Achievement of pre-announced targets was expected to improve the behaviour of labour and product markets and lessen the trade-off between inflation and unemployment. In this way, a swift return to price stability was to be ensured without major sacrifices of output and employment.

A deep and prolonged recession nevertheless occurred, with the rate of unemployment climbing rapidly from under 6 per cent in 1979 to over 10.5 per cent in the fourth quarter of 1982, exceeding the previous post-war record of 1975 by more than 1.5 percentage points. Capacity utilization in manufacturing fell to a post-war trough of 68 per cent in late 1982. Even more significant was the duration of recession; setting aside the short revival in economic activity after mid-1980, it lasted 12 quarters, whereas the previous post-war record, in 1974-1975, had been five, with all other post-war recessions lasting less than four. The rise in unemployment and the fall in activity entailed a cumulative loss of output of more than \$500 billion.

Expectations that the change in the conduct of monetary policy would ease the disinflation process were not borne out in practice. Inflation stayed high throughout 1980 and most of 1981, coming down only when recession deepened. While the inflation proved no less stubborn than in the past, the extent and speed of the disinflation sought was much greater; consequently, the real costs were proportionately larger. On average, it cost about 2 percentage points of output growth to reduce inflation by about 1 percentage point.

Fiscal policy played initially little or no role in this process, and the structural budget deficit barely changed from the last quarter of 1979 to the second quarter of 1982. Thereafter fiscal policy came to the fore: domestic demand rose substantially during the second half of 1982 owing to the fiscal stimulus imparted

by the 1981-1982 tax cuts (discussed below), but GNP failed to recover because of the continued fall in exports caused by the appreciation of the dollar and sharp import cuts on the part of developing countries. Despite the slowdown in inflation and the deepening of recession, and notwithstanding attempts to start recovery through tax cuts, monetary policy remained contractionary during the first three quarters of 1982. However, in October 1982 the Federal Reserve Bank revised its money supply targets upwards.

Beginning in 1979 interest rates escalated sharply. From the last quarter of 1979 to the end of 1982, the nominal rate on three-month Treasury bills averaged 12 per cent, representing an average real rate of 3.5 per cent, which were respectively two and two-and-a-half times higher than at any point in the previous 26 years. The nominal rate exceeded the average for the previous four-year period (1976-1979) by more than two-thirds, while the real rate in the previous period was barely positive.

The persistence of high interest rates cannot be explained entirely by inflationary expectations. For one thing, short-term interest rates are not sensitive to expectations; rather, they reflect the stance of monetary policy. Over 1980-1982 its stance was clearly tight, for the average annual rate of increase in M1 fell considerably short of the average rate of price inflation, implying a decline in money holdings in real terms; the highest rates of interest were recorded during 1980-1981, when the money stock fell substantially in relation to nominal income. For another, nominal interest rates showed no tendency to fall when inflation started to decline at the end of 1981, and did not do so until the Federal Reserve Bank raised its monetary targets. Far from pushing up short-term rates, this brought them down by a full 4.5 percentage points within two quarters, and they did not show any tendency to rise until the recovery picked up in the first half of 1983. However, since the fall in interest rates was accompanied by a slowdown of inflation, the real rate of interest remained high.

The rise in the exchange rate of the dollar was another notable feature of the recession period; from the last quarter of 1979 to the end of 1982, the effective rate rose by about one-third in both nominal and real terms. The major factor in the strength of the dollar was the widening of interest rate differentials resulting from the rise in the rates on dollar-denominated assets. In 1981, when the real interest rate differentials turned sharply in favour of the United States, both the real and nominal effective ex-

<sup>5</sup> "US monetary policy in recent years: An overview", *Federal Reserve Bulletin*, January 1985, p. 16.

change rates of the dollar made a big jump, rising by about 20 per cent. Over this period, the short-term dollar interest rates exceeded the competitive rates on average by more than 2 percentage points.

The policy of money supply targeting ran into a number of problems. The monetary aggregates did not prove to be as controllable as had been expected; despite the wide margins of the targets set, M1 was outside the range more than half the time. In particular, the markets' search for liquidity in a context of financial deregulation resulted in the introduction of various interest-bearing transaction accounts and entailed shifts of funds, with implications for the various monetary aggregates. Consequently, the major monetary aggregates moved disparately, reducing their reliability and usefulness as a guide to policy, and forcing the Federal Reserve Bank to redefine its monetary aggregates.

Moreover, financial innovation and deregulation altered the relationship between monetary aggregates, on the one hand, and interest rates and nominal income, on the other. The relationship between the demand for money and income proved unstable and the velocity of circulation of M1 became erratic. Movements in nominal income were not related in any predictable way to the movement of monetary aggregates. There was, in fact, a strong *negative* correlation between money growth and nominal GNP growth from the first quarter of 1981 to the first quarter of 1983. In 1982, the historical relation between M1 and nominal income overpredicted the latter associated with a given growth rate for the former, owing to the shift in the demand for M1. Monetary policy therefore became more contractionary than would have been expected from the historical patterns.

## 2. *Tax cuts and fiscal stimulus*

While the pursuit of the prime objective of reducing inflation by means of monetary restraint continued uninterrupted, the United States Administration sought to bring about recovery through increased private initiative. In the belief that private initiative was inversely related to the size of government, massive cuts in personal and corporate taxes, beginning with the 1981 Economic Recovery Tax Act (ERTA), sought to give incentive to work and effort, and to private saving and investment. In other words, the stimulus was expected to come from the supply side via relative prices and deregu-

lation, rather than through effective demand and incomes.

There were basically two schools of thought in reconciling tax cuts with budgetary discipline. Some held that lowering revenues would eventually lead to cuts in government spending since, in the long run, tax revenues would determine the size of government. Hence, future spending cuts were an integral part of the fiscal programme. Others maintained that cuts in marginal tax rates would bring about a balanced budget by stimulating private initiative and generating higher output, thereby generating higher tax receipts. While these two views were not necessarily in agreement on the impact of tax cuts on the size of government, they converged on the need for increased "supply side" stimulus, and both played a part in the introduction of ERTA.

Subsequent developments have not so far fulfilled either of these expectations. Tax revenues have lagged behind the rise in incomes. Moreover, government expenditures have not fallen, and the share of budget outlays in GNP has recorded an increase of about 0.5 of a percentage point between 1981 and 1985, for, although civilian expenditures were cut heavily, the decline was counterbalanced by additional defence expenditures. Consequently, the actual budget surplus of 1979 was followed both by actual deficits which rose to about 4 per cent of GNP in 1985, and by structural deficits of about 2 per cent of potential output in the same year. The total gross public debt climbed by about \$800 billion between 1981 and 1985, from 35 per cent to more than 45 per cent of GNP.

The United States fiscal deficits have not been generated in the context of deliberate demand management policy. Indeed, systematic resort to fiscal policy tools for counter-cyclical purposes has been eschewed in the belief that, once deregulated and freed from high taxes, the economy would not need management of this sort, and the private sector would generate the requisite level of demand. Consequently, monetary policy remained the only means of affecting the course of the economy.

However, the increased role for monetary policy has not been accompanied by a commensurate widening of its perspectives and objectives; reducing inflation has remained its prime goal (though more recently exchange rate considerations have also come into the picture). Monetary policy was tightened soon after the economic recovery accelerated in order to check the pressure of aggregate demand on supply and in July 1983, less than six months after the trough of the recession, the Board of Governors of the Federal Reserve System re-



ported to the Congress that "there are indications that some of the cyclical influences that helped reduce inflation during the recession have waned . . . and growth in *nominal* spending at the present rate over a sustained period would suggest renewed inflationary pressures."<sup>6</sup> Again, in 1984, the targets for all monetary aggregates were lowered by comparison with 1983 as recovery quickened. The refusal of monetary authorities, before 1985, to finance fully the growth stimulated by fiscal deficits pushed real interest rates to record levels. This in turn has damaged heavily indebted sectors of the economy, such as agriculture, and pushed up the dollar, undermining the competitiveness of domestic producers and helping to generate large trade deficits and the associated deterioration in the external assets position.

### 3. *Interest rates and the dollar*

The popular view is that the rise in United States interest rates has been due to increased fiscal deficits, but there is a certain lack of clarity as to how the two are related. One possible channel is the portfolio effect: a rise in fiscal deficits financed by borrowing from the public implies an increase in the supply of government bonds, the absorption of which in private portfolios may require a rise in interest rates. But the flow involved of such funds is very small relative to the outstanding stock of financial assets, barely exceeding 2-3 per cent.

Another possible way in which increased deficits could give rise to higher interest rates is that, as deficits continue to increase, the increase in taxes expected to become necessary eventually to replace the amount otherwise raised by new bond issues will expand. It will become too large and politically too difficult to carry out, leading to expectations of monetization of deficits and increased inflation, and hence to higher interest rates. However, this explanation is not consistent with the substantial rise in real short-term rates.

Another explanation put forward is that the expected return on investment has risen - thanks to tax concessions and depreciation allowances, the easing of the burden of regulation, increased confidence, etc. - thereby increasing the demand for funds. Again, the amounts involved are too small in comparison to total portfolios to explain the substantial rise in real interest rates. For example, over

1982-1984 the *total* funds raised by the non-financial corporate sector remained less than 5 per cent of GNP and below the ratios observed during 1979-1981. Besides (as discussed below), the pattern of sectoral investments has not been closely related to rates of return after tax.

The origin of the rise in interest rates must rather be sought in the impact of increased spending, which was stimulated by tax cuts, on the demand for liquidity in the context of a tight monetary policy. As recognized by a recent OECD study, "interest rate increases might be a natural corollary of a successful fiscal policy; if deficit spending raised aggregate demand then it would increase the demand for money, and in the face of tight monetary policy the costs of holding money would rise."<sup>7</sup> Much the same thing would have occurred if recovery had come about as a result of a spontaneous burst of private spending or rise in exports instead of fiscal deficits. Conversely, the rise in interest rates would not have occurred if tax cuts had resulted in largely corresponding higher savings; but in this case, the rise in interest rates would have been avoided only at the expense of recovery.

In other words, a cut in fiscal deficits, unless accompanied by less restrictive monetary policy, would have reduced the interest rates primarily by reducing the level of activity. One estimate suggests that a permanent \$50 billion budget cut starting in 1984 would have generated, over a period of five years, an average reduction of between 0.8 and 1.8 percentage points in short-term interest rates, and of the rate of output by a similar margin. The same study also indicates no portfolio effect of increased deficits on interest rates. Again, a deficit-cut scenario predicts about a 4 percentage point fall in interest rates by the end of the decade, but in the context of a sharp deceleration in economic activity; domestic demand would shrink by 2 per cent per annum, with unemployment rising to over 15 per cent. Similarly, the findings of another study that set out to establish the direct link between budget deficits and interest rates suggests that two-thirds of the rise in real interest rates over 1981-1984 may have been caused by changes in monetary policy, financial deregulation and other non-fiscal developments, and that the link between fiscal deficits and interest rates was weakened during that period. Finally, a study on the timing of swings in real interest rates suggests that the recent interest rate behaviour is explained largely by changes in the monetary policy regime.

<sup>6</sup> "Monetary policy report to the Congress", *Federal Reserve Bulletin*, August 1983, p. 580.

<sup>7</sup> Jean-Claude Chouraqui and Robert W.R. Price, "Medium-term financial strategy: The co-ordination of fiscal and monetary policies", *OECD Economic Studies*, No. 2, Spring 1984, p. 21.

Despite the sharp decline in nominal interest rates, real interest rates remained at 4-5 per cent during 1983-1985. The differential between the Eurodollar real rate and the weighted average real short-term interest rate of the other major countries has also remained relatively stable, at around 3 percentage points. As mentioned earlier, the rise of the dollar in 1980-1982 can largely be explained by the widening of the interest rate differentials. However, the dollar continued to rise between 1983 and the third quarter of 1985, although there was no substantial change in the interest rate differentials. This appears to have been due to "speculative bubbles" or a "bandwagon type" movement, resulting from an upward revision of expectations concerning how long the interest rate differentials would persist, and expectations that the dollar would keep rising.

While the decision of the monetary authorities not to accommodate fiscal stimulus and recovery resulted in sharp rises in interest rates and the dollar, these in turn contributed to the growth of government debt by exerting a downward influence on budget revenues and increasing the interest payments (see box 1).

#### 4. *The strength and main characteristics of the recovery*

Since early 1983, the United States economy has enjoyed an average annual growth rate of 4.8 per cent over ten consecutive quarters. Rapid growth is typical of recovery from recession; in the five previous such episodes during the post-war period the annual growth rate averaged 5 per cent over the same span of time. Real output grew from the previous peak (in the second half of 1979) by 10 per cent within two years whereas in the previous cycles the average had been 12 per cent.

A distinct feature of the present recovery has been the disparity between the rates of growth of output and of final domestic demand. The latter has increased more rapidly than in previous recoveries - 5.4 per cent annually, compared to 4.3 per cent - but because of the swing in the trade balance GNP growth fell below the rate of growth of domestic demand. The deterioration in the net external balance lowered the GNP growth rate by about 1.5 percentage points per annum, whereas in five previous expansions the effect of net exports (i.e., exports minus imports) on recovery was, on average, neutral.

The worsening of the trade balance has been due to the dollar appreciation, stagnation in other major OECD countries, and import cuts by developing countries. One estimate puts the contribution of the dollar to the swing in the United States current balance at around two-thirds, and another at one-third, with the second and third factors accounting for the rest. There can be little doubt that the dollar's strength has contributed significantly to the swelling of imports, which rose at an average annual rate of more than 18 per cent (compared to less than 7 per cent in previous recoveries), and to the weak performance of exports, which grew at less than 0.5 per cent per annum (against more than 8 per cent in previous expansions).

In the absence of the dollar appreciation and the consequent demand leakage abroad, much of the excess of investment over domestic savings could have been avoided, since domestic output and aggregate savings would have been larger (and, as shown below, the fiscal deficits smaller); both unemployment and underutilized capacity remained high in the recovery. Monetary policy in the United States has thus had a depressive influence on domestic production and employment through its impact on the dollar. This conclusion does not tally with the popular notion that capital inflows helped restrain the rise in United States interest rates, and hence increased the level of expenditures by checking the "crowding out" effect of fiscal deficits.

Business inventories have increased more rapidly than in previous expansions, but by far the most significant departure from the previous episodes has been the rise in business fixed investment. Despite very high interest rates, it has recorded an average real rate of growth of more than 13 per cent, almost twice the average observed in previous cycles, and accounted for 1.5 percentage points, or 30 per cent, of the annual growth in real GNP. The pace of recovery in business investment appears equally remarkable when comparison is made in terms of the rise from the previous peak.

The investment boom has taken place in the context of a shift towards short-lived capital. Investment in producers' durable equipment (PDE) rose during the first two years of the recovery at nearly 16 per cent, i.e., more than twice that of investment in non-residential structures. Business purchases of automobiles and office equipment (including home computers) accounted for more than 90 per cent of the total rise in PDE over 1979-1984. Recovery in other capital equipment remained weak.<sup>8</sup> Do-

<sup>8</sup> There is a problem of allocating individual products between consumption and investment application, since the na-

## BOX 1

**EFFECTS OF INTEREST RATES AND THE DOLLAR ON FISCAL DEFICITS AND PUBLIC DEBT**

- *The rise of interest rates and the dollar have widened budget deficits in two ways. First, they have slowed down the level of activity, principally by worsening the trade balance, and have hence reduced government revenues. It has been estimated that a reduction of the gap between actual and potential output by one percentage point in 1983 would have lowered the actual budget deficits by about \$13 billion per annum, or the ratio of budget deficits to GNP by 0.4 percentage points.*
- *The second effect, via government interest payments, is far more important. Net interest payments as a proportion of total primary expenditures increased from 9 per cent in 1979 to almost 16 per cent in 1985. The average implicit interest rate (i.e., the ratio of gross interest payments to gross public debt) rose from 6.3 per cent to 8.8 per cent. In 1985, gross government interest payments were 4 per cent of GNP and more than 40 per cent of total transfer payments. The rise in interest rates has had a cumulative impact by increasing deficits and the volume of debt.*
- *A hypothetical exercise shows, ceteris paribus, that if the average interest rate on government debt outstanding in 1979 had remained unchanged, the total interest payments and hence debt accumulation over 1980-1985 would have been lower by about \$200 billion - a figure which represents about one-tenth of the total outstanding debt in 1985 and a quarter of total gross interest payments and of total deficits over 1980-1985. The increase in primary deficits during this period accounted for only \$50 billion of the \$200 billion; the rest was due simply to the rise in interest rates operating on and adding to the initial stock of government debt. The rise in interest rates also increased the structural deficit, for it entailed a larger stock of debt at each point in time. Calculating the structural deficits on the basis of a 6 per cent unemployment rate, this amount represents as much as 40 per cent of cumulative structural deficits.*
- *Indeed, the dynamics that explain much of the debt predicament of many developing countries is equally relevant here. When primary deficits are zero, total debt grows at the same rate as the rate of interest; if  $i$  stands for the nominal rate of interest,  $D$  for debt, and  $dD$  for changes in debt, then when primary deficits are zero,  $iD = dD$  or  $i = dD/D$ . The ratio of public debt to GNP, on the other hand, grows at the same rate as the difference between the real rate of interest and the rate of growth of real GNP; that is, the growth rate of  $D/PY$  when  $PY$  is nominal income is equal to  $(i-p)-g$ , where  $p$  is the rate of inflation and  $g$  the real growth rate. This difference is at present greater than 2.5 per cent, and is likely to remain positive as long as the present real interest rates persist, since these rates are above the sustainable rate of real growth. Under these circumstances, the reduction of the debt/GNP ratio will require substantial primary surpluses, in much the same way as in the debtor developing countries which have had to generate massive trade surpluses in order to service debt and reduce further debt accumulation. Thus, to the extent that the rise in the rate of interest explains the rise in federal deficits and in the ratio of public debt to GNP, its reduction is essential for reducing deficits and indebtedness without generating deflationary impulses.*

mestic capital goods production rose by 1984 to only 85 per cent of its 1979 level, after having fallen to 70 per cent during the trough of the recession. Within the non-residential structures, commercial investment rose by an annual rate of about 11.5 per cent while industrial structures fell at a rate close to 12 per cent, far greater than its rate of decline (under 2 per cent) during the recession; between 1980-1984, industrial construction remained almost unchanged whereas the total rise in commercial construction in this period was about 70 per cent.

This pattern cannot be explained by the investment incentives provided by the 1981 Act referred to in section 2 above. Spending on office equipment and automobiles started to increase before the Act came into effect, and the recovery was not led by those types of capital that qualified for the largest reduction in effective tax rates: indeed, there was no change in tax treatment of automobiles, and the rate on computers rose. On the other hand, while there were substantial tax reductions for all

kinds of non-residential structures, investment in commercial buildings rose but in industrial structures declined. It would appear that in sectors where demand was weak companies tended to use tax cuts to increase dividends rather than capital spending.

The rate of growth in manufacturing output capacity has remained markedly low, partly reflecting the drastic decline in investment in industrial structures. During the 11 quarters from the first quarter of 1983 to the third quarter of 1985, output capacity in manufacturing increased by just over 5 per cent whereas the rate of increase was about 10 per cent during the 12 quarters from the first quarter of 1980 to the fourth quarter of 1982.

The leakage of demand through reduced competitiveness with imports has meant that, while the non-traded goods sectors, in particular services, have enjoyed steady and firm growth, the output growth in manufacturing has lagged. Of the 7 million increase in aggregate non-agricultural payroll employment dur-

tional income accounts measure investment as a summation of sales. Thus, one survey of business capital spending gives a much lower figure (14 per cent) for the growth of business investment than the national income accounts (33 per cent).

ing the first two years of the recovery, only 2.2 million was in manufacturing, mining and construction; trade, finance and other non-government services absorbed twice as much. The capacity utilization rate in manufacturing recovered more slowly than usual and remained relatively low; although it rose from a monthly low of 68 per cent in 1982 to 82 per cent at the end of 1984, it declined further to 80.5 per cent in July 1985, staying about 6 percentage points below the monthly high observed during 1978-1980.

It remains uncertain what the longer-term consequences of these patterns will be, particularly the shifts to short-lived capital and to services sectors, for the growth potential of the United States economy. OECD has pointed out that "on the one hand it could mean a more flexible industrial structure, with an automatic upgrading of technology reducing the chance of large-scale obsolescence such as occurred in auto, steel, machinery and other large-scale United States manufacturing in the late 1970s. On the other hand, a shorter-lived capital stock could increase instability, especially if investment were to remain depressed for an extended period and the capital stock were quickly run down."<sup>9</sup>

The macroeconomic policies of the United States during the first half of the 1980s have been successful in bringing down inflation from very high to very low levels. The rate of increase of consumer prices was more than halved between 1980 and 1982, falling from 13.5 per cent per annum to 6 per cent. Moreover, the United States recovery provided the world economy with its only autonomous expansionary stimulus, since the other major developed market economy and the developing countries were undertaking deflationary measures. The downward trend in output and the upward trend in unemployment in the United States were successfully reversed after 1983, but disinflation continued: the consumer price inflation fell by a further 2.5 percentage points between 1983 and 1985 (see chapter III, section D). Nevertheless, in addition to the earlier costs of disinflation in terms of lost output and employment, which were substantial due to the size and speed of disinflation sought, the inconsistency between the United States monetary and fiscal policies, together with the rise in interest and exchange rates, have generated serious problems for several sectors of the economy.

The appreciation of the dollar and the consequent deterioration in the external balance has led to a sharp swing in the net external

asset position of the United States economy. In the two years beginning in 1983, the United States lost its status as the world's largest creditor country, which it had held since the First World War, and accumulated debt amounting to over \$250 billion, i.e., almost half the total outstanding bank debt of developing countries. It has been estimated that on current trends, by the end of the decade, the United States net foreign debt will be between \$400 and \$1000 billion, depending on the dollar. This would mean that an annual trade surplus of between \$50 billion and \$100 billion would be required just to balance the current account.

Despite increased trade restrictions in some areas, import penetration in the United States market rose substantially for manufactures. At the same time, exports of manufactures as a proportion of output fell from about 19 per cent in 1981 to under 15 per cent in 1985. In consequence, the trade balance in manufactures has deteriorated by more than \$100 billion over this period. The deterioration has been particularly severe in semi-manufactures, autos, parts and engines, electronics and other capital goods, as well as in clothing and footwear. While some of these industries may have structural weaknesses, others, including capital goods and high-technology industries, are regarded as highly competitive in world markets. Moreover, in some of these industries there was not only a fall in exports in relation to output, but also a fall in the level of output, even during the recovery phase. These developments gave rise to increased pressures for protectionism and threatened to disrupt the trading system (see chapter IV, section C).

Agriculture is another sector in the United States that has traditionally been considered highly competitive but was dislocated by the imbalances that characterized the country's economy in the 1980s. The combined effects of the recession and the dollar on export revenues and cash flows of farmers and the impact of high interest rates have created an acute debt problem in this sector (see chapter III, section B).

Another notable feature of the 1980s has been the surge in the volume of financial transactions spurred by deregulation and innovation. Daily transactions in shares more than doubled over a period of five years; trading in the government securities market quadrupled, and financial futures and options trading rose to unprecedented levels. Moreover, there has been a considerable surge in corporate take-

<sup>9</sup> *OECD Economic Surveys, United States* (Paris, November 1985), p. 12.

overs. The volume of mergers, acquisitions and buyouts in 1984 exceeded the previous annual high by about 60 per cent.

This increased financial activity has reflected, in part, a shift from investment in physical assets to investment in financial assets, and increased indebtedness contracted in order to acquire financial assets or to buy control. The increase in the indebtedness of the non-farm private sector has matched that of the farm sector, the government, and the economy as a whole (see chapter IV, section A). It has also been unrelated to the growth of real economic activity: as noted by a chief economist of a top investment bank which alone handles annual financial transactions worth more than

GNP: "You can argue all you want that this is motivated by the free market, but the fact is that we don't need these high transaction volumes to produce the current level of gross national product."<sup>10</sup> Similar concerns were expressed by the chairman of the Board of Governors of the Federal Reserve System, Mr. A. Volcker, who is reported to have said that "we've become expert in trading all kinds of financial assets and companies . . . but all the while, productivity still lags. . . . We spend our days issuing debt and retiring equity - both in record volume - and then we spend our evenings raising each other's eyebrows with gossip about signs of stress in the financial system."<sup>11</sup>

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## C. Western Europe and Japan

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### 1. *Stance of fiscal and monetary policies*

During the 1970s the major Western European countries experienced exceptionally high rates of inflation and unemployment as well as slower growth. While economic growth recovered during the second half of the decade and prices slowed down somewhat, both unemployment and inflation rates remained high. In Japan, unemployment remained low throughout the 1970s, but inflation accelerated and growth slowed down sharply in the mid-1970s. Inflation was gradually reduced during the second half of the 1970s and activity picked up, but the rate of growth of GNP remained low compared with the 1960s and early 1970s. While in both Western Europe and Japan monetary restraint was widely applied in response to persistent inflation, in general, fiscal stance remained expansionary. Indeed, fiscal policy was seen in several countries as the main instrument of active demand management to restore growth. This was particularly true for Japan, where deficit financing was seen as a means of providing support for demand in the face of deceleration in private investment and a high savings ratio. Although real government expenditure did not grow any more than before, the decline in GNP growth entailed a rise in actual deficits as well as in the ratio of public debt to GNP.

Against the background of high unemployment, inflation accelerated once more during the late 1970s and early 1980s. The dispersion of inflation rates also increased, ranging from a moderate level of around 4 per cent in the Federal Republic of Germany and Japan to about 13-15 per cent in the United Kingdom and Italy in 1979, accelerating further in Japan, the United Kingdom and Italy during the early 1980s (see annex table 19). While the second oil price rise was viewed as an important factor in the acceleration of inflation, the increased pressure of demand on capacity and the lagged effects of rapid monetary expansion were also widely regarded as important. The policy response was therefore different from that of the mid-1970s. Unemployment and slowdown in growth in many, perhaps nearly all, OECD countries were increasingly traced to structural rigidities, including growing inflexibility in labour and product markets, the emergence of major imbalances in the share of aggregate income, and a shift in the tax burden to employment and investment, resulting in a decreasing responsiveness of domestic supply to increases in demand and a lessening of the trend forces for growth. Hence, "economic performance would quite possibly have deteriorated even without the two oil price shocks."<sup>12</sup>

Thus the late 1970s and early 1980s witnessed a shift in policy from the management of aggregate demand designed to secure high

<sup>10</sup> Remarks made by Mr. Albert M. Wojnilower of First Boston Corp. (reported in *Business Week*, 16 September 1985, p. 55).

<sup>11</sup> *Ibid.*, pp. 55 and 66.

<sup>12</sup> *OECD Economic Outlook*, No. 31, July 1982, pp. 6 and 7.

growth and full employment to what has come to be known as "medium-term financial strategy". The overriding emphasis of this strategy was on financial objectives, and it comprised convergence of monetary and fiscal policy in order to better control monetary growth and inflationary expectations; and reduction in the growth of public spending relative to nominal income in order to alleviate the "supply side" distortions; and reduction in government borrowing and debt to reduce the growth of public sector debt service and lessen "the crowding out" of private investors in financial markets. Cuts in public spending were seen as essential for reducing government borrowing and interest rates in order to stimulate recovery through increased private investment and also in order to permit tax cuts.

While there were differences in the extent to which this strategy was applied, the fiscal policies of almost all major Western European countries as well as Japan were aligned to it. Japan set itself the target of reducing public sector deficits to 3.3 per cent of GNP, through a "zero ceiling" on public spending growth over 1980-1985; the Federal Republic of Germany set out to reduce federal deficits from DM34 billion to DM17.5 billion (representing less than 1 per cent of GNP), to be achieved by holding public expenditure growth below 4 per cent a year over 1981-1985; France sought to stabilize the central government deficit at 3 per cent of GDP in 1982-1983; Italy attempted to freeze the Public Sector Borrowing Requirement (PSBR) at its 1980 level over 1981-1983; and the United Kingdom targeted a 3.7 percentage point reduction in the PSBR to 2 per cent of GDP over 1980-1985, implying a 4 percentage point reduction in the share of total public expenditure in GDP, to be achieved largely by cutting capital formation in the public sector and increasing taxation.

The outcome of this strategy was a sharp contraction of public sector deficits. The ratio of actual deficits of these countries taken together to total GNP/GDP fell by about 0.8 percentage points from 1979 to 1985. More importantly, the ratio of structural deficits to potential GNP/GDP fell by more than 2.5 percentage points in the same period. In the United Kingdom and the Federal Republic of Germany, the structural deficits of over 3 per cent and 2 per cent of potential GNP/GDP in 1978-1979, respectively, turned into structural surpluses of about 2.4 per cent and 1.2 per cent in 1985. In Japan, the structural deficit as a percentage of GNP was cut every year after 1978, giving a total swing of 4.4 percentage points and a more or less structurally balanced

budget in 1985; the actual deficits also fell continuously, from 4.8 per cent of GNP in 1979 to 1.3 per cent in 1985. In France, the structural deficit rose during 1982-1983 in the course of the Government's attempt to reflate, but cuts earlier and later meant a total swing of 1.5 percentage points over 1979-1985. In Italy, after a rise in 1981, the structural deficit fell in 1983; however, it has kept up during 1984-1985.

Hence, fiscal policy largely ceased to be geared towards employment and output objectives, and was subordinated to monetary and inflation control. As an adviser to the Governor of the Bank of England has stated, "use of strong intermediate targets, for money supply and government borrowing, enabled the authorities to stand back from output and employment as such . . . For what matters is the refusal of the authorities to stimulate demand in 'Keynesian' fashion, or to 'reflate', as conditions develop that would in the past have justified and provoked such a response. The fact that the monetary targets have not concurrently been met, or that the meaning of particular developments in this or that aggregate has become very ambiguous, is of much less importance."<sup>13</sup>

In the majority of cases, fiscal tightening was seen as necessary to support monetary policy, not only to reduce inflationary pressures but also to ease the pressure on interest rates that monetary tightening entailed. In almost all cases, targets for monetary aggregates remained well below the potential output growth rate after making allowances for a moderate rate of inflation. In the Federal Republic of Germany, money supply targets exceeded the potential annual output growth rate by only 2.5 percentage points while consumer price inflation was 5 per cent. In Japan, the average annual money supply growth barely matched the rate of potential output growth. As the main purpose was to disinflate rather than to provide the liquidity required for potential real growth, contractions of the real money supply were widespread, particularly during the early 1980s.

Monetary and fiscal restraints in Western Europe and Japan resulted in a substantial slowdown in inflation. However, disinflation was achieved more rapidly in Japan. The rise in the consumer price index in Japan fell from 8 per cent in 1980 to around 2 per cent in 1983 and continued at this lower rate during 1984-1985. While some countries in Western Europe, notably the Federal Republic of Germany, started from lower peak rates of inflation in the early 1980s and achieved a faster

<sup>13</sup> J.S. Fforde, "Setting monetary objectives", *Bank of England Quarterly Bulletin*, vol. 23, June 1983, p. 207.



disinflation, for the region in general, inflation proved to be more stubborn than in the United States and Japan due in part to the extent of currency depreciation and the rigidity of domestic food prices (see chapter III, section D). Nevertheless, it declined from more than 14 per cent in 1980 to under 7 per cent in 1985.

## 2. *Demand, output and employment*

The outcome of the combination of monetary restraint and fiscal retrenchment was also a deep and prolonged recession in Western Europe and a marked slowdown in Japan. Unemployment in the OECD European countries climbed from under 6 per cent in 1978-1979 to over 10 per cent in 1983. Output fell for two consecutive years in the Federal Republic of Germany, the United Kingdom and Italy. In Japan, the rise in unemployment was moderate, but the deceleration in growth substantial; the average GNP growth rate was about half what it had been in the late 1970s. In the OECD area as a whole, outside the United States, there was a cumulative increase in real output of about 4 per cent between 1980 and 1982, half of which was due to the growth of net external demand (almost all from the United States); even with unchanged fiscal policies the increase in output could have been at least 5 per cent. The output gap widened substantially, from an average of about 1 per cent at the end of the 1970s to over 5 per cent in 1982 in these countries as a whole, reaching over 8 per cent in the United Kingdom and 7 per cent in the Federal Republic of Germany.

The impact on real activity varied. The recession came earlier in the United Kingdom and nowhere else was it so deep and prolonged. Real output fell at an average rate of 2 per cent over 1980-1981, and in 1982 output was 7 per cent below the trend prevailing in the 1970s. The capacity utilization rate in manufacturing fell from the 1979 peak of about 88 per cent to 73 per cent. The rate of unemployment rose continuously every year. It doubled the 1978-1979 level by 1982 and stayed at about 13 per cent for the next three years. The decline in total manufacturing employment of 20 per cent during 1979-1982 accounted for almost the entire rise in the unemployment rate, and youth unemployment exceeded 25 per cent. On average, it took roughly a cumulative 2.5 percentage point rise in the unemployment rate to secure a single percentage point fall in the rate of inflation. The fact that employment fell more than output - i.e., that productivity rose - largely reflected the scrapping of marginal equipment rather than capital accumulation

and technical progress, casting serious doubts on the sustainability of the increase.

Japan's performance over 1980-1982 was tied to its external sector. Capital spending and budget deficits as a proportion of GDP fell by 2 and 1 percentage points, respectively, from 1979 to 1982 and, of the average GNP growth of 3.5 per cent per annum, no less than 2 per cent per annum was due to growth in net exports. The rate of unemployment increased and the rate of capacity utilization in manufacturing fell to under 79 per cent from the 1979 peak of 91 per cent. In the Federal Republic of Germany, too, the contribution of external markets to aggregate demand alleviated the impact of government policy on output and employment. Nevertheless, because of the decline in the domestic "autonomous" components of effective demand, output fell in 1981 and again in 1982, the output gap increased from about 1 per cent in 1979 to more than 7 per cent in 1982, the unemployment rate doubled and capacity utilization in manufacturing fell by more than 10 percentage points. In France private investment fell in 1980-1982 and the contribution of net exports to GNP growth remained negative, but moderate growth in consumer spending prevented a sharp decline in output. Italy, on the contrary, experienced a substantial slowdown in consumer spending during 1981-1982 which, in combination with stock decumulation and the decline in private investment, caused output to fall.

Activity picked up in late 1982 in the Federal Republic of Germany and the United Kingdom, and in early 1983 in Japan and Italy. The recovery, however, has been exceptionally weak by historical standards. Whereas in three previous upswings output recovered, on average, by about 25 per cent over the three-year period after the trough in Japan, and by 13 per cent in the Federal Republic of Germany, France and the United Kingdom taken together, in the three years of this recovery GNP growth has remained under 14 per cent for Japan and at 7.5 per cent for the other countries. Hence, unlike previous expansions, Western Europe has lagged substantially behind the United States, while Japan's performance has remained relatively weak. The capacity utilization rate has not been restored to its 1979-1980 peak; in the third quarter of 1985, it was lower in Japan by 6.6 percentage points and for the United Kingdom, the Federal Republic of Germany and Italy from 2.6 to 3.5 points. Since actual GNP growth did not stay above the potential growth rate for any considerable period, the output gap has not shown any tendency to diminish. More importantly, unlike previous recoveries, the unemployment rate rose.

This weak performance outside the United States reflects continued adherence to restrictive policies, notwithstanding the slowdown in inflation. Fiscal retrenchment entailed a reduction of 0.5 percentage points a year in the GNP growth rate as structural budget balances rapidly turned into surplus, particularly in Japan, the Federal Republic of Germany and the United Kingdom. Unlike its trend in the United States, the share of investment in total expenditure has not recovered; it is about 4 percentage points below the pre-recession peak in Japan, and from 1.5 to 2.5 points below in the Western European countries. In Japan the total rate of growth of business capital stock in the first three years of recovery was 12 percentage points lower than the average of previous expansions, whereas in Western Europe it was lower by 7 points.

The external sector provided most of the little stimulus that was forthcoming. During 1983-1985, GNP growth exceeded the growth in domestic demand by 25 per cent in Western Europe and 40 per cent in Japan, exactly the reverse of the situation in the United States. The swing in the trade balance with the United States owing to the substantially faster growth of the United States domestic markets and the appreciation of the dollar added almost a full percentage point to the *ex-post* GNP growth rate in Western Europe and Japan. In view of the feedback to domestic demand, the overall impact was much greater, particularly in Japan, which exported a higher share of its output; here the *ex-post* contribution of net exports alone accounted for between one-third and one-half of GNP growth in 1983-1985. It has been argued that when the multiplier effects are included, exports accounted for all of Japan's growth in 1983 and two-thirds of its growth in 1984. The trade surplus as a proportion of GNP rose rapidly to about 4 per cent. Thus, the contribution of the United States expansion to recovery in Western Europe and Japan was made by generating imbalances in trade and payments and in external asset positions.

### 3. *Interest and exchange rates and national autonomy in economic policy*

The first half of the 1980s witnessed substantial increases in interest rates in Western Europe and Japan. Nominal short-term rates reached a peak in 1980-1981, and started to fall thereafter as inflation decelerated. But real interest rates settled at appreciably higher levels in all countries concerned; compared with the late 1970s, they stood in 1984-1985 at 2-3 percentage points higher in the Federal Republic

of Germany and Japan, 5 points higher in France and 6-8 points higher in the United Kingdom and Italy.

While these interest rates did not move on a par with the United States rates, and the differentials widened, there was an association between their movements. This has led many observers to explain the rise in real interest rates in OECD countries other than the United States in terms of the latter's budget deficits and high interest rates and the strength of the dollar. According to this view, the increased integration of national financial markets and capital mobility entail an international allocation of national savings in world capital markets so as to equalize rates of return on assets denominated in various currencies. Consequently, the increase in the United States savings gap and interest rates exerted pressure on savings in other countries and resulted in a generalized rise in interest rates.

The exact mechanism through which high United States interest rates are transmitted abroad is, however, unclear. First, a change in United States interest rates does not imply that equality of rates of return on alternative assets would be restored by a change in foreign interest rates; a more plausible mechanism is changes in the exchange rate of the dollar, and one of the strongest arguments in favour of floating has been that exchange rate adjustment can allow national interest rates to be delinked. Secondly, as has already been pointed out, even if interest rates could be related directly to budget deficits, this would not explain the generalized rise in interest rates, since fiscal stance in OECD countries as a whole was more or less neutral. Indeed, it can be argued that the flow of savings to the United States from other countries, and, Japan, in particular, stemmed from a decline in the demand for savings in these countries (see subsection 5 below).

Of course, lower United States interest rates and a cheaper dollar would have entailed lower interest rates in Western Europe and Japan by giving them less expansionary stimulus relative to the liquidity that their central banks were prepared to supply. But this is to say no more than that the United States contribution to their high interest rates reflected its contribution to their recovery. Empirical work does not indicate that United States interest rates have a substantial direct influence on rates in Western Europe. The OECD inter-link model suggests that a 100-basis points increase in United States rates would generate about a 20-basis points increase in interest rates in Western Europe, and a full elimination of the United States budget deficits would lower European rates by only 100 basis points.



There is, however, a more plausible explanation of the synchronization of monetary policy and interest rates in the United States and abroad. Countries outside the United States were concerned with the inflationary consequences of the appreciation of the dollar, and the possible emergence of a vicious circle. Consequently, they had limited room for taking monetary action to reduce interest rates, which would have led to a further depreciation of their currencies. In Japan, the protectionist sentiment in the United States was also seen as providing a reason to pursue tighter monetary policies. More generally, it has been the case that the "benign neglect" by the United States of the exchange-rate consequences of its policies has shifted the burden of exchange-rate management onto other industrial countries, and induced procyclical monetary measures abroad. In the 1980s, on various occasions, monetary authorities in Japan, the Federal Republic of Germany and the United Kingdom raised domestic interest rates and lowered monetary growth in order to check the depreciation of their currencies against the dollar. This loss of control over monetary policy has been noted by many observers. The former President of the Deutsche Bundesbank remarked that industrial countries outside the United States "had to maintain higher interest rates than warranted by their domestic situation in order to prevent the dollar from going even higher, to the detriment of their price stability . . . Monetary policy in Germany, as in Britain, had to orient itself very much towards the exchange rate of the dollar in order to restrain inflation."<sup>14</sup>

However, the loss of national autonomy should not be exaggerated. Indeed, monetary restrictions were applied before the dollar started its climb and "it is less easy to marshal quantitative evidence to show that, over the period as a whole, monetary policy was significantly tighter than it would otherwise have been because of the strength of the dollar."<sup>15</sup> Moreover, fiscal stance in Western Europe and Japan cannot be explained by external influences. The stance of policy and its outcome have thus largely reflected national choices.

#### 4. *Unemployment and labour market rigidity in Western Europe*

The persistence of high unemployment in the major Western European countries has been increasingly attributed largely to labour market rigidities. It is argued that the commitment of governments to maintain full employment has reduced the response of real wages to supply and demand shocks, and hence put the burden of adjustment on employment and profits. It also entailed a decline in the economically viable capital stock, accelerated the scrapping of equipment, retarded physical capital formation and encouraged a labour-saving bias in investment. Further according to this view, the consequent mismatch between the supply of labour and productive capacity generated a structural "excess supply of labour" which cannot be reduced by demand management. Moreover, wage rigidity reduced the demand for labour associated with any rise in effective demand by forcing enterprises to seek productivity gains by means of labour shedding, and hence increased the rate of unemployment at any given rate of capacity use. For these reasons the rate of unemployment consistent with stable inflation (the "natural" rate of unemployment or the non-accelerating inflation rate of unemployment (NAIRU)) is now substantially higher than before.

In the same vein, the weak performance of Western Europe relative to the United States has been attributed to differences in market structures, including the labour market. For example, the IMF staff has stated that, "in the United States, expansion has owed much to declines in inflation and in interest rates, as well as to improvements in fiscal incentives and in the flexibility with which United States markets have functioned. In Europe, by contrast, recovery has been retarded by structural factors, including high wage costs (relative to output prices) and other market rigidities."<sup>16</sup>

While there can be little doubt that many structural rigidities are present in the major Western European countries, it does not follow that the weak performance of their economies in the 1980s can be explained primarily by structural problems rather than by macroeconomic policies. Although there is a consensus that, among the major industrial countries, Japan has the most flexible labour market, the

<sup>14</sup> O. Emminger, "The search for a more stable international monetary system", *World Money and National Policies* (New York, Group of Thirty, 1983), p. 24.

<sup>15</sup> S. Marris, *Deficits and the Dollar: the World Economy at Risk* (Washington, D.C., Institute for International Economics, 1985), p. 70.

<sup>16</sup> *World Economic Outlook*, Washington, D.C., April 1985, pp. 7-8.

empirical evidence on real wage rigidity in Western Europe relative to the United States is mixed. A number of recent studies, based on more appropriate measures of real wage rigidity than those used in the past, have cast doubt on the conventional wisdom that real wages are relatively more flexible in the United States. These studies suggest that only the United Kingdom has an unambiguously greater degree of wage rigidity whereas in the Federal Republic of Germany, France and Italy real wages are no less, and perhaps even more, flexible than in the United States.

Moreover, wage cuts cannot compensate for paucity of effective demand any more than wage rigidity can restrain effective demand. Model simulations by the Commission of the European Communities have found that "wage moderation unaccompanied by a supporting demand policy is likely to have only a slow and small positive impact on employment. However, wage moderation supported by demand policy . . . will have a significantly beneficial impact on employment."<sup>17</sup> A similar point was also made by OECD: "Since (1979) European unemployment has risen by more than 80 per cent but European real labour cost growth has decelerated sharply. Even allowing for the fact that the adjustment lags are long and rather uncertain, this is *prima facie* evidence that other factors than just the growth of real labour costs alone have accounted for the rise in European unemployment since the second oil shock. In particular, the decision . . . to adopt a non-accommodating macroeconomic policy stance . . . meant that a decline in capacity utilization and hence a rise in unemployment was an unavoidable consequence."<sup>18</sup>

The assumption that increased demand stimulus in Western Europe would raise prices more than output and employment has nevertheless played a major role in the adherence of governments to deflationary fiscal policies even after disinflation was achieved. But the same result - more inflation rather than more output - should also be expected from the spontaneous rise in private capital spending or in exports which all governments in Western Europe have sought to encourage. There is no evidence that fiscal-induced expansion is necessarily more inflationary, and the resistance to it is perhaps rooted in a desire to reduce the size of the public sector and to limit the scope of its activities. There is little reason to assume that increased private expenditures would result in

greater productivity gains than would accrue from a judicious combination of public investment and tax reductions.

In any event, unemployment rates in almost all major Western European countries during the first half of the 1980s exceeded, in some cases substantially, the estimated NAIRUs. It has been found that the weighted average value of the NAIRU in the European Economic Community was no more than 7.5 per cent, while the unemployment rate exceeded 10 per cent. Similar estimates are also provided by OECD studies. Hence, on this measure alone, policies have been unnecessarily restrictive; at least one-quarter of total unemployment in Western Europe could have been avoided by demand expansion without generating inflationary pressures.

The argument that the "natural" rate of unemployment in Western Europe is so high that attempts to bring unemployment down substantially would generate inflation is self-defeating in one important respect. The "natural" rate is not an exogenously given constant; it depends predominantly on the evolution of the actual rate of unemployment. When the economy is run above the "natural" rate of unemployment the problem of structural unemployment is exacerbated, because those who are involuntarily unemployed suffer a deterioration in their skills and become increasingly unemployable. Since productivity growth typically takes place in the context of rising employment and output, keeping the actual rate of unemployment high over extended periods would itself cause the "natural" rate to rise. Hence, the "natural" rate of unemployment is not independent of what governments do. Indeed, the continuous upward revisions in estimates of "natural" rates of unemployment in Western Europe during the late 1970s and early 1980s suggest that it was the persistence of high unemployment that raised the "natural" rate. As has been pointed out "there are few recent changes in structural factors that would explain such a dramatic rise in the natural rate."<sup>19</sup>

To the extent that the rate of unemployment consistent with stable inflation rises under the influence of persistently high unemployment, price stability may only be ensured at the expense of not merely high, but rising unemployment. To avoid this trap requires a combination of demand stimulus to reduce unemployment and policies designed to deal with structural rigidities (see chapter VI, sec-

<sup>17</sup> *European Economy*, No. 22, November 1984, p. 179.

<sup>18</sup> *OECD Employment Outlook*, September 1985, p. 36.

<sup>19</sup> J.D.T. Coe, "Nominal wages, the NAIRU and wage flexibility", *OECD Economic Studies*, No. 5, Autumn 1985, p. 97.

tion C), rather than a single-minded policy of deflation.

### 5. *The savings-investment gap in Japan*

Japan's chronic trade surplus and the dependence of its economic growth on export markets during the 1980s resulted from the superimposition of a tight fiscal stance on a persistent excess of savings over domestic investment in the private sector. The private savings/investment gap emerged after the end of the boom of the late 1960s and early 1970s, when the share of investment declined from about one-third of GNP in 1973 to under one-quarter in 1979, while the shares of household and business savings in GNP fell very little. As a result, the private sector moved from a balance between saving and investment in the early 1970s to an excess of savings equal to 4.4 per cent of GNP.

During the second half of the 1970s this gap was largely filled by government deficit spending, which allowed domestic economic activity to be supported by domestic demand. By contrast, in the 1980s the government balance had been drastically reversed, while the excess of private savings over investment has continued to rise. In 1984 the excess reached 5 per cent of GNP, half of which was absorbed by the Government and half by other countries, through Japan's current-account surplus. In 1985, government deficits fell yet further, and the net surplus of the economy as a whole rose from 2.5 per cent to 4 per cent of GNP. If this trend were to persist, Japan would become the largest creditor country in history by the turn of the decade, with an unprecedented \$400 billion of net external assets and a substantial net investment income.

The growing surplus of private savings presented a dilemma for the Japanese authorities, for absorbing it with budget deficits would constantly raise the ratios of deficits and of public debt to GNP, while absorbing it through a surplus of exports over imports would require other countries to run up substantial deficits and accumulate a vast debt. The latter course, which, unintentionally, was tantamount to a "beggar-my-neighbour" policy in respect of unemployment, has in effect been followed, and has set off acute tensions between Japan and its principal trading partners. If the private savings/investment gap and the stance of fiscal policy both remain unchanged, these tensions will not only continue but will mount. On the other hand, switching domestic demand towards imports would redirect the deflationary pressure towards the Japanese economy, and the private sector's surplus of savings would

eventually be extinguished by the depression of output. Such a switch would not be easy to effect since the demand for imports is constrained, among other things, by structural, organizational and cultural characteristics of the economy, including established supply relations among companies, an industrial structure which emerged from a strategy of maximum reliance on domestically produced inputs, and consumer preferences which die hard.

If running large deficits with Japan is unacceptable to the United States and other OECD countries, and if Japan continues to require export surpluses to avoid budget deficits or recession, it will be necessary for it to generate a larger trade surplus with developing (or socialist) countries. However, that will not be possible unless those countries are provided with the necessary finance. For many such countries, the existing levels of indebtedness are an obstacle to borrowing from capital markets, and consequently special financial arrangements would be needed.

There is a tendency to regard these saving and trade surpluses as unavoidable in the sense that they would emerge even if all relevant variables (i.e., domestic output, world trade, foreign output and the exchange rate) returned to their "normal" levels. However, what is considered as normal often reflects the policies and objectives pursued. The structural balance of the budget is governed by the pattern of expenditures and taxes set by discretionary action, and today's structural surpluses are no more "normal" than the structural deficits of the 1970s. Private savings behaviour reflects various influences, including the tax treatment of savings and the level of provision for social security. Similarly, while the secular decline in the share of investment in GNP may reflect a decline in productivity and profitability due to the maturity of the Japanese economy, it is also influenced by the strength of domestic demand, as well as by interest rates and taxes. Indeed, high interest rates and prices for urban land have played a major role in depressing residential construction during the 1980s, while high taxes in the corporate sector have resulted in a sharp rise in the user cost of capital. The heavy concentration of investment in export industries is as much a reflection of the slow growth of domestic markets as of capital saturation. Indeed, the quality and quantity of the social and economic infrastructure in Japan stand in sharp contrast to its well-developed high-technology industries, and substantial scope exists for closing this gap, and hence disposing of surplus resources by accelerating social development, rather than by depressing incomes or disequilibrating international payments (see chapter VI, section C).

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## D. Conclusions

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A number of broad conclusions can be drawn from the preceding analysis:

- The major developed market-economy countries have successfully accomplished their goal of conquering inflation, but without attaining adequate growth and international equilibrium;
- Although "fine tuning" has been eschewed, the level of demand generated directly or indirectly from fiscal policies has continued to exert a strong influence on output and employment. The impact of the macroeconomic policies pursued by individual countries has not been limited to their own economies; by the same token, the economic performance of individual countries has been shaped in part by the policies pursued abroad. For large countries, the domestic impact of their own policies has to a significant degree been the consequence of their international impact;
- The high degree of international financial integration has given added importance to both the mix and the stance of monetary and fiscal policies. Two sets of policy disparities have been at work - between the expansionary fiscal and the restrictive monetary policies pursued by the United States, and between the overall expansionary stance of the United States and the overall restrictive stance of other major market economies. For the United States, these disparities have increased the costs, in terms of external indebtedness and international competitiveness, of pursuing expansionary policies; for other developed countries the disparities have lessened the costs, in terms of output and unemployment, of pursuing deflationary policies. Nevertheless, almost all countries have been dissatisfied with the outcome;
- Currency markets have not behaved in such a way as to offset the disparities in the mix and stance of policies: indeed, despite the growing external deficits of the United States, the dollar was bid up, widening those deficits;
- Structural problems, which have been present in all economies, have not on balance been appreciably lessened by deflationary policies; although progress has been recorded on some fronts, new problems have emerged that are - or risk becoming - structural in character. Indeed, such policies have held back the growth of productive capacities needed to bring about structural adjustment;
- The experience of the past few years has left a legacy of large imbalances in international trade. These will need to be corrected. However, the process of correcting them could impose further strains on the world economy. ■

## Chapter II: Notes and references

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## CHAPTER III

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# THE TRANSMISSION OF GROWTH AND THE STABILITY OF THE WORLD ECONOMY

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### Introduction

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The macroeconomic policies and the associated output movements in the major market economies examined in chapter II had a number of direct consequences for the developing countries, as well as for the primary sector of the world economy, which further affected the economies of the developed countries. These consequences were largely the result of certain institutional features of international trade and finance, some of which were the products of developments in the 1970s, while others were of long standing.

One of the newer features was the large stock of variable interest debt accumulated by certain developing countries and their heavy reliance on bank credit. This made them highly vulnerable to changing circumstances and to changes in the outlook of financial markets. Another was the influence exerted on the exchange rates of major currencies by interest rates and currency speculation, which likewise increased the impact of monetary and financial forces on the real economies of countries and their performance. All these factors have assumed great importance in the 1980s owing to the particular thrust and pattern of macroeconomic policies pursued, and have affected both the level and the distribution of world economic activity generally as well as the performance of developing countries.

Among the less novel features was the instability of the prices of most primary commodities. The sensitivity of these prices to swings in the level of aggregate demand has long served to transmit fluctuations in the industrial sector of the world economy to the primary sector and, *pro tanto*, to transmit fluctuations in developed countries to developing countries. This transmission mechanism has assumed particular force in the 1980s owing to the depth and persistence of deflationary pressures. In addition, the very pronounced movements in interest rates and exchange rates have also exerted a powerful influence on commodity prices. The incidence of recession on the commodity sector of the world economy, however, has not been even, and has been determined not only by relative

costs but also by the extent and type of support given by governments to domestic producers.

One primary commodity - namely petroleum - has traditionally been under a régime of administered, rather than flexible pricing: while oil prices have been raised from time to time by large margins, they had until recently been sheltered from temporary fluctuations in market conditions. But that is no longer the case, for both oil prices and the oil pricing system have collapsed. This collapse stemmed from two sources: the shifts in supply and demand triggered by the price increases of the 1970s, on the one hand, and the slowing down of world economic activity, on the other. While the price factor was the more preponderant, the slowdown in activity was also of key importance, for by adding significantly to the contraction of demand for OPEC oil it made the financial strains on members of OPEC unmanageable.

While economic fluctuations in importing countries have affected commodity prices and hence the economies of the exporting countries, the swings in commodity prices have influenced - and continue to influence - price levels in the importing countries. The downward pressure on commodity prices generated by the policy-induced slowdown of activity has been a key factor behind the large and rapid disinflation achieved by OECD countries in the 1980s. Exchange-rate movements have also played a key role in assisting or obstructing disinflation in different countries.

In short, the characteristics of international financial and monetary linkages, and of the world commodity economy, have been a major influence on national economies. This chapter begins by examining how recession and recovery in the OECD countries have been transmitted to developing countries through trade and finance. It goes on, in section B, to depict the changes that have taken place in the global commodity economy as a result of the persistent weakness of demand, focusing on how the burden has been distributed among different categories of producers of agricultural and mineral products respectively. Section C

begins by analyzing the factors that led to the collapse of oil prices and of the oil pricing system, and goes on to review the present state of play among oil-exporting countries, and to discuss some of the possible consequences of failure to re-stabilize oil prices. The final section assesses the contribution made by oil and other

commodity price movements to the disinflation achieved by OECD countries as a whole, and the respective roles played by these movements, and by movements of exchange rates, wages, and related variables, in the price performance of different developed market-economy countries.

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## A. Overview

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### 1. *The transmission of recession to developing countries*

The tightening of monetary policies at the end of the 1970s (discussed in chapter II) had, as one of its most significant consequences, a sharp increase in the interest payments of developing countries. Excess interest payments, calculated by comparing actual levels with those that would have resulted had interest rates remained at their pre-1979 averages, accounted for between one-third and one-half of total interest payments by developing countries in 1982. Moreover, in that year these excess payments were accounted for, to the extent of 85 per cent, by no more than 10 countries (Algeria, Argentina, Brazil, Chile, Colombia, Mexico, Peru, Philippines, Republic of Korea, and Venezuela).

The interest rate shock was accompanied by a widespread decline in capital flows from both banks and other sources, such as official export credits. In addition to the negative impulse provided by high interest rates and the cutback in lending, the trade impulses were virtually non-existent or actually negative during the recession years of the early 1980s. This is most evident at the world level. Thus, as world industrial production fell steadily at a rate of close to 2 per cent annually during 1980-1982, the volume of world trade stagnated in 1981 and actually fell by 3 per cent in 1982. This was only the third such annual decline in world trade during the postwar period. All in all, the performance of world trade during the first three years of the 1980s was the weakest during the past 35 years.

The declines in the volume of world trade affected disproportionately the products of export interest to the developing countries. In particular, exports of minerals and fuels declined steadily for three consecutive years and the cumulative drop during 1979-1982 amounted to as much as 25 per cent; but there was also a widespread collapse of other primary

commodity prices. It has been estimated that the cumulative loss of export earnings due to adverse changes in non-oil primary commodity prices in 1980-1983 amounted to about \$28 billion for 48 commodity-exporting developing countries, accounting for almost one-third of the total current-account deficits and almost half the increase in the indebtedness of those countries during that period. For some oil-exporting developing countries, higher oil prices were more than offset by declines in export volumes and high interest rates. In consequence, for the majority of oil-exporting developing countries, the current account, which was in surplus in both 1979 and 1980, turned into a deficit in the following two years. For many other developing countries, imports were cut drastically, sometimes even though export earnings were rising. The reductions were most pronounced in those countries which had heavy debt-servicing obligations or faced substantially smaller capital inflows. They were uniformly accompanied by cutbacks in growth, and, in some cases, to sharp falls in output.

### 2. *The recovery of 1983*

The developed market-economy countries staged a recovery toward the end of 1982, though the pattern of recovery was very uneven: real domestic demand increased by as much as 5 per cent in the United States in 1983, remained more or less stagnant in Western Europe and increased by only 1.5 per cent in Japan. The discrepancies widened further in 1984 (see table 5).

In total, despite the relatively strong upswing in the United States economy, the rate of increase in real output of OECD member countries averaged only 2.2 per cent annually during the first five years of the 1980s, a sharp drop from the rate of 3.3 per cent annually during the 1970s and as much as 4.8 per cent during the 1960s. As was the case with

Table 5

**DOMESTIC ABSORPTION IN DEVELOPED MARKET ECONOMIES, 1975-1984 <sup>a</sup>**  
(Annual percentage change)

<i>Country/region</i>	<i>1975- 1980</i>	<i>1980</i>	<i>1981</i>	<i>1982</i>	<i>1983</i>	<i>1984</i>
All developed market economies	3.3	0.6	1.2	-0.3	2.3	5.1
<i>of which:</i>						
United States	3.4	-1.5	3.8	-1.4	5.0	8.7
EEC	3.3	2.0	-1.8	0.6	0.2	1.7
Japan	4.3	1.3	2.1	3.1	1.5	4.0

*Source:* UNCTAD secretariat calculations.

<sup>a</sup> GDP plus imports minus exports.

real domestic demand, the slowdown in real output reflected in the main the poor performance of Western European countries, whose economies have expanded on average only 1.3 per cent since 1980, in contrast to about 2.9 per cent during the 1970s and as much as 4.7 per cent in the 1960s. Furthermore, even during the recent upswing, the average annual rate was only 1.9 per cent, or less than half that of the United States.

This economic expansion in the United States toward the end of 1982 had two unusual characteristics. First, net exports had declined much more steeply than was typical of earlier recoveries, due mainly to a sharp rise in imports. This rise in imports was an important vehicle for the transmission of growth from the United States to other countries, especially to those with which it had strong trading ties. Second, the expansion was accompanied by interest rates that, while lower in 1983 than in 1982, were still high in real terms. These trade linkages and the structure of United States imports were instrumental in determining the transmission of growth impulses among developed market economies.

The volume of imports into the United States increased by about 10 per cent in 1983 and as much as 24 per cent in 1984, after having actually declined by 4.6 per cent in 1982; four-fifths of the increase in world exports in 1984 was accounted for by imports into the United States alone. In both 1983 and 1984, however, this increase in imports consisted mainly of manufactured products. In 1983, the rise in the value of imports of manufactures was as much as double that of total imports on account of the absolute decline in the value of

imports of fuels. The contribution of manufactures to the total increase in imports amounted to as much 90 per cent in 1984.

Because of this heavy concentration on manufactures in the expansion of imports and of the existing trading links of the United States, the direct benefits have accrued mainly to manufactures exporters among both developed market-economy and developing countries. In other words, the magnitude of the direct trade effects on the developing countries has been determined by both the strength of the import demand and the relative importance of the United States as an export market for these countries. For manufactures, the United States is indeed a significant market for developing countries and its weight is relatively great in this trade. Nevertheless, for exports in general of developing countries, important as it is, the United States is by no means their major world market. For example, not only for manufactures but also for other important products - foodstuffs, agricultural raw materials, ores and metals, and fuels - the developing countries themselves are a more important market for their exports than is the United States. For a large number of developing countries, therefore, the strength of intra-regional trade has been a more important determinant of overall export performance. Western Europe is also a more important market for the developing countries than the United States for all primary product categories.

During 1983, the first year of the upswing, imports of a large number of manufactured products into the United States increased much faster than sales from domestic manufacturers, particularly for machinery, pe-

Table 6

**DEVELOPING COUNTRIES: BARTER TERMS OF TRADE, 1980 = 100**  
(Number of countries)

<i>Terms of trade index</i>	1981	1982	1983	1984	1985
Less than 80	5	7	5	6	10
Between 80 and 90	20	31	20	10	24
Between 90 and 100	40	32	44	43	38
Between 100 and 110	20	15	25	26	21
Above 110	20	20	11	20	12

*Source:* UNCTAD secretariat calculations.

roleum and coal products, and paper and allied products. With respect to such imports from developing countries, however, the rise was greatest for those manufactures in which the shares of imports from these countries were very small in relation to domestic consumption. For example, imports of transport equipment from the developing countries expanded by over 50 per cent in 1983 but still accounted for a negligible share (0.2 per cent) of domestic consumption.

In sharp contrast, the growth of imports of textiles and clothing from developing countries, whose share in domestic consumption of such products in the United States is relatively large, hardly exceeded that of imports from the world. Thus, because of the low base from which they started, the fast-growing exports of developing countries had hardly changed during the upswing in terms of their shares in final consumption in the United States. The developing countries, moreover, failed to share fully in the acceleration of import demand in 1984. Exports from Western Europe and Japan expanded sharply during that year and the share of developing countries in United States imports consequently declined, both in total and more particularly for manufactures. One contributing factor was the change in domestic demand in the United States from an essentially consumption-dominated one in 1983 to a more investment-oriented one in 1984, which the more industrialized countries were in a better position to exploit. Nevertheless, developing country exports in the latter year were also supported by recovery in the other developed market-economy countries as well as the sharp reversal of the decline in trade among themselves.

As is described in more detail in the following section, the recent recovery has, by and large, by-passed the commodity economy almost entirely. In earlier business cycles an upsurge in the developed market-economy countries led to an increased volume of international trade in primary commodities and an increase in their prices. In the recent upswing, however, although the volume of primary commodities exported by the developing countries has increased, the accompanying rise in prices had been very weak and very short-lived. In particular, the "real" price of commodity exports, i.e., nominal prices deflated by the export unit value of manufactures, had also been very weak. In consequence, many developing countries faced a continuous deterioration in their terms of trade. On average, two out of three developing countries had terms of trade which were less favourable than at the beginning of the 1980s (see table 6). When translated into dollar terms, the losses in the purchasing power of exports due to the terms of trade have been substantial in many instances, amounting to over \$20 billion during the recovery year of 1983 and almost \$28 billion two years later, if developing countries of West Asia are excluded (see table 7).

These terms-of-trade losses also reduced considerably the contribution of the external sector to GDP growth in many developing countries. Since the majority of them are exporters of primary products, often competing directly with each other over a narrow range of products, separate efforts by each to expand shipments in the face of stagnant or weak demand often led to price reductions for all. As can be seen from annex table 9, although the contribution of exports to GDP growth was substantial or at least positive in many in-

Table 7

**DEVELOPING COUNTRIES: GAINS AND LOSSES  
IN EXPORT EARNINGS DUE TO TERMS OF TRADE CHANGES**  
(Billions of dollars)<sup>a</sup>

Region	1981	1982	1983	1984	1985	1981-1985 Average
North Africa	4.2	2.2	-0.5	-0.4	-0.8	0.9
Other Africa	0.4	-2.1	-3.5	-2.4	-4.0	-2.3
Latin America	-3.1	-10.1	-10.1	-7.3	14.0	-8.9
West Asia	19.3	19.4	6.2	7.1	4.5	11.3
South Asia	-0.7	-1.1	-0.5	0.0	-0.3	-0.5
East Asia	-2.6	-7.3	-6.8	-3.1	-9.1	-5.8
All developing countries	17.5	1.1	-15.3	-6.2	-23.8	-5.3

*Source:* UNCTAD secretariat calculations.

<sup>a</sup> Calculated on the basis of 1980 export values.

stances, the picture changes if terms-of-trade changes are taken into account: the contribution is then seen to be decidedly negative or insignificant particularly for Latin America and sub-Saharan Africa, which comprise the countries suffering most from debt-servicing difficulties.

As was noted earlier, Western European recovery has lagged very much behind that of the United States. Western European trade, however, plays an important role in the world economy, and its role in most primary commodity markets far exceeds that of the United States. Consequently, a more evenly balanced upswing than the one which actually took place, i.e., with a greater contribution from effective demand in Western Europe, could have helped in the recovery of the depressed commodity markets. A more buoyant commodity economy would have contributed to ease external balance-of-payments constraints in many developing countries. Higher import demand into the latter would have served to boost activity in Western Europe and thereby contribute to easing its unemployment problems. The bias against primary trade which was inherent in the recent upswing is illustrated by the statistics shown in table 8. Specifically, weighted averages of industrial production indices, combining those of the United States and of individual EEC member countries, were calculated for three successive upswings in those countries

- two during the 1970s and the most recent one, which started towards the end of 1982. Five different weighting systems were used, the first three being, respectively, imports of these countries' agricultural raw materials, ores and metals and fuels. For reference purposes total imports and the value of industrial production were also used as weights. If industrial production is used as an indicator of demand for the primary commodities shown, it can be seen that the recent upswing was only about half as strong as that lasting from the fourth quarter of 1971 to the first quarter of 1983, and was only about as strong as that which followed the 1974-1975 recession. Of particular interest, however, is the fact that the growth of the industrial production indices associated with agricultural raw materials and with ores and metals was particularly weak, as can be judged from the discrepancy between the growth rates of these two indices (3.8 and 4.2 per cent) and of that of actual industrial production (5.5 per cent) during the recent upswing. In other words, because of the unbalanced expansion in economic activity during the recent upswing, the demand facing primary commodity exports was not as strong as it could have been, since the fastest pace of economic expansion took place in a country which relied less than others on imports of these products.

Alternatively, the lopsided development in import demand during the recent upswing

Table 8

**INDUSTRIAL PRODUCTION IN THE  
EUROPEAN ECONOMIC COMMUNITY AND THE UNITED STATES <sup>a</sup>**  
(Annual rate of increase, in per cent)

<i>Production weighted by:</i>	<i>Two preceding upswings</i>		<i>Present upswing</i>
	<i>1971 IV</i> <i>1973 I</i>	<i>1975 I</i> <i>1980 I</i>	<i>1982 IV</i> <i>1985 III</i>
Imports of:			
Agricultural raw materials	7.5	4.2	3.8
Ores and metals	7.9	4.3	4.2
Fuels	8.2	4.7	4.7
Total imports	8.1	4.4	4.4
<i>Memo item:</i>			
Production weighted by the value of industrial production	8.9	4.9	5.5

*Source:* UNCTAD secretariat calculations.

<sup>a</sup> Weighted averages of the industrial production indices of the United States and the (ten) individual EEC member countries. The import weights are the countries' imports in the base year of the items specified.

can be illustrated by considering the influence of market orientation on export performance. Table 9 provides hypothetical figures to indicate the increase in exports which could have been expected of each developing country as a consequence of the changes in demand in its principal export markets. The most salient aspect of the market-growth patterns observed for the 112 developing countries in the sample is the uniformity of developments during the last half of the 1970s and the first three years of the 1980s. Thus, for the majority of the developing countries the potentials for market growth were concentrated in the range of from 5 to 10 per cent annually between 1975 and 1980. Almost all the remaining countries faced market growth of between 0 and 5 per cent annually during the same period. The subsequent three years saw a worsening of prospects which also affected the majority of them uniformly. There was a high concentration of market growth of between -5 per cent and zero during 1980-1983. The remaining growth rates fell mainly between zero and 5 per cent during the same period. With the onset of the uneven recovery, however, there ensued a dispersion of rates which covered the whole spectrum, ranging from less than -5 per cent to well over 15 per cent annually. Thus, the uneven recovery in the developed market economies, because of the associated uneven growth of import de-

mand, has produced a very unstable environment for the export trade of the developing countries.

The uneven export development can also be seen on a broader level, and most clearly from the observed shifts in regional export patterns. The value of exports of Latin American countries with debt-servicing difficulties, which are important exporters of manufactures, increased strongly in 1984. Equally rapid was the rise of export shipments from other developing countries which are suppliers of manufactures. In contrast, the performance of most other developing countries has been much weaker. Preliminary estimates furthermore suggest that the pace of increase in export earnings has declined absolutely for all developing countries in 1985. Data available for the first half of that year thus show that they were more than 12 per cent lower than in the corresponding period of the previous year. The decline was most pronounced in the case of their exports to EEC, but was also very marked in their exports to each other. The reversal in trend, moreover, was dramatic in the case of the United States which, as has been seen earlier, constituted the most dynamic source of import demand for many developing countries during the recent upswing. As is shown in annex table 6, after having risen by 8 per cent in 1983 and over 14 per cent in 1984, developing

Table 9

**DEVELOPING COUNTRIES:  
HYPOTHETICAL GROWTH OF EXPORT MARKETS, 1975-1984**  
(Number of countries)

<i>Annual percentage volume change in market growth rate</i>	<i>1975-1980</i>	<i>1980-1983</i>	<i>1983-1984</i>
Below -5 per cent	2	5	11
Between -5 and 0 per cent	3	70	6
Between 0 and 5 per cent	37	35	24
Between 5 and 10 per cent	70	2	44
Between 10 and 15 per cent	0	0	22
Above 15 per cent	0	0	5
Average growth rate (112 countries)	4.7	-1.0	4.5
(Standard deviation)	(2.8)	(3.5)	(11.3)

*Source:* UNCTAD secretariat calculations. For the basis of the calculations see *Trade and Development Report 1985*, table 3.

country exports to the United States actually fell by 8 per cent during the first half of 1985.

Intra-regional trade of the developing countries also had, in one major instance, an important role in determining overall export performance. In this respect there is a sharp contrast between Latin America and South and East Asia. For both groups of countries the fast-growing United States market during the recent upswing was of major benefit to their exports, but the total increase in exports from developing countries in Latin America was considerably smaller than from the South and East Asian countries in both 1983 and 1984. The explanation appears to be the sluggishness of trade among the developing countries of Latin America during both years. In both groups of countries a significant share of exports is to other developing countries in their respective regions (in both cases about one-fifth), but whereas the intra-trade of South and East Asia has been expanding steadily (close to 5 per cent in 1983 and as much as 10 per cent in 1984), trade among the developing countries in Latin America actually fell by more than 10 per cent in 1983 and virtually stagnated in

1984 (see annex table 7). This was an indirect consequence of the contractionary demand policies pursued by the latter countries to improve their balance of payments in face of their debt-servicing difficulties.

Data available for the first half of 1985 showed an across-the-board decline in the intra-trade of all major developing regions, reflecting the overall decline in both the quantities and unit value of exports of the majority of the developing countries. The year 1985 also saw renewed efforts to cut down on imports, in many cases not only because of continued debt-servicing difficulties, but also because of the weakening of the oil market (see chapter V).

All in all, for many developing countries and especially for those with debt-servicing difficulties, the increases in export proceeds, in the United States market as well as elsewhere, proved insufficient to allow a comparable expansion in the value of their imports during the recent upswing in world economic activity largely because high interest rates for their external debt servicing continued to absorb domestic savings and available foreign exchange.

## B. Recession and the global commodity economy

One of the major features of the economic recession of the first half of the 1980s has been a sharp downswing in world prices of primary commodities. Though there was a mild recovery in prices in 1983-1984, a further decline set in during 1985. By the latter year, the UNCTAD index of market prices of the principal non-fuel commodity exports of developing countries had fallen by one-third from the 1980 level, in terms of United States dollars (annex table 8), representing an annual average decline of 7.5 per cent a year. When deflated by the price index of manufactures exported by developed market-economy countries, the (real) prices of primary commodities in 1985 were lower than the 1980 level by one-fifth, an annual average decline of almost 4.5 per cent a year, reaching the lowest level for half a century.

This sharp deterioration in the terms of trade of the commodity-exporting developing countries has been a major cause of their severe balance-of-payments difficulties since 1980. The price fall has also had a substantial adverse effect on the commodity producers in those developed market-economy countries where domestic prices are related, to a greater or lesser extent, to world market trends. Primary commodity producers in North America, Australia and New Zealand in particular, have suffered from the recession, in contrast especially to the farm sector in the European Economic Community, which has been effectively protected from the vicissitudes of the world market by the maintenance of remunerative prices for agricultural products under the Common Agricultural Policy.

Since the impact of the recession on agriculture has been very different from that on the mineral sector, these two sectors are considered separately below. For each, the impact on developing and developed countries can be traced through the movements in prices, in the volume of production, in real income and, for certain important minerals and metals, in productive capacity.

### 1. *The impact on the agricultural economy*

#### (a) *Commodity prices*

A comparison of prices received by producers in different regions should, in principle, make allowance for their different commodity compositions of output. Table 10, which summarizes trends over the period 1975-1985 in prices of agricultural products received by farmers in the United States and EEC, also shows a broadly comparable series for the prices of agricultural exports from developing countries. The latter excludes tropical beverages, so that this index relates essentially to products competitive with the farm output of the United States and EEC.<sup>20</sup>

Over the period 1980-1985, while the prices of competitive agricultural exports from developing countries were on a marked downward trend in terms of United States dollars (the fall amounting to as much as 40 per cent), the index of prices received by United States farmers fell by only 4 per cent. For farm produce sold in EEC, domestic prices rose each year - prices in 1984 being almost 40 per cent above the 1980 level in ECU terms - but owing to the strong appreciation of the dollar, there was a decline - of some 20 per cent from 1980 to 1984 - in dollar terms.

A more meaningful comparison can be made in terms of the "real" prices of agricultural output in the three areas, as shown by the deflated price series in table 2. For this comparison, changes in farm output prices in the United States and EEC have been deflated by the corresponding changes in the prices of physical farm inputs.<sup>21</sup> For the developing countries, the deflator used is the index of unit values of manufactures exported by developed market-economy countries. The resultant series can be considered, in a broad sense, as comparable with those for the two developed areas, in so far as purchases of manufactures by developing countries constitute one essential input, among others, into their farm sector.

<sup>20</sup> The indices in the table should be taken as indicative of broad trends only, since they may be substantially influenced by the different patterns of farm output in the three regions.

<sup>21</sup> Had United States farm prices been deflated by prices of total inputs, including, *inter alia*, interest on farm debt, real output prices in 1985 would have been almost 20 per cent below the 1980 level. However, a comparable index for the developing countries which made due allowance for the increase in interest charges on their foreign debt would show a considerably larger decline from 1980 to 1985 than the 31 per cent shown in table 10.



Table 10

PRICE TRENDS FOR AGRICULTURAL PRODUCTS <sup>a</sup> OF DEVELOPING COUNTRIES,  
THE UNITED STATES AND THE EUROPEAN ECONOMIC COMMUNITY, 1975-1985  
(Indices, 1980 = 100)

Year	In dollars			Deflated		
	Developing countries	United States	EEC	Developing countries <sup>b</sup>	United States <sup>c</sup>	EEC <sup>d</sup>
1975	63	75	61	100	116	103
1976	60	76	64	95	110	107
1977	61	75	70	88	103	105
1978	67	86	80	85	109	106
1979	79	99	92	88	110	104
1980	100	100	100	100	100	100
1981	85	104	90	90	97	99
1982	66	99	88	72	92	101
1983	71	101	85	80	91	100
1984	70	106	79	82	95	99
1985	59	96	73 <sup>e</sup>	69	88	101 <sup>e</sup>

*Source:* UNCTAD, *Monthly Commodity Price Bulletin, and Supplement, 1960-1984*; *Statistical Abstract of the United States, 1985*, Bureau of the Census, Washington, D.C., 1984; *Agricultural Outlook*, October 1985, United States Department of Agriculture, Washington, D.C.; *EC Agricultural Price Indices (Output and Input)*, No. 2, 1985, Brussels; *The Agricultural Situation in the Community, 1985 Report*, Commission of the European Communities, Brussels, 1986.

<sup>a</sup> Excluding tropical beverages.

<sup>b</sup> Deflated by the United Nations index of unit values of exports of manufactures from developed market-economy countries.

<sup>c</sup> Deflated by the price index of 'production items' purchased by farmers.

<sup>d</sup> Deflated by the price index of 'the means of agricultural production' (seeds, fertilizers, feed, etc.).

<sup>e</sup> EEC estimate.

On these definitions, "real" prices of the exports of developing countries which are competitive with the farm produce of developed countries have fallen much more sharply since 1980 than those received by farmers in either the United States or EEC. From 1980 to 1985, they fell by some 30 per cent, against 12 per cent for the United States farm sector, while for EEC farm prices have remained substantially unchanged since 1980 (see also figure 1).

These different outcomes essentially reflect the differences that exist, among the three areas, in the institutional framework within which agricultural produce is marketed. For the developing countries, trends in commodity export prices reflect, directly or indirectly, the interplay of supply and demand changes on world markets. By contrast, prices received by farmers in the United States and EEC benefit from complex systems of governmental price support, which also involve sales of surplus stocks in third markets at subsidised prices.

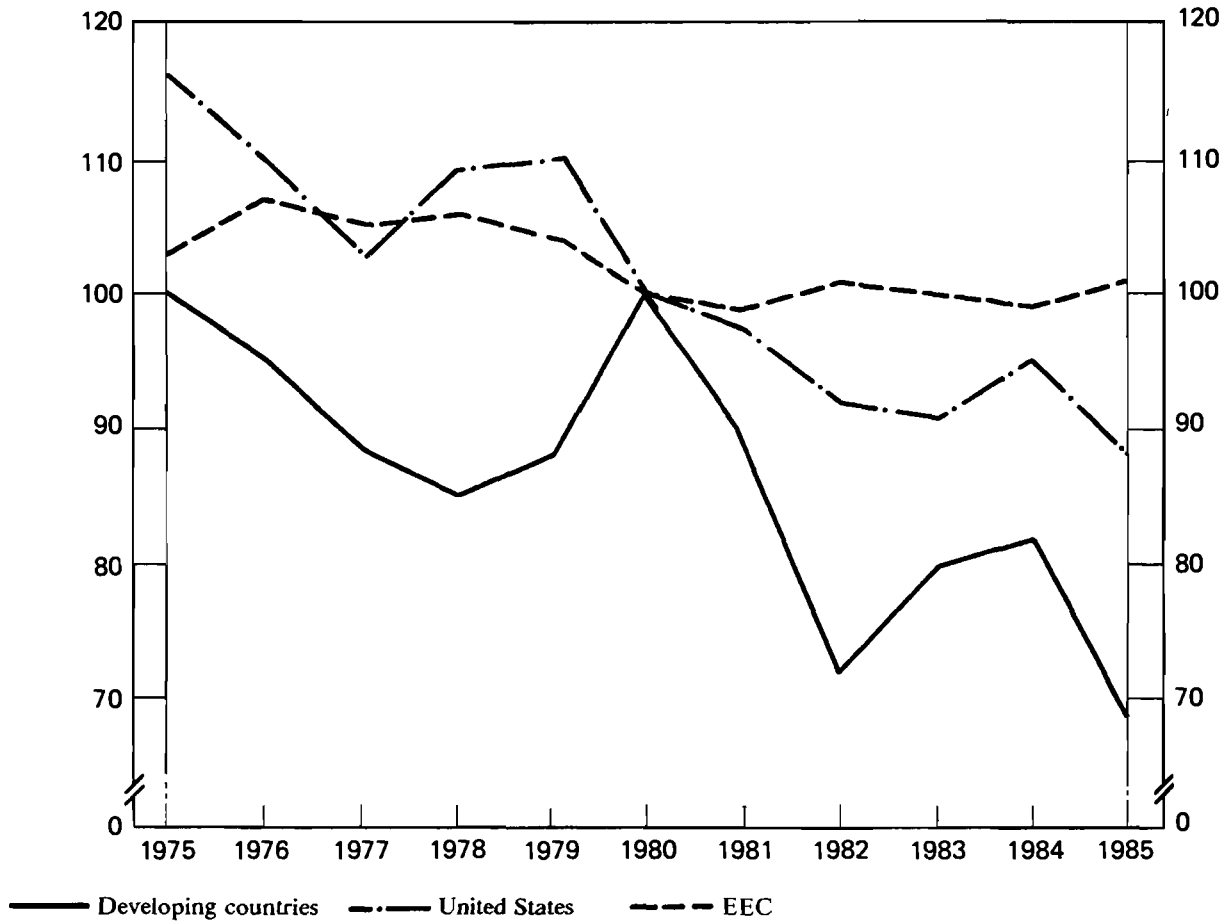
In the United States, the central feature of price support consists of loans to farmers at specific rates for particular crops, based on the

actual crop as collateral, with the proviso that farmers taking such loans must remove a specified proportion of their acreage from production of that particular crop. If market prices remain above the loan rate (i.e. the support price), the farmer can sell his crop and repay the loan. If, however, prices fall below the loan rate, he can opt not to repay, in which case the crop becomes part of Government-owned stocks. Thus, the loan rate becomes, in effect, a guaranteed price floor for particular crops. In addition, again for selected crops, farmers receive a deficiency payment covering the difference between the loan rate and a higher target price, both the loan rate and the target price being subject to annual variation according to the stock position. Thus, the effective prices received by farmers producing crops subject to these, and related, price support arrangements will fall during a recession by only a proportion of the corresponding decline in market prices.

By contrast, the price support system of EEC is based on control of market prices themselves, which are fixed at annual negoti-

Figure 1

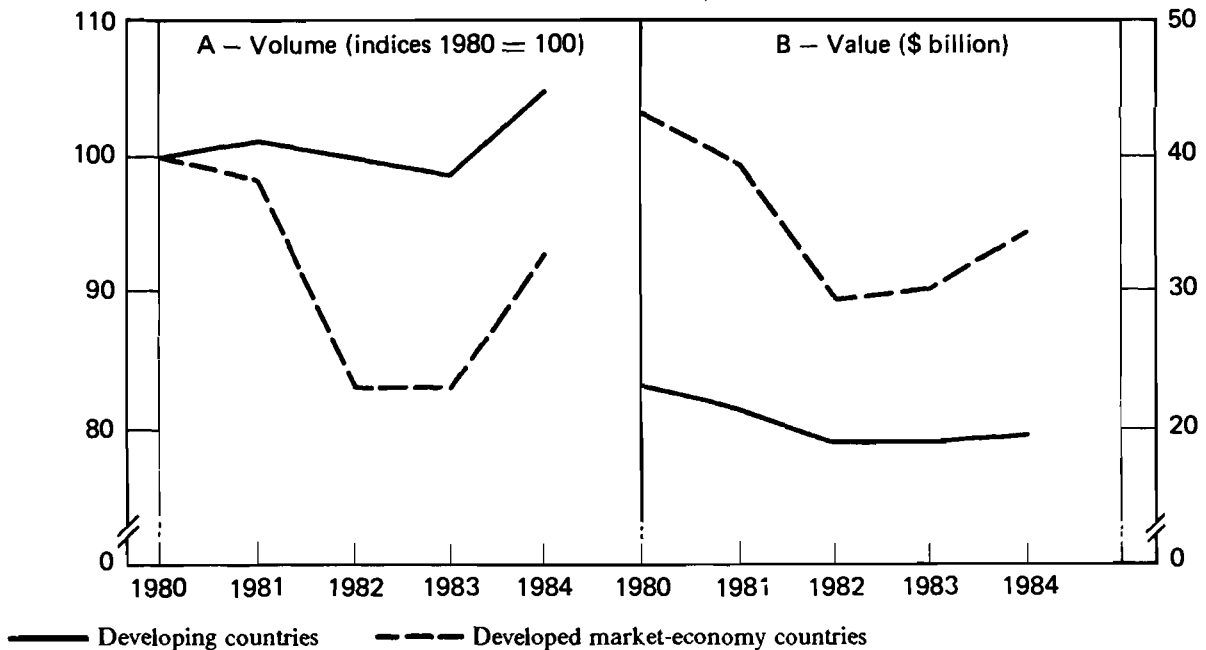
MOVEMENTS IN THE REAL PRICES OF TEMPERATE-ZONE  
AGRICULTURAL PRODUCTS IN MAJOR MARKETS, 1975-1985  
(Indices, 1980 = 100)



Source: Table 10

Figure 2

VOLUME AND VALUE OF PRODUCTION OF MAJOR MINERALS,  
ORES AND METALS, 1980-1984



Source: Annex Tables 11 and 12

ations at intergovernmental level. These negotiations have traditionally resulted in a relatively high level of domestic farm prices, with variable import levies imposed on competing imports from lower-cost sources to bring import prices up to domestic levels. The high budgetary cost of the EEC Common Agricultural Policy has prompted many proposals for reform in recent years, but pressure to reduce guaranteed prices has not so far resulted in any significant decline in real farm prices (see table 10).

The EEC system incorporates export subsidies for shipments abroad of surplus farm produce, while since 1983 the United States has operated a special subsidy programme for grain exports in a bid to regain markets lost through dollar appreciation and competition from subsidised EEC exports. Subsidised food exports have added to the downward pressures on world market prices of food, especially cereals, and to that extent have aggravated the effects of the recession on the prices of agricultural commodities exported by third world countries. It is not only developing countries that have been affected, but also other developed market-economy countries such as Australia which are heavily dependent on commercial sales to the world markets.

For the five years 1986-1990, United States farm policies will be governed by the Food Security Act, 1985. This Act, while based on a continuation of existing target prices for the immediate future, envisages a decline in these prices over the five-year period. The Act also provides, *inter alia*, for acreage reduction programmes when stocks exceed certain levels, as well as for increased subsidies on United States farm exports. This additional stimulus to exports, which is in support of the Export Enhancement Programme instituted in May 1985, is likely to intensify competition in the world market for agricultural products and strengthen further the forces depressing world food prices.

#### (b) *Volume and value of commodity production*

Despite the substantial decline in the real prices of agricultural products and exports in developing countries, the volume of their farm output has risen over the first half of the 1980s. Taking the average of consecutive years to minimize the influence of climatic variations and special factors, the volume of output of the principal agricultural exportable products of developing countries rose by rather more than 10 per cent between 1978-1980 and 1983-1984 (annex table 10). The expansion in output oc-

curred in each main commodity group, except for agricultural raw materials, where output of textile fibres and industrial timber fell from earlier levels, partly as a result of greater inroads by synthetic substitutes in a number of their traditional end-uses.

The continuing expansion in output reflected partly an underlying upward trend in agricultural productivity (though in a number of developing countries this trend was halted, or even reversed, after 1981 as a result of a limitation of imported inputs, such as fertilizers, due to foreign exchange difficulties), but partly also of the encouragement of greater export shipments by national governments anxious to minimise the foreign exchange loss on their agricultural exports. A further factor in this period encouraging production for export was the exceptional strength of the United States dollar, which resulted in United States farm exports (representing some 25 per cent of total farm output in that country) suffering a serious loss of market share. In rice, for example, Thailand overtook the United States in 1982 as the largest producer, its exports increasing by 50 per cent between 1981 and 1984, while United States rice exports fell by almost 30 per cent in this period.

While average farm incomes declined substantially in the United States (see subsection (c) below), in the EEC area they have been broadly maintained since 1978-1980, the modest deterioration in farmers' terms of trade noted above having been approximately offset by a declining number of farms and improvements in productivity.

Comparable data for the farm sector of developing countries are not available, but some broad indications of the movement in real earnings can be derived from an analysis of changes in the value, unit value and volume of major agricultural exports of these countries (see table 11).

Over the four years 1981-1984, the cumulative shortfall in foreign exchange earnings from exports of agricultural commodities amounted to \$23 billion, representing one-third of the corresponding total for 1980. Had developing countries not succeeded in expanding the volume of their agricultural exports, the shortfall would have been substantially greater - some \$42 billion, equivalent to three-fifths of the corresponding export value in 1980. For those developing countries with substantial foreign debts, the loss in earnings resulting from the commodity price recession has been compounded by the sharp increase in debt-service payments consequent upon abnormally high levels of interest rates.

Table 11

**CHANGES IN VALUE  
OF MAJOR AGRICULTURAL EXPORTS FROM DEVELOPING COUNTRIES, 1980-1984**  
(Billions of dollars)

Major agricultural export	Value		Cumulative change, 1980-1984		
	1980	1981-1984 average	Total <sup>a</sup>	Due to Unit value	Volume
Temperate-zone food	28.6	29.9	5.2	-13.3	18.5
Tropical food and beverages	16.9	13.2	-14.4	-17.9	3.5
Vegetable oilseeds and oils	6.3	6.3	-0.1	-1.6	1.5
Agricultural raw materials	15.7	12.2	-13.9	-9.6	-4.3
Total	67.5	64.2	-23.2	-42.4	19.3

Source: Estimates by the UNCTAD secretariat.

<sup>a</sup> Aggregate value in 1981-1984 less four times corresponding value in 1980.

(c) *Financial stress in United States agriculture*

The United States farm sector has been hit by shocks from both the trade and financial sides in much the same way as many developing countries. Revenues and incomes have fallen while interest costs have escalated, resulting in a massive net flow to creditors as well as widespread insolvency.

United States farmers expanded production and investment rapidly in the 1970s owing to buoyant world markets and favourable terms of credit. There was a rapid expansion of farmland as well as of investment in machinery, equipment and structures. Land prices soared, bringing substantial capital gains and attracting speculative buying. However, the farm boom also induced young farmers to buy land and expand business. Consequently, the sector's indebtedness rose by 60 per cent during the 1970s while the total equity rose by under 30 per cent.

The expectations underlying this expansion were not validated by the developments in the 1980s. Consequently, not only the speculative buyers but also the highly indebted young farmers were placed under stress. Interest rates on farm loans rose to a record high, reaching 20 per cent in mid-1981, raising the debt-servicing obligations on short-term debt as well as on debt contracted at variable interest rates. The interest rates subsequently fell (to about 15 per cent in 1984 and 12.5 per cent in 1985), but so did farm prices, and in 1985 the ratio of prices received by farmers to prices paid

by them (on all commodities and services, including interest payments, taxes and wages) stood at about 20 per cent below the 1980 level.

The strong dollar and the efforts of many debt-stricken developing countries to increase the supply of commodities to shrinking world markets, together with the decline in their imports of cereals and other farm produce from the United States, meant a loss of export volume by the United States farm sector of about 20 per cent between 1980 and 1985. The lower export prices caused an even sharper drop in the value of farm exports, the 1984/85 total being over 25 per cent below the 1980/81 peak. Overall, the United States farm sector lost a cumulative amount of more than \$30 billion of export earnings during this period.

These influences are reflected in the evolution of the farm cash flow during the 1980s. Measured at 1983 prices, real cash flows before interest payments (including Commodity Credit Corporation loans) declined from \$75 billion in 1978 to \$64 billion in 1983, while interest payments rose by 50 per cent, from \$14 billion to \$21 billion. Net borrowing (excluding CCC loans) stood at \$4 billion in 1983, less than a fifth of its level in 1978. Consequently, funds available for investment, saving and consumption dropped by more than 40 per cent between 1978 and 1983, from over \$80 billion to under \$50 billion. After a slim recovery in 1984, the decline continued into 1985, when cash flow remained at less than half of the 1978 level, due, also, to a net debt repayment of \$4 billion. The combination of high interest payments and

lower level of new lending entailed substantial net transfers from the farmers to banks.

The deterioration in net farm income (profits) and in the rate of return on equity has been even more drastic. In 1978, total return from assets before interest payments stood at \$117 billion when interest payments were \$14 billion (at 1983 prices). In 1983 total return from assets before interest payments fell to \$24 billion while interest payments rose to \$21 billion, leaving only \$3 billion (or \$12 billion if real capital gain on debt is included) as net return from a total equity of more than \$750 billion. Thus, "net income, after interest payments has been averaging near zero in the 1980s, which implies that farmers with average profitability and average debt have been able to meet their interest charges from current earnings, whereas those with average profitability but heavier debt have seen their earnings fail to cover their debt service."<sup>22</sup>

Because of their high capital intensity and the low return on very large and long-lived farm assets, farmland prices tend to be extremely sensitive to changes in interest rates and in expected income flows. The rise in the interest rates and the fall in the income-generating capacity, therefore, resulted in sharp declines in land values, by an average of 19 per cent over 1981-1985, reaching as high as 45 per cent in certain areas. This has contributed to the substantial capital loss on farm assets, which has been estimated to range from \$150 to \$300 billion during the first four years of the 1980s.

There are various estimates regarding the extent of the financial distress. The proportion of farm operators estimated to be financially vulnerable or imperilled as a result of the debt problem range from 10 per cent to 25 per cent, holding 15-25 per cent of total farm assets and owing between 40 and 60 per cent of total farm debt. There are also many farm-supply firms and rural banks affected by the crisis.<sup>23</sup> The farm debt problem is so serious that a resumption of economic growth is not generally viewed as being sufficient to ensure the survival of the system. Rather, a scheme of social refinancing is increasingly thought to be necessary for allocating losses between creditors and debtors, and between the public and private

sectors, through such methods as debt moratorium, loan guarantees, debt restructuring and write-down, interest-rate subsidies or buy-downs and asset leaseback.

## 2. *The impact on the mineral sector*

In marked contrast to the position in agriculture, the economic recession has had a much sharper effect on mineral and metal production in developed market-economy countries than in developing countries. Aggregate production of the major non-fuel minerals, ores and metals in the developed market-economy countries fell substantially in 1982 (by some 15 per cent) and remained at that level in 1983, before recovering in 1984, though only to a level some 7 per cent below that of 1980. By contrast, developing countries' production remained essentially unchanged, in aggregate, over the period 1980-1983, and then rose by some 5 per cent in 1984 (see annex table 11 and Part A of figure 2).

The downturn in mineral production was considerably greater, proportionately, than for industrial production as a whole in the developed market-economy countries, partly because of the greater incidence of the recession on output of durable goods, in particular basic metals, than on most other sectors, and partly because of the continuing secular decline in the metal-intensity of industrial output. The ratio of aggregate minerals and metals consumption to industrial production in the developed market-economy countries declined by 9 per cent between 1979 and 1984, or by an average of 1.8 per cent per annum, compared with an annual average decline of 0.9 per cent during the 1970s; in 1981-1984, the ratio fell to 15 per cent below the level of 1971-1974.

For the developed market-economy countries, the drop in minerals and metals production was compounded by the price decline. Market prices of minerals, ores and metals exported by developing countries fell by 27 per cent (in dollar terms) between 1980 and 1984 (see annex table 8), but the decline in export unit values was considerably less, mainly be-

<sup>22</sup> Statement by E. Melichar, on 23 October 1985 to the Sub-Committee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, in *Federal Reserve Bulletin*, December 1985, p. 941. Indeed, since an average profitability of 2 per cent on total assets yields a zero return on equity with an average debt/assets ratio of 20 per cent and an average interest rate of 10.3 per cent, those farmers with a higher debt/assets ratio and/or with a higher rate of interest on outstanding debt must have clearly been driven into financial stress. This follows from a simple relation defining the rate of return on equity as  $r = (q-id)/(1-d)$ , where  $q$  is the rate of return on assets,  $i$  the rate of interest and  $d$  the debt/assets ratio. Hence, when  $id$  is greater than  $q$ ,  $r$  will be negative. For calculations based on such a formula see E. Melichar, "A Financial Perspective on Agriculture", *Federal Reserve Bulletin*, January 1984, table 3, p. 9.

<sup>23</sup> For the effect on banks see chap. IV, sect. A, below.

cause much of this trade is transacted on annual contracts, or consists of intra-firm transactions. Unit values of minerals, ores and metals exported by developed market-economy countries, when weighted by relative value added in production, fell by 17 per cent from 1980 to 1982, and failed to recover in the two subsequent years. There was a closely corresponding movement in unit values for developing countries, though in this case, they rose marginally from 1982 to 1984 (table 12).

In terms of the current value of production, the decline was much greater, both proportionately and in absolute terms, for developed market-economy countries. Between 1980 and 1982, the mining sector of these countries lost about one-third of the value of its 1980 total production, compared with a loss of one-sixth for developing countries (see part B of figure 2). Over the four years 1980-1984, the cumulative loss from the 1980 level amounted to \$40 billion for the developed market-economy countries (virtually equivalent to their entire output in 1980), as against a loss of some \$13 billion for the developing countries (just over one-half of their 1980 production).

The commodity pattern of change was, however, different in the two groups of countries (see annex table 12). For the developed market-economy countries, one-half of the cumulative loss in the value of output since 1980 reflects both a cut in aluminium production and a decline in the unit value added through processing, whereas for the developing countries the major loss in value terms came from copper, which was due entirely to the fall in copper unit values, since copper production in developing countries rose (by 12 per cent from 1980 to 1984). In volume terms, there has been a shift in the location of production, for both aluminium and copper, from developed to developing countries, as increased smelting or refining capacity has come on stream in the latter and has been retired in the former. A similar shift has occurred for iron ore.

For both copper and iron ore, the United States, the largest producer among developed market-economy countries, is relatively high-cost, and the early 1980s were characterized by widespread mine closures in that country as prices fell sharply and imports - stimulated by the strength of the dollar - rose considerably. A similar situation prevailed in Canada. While production was being cut in the North American copper and iron ore mines, mine and smelter capacity were being enlarged as a result of earlier investment decisions. For *copper*, mine closures from 1981 to mid-1985 corresponded to 887,000 tons of capacity in the United States (representing some 40 per cent

of total capacity at end-1984), and to 214,000 tons in Canada (almost 25 per cent of total capacity) though only a proportion of these closures can be considered as permanent. Copper mine capacity has been expanded substantially in Chile since 1980, as well as in a number of other developing countries, and by end-1984 copper mine capacity in developing countries, which had exceeded that in developed market-economy countries by almost 30 per cent in 1980 had, by 1984, become about 40 per cent greater than in those countries. Investment decisions already taken indicate a further substantial expansion in copper mine capacity during the later 1980s. By end-1990, total capacity in developing countries is estimated to rise by some 870,000 tons (19 per cent) over the end-1984 level, while that in developed market-economy countries is estimated to decline by about 100,000 tons (3 per cent).

For *iron ore*, a similar shift has taken place since 1980 and is expected to continue. Mine closures in the United States brought capacity down by some 12 million tons (17 per cent) between 1981 and 1984, and current plans indicate a further fall of 13 million tons (22 per cent) by 1990. Capacity in developing countries, by contrast, is planned to rise by 13 million tons (7 per cent) from 1984 to 1990, essentially as a result of large new investments in Brazil, a low-cost producer, which is likely to raise that country's share of the world market significantly over the coming decade (see annex table 13).

For the *bauxite/aluminium* industry, major structural changes have also taken place since 1980, as a result of a decline in demand for aluminium caused by both slow economic growth in developed market-economy countries and a virtual cessation of the trend of substitution of aluminium for other materials. High-cost producers, particularly in the United States and Japan, reduced output and retired some capacity, while production expanded and new capacity was installed in low-cost areas, including Australia, Canada, Brazil and Venezuela. The contraction in the United States led also to a decline in output of bauxite and alumina by Caribbean producers supplying the United States. Existing investment plans indicate an expansion of some 110,000 tons (1 per cent) in aluminium capacity in developed market-economy countries between 1984 and 1990, with a much larger growth of 890,000 tons (33 per cent) in capacity in developing countries. Similarly, installed capacity at the bauxite and alumina stages is likely to expand over this period (by some 15 and 40-45 per cent, respectively) in developing countries, with little change in bauxite capacity and some

Table 12

**EXPORT UNIT VALUES AND VALUE OF PRODUCTION OF MINERALS, ORES AND METALS <sup>a</sup>  
IN DEVELOPING COUNTRIES AND IN DEVELOPED MARKET-ECONOMY COUNTRIES, 1980-1984**

<i>Item/country group</i>	<i>1980</i>	<i>1981</i>	<i>1982</i>	<i>1983</i>	<i>1984</i>	<i>1980-1984 cumulative change <sup>c</sup></i>
	<i>Indices (1980=100)</i>					
<i>Unit value <sup>b</sup></i>						
Developing countries	100	93	81	84	85	..
Developed market-economy countries	100	94	83	82	85	..
	<i>Billions of dollars</i>					
<i>Value of production at current prices <sup>d</sup></i>						
Developing countries	23.0	21.5	19.0	18.9	19.6	-12.9
Developed market-economy countries	43.4	39.4	29.3	30.2	34.5	-40.4
Total	66.4	60.9	48.3	49.1	54.1	-53.3
	<i>Per cent</i>					
Share of developing countries	35	35	39	38	36	..

*Source:* UNCTAD, *Yearbook of International Commodity Statistics, 1985*; International Lead and Zinc Study Group, (London), *Lead and Zinc Statistics*.

*a* For minerals, ores and metals covered, see annex table A.12.

*b* Index of value at current prices divided by index of volume shown in table 5. Differences in unit value for developing countries and developed market-economy countries reflect different weighting of the minerals and metals included.

*c* Aggregate value of production in 1981-1984 less four times the value of production in 1980.

*d* Quantities produced valued at unit values of exports in relevant year. For refined metal, the unit value taken was the unit value of the metal minus the unit value of the corresponding ore (in metal content), this derived figure corresponding to the value added at the processing stage.

decline in alumina capacity in the developed market-economy countries.

### 3. *The policy response*

The world economic recession of the first half of the 1980s has had a profound adverse impact on the commodity sector of the majority of developing countries. Over the four years 1981-1984, the cumulative loss, from the 1980 level, in foreign exchange earnings from their exports of the principal primary commodities, both agricultural and mineral, amounted to \$38 billion (equivalent to over 40 per cent of the 1980 total). The loss attributable to the fall in world commodity prices was as high as \$55

billion, a loss partly offset by an expansion in export volume amounting to \$17 billion over the four-year period (table 13).

The sharp decline in commodity prices also affected the total value of commodity production in developing countries, whether for export or for home consumption, and in some cases led to involuntary stocking. A broad guide to the magnitudes involved can be gained by valuing the quantities of the major commodities produced in developing countries by the unit value of world exports in each year since 1980. On this basis, as table 13 also indicates, the loss of income to developing country producers of the major primary commodities over the four years 1981-1984, compared with the 1980 level, as a result of the fall in prices, amounted to some \$130 billion,

Table 13

**CUMULATIVE CHANGE IN THE VALUE OF PRODUCTION AND EXPORTS OF  
MAJOR COMMODITIES OF DEVELOPING COUNTRIES, 1980-1984**  
(Billions of dollars)

	Production			Exports		
	Agricultural <sup>a</sup>	Mineral <sup>b</sup>	Total	Agricultural <sup>a</sup>	Mineral <sup>b</sup>	Total
Value in 1980	230	23	253	68	19	87
Cumulative change, 1980-1984 <sup>c</sup>	-61	-13	-74	-23	-15	-38
<i>of which due to:</i>						
Prices <sup>d</sup>	-118	-14	132	-42	-13	-55
Volume	56	1	57	19	-2	17

Source: UNCTAD, *Yearbook of International Commodity Statistics, 1985*.

<sup>a</sup> See annex table A.10 for commodities included.

<sup>b</sup> See annex table A.12 for commodities included.

<sup>c</sup> See note c to table 12.

<sup>d</sup> World export unit values.

equivalent to one-half the total value of production of the same basket of commodities in 1980. However, there was a substantial compensatory expansion in the volume of production (almost all of which was in the agricultural sector) equivalent to a cumulative increase of \$57 billion.

The consequent severe squeeze on the incomes of commodity producers coincided with a major deterioration of the budgetary position in the majority of developing countries.

In certain cases, notably in mineral production where mines were in State ownership or under State control, the fall in export earnings has been offset, at least in part, by increased government subsidies in order to maintain and, where possible, expand the volume of exports. However, such subsidies have tended to exacerbate an already tight budgetary situation caused by the decline in export earnings and in associated budgetary revenues, often combined with increased debt-servicing charges, and have thus reinforced domestic inflationary pressures. For the majority of developing countries, however, and particularly for those where export production is largely in the hands of smallholders, governments have generally not found it possible to provide similar subsidies to farmers.

It was noted above that the recession has hit more severely the mineral sector in the developed market-economy countries than in the developing countries, since they have the higher-cost mines for the major mineral products, and governments in those countries do not generally follow policies of price - or income - support for domestic mines. The recession has thus resulted in a contraction in total mineral production in the market economies - output in both 1982 and 1983 being some 10 per cent below the 1980 or 1981 levels, followed by a recovery in 1984 to almost the earlier total - accompanied by a shift in the location of output in favour of lower-cost production in developing countries.

By contrast, in the agricultural sector there is considerable government intervention in the market process in most developed market-economy countries. As was seen earlier, the operation of price supports under the Common Agricultural Policy has been effective in generally maintaining the real value of farm incomes in EEC, while in the United States price supports and direct government payments to farmers have substantially mitigated what would otherwise have been a general financial crisis in the farm sector. Even so, as described earlier in this chapter, by January 1985 a considerable number of family commercial farms had become insolvent or were suffering from extreme financial problems.



Thus, while the problems for the commodity sectors of both developing and developed countries arising from the economic recession have been similar in kind, though different in magnitude, there has been a marked contrast in the policy responses of governments and in the efficacy of remedial measures that have been taken. While the farm sectors of the major developed market-economy countries have been protected, to a greater or lesser extent, from the decline in world market prices,<sup>24</sup> it has so far not been possible to agree on any action to safeguard even a minimum level of commodity prices or of foreign exchange earnings from the commodity exports of developing countries.

The severe squeeze on the external payments positions of the great majority of developing countries as a result of the depressed level of commodity prices, combined, for many of these countries, with sharply increased interest payments on their foreign debts and greatly curtailed inflows of long-term capital, have forced governments into drastic shifts in policy. The central objective of policy has become the expansion of foreign exchange availabilities to meet debt-servicing obligations. One mechanism in general use, along with others, to achieve this objective has been currency devaluation, often undertaken as part of an IMF package of measures, which have also generally included cuts in government expenditure, including food subsidies, and the liberalization of imports.

However, as was argued in the *Trade and Development Report, 1985* (Part Two, chapter III), where currency devaluation has been substantial in relation to increases in domestic prices and in associated costs of production of exportable commodities there is likely to be a perverse result, in so far as the rise in the profitability of commodity production in terms of domestic currency engenders an expansion in commodity production and exports, thus still further depressing world commodity prices. This thesis was generally confirmed by the analysis in the Report, relating to a selection of agricultural commodities for which world prices in dollar terms had fallen between 1980 and 1983. That analysis has now been extended to 1984, covering 28 commodity/country situations, in 12 of which real domestic prices of commodities had increased by 10 per cent or more since 1980. For this latter group, there was an average rise since 1978-1980 of 17 per cent in the harvested or planted area, while production and exports rose in volume by an average of 12 and 26 per

cent, respectively. By contrast, for the 16 cases in which real domestic prices had increased by less than 10 per cent, or had fallen, between 1980 and 1984, the harvested or planted area, on average, fell by 2 per cent over this period, while production and export volume rose by 7 and 12 per cent, respectively.

The sharp contrast between the two groups in the change in harvested or planted area, consequent upon changes in real domestic prices associated with currency devaluations, does indicate that large real devaluations may well have had, in many cases, the perverse result on commodity production and exports (and hence on world commodity prices) that might be expected on theoretical grounds.

A further element in the policy response of many developing countries to the depressed state of world markets for their traditional commodity exports has been an effort to diversify the pattern of their commodity exports towards more profitable lines, or towards those with more dynamic export prospects. There are, however, a number of major constraints on the ability of most developing countries to diversify their commodity sectors, let alone to create more broadly-based economic structures by developing or expanding their manufacturing sector. Such constraints arise particularly from the severe shortage in recent years of foreign exchange to purchase essential inputs for diversification programmes, as well as from inadequate domestic infrastructures and inappropriate pricing policies in many countries. Furthermore, import barriers in developed country markets also often constitute significant limitations to the expansion of new product lines.

None the less, it is of interest to assess the extent to which developing countries have succeeded in diversifying their commodity exports in spite of these various constraints. An analysis of commodity exports patterns of 55 developing countries reveals a number of significant changes over the period 1980-1984. First, two-thirds of these countries, 37 in all, did not succeed in achieving any significant diversification in their commodity exports over this period. Second, of the 18 that succeeded most of the increase in exports came from the larger countries, which already had relatively diversified commodity sectors in earlier years. This was particularly the case for Brazil (which diversified exports into, *inter alia*, orange juice, soyabean oil and sugar), Argentina (oilseed cake and meal, sunflower oil and soyabean oil), and Malaysia (palm oil and cocoa).

<sup>24</sup> To the extent that price or income support measures have involved additional barriers to imports into developed market-economy measures, these have had the incidental effect of depressing world commodity prices even further.

Though a number of smaller exporting countries have also been diversifying their commodity exports, this process is not likely to add significantly to the depressive forces already prevailing in the world market. In so far as some of the larger countries have run into difficulties in fulfilling their diversification programmes, there may likewise be little significant effect on market prices. None the less, in a situation of persistent recession in world commodity markets, the danger remains that diversification programmes of the larger developing countries may well, in the future, result in the shifting of resources into the production

of commodities already in global oversupply. Though the diversifying country might thereby gain in market share, there would inevitably be a net loss for developing countries as a whole in their foreign exchange earnings from the commodities concerned. Some consideration thus needs to be given to the creation of an appropriate institutional framework within which a harmonization of the diversification programmes of commodity-exporting countries could be effectively negotiated, so as to avoid the danger of transferring surplus situations from some commodity markets to others.

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### C. The collapse of oil prices

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Unlike most other primary commodities, oil prices have for decades been subject to deliberate management by producers. While trends in supply and demand and shifts in supply capabilities have eventually been reflected in prices, prices have on the whole been sheltered from temporary swings in market conditions. In recent years, the administration of prices has been carried out by OPEC. When faced with a tight market, it generally responded by raising production, although on occasions when the tightness stemmed from a major supply shortfall, it also increased prices. Similarly, when faced with a slack market, it generally responded by reducing output.

This system collapsed in the course of 1985, and petroleum is now under a "flexible" régime, like many other primary commodities. Prices plunged from around \$28 per barrel to reach \$12 in April 1986, bringing the price in real terms down to the level prevailing before 1973. Moreover, prices have displayed a high degree of volatility in recent months.

The main reason for this collapse was the inability of OPEC countries to withstand the financial pressures resulting from the contraction of the demand for their exports. In quantitative terms, this contraction was due mostly to the changes in patterns of production, consumption and trade triggered by the price increases in the 1970s. However, the slowdown of growth in developed and developing countries has also played a key role. Thus, the decline in oil prices has been closely linked to the past performance of the world economy, as well as to developments within the oil sector itself. Moreover, the price decline, by generating a huge transfer of world income, is now exerting a powerful influence on economic activity and price performance in both importing and exporting countries.

This section begins by examining the various factors responsible for the contraction of OPEC revenues and hence for OPEC's decision to abandon its policy of concerted production restraint. It goes on to characterize the present state of play and its possible outcomes. Finally, it discusses the likely impact of continued instability and uncertainty on the energy sector; other consequences of the decline of oil prices are discussed in chapters V and VI.

#### *1. Changing market shares and world consumption*

Numerous (though not all) long-term forecasts made at the end of the last decade envisaged rising oil prices. Increased investment in high-cost alternative energy sources, particularly nuclear, tar sand and shale oil, and a rapid increase in worldwide oil exploration and development activity were expected to take place in response to the higher price of oil, but the energy market was expected by many observers to be tight for the rest of the century. It was therefore thought in OPEC circles that the threat to the Organization's role as price administrator would come from an inability to prevent a new surge in oil prices induced by a supply shortfall, rather than from failure to maintain prices during a period of depressed demand. A wide margin of spare capacity was therefore viewed as being necessary - a view which was reflected in the Long-Term Strategy formulated by OPEC in 1980.

The rise in oil prices in the 1970s did, indeed, improve the economics of alternative energy sources by making investments in high-cost oil outside the OPEC area and the

development of natural gas, coal and other resources, including nuclear, more attractive. Moreover, concern over the security of supply led to exploration and development being diverted away from the OPEC area (despite the lower exploration and development costs) to other high-cost areas.

The increase in non-OPEC crude oil supplies far exceeded expectations. Total non-OPEC supplies of oil, including natural gas liquids (NGLs), to developed market economies and developing countries increased by a net amount of 8.6 million b/d (barrels per day), or some 48 per cent, between 1972 and 1984. The increase started in the mid-1970s and accelerated following the 1979/1980 oil price increases. The major increase in supplies came from the North Sea producers, Mexico and the socialist countries but almost one-third was accounted for by other non-OPEC producers, excluding the United States and Canada, where supplies declined by almost 1 million b/d.

The growth of non-OPEC supplies was matched, to the extent of about one-half, by a decline of OPEC production, from 31 million b/d in 1979 to 16 million in 1985. Figure 3 shows how OPEC oil production has been overtaken by production in other countries (excluding the socialist countries). In 1972, non-OPEC production (so defined) stood at almost 17 million b/d, compared with 27 million for OPEC. After 1979, OPEC production dropped continuously to 17 million b/d by 1984, while non-OPEC production rose steadily, to reach 24 million b/d in 1984, thus almost reversing the two positions. The total increase in supply from smaller developing country producers outside OPEC (i.e. excluding Mexico) proved to be unexpectedly high, rising by some 2 million b/d from 1972 to 1984 of which nearly 40 per cent was accounted for by Brazil and India.

It is difficult to separate the impact of the two price increases in the 1970s on the decline in oil consumption which so far has taken place in the 1980s because long time-lags are involved in adjusting production technology to higher prices. The combined effect of the two oil price rises and the world economic recession was to cause world oil consumption to drop.

The particularly sharp decline (2.1 million b/d) of oil consumption in the electricity generation sector in the OECD countries in the period 1973-1983 accounts for a large part of the total fall in oil consumption in those countries during that period. Oil consumption by industry as a whole in the OECD area declined by one-third (2.9 million b/d) and in the residential/commercial sector there was a decline of 2.3 million b/d. Transportation, which

accounted for almost one-half of total oil requirements in 1983, is the only sector where OECD oil consumption increased substantially during this period (by 1.5 million b/d).

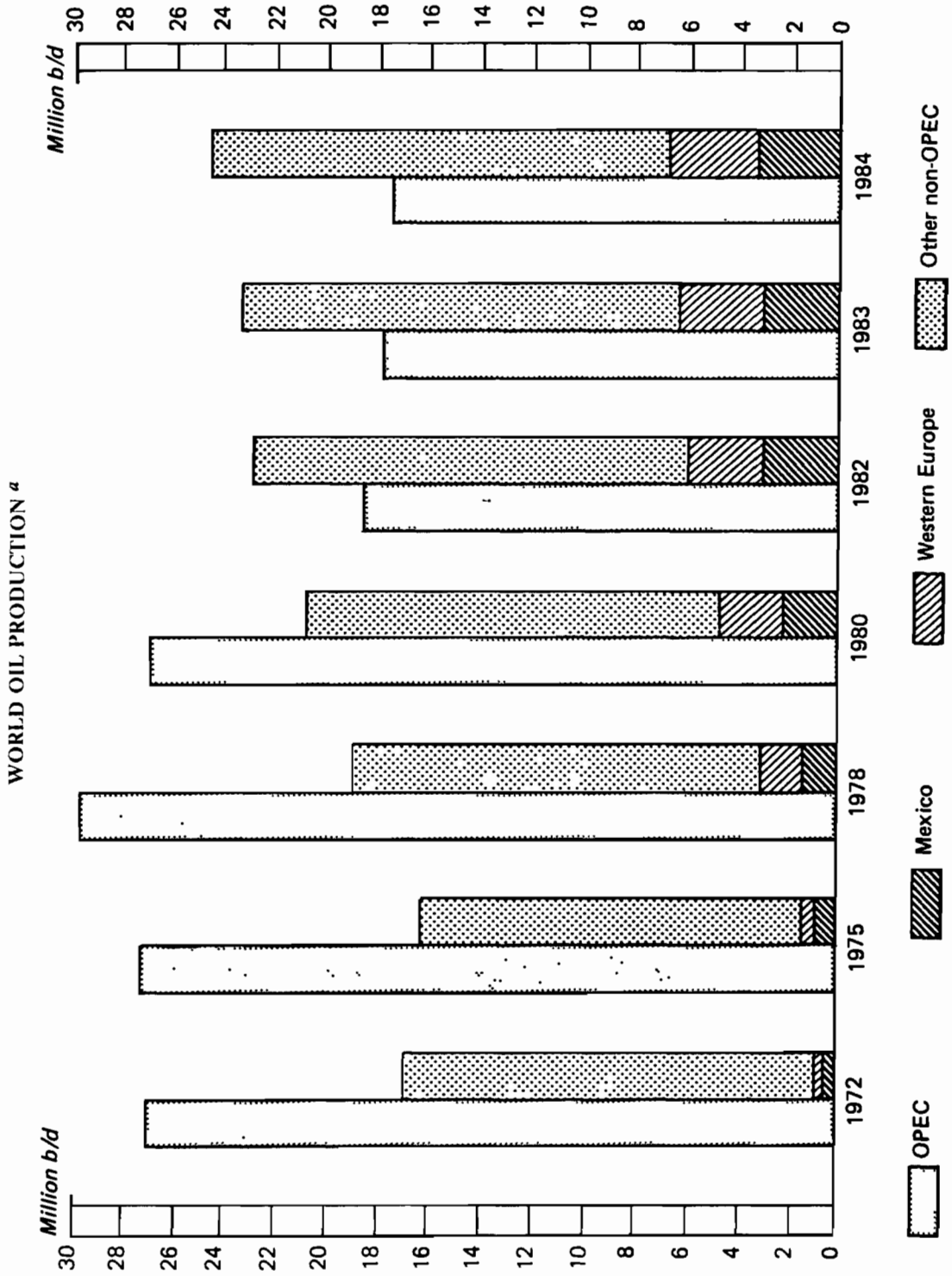
Another factor reducing energy use was a structural change in the composition of GNP in industrial countries, with a rise in the share of the less energy-intensive sectors, in particular services. However, a detailed comparison of past trends in total energy demand, especially consumption of oil, with economic growth shows that this structural factor, while significant, had less effect than generally thought. If only the major energy-consuming industries are considered, a downward trend can be observed, but it is rather modest. A more important reason for the reduced oil consumption in industry was conservation and the substitution of other fuels for oil.

The loss of oil markets due to higher oil prices was compounded by the slowdown of the world economy. Between 1980 and 1984 growth in developed market-economy countries averaged 1.9 per cent annually and in the developing countries fell to an average of 2.5 per cent. Had these countries sustained in that period their respective growth rates of the 1970s, and assuming an energy coefficient of 0.75 per cent, demand for oil would have been higher by around 3-4 million b/d in 1984, and revenues over the period would have been higher by \$145-\$180 billion. Had this loss not occurred, the contraction of revenues stemming from the growth of non-OPEC production, conservation, and fuel substitution might have proved manageable, and permitted orderly supply adjustment to be made, instead of leading to a collapse of oil prices and of the system of oil pricing.

The loss of market share was initially not unwelcome to the OPEC countries. The increase in revenues of 48 per cent in 1979 and 40 per cent in 1980 resulting from the price rise of 1979 permitted a growth of imports of 34 per cent in 1980. The absence of financial stringency allowed countries to accommodate some reduction of demand by reducing output, thereby extending the life of their oil reserves. However, the reduction of exports far exceeded expectations, and revenues contracted by around 10 per cent in 1981, 20 per cent in 1982 and 20 per cent in 1983. This trend triggered a series of developments which disrupted the market and finally destabilized the supporting base for the OPEC official crude oil price of \$34/b.

By 1982, the over-supply was beginning to lead to a rapid softening of realized prices. By the end of March 1983, spot prices of African light crudes fell by about \$8/b. The

Figure 3



Source: UNCTAD secretariat, based on data of OPEC.  
<sup>a</sup> Excluding the socialist countries.

spot price of OPEC's Marker Crude dropped to \$28.60/b, or more than \$5/b below its official price. In February 1983 North Sea producers cut their prices by between \$3 and \$3.50/b, prompting one OPEC member to announce a unilateral price cut for its Bonny Light crude, to \$0.50/b below the new price of North Sea crudes.

In the face of this new situation, in March 1983 OPEC reduced the official price of Marker Crude by \$5/b, to a level of \$29/b. Because of the rising value of the dollar at the time, the price did not fall in real terms. Nevertheless, it was the first time that nominal prices had been reduced in response to a weakness in the market. Even more significant was OPEC's decision to adopt a formal production ceiling and to set quotas for all members (a step which, unlike the price cut, enjoyed the unanimous support of all members). To defend the new price structure, the Organization agreed on a ceiling of 17.5 million b/d for total OPEC production and established a quota system for individual member countries (see table 14). Proposals for production programming had been made before, but this was the first formal OPEC-wide agreement, and set the stage for similar accords later. OPEC's 1983 accord also attempted to address the thorny issue of crude oil price differentials.

Nevertheless, pressure on OPEC production continued unabated as non-OPEC oil supply continued to increase, by an additional 1.4 million b/d in 1984 and 0.8 million in 1985, as a result of previous investment in exploration and development, particularly in the North Sea. The weakness of spot prices during the last quarter of 1984 led the North Sea producers once more to cut their official prices, again followed promptly by similar action by one OPEC member. To forestall another round of price cuts, OPEC reduced the production ceiling by 1.5 million b/d to 16 million b/d, i.e., 8.6 per cent (see table 14). A separate (and at the time unpublicized) accord between Saudi Arabia and Kuwait called for the two countries to further reduce output, if necessary, in order to absorb any production quota violation by other members in excess of the new ceiling. However, the reduction proved to be less transitory than initially envisaged.

## 2. *The financial squeeze and production policy*

By 1984 the combined oil revenues of OPEC member countries had fallen in real terms to their levels of the mid-1970s, and

OPEC's share of the world oil market (excluding the socialist countries) had fallen from one-half in 1974 to about one-third in 1984. The financial squeeze on individual countries made both the setting of individual quotas and adherence to them difficult (see figure 4), and prompted many countries to resort to a variety of sales promotion measures such as hidden discounts, offshore processing arrangements, extended credit terms, spot sales and counter-trade. The Organization's decision to set up a system to control and verify production volumes and selling prices failed to ensure strict adherence to production quotas and official prices.

Some OPEC countries were adversely affected by other factors as well. Whereas the net creditor countries benefited from the rise in interest rates after 1979, most debtor countries among OPEC members were subject either to a substantial rise in the interest cost of their external debt or to a discontinuance of new lending by banks, or both. The interest shock was felt with particular strength in the Latin American member countries, where the nominal implicit interest rate on medium- and long-term external debt more than doubled between 1979 and 1982. Bank lending to Ecuador ceased abruptly in 1982. Both Ecuador and Venezuela had to renegotiate their debt. Outside Latin America, debt renegotiation was necessary in Nigeria. Moreover, export earnings, from non-oil commodities which were of some importance to Ecuador and Indonesia, also suffered from falling prices.

The decline in OPEC production and the drop in official oil prices led to the disappearance in 1982 of previous huge current-account surpluses, which in 1980 had amounted to over \$100 billion. 1982 was the last year of positive import growth - by 6 per cent - by OPEC member countries taken as a whole. In each of the following years, cuts of more than 10 per cent took place. The process of import reduction began in 1982 in the "high-absorber" countries, in particular Venezuela and Ecuador. However, the so-called "low-absorber" countries also began to reduce their imports, as from 1983. For some, this was at first relatively painless, since a number of capital-intensive infrastructure projects were on the point of being completed, and further such investments were not being planned on a large scale; moreover, the labour released by the slowing of investment was largely immigrant. But by 1985 the distinction between "low" and "high" absorbers had narrowed considerably. The former, although still enjoying considerable room for manoeuvre financially, faced the prospect of having to make deeper and more costly import cuts if their revenue prospects did

Table 14

**PRODUCTION QUOTAS AGREED BY OPEC**  
(Thousands of barrels per day)

<i>Country</i>	<i>March 1983 quota</i>	<i>November 1983 quota</i>	<i>Percentage reduction</i>
Algeria	725	663	8.6
Ecuador	200	183	8.5
Gabon	150	137	8.7
Indonesia	1300	1189	8.5
Iran (Islamic Republic of)	2400	2300	4.2
Iraq	1200	1200	.0
Kuwait	1050	900	14.3
Libyan Arab Jamahiriya	1100	990	10.0
Nigeria	1300	1300	.0
Qatar	300	280	6.7
Saudi Arabia	5000 <sup>a</sup>	4353	12.9
United Arab Emirates	1100	950	13.6
Venezuela	1675	1555	7.2
Total	17500	16000	8.6

*Source:* OPEC Conference press releases.

<sup>a</sup> For the first time, Saudi Arabia formally accepted to act as a swing producer to supply the balancing quantities within the ceiling of 17.5 million b. d. This effectively limited Saudi production to 5 million b/d.

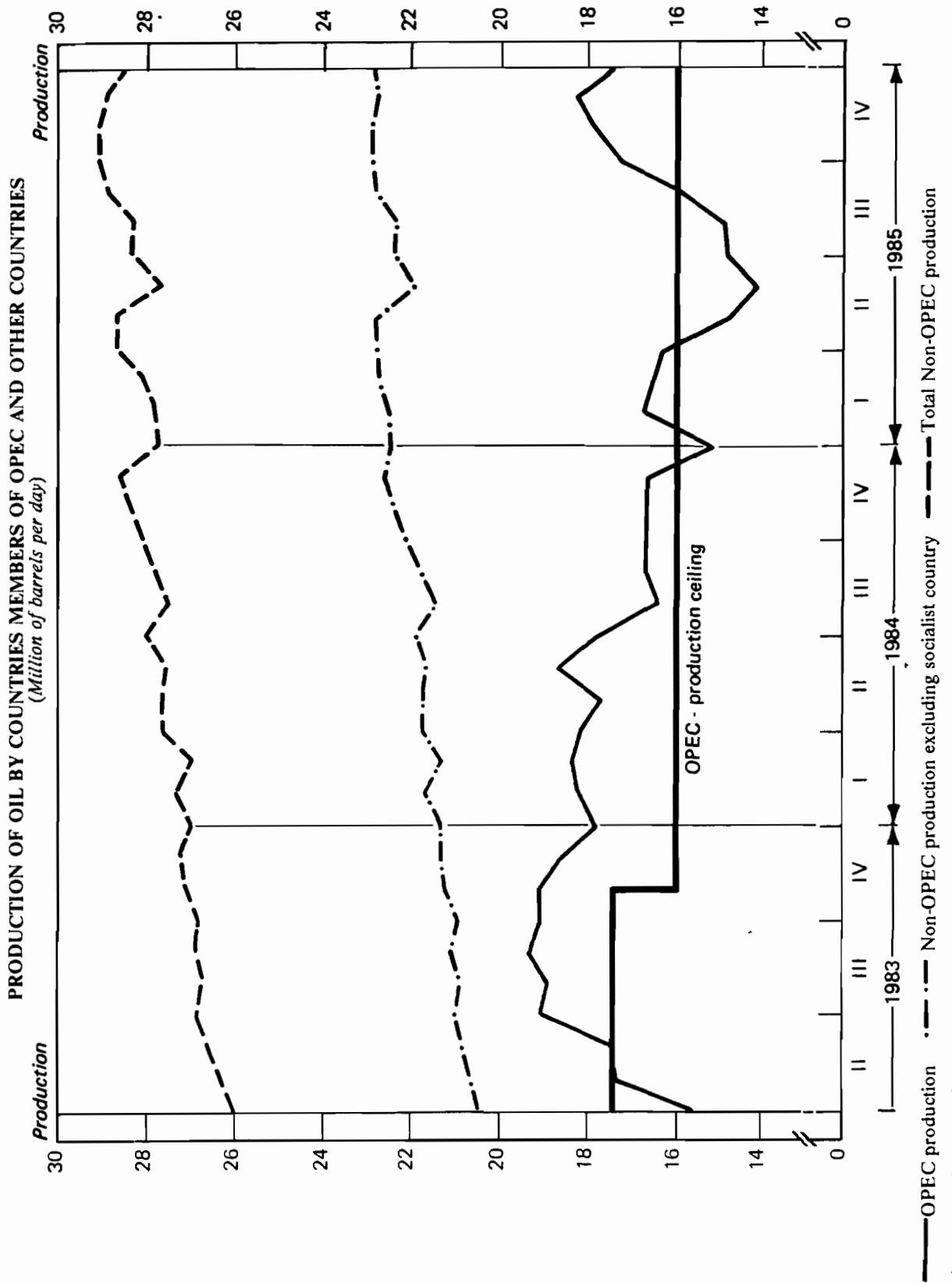
not improve, while many of the latter, having reduced their imports sufficiently to bring their payments deficit to manageable levels, were also not in a position to make further cuts without suffering disruption.

These factors help to explain why the contraction of demand for OPEC oil proved even harder for those countries to accommodate than before, even though it was much less pronounced. The reduction of the production ceiling in 1984 from 17.5 million b/d to 16 million b/d left OPEC oil production far below the levels regarded as acceptable by those countries, several of whom sought an increase in their own quotas. These pressures made it increasingly difficult to distribute cuts, and resulted in a disproportionate burden being placed on Saudi Arabia and Kuwait. Moreover, Saudi Arabia's swing producer role within OPEC, which had already been influenced by frequent war-related fluctuations in output in the Islamic Republic of Iran and in Iraq, now had to take into account the increase in Iraq's export capacity and production to about 1.8 million b/d (compared to the quota of 1.2 million agreed upon in October 1984) as its pipeline through Saudi Arabia become operational in mid-1985. In addition, Kuwait's initial all-out support of the price structure had proved too onerous to follow through. Saudi

Arabia thus found itself with a current-account deficit of the order of \$20 billion and an output level far below its maximum sustainable capacity of 11 million b/d (at times falling to as little as 2 million).

Thus, by 1985, a few OPEC countries found themselves in a situation in which, on the one hand, in order to protect the short-term revenue stream of OPEC members as a whole they were suffering large falls in revenues, while, on the other hand, the price that they were defending was progressively diminishing oil use in the long run - a prospect that was not appealing to them, given the high level of their oil reserves. It was in these circumstances that prices plunged. It was expected that a price collapse would persuade those oil-exporting countries that had hitherto enjoyed a "free ride" at the expense of OPEC's swing producers to co-operate in production-management by voluntarily curtailing their own output. Such a course of action would also serve their own interests, both in the short term, by strengthening prices, and in the long-term, by reducing their pace of depletion. Alternatively, the price cuts would induce "involuntary" production cuts through familiar market processes, both immediately by making marginal fields uneconomic and over the medium-term by depressing the pace of new

Figure 4



drilling and exploration. It was expected that if the price cuts succeeded in inducing co-operative behaviour on the part of non-OPEC producers, prices would be re-stabilized relatively soon, though not necessarily at their previous levels; but that if they did not, a combination of reserve depletion in other countries and a revival of oil demand triggered by the low prices would, after a number of years, improve the balance of supply and demand in favour of the countries that had hitherto acted as 'swing' producers. The first scenario would be less costly for OPEC countries in the immediate future; but even the costs of the second, in terms of payments deficits or import cuts, could be sustained by the swing producers since their foreign asset holdings were still relatively high.

The goal of associating non-OPEC producers in production programming was widely shared within OPEC. However, those countries with little or no room for further import cuts and with scanty reserves or borrowing capacity wished to avoid any action that would reduce their revenues in the short term. Moreover, some countries expected their oil reserves to be largely depleted before any longer-term benefits from lower oil prices would make themselves fully felt, and were therefore not convinced that prices needed to be reduced.

Nevertheless, in December 1985 OPEC decided on a policy intended to "secure and defend for OPEC a fair share in the world oil market consistent with the necessary income for member countries' development". While a fair share has not been precisely defined - perhaps intentionally so, in order to leave room for bargaining with non-OPEC producers - it is commonly considered to lie in the range of some 17 million b/d. It would not be difficult to achieve this, or even a substantially higher, figure, given the wide margin of spare capacity present in many OPEC countries. The problem is, rather, how to reconcile the market share objective with the revenue objective. That will depend on the willingness of non-OPEC producers to co-operate. A number of oil-exporting developing countries outside OPEC have indicated their willingness to participate in voluntary output cuts. Co-operation from the USSR is also expected to be forthcoming. Among the developed market-economy countries, Norway has recently signalled willingness to contribute to efforts to restabilize the oil market, but the United Kingdom has not. Much will depend on whether the United Kingdom maintains its present position or, alternatively, whether other countries will be willing to attempt to restabilize the market without that country's participation. Such a task might not be easy in any event, for OPEC countries under financial pressure might find it

even harder to maintain self-discipline than before if, as is expected, the new target prices were lower than those set previously, even if the more realistic alternative were the current level of prices, which are lower.

While the eventual outcome of the "game" being played in the oil market is highly uncertain, a continuation of the present situation would have a number of important consequences, some of which are discussed in chapters V and VI. The following paragraphs consider the consequences for the energy industry.

### 3. *Prospects for supply and demand*

The prospects for oil supply will be affected markedly in the longer term by recent developments in the oil market. On the basis of country-by-country and area-by-area analysis, it is expected that supplies of oil from non-OPEC sources to developed market-economy countries and developing countries will reach 27.83 million b/d by 1990, or 1.20 million b/d more than in 1985, assuming that prices will be in the range of \$14 - \$18 per barrel. The impact of recent price fluctuations is not expected to have a major effect on supplies in the near future, since investment in new fields has already taken place, and changes in supply in this period will be in response to earlier investments. The marginal wells, such as "stripper wells" in the United States and some in the North Sea, will be affected if prices remain low for long, but such reductions in supply will be small relative to world supplies. In the longer run, after 1990, the effect will become quite noticeable as a result of reduced investment in exploration and development in response to the decline in oil prices and the uncertainty regarding future prices.

The forecast increase in non-OPEC oil supplies between 1985 and 1990 is not expected to be highly concentrated but spread over a number of different countries, with the developing countries outside OPEC offsetting declines elsewhere. Table 15 summarizes forecast non-OPEC oil supplies to the world (excluding the socialist countries) in 1985 and 1990.

Lower oil prices will stimulate demand in the longer term rather than in the immediate future, and it is important to bear this in mind during the present period of accelerated price decline. Decreases in oil prices today might arrest the decline in oil consumption, but would not increase oil consumption sharply in the immediate future. The short-term effect of



Table 15

**EXPECTED WORLD <sup>a</sup> SUPPLY OF OIL IN 1990 FROM NON-OPEC SOURCES**  
(Millions of barrels per day)

<i>Country/region</i>	<i>1985 (Actual)</i>	<i>1990 (Forecast)</i>	<i>Change from 1985</i>
<b>Production in:</b>			
United States	10.55	9.75	-0.80
Canada	1.95	2.05	0.10
North Sea countries	3.36	3.10	-0.26
Other OECD	1.05	1.28	0.23
Developing countries	7.97	9.75	1.78
Net imports from socialist countries	1.75	1.90	0.15
<b>Total supply from non-OPEC sources</b>	<b>26.63</b>	<b>27.83</b>	<b>1.20</b>

*Source:* Based on data provided by Energy and Economics Research Inc.

*a* Excluding the socialist countries.

prices in the \$15/b range on demand will be minimal, because the forces of conservation, substitution and structural change were set in motion in the past, when it was widely expected that real oil prices in the second half of the 1980s would exceed \$35/b in 1980 prices. Lower oil prices will, however, influence the pace of further energy saving and fuel substitution measures planned now for the late 1980s and early 1990s, leading to an accelerated rise in energy and oil demand in the medium and long term.

Most forecasts prior to 1985, based on the then prevailing prices of \$28 per barrel, assumed a balance in the oil market by 1990 and the disappearance of any excess production capacity by the year 2000. The sharp fall in oil prices makes it likely that the emergence of tight oil market conditions will occur sooner, with prospects for an earlier increase in both nominal and real oil prices.

#### **4. *The impact of oil price uncertainty on the energy sector***

The fluctuation in oil prices has introduced an element of uncertainty into the investment and planning and the overall financial

prospects of the energy industries in general and the oil industry in particular. Most energy and oil companies, in the process of planning their investment in the late 1970s and early 1980s, took into consideration the prevailing views regarding the outlook for the energy and oil market, particularly oil prices. On that basis, a number of large-scale investments seemed to be cost-effective. However, with present prices and the uncertain outlook, most such projects will no longer be economical. Furthermore, with the prevailing uncertainty regarding oil prices, it is very difficult for these industries to make any meaningful cost-benefit analyses for their investment. This makes investment planning difficult, if not impossible, under present circumstances.

The cost of power generation from nuclear energy seemed to be quite justified and a number of countries, in particular France, embarked on the development of nuclear energy technology as the corner-stone of their energy planning. Both cost over-runs and the reversal in the trend of rising oil prices reduced the competition of nuclear energy with oil, and the industry only continued to survive with the help of government subsidies. Moreover, environmental considerations and the risk of accidents have also been important factors in changing the attitude towards nuclear energy. A number of projects are already being cancelled and

there are hardly any new orders for nuclear power plants.

Coal, which has displaced a substantial share of fuel oil in electricity generation, could also come under pressure. Most of the electrical power generators in Western Europe and in other industrial countries have maintained their dual power capacity characteristic and can easily switch from using coal back to fuel oil. While even with a low oil price the coal produced in Australia and South Africa could remain competitive, that of Western Europe and some of the coal produced in the United States will eventually lose their competitiveness. In such a case, the choice would be either to reduce output of coal in order to support prices, or to let the price fall as a result of competition with fuel oil. The price fall will eventually result in mine closures, resulting in severe unemployment in the localities concerned.

The oil industry is suffering the same fate as other energy industries with huge investments in marginal fields, both in the industrialized and in some developing countries. The oil industry had committed itself to the development of high-cost oil, a commitment which was only justified by the prevailing expectation that real oil prices in the second half of the 1980s would be in the range of from \$38 to \$40 in 1980. The reversal in the oil market and the declining prices changed the picture drastically. However, since the investment for exploration and development (which are 'sunk costs') had already taken place, the oil industry has been forced to maintain production of the high cost oil even in the face of falling oil prices.

For instance, it has been estimated that a drop in price from \$24 to \$15 will lead to a fall in well-head revenues of the 13 major and integrated companies in the United States of the order of \$5.5 billion in 1986 compared to 1985 (see annex table 20), which would be more than half of total revenue in the latter year. Among the oil companies, the integrated ones have a better chance of coping with the fluctuations in the oil prices, since they can cover their upstream losses in a period of falling prices by their downstream activities. However, the uncertainty in the market would inevitably affect the downstream sector also, leading to an overall deterioration of the financial condition of these companies.

The worsened financial situation of oil companies and energy-related industries has also caused difficulties for the financial institutions that are their creditors, a topic which is taken up in chapter IV, section A, below.

The worsening financial situation of some oil companies has been the main reason for restructuring of the industry by, *inter alia*, mergers and acquisitions, a situation which will continue in the future. The result is the switch of the oil industry towards concentration and monopolization, with smaller and financially weak companies being absorbed by larger oil companies.

The fall in oil prices and uncertainties about the future has already led a number of major international oil companies to announce substantial cuts in their capital expenditure for exploration and development. The reduction in planned capital investment has ranged from 49 per cent for Pennzoil and 48 per cent for Amerada Hess to around 6 per cent for Conaco and Philips Petroleum (see annex table 21). The average cut in investment by major and integrated companies could be as much as 22 per cent in 1986 and 1987 compared to the two previous years. In fact, acquisitions and mergers indicate that it would be cheaper to obtain oil reserves through financial arrangements than through exploration and development. Such a change in attitude would inevitably affect the future pattern of oil supplies.

Some participants in the oil market are making a profit from speculation and price gyrations and are, therefore, benefiting from volatility. Most, however, have a stake in market stability and predictability. In the absence of defence of prices by OPEC it is difficult to envisage any other player(s) capable of stabilizing the market. This is due to the nature of the market, in which the number of participants at all levels in the industry has increased manifold during recent years.

With the advent of participation and nationalization of oil industries in OPEC countries, and the transformation of the role of major oil companies in the late 1970s, the number of participants has increased sharply, on both the supply side (national oil companies and other government agencies of oil-exporting countries) and the demand side (major oil companies, smaller independent refiners, oil traders and other trading companies). This has been accompanied by significant changes in the supply pattern and the price structure. Long-term supply arrangements made before 1979 covered only some 20 per cent of OPEC exports in 1985, the remainder being sold at spot or spot-related prices or disposed through countertrade or other novel supply arrangements. In the present situation of gyrating oil prices, the oil trade has become even more competitive and considerably more speculative. A single cargo of oil can often change hands many times before it reaches its final destina-

tion. The crude oil spot market, which constituted only some 5 per cent of the volume of internationally traded oil prior to 1979, now accounts for more than 50 per cent, effectively dominates the price structure in the market. In striving to secure an outlet for their crude exports, oil producers are making increased use of spot or spot-related prices.

Agreement among producers regarding market share appears essential for restabilizing the oil market. The extent of their market, however, will depend importantly on the pace of world economic growth. The question thus arises whether it might not be possible to establish a new structure of co-operation both among producers and between producers and consumers, in the context of a long-term growth strategy for the world economy, designed to enhance predictability regarding demand, supply, and prices.

## 5. *Conclusions*

Because of the pricing system in force, the effects of the slowdown of the world economy

on oil markets were different from those on other commodities. The fall in demand stemming from that source and from the substitution and switching induced by higher energy prices was initially accommodated by cuts in output by OPEC members while production in many other oil-producing countries increased. However, the financial strain on OPEC countries proved too great.

The collapse of the system of price formation for oil has made the price of that commodity as volatile as that of any other primary commodity. But unlike the prices of other individual commodities, the price of oil is a key variable for the global economy. Consequently, the decline in its price will have major repercussions, not only in the immediate future but also in the long run, by paving the way for continued price gyrations. Moreover, the added uncertainty resulting from the breakdown of the pricing system will continue to affect adversely investment in energy and the performance of the world economy as a whole. It is therefore important that there should be international co-operation to stabilize oil prices, alongside efforts to revitalize economic growth and development and to reduce instability.

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## D. Commodity prices and disinflation in OECD countries

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### 1. *Commodity price swings and disinflation*

The major developed market economies have achieved a substantial slowdown of inflation since the beginning of the decade. In the seven largest OECD countries, the rate of increase in consumer prices was brought down from an average of over 12 per cent in 1980 to about 3.5 per cent in 1985, the lowest for more than two decades. Much of this deceleration took place during the 1980-1982 recession, when the pace of consumer price increase fell by 5.2 percentage points over that period. The speed with which disinflation was achieved varied among countries. In the United States the consumer price rise was more than halved between 1980 and 1982 and in Japan it was cut by two-thirds, whereas in Western Europe only by one-third. By the end of 1985, the United States inflation had dropped by 10 percentage points - from 13.5 per cent to 3.5 per cent, in

Western Europe by 8 points - from 14.3 per cent to 6.3 per cent, and in Japan by 6 points - from 8 per cent to 2.1 per cent. The decline accelerated during the first quarter of 1986 due to the collapse of oil prices, and the consumer price index in the United States and the Federal Republic of Germany fell for the first time since the 1950s.

Reduced demand in OECD countries exerted a strong disinflationary impact in those countries not only through its direct effects on domestic money wages and prices but also, and no less, by pulling down commodity prices. Indeed, this was a factor of significance to all OECD countries, to a greater or lesser degree.

Following a steep rise of some 14 per cent per annum during 1978-1980, non-oil commodity export prices fell by more than 8 per cent per annum during 1980-1982 (see table 16).<sup>25</sup> As a result, the swing in the rate of non-oil commodity price inflation (i.e., the dif-

<sup>25</sup> Since prices paid for imports may differ from market prices, export prices are reported in table 16. Indeed, the decline in the market price index during 1980-1982 was much greater, exceeding 15 per cent per annum.

ference between the annual rates of change) was over 22 per cent per annum between the two periods. Because of the moderate rise during 1983-1984 the annual rate of decline over 1980-1984 was somewhat lower. However, compared with 1978-1980, the swing in non-oil commodity prices was substantial. Crude oil prices, on the other hand, continued to rise at the beginning of the decade, but much less than in 1978-1980, giving an annual swing of about 60 per cent in 1980-1982 compared with 1978-1980. They then declined from more than \$34 per barrel in 1980-1981 to under \$28 in 1984, adding further to the swing. The decline in non-oil commodity prices during 1980-1982 and in oil prices in the later years meant that there was an almost continuous decline in the overall commodity price index over 1980-1984.

This was largely reflected in the prices of primary commodities imported by the OECD countries. The OECD non-oil commodity import price index, after rising at an annual rate of 11.5 per cent over 1978-1980, fell by more than 7 per cent per annum during 1980-1982. This swing of 19 per cent per annum was smaller than for world non-oil commodity export prices. This may have been partly due to differences in the composition of the world export and the OECD import price indices, but it also reflects the impact of the prices of commodities produced and traded within the OECD area. As noted in section B above, due to the subsidies and protection, such as the Common Agricultural Policy of EEC, prices of primary commodities, and particularly the foodstuffs produced and traded within OECD, do not follow the same movements as world commodity prices. As can be seen from the movements of the non-oil commodity export prices in table 16, during 1978-1980, OECD non-oil commodity export prices rose slightly more than the corresponding export prices from developing countries. During 1980-1982, on the other hand, developing country non-oil commodity export prices declined by 12.4 per cent per annum, but the OECD commodity export prices lagged substantially, falling only by 5.8 per cent. This suggests that, compared with the prices of commodities exported by developing countries, prices of commodities in the OECD are relatively inflexible downwards (although here part of the difference between the two price indices may be due to differences in the commodity composition of exports).

The sharp swing in oil and non-oil prices was the major factor behind the swing in the

OECD's overall import price inflation (in terms of national currencies) of 10.5 per cent per annum during 1980-1982 compared with 1978-1980. However, the decline in aggregate import price inflation remained much less than the decline in oil and non-oil commodity price inflation because the prices of manufactured imports kept up. Indeed, the swing in the prices of OECD manufactured exports was only equal to the swing in the average rate of inflation over 1980-1982, ruling out any significant independent disinflationary influence from trade in manufactures within OECD. Therefore, the contribution of slowdown in import prices to disinflation reflects the impact of commodity prices.<sup>26</sup>

Changes in import costs affect consumer prices directly when the imports are consumer goods, or indirectly when they are inputs into production of consumer goods, although they may be temporarily absorbed by profit margins. It can reasonably be assumed that the weight of commodity imports in the consumer price index, including the pass-through of imported primary inputs into final output is more or less the same as in GDP. Since the share of imports in the combined GDP of OECD countries is around 16 per cent, an annual swing of 10.5 per cent in import price inflation gives a disinflationary impact of 1.6 per cent per annum. This represents approximately 60 per cent of the total OECD disinflation that in fact took place over 1980-1982. If the calculation is extended to include 1984, the behaviour of import prices can account for about one percentage point of the average OECD disinflation of 2.5 points from 1982 to 1984.

Since import prices and wages are two major components of domestic prices, the disinflationary impact of commodity price movements would be enlarged to the extent that a slowdown in import prices results in a deceleration of money wages. Evidence suggests that the response of wages to changes in import prices is substantial. Moreover, as pointed out by an OECD study of inflation during the 1970s, "the simple notion of import prices influencing expenditure deflators according to the actual share of imports is incomplete, because the influence of imports on the prices of domestically-produced tradeables which compete with imports may be equally important."<sup>27</sup> Thus, the ultimate impact of the decline in commodity prices depends also on the size and speed of the response of wages and the prices of the domestically-produced commodities.

<sup>26</sup> In comparing commodity and import prices in the last two rows of table 16, exchange rate effects should also be taken into account. Since the dollar rose over 1980-1984 relative to the other major currencies, the swing in local currency prices was smaller than the swing in dollar prices.

<sup>27</sup> "International aspects of inflation", *OECD Economic Outlook, Occasional Studies*, June 1982, p. 16.

Table 16

ANNUAL RATES OF CHANGE AND ANNUAL RATES OF SWING IN COMMODITY PRICES  
(Percentage)

	Change			Swing	
	1978-1980 (1)	1980-1982 (2)	1980-1984 (3)	1980-1982 (4) = (2)-(1)	1980-1984 (5) = (3)-(1)
Non-oil commodity export prices <sup>a</sup>	13.9	-8.3	-4.2	-22.2	-18.1
<i>By commodity group</i>					
Food	14.6	-11.3	-7.4	-25.9	-22.0
Agricultural raw materials	12.5	-9.8	-2.0	-22.3	-14.5
Minerals	15.8	6.2	2.3	-9.6	-13.5
Metals	21.5	-12.6	-7.0	-34.1	-28.5
<i>By country group</i>					
Developed market-economy countries <sup>b</sup>	14.2	-5.8	-4.1	-20.0	-18.3
Developing countries	13.8	-12.4	-4.6	-26.2	-18.4
Crude petroleum export prices <sup>a</sup>	58.8	2.7	-2.4	-56.1	-61.2
Non-oil commodity import prices of DMECs <sup>a b</sup>	11.5	-7.4	-4.5	-18.9	-16.0
Overall import prices of DMECs <sup>b c</sup>	18.1	7.6	5.8	-10.5	-12.3

Source: United Nations, *Monthly Bulletin of Statistics*, March 1986; *OECD Economic Outlook*, various issues.

<sup>a</sup> In terms of United States dollars.

<sup>b</sup> Countries members of OECD.

<sup>c</sup> In terms of national currencies of member countries.

The results here are broadly consistent with the OECD estimates pertaining to inflation after the first oil price rise, and the impact of the deceleration of import prices during 1977-1978 on consumer prices. Applying the same coefficients to recent disinflation, the contribution of commodity prices, including the multiplier effect, would amount to about three-quarters of the total slowdown in inflation during 1980-1982, and half during 1982-1984.

While the evidence on whether or not unemployment in OECD countries has exerted an independent influence on wage and price behaviour is mixed, there is no doubt that reduced demand has caused commodity prices to fall, which in turn has contributed substantially to the decline in OECD inflation, directly and through its impact on wage moderation.

However, while both developed and developing countries have shared the costs of restrictive monetary and fiscal policies in the OECD, the benefits have not been equally distributed. Indeed, the decline in the commodity export earnings, combined with the rise in interest rates and cutback in bank lending, have forced developing countries to make drastic import cuts and thereby intensified inflationary pressure in their own economies. It is to be noted that developing countries did not have the option of improving their terms of trade by depressing demand and output in their economies, thereby reducing inflationary pressures. In view of the damage inflicted upon developing countries by the fall in commodity prices, an improved balance in the developed market economies between output and employment objectives, on the one hand, and the rate of disinflation, on the other, would seem

indispensable. In this way, growth would be enhanced in both developed and developing countries.

## 2. *Exchange rates and domestic wage and price responses*

Two broad factors determined differences among OECD countries in their pace of disinflation: the incidence of the decline in import prices and the size and speed of the response of domestic wages and prices to unemployment and import prices. The former depended on changes in exchange rates and on the share of commodity imports in domestic demand. On the other hand, while the response of wages differed among countries, the degree of flexibility of domestic prices of commodities also played a crucial role.

Given the other factors influencing prices, an appreciation of the dollar reduces the dollar prices of commodities, and the reduction will be higher, the lower the share of the United States in world final commodity demand. Various estimates indicate that the elasticity of the dollar prices of non-oil commodities with respect to the exchange rate of the dollar vis-à-vis other major currencies range between -0.50 and -0.75 so that, *ceteris paribus*, a 10 per cent appreciation of the dollar tends to depress the dollar prices of commodities between 5 and 7.5 per cent. However, since prices in other currencies rise by the difference between their rate of depreciation and the rate of decline in dollar prices, commodity prices would remain unchanged when expressed in terms of a basket of major currencies carrying weights equal to commodity market shares.

The decline in the dollar prices of commodities during the 1980s reflected both the impact of the appreciation of the dollar and the weak demand stemming from recession and high interest rates. A full decomposition of the decline is an intricate issue, but some estimates are available. From the last quarter of 1980 to the end of the third quarter of 1984, world food prices relative to average United States consumer prices declined by 45 per cent, fuel prices by 24 per cent and material prices by 20 per cent. Commodity price changes relative to consumer prices in other OECD countries were smaller (26 per cent decline for food, 9 per cent decline for materials, but a 3.6 per cent rise for fuel), the difference reflecting the real appreciation of the dollar vis-à-vis the currencies of the

other major countries. Thus, the decline relative to overall OECD consumer prices (about 31 per cent for food, 4 per cent for fuel and 16 per cent for materials) was smaller than the decline relative to United States consumer prices, and reflected influences other than the appreciation of the dollar.

Because of the dollar appreciation, import prices fell much faster in the United States than in the rest of OECD. Commodities accounted for just under half of total United States imports in 1980-1984, with the result that import prices in that period fell overall by almost 4 per cent per annum. Import prices of capital and finished consumer goods did not fall to the full extent as the appreciation of the dollar, because foreign suppliers, mostly the other OECD countries, raised the prices in their own currencies of their exports to the United States and hence increased their profit margins: evidence suggests that the cost conditions in the United States were far more important determinants of the prices of manufactures imports than costs abroad. In the case of restricted imports such as automobiles, import prices rose, increasing the profit margins of foreign suppliers substantially; OECD has noted that, according to one analysis, "the automobile VER (voluntary export restraints) increased the profitability of Japanese sales in the US market by 12 percentage points".<sup>28</sup>

Although in the United States the share of imports in general, and of commodity imports in particular, in total domestic spending is relatively small, the large swing in the import price index in 1980-1982 compared with 1978-1980 made a substantial contribution to the slowdown in consumer price inflation. The two-year swing in import price inflation was close to 50 per cent, and its direct contribution amounted to almost two-thirds of the slowdown in consumer prices.

The prices of domestically produced manufactures were not much affected by increased competition from imports; they depended mainly on the slowdown in production costs, and there was no tendency to reduce prices by lowering profit margins. Thus, this fix-price behaviour at home caused the burden of exchange rate appreciation to fall largely on the level of industrial production and primary product prices.

The impact of the United States import prices was enlarged as price declines became built into wage behaviour. Domestically, however, the prime disinflationary impulse came again from commodity sectors. First, domestic

<sup>28</sup> *Costs and Benefits of Protectionism* (Paris, OECD, 1985), p. 17.



oil prices stabilized and later declined in line with the world market prices, and contributed to the slowdown in inflation as much as imported oil, since domestic production accounted for half of total consumption. Second, prices of agricultural products and food fell; although prices received by farmers fell much less than world prices (see section B above), their contribution to disinflation was comparable to that of commodity imports because of the very large share of domestic production in consumption.

Thus, disinflation in the United States can largely be explained by the decline in the prices of both domestically produced and imported commodities, and by the appreciation of the dollar. While the increase in unemployment has played an independent role and speeded up the response of wages to falling inflation, it cannot account for the greater part of the fall, particularly considering that inflation continued to slacken during the recovery, when unemployment was falling.

For the major Western European countries, these influences worked differently. Because of the depreciation of their currencies, the swing in the dollar prices of commodities was only partly reflected in prices expressed in domestic currencies. For instance in terms of the Deutsche mark, commodity prices fell by only 4 per cent in 1980-1982, after rising 17 per cent in 1978-1980, giving a total swing of 21 per cent. For Western European countries as a whole, the swing expressed in prices of commodities expressed in terms of the ECU, was even smaller - 16 per cent. Moreover, the continued appreciation of the dollar after 1982 and the stabilization of the dollar prices of commodities during 1983-1984 entailed a rise in the ECU prices of commodities, but at a rate well below that of the consumer price index. Since the share of commodity imports in total spending is substantially higher in Western Europe than in the United States, swings in the domestic currency prices of imports and commodities have a much greater impact on domestic price inflation than they do in the United States. Indeed, while the fall in the rate of increase in import prices was only 8-10 percentage points in the Federal Republic of Germany and the United Kingdom from 1978-1980 to 1980-1982, it generated a direct disinflationary impact of 2.5-3 per cent, because

the share of imports in domestic spending was as high as 30 per cent.

On the domestic side, there was some inertia in the reaction of wages to slowdown in import and consumer prices, particularly in the United Kingdom and Italy. Moreover, agricultural prices in EEC were sustained at high levels on account of the Common Agricultural Policy. Between 1980 and 1982, while the world commodity prices expressed in ECU rose by about 2 per cent, the EEC agricultural price index rose by more than 10 per cent.<sup>29</sup> These factors, together with the depreciation of the Western European currencies, meant that disinflation involved greater costs in terms of output and employment than in the United States.

The Japanese experience was in some respects similar to that of Western Europe and in other respects to that of the United States. The share of imports in domestic spending is low compared with Western Europe, but because oil and non-oil commodities account for more than three-quarters of imports, Japanese import prices are highly sensitive to changes in commodity prices and in the exchange rate. The direct impact on domestic costs of a 10 percentage point change in the yen prices of commodities amounts to one percentage point, which is far greater than in the other major OECD countries.

The Japanese import prices rose by about 35 per cent per annum during 1978-1980, but the average rate of consumer price inflation was only 2 percentage points higher than in 1976-1978, much less than the direct effect of import prices. The crucial factor in keeping inflation low was the behaviour of wages; indeed, unit labour costs in manufacturing fell by about 2 per cent during that period. During 1980-1982, the decline in commodity prices was reflected in a sharp swing in the rate of increase in import prices since the rate of depreciation of the yen vis-à-vis the dollar was small. However, consumer price inflation fell by much less than was accounted for by the direct impact of the swing in import price inflation. Since unit labour costs rose only moderately, the decline in commodity prices helped to sustain profits in the face of the recession. In Japan, therefore, commodity price changes were not fully carried through into consumer prices because of the behaviour of wages and profits.

<sup>29</sup> This can also be deduced from the figures in table 10 above. While the dollar prices of the EEC commodities in the ECU basket declined by 12 per cent in 1980-1982, the ECU prices rose since the depreciation of ECU vis-à-vis the dollar was over 25 per cent.

### 3. *Conclusions*

Rarely are inflation and disinflation distributionally neutral. The preceding analysis of the disinflation achieved by the developed market economies in the 1980s underscores this point. First, much of the burden has been borne by commodity-exporting developing countries. Second, developed market-economy countries have differed in the extent and distribution of the burden placed on their domestic sectors. In the United States, movements of the currency and of domestic commodity prices reinforced the impact of the swing in world commodity prices, thereby lessening the burden of disinflation on industrial wages, employment and profits (except in the foreign trade sector, which was hit hard by the dollar appreciation). In Western Europe, the situation was the reverse, while in Japan external factors and wage moderation together made a sufficiently large contribution to allow both

disinflation and a rise in profit margins to take place.

By strengthening commodity prices, a significant acceleration of growth in developed market economies would put some upward pressure on the price level. But that is not a valid reason to continue to restrain the pace of expansion and perpetuate high levels of unemployment. An improvement of commodity prices is badly needed in order to revive the developing economies, and it is something that can be accommodated by developed countries. What the latter would need to do is ensure that the improvement does not trigger an inflationary spiral.

The behaviour of currencies also needs to be improved, for a variety of reasons. In the context of the present discussion, improvement should consist in ensuring that exchange rate movements do not continue to distribute inflationary and disinflationary pressures in an arbitrary manner and oblige countries to make unnecessary adjustment and readjustments. ■



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### Chapter III: Notes and references

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## CHAPTER IV

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### DEFLATION, DEBT AND TRADE

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#### Introduction

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The deflationary pressures and other monetary and financial disturbances that have persisted over the first half of the 1980s have impaired significantly the capacity of the international financial and trading systems to contribute to growth and development and to foster the efficient use of resources.

The pervasiveness of debt-servicing problems - for instance, among developing countries and among farmers and in the energy and energy-related industries in the United States - brought about a marked deterioration in the quality of the portfolios held by financial institutions. This prompted banks to reduce the flow of credit to problem debtors and to seek to increase profits through fee-earning activities. Such adjustments have helped reduce the vulnerability of banks to insolvency on the part of their debtors, but have not eliminated it. Moreover, the impact of such insolvency will not be confined to the debtors' own creditors, for banks are highly interdependent through the inter-bank market, whose growth has enhanced the potential for chain reactions. Financial innovation and deregulation have also served to further integrate financial markets within and among countries. Many of the structural changes which are taking place in the financial markets tend to make the international financial system, and hence trade and development, more exposed to fresh shocks such as a new wave of deflation. This poses challenges for prudent regulation and central bank intervention, as well as for the conduct of monetary and fiscal policies.

The external liquidity squeezes on developing countries have tended to feed on themselves, eventually threatening the whole

spectrum of the financing and payments arrangements of the countries concerned. As a result, both the costs and the availability of finance for their international trade have been adversely affected. The interaction of external financial stringency and depressed export demand has greatly increased pressure to engage in countertrade. While countertrade generally entails costs, these costs may often be less for financially squeezed countries than alternative methods of paying for imports. The extent of countertrade in the future will depend importantly on the financial pressure faced by countries, and hence on overall conditions in international markets for finance and goods.

Deflationary monetary and financial disturbances have also fuelled protectionist pressures. Trade policy in developed market economies became considerably more restrictive as unemployment rates rose and output growth slackened in the early years of the decade. The pace at which it has tightened has moderated with the onset of recovery, but the expected - and promised - roll-back has failed to materialize. This is to be explained partly by the strength of the currency of the country in which the recovery of OECD output was principally concentrated, namely the United States - or, viewed from the other side, by the weakness of recovery in the Western European countries with depreciating currencies. Another important influence has been the intensified competition from developing countries attempting to overcome their acute financial pressures. The prospects for reducing protective barriers in the future will thus be sensitive to the rhythm of output, the pattern of exchange rates, and the financial pressure on developing countries.

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#### A. Deflation, deregulation and the financial system

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An effective international financial system is essential for the growth and stability of the world economy. Disruption or failure in

part of the financial system, if not immediately controlled, can spread rapidly, impairing confidence and depressing business activity.<sup>30</sup> In-

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<sup>30</sup> The Chairman of the United States Federal Deposit Insurance Corporation (FDIC) has referred to this danger in unusually graphic terms: "The financial area is probably, next to nuclear war, the kind of area that can get out of

deed, in the past, major economic collapses have frequently been triggered by financial panics, or even by the failure of a single large financial institution.

In recent years the international financial system has tended to become more vulnerable. The portfolios of financial institutions have been weakened by the impact of high interest rates and flagging demand for the output of certain productive sectors. At the same time, changes have been taking place in financial markets and in banking practices, many of which are widely believed to have lessened the ability of the system to withstand shocks. In particular, the inter-bank market, which has grown dramatically in recent years, has heightened the potential for chain reactions. Banks, either voluntarily or under the pressure of regulatory authorities, have taken steps to protect themselves from debt crisis or difficulties of various types. However, some of the resulting changes that have occurred in the structure of international markets may contain the seeds of further problems, and it is unclear whether, on balance, the capacity of the system to withstand further stresses has been enhanced. Both banks and monetary authorities have in recent months been expressing their concerns in this regard and increased attention is being focused on the new challenges posed to central banks as lenders of the last resort. The pressures on financial institutions and regulatory authorities, and the overall stability of the financial system, will depend critically on the strength of the primary sector, and more generally on overall economic activity and on the course of interest rates.

This section begins by examining banks' exposure to developing countries and to certain troubled sectors whose debt-servicing difficulties are a potential threat to international financial stability, and the role of the inter-bank market. It goes on to examine the way banks and regulatory authorities are responding, the changes in the international financial markets stemming from their moves, and the policy challenges raised by these changes.

### 1. *Bank exposure to developing countries*

As was pointed out in the *Trade and Development Report, 1985*, the developing countries' debt crisis has confronted banks with a two-fold challenge: how to avoid default by

debtors and the precipitation of an international financial crisis and how to reduce the underlying potential for such a crisis. While the first objective requires an increase in bank exposure to debtor countries, the second implies a reduction of such exposure. By compressing their financing requirements to the bare minimum, developing countries have allowed banks to keep the growth of their exposure to a very low level. However, since economic growth has failed to revive in most developing countries confronted with debt difficulties, the potential for disruption in creditor-debtor relations has not diminished; indeed, it may well have increased. The dilemma facing banks has therefore not been resolved.

As described in section II of the annex to chapter V, the decrease in the flow of new bank lending to developing countries has been particularly marked in the last two years. The growth of United States bank exposure to developing countries fell continuously after 1982, and there was an absolute decline of about 6.5 per cent in the first three quarters of 1985 (see table 17). Bank lending from other countries also decelerated. Indeed, claims of United Kingdom banks on developing countries actually declined by about 4.7 per cent in 1984 and by about 5.9 per cent in the year ending June 1985.

United States banks' claims on developing countries fell in relation to their capital from a peak of 192 per cent in 1981 (see annex table 22) to about 117 per cent in September 1985 - i.e., below the 1978 or pre-crisis level. This decline partly reflected an increase in the capital of the banks by 44 per cent between 1982 and 1985, which was to some extent prompted by the regulatory authorities.

Some two-thirds of United States banks' exposure is concentrated in problem countries in Latin America and the Caribbean and involves principally the nine largest banks; these banks, which are at the core of the international banking system, account for about 65 per cent of total United States banks' claims on developing countries. On the other hand, total developing country debt represents no more than 8 per cent of the total assets of all United States banks, and that of Latin America only 5.6 per cent, both down from the 1982 figures (see table 18). For the nine largest banks the proportions are much higher - 13 per cent and 8.5 per cent - but even for them developing country debt is a minor share of their overall portfolio.

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control, and once out of control cannot be contained and will probably do more to upset the civilised world than about anything you can think of." (As reported in *Financial Times*, 29 May 1986.)

Table 17

**EXPOSURE OF UNITED STATES BANKS IN DEVELOPING COUNTRIES**  
(Billions of dollars, end of year)

Region	1978	1979	1980	1981	1982	1983	1984	1985 <sup>a</sup>
Latin America	42.6	49.4	62.2	75.0	83.9	84.1	86.2	82.0
Africa	5.2	5.7	6.2	6.8	7.2	7.3	6.1	5.1
West Asia	7.0	6.2	6.3	7.2	6.9	8.2	7.2	6.1
South and South-east Asia	11.1	17.8	21.6	26.0	31.5	32.0	28.6	26.6
Total developing countries	65.9	79.1	96.3	115.0	129.5	131.6	128.1	119.8

*Source:* Statistical releases of the Federal Financial Institutions Examination Council (*Country Exposure Lending Survey*).

<sup>a</sup> End of September.

United States banks hold around 30 per cent of the total international bank debt of all developing countries. The shares of banks in two other important creditor countries, namely the United Kingdom and the Federal Republic of Germany, are much smaller - about 11 and 8 per cent, respectively. Moreover, in a worldwide perspective, the weight of United States creditors in Latin American debt is particularly significant, since 36 per cent of the debt of that region is to United States banks.

While banks have thus far reacted to their "developing country lending" problem by drastically reducing or halting altogether new lending to those countries, to continue such a policy would be to aggravate the problem. For one thing, as pointed out in the *Trade and Development Report, 1985*, the sacrifices required from developing countries to service their debt in the face of sharp contraction in bank lending may prove intolerable. In any event, the containment strategy is now under a new source of pressure stemming from the collapse of oil prices. As is shown in annex table 24, major oil exporters together account for more than 40 per cent of bank claims on developing countries. For heavily indebted exporters such as Mexico, Venezuela, Indonesia and Nigeria - respectively, the second, fifth, sixth and eleventh developing country debtors in terms of bank debt - oil exports represent between 60 and 90 per cent of export revenues, and an oil price of \$15 a barrel would entail an export revenue decline of between 30 and 40 per cent. The share of their earnings to be devoted to debt servicing

would hence increase dramatically, from 18 to 34 per cent for Venezuela, from 33 to 51 per cent for Mexico and from 13 to 64 per cent for Nigeria. In Mexico and Venezuela alone, the nine largest United States banks had assets amounting to \$21 billion in September 1985, representing about 52 per cent of their total capital; two-thirds of this debt was held by four banks. The fall in oil prices will also add to pressures on Peru, a country which had even before the oil price decline felt it necessary to limit strictly the proportion of export earnings to be devoted to debt service; Nigeria, too, had moved in the same direction.

As pointed out in the *Trade and Development Report, 1985* a revival of growth in developing countries is essential to enable them to service their debt. However, as discussed below, in chapter VI, the capacity of developing countries to finance development by mobilizing domestic savings has been substantially reduced. Larger financial flows from both private and official sources will therefore have to be a central objective in any viable debt strategy in the coming years.

## 2. *Energy and energy-related industries*

The depressed state of the energy and energy-related sector had already produced, before the more recent and dramatic collapse of oil prices, a series of energy-related bank failures in the United States, such as those of

Table 18

**CLAIMS ON DEVELOPING COUNTRIES AS A PERCENTAGE OF  
TOTAL ASSETS OF UNITED STATES BANKS**

<i>Creditor banks</i>	<i>December 1982</i>		<i>September 1985</i>	
	<i>Total developing countries</i>	<i>of which: Latin America</i>	<i>Total developing countries</i>	<i>of which: Latin America</i>
Nine largest banks	14.0	8.7	12.7	8.5
Fifteen next largest banks	10.0	6.6	8.2	5.4
All other reporting banks	5.1	3.8	3.2	2.4
All United States banks	10.3	6.6	8.2	5.6

*Source:* As for table 17.

Penn Square Bank in 1982 and Continental Illinois in 1984. The situation has, however, seriously deteriorated in recent months. As a result of the borrowings associated with the wave of mergers and takeovers in the oil industry mentioned in chapter III, section C, a number of oil companies have substantial amounts of long-term debt (for example, an amount of \$80 billion at the end of 1985 for the 14 largest oil companies based in the United States). They are at the same time faced with the prospect of reduced cash flows, following the fall in oil prices. The oil service sector, such as rig and pipeline builders and operators, may be even harder hit by this fall.

A survey carried out by the Federal Deposit Insurance Corporation in 1985 for 563 energy banks in the United States (that is, banks which have more than 25 per cent of their capital invested in loans to oil and gas companies) showed a total exposure to the oil and gas industry (not including oil producers in developing countries) of \$61 billion, 92 per cent of which was concentrated in 59 large multinational and regional banks. When reviewed in April 1985 by the bank examiners, 17.5 per cent of these loans were criticized or subject to questioning, which is three times the percentage for all other industry credits. Other information on 245 United States national energy banks indicates that the banking industry's exposure to the United States oil majors, which are considered the best financial risk, is relatively low, whereas more than half of their

portfolios consist of debts of independent producers and oil field service companies, a much more vulnerable group. Of their total loans, about 7.8 per cent were non-performing, which is more than twice the national average. These data were collected before the sharp collapse in oil prices, and a further deterioration has occurred since. By the middle of 1985, for instance, many banks in the United States had set a "sensitivity level" or a "worst-case scenario price": at \$20 per barrel for some, and \$16-\$18 per barrel for others, but in any case, significantly above the levels registered in early 1986. Even at \$18 per barrel, some bankers considered that they would be in grave difficulty, and others that 30-35 per cent of their energy loans might become problem loans.

Particularly affected by the difficulties in the energy industry are the Texan banks,<sup>31</sup> whose problem loans have soared by 50 per cent in two years, to reach \$3.7 billion at the end of 1985. Non-performing loans at each of the six biggest bank holding companies in Texas already represented between 3.5 and 5 per cent of their respective loan portfolios before the recent oil price collapse. Energy-related loans are the main component of this significant accumulation of non-performing assets. Texan banks are also affected by international developments: loans to Mexico represent about 2 per cent of their aggregate portfolio. Other difficulties for those banks include developments in the real estate sector and the overall ripple effect of falling energy prices

<sup>31</sup> Other states affected by the fall in energy prices include Louisiana and Oklahoma, also hit by the recession in agriculture, and Alaska.

on the Texan economy. The major banks are not in danger, however, although a few of them had to make substantial write-offs in 1985.

In Canada, the first bank failures in 62 years occurred in September 1985 when two Alberta banks, which had concentrated their assets in the booming energy and real estate sectors during the 1970s, closed their doors. They were especially hard hit by the deep recession in western Canada and by oil and other commodity price slumps in the early 1980s. In addition, they, as well as the other regional banks, had to pay above-average interest rates to attract deposits. Additional difficulties have been experienced in a few other institutions. Altogether, these troubles have not threatened the stability of the Canadian banking system, but they have exposed a number of weak spots; the two failures in particular are expected to lead to tighter supervision of financial institutions and to delay in introducing earlier government proposals for deregulation of the financial sector.

### 3. *The United States farm sector*

As indicated in chapter II, section B, farming in the United States has been hit since the early 1980s by a combination of falling revenues and higher interest rates. Farmers who entered the 1980s heavily indebted are under the most intense pressure. Although a minority, they account for around half of total United States farm debt, which has now reached a little over \$210 billion - equivalent to almost twice the United States banks' exposure in developing countries. Most of this debt is owed to the Farm Credit System and to federal agencies, which together account for around half of farm credit. None the less, about one-quarter of farm credit is provided by commercial banks, and a significant part of banks' portfolio in the agricultural sector has become troubled. Agricultural banks, which hold about two-thirds of commercial banks' farm loans, have been most affected. Though the majority of them are still in good condition, a significant number are experiencing some degree of stress.

For instance, the number of agricultural banks whose non-performing loans exceeded total capital rose from 44 in 1984 to 102 one year later and to 167 by mid-1985, while the number of agricultural bank failures jumped from 7 in 1983 to 32 in 1984 and to an estimated 46 by late 1985.

For the time being, the biggest worries concern the Farm Credit System (FCS).<sup>32</sup> This is the biggest lender to the United States farm sector and most of its financing comes from the sale of bonds and notes in national and international financial markets by the fund-raising arm of the System, the FCS Bank Credit Corporation. The Farm Credit System's financial stress is reflected in its continuously decreasing income and the significant increase in its loan-loss provisions since 1984. Performance deteriorated considerably last year. The System is well capitalized, but its problems are not subsiding:<sup>33</sup> estimates by the General Accounting Office indicate that the System's bad loans could double in 1986, producing a drop in earnings which would eat into its capital base.<sup>34</sup> The exposure of United States commercial banks to the System's institutions - they hold much of the approximately \$100 billion in bonds and notes issued annually by the Federal Credit System, and also deal with the System in the money market - makes commercial banks doubly affected by financial stress in the farm sector of the United States, and gives them a strong interest in its evolution.

The farm-debt crisis has provoked reactions and policy responses of various types. Some financial institutions are trying to limit their involvement by selling some of their agricultural banks or by limiting lending to farmers, but many banks find that they cannot withdraw credit without triggering the borrower's collapse. Apart from the few large banks with a significant exposure to the farm sector, however, it is the agricultural banks and the Federal Credit System which face the most serious problems.

Like the developing country debt crisis, the United States farm debt crisis has prompted a number of proposals for solutions. These include debt moratoria, loan guarantees by fed-

<sup>32</sup> The Farm Credit System, a network of quasi-banks which was set up between 1916 and 1933, is divided into 12 geographical districts. Altogether, the system comprises 37 banks (12 Federal Land Banks, 12 Federal Intermediate Credit Banks and 13 Banks for Co-operatives). It also includes 400 Federal Land Bank Associations and 370 Production Credit Associations. The Farm Credit System banks are owned by the borrowers; they are not really banks as they do not take deposits.

<sup>33</sup> A major difficulty for the FCS is that capital and bad loans are unevenly distributed among its banks. As a result, while the overall picture is not unsatisfactory, some parts of the system are facing more serious troubles: this is particularly the case for some Production Credit Associations (PCAs), which provide short-term and intermediate loans.

<sup>34</sup> Already two of FCS' Intermediate Credit Banks (those of Omaha and of Spokane), two main lenders to the Production Credit Associations, have had to be bailed out. The rescues have been made at a cost of, for instance, \$435 million in the case of the Intermediate Credit Bank of Omaha.

eral or state agencies, debt restructuring with potential write-down, interest rate relief and recapitalization of farm business through equity infusion from outside. One proposal also envisages the creation of an agency for bad farm loans which would buy non-performing loans from farm banks, and which would also ensure liquidity by supporting secondary markets. Another involves the creation of a federal entity which would buy land used to secure loans in default and rent it until it could be sold without aggravating the fall in land prices.

Opinions as to the ability of the farm sector difficulties to upset the banking system generally are divided. A number of observers believe that there is no cause for alarm, since the debt is spread among a very large number of banks, most of them small, and because the overall capital position of agricultural banks is strong and has been improving. However, much will depend on how farm incomes and interest costs evolve. The farm sector could at least shake some institutions, particularly since a few of the major banks are simultaneously exposed to both farmers and other troubled debtors such as shipping and real estate, as well as to developing country borrowers. Its impact on the financial system as a whole would be cushioned by the fact that the bulk of farm debt is owed to the Federal Credit System and the small agricultural banks; nevertheless, it could set off waves of uncertainty and necessitate costly interventions in an effort to avert domino effects.

In spite of the above developments in sectors to which banks are exposed, financial markets in the United States are relatively calm. One reason is that the United States banking system appears stronger than, for instance, two years ago. The largest 24 banks have almost doubled their capital and made substantial charge-offs in bad loans in the last three years. The average primary capital to asset ratio of the nine money centre banks, for example, has increased from less than 5 per cent to about 6.3 per cent during the same period. Most of the major banks made significant efforts in 1985 to increase loan-loss reserves, and still managed to post healthy profit increases: the overall net earnings of the 15 largest United States banks is reported to have increased by 11.6 per cent on average in 1985. Nevertheless, since these higher earnings have been in part due to a series of one-off "special gains" (such as property sales and early debt retirement), some analysts are questioning the underlying strength of this improvement. In addition, capital may have increased in relation to risk exposure much less than in relation to assets (if at all), owing to the rapid increase in off-balance-sheet risks (see section 6(a) below). At present, United States

regulators are facing a rising tide of failures: the number of bank failures jumped from 43 in 1983 to a record 120 in 1985 (the highest since the mid-1930s) and is expected to be even higher in 1986.

#### 4. *Other private sector indebtedness in the United States*

The non-farm private sector in the United States also increased its indebtedness in the 1980s. Consumer debt rose substantially. The ratio of outstanding household debt to personal disposable income reached a record level in the third quarter of 1985 due largely to increased indebtedness of high income groups, and there are concerns that, in conjunction with low savings, shortened maturity and a growing share of the variable-rate debt, increased debt obligations will further eat into personal disposable incomes. The financial position of the non-financial corporate sector also worsened. First, reliance on short-term debt relative to long-term debt has increased significantly (by about 50 per cent from the late 1970s to the mid-1980s) while liquid assets have fallen relative to short-term debt. Second, the debt/equity ratio rose substantially, due partly to increased borrowing to finance takeovers. The substitution of debt for equity has proceeded at such a pace that in 1984 alone some \$78 billion in equity vanished, while companies were adding \$169 billion to their debt. Much of the growth of the non-financial corporate sector indebtedness has been unrelated to the growth in real economic activity: as noted by the President of the Federal Reserve Bank of New York, the volume of corporate debt is much higher than usual for this stage of the economic cycle (partly because of all the debt-financed buy-outs which have been occurring in recent years).

These developments have been reflected in the increase in the proportion of gross company profits absorbed by interest payments. The higher indebtedness, combined with floating rates and shortened maturity of debt, has enhanced borrowers' vulnerability. Defaults on mortgages and non-financial business failures have increased and, if once more income flows were to slow down or interest rates to rise substantially, there would be a much smaller cushion of equity to absorb the shock.

Banks have also been affected by developments in other sectors, such as the recent tin crisis. The impact of this crisis on banks, however, is not so much due to the volume of loans involved; rather, it stems from the fact



that the crisis has raised a number of questions that are basic to the international activities of banks. These questions relate in particular to the enforceability of obligations undertaken by sovereign traders and the liability of States members of intergovernmental agencies (see box 2).

## 5. *The international inter-bank market*

Though the growth of the inter-bank market has been slower in recent years, the volume of activity in this market continues to be very large. At end-1985, for instance, the size of this market in the BIS reporting area, measured in terms of total cross-border claims of the BIS reporting banks on one another, amounted to some \$1,500 billion: about 60 per cent of these banks' total external assets was thus accounted for by inter-bank lending.

The development of a large international inter-bank market has underpinned the rapid growth of international bank lending by facilitating the adjustment of asset and liability positions, thus reducing funding risks and allowing banks to pursue operations with smaller precautionary balances. This in turn has made banks more vulnerable to risks associated with unfavourable economic movements affecting several borrowers simultaneously ("systemic" risks). In addition, the inter-bank market can become a potential source of instability during periods of disturbance: by serving as a conduit for flows of funds between banks it can transmit widely throughout the capital markets the effects of local shocks originating anywhere in the international financial system. Hence, troubles in particular sectors, such as those examined, could be transmitted throughout the international financial system and amplified in the process.

In this context, questions about the availability of emergency assistance to banks active in the international inter-bank market have become more acute. In the mid-1970s, central bankers had tried to lessen anxieties by announcing that, although they recognized that it would not be practical to lay down in advance detailed rules for the provision of temporary liquidity, "means are available for that purpose and will be used if and when necessary."<sup>35</sup> The growing interdependence of na-

tional banking systems has also led to initiatives for increased co-operation between national authorities, such as the creation of the Committee on Banking Regulations and Supervisory Practices under the auspices of the Bank for International Settlements, whose main task has been to ensure that all banks are supervised according to certain broad principles. The revised agreement issued in 1983 on supervision of foreign bank establishments (known as the revised Basle "Concordat") has helped to clarify the division of supervisory responsibilities in order to eliminate gaps in the supervision of foreign bank establishments. Despite recent clarification, however, a number of grey areas remain, such as the offshore financial centres and banks with head offices in countries outside the competence of the Basle Committee. In addition, a number of questions are left unanswered, as the Concordat, for instance, did not address the problems of proper and specific tools for regulation of international banking and also explicitly excluded from its scope the issue of the responsibilities of a lender of last resort.

## 6. *Bank difficulties and the evolution of financial markets*

### (a) *Bank strategies, innovation and deregulation*

The debt crisis has prompted banks to focus less on the growth and more on the quality of their portfolios, and to try harder to improve efficiency and profitability. Partly on their own initiative and partly due to supervisory pressures, they have sought to strengthen their financial structures. As a result, they have not only halted new voluntary lending to developing countries with debt-servicing difficulties, but have also stressed fee-earning activities that entail contingent liabilities rather than direct claims on the borrowers.<sup>36</sup> Banks thus have shifted emphasis towards investment banking activities, that is mostly underwriting and distributing securities. Innovation and deregulation have played an essential role in this process, but the resultant changes in financial markets have been of concern to bank regulators and other authorities.

Changes in both the supply of and the demand for financial assets have also stimu-

<sup>35</sup> Press communiqué of the Governors of the central banks of the Group of Ten and Switzerland, September 1974.

<sup>36</sup> These activities include commitments to lend which may or may not be drawn upon at a later stage, such as letters of credit, stand-by credit lines, and other arrangements, including note issuance facilities and revolving underwriting facilities (for definitions, see the annex to chapter V below, footnote 4). In general, these instruments do not appear on bank balance sheets unless they give rise to actual lending and thus to claims on borrowers.

## BOX 2

**THE INTERNATIONAL TIN CRISIS**

- *The tin crisis erupted in October 1985 when the announcement by the Buffer Stock Manager of the International Tin Agreement that he had suspended his operations led to the closure of dealings in tin on both the Kuala Lumpur Tin Market and the London Metal Exchange. It had serious implications for the banks which lent to the International Tin Council (ITC) and for member organizations of the London Metal Exchange (LME) not so much because of the amounts involved as the issues it raised.*
- *ITC had accumulated a debt of about \$1.3 billion to banks and metal brokers. A third of this amount had been lent by 14 banks and two non-bank creditors to finance part of the tin stockpile built up in the context of the buffer stock mechanism. The rest was forward purchase commitments to LME brokers; here also banks were involved as lenders to members of the Exchange. Even after the situation had begun to deteriorate, creditors continued to lend to the Buffer Stock Manager on the assumption that the 22 member countries of the ITC would stand behind the Council's obligations. When the Council ran out of funds, the majority view of its members was that they did not have legal responsibility for its debt, and hence did not have to honour the Buffer Stock Manager's commitments.*
- *Particularly worrying were the possible ripple effects of failures in the LME, since if one member firm were to collapse others would have been severely affected, thus threatening the Exchange itself, and the danger of a contagion spreading to other commodity and financial markets. After the collapse of a rescue plan which had been put forward by banks and metal brokers, the LME authorities decided to limit the damage to member traders with ITC contracts by organising a fixed-price settlement of their outstanding tin contracts. Its members would take a loss, but an end would be put to the financial uncertainty they faced since the crisis erupted. As to the bank creditors, they were left with their approximately \$430 million claims on the ITC and with collaterals whose value had been continuously declining. Two of them have started legal actions against the Council, and another has instituted proceedings naming not only the Council but also its member States and the European Communities.*
- *More than the loan losses, which some argue the concerned banks can absorb without too much difficulties, it is rather through the way the crisis developed, the uncertainty it has created, and the fact that some principles have been brought into question that banks have been and are affected. Among the issues raised by the crisis is the enforceability of obligations undertaken by sovereign traders and the liability of States members of intergovernmental agencies, since banks were faced with the fact that the majority of ITC member countries did not acknowledge responsibility for the Council's debt. Some have argued that at least the banks have been taught to be more cautious about lending to governments and to international organizations, a lesson whose value might be questioned, however, in the present context of the debt crisis.*
- *The crisis is also having a serious impact on developing country producers. On the whole, most of the industry's cuts will be borne by South-East Asian countries, in particular, Thailand, Malaysia and Indonesia (the latter two being rather heavily indebted). Even more seriously affected, however, is Bolivia, which relies on tin sales for about 40 per cent of its export revenues and is already in a very severe economic situation. Beyond its direct impact on developing countries, the tin crisis may also have a specific consequence: some observers have indeed interpreted the situation as one where some countries, among the most creditworthy, have walked away from their obligations and have thereby set a precedent for developing country debtors.*

lated a switch away from bank lending towards capital markets and encouraged the development of new techniques and instruments. The countries with balance-of-payments surpluses in the 1970s, whose capital markets were still for the most part embryonic, naturally gravitated towards banks. By contrast, the main surplus country of recent years - Japan - is much better able to invest in securities. The demand for traditional bank lending by prime borrowers has also declined substantially as high-quality borrowers have found it cheaper to issue their own paper on international markets than to borrow from banks and have often issued such securities to retire their own existing bank debt.

The shift in emphasis towards investment banking has led to a tremendous increase in banks' contingent liabilities. In the United States the largest 25 banks have today \$1,500 billion of such commitments. Stand-by letters of credit, for instance, jumped from a total of \$10 billion in 1976 to \$176 billion in mid-1985;

note issuance facilities have increased by 80 per cent since end-1983 to reach \$31 billion in September 1985, and interest rate swaps, barely known few years ago, now stand at a level of \$180 billion. For many banks, such commitments far exceed the total amount of on-balance-sheet assets. For the top seven United States banks, for instance, they are equivalent to between 170 and 300 per cent of on-balance-sheet assets, with stand-by letters of credit and other commitments to lend, such as note issuance facilities, accounting for 50-60 per cent.

Innovation and deregulation have gone hand-in-hand. Diversification of activities and increased room for manoeuvre have been perceived as necessary in order to reduce risk concentration and improve banks' earnings. A desire to foster efficiency and competition in financial markets has also been an important factor behind deregulation, especially in countries where commercial banking and investment banking have traditionally been separated by

law or which have restricted geographical diversification. Restrictions have been eased on competition between banks and securities companies in some countries; and there is a trend towards permitting greater bank participation in stock exchange operations, relaxing restrictions on interest rates on deposits and widening the scope to issue such instruments as floating rate notes, zero coupon bonds and swap-related issues. In the Federal Republic of Germany, for instance, the authorities allowed in 1985 the issue of DM-denominated floating rate notes, zero coupon bonds and swap-related issues. In the Netherlands, a package of deregulation measures included the introduction of floating rate notes, certificates of deposit, and commercial paper. In 1985, too, France introduced certificates of deposit and also allowed the use of commercial paper to enterprises to raise funds in its domestic money market. A process of competitive deregulation has also been in force as individual countries have sought to avoid loss of competitiveness to institutions in the offshore and Euromarkets or in other major financial centres.

At the international level deregulation measures have encompassed the reduction or removal of capital controls in some major financial centres, the relaxation of restrictions on access to the national markets by foreign borrowers, and the lifting of withholding taxes on interest payments by non-residents in several countries. Restrictions have also been eased or removed on activities in futures and options for foreign exchange, as well as for financial assets and equities, in a number of countries. In addition, many countries have liberalized the rights of establishment of foreign financial institutions in their domestic financial markets.

These deregulation measures have greatly contributed to lowering barriers between the various segments of financial markets at home, and between domestic and foreign financial markets. Likewise, financial innovation has resulted in greater integration of markets, by easing access to non-bank savings and to foreign markets, and by offering increased possibilities to hedge against interest-rate or exchange-rate risks.

#### *(b) Impact on the financial system*

The changes occurring in financial markets, however, have raised a number of concerns, in particular regarding their impact on

risk and supervision in the banking industry and their implications for the effectiveness of monetary policies. For instance, the stunning growth of off-balance-sheet assets has begun to cause concern among bank authorities, and to some extent among banks as well, about the dangers that could flow from a sudden liquidity squeeze or surprise losses that might result, for instance, from a major shock in the economy that hit banks through their large exposure in security markets, or from the simultaneous activation of a substantial portion of banks' commitments under note issuance facilities. At present there is no agreement on the full extent of the risks involved. Some analysts consider that for many of the new instruments the risks are being underestimated (many of the instruments being underpriced) and their liquidity overestimated. It is also argued that the buyers of the instruments rely too heavily on the credit assessments made by selling institutions, and that this is a potential source of financial instability.

The transparency of financial institutions and financial markets has also been affected by the ways in which banks report and give statistical coverage to off-balance-sheet activities. As noted in a recent report of the BIS Committee on Banking Regulations and Supervisory Practices, many supervisors consider that "the information about off-balance-sheet exposures presently supplied in banks' published accounts is generally insufficient to give shareholders and depositors a reasonable picture of banks' activities".<sup>37</sup> Moreover, the absence of accounting rules comparable to those governing balance-sheet assets may mean that bank managements themselves have insufficient control. As markets become increasingly complex and new instruments multiply, the potential costs of inadequate control and inaccurate evaluation will tend to grow.

Monetary authorities have also been concerned. Financial innovation, by blurring the differences between different types of financial assets, has eroded the meaning and usefulness of some indicators of monetary policy, such as monetary and credit aggregates. They have also further increased the international mobility of capital, which in turn has meant that the exchange rate is becoming increasingly important as a channel of transmission for domestic policies, thus reducing the scope for pursuing independent policies. Likewise, it is felt that, with variable rate financing largely available to many borrowers, a temporary increase in interest rates may not reduce the demand for loans. The changing role of

<sup>37</sup> BIS Committee on Banking Regulations and Supervisory Practices, "The management of banks' off-balance-sheet exposures: A supervisory perspective", Basle, March 1986, p. 2.

banks has also raised a number of questions concerning the central banks' function as lenders of last resort and their responsibilities for monetary policy. As commercial banks' weight in the credit process diminishes, so does their role as a channel for monetary policies and they become less able to provide a liquidity buffer to the system as a whole. The question has therefore been posed whether the system now emerging will have the resilience to withstand the stresses and strains of further disinflationary policies.

These various concerns have been articulated with increased force in recent months. Warnings have been voiced that the movement of banks into new fields of activities and new techniques and instruments could make the banking system more vulnerable to shocks, and some are questioning whether the world financial system is losing in stability what it might be gaining in efficiency.<sup>38</sup>

These increased concerns have prompted efforts to strengthen supervision, including new measures aimed at improving the adequacy of bank capital and liquidity. Close attention is being paid, for instance, to note issuance facilities as well as to subordinated debt. In the United Kingdom, for instance, the central bank announced in 1985 that it was imposing a risk-asset ratio of 0.5 on note issuance facilities and revolving underwriting facilities. The United States Federal Reserve Board proposed in early 1986 new capital adequacy guidelines whereby certain off-balance-sheet items would be assigned to one of four risk categories, and given a weight corresponding to the risks of that category. For instance, legally binding loan commitments including note issuance facilities would be given a weight of 30 per cent and stand-by letters of credit a weight of 60 or 100 per cent depending on the type considered. Japan also announced in 1985 its intention to move towards a system similar to that of the United Kingdom and to include off-balance-sheet items in capital adequacy ratios. The banking supervisors of the Federal Republic of Germany indicated, in April 1986, that they were aiming at new rules to take account of the risks involved in off-balance-sheet business. Moreover, supervisors are making efforts to improve the supervision of banks' international activities on a worldwide basis. Japan has moved to a consolidated monitoring procedure,

and in the Federal Republic of Germany legislation on consolidated supervision of banks was implemented last year.

However, competition between different financial centres is inhibiting bank supervisors from tightening prudential regulations for, unless regulations affecting costs are harmonized, banks will tend to move to the cheapest financial centres. This factor will continue to be important, and to require closer co-operation among supervisory and monetary authorities. Likewise, at the domestic level, tighter regulations on banks may put them at a disadvantage compared with the other non-bank institutions operating in the same markets, and there is a growing recognition that supervisory practices should be adapted to fit the more integrated financial markets.

(c) *Government intervention in the new international financial environment* <sup>39</sup>

In the financial environment which has been emerging in recent years, with an international financial system undergoing significant changes and characterized by increased vulnerability, the issue of government intervention and of the responsibilities of central banks as lenders of last resort is assuming a renewed importance. The best-known interventions in recent months include the rescue of a major bank in the United States in mid-1984, referred to in section A.2 above, and an important operator in the gold bullion and precious metals market in the United Kingdom in late 1984. In the first-mentioned intervention monetary authorities could not ignore the destabilizing forces which were at play and, in the second, the central bank wished to avoid a crisis of confidence.

The principle that support by bank authorities will be provided only to solvent institutions has suffered some setbacks in recent years. First, the increased integration of markets and economies has enhanced the threat of domino failures. In addition, when a number of financial institutions face increasing difficulties not only because of acceptance of risky lending, but also largely because of fundamental changes in the circumstances under which a large number of their commitments were made,

<sup>38</sup> "La question fondamentale que je me pose, et à laquelle je n'ai pas de réponse, est celle-ci: ce monde financier innovateur, complexe et sans aucun doute très compétitif - donc plus efficace dans l'affectation des ressources - comment réagirait-il face à un choc "réel", ou simplement en présence d'une détérioration de la conjoncture? Ce qu'il gagne en efficacité ne risque-t-il pas de le perdre en stabilité?" Extract from a statement by A. Lamfalussy, Director-General of BIS, at the 'Institut d'Etudes bancaires et financières', Paris, 25 November 1985 (reproduced in *Bank for International Settlements Press Review*, No. 232, Basle, 26 November 1985).

<sup>39</sup> This sub-section deals with the issue of official intervention to the extent that it is affected by the new trends in financial markets.

the strict application of that principle becomes very difficult. At the same time, though, ensuring automatic support to failing institutions is not possible, in particular because it raises the problem of moral hazard. In addition, support interventions can be of a considerable financial cost for the economy, as in the case of the mid-1984 rescue in the United States; though the exact amount has not yet been calculated, it could cost the Government alone an amount in excess of \$2.5 billion. Given that the banks which are more likely to benefit from a rescue intervention are large institutions, it appears that the amounts at stake are sizeable.

Bank authorities are confronted with the uncomfortable prospect of being increasingly forced into rescue operations. Proposals have been made to provide some kind of alternative support arrangement, for instance, through in-

surance schemes based on banks' contributions. However, for the time being, bank authorities continue to rely on preventive measures, and as indicated above, are working at supervisory systems which would enable them to disclose problems in due time, through tighter monitoring of financial institutions. They have also warned more conspicuously in recent months against the growing vulnerability of the international financial system, thus trying to increase the awareness in the banking industry, and elsewhere, of the dangers which may lurk behind the new features of that system. This may presage an inclination on the part of policymakers to reassess the costs and benefits of the development of offshore banking and deregulation of onshore banking that has been taking place over the last 15 years, and perhaps even eventually to reconsider the fundamental directions of policy.

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## B. Deflation, external financial stringency and the rising costs of engaging in trade

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### 1. Introduction

The external financial stringency faced by developing countries since 1982 has highlighted the connection between financing and payments arrangements, on the one hand, and the growth and pattern of their trade, on the other. Macroeconomic interactions in this area have been extensively analysed elsewhere.<sup>40</sup> However, less attention has been devoted to the way in which external financial stringency has increased the day-to-day costs in developing countries' trade. Such increases have undoubtedly contributed to the slow-down of trade which has taken place since 1982, though to an extent impossible to quantify. They have also saddled with higher transactions charges much of the trade of developing countries which still remains. Among their most important effects in this context is the stimulus which they have given to countertrade.

All the various types of external financial flow, official as well as private, are used to finance international trade. Some of them, such as official development assistance (ODA), do not in general respond to changes in developing countries' external financial positions, but such responsiveness is characteristic of financing from private sources, in particular bank lending

and suppliers' credits (whether or not covered by official insurance in the exporters' countries). Moreover, since the different forms of private financing each respond unfavourably to deteriorations in borrowing countries' external financial positions, movements in their availability and costs tend to be mutually reinforcing during liquidity squeezes. The financing of trade, especially on the basis of short-term maturities, is in many cases linked to payments arrangements, and hence their cost and availability can likewise be adversely affected by external financial stringency.

### 2. *Some effects of an external liquidity squeeze on financing and payments arrangements*

The evolution of a liquidity squeeze for a developing country is affected by the pattern of its dependence on different forms of borrowing. Nevertheless, although the course of events typically has features unique to particular cases, it is possible to single out factors which can be expected to be prominent during such periods. Thus, as the squeeze on a debtor country's external cash flows tightens, delays in

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<sup>40</sup> See, for example, the *Trade and Development Report, 1984* (UNCTAD/TDR/4/Rev.1), United Nations publication, Sales No. E.84.II.D.23, Part III, and the *Trade and Development Report, 1985* (UNCTAD/TDR/5), United Nations publication, Sales No. E.85.II.D.16, Overview and Part Two, chap. IV.

payments lengthen and arrears generally tend to accumulate fairly rapidly, frequently in conditions where knowledge of the different aspects of its external financial position on the part of both its own government and its creditors is deficient. In consequence, liquidity squeezes tend to be self-reinforcing, eventually threatening the whole spectrum of a country's financing and payments arrangements. Moreover, as the risks of non-payment to a country's creditors increase, the prices of its imports are often inflated (as is explained below).

Various mechanisms are at work in this context. Their impact is felt on both financing and payments arrangements which are covered by official insurance extended in exporters' countries, and on those which are not. For example, imports are often purchased on open account, whereby the importer and the exporter agree that the debt of the former will be settled at some pre-determined date; but the exporter loses control of the goods at the time of their despatch and has no way of enforcing payment. Clearly, such an arrangement presupposes confidence in the importer's creditworthiness and in the continuing absence of restrictions on the supply of foreign exchange. Thus as an external liquidity squeeze leads to uncertainties over the availability of foreign exchange, open-account trading will normally be discontinued.

In the case of export credits, the costs and availability of official insurance are determined by the policies of export credit agencies (ECAs). In situations where a debtor country's creditworthiness is being adversely affected by an external liquidity squeeze, the procedures followed by ECAs vary, but generally include tighter limits on the availability of export credit insurance, the charging of higher premia, and a more restrictive application of other terms of such insurance (such as a requirement of confirmed irrevocable letters of credit<sup>41</sup> as a condition for the extension of cover). At a certain point, frequently the opening of negotiations

on the rescheduling of the borrowing country's official debts, cover is formally suspended for some or all types of trade credit to it.

Unfavourable changes in the cost and availability of official insurance will be reflected in higher rates of interest on credits from suppliers and on buyers' credits from banks. Moreover, during an external liquidity squeeze the borrower will find it increasingly difficult, or even impossible, to obtain financing from these sources. In such circumstances there are also various other ways in which the country's costs of importing rise as a result of the increasing risk that it will not be able to meet its external obligations. For example, suppliers often raise their prices. Thus, there is evidence that for certain African countries the accumulation of arrears has led to increases in the prices of imports varying from relatively small amounts to as much as one-half, depending on the position of the debtor and the payments and financing arrangements previously in force. Moreover, the rates on forfaiting (a financing technique used in connection with medium-term trade credits)<sup>42</sup> can be expected to rise, and the charges of banks for confirming letters of credit are also likely to go up.

### 3. *The stimulus to countertrade*

The term "countertrade" is generally used to denote certain types of business arrangement under which an exporter undertakes to generate himself, or cause to be generated by others, benefits such as revenues for an importer. The arrangements typically entail linked trading obligations of enterprises in two countries involving exchanges of products, technology and other services. The forms taken by countertrade include barter, counterpurchase, compensation and buy-back, various kinds of industrial co-operation (including offset agreements), and

<sup>41</sup> In the case of a confirmed letter of credit the conditional liability of the original issuer of the letter of credit to make payment according to its terms is assumed by a confirming bank, which is usually (though not always) in the country of the exporter. Irrevocable letters of credit may not be amended or cancelled without the agreement of all the parties involved. Irrevocable confirmed letters of credit guarantee payments to the exporter so long as the standing of the confirming bank is undoubted. They are thus favoured by suppliers and ECAs as a source of protection against failures by importers to meet their payment obligations for reasons such as limits on the availability of the required foreign exchange.

<sup>42</sup> Forfaiting denotes the purchase at a discount of financial obligations associated with trade transactions without recourse to the seller.

<sup>43</sup> Although the terminology of countertrade is far from uniform, a brief account of some frequently used terms may be useful. Barter signifies the exchange of goods without the medium of cash payments. Counterpurchase denotes linked trade transactions in which the goods in the deliveries by the two parties are generally not closely related and each transaction is covered by a separate contract. Compensation and buy-back refer to transactions in which the goods included in the counterdeliveries are closely related to the original exports, in the case of buy-back consisting of products of the equipment in the original sale. Terminology is particularly fluid in the case of compensation and buy-back, on occasion including only transactions covered by two parallel but separate contracts but sometimes also those involving a single contract. Industrial co-operation may comprise buy-back arrangements. More generally, it covers agreements under which benefits are to accrue to the importing countries in forms such as technology transfers, joint



switching.<sup>43</sup> Several reasons are cited for developing countries' resort to countertrade. These include its use for marketing and promotion, for reducing the availability of export earnings for servicing external debts, in attempts to maintain market shares, and for the purpose of pursuing various other objectives in the context of development and industrialization policies. But there is widespread agreement that recently the interaction of external financial stringency and depressed export demand has greatly increased pressures to engage in countertrade.

These pressures can be understood from consideration of the circumstances discussed above, where it was demonstrated that for a country facing an external liquidity squeeze, the costs of credit and payments arrangements for its imports tend to rise. In extreme cases many of the normal arrangements of this type cease to be available. The evidence on which the discussion above is based comes mainly from the financing of trade between developing and developed market-economy countries. Nevertheless, an external liquidity squeeze is often also likely to have analogous effects in trade among developing countries, although, in contrast to trade between developing and developed market-economy countries, both parties to transactions may be facing severe foreign exchange constraints.

During an external liquidity squeeze the other alternatives open to a debtor country for paying for its imports also mostly involve special costs. One alternative is to pay cash. But the cost of doing so is high since cash settlement in international trade typically takes place at the time of the order. Thus, if there is a significant lapse of time before the goods are received, the importer is actually financing the exporter. Moreover, cash payment presupposes that the required foreign exchange is available, which may well be not the case during an external liquidity squeeze.

Another alternative is to take special steps to accelerate export sales to increase the availability of foreign exchange. However, in conditions in which international markets for many goods are glutted, this option too has disadvantages. Not only may large price discounts be necessary, but future prospects may be harmed for an improvement in the balance

of supply and demand in the markets where the accelerated sales are made.

For trade among developing countries, it may be possible to avoid the high costs of conventional methods of financing and payments through recourse to a regional clearing arrangement. However, this option will not be available if the parties to particular transactions are not both members of the same arrangement. Moreover, even if they are, it appears that increased bilateral imbalances in developing countries' trade with each other, together with shortages of convertible foreign exchange for settling clearing balances, are in many cases hampering recourse to such arrangements.

For a debtor developing country, the option of countertrade as a means of paying for imports also generally entails special costs. Furthermore, there is no way of determining whether the discounts<sup>44</sup> on its exports in countertrade are generally greater or smaller than the reductions in price which would result from an attempt to accelerate export sales for cash. However, a variety of information (which is discussed below) is available as to the costs of alternative methods of paying for imports in the case of countries experiencing external liquidity squeezes. It suggests that even when the charges associated with countertrade are taken into account, this solution to paying for imports will not necessarily compare unfavourably with attempts to use conventional methods of financing and payments.

It should be emphasized that more direct testing is not possible of the arguments put forward here to explain the recourse to countertrade of countries facing external financial stringency. This is partly because of the difficulty of estimating the costs associated with alternative methods of settling a particular transaction, but also because of the possibility that even where external financial pressures are an important part of the explanation for recourse to countertrade, they may often not be the only motive. As was mentioned earlier, there are various reasons for countertrade. For countries facing an external liquidity squeeze, the objective of tapping the expertise of trading companies or exporters in developed market-economy countries for the purpose of selling goods lacking established marketing channels is often likely to complement the reasons re-

ventures, and subcontracting. This heading includes offset agreements under which a country requires foreign suppliers to make purchases or investments (or both) locally to offset a percentage of the value of their sales. Switching refers to the practice of switching to third parties the obligation to settle imbalances in the clearing accounts associated with bilateral payments arrangements.

<sup>44</sup> In countertrade transactions there is frequently no reduction in the price of a developing country's export below that prevailing in international markets. In such cases the prices of the imports in the transaction will be increased, and the term "discount" would be more accurately replaced by the phrase "unfavourable shift in the terms of trade".

sulting from the high cost or non-availability of conventional financing and payments arrangements. Where there is more than one reason for countertrade, the task of weighing up its costs and benefits is more complex.

Information concerning the additional costs of conventional methods of financing and payments actually experienced by countries during periods of external financial stringency is fragmentary. Nevertheless, it appears that they may sometimes be quite large. Available data concerning surcharges by ECAs on official insurance premia indicate that they are often not large in relation to the value of the transactions covered (although they may represent substantial proportional increases over normal rates). However, as noted above, such surcharges are often accompanied by restrictions on availability of cover, which may have much greater effects in raising financing costs or import prices (or both). For example, the charges associated with the confirmed irrevocable letters of credit, which may be required as a condition for the extension of official insurance cover, are likely to be substantial for countries undergoing difficulties over debt service (a proportion of 5-10 per cent of the value of imports being not uncommon). Moreover, the rates on forfaiting for such a country may rise to levels of more than 5 per cent above international inter-bank rates. As the risks of non-payment assumed by suppliers and financial institutions increase, so do their charges to debtor countries. This process cannot be quantified with precision, but as was noted above, involves such features as penalty interest rates and increases in prices for the goods exported (which may be as much as 50 per cent). Sometimes conventional financing and payments arrangements may not be obtainable at any cost. In other words, their costs then become infinite.

The costs of countertrade, on the other hand, vary with such factors as the type of transaction and the kind of financing used in association with it. Some information is available about two components of these costs, namely the discounts on goods prices and the commissions paid to intermediaries. Discounts vary according to the category of goods. For easily marketed bulk commodities they may be as low as 1-3 per cent, whereas for manufactured goods which are harder to sell discounts of 20 per cent or more are not uncommon. Commissions paid to intermediaries appear to vary from about 0.5 per cent to more than 5 per cent of the value of the transactions, depending on the nature of the services provided.

Evidence on other costs, such as the time taken to negotiate contracts, is much harder to come by. It is reasonable to assume that the

costs of the time spent on negotiating countertrade contracts to firms and financial institutions in developed market-economy countries are generally included in their commissions and in the discounts on goods which they purchase, but this is less likely to be true for the parties concerned in developing countries. However, information is not available concerning the extent to which the time taken in countertrade negotiations exceeds that required for analogous transactions for which more traditional financing and payments arrangements are used.

Financing is another factor complicating the comparison. Barter deals (i.e., transactions involving an exchange of goods without the medium of cash payments) require no financing for either party. Moreover, even certain types of countertrade which entail delays between exports and imports do not necessarily require outlays of foreign exchange or international lending. For example, the technique of advance purchase may be used when a developing country is unable to arrange letters of credit covering payments for its imports. Under this technique payment by its trading partner (say, an enterprise in a developed market-economy country) is placed in an escrow account, which is subsequently used to pay for the country's imports. Where there is no expenditure of foreign exchange, financing costs in national currencies to the parties involved may none the less affect the terms of trade of the transactions in question.

However, counterpurchase, compensation and buy-back transactions often do require international financing. The methods conventionally used to finance international trade are available for such transactions. However, their availability will help a debtor country undergoing an external liquidity squeeze only if using countertrade in conjunction with these methods can be a means of reducing the charges associated with paying for imports. Studies of countertrade have not so far focused on the relationship between countertrade and financing costs, so that it is impossible to arrive at conclusions concerning actual experience of this option. Nevertheless, there are clearly ways of structuring countertrade transactions requiring international financing in such a way as to by-pass certain aspects of conventional methods of financing and payments and to achieve a different pattern of costs under this heading.

From the above discussion some tentative conclusions may be drawn as to the relative costs of countertrade and of conventional methods of external financing and payments. In comparison with conventional methods, countertrade will often be associated with ad-



ditional non-financing costs (discounts, commissions to intermediaries, etc.) of some 5-15 per cent of the value of transactions, though sometimes rather more. However, this comparison takes no account of the increases in the charges associated with conventional methods of financing and payments which confront countries experiencing foreign exchange difficulties. Nor does it allow for the possibility that some of these methods may cease to be available in such circumstances. Where both partners have a foreign exchange constraint, as will often be the case in trade among developing countries, barter deals and other forms of countertrade which avoid foreign exchange outlays can make possible trade which otherwise would not take place. These forms of countertrade can also help economize on foreign exchange in trade between developing and developed market-economy countries. The position as regards countertrade requiring international financing is less clear, but there are indications that the expenses associated with countertrade may be an acceptable alternative for a debtor country to the costs of conventional methods of financing and payments, if the latter have been inflated as a result of difficulties over servicing external debts, or to actually giving up certain transactions.

#### 4. *The extent of countertrade*

The extent of countertrade is the subject of much controversy, reflecting uncertainty over a number of factors. For example, there is still disagreement as to just what should be included in the concept of countertrade. Moreover, there is no comprehensive reporting system for countertrade at either the national or the international level. As a result, the different parties to the debate as to its costs and benefits are able to put forward widely varying estimates of its extent. The uncertainty is probably increased by the desire of transnational corporations to maintain confidentiality concerning global procurement operations linked to countertrade.

If a sufficiently broad definition of countertrade is used, its extent is unlikely to be much less than 15 per cent of world trade and may be substantially greater. In the existing state of knowledge there is no way of making a separate estimate of the quantitative importance of financial as compared to other reasons for countertrade. Nevertheless, it is significant that available evidence suggests that there has been a rapid growth of such trade during a period characterised by widespread difficulties over debt service among developing countries

and depressed levels of demand for much of their exports.

#### 5. *Conclusions*

Increases in the costs, and disruptions of the availability, of financing and payments arrangements can significantly affect the net benefits to developing countries of their international trade. Like other obstacles to trade, such as those due to protectionism, they can reduce its level and influence both its directions and its structure. The inefficiencies and distortions which have resulted from the increased costs of doing business described in this section can be substantially reduced only by the revival of traditional methods of financing and payments, and by generally improving the macroeconomic environment for developing countries' trade.

These considerations have an important bearing on the prospects for the future expansion of countertrade, a question which, like its current extent, is controversial. As indicated above, such trading needs to be understood in many cases as part of the response by developing countries to external financial stringency and depressed export markets. Yet even if the macroeconomic environment becomes more favourable, the incidence of the improvement is not likely to be evenly distributed. Thus, at least for some developing countries and for some sectors, it may be expected that there will be continued resort to countertrade on account of the interaction of financial difficulties and depressed markets.

Moreover, the different forms of countertrade which take place under the heading of industrial co-operation are now probably so well entrenched that a substantial contraction in the foreseeable future is unlikely, even in response to a marked improvement in macroeconomic conditions. Indeed, the experience of recent years has in many cases probably indicated benefits from arrangements for this purpose which are additional or unrelated to their capacity for facilitating sales to countries undergoing external financial stringency. For example, offset agreements were a significant feature of international transactions involving sales of military hardware, civil aircraft and certain other forms of equipment before the debt crisis and world depression of the early 1980s. They are likely also to be an important means of helping developing countries to finance purchases of investment goods in the future if, as seems probable, medium-term bank loans are less easily available to such countries than before the debt crisis. A similar role can be envisaged for buy-back agreements.

### C. Deflation and protectionism

Protectionism and other forms of trade intervention have tended to increase in the 1980s. The decline in economic activity and rise in unemployment during the 1980-1982 recession led to a widespread increase in protectionist pressures and measures. The subsequent recovery, on the other hand, has failed to trigger a generalized move to roll back quantitative restrictions and other measures having similar effects or even to bring about a stand-still in protectionism, despite the commitments made at the GATT Ministerial Meeting of November 1982 or at UNCTAD VI in Belgrade in 1983. While there have been some moves since 1982 towards relaxation or elimination of some existing measures, these have been more than offset by new restrictions elsewhere.

The failure to achieve a significant advance in trade liberalization since 1982 is closely connected to the imbalances in the recovery process. First, in the country where the recovery was the strongest, i.e., the United States, a substantial trade deficit emerged as a result of the overvaluation of the dollar and the disparities in demand growth between the United States and its major trading partners, generating new pressures for protectionism. Second, in the majority of the industrial countries whose trade balances improved recovery remained too weak to reduce unemployment and generate a significant move towards reducing protectionism. Third, the efforts of developing countries to step up their export earnings in order to cover a rising import bill and meet higher debt-service obligations have prompted the imposition of trade restrictions in the face of weak demand in industrial countries. Several voluntary restraint arrangements have been concluded or renewed, anti-dumping and countervailing measures have been taken or initiated (see box 3), and quantitative restrictions have been imposed on products and sectors in which developing countries have a competitive advantage. Finally, although a number of developing countries have made changes aimed at liberalization of quantitative restrictions (e.g.

Brazil, Colombia, Republic of Korea, and the Philippines), the majority have felt obliged to take trade-restricting actions because of increased balance-of-payments difficulties (rather than for the purpose of protecting or assisting specific sectors).

The link between trade intervention and the general economic environment is evident from an analysis of movements in the UNCTAD index of trade intervention, derived from the UNCTAD Data Base on Trade Measures<sup>45</sup> for a number of selected developed market-economy countries; the data also provide an indication of the degree of the fulfilment of international commitments in respect of protectionism. For non-fuel items in the main OECD countries the UNCTAD index of trade intervention registered an increase of 10 per cent from 1981 to 1982, during which period the OECD index of industrial production continued to decline. In North America, industrial production declined by approximately 10 per cent, while the index of trade intervention increased by 25 per cent in the United States and by almost 9 per cent in Canada. During the subsequent recovery the index of intervention continued to increase - by 3.5 per cent between 1982 and 1984 for non-fuel imports into selected developed market-economy countries - while the trade coverage of quantitative restrictions affecting non-fuel imports increased by 6.7 per cent (see table 19). There was thus a significant increase in the trade coverage ratio for imports other than fuels between 1981 and 1984 (from 16.7 per cent to 18.9 per cent), particularly in the United States, and concentrated on certain sectors (see box 4).

An examination of the movements in the trade intervention indices of individual OECD countries during 1982-1984 reveals that, with the exception of a few smaller countries, there was no roll-back of protectionist measures. Even though output rose substantially in Japan, there was no change in the indices of NTMs and quantitative restrictions. In EEC,

<sup>45</sup> The index measures the trend in the application of any of the selected measures, without analysing its actual or potential effect on trade. Certain trends in trade intervention are not measured by the trade intervention index as presently constructed, e.g. the easing of trade restrictions by increasing quotas or by replacing certain non-tariff measures (NTMs) by less restrictive measures. The indicator used to analyze the extent of trade intervention is the trade coverage ratio, which is the amount of imports affected by NTMs expressed as a percentage of total imports of the same product groups. As 1981 trade weights are used throughout, the indicator is unaffected by changes in the value of trade over time. As the degree of restrictiveness of NTMs varies widely from case to case, the trade coverage ratios cannot strictly be used as a comparison of the level of protectionism in different countries. For this reason the ratios are shown only for a selected member of developed market-economy countries as a group. Figures for individual countries are shown only in the form of index numbers.

## BOX 3

**COUNTERVAILING MEASURES AND ANTI-DUMPING ACTIONS**

- *Countervailing and anti-dumping actions can technically be considered as corrective actions against alleged unfair trade practices by foreign governments (subsidies) or enterprises (dumping). However, figures drawn from the UNCTAD Data Base on Trade Measures suggest that the frequency of these actions has a strong correlation with the economic environment, as have other actions which interfere with imports.*
- *The share of non-fuel imports into selected developed market-economy countries (DMECs) affected by countervailing duty or anti-dumping actions increased from 1.6 per cent in 1981 to 2.7 per cent in 1982, but declined to 2.6 per cent in 1983 and to 2.2 per cent in 1984. The strongest changes are observed in the United States, where the trade coverage of such actions roughly doubled between 1981 and 1982, but declined significantly in 1983 and 1984. In Canada and EEC, the other two markets in this group of countries where countervailing and/or anti-dumping actions are initiated with certain frequency, there was also a sharp increase of the trade coverage of such measures between 1981 and 1982, but none in the period 1982-1984. (Many anti-dumping actions have been undertaken in Australia, but this country is not included in the present analysis.)*
- *Of course, legal aspects play an important role in anti-dumping and countervailing duty actions. Not all countries have enacted corresponding trade laws. In other countries these actions are not normally initiated, although legal provisions exist, often because other measures are available. The fact that anti-dumping and countervailing duty actions are often suspended or terminated with price or volume restraining undertakings between interested parties also complicates the interpretation of changes in the volume of trade affected. However, the observed changes in the trade coverage of these actions could to a large extent be explained by the long economic recession in the OECD area which ended in late 1982, the overvaluation of the dollar and the increased use of export subsidies in some major developing countries, where the foreign debt crisis became acute in 1982. (For instance, there was a large increase of countervailing duty investigations in the United States affecting Brazil after the reintroduction of fiscal export subsidies in that country in April 1981).*
- *An additional factor was the difficult situation of the United States steel industry and the role of the United States market as an outlet for steel producers in both developed market-economy and developing countries which possessed overcapacity in relation to their domestic markets. (In January 1982 United States producers filed 132 petitions. The subsequent suspension of the trigger price mechanism, that had been introduced as a substitute for individual investigations, led to a further increase in the number of investigations.)*
- *The development in the initiation of anti-dumping and countervailing duty investigations in the most recent period can be analyzed on the basis of actions reported to the relevant GATT committees. The total number of new investigations in developed market-economy countries increased from 199 in 1983 to 210 in 1984 and 244 in 1985. Investigations affecting developing countries increased in absolute and relative terms, from 64 in 1983 to 76 in 1984 and 103 in 1985. Compared to 1984, the number of investigations initiated in 1985 increased in North America, but declined in EEC, which might be partly explained by exchange rate movements and divergent growth rates of the economies.*

where recovery remained weak, both indices rose over 1982-1984 by 7 and 5 per cent, respectively (see table 19). Although the index for all NTMs was stable in the United States, there was a significant increase (over 10 per cent) in the index for quantitative restrictions. The sharp decline observed in the index for all products and all measures in that country (to an index of 29.1 in 1984 (1982=100) is mainly due to the termination, at the end of 1983, of the automatic licensing requirements for fuel imports, following the deregulation of domestic oil prices.

The above analysis must be qualified, since the trade intervention index has some shortcomings as an analytical tool. In the first place, while the expected link of economic activity is with protectionist "pressures", the index is of trade "measures". The extent to which pressures for protectionism actually result in intervention depend, to a large extent, on the outcome of the "political economy of protectionism" and the degree of commitment

by governments to their international obligations.

In the United States increased import penetration and loss of competitiveness of domestic industries (see chapter II, section B.4) have led to mounting pressures for protectionism. The United States Administration has sought to resist such pressures, but, as pointed out by OECD, "the share of restricted products in total manufactured imports increased over the period 1980 to 1983 from 6 per cent to 13 per cent", even using a narrow definition of non-tariff barriers.<sup>46</sup> Pressures for protection increased during 1985, when imports continued to rise but activity slowed down; during the first eight months of that year a record number of (more than 400) trade bills were introduced in the United States Congress. While such protectionist measures or pressures are to be distinguished from those that aim at improving the current-account balance, measures for protecting production and employment in various sectors were at times introduced or

<sup>46</sup> *Costs and Benefits of Protection* (Paris, OECD, 1985), p. 11.

Table 19

**IMPORT COVERAGE INDICES OF NON-TARIFF MEASURES AND OF QUANTITATIVE  
RESTRICTIONS APPLIED BY 18 DEVELOPED MARKET-ECONOMY COUNTRIES <sup>a</sup>, 1983-1984  
(1982 = 100)**

Country	<i>All products</i>				<i>All products (excl. fuels)</i>			
	<i>All selected measures <sup>b</sup></i>		<i>Quantitative restrictions</i>		<i>All selected measures <sup>b</sup></i>		<i>Quantitative restrictions</i>	
	1983	1984	1983	1984	1983	1984	1983	1984
Austria	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Canada	97.7	99.4	101.2	101.7	97.6	99.3	101.5	102.0
EEC	104.0	104.1	102.4	102.3	106.8	107.1	105.0	104.8
Belgium-Luxembourg	102.5	102.7	101.2	101.2	102.9	103.2	101.1	101.2
Denmark	103.3	104.0	106.3	106.7	103.3	104.1	106.4	106.7
France	103.7	103.4	101.8	101.9	113.4	114.1	114.0	115.1
Germany, Federal Republic of	107.2	108.1	105.2	106.2	107.2	108.0	105.2	106.2
Greece	106.6	103.6	105.0	99.9	106.7	103.6	105.0	99.8
Ireland	101.5	102.3	116.0	120.9	101.4	102.3	116.1	125.4
Italy	105.9	105.9	102.2	103.0	105.8	105.9	102.3	103.0
Netherlands	103.7	103.7	101.4	102.0	106.1	106.3	101.4	102.1
United Kingdom	104.0	103.6	104.8	100.2	104.0	103.6	104.8	100.1
Finland	100.0	100.0	100.2	100.2	100.0	100.0	101.5	101.5
Japan	100.1	100.1	100.2	100.2	100.1	100.1	100.1	100.1
Norway	98.5	88.8	98.5	97.3	98.4	96.9	98.4	96.7
New Zealand	100.0	99.4	100.0	99.4	100.0	99.4	100.0	99.4
Switzerland	100.8	100.8	101.3	101.3	100.8	100.8	101.2	101.2
United States	99.4	29.1	97.6	111.4	97.8	100.2	97.6	111.3
Total, 18 countries	101.1	67.2	101.4	104.3	102.5	103.5	105.4	106.7

*Source:* UNCTAD Data Base on Trade Measures.

<sup>a</sup> The accuracy of the information on non-tariff measures has been verified by certain developed market-economy countries. The basic data are currently being verified by other countries. Accordingly, the figures in the table are to be regarded as preliminary and subject to revision.

<sup>b</sup> The selected measures exclude health and safety controls and standards (see TD/B/1081(Part I), para. 48).

advocated in the context of trade imbalances with individual countries. For instance, the Trade Emergency and Import Promotion Act introduced in the United States Senate in 1985 stipulated a system of tariffs to be levied against imports from four countries on such grounds.

Although the rise in protectionism in the United States cannot all be attributed to the overvaluation of the dollar, evidence suggests that there is a close relationship between the two. It has been shown that while the appre-

ciation of the real exchange rate tends to increase import penetration beyond what would typically accompany the normal growth in international trade, the probability of the occurrence of non-tariff barriers is closely related to increased import penetration, particularly in the case of the United States. Indeed, it was largely the threat posed by the mushrooming protectionist pressures that led the United States Government to take initiatives in September 1985, designed to lower the value of the dollar and to accelerate growth in the other major developed market economies.

## BOX 4

**SECTORAL TRADE INTERVENTION**

*Analysis of movements in the UNCTAD trade intervention index for the period 1981-1984 shows that:*

- *There was a considerable decline in the import coverage ratio for all imports into developed market-economy countries, from 26.6 per cent in 1983 to 17.6 per cent in 1984, partly due to the termination of an automatic licensing requirement for fuel imports into the United States in 1983, following the deregulation of domestic oil prices. This decrease is not reflected in the index for quantitative restrictions as defined in this analysis, which shows an increase of more than 10 per cent between 1982 and 1984, as this subgroup excludes automatic licensing.*
- *In the period of economic recovery after 1982 increased application of quantitative restrictions was heavily concentrated in iron and steel (around two-thirds of new restrictions applied between 1982 and 1984 affected, on the basis of 1981 imports concerned, iron and steel products), due principally to measures adopted in the United States.*
- *If all selected NTMs are considered an even larger tightening of measures against iron and steel imports is observed, principally in the United States and Canada (anti-dumping actions). Restrictions against imports of non-ferrous metals increased in 1983, as a consequence of measures adopted in Canada, the United States and EEC. There has been a continuous increase in trade intervention in leather, especially in 1984.*
- *There is a persistently high level of trade intervention in food items. The increase between 1981 and 1982 was largely due to an increase in the United States import coverage ratio, although the ratio remains well below the average of all selected developed market-economy countries.*
- *There is a persistent high level of trade intervention in textiles and clothing. (In addition, industry sources suggest there has been some tightening of quotas under the Multi-Fibre Arrangement.)*
- *There was a decrease in trade intervention in footwear, entirely due to developments in the United States, where general import monitoring measures and orderly marketing agreements with the Republic of Korea and Taiwan, Province of China were terminated in 1981, while a countervailing duty order against imports from Brazil was revoked in 1983. This development fully outweighed increased intervention in EEC in 1984 (surveillance measures in France against imports from China).*

In short, since the general economic environment of the 1980s has not been conducive to a lessening of protectionism, with a few exceptions, there has been no generalized "roll-back". The impact of trade actions has not fallen evenly on trading partners, with the new measures tending to fall more heavily on the developing countries. The depreciation of the dollar has improved the monetary and financial environment for trade liberalization, but if trade and payments difficulties are not ad-

ressed in the context of expansion, there is a danger that pressures for increased protection may intensify, which would in turn obstruct growth and development. A balanced expansion of the world economy would therefore appear to be essential for reducing protectionist pressures and encouraging the fulfilment of commitments of the trading countries to the rules and principles of the multilateral trading system. ■

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## Chapter IV: Notes and references

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## CHAPTER V

### THE WORLD ECONOMY IN 1985 AND PROSPECTS FOR THE NEAR FUTURE

The preceding chapters have reviewed the main characteristics of the acute crisis facing most of the developing world; the evolution during the 1980s of problems and policies in the developed market-economy countries, which have played such an important role in shaping the external environment for development; and, more specifically, the way in which these problems and policies influenced commodity prices, the trading régime, financial flows and debt. The present chapter takes up these same issues, focusing on the most recent aspects of economic performance and the immediate outlook.

As in earlier years, the evolution of the major developed market economies continues to be the most important single factor shaping the external environment for development. The slowdown of growth in 1985 in the developed market-economy countries, and particularly the slackening of demand in the United States, presented developing countries with a less favourable trading environment. Largely for this reason, the growth in the volume of their exports declined in 1985, after having risen in 1984.

Commodity markets continued to experience weakness during the year, and the UNCTAD index of prices of non-oil primary commodities exported by developing countries fell by about 11 per cent. This reflected a continuation of the situation that has prevailed in recent years of an expansion of supply in the face of stagnant or slowly growing demand, in particular for many agricultural commodities. Moreover, for many commodities the existence of stocks that are large relative to annual consumption has also contributed to price weakness.<sup>47</sup> There was thus a further deterioration in the prices of commodities relative to those of manufactures, which contributed to a deterioration in the terms of trade of developing countries by 1 per cent in 1985.

In the financial area, there was some slight easing in 1985, although this did little to alter the extremely difficult situation facing most developing countries. Reference interest rates (primarily LIBOR and the United States

prime rate) declined somewhat during the year, and average spreads over reference rates also contracted. On the other hand, the volume of new financing to developing countries flowing through private markets continued to be quite low, with the main statistical indicators moving in opposite directions. New medium-term bank loans fell by 30 per cent in 1985, while recorded bank exposure to developing countries rose somewhat. The difference between these two indicators is presumably accounted for primarily by changes in short-term lending and by debt rescheduling.<sup>48</sup>

The opening months of 1986 saw a continuation of these overall tendencies. Growth in the developed market-economy countries continued to be slow, with better performance in the United States being largely offset by poorer performance in the Federal Republic of Germany and Japan. World trade remained sluggish, but commodity prices, excluding petroleum, advanced, due above all to food and tropical beverages. Interest rates declined further, but bank lending remained depressed.

There can be little doubt, however, that the dominant influence in world markets during 1986 will be the sharp fall which has taken place in the price of oil, which will have a significant impact throughout the world economy. This change has already had important consequences for price behaviour; price levels in some major developed market-economy countries were actually falling during the opening months of 1986, and rates of inflation in the others were minimal. The impact of the oil price fall on levels of activity in the world economy is much more difficult to gauge. This difficulty, together with uncertainties regarding the future of oil prices, has compounded the problems entailed in assessing the immediate outlook for the world economy.

The remainder of this chapter takes up in more detail recent developments in the world economy, reviewing recent developments and prospects respectively for developing countries, developed market-economy countries, socialist countries of Eastern Europe and China.

<sup>47</sup> For a more detailed review of the behaviour of commodity markets in 1985 see section I of the annex to this chapter.

<sup>48</sup> For a more detailed review of recent developments in capital markets see section II of the annex to this chapter.

## A. Developing countries

### 1. Overall progress

During 1985 economic activity in developing countries as a group continued to expand only at a very moderate pace, reflecting the persistence of the problems that have restrained growth in the majority of these countries. At 2.0 per cent (see table 20), the expansion of aggregate output was lower than in 1984 (when it reached 2.5 per cent), as the expansion in many fast-growing countries slowed and performance in those which lagged behind in 1984 remained very modest. Thus, per capita output growth in developing countries as a group registered another decline, with GDP growth lagging behind population growth in an increasing number of countries. Furthermore, the need for many countries to sustain or increase their net exports in order to service their debts has led again to levels of domestic absorption that are below those of output, implying a decline in living standards beyond that indicated by per capita output.

During 1984, the buoyant growth in the volume of exports, together with a small improvement in the terms of trade, led to an increase in the purchasing power of the exports of developing countries (see annex table 5). This allowed a significant improvement in their trade balances to be accompanied by a modest resumption of import growth. Conversely, in 1985, the stagnation or decline in the volume of exports compounded the effects of worsened terms of trade; improvements in trade balances were therefore achieved through renewed cuts in the volume of imports. For developing countries as a whole, the volume of imports declined by more than 3 per cent, and the decline was quite widespread. Although a certain slowdown in the growth of imports was expected as a direct result of the slowdown in the growth of exports, the actual contraction in import volume reflects the continued adjustment of countries to their reduced export revenues, whether or not they already had current-account deficits. For countries with no debt-servicing problems, but with large debts, the reduction in imports was often the result of a deliberate policy to improve their current-account positions in order to avoid possible debt-servicing problems and to maintain or strengthen their international credit-

worthiness. For countries with debt-servicing difficulties, the contraction in imports was the only means of adjustment to external imbalances, in the light of their continued high-interest payments, the further contraction in new financial flows and the past depletion of their reserves.

The decline in interest rates was almost the only positive external development during 1985. Its effect on net interest payments for developing countries as a whole, however, was partly offset by the reduction in interest payment arrears, the increase in outstanding debt for the net debtor countries and the reduction in the assets, and consequently of the net investment income, of capital-surplus oil-exporting countries, which have recently been running current-account deficits. Thus, the further decline in the deficit on the current account of developing countries in 1985 was again accounted for by the increase in the trade surplus and the decrease in the deficit of the non-factor services (see table 21). Furthermore, hardly any of the countries that had previously experienced debt-servicing difficulties were able to meet their scheduled payments in 1985, and the expectation that the significant improvement of their balances of payments that had occurred in 1983 and 1984 would soon lead to a resumption of voluntary lending and to sustained growth were unfulfilled, suggesting that conditions for sustained growth in developing countries have not yet been established.

### 2. Financing of the current account

In contrast to 1984, the net debtor developing countries,<sup>49</sup> despite further import restraint, were unable to improve their current-account balance. The increase in their deficit was, however, marginal and was accompanied by a significantly slower rate of reserve accumulation, reflecting a decline in capital flows (see table 22).

Official flows (excluding IMF credit) on the whole declined slightly in 1985. There was, however, an increase in the share of grants in bilateral assistance, mainly to cover the aid requirements of the famine-stricken countries in

<sup>49</sup> For definition, see note *a* to table 22.

Table 20

**WORLD OUTPUT BY MAJOR COUNTRIES AND COUNTRY GROUPS, 1980-1985,  
AND FORECASTS FOR 1986 AND 1987**  
(Percentage change)

Country or country group	1980- 1983 (Annual average)	1984 Actual	1985 Estimated	1986 Forecast <sup>a</sup>	1987
World	1.4	4.2	2.9	3.0	3.1
Developed market-economy countries <sup>b</sup>	1.3	4.5	2.8	2.8	2.9
North America	1.3	6.7	2.5	3.2	3.5
Western Europe	0.6	2.2	2.3	2.4	2.5
Japan	3.3	5.8	5.0	3.5	3.5
Others	1.4	5.3	2.8	2.5	2.6
Developing countries and territories <sup>c</sup>	0.5	2.5	2.0	2.6	2.7
Latin America	-1.1	2.9	2.8	2.1	3.1
North Africa	1.1	3.3	2.3	2.3	2.1
Other Africa	-0.9	-1.5	1.9	0.2	-0.6
Oth. Afr., excl. Nigeria	1.3	1.4	2.4	2.2	2.3
West Asia	-2.2	-1.0	-2.8	2.5	1.2
South Asia	4.7	4.2	5.0	4.8	4.9
East Asia	5.5	5.8	2.6	3.6	3.6
China <sup>d</sup>	6.5	7.9	13.0	8.0	7.0
Socialist countries of Eastern Europe <sup>e</sup>	3.2	3.8	3.2	4.2	4.2

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

<sup>a</sup> See *Trade and Development Report, 1985*, note *b* to annex table A1.

<sup>b</sup> Gross domestic product/gross national product.

<sup>c</sup> Gross domestic product.

<sup>d</sup> National income.

<sup>e</sup> Net material product.

Africa. Non-debt-creating official flows increased by more than 25 per cent in 1985, to reach \$14.5 billion. Conversely, a contraction in official loans occurred, reflecting mainly a fall in export credits related to the decline in imports of developing countries.

Multilateral flows have also declined, in line with the contraction of new commitments by multilateral institutions, and reflecting, on the one hand, the difficulty for many countries of financing domestic counterpart expenditures, in view of continued pressures on national budgets, and, on the other, the postponement

of the initiation of new projects by the larger borrowers facing debt-servicing difficulties.

The trend towards a reduction in the use of IMF credit, which started in 1984, continued in 1985, reflecting both the decline in new drawings as well as the commencement of sizeable repurchases under arrangements previously entered into. Net drawings by developing countries dropped to around \$600 million in 1985 from a peak of \$10.7 billion in 1983, and from \$4.6 billion in 1984. They are expected to drop further in 1986 and to become negative by 1987, as repurchase obligations will continue to mount while new drawings will remain low

Table 21

**CURRENT-ACCOUNT BALANCES: <sup>a</sup> MAJOR COUNTRIES AND COUNTRY GROUPS,  
1984 AND 1985 AND FORECASTS FOR 1986 AND 1987**  
(Billions of dollars)

Country or country group	1984	1985	1986	1987
	Actual	Estimated	Forecast	
Developed market-economy countries	-44.0	-31.0	20.0	10.0
<i>of which:</i>				
Germany, Fed. Rep. of	12.6	19.2	32.0	27.0
Japan	36.4	51.0	75.0	70.0
United States	-97.3	-105.0	-115.0	-105.0
Developing countries <sup>b</sup>	-49.6	-41.1	-65.6	-50.5
<i>of which:</i>				
Latin America	-3.3	-5.8	-7.4	-5.0
North Africa	-5.6	-1.7	-9.0	-7.6
Other Africa	-6.7	-8.3	-8.4	-5.9
West Asia	-26.9	-20.7	-36.0	-27.2
South Asia	-7.9	-9.4	-8.8	-9.5
East Asia	0.8	4.7	4.0	4.8
China	2.4	-7.4	-3.7	-3.7
Socialist countries of Eastern Europe	9.3	1.3	-2.0	0.0
Statistical discrepancy <sup>c</sup>	-81.6	-78.2	-51.3	-44.1

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

<sup>a</sup> Goods, services and private transfers.

<sup>b</sup> All countries, territories and areas not included in other groups.

<sup>c</sup> The statistical discrepancy is composed of a (usually negative) discrepancy on merchandise trade, mainly due to timing asymmetries, and a positive discrepancy on services reflecting, in the main, under-reporting of interest income, receipts from sales of transportation services and remittances.

as fewer countries will make use of Fund resources.

The decline in official flows meant that a sizeable proportion of the current-account deficit of the net debtor countries had to be met through private sources of finance. These were largely in the form of new money provided in connection with rescheduling agreements. There was also some further transformation of short-term bank claims into longer-term maturities, which increased the recorded level of private long-term financing.

### 3. Debt and debt service

As a result of the deterioration in the situation of many indebted countries, debt-servicing difficulties persisted or re-emerged during 1985, reflecting the long-term nature of the debt problem facing a number of developing countries and the limitations of the approach to its solution adopted up to the present. Almost none of the countries which had previously run into debt-servicing difficulties was able to meet its scheduled payments, and year-to-year rescheduling continued to be the prevailing response, particularly among of-

Table 22

**DEFICIT OF NET DEBTOR DEVELOPING COUNTRIES: <sup>a</sup> SOURCES OF FINANCING IN  
1984 AND 1985 AND FORECASTS FOR 1986 AND 1987**  
(Billions of dollars)

Item	1984	1985	1986	1987
	Estimated		Forecast	
Current-account deficit	35.8	38.5	43.2	38.7
<i>Source of financing:</i>				
Increase in official reserves	11.2	4.5	-6.3	-2.0
Total net capital flows	47.0	43.0	36.9	36.7
Official bilateral flows on concessional terms .				
Grants <sup>b</sup>	15.5	17.4	17.1	17.6
Medium- and long-term loans	11.5	14.5	13.7	14.2
Other medium- and long-term official bilateral loans	4.0	2.0	3.4	3.4
Multilateral institutions	5.7	4.0	3.5	3.5
Private flows	13.7	12.4	11.3	11.8
Direct investment	21.2	22.2	20.6	21.8
Export credits	8.8	8.8	8.8	8.8
Other private flows	2.8	2.4	2.8	3.0
Medium- and long-term loans	9.6	11.0	9.0	10.0
Short-term loans	22.8	22.0	16.0	10.0
IMF lending	-13.2	-11.0	-7.0	-
Other capital, unrecorded flows, errors and omissions	4.6	0.6	0.2	-3.0
	-13.7	-13.6	-15.8	-15.0
<i>Memo item:</i>				
Total interest <sup>c</sup> and profit remittances (sign reversed)	62.9	58.7	51.6	52.7
Net transfer	-15.9	-15.7	-14.7	-16.0

*Source:* UNCTAD secretariat calculations, based on international sources.

<sup>a</sup> Defined as developing countries, territories or areas other than those with net foreign assets greater than \$1 billion in 1982 (Brunei, Hong Kong, Iraq, Iran (Islamic Republic of), Kuwait, Lebanon, Libyan Arab Jamahiriya, Qatar, Saudi Arabia, Singapore, Taiwan, Province of China, Trinidad and Tobago and United Arab Emirates).

<sup>b</sup> Excluding technical assistance.

<sup>c</sup> Balance-of-payments basis, excluding interest on short-term debt or on IMF drawings.

ficial creditors. As regards private lending, the expectations that multi-year rescheduling agreements, in conjunction with the progress made by some of the major problem borrowers in their external payments during 1983 and 1984, would lead to an early return to voluntary lending, were soon frustrated. Not only did this not occur but, on the contrary, the progress in debt restructuring was also slower than expected. In fact, the number of countries that completed rescheduling arrangements in 1985 and the total value of debt rescheduled in that year increased significantly over 1984. However, some of the debt rescheduled in 1985 resulted from previous agreements, and some of

the agreements reached in 1985 were not implemented in that year. The Mexican arrangement, for instance, involving more than half of the total value rescheduled with private creditors during 1985, had already been agreed in 1984. About another \$26 billion are involved in arrangements which were agreed in principle in 1984 and 1985 but had not yet been signed at the beginning of 1986, including the multi-year agreement for Venezuela. Even in the case of Brazil, which experienced buoyant domestic growth in 1985, the negotiations for rescheduling debt, which had been close to agreement at the end of 1984, were still incomplete in mid-1986.

The growth in total debt (i.e., short-, medium- and long-term official and private debt and use of IMF credit) during 1985 was around 4.8 per cent, not significantly different from that of 1984.<sup>50</sup> Medium- and long-term debt continued to increase faster than overall debt as short-term debt was consolidated: new medium- and long-term net flows declined by more than 25 per cent while net medium- and long-term debt increased by around 7.0 per cent (see annex table 14).

Interest payments declined only slightly, despite the decrease in interest rates, mainly owing to the gradual elimination of arrears. Because of reschedulings, amortization payments have continued to increase only slowly, remaining at around 55 per cent of scheduled repayments. Nevertheless, since exports have declined, the ratio of actual debt service to the exports of developing countries has continued to increase. For some highly indebted countries which have experienced, or continue to experience, large contractions in their exports, the increase in the ratio of their debt service to exports has prompted the announcement of decisions to tie debt payments to export performance by limiting them to a given percentage of total export revenues. Such decisions reflect the pressing need for new approaches to the debt problem that would involve both creditors and borrowers.

#### 4. *Regions*

##### (a) *Latin America*

The performance of the countries in Latin America and the Caribbean in 1985 was affected by both external and domestic factors. The slower growth of external demand contributed to a decline in the volume of exports, while the deterioration of the terms of trade further reduced the capacity to import. In many countries, these developments were accompanied by a continuation of the contractionary adjustment process that has characterized the region following the onset of the debt crisis in 1982, and together contributed to a new slowdown in the growth of economic activity for the region as a whole. (Brazil is an exception to the general trend as noted below. In that country, there was a rapid expansion of economic activity, stimulated by domestic demand.) Notwithstanding the general slowdown of economic activity, the acceleration of inflation, which has been one of the disturbing features of recent experience in the region, continued in

most countries in 1985, and in some it reached levels which threatened the day-to-day functioning of the economy. In a number of countries, such as Argentina, Bolivia and Peru, drastic measures were taken in 1985 to arrest inflation; similar measures were taken in Brazil during the early months of 1986.

In 1985, the export earnings of the region declined by 5.7 per cent as a result of declines in both the volume and the prices of exports. The fall in volume after increases of approximately 7 per cent in 1983 and 1984 was accounted for mainly by the oil-exporting countries, reflecting continued weak oil demand, and by Brazil. In the latter, the stimulation of domestic demand during 1985 and the concurrent slowdown in United States demand led to a slight decline in the volume of exports after an overall increase of 33 per cent in the previous two years. The decline in the region's export prices was rather greater than for export volume and affected almost all countries, reflecting the severe and widespread drop in the international prices of primary commodities that took place during the year.

As a result of the decline in export prices, the terms of trade worsened by 3 per cent, in spite of some weakening in import prices. The consequent reduction in the region's capacity to import, together with the continued financing constraints in most countries, led to a further contraction in imports. The value of imports, which at the end of 1984 was 35 per cent below the 1980 level, declined further in 1985, with continued high import growth in Mexico offsetting, in part, larger contractions in most of the other large countries in the region. The strong growth in Mexican imports had already resumed in 1984 with the adoption of a more expansionary policy, following substantial improvement in its current-account position in that year and the previous one. During the first six months of 1985, Mexican imports expanded even more rapidly (36 per cent on an annual basis). This increase and the concurrent decrease in exports and the terms of trade led to a drastic reduction of the trade surplus and caused the authorities, in the light of persistent inflation, to adopt more restrictive fiscal and monetary policies during the second half of the year. As a consequence, import growth also slowed down. In both Venezuela and Argentina, after some resumption of import growth in 1984, imports declined again, while in Brazil imports have declined continuously since 1982. In the latter country, the reduction in imports during 1984 and 1985 was due almost exclusively to lower imports of fuel

<sup>50</sup> However, in constant dollars, the growth of debt must have been slower. The drop in the dollar exchange rate in 1985 has had the effect of increasing the growth rate, in terms of current dollars, of debt not denominated in dollars.

as a result of increased oil production and substitution. In contrast, imports of intermediate and capital goods, which, at the beginning of the recession, had declined at the same pace as oil imports, stagnated in 1984 and resumed their growth in 1985. Imports also declined in the majority of the other countries in the region.

With exports falling much faster than imports, the trade surplus of the region went down in 1985. Thus, after increasing more than fourfold between 1982 and 1984, it declined by \$4.3 billion to \$34.3 billion in 1985. Furthermore, this decline was only partially offset by lower net payments on non-factor services and lower investment and interest payments. Consequently, the deficit on current account, which had fallen dramatically from \$41 billion in 1982 to only \$3.3 billion in 1984, rose to \$5.8 billion in 1985. This increase was accounted for entirely by those countries that had contributed to the improvement in 1983 and 1984, and particularly by Mexico, where a surplus of \$3.7 billion in 1984 gave way to one of only \$200 million. The deterioration in Mexico and Venezuela was partly offset by an improvement in Argentina and Chile, which, however, reflected slower growth of output and of import demand in these economies, rather than more buoyant export earnings.

In contrast to 1984, when the improvement in the current-account deficit was accompanied by an increase in the net inflow of capital<sup>51</sup> which allowed the rebuilding of reserves by \$9.3 billion, the net inflow of capital in 1985 was only \$5.1 billion, not even covering the deficit on current account and reflecting the continued reluctance of private creditors to resume spontaneous lending in view of the new deterioration in the economies of most of these countries. Moreover, since the fall in the net inflow of capital was greater than that of net payments on interest and profits (net investment income), the annual transfer of resources out of the region increased by almost \$4 billion, to reach \$30 billion. The drop in interest rates has reduced interest payments and thus contributed to the overall reduction in the net outflow of interest payments and profits. Since, however, outstanding debt has been increasing, albeit at a very slow rate, such payments have dropped by only \$1.8 billion.

The decrease in the volume of exports, continued weak domestic demand and the new deterioration in the terms of trade have led to a slowdown in the already very weak expansion

in most countries in the region. A particularly disturbing feature is the continuing stagnation of domestic investment which, since 1983, has been 30 per cent below its 1980 level. Low investment not only has contributed to the current slowdown but also endangers the future development of the region. Furthermore, the stagnation in domestic savings, which it reflects, also operates through its linkage to external financial flows: the non-availability of local funds for development projects has been an important factor in the reduction of commitments by multilateral institutions like the World Bank and the Inter-American Development Bank.

Aggregate output in the region grew by 2.8 per cent in 1985, compared with 2.9 per cent in 1984 (see table 20). This decline was very widespread, with above-average reductions in most middle-sized and small countries. Output growth in the larger countries also declined, or, at best, stagnated, with the exception of Brazil, where output grew by 8.3 per cent. If Brazil is excluded, output growth for the region as a whole was less than 1 per cent, implying a further decline in per capita output. Given a fall of about 3 per cent in net exports, the main positive stimulus to growth was the rise in domestic demand following the adoption of more expansionary policies in some of the major countries, in particular Brazil. In that country there was continued growth in manufacturing and mining and a good performance in agriculture; the impetus to growth was given by increased domestic demand, primarily through large increases in real wages. In Mexico, output expanded very rapidly during the first half of the year, but the tighter monetary and fiscal policies adopted following the sharp deterioration of the trade surplus, the damage caused by the earthquakes and the weakening of the oil market towards the end of the year, led to a considerable slowdown during the second half and a growth of 2.7 per cent for the whole year. In Venezuela, output declined again owing to a sharp cutback in oil production, which was followed by more restrictive fiscal and monetary policies and by a postponement of outlays intended to reactivate the economy. In Argentina, government efforts, following the mixed results achieved by adjustment policies in 1983 and 1984, were swiftly directed towards the reduction of external and internal disequilibria. As a result, inflation was brought down, by the end of the year, to around 38 per cent from a four-digit level in June 1985, the current-account deficit was halved, and out-

<sup>51</sup> This involved mainly new money from private creditors provided under managed loans in conjunction with rescheduling agreements. The amount of new long-term money raised in international capital markets during 1984 came to \$15.9 billion, and in 1985 to only \$6.3 billion. Of these amounts \$11.1 billion and \$4.7 billion, respectively, were in the form of "managed loans".



standing external arrears were expected to drop to \$1.1 billion - only one-third of their July level. Conversely, economic activity, which had partially revived in 1983 and 1984, declined by 3 per cent in 1985. This decline took place from the beginning of the year and continued after the adoption of the austerity programme.

Inflation, which had previously been a serious problem in a limited number of countries, became more generalized in 1985, with the majority of countries registering higher rates of inflation than in 1984. The average figure for the region (excluding Bolivia, which registered an inflation of 12,000 per cent) remained at its 1984 level of about 150 per cent, mainly because of the slowdown of inflation in Argentina during the second half of the year. In some of the traditionally high-inflation countries, price increases during the first months of the year became uncontrollable, as inflationary pressures, partly caused by price adjustments, were reinforced in the process of adjustment by the inflationary expectations of the different economic agents which, acting as a self-feeding mechanism, led to further price increases. During the second part of 1985 and the early months of 1986, however, these countries, as well as others, have taken measures to bring inflation under control. In Argentina, the economic programme adopted in June 1985 has involved a wage/price freeze, currency reform, including a new currency, and measures for substantial reductions in the public deficit and financing of the deficit entirely from external sources. The immediate impact of these measures was reflected in the sharp drop in the monthly pace of consumer price increase from over 30 per cent per month in June to around 2 per cent in the period September-November. In Brazil, inflation was running at around 220 per cent for the greater part of 1985. But the Government, after two years of austerity, hesitated between the need to strengthen the recovery and the need to control inflation. By the beginning of 1986, as inflation accelerated to a yearly rate of 250 per cent, the Government felt obliged to take drastic measures to check it, through a programme which included wage and price controls, de-indexation of most financial and other markets and a new currency. In Bolivia, inflation, after having risen to almost 2,200 per cent at the end of 1984, accelerated to 20,500 per cent by August 1985. The countervailing measures taken by that country were of a completely different nature and included the liberalization of imports and of the system of prices and the fixing of the exchange rate through public sale of foreign exchange by the central bank. It appears that, after an initial jump in prices following the adoption of the stabilization programme, inflation had slowed down considerably by the end of the year.

## (b) Asia

### 1. East Asia

The virtual stagnation of export volumes after the 1984 export boom, which had been mainly due to the expansion of United States demand, has led to a significant slowdown in growth of developing countries in East Asia. Since, however, there was a fall in the volume of imports and the terms of trade underwent little change, the trade balance of the region as a whole continued to improve, although at a slower pace. The reduction in the volume of imports, which occurred in most countries to varying degrees, was partly the result of policies intended to improve the balance of payments, where there was concern about current-account deficits and/or large debts, and partly the effect of the slowing down of domestic demand and output growth. Thus, in many of the countries in the region, lower growth was accompanied by an improvement in the external balance.

Because of the larger trade surpluses, the current-account surplus for the region increased from \$0.8 billion in 1984 to \$4.7 billion in 1985. This improvement was fairly widespread, the only exception being the oil-exporting countries, where the deterioration in the terms of trade and in the volume of their exports was not matched by a decline in the volume of imports. Furthermore, in view of the fall in commodity prices, the improvement in the external balance of countries exporting non-oil primary commodities has implied greater reductions in imports for them than for countries exporting manufactures.

In the countries with current-account surpluses, the very sharp fall in the growth of their export volumes (essentially manufactures), along with slower domestic demand growth, resulted in lower GDP growth as well. However, the decline in export volume was matched by that of imports, reflecting in part the importance of imports as inputs in the production of exports. Nevertheless, the terms of trade improved, so that, in these countries, too, lower growth was accompanied by an improvement in the external balance.

The growth in aggregate output which, in 1984 had been considerably above the average for developing countries, fell to only 2.6 per cent in 1985. In Singapore output actually declined and in Hong Kong increased by less than 1 per cent. Among the countries that experienced buoyant recovery in 1983 and 1984, only in the Republic of Korea did growth reach 5 per cent in 1985, mainly owing to an acceleration in the second half of the year following



an easing of monetary and fiscal policies and the adoption of measures to stimulate investment. Austerity measures, declining prices for the region's non-oil exports and weak oil markets resulted in a growth of only between 3 per cent and 4.5 per cent in Indonesia, Malaysia and Thailand. The Philippines significantly reduced its current-account deficit in 1985, but the contraction of its output continued, albeit at a slower pace.

## *II. South Asia*

As in recent years, the economies of South Asia continued their steady growth in 1985, output increasing by 5.0 per cent. Agriculture is the most important sector in these countries, and the steady progress in output appears to be largely due to the structural and technological improvements in that sector, which have, except in Bangladesh, reduced the vulnerability of output to the vagaries of the weather, thus avoiding the severe losses suffered in the past. Nevertheless, total GDP growth has not yet acquired, in the major countries in the region, the momentum that could lead to rapid per capita income gains and has remained below planned targets. In India, for example, average annual growth during the period 1980-1983 was about 1.5 percentage points higher than in 1976-1980, but remained below the target of 5 per cent. In the past, this shortfall has been attributed to sluggish growth in industry, which has been constrained by shortages in energy, and, in general, by poor infrastructure and, according to some analysts, by limited absorption of new technologies. Policies designed to overcome these difficulties would imply, among other things, increased imports and a consequent deterioration of the current-account deficit in the short run, as well as increased capital inflows. Furthermore, given its diminished prospects of receiving official development assistance (ODA), a greater share of the financing of India's current-account deficit would be expected to originate from private borrowing. Indeed, according to available estimates, the 5 per cent GDP growth target in India's seventh plan will entail a capital inflow almost double the amount required by the sixth plan. Since ODA is expected not to exceed \$2.5 billion per annum, India may have to resort to commercial borrowing to the extent of \$4.5 billion per annum.

In 1985, the current-account deficit of the region increased by approximately \$1.5 billion, mainly on account of India, where net oil exports declined because of rapidly increasing domestic consumption. The current account of Pakistan deteriorated also, as the slight im-

provement in its trade account was offset by a decline in workers' remittances. For the remaining countries higher export volumes were offset by declines in the terms of trade, while import volumes remained more or less unchanged. Consequently, the deficit on their current account also remained unchanged.

The financing of the current-account deficit has also seen an increase in the share of commercial borrowing. Both India and Pakistan have been more active in tapping capital markets, commercial borrowing in India having financed 30 per cent of the current-account deficit in 1984. Furthermore, gross disbursements of commercial loans in India have more than doubled since 1982, as well as net flows from private creditors in general, and during the same period net flows from official creditors declined by 8.5 per cent.

## *III. West Asia*

The persistence of soft oil markets and the OPEC policy of defending oil prices during the greater part of 1985 led to new cuts in oil production by most oil-exporting countries members of OPEC in West Asia, and contributed to a resumption of the downward trend in the economic activity of the region as a whole. For the oil-exporting countries the contraction in output, however, has not been limited to their oil sectors. The adjustment to reduced export revenues, which started in 1983, has led to significant declines in the growth and, in some countries, in the level of output of their non-oil sectors. This trend will be even more pronounced in 1986, since higher growth of output in the oil sector during the first months of the year, which has contributed to the lower oil prices, will not make up for the contraction of their non-oil sectors resulting from further cuts in expenditure, necessitated by the deterioration of their terms of trade.

In 1985 the decline in output for the region as a whole came to 2.8 per cent. As in 1984, sharp cuts in expenditure led to further significant cuts in imports of goods and non-factor services and to a reduction of the deficit on current account. Imports of goods declined by around 10 per cent, leading to a stabilization in the surplus of the trade account. The improvement in the balance of non-factor services was only partially offset by the decline in the surplus of investment income, which resulted from a fall in assets and in interest rates. A reduced net outflow of private transfers brought about a further reduction in the current-account deficit.

*(c) Africa*

The end of the drought in 1985 and the attendant recovery in agricultural production have brought some relief to the famine-devastated countries of sub-Saharan Africa. The region is, however, emerging from one of the worst famines in recent history, with its productive system further weakened by the recent recession. Furthermore, domestic policies intended to reorient development efforts have been again compromised by a continued worsening of their external trading environment which, for many countries, has meant continued debt-servicing difficulties, necessitating further reschedulings and the continuation of austerity programmes. Thus, imports and investment have continued to decline in many countries, making the reversal of the trend of slow growth in sub-Saharan Africa a long-term prospect contingent on substantially greater support from the international community.

Output growth in sub-Saharan countries (excluding Nigeria) improved somewhat in 1985, but still came to only 2.4 per cent, which implies a continuing decline per capita. The growth has been accounted for mainly by the recovery in agricultural production which, however, has been gradual, due to after-drought effects. According to FAO, if favourable weather conditions continue, agricultural production should reach its pre-drought level in most countries in 1986. However, abnormal food shortages may continue in about five countries. Further growth in the short term, however, will be slow in view of low productivity and poor distribution and infrastructure systems, as well as of price structures which are slow to improve (although rapid progress has been made in some countries). Activity in the non-agricultural sectors has continued to suffer from shortages of raw materials and imported inputs (manufacturing), poor demand conditions (mining, including oil) and cuts in public spending (infrastructure), as well as sluggish private investment. This has even occurred in some of the countries that have experienced above-average growth in the region. In the Côte d'Ivoire, where output grew at around 5 per cent, investment, in 1985 alone, fell by about 20 per cent in current prices, as both public and private investment continued to decline. The fall was most dramatic in the petroleum sector, reflecting the changing prospects for oil development. In Ghana, capacity utilization in the bauxite and aluminium sector has been constrained by transport problems and shortages of electricity.

The somewhat better performance in domestic output has not been followed by an improvement in the external position in most countries of sub-Saharan Africa (excluding Nigeria). Both the trade balance and the current-account balance deteriorated for the region as a whole, with only a small number of countries showing some improvement.

The deterioration in the trade balance was the result of both reduced exports and increased imports. The significant declines in the prices of most primary commodities, combined with the stagnation in the volume of exports, led to an overall decline of 6.5 per cent in the value of exports. In some countries the decline of prices was accompanied by a significant fall in volume, still reflecting the impact of the drought, since exports in a given year involve quantities harvested partly in the preceding year. In a number of countries in which production had already started to recover in 1984, the volume of exports increased but this was partly offset by falling prices. The increase in the value of imports was accounted for almost entirely by increased volumes, reflecting both higher food imports for the drought-stricken countries and the resumption of import growth in countries undergoing structural adjustment programmes for which financing had become available through multilateral or bilateral official flows.

In spite of the drop in interest rates and the relief provided through the rescheduling of interest payments on official export credits, net debt service and investment income payments of countries in sub-Saharan Africa (excluding Nigeria) have remained high, firstly because of attempts to eliminate arrears and secondly because a large share of their debt is owed to official creditors and carries fixed interest rates. In fact, at the end of 1984, this share had increased to around 95 per cent of the medium- and long-term public debt.

The current-account deficit was financed through official flows, and particularly grants, reflecting the response of the international community to the emergency in the region. Rescheduling, which in general has been another way of financing external imbalances in the absence of new money, has been of limited scope in some African countries, because a large share of their debt is owed to preferred debtors (multilateral institutions) and is thus ineligible for rescheduling.<sup>52</sup> With the trade balance in surplus, 50 per cent of the capital

<sup>52</sup> For sub-Saharan Africa as a whole the share of multilateral debt (including use of IMF credit) in total short-, medium- and long-term debt was 33 per cent at the end of 1984. The corresponding debt service over the period 1985-1987 accounts for between 30 and 65 per cent of total debt service in about 20 countries.

flows have been used to meet interest payments.

The performance of the net oil-importing countries in North Africa has, on the whole, been constrained by high indebtedness and/or debt-servicing difficulties. The improvement in weather conditions and the relaxation of austerity measures in some countries have, however, ensured a modest growth in output. Conversely, these countries have not improved their current-account positions, and for some this therefore implies seeking new rescheduling of debt payments.

The weakness in oil markets was reflected in the economies of the oil-exporting countries in Africa in different ways. For some countries slower growth has been associated with the stagnation in oil output. For Nigeria, on the other hand, which, in view of its high indebtedness, increased its oil production significantly during 1985, the growth in the oil sector was partly offset by inferior performance in non-oil sectors, reflecting the larger deterioration of its terms of trade and the reduction of imports.

##### *5. Prospects for the near future*

The modest performance of the developing countries during 1985 following the slowdown in the recovery of the developed market-economy countries, particularly when compared to the optimistic expectations of 1984, has shown again how vulnerable these countries remain to the international economic environment. Growth in developed market-economy countries, which is expected to continue at the same rate as in 1985, will not provide any additional stimulus in 1986. Different countries or groups of countries can be expected to be particularly affected by other specific developments on the international economic scene. These include the evolution of the price of oil and of other commodity prices; the impact of policy and developments in major developed market-economy countries on interest rates and on the forces of protectionism, the evolution of private lending to highly indebted countries. Under the impact of these factors and of the domestic policy actions taken by developing countries themselves, output growth is expected to be slightly higher in 1986.

As a result of the fall in the price of oil, net oil-exporting countries will see their export revenues decline. For net oil-importing countries, on the other hand, there will be a substantial savings on the oil import bill.

Among net oil-exporters, countries which have been capital exporters can be expected to respond to lower export earnings with a com-

bination of import reduction and/or disinvestment abroad in proportions which will depend on absorptive capacity, on returns on investment abroad as compared to investment at home and on views on the future price of oil. It should be stressed, however, that these countries have already decreased their imports by more than 30 per cent in the last three years. Furthermore, some of them have significantly increased the volume of their exports, so that the negative impact on their economies of the price fall will be less marked. For net oil-exporting countries which are also net debtors and/or face acute financing constraints, the extent of reduction of imports will depend on their ability to secure new financing. Since new financing can be expected to be extremely difficult to secure, the reduction in imports and in the level of activity could be sizeable. For the oil-exporting countries, as a whole, however, the impact on overall activity will depend not only on the behaviour of imports, but also on the potential contractionary impact on domestic activity of policies aiming at compensating for losses in government revenues from the oil sector, as well as on the links of the oil sector to other sectors of the economy (such as petrochemicals).

As regards savings in the oil import bill by net oil-importing countries, the main beneficiaries, in principle, will be the middle- and higher-income countries, where oil imports generally account for more than 25 per cent of total imports, reflecting their relatively greater level of industrialization and higher energy intensity of output. On the other hand, for poorer countries, such as those in sub-Saharan Africa, where net oil imports account for not more than 15 per cent of total imports, the savings will be relatively smaller. Whether the benefits of lower oil prices will result in an overall improvement of the trade balance will depend on the behaviour of non-oil imports. Countries with debt-servicing difficulties may be compelled to use part of the savings from oil to reduce arrears, build up exchange reserves, reduce external borrowing, or even cut back levels of indebtedness. To the extent that they do so, the resources would not be available for imports, affecting the level of both non-oil imports and output.

A number of less direct effects may also have a bearing on the trade balance. For example, for countries for which exports to oil-exporting countries have been significant in recent years, reductions in imports by the latter can be expected to have an adverse effect on export earnings. Likewise, countries that have benefited from sizeable remittances from nationals working in oil-exporting countries can be expected to see earnings from this source

reduced. Furthermore, any acceleration in economic activity will be associated with higher energy use which, in turn, may involve a faster rise in the volume of oil imported (although this is likely to be a longer-term effect).

As regards oil-importing countries, the rise in commodity prices is expected to lead to a very modest improvement in their terms of trade. For developing countries that are large exporters of coffee, export prices will rise significantly due to the sharp rise in the price of this commodity following the drought in Brazil. A number of these countries are in sub-Saharan Africa and coffee constitutes a large share in their exports. Similarly, countries that export mainly manufactures may witness a significant improvement in their terms of trade, in comparison to oil-importing countries as a whole.

Interest rates declined significantly in the second part of 1985 and the beginning of 1986. Should they remain throughout 1986 at the levels reached by mid-year, for the year as a whole they would be about 1.6 percentage points lower than in 1985, representing a saving of around \$4.5 billion for net oil-importing debtor countries and of \$3.1 billion for oil-exporting debtor countries. As for oil, it is the higher-income countries which will benefit from the drop in interest rates, because a larger share in their total debt carries variable interest rates. Among the net oil-importing countries, 50 per cent of the savings would be accounted for by four countries, namely, Argentina, Brazil, Republic of Korea and the Philippines. Similarly, among the net oil-exporting debtor countries, Mexico and Venezuela would account for more than 60 per cent of the total savings in interest payments.

The prospective continued slow output growth in developed market-economy countries is expected to continue to constrain developing countries' export volumes, the growth of which is expected to resume in 1986, largely due to the resumed growth of oil exports, following the decline in oil prices. Export growth in net oil-importing countries is expected to be slight, remaining below the world average. In contrast to 1984, however, the trend towards convergence of growth among developed market-economy countries should have, in the absence of supply constraints, a more uniform impact on the export volume growth of developing countries.

Apart from external conditions, the prospects for developing countries are affected by

the domestic policies they pursue. The improved prospects for the external sectors of some developing countries would allow some margin for easing the austerity policies followed during recent years. As already pointed out, the combined effect of the various factors mentioned above is expected to vary considerably among countries. On developing countries as a whole, however, it is expected to be limited, as negative developments in some countries are expected to offset positive ones in others.

Output growth for developing countries as a whole is expected to rise slightly in 1986 and to stagnate in 1987. In the majority of oil-exporting countries growth should slow down considerably and even become negative in some cases. For a small number of such countries, however, mainly in West Asia, oil production levels in 1986 are likely to be considerably higher than in 1985, when oil production declined sharply (see chapter III, section C). In these countries, because of the importance of the oil sector in their economies, real GDP is expected to be higher than in 1985, in spite of a decline by more than 3 per cent in the non-oil sector. Output growth is expected to accelerate in East Asia, but nevertheless to remain below levels achieved in recent years, mainly as a reflection of the slow growth of demand for the region's exports, which had been the engine of fast growth in 1984, of cautious domestic policies applied in order to preserve both internal and external balance and of the slowdown in the oil-exporting countries. Growth is expected to be maintained in North Africa, South Asia and sub-Saharan Africa (excluding Nigeria). In this last region, the higher growth achieved during 1985, as agricultural production returned to normal levels after the drought, is not expected to be sustained in full. A number of the larger sub-Saharan economies are expected, however, to continue to grow at around 4 per cent. In Latin America output growth will reflect primarily the performance of the larger countries in the region, most of which will do less well, although with increasingly divergent patterns. Output growth in Brazil will remain robust and outstanding for the region, although lower than the rate of 8.3 per cent achieved in 1985. Conversely, output in Venezuela and in Mexico is expected to decline in absolute terms; and of the remaining large Latin American countries, only Argentina, where output declined in 1985, is performance in 1986 expected to be better than in 1985.

## B. Developed market-economy countries

### 1. *Fiscal and monetary policies*

The overall fiscal policy stance in the developed market-economy countries has not changed perceptibly during recent months. Fiscal policy in general remained as restrictive in 1985 as in 1984. In the United States the budget deficit remained large, thus offsetting the fiscal restraint in Western Europe and Japan. However, a lessening of the disparity between the expansionary stance in the United States and restraints elsewhere can be expected in the near future.

General government deficits for the seven major OECD countries taken together were virtually unchanged in 1985. This situation reflected a widening in the fiscal deficit of the United States, France and Canada, which was offset by improved fiscal positions in the other major countries. The combined deficit of the major countries was estimated to have amounted to around 3.5 per cent of GNP in 1985, i.e., the same as in 1984 (see chapter II above, table 4). At the same time, the structural (i.e., cyclically adjusted) component of the budget deficit, changes in which provide an indication of the discretionary impulse of fiscal policies, also remained stable in 1985.

The most noteworthy recent development was the passage by the United States Congress of the Concurrent Budget Resolution in the summer of 1985, the aim of which was to reduce the federal deficit from 5.5 per cent of GNP in fiscal year 1985 to 3 per cent of GNP in 1988. Furthermore, the Gramm-Rudman-Hollings amendment to this resolution also provided for automatic reductions in spending in case Congress and the President were unable to agree on a budget that would be consistent with the goal of achieving a fiscal balance by 1991. The expectation is thus for a move toward fiscal restraint in the United States in 1986. At the same time, fiscal policy in both Japan and Western Europe appears likely to remain restrictive. Consequently, successful cuts in the United States budget deficit would lead to a marked change in the overall fiscal stance toward more restraint in the major OECD countries in the coming months.

A more expansionary monetary policy has led to an easing of credit conditions in the United States since September 1984, with consequent falls in short-term interest rates there

that amounted to about 3 percentage points by January 1985. By the end of June 1986, short-term rates were at their lowest levels since 1978, i.e. about 3.5 percentage points below their 1984 peak. This downward movement in short-term rates was followed fully by Canada only. The falls in short-term rates in the Federal Republic of Germany, France and Italy, were much less. The reasons for this disparity of movements are diverse. Interest rates in the Federal Republic of Germany were already substantially below United States rates, so that the scope for a reduction was more limited. In France and Italy marked declines in interest rates were deemed to be undesirable in view of the relatively strong inflationary pressures still prevailing. In Japan, short-term interest rates were even allowed to rise slightly, in an effort to prop up the exchange value of the yen.

In contrast to short-term interest rates, domestic long-term rates moved much more in sympathy with each other and fell substantially in most countries during 1985. This suggests that the international transmission of interest rates affects mainly markets for long-term borrowing. In other words, short-term rates tend to reflect more fully the adjustments made by the monetary authorities, whose preoccupations are chiefly with domestic economic developments, and hence these rates are less influenced by developments taking place in other countries.

Concern that a strong dollar was exerting a deflationary impact on the domestic economy was a major factor leading the Federal Reserve Board of the United States to lower the discount rate to 7.5 per cent in May 1985. Reflecting in large part this change, the dollar declined steadily until the late summer of 1985. At that point, more favourable economic developments, especially regarding the trade deficit and unemployment, induced a subsequent appreciation of the dollar. This was halted only by the co-ordinated action of the Group of Five in September of that year, which triggered a weakening of the dollar on a broad scale. By the end of 1986 the dollar/yen exchange rate was nearly 25 per cent lower than in February 1985, and the decline of the dollar with respect to the Deutsche mark and the French and Swiss francs was even steeper. Notwithstanding these changes, the effective exchange rate of the dollar, as calculated by IMF, was more than 35 per cent higher at the end of 1985 than in 1980.



## 2. Demand and output

Widespread deceleration in the rate of growth of output took place in the developed market-economy countries in the first half of 1985, but growth accelerated again during the second half of the year. None the less, at 2.8 per cent for the year as a whole, the rise was short of the 4.5 per cent advance registered in 1984. Expansion in 1985 was fuelled mainly by buoyant expenditure on private consumption; investment, on the other hand, weakened in most countries.

The recovery in Western Europe in the second half followed the same vigorous pattern, but for the year as a whole growth was only about 2.3 per cent, much the same as in 1984. In the United States, output growth decelerated sharply in the second half of 1984 and remained weak during the next six months. There was a subsequent revival, but the annual rate of increase of GNP, at an estimated 2.5 per cent for 1985 as a whole, was much below the 6.6 per cent achieved in 1984. In Japan as well, there was a slowdown during the first half of 1985, and as the subsequent recovery was relatively weak, real output grew by 5 per cent in 1985, somewhat less than the 5.8 per cent rate recorded a year earlier. The sharp slowdown in the United States was the main cause of the significantly lower growth in 1985 for developed market-economy countries as a whole. Both private and public consumption rose strongly in that country in 1985, but there was a marked deceleration in fixed investment, destocking and a negative contribution from net exports.

As noted above, domestic demand in general was weak outside the United States, especially in Western Europe, during the first half of 1985, reflecting, among other factors, greatly reduced construction activity because of the hard winter. In all, domestic demand in Western Europe received strong support mainly from private consumption, which accounted for nearly half of the increase in GNP in these countries in 1985. The other components of demand, i.e., public consumption, stockbuilding and fixed investment, were slightly weaker than in 1984. In addition to the hard winter, the relatively slow growth of disposable income and high real interest rates also contributed to a slackening of dwelling construction. Net exports continued to advance, and their contribution to GDP growth was about the same in 1984 as in 1985. In contrast to the first year of the upswing, when the impact of net exports was most pronounced among the smaller countries, the impact in 1985 was confined to the larger economies in Western Europe. In

Japan, exports provided about 40 per cent of GNP growth during 1985. Private consumption in that country was adversely affected by smaller wage increases, and fixed investment also weakened as public-sector investment fell sharply.

## 3. Inflation and unemployment

The modest output growth which took place in the developed market-economy countries in 1985 was accompanied by a further fall in the inflation rate. In Western Europe and Japan falls in import prices, in terms of national currencies, appear to have contributed significantly to reduce the upward movement of prices. These falls reflected the twin influences of declining commodity prices and the appreciations of national currencies vis-à-vis the dollar. In principle, currency realignments should have worked in the opposite direction in the case of the United States, but there is little evidence that they did so in 1985. Import prices actually fell by an estimated 2 per cent, while the consumption deflator rose at an estimated 3 per cent in 1985, which was somewhat less than in 1984.

The continued slower rise in unit labour costs has also contributed to better price performance by the developed market-economy countries during recent months. This trend in costs, however, had become less pronounced in 1985 owing to a generally weaker growth of labour productivity. In addition, wage increases were no greater in 1985 than in the previous year, reflecting slack in the labour market and slower increases in the cost of living in most countries. The average unemployment rate in the developed market-economy countries taken together rose slightly during the first half of 1985 to 8.4 per cent, mainly as a result of slower output growth. In the aggregate, employment growth slackened noticeably in 1985, after having risen strongly in 1984, and was more than offset by increases in the labour force during the year. As a consequence, the number of persons unemployed in the developed market-economy countries taken together was estimated to be 30.8 million, i.e., slightly higher than the 30.6 million recorded in 1984.

## 4. Trade and the balance of payments

International trade among the developed market-economy countries appears to have grown much more slowly in 1985 than in 1984.

These countries' exports also increased in 1985 at less than half the high rate of 9.7 per cent in real terms attained in 1984, reflecting the more sluggish pace of increase in shipments to non-oil-exporting developing countries, as well as the accelerated fall in exports to the oil-exporting developing countries (see section A.4(b)). The developed market economies' imports from the rest of the world, on the other hand, also expanded at a very slow pace in 1985 and in volume terms were only about 1 per cent higher than in 1984, principally on account of the sharper decline of oil imports and a more widespread slowing down in imports of manufactures. Non-oil commodity imports were more stable and rose at about the same rate as in 1984 (about 4 per cent in real terms).

The terms of trade of the developed market-economy countries taken together improved by an estimated 1 percentage point in 1985, although there were divergences among countries, reflecting in the main the recent changes in exchange rates. Thus, the terms of trade of the United States improved while those of the Western European economies deteriorated in early 1985. These tendencies appear to have been reversed subsequently as the decline in the value of the dollar gathered momentum.

As United States imports continued to grow more rapidly than exports and as the opposite situation continued to characterize Japanese trade flows, there was a further widening of the uneven distribution of the current-account balances among the developed market-economy countries in 1985. The United States trade deficit reached some \$124 billion and was accompanied by a decline in the surplus on invisible trade. As a result, the country's current account posted an overall deficit of \$105 billion in 1985, up from \$97.3 billion in 1984. The major counterpart of this change was the increased surplus of Japan, which came about because of a rise of \$12 billion in the trade surplus and a fall of about \$3 billion in the invisible deficit. The Japanese current surplus stood at \$51 billion in 1985, as against a surplus of around \$36 billion recorded a year earlier. A further, but more modest, counterpart was the larger surplus of the Federal Republic of Germany, which amounted to around \$19 billion, against \$12.6 billion in 1984. These divergent movements also appear to have been subject to the so-called J-curve effects, whereby the initial impact of currency depreciation (appreciation) produces a deterioration (improvement) in the current account as the terms of trade worsen (improve). The accentuated imbalances in the external accounts of the developed market-economy countries appear, therefore, to have reflected also the decline in

the effective exchange rate of the dollar during the second half of 1985 and the concomitant rises in the effective exchange rates of the Western European currencies and of the yen during the same period.

## 5. *Prospects for the near future*

Among the factors that will shape the more immediate prospects of the developed market-economy countries are the expected lessening of the expansionary fiscal policy stance in the United States and continued fiscal restraints elsewhere; the future direction of monetary policy; the realignment of exchange rates and the timing of their impact on trade flows; and the recent large fall in the price of oil, of as much as 45 per cent in dollar terms. Some of the consequences of the fall in oil prices are examined later in this subsection. The following paragraphs comment briefly on the underlying trends likely to prevail in the developed market economies in the period immediately ahead.

The recent expansion in the developed market-economy countries is entering its fourth year and recent trends, which have shown some weaknesses in a few major cases, are expected to continue in the future. The improvement in growth performance that may be realised by some countries will be modest, and will have no significant effect on unemployment, especially in Western Europe. On the other hand, in many countries there may be further successes in bringing down the rate of inflation.

In the United States, it was generally expected that a downturn would occur about four years after the 1981-1982 recession, which ended towards the fourth quarter of 1982. Indeed, output growth in 1985 was weak, especially compared to the strong performance of 1984. Nevertheless, economic indicators were, on the whole, favourable in early 1986. Industrial production was relatively strong and interest-sensitive outlays, such as car sales, were buoyant. Housing starts were also promising. The negative contribution of net exports to domestic activity can also be expected to lessen gradually, owing to an expected improvement in competitiveness following the depreciation of the dollar. However, considerable uncertainties still surround the outlook for business fixed investment, in spite of lower interest costs. In any event, real GNP was estimated to have risen only moderately during the first quarter of 1986 (2.9 per cent, at a seasonally adjusted annual rate).

In Japan, on the other hand, personal consumption seems to have continued to be sluggish in early 1986, but may be gaining some strength owing to expected increases in real wage and other incomes, but business investment has shown signs of slowing down, as profits declined mainly because of poor export growth. The loss in competitiveness due to the appreciation of the yen and the consequent effect on exports can thus be expected to act as a brake on activity in the country. This was already evident in the first quarter of the year, when a fall in real exports was accompanied by a decline in real GNP by an estimated 0.5 per cent, the first such quarterly decline since 1974.

The underlying economic trend in Western Europe appears to be a broad continuation of the relative slow growth of 1985. Boosted by an expected increase in real incomes, private consumption growth may accelerate and will probably account for the bulk of GNP growth. A revival of construction from the depressed levels of 1985 can also be expected if long-term interest rates stay low. In addition, business fixed investment can be expected to show some strength. Indeed, the Business Survey carried out in EEC in October-November 1985, i.e. just before the sharper falls in oil prices, showed that investment intentions in industry were broadly very favorable. Thus, in many countries, demand is likely to be sufficiently buoyant to allow for a firm, albeit relatively modest, expansion of output. Nevertheless, in some smaller countries, the need to deal with both internal and external imbalances may constrain growth.

The outlook for the next year or so presents major new uncertainties and risks. The difficulties inherent in forecasting economic developments have been very much compounded by the recent large falls in the price of oil and the uncertainty surrounding the future evolution of oil prices. Because of the diversity in energy production and trading patterns in the developed market-economy countries, the impact of the oil price declines will differ markedly from one country to another. The net energy exporters, in particular the United Kingdom, Norway and Canada, will have reduced export earnings from energy. In countries where large quantities of oil are produced as well as imported, such as the United States, the losses to domestic oil producers and related industries may have an impact that will outweigh that of any short-term gain to the economy at large.

For other net oil importers, the immediate impact will be a fall in import prices, which can be expected to be very substantial in many cases, particularly when it is reinforced by the appreciation of domestic currencies with re-

spect to the dollar. In principle, the impact will be the largest where oil imports are high in relation to GNP. In Japan and the major countries of Western Europe, imports of oil corresponded to least 4 per cent of GNP in 1985, and exceeded 5 per cent in Italy. In spite of being a large net importer in absolute terms, the share of net oil imports in GNP (measured in dollars at current prices and exchange rates) was lowest in the case of the United States, amounting to just about 1.5 per cent.

Lower oil prices will not only bring benefits to energy-using sectors, but also slow down the rate of increase in the overall price level. This will allow nominal interest rates to fall and the real value of financial assets to increase. Unless interest rates fall substantially in real terms, the main direct influence on demand and output will be the net outcome of two factors: the proportion of the increased income in the OECD countries that will be spent (rather than saved), and how that compares with the proportion of the decreased income of oil-exporting developing countries that will be absorbed through financing (rather than through a reduction of imports). Both are subject to considerable uncertainties.

It is difficult to foresee how much consumers will spend or save of their extra real income and how far energy-using or consumer goods industries will expand their investment. It seems certain, however, that investment plans in the oil and other energy sectors will be radically revised: a number of energy projects in Canada and the United States have already been cancelled or postponed. The reactions of governments will also be of critical importance. Some may choose to allow the disinflationary process to deepen rather than foster growth, or consider that the fall in energy costs will itself provide sufficient stimulus. In either case, the impact will be to subdue the rate of expansion. Finally, those central and local governments that directly or indirectly receive oil revenues may react by adopting a more restrictive fiscal stance, or, at least, avoiding any relaxation. In the United Kingdom and Norway, the fall in oil prices will have an adverse effect on the budget, and may also add to inflationary pressures through downward pressure on the exchange rate. State and provincial governments in the United States and Canada will also be under pressure from the effects on their budgets.

Equally important, however, is the potential negative impact on the developed market-economy countries of the cutback in imports by oil-exporting developing countries. If the import reductions turn out to be substantial, their impact will in all likelihood be



distributed very unevenly. In particular, they are likely to be most serious for Western European countries, since their exports are relatively more concentrated on the oil exporters' markets. For example, while, in recent years, United States exports to the major developing countries exporters of oil constituted about 0.5 per cent of GNP, and those of Japan a little more than 1 per cent, for EEC member countries as a whole the proportion was about 1.7 per cent.

Furthermore, the realignment of exchange rates, especially between the dollar and other currencies, can be expected to have a marked influence on the performance of the developed market-economy countries in the near future. In the United States in particular,

with an enhanced competitive position, economic activity is likely to benefit from a gradual easing of the external payments position. Conversely, other developed market-economy countries, especially Japan and those in Western Europe, will probably be adversely affected.

All in all, it can at this stage be tentatively expected that, in spite of a substantial improvement in their terms of trade with the rest of the world, the rate of growth of GDP of the developed market-economy countries as a whole will be much the same in 1986 as in the previous year (i.e., 2.8 per cent). Better performance in North America, and to a lesser extent in Western Europe, should be offset by a sharp deceleration in Japan.

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### C. Socialist countries of Eastern Europe

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Economic growth in the socialist countries of Eastern Europe was not as pronounced in 1985 as in the two previous years, and some of the basic economic indicators remained slightly lower than expected. The growth of net material product (NMP) of the region as a whole was half a percentage point lower than in 1984. However, the expansion of gross industrial output was more marked, approaching the 1983-1984 levels. Thus, the slowdown in NMP may be attributed essentially to agriculture, where gross output declined or rose more slowly in some countries. Indeed, the overall performance in 1981-1985 indicates that consequences of the unfavourable tendencies appearing at the end of the 1970s, in both the international and the domestic economy, and which worsened during the early 1980s, have not yet been completely overcome. Nevertheless, the five-year NMP growth target for this period was almost achieved (taking into consideration the 1983-1985 plan in Poland). However, some of the other 1981-1985 plan objectives were not attained.

#### 1. *General economic developments*

In 1985, economic expansion in the Soviet Union came very close to the targets set by the annual plan. The growth of NMP used for domestic consumption and accumulation reached about 3.1 per cent, against 2.6 per cent in 1984. The accelerated rate of expansion of industrial output achieved in 1983-1984 was maintained in 1985, reaching 3.9 per cent, reflecting the objectives of the annual plan.

None the less, a certain weakness persisted in the energy sector, particularly during the first half of the year, though in the second half an annual rate of 4.6 per cent was reached. On the other hand, despite improved grain production in 1985, gross agricultural output remained unchanged.

The economic performance of other socialist countries of Eastern Europe varied considerably in 1985. The trends observed in 1983-1984 in the German Democratic Republic and Czechoslovakia continued in 1985, with high growth rates of NMP. However, the modest performance of Bulgaria and, in particular, that of Hungary, contributed to a 1.8 percentage point decline from the previous year in the NMP growth rate for the socialist countries of Eastern Europe, other than the USSR, as a whole.

In Hungary, the low NMP rate of growth in 1984 (2.5 per cent) was followed by a 1 per cent decline in 1985, which was the worst performance since 1979. The decline was due mainly to agriculture, although industrial output was also below the 1984 level. The slowdown of growth in Bulgaria, from 4.6 per cent in 1984 to 1.6 per cent in 1985, was primarily due to unfavourable weather. Nevertheless, although below the planned figures, the relatively good performance in the industrial sector, combined with the successes achieved in 1981-1984, allowed the country to attain its five-year target of 3.7 per cent annual growth of NMP. The economic recovery in Czechoslovakia, which had started in 1983 and gathered strength in 1984, continued in 1985, although at a slower pace. Three years of rising

Table 23

**SOCIALIST COUNTRIES OF EASTERN EUROPE: ANNUAL GROWTH OF EXPORTS  
BY COUNTRY OF ORIGIN AND MAJOR AREAS OF DESTINATION, 1984-1985 <sup>a</sup>**  
(Percentage increase over previous year, based on values in dollars)

<i>Origin</i>	<i>Destination</i>	<i>World</i>	<i>Developed market economies</i>	<i>Developing countries</i>	<i>Socialist countries <sup>b</sup></i>
<b>Bulgaria</b>					
1984		6.0	-1.0	18.3	4.7
1985		3.5	-7.4	1.1	5.6
<b>Czechoslovakia</b>					
1984		4.3	1.7	-3.5	5.8
1985		1.6	-3.4	-4.5	3.6
<b>German Democratic Rep.</b>					
1984		4.4	4.9	-9.6	5.8
1985		0.7	4.4	1.6	-0.6
<b>Hungary</b>					
1984		-1.7	4.9	-10.7	-3.6
1985		-1.7	-14.3	-1.7	6.4
<b>Poland</b>					
1984		1.6	7.8	1.0	-2.9
1985		-2.3	-5.5	-1.8	-2.4
<b>Romania</b>					
1984		5.5	12.0	11.8	-9.8
1985		4.6	-15.3	11.9	21.7
<b>USSR</b>					
1984		-0.2	-1.1	-2.4	1.2
1985		-5.1	-15.8	-6.4	1.6
<b>Total</b>					
1984		1.7	2.0	-1.0	2.0
1985		-2.1	-10.8	-3.3	2.6

*Source:* Data provided by the secretariat of the Economic Commission for Europe and estimates by the UNCTAD secretariat.

*a* 1985 figures are estimates.

*b* Socialist countries of Eastern Europe and Asia.

output in agriculture were followed by a 1.6 per cent fall in 1985, but a good performance in industry (a 3.4 per cent rate of growth against the planned rate of 3.0 per cent) resulted in an NMP growth rate of 0.1 per cent above the planned target, comparable to the growth in the two previous years. NMP growth in the German Democratic Republic accelerated to 4.8 per cent, against a planned 4.4 per cent, with a steady increase in output in both agriculture and industry. The average of 4.5 per cent for the five-year period 1981-1985 was the highest among all these socialist economies. However, for 1985 alone that position was occupied by Romania (5.9 per cent), although it should be mentioned that this was a smaller increase than in 1984 and was below the plan target. The pronounced deceleration in NMP

growth in Poland after two years of very high growth had been envisaged by the annual plan. In fact, it can be considered that the three-year recovery plan has been successfully undertaken, resulting in an average growth rate of 4.9 per cent, which is in the middle of the range originally envisaged (3.5 - 5.6 per cent).

## 2. *The external sector*

Results for 1985 indicate a slower expansion of foreign trade for the region as a whole. This is mainly attributable to a setback in exports in terms of both volume and value, which, for the first time in many years, fell in absolute

Table 24

**SOCIALIST COUNTRIES OF EASTERN EUROPE: ANNUAL GROWTH OF IMPORTS <sup>a</sup>**  
**BY COUNTRY OF DESTINATION AND MAJOR AREAS OF ORIGIN, 1984-1985 <sup>b</sup>**  
*(Percentage increase over previous year, based on values in dollars)*

<i>Destination</i>	<i>Origin</i>	<i>World</i>	<i>Developed market economies</i>	<i>Developing countries</i>	<i>Socialist countries <sup>c</sup></i>
Bulgaria					
1984		3.5	2.8	6.9	3.3
1985		6.7	15.7	25.5	2.8
Czechoslovakia					
1984		4.6	-5.6	-0.9	7.6
1985		2.5	3.9	-2.1	2.1
German Democratic Rep.					
1984		6.6	7.3	2.9	6.4
1985		1.1	-7.1	4.7	5.4
Hungary <sup>c</sup>					
1984		-5.0	-4.0	-8.1	-5.0
1985		0.7	4.3	-31.5	3.3
Poland					
1984		0.5	1.8	15.6	-2.3
1985		1.4	10.2	3.8	-4.6
Romania					
1984		-1.1	12.6	5.9	-12.0
1985		14.6	-4.6	19.5	17.8
USSR					
1984		-0.1	-4.6	2.4	0.8
1985		3.0	-4.7	10.5	3.8
Total					
1984		1.3	-1.6	2.7	1.9
1985		3.3	-1.5	8.7	3.5

*Source:* As for table 23.

*a* f.o.b., except for Hungary (c.i.f.).

*b* 1985 figures are estimates.

*c* Socialist countries of Eastern Europe and Asia.

terms. As the value of imports grew at much the same rate as the previous year, the trade surplus of the region as a whole declined significantly.

Exports from the USSR in 1985 (see table 23) were affected by supply difficulties in the petroleum sector as well as by weak demand for oil products in developed market-economy countries. Despite the fall in oil prices which occurred around the end of the year, the Soviet Union achieved a small gain in its terms of trade. Nevertheless, the trade balance remained largely positive.

The other socialist countries of Eastern Europe also had slower export growth in 1985, particularly in Poland, Czechoslovakia and Bulgaria. The decline mainly affected their

trade with developed market economies and developing countries. Exports to these two groups of countries contracted by 3.6 and 1.6 per cent, respectively. The further increase in the growth of imports in Romania and Bulgaria (see table 24), because of the poor harvests, together with similar rises in imports in Poland and Hungary, resulted in a decline in the overall trade surplus from \$6.9 billion in 1984 to \$5.1 billion in 1985. Nevertheless, only in Bulgaria and Czechoslovakia was the trade balance in deficit.

Although the estimated balance-of-payments position for the socialist countries of Eastern Europe as a whole weakened owing to the contraction of the trade surplus, the overall payments position remained much as it was in

1984, because of, *inter alia*, the fall in the exchange rate of the dollar and also because some debt-related indicators (e.g. interest payments as a share of exports and international reserves as a share of imports) have significantly improved. As a consequence of the development envisaged in the external sector, a weakening of these indicators in the near future is, however, very likely.

### 3. Outlook

A new economic policy has been adopted aimed at using resources more efficiently rather than increasing their availability over the next 15 years. It will require growth rates higher than those of the two previous five-year plan periods, structural changes, and improvements in economic mechanisms and the system of management. The plans for 1986-1990 are regarded as an important step in the implementation of this policy. Annual NMP growth is planned to accelerate to around 3.5-4.1 per cent for the Soviet Union and on average to 4.6 per cent for the other countries. The rates of growth of gross industrial output are projected to attain 3.9-4.1 per cent in the Soviet Union, 4.6-5.4 per cent in Bulgaria, 4.7-5.1 per cent in the German Democratic Republic, 2.8-3.4 per

cent in Czechoslovakia, 2.7-3.0 per cent in Hungary, 3.1 per cent in Poland and 6.0-6.5 per cent in Romania. Considerable increases in agricultural output have also been foreseen. All national plans refer to such an acceleration in the various rates of growth of the different sectors of the economy.

The long-term economic strategy of the Soviet Union aims at intensifying the social and economic development of the country. Accordingly, it is planned to double national income by the end of the century on the basis of the acceleration of technological progress and far-reaching structural changes. Significant alterations in investment policies for modernizing and re-equipping existing enterprises, rather than establishing new ones, have already been envisaged for the current five-year period. Resources will be increasingly concentrated in the key industrial branches. Improvements in economic mechanisms and the system of management, tested in operation during the last two years, will be introduced. The strategy implies important qualitative and quantitative changes in the foreign trade of the USSR. For a number of years exports of energy will continue to play an important role in total exports. However, by 1990 their share is expected to decrease significantly. The new economic strategy places special emphasis on the development of imports and exports of manufactures, in particular those incorporating high technology.

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## D. China

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During the first months of 1985, the Chinese economy continued to expand at an accelerated pace, exceeding target rates, partly in response to the various reforms adopted in late 1984. However, increasing concern about the overheating of the economy and its possible impact on the future of the reform led the Government to reassert central control over various aspects of the economy, and to move more slowly towards the implementation of reforms already announced. Although structural reform of the economy continues to be a top priority of the 1986-1990 five-year plan, emphasis during the first two years of the plan will be on "controlling social demand in general, to solve the problems of overly rapid growth rates, excessive investment in fixed assets and sharp increases in consumption funds".<sup>53</sup>

The partial wage reform, which has meant wage increases across the board, together with the opening of the credit system and of competition among banks for lending, which has fed the growth in investment in fixed assets, contributed to the acceleration in the growth of industrial production during the first months of 1985. Up to July of that year, industrial output grew at an annual rate of 23 per cent. Although by the end of the year this rate had been brought down to 8 per cent, for the whole year it was almost 18 per cent, that is, twice as high as the average for the period 1980-1984 and 4 percentage points higher than in the year 1984 alone. Given the high growth in consumer demand, the growth in light and heavy industries remained in balance. However, the sheer magnitude of the expansion has continued to put strains on infrastructure and has brought about a rise in prices of intermedi-

<sup>53</sup> Zhao Ziyang, "Explanation of the Proposal for the Seventh Five-year Plan" (Speech delivered at the National Conference of the Communist Party of China, 18 September 1983), *Beijing Review*, vol. 28, No. 40, 7 October 1985, "Documents", p. III.

ate goods. Thus, while energy production has been growing at healthy rates (oil, 10 per cent, electricity, 9 per cent), energy shortages have continued. The pressure on infrastructure has been felt particularly in industries producing intermediate goods such as iron and steel, where output has been growing at rates around 6-8 per cent. Combined with the increased demand, this has led to price increases in these goods, and also partly contributed to the non-fulfilment during the first part of the year of the supply contracts with the State for a number of major products for which contract prices were lower. To curb the excessive growth in industrial production and capital construction, interest rates were raised and lending for investment was tightened, as banks under the control of the Central Bank were asked to monitor the purpose and use of investment funds, wage increases were checked and there were renewed calls for the need to improve the quality of goods. However, direct measures, such as production quotas, have not been enacted.

Agricultural output has also continued to expand rapidly, by 13 per cent in value terms. Rural enterprises (still included under agriculture) and cash crops have been the most dynamic sectors, with output of the former increasing by 35 per cent. Conversely, the output of some traditional crops like cotton and food grains has declined. In the case of cotton the decline is attributed to a planned reduction of acreage in response to surplus supplies in domestic and world markets. The production of food grains, on the other hand, after record harvests in 1984, has dropped back to its 1983 level. This decline is not only attributable to adverse weather but also to a reduction in acreage, only partly planned, and to smaller productivity gains as farmers shifted their attention to the more profitable cash crops.

The resumption of inflation for the first time since the 1950s has also slowed down the implementation of the price reform. Retail prices in 1985 increased by 8.8 per cent for the country as a whole and by more than 12 per cent in the urban centres. A limited increase in retail prices had been envisaged as a result of the 1985 price reform, which involved increases in the controlled prices of certain goods or services, as well as partial decontrol of the prices of a wide range of goods. However, the price

reform, combined with the wage reform and the growth in lending that followed the banking reform, have all contributed to excessive demand and to increasing inflationary pressures. In order to check the inflation, in addition to the measures taken to contain demand, the Government has also taken measures on the sides of supply and prices. To ensure steady supply and more stable prices for vegetables in urban centres, it has demanded a certain guaranteed acreage for vegetables in suburban areas and the control of supply sources in government-controlled shops. With regard to prices, ceilings have been imposed on the market prices of certain vegetables and some of the major intermediate goods that had been decontrolled under the reform. Indirect measures for price supervision and management are also envisaged. However, real incomes have continued to increase, with urban incomes rising 5 per cent and farm incomes 3 per cent.

These developments in the domestic sector have also affected China's trade and payments. Demand for consumer and intermediate goods has continued to push up imports, while exports, partly affected by weakened foreign demand, have been growing only marginally. According to preliminary figures of the State Statistics Bureau, imports in 1985 increased by 54.2 per cent in value and exports by 4.7 per cent (in dollar terms).<sup>54</sup> Imports of manufactured goods, which now account for about 87 per cent of total imports, increased by 150 per cent; imports of consumer goods, which now account for 29 per cent of imports of manufactures, increased more than four-fold. Furthermore, imports of some intermediate goods whose production has been lagging, such as steel, have also increased much faster than overall imports, reflecting yet again the rapid increase in capital construction. As the traditional policy has been to peg imports to export performance, the intervention of the central Government to correct the imbalances in the external sector has been immediate and direct. Duties were increased, foreign exchange controls were imposed and the renminbi was devalued. In addition, new rules were imposed on the licensing of a wide range of imported goods, imports of certain goods were banned, while for others, imports were again made subject to quotas. These measures could not have much impact before the end of 1985 because many import agreements had already been

<sup>54</sup> There is a large discrepancy among the various figures for imports and, thus, the resultant trade deficit given by the different Chinese authorities. The figures provided by the Ministry of Foreign Economic Relations and Trade (MOFERT) put imports at \$33.4 billion and the trade deficit at \$7.6 billion. However, it appears that the MOFERT figures disregard imports of goods, that are re-exported after being processed, as well as aid in kind and donated goods. The figures given by the General Administration of Customs and the State Statistics Bureau are similar to, and more consistent with, China's trading partners' data, and it is these that have been used here as well as in previous issues of the *Trade and Development Report*.

signed at the beginning of the year, but the impact should become apparent in 1986.

The trade deficit in 1985 is estimated at \$11.8 billion, whereas trade was in balance in 1984. The non-trade surplus in the current account of the balance of payments, however, continued to increase, as did net private transfers, thus bringing down the current balance to a deficit of \$7.4 billion. Part of the deficit has been financed through an inflow of capital (loans, direct investment and commodity credits). Thus, the drawing down of reserves was limited to around \$4.6 billion.

The prospects for 1986 and 1987 must be viewed in relation to the targets of the five-year plan for 1986-1990. Although the details of the plan have not yet been elaborated, its main targets and orientation are already known. Thus, it appears that the emphasis of the plan will be on development strategy policies and principles rather than on detailed quantitative targets. This approach is in line with the structural reform of the economy, which envisages progressively increasing flexibility and deregulation at the microeconomic level and management of the macroeconomy through appropriate legislation rather than through direct central controls. Within this framework the main objectives of the new plan are: first and most important, the creation of the appropriate environment for the smooth progress of the reform; second, acceleration and implementation of certain key projects, technological transformation and intellectual development; and, third, the further improvement of standards of living. The plan will be implemented in two stages. A first stage of two years is envisaged for the gradual solution of the problems of inflation, bottlenecks and the deterioration in the current-account balance. These problems emerged during 1984 and 1985 and were associated with rapid growth in investment in fixed assets and consumption funds. This course of action has been preferred to an abrupt slowdown of the economy in the second half of 1985. During this period, investment in fixed assets will remain at its 1985 level, but its sectoral allocation will be changed to allow for faster completion of key projects. During the second stage of the plan, investment in construction will be increased in accordance with the conditions prevailing at that time.

Table 25

**CHINA: MAIN ECONOMIC INDICATORS**  
(Annual average percentage rate  
of growth)

Indicator	1984-	1986-
	1985	1990
	<i>Forecast</i>	
Gross industrial output	18.0	6.8
Heavy industry	17.9	6.6
Light industry	18.1	7.0
Gross agricultural output	13.0	5.4
Output of services	..	11.4
GNP	..	7.3
National income	12.3	9.3
Consumption	..	6.9

*Source:* State Statistics Bureau.

Taking the above into consideration, the quantitative targets for the rates of growth of the main economic variables have been put at levels significantly lower than those achieved in 1985 (see table 25). Thus, gross industrial output is expected to grow by 6.8 per cent per annum and agricultural output by 5.4 per cent. For the first time, emphasis is given to the tertiary sector and to the need to bring output in that sector into step with that of the primary and secondary sectors. In order to increase the efficiency of the service sector, as well as to absorb excess labour resulting from continuous improvement in labour productivity elsewhere in the economy, growth in this sector is planned to be 11.4 per cent per annum. To take account of this sector, planning now makes provision for targets for GNP.<sup>55</sup> According to the plan, GNP is planned to grow by 7.3 per cent per annum and national income by 9.3 per cent. Growth in 1986 and 1987 is expected to remain higher than this average, at around 8 per cent, reflecting the Government's decision to proceed by gradually cooling the economy. With respect to trade, the plan remains vague, recognizing the need for continued expansion of essential imports. However, given the explosive

<sup>55</sup> So far the concepts of gross social product and national income have been used as measures of output, in accordance with the System of Material Product Balances.

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import growth in 1985 and the prospects for exports in 1986, imports are likely to be curtailed in order to bring down the current-

account deficit, which is expected to decline to half its 1985 level.■

## ANNEX TO CHAPTER V

## RECENT DEVELOPMENTS IN WORLD COMMODITY MARKETS AND WORLD CAPITAL MARKETS

## I. Commodity markets

## 1. Overall performance

The unfavourable conditions prevailing in primary commodity markets since the beginning of the 1980s persisted in 1985. Despite some increase in the prices of non-oil primary commodities in 1983-1984, the average annual rate of decline over the period 1981-1985 was about 7.5 per cent. In nominal terms, the UNCTAD index of non-oil primary commodities exported by developing countries fell by about 11 per cent in 1985, following a very modest increase in 1983-1984 and a steep decline in 1981-1982. For most primary commodities the peak in 1984 was far below the previous one in 1980, and the trough in 1985 was below that of 1982 (see figure A). The depreciation of the dollar, which started in the second quarter of 1985 and accelerated in the fourth quarter, has not brought about the expected improvement on commodity markets. However, it has apparently had some influence on prices of manufactures. The United Nations index of unit value of manufactured goods exported by developed market-economy countries has been rising ever since the second quarter of 1985, with a pronounced acceleration in the fourth quarter, in line with movements in the effective exchange rate of the dollar (see table A). There has thus been a further deterioration in the prices of commodities relative to those of manufactures.

The weakness of commodity prices during recent years has reflected the expansion of supply in the face of stagnant or slowly growing demand, in particular for many agricultural commodities. The tendency for supply to expand despite sharply lower prices has continued: in 1984, total commodity production rose by 6 per cent, the sharpest rise experienced since the late 1960s, and reached a record level. In 1985 a further substantial rise in output occurred.<sup>1</sup>

The outlook for 1986 is for some strengthening of commodity prices vis-à-vis the averages for 1985, reflecting mainly better growth in developed market-economy countries, the lower exchange rate of the dollar, and particular developments on the supply side, especially the impact of drought on supplies of coffee. This strengthening will be uneven, and may not apply to all markets. As of early 1986, for ex-

ample, the minerals and metals markets continued to show weakness, reflecting in part the collapse of the tin market and its repercussions. The overall strengthening of commodity prices expected in 1986 is not likely to match that likely to occur for prices of manufactures exported by developed countries, so that the terms of trade of commodities relative to manufactures are expected to deteriorate further.

The following paragraphs summarize recent developments in major commodity markets.

## (a) Food and beverages

## 1. Cereals

According to FAO estimates, world cereal production increased by about 2 per cent in 1985 over the record level reached in 1984. Output of coarse grains rose more than 7 per cent, while production of wheat and rice fell slightly. Notwithstanding a decline in wheat and rice production, larger carryover stocks are anticipated in the main exporting countries at the end of the 1985/86 season. This is due to the fact that, as a result of larger crops in 1985 in a number of major importing countries, the volume of cereals traded so far in 1985/86 has been significantly lower than in previous years. Compared with 1984/85, trade in wheat and coarse grains in 1985/86 is expected to fall by 15.5 and 14.5 per cent, respectively. In view of the ample supply available for export and the depressed level of demand in importing countries, the prices of most cereals declined throughout 1985. On average, the price of wheat dropped by 10 per cent, that of maize by 17 per cent and of rice by 14 per cent. The outlook for 1986 is for some decline by mid-year. Certain policy measures introduced by the United States Department of Agriculture (lower loan rates and a large acreage reduction programme) are likely to reduce United States production in 1986. It is, however, hardly likely that the reduction will be enough to balance the existing oversupply in the short run, barring unfavourable weather.

<sup>1</sup> Some of the factors accounting for the rise in supply in the face of weak prices have been described in chapter III, section B.



Table A

**WORLD MARKET PRICES OF PRIMARY COMMODITIES EXPORTED BY DEVELOPING COUNTRIES, 1980-1986**  
(Index numbers, fourth quarter 1982 = 100)

Commodity group	Year and quarter																	
	Peak in Trough in 1980				1983				1984				1985				1986	
	IV	IV	I	II	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	
Food and tropical beverages	157	100	101	108	112	116	116	118	118	115	107	104	103	96	93	105	129	
Vegetable oilseeds and oils	159	100	102	117	159	172	172	198	214	214	170	163	152	145	113	102	88	
Agricultural raw materials	141	100	104	114	115	114	114	117	113	104	104	101	97	101	99	96	97	
Minerals, ores and metals	141	100	101	106	104	99	99	100	100	100	94	93	91	98	98	98	95	
Total primary commodities:																		
Denominated in dollars	147	100	102	109	115	116	116	119	117	108	108	105	103	101	97	103	113	
Denominated in SDRs	123	100	101	109	116	118	118	122	120	115	114	114	114	109	101	102	108	
Effective dollar exchange rate	77	100	97	100	104	104	104	105	106	112	112	115	122	118	112	104	..	
Manufactures <sup>a</sup>	115	100	103	101	99	98	98	99	99	95	93	93	90	94	99	106	..	

**Source:** UNCTAD secretariat calculations, based on UNCTAD, *Monthly Commodity Price Bulletin*; United Nations, *Monthly Bulletin of Statistics*; IMF, *International Financial Statistics*.

<sup>a</sup> United Nations index of unit value of exports of manufactures from developed market-economy countries.

## II. Sugar

The basic problem facing the sugar market is that production has outstripped consumption for several years. Throughout 1975-1985, world production of sugar was on average about 3 per cent higher than consumption. In consequence, the huge stocks, which exceeded 40 million tons in 1985, against 25 million in 1980 and as little as 16 million in 1974, have been overhanging the market and depressing prices. In 1985, the price of sugar dropped to its lowest level since 1969, sinking to below 3 c/lb. in June. Current indications are that world production will decline by about 3 per cent in 1985/86, with consumption increasing by 1.4 per cent (mostly due to an increase in developing countries). This will lead to some reduction in carryover stocks for the first time since 1982. However, world stocks are still expected to represent about 40 per cent of world consumption. Consequently, the overall market situation is not likely to change radically.

## III. Coffee

The decline in coffee prices was reversed in November 1985 in reaction to the news that coffee production in Brazil would be some 40-50 per cent lower in the 1986/87 season on account of severe drought. In January 1986, the price of coffee was more than 70 per cent higher than in September 1985. The persistence of high coffee prices triggered a suspension of the International Coffee Agreement quotas on 19 February, the coffee trade thus returning to a free market. Brazil normally produces about one-third of the world's coffee, and a reduction in Brazilian output could create a significant gap in coffee supply. However, with world stocks at the end of 1985/86 still at about 50 per cent of annual consumption, after an initial nervous reaction the market could stabilize at a lower level of prices later in 1986. In April 1986, the average price of coffee was already about 7 per cent lower than in March. The Brazilian drought might, however, create shortages of particular varieties and qualities. Thus, disruptions in the availability of arabica were reflected in a higher increase in prices of arabica than of robusta in April 1986, over the average for 1985.

## IV. Cocoa

The supply/demand balance indicates that the overall position for cocoa remained relatively unchanged, with some surplus in 1985 and this situation is expected to continue in 1986. Therefore, cocoa price fluctuations in 1985 and the early months of 1986 were probably influenced by currency fluctuations, and by the disagreement over renewal of the International Cocoa Agreement, as well as by differences in market assessments of production prospects. In July-December 1985, prices responded positively

to the changes in the dollar exchange rate, and in March-April they reacted negatively to the failure to conclude a new international cocoa agreement.

## V. Tea

The weakening of the tea market in 1985 was mainly the result of the large production increases in many countries in 1984 and good prospects for 1985. Indeed, tea production in 1985 rose by about 8 per cent over the record level reached in 1984. As from September 1985, the price of tea has been recovering, possibly due to currency fluctuations. In November of that year, the price was 13 per cent higher than in July.

### (b) Vegetable oilseeds and oils

Prices of soybeans and other vegetable oilseeds reacted strongly to the ample supply coming from good crops for the second consecutive year. World production of soybeans increased by about 6 per cent in the 1985/86 season, following a 10 per cent increase in 1984/85. Most of the increase reflected larger oilseed crops in the United States, mainly soybeans, and higher output of palm oil in South East Asia. The decline in prices has been continuing since the middle of 1984. On average, the prices of vegetable oilseeds and oil experienced a decline of more than 30 per cent in 1985 over 1984.

### (c) Agricultural raw materials

#### I. Cotton

In 1985, the price of cotton sank to its lowest level for 10 years. The record crop in the two consecutive seasons 1984/85 and 1985/86 contributed to the huge surplus of cotton. At the end of the 1985/86 season, cotton stocks are expected to account for 70 per cent of yearly world consumption. The largest build-up of cotton stocks occurred in China. Within the framework of agricultural reform in the late 1970s, the package of incentives (the new arrangements to grow cotton by individual farmers under State contracts, and the increase in procurement prices) resulted in a considerable increase in output, which doubled in recent years.<sup>2</sup> The modest growth in world cotton consumption is likely to make a marginal contribution to the needed supply adjustment. On the other hand, the prospects of a significant reduction in cotton production in the near future are not very encouraging. The measures taken by the Chinese authorities are not likely to reduce cotton output significantly in the coming season, and

<sup>2</sup> See section D of this chapter.

the reduction in acreage outside China in response to the decline in cotton prices appears to be relatively small. Thus, high world stocks are likely to depress cotton prices for some time to come.

## *II. Natural rubber*

Continued weakness was also observed in the natural rubber market. In 1985, the price of natural rubber dropped 20 per cent below its level in 1984. Despite some increase in consumption in most countries, the overall supply/demand balance did not improve in 1985, and the situation of oversupply that has prevailed on the natural rubber market for some years is expected to persist. This, together with the high level of buffer stocks, which are approaching their ceiling, will prevent prices from rising.

## *III. Tropical timber*

The only exception to the generally disappointing performance of agricultural raw materials was an upward movement in tropical timber prices in the second half of 1985. On average, the price of tropical timber was slightly lower in 1985 than 1984, but a further strengthening of the upward trend in 1986 is considered to be an encouraging sign. The price increase mainly reflects the depreciation of the dollar, as the fundamentals of the market seem basically unchanged.

## *(d) Minerals and metals*

In aggregate, the prices of minerals and metals (excluding tin) dropped by 3.8 per cent in 1985,<sup>3</sup> following the drop of 7.5 per cent in 1984. There were, however, divergent movements in the prices of copper and other metals.

### *I. Copper*

The price of copper increased by about 3 per cent in 1985 after a considerable decline of 13 per cent in 1984. The supply/demand balance improved in 1984, when consumption rose by 10 per cent and production declined by 3 per cent. Despite the fact that stocks of copper were cut substantially, by about 28 per cent, prices remained depressed throughout 1984 and early 1985. Only in the second quarter of

1985 did copper prices respond to consumption, which was running at a level higher than production. The depreciation of the dollar is also likely to have contributed to the price improvement.

### *II. Tin*

The excess of consumption over production resulted in some destocking of tin in 1984 and 1985, but it did not generate any significant strengthening of the market. Over the years 1979-1983, tin production tended to outstrip consumption, thus resulting in an enormous accumulation of buffer stocks, which have amounted to 62,000 tons or about 40 per cent of annual consumption. The overhanging stock exerted considerable pressure on the market. In dollar terms, the price of tin in 1985 stood at about 30 per cent of its 1980 level. The weakening of the tin market reached its bitter climax in October 1985, when the International Tin Council ran out of money and was unable to continue to support purchases (see chapter IV, section A.5). Since 24 October, sales of tin have been suspended on the London Metal Exchange. All the negotiating efforts to resolve the problem have not had any positive result as yet. It has recently been reported from the free market in London that transactions have been concluded at a price over 50 per cent below the average quoted for January-October 1985.

### *III. Aluminium and other non-ferrous metals*

The efforts made by some producers to adjust aluminium output did not prove successful. Prices of aluminium were on average 15 per cent lower in 1985 than in 1984. Owing to a substantial increase in production of zinc and lead in the first half of 1985 and to sluggish demand, prices of those metals continued to decline throughout the whole of that year.

### *IV. Phosphate rock*

Contract prices for phosphate rock have been constant since January 1984, but prices might possibly increase by 3-5 per cent in 1986 in view of the depreciation of the dollar against the currencies of the major phosphate rock importing countries. However, given present market conditions and the expected decline in United States fertilizer consumption, it is doubtful whether an increase in the price of phosphate rock could be sustained for long.

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## **II. Capital markets**

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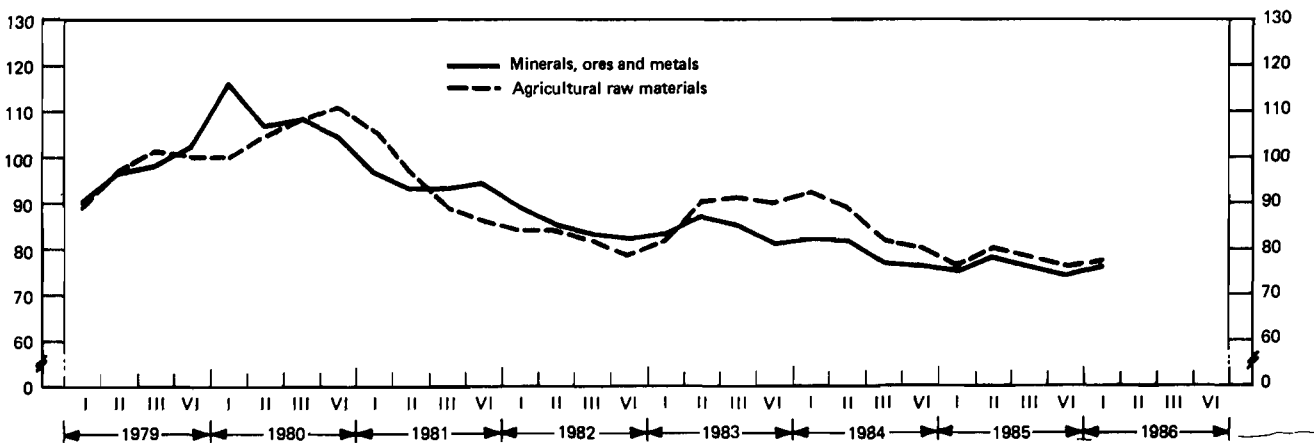
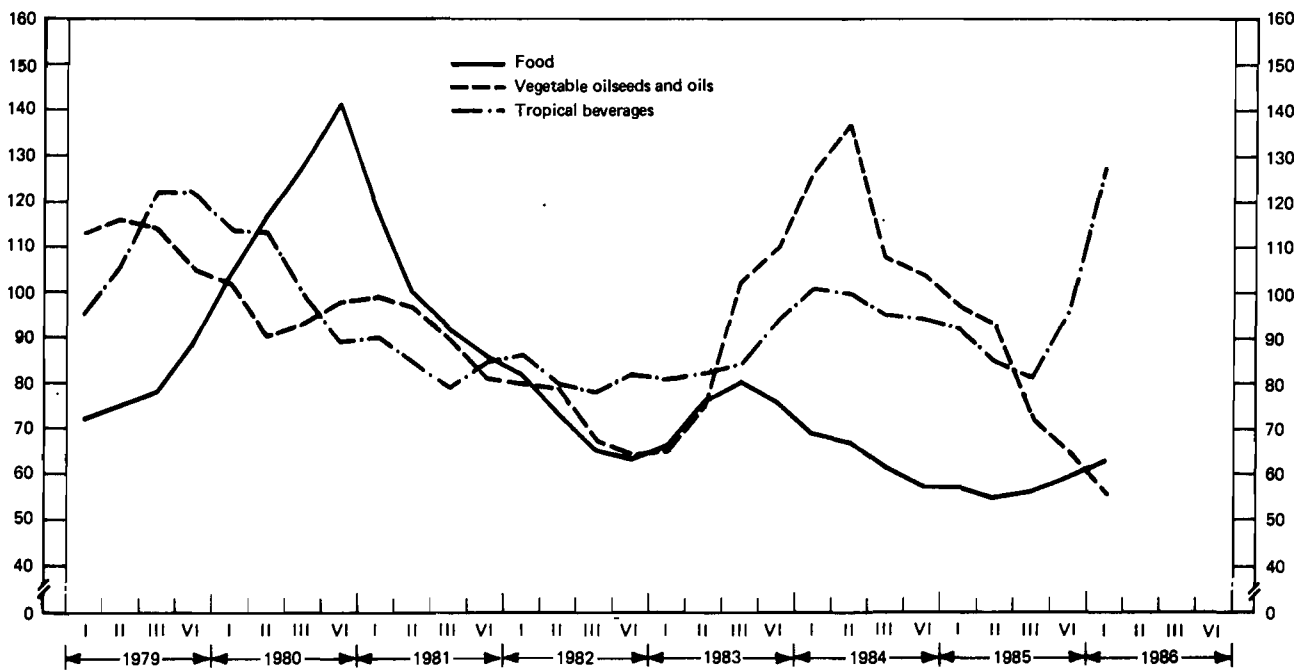
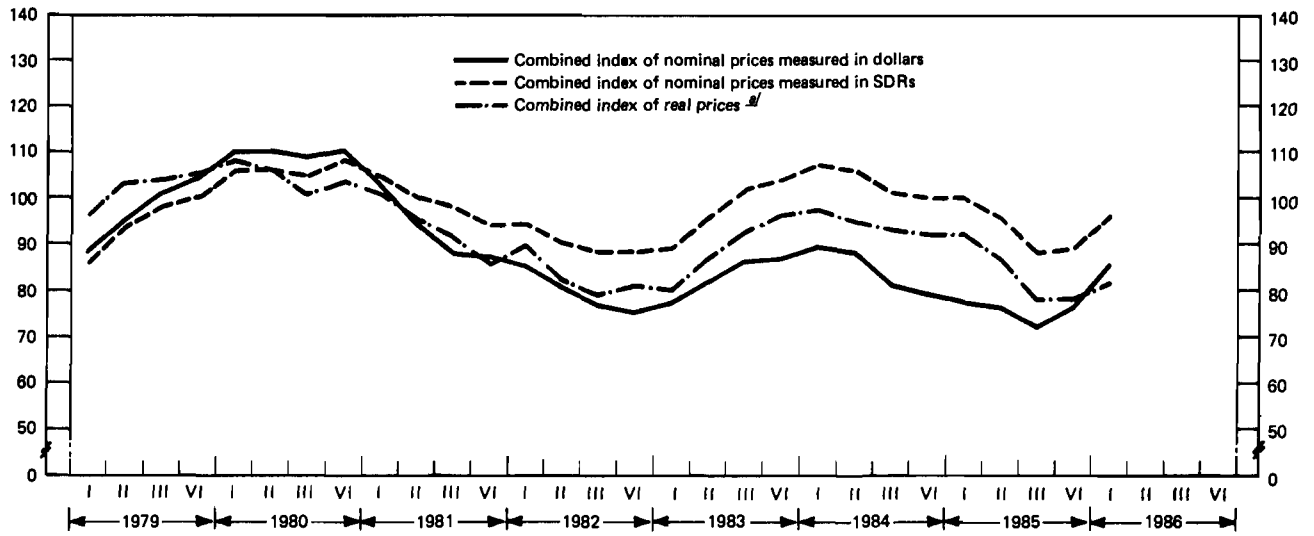
Activity in international capital markets continued to increase vigorously in 1985. Following the

already high 28 per cent growth registered in 1984, the overall volume of borrowings continued to increase

<sup>3</sup> Tin prices have been excluded from the UNCTAD index due to suspension of sales in 1985.

Figure A

QUARTERLY INDICES OF FREE MARKET PRICES OF SELECTED  
PRIMARY COMMODITIES EXPORTED BY DEVELOPING COUNTRIES  
(1979-1981 = 100)



Source: UNCTAD, *Monthly Commodity Price Bulletin*

a/ Combined index measured in dollars deflated by the United Nations of exported of unit values of manufactured goods from developed market-economy countries

by about 30 per cent in 1985. This was largely due to a doubling of bond issues over 1984 and 1985, but equally striking was the increase in activity in bank facilities, such as the note issuance facilities (NIFs) or the revolving underwriting facilities (RUFs),<sup>4</sup> arranged to back up the issue of other financial instruments, in particular short-term Euronotes. As a result, securities and security-related means of financing accounted in 1985 for about 80 per cent of total borrowing (compared to less than 50 per cent in the early 1980s). Demand for refinancing by borrowers wishing to take advantage of the new borrowing techniques and lower interest rates have contributed to the surge of activity in capital markets.

In stark contrast, new medium-term and long-term funds raised in the international capital markets by developing countries as a whole fell by 16 per cent in 1985, and for non-OPEC developing countries by 20 per cent.<sup>5</sup> As a result, the share of developing countries in total borrowing in capital markets registered a further and sharp fall, to reach around 11 per cent in 1985, compared to around 17 per cent the previous year (and about 23 per cent in 1983).

In contrast to the bond and other security markets, activity in the loan market flagged. Syndicated lending in particular continued to decline, for the third consecutive year. New syndicated medium-term and long-term bank loans decreased by 25 per cent in 1985 to reach \$42 billion, which is about 40 per cent of the amount raised in the 1982 peak year. After making allowance for debt repayments, prepayments of loans by some borrowers and cancellation of lines of credit, net international bank lending at medium term probably advanced very little, if at all, in 1985.

The decline in activity in the bank credit markets is partly due to the shift in developed market-economy countries away from bank loans towards bonds and various new financing instruments. It also reflects the continuation of the marked slowdown in bank lending to developing countries, starting in 1982. The gross volume of medium-term external bank loans to developing countries (excluding renegotiations of outstanding loans) was about \$16 billion in 1985, or 30 per cent below the 1984 figure. Bank credit flows continued to be largely concentrated in developed market-economy countries, much of it inter-bank. The major destination of bank lending was the United States, which was a net taker of funds in the first half of 1985, as in 1984.

The growth of the claims on developing countries of banks reporting to the Bank for International Settlements, which had slowed down to less than 1 per cent in 1984, revived slightly to 3.6 per cent in 1985, although this is still below the 1983 figure (see

annex table 23). The slowdown was particularly sharp in Latin America in 1984 and 1985, and in Africa in 1984; bank claims actually contracted in absolute terms in these two regions in 1984. Bank claims on developing countries of Western Asia also registered a sharp reduction in absolute terms in 1985. In the South and South-East Asian region, bank claims continued to increase, but at a much slower pace.

The slow pace of bank lending stems from both caution on the part of developing countries and banks' reluctance to lend to the many developing countries that are already heavily indebted and/or are experiencing serious difficulties. Spontaneous lending to developing countries was almost confined to Asia; it has shown little tendency to revive in countries that have recently restructured their debt. About 60 per cent of bank lending to developing countries in 1984 and the first half of 1985 was accounted for by "concerted lending" - i.e., new credits extended by banks under the co-ordination of a bank advisory committee and in conjunction with restructuring agreements and IMF-supported programmes.

Reference interest rates (primarily LIBOR and the United States prime rate), which had increased on average by 1-1.25 percentage points in 1984, fell by some 2-2.5 percentage points in 1985. Other borrowing terms of bank credits also eased in 1985, as banks competed heavily for creditworthy borrowers. Average spreads over reference rates on new medium-term loans declined by one-third to a low of 0.60 per cent. As a result, the gap between the spreads paid by developing countries with access to spontaneous bank credits and those for developed market-economy countries narrowed sharply. Spreads applied in restructuring agreements since 1984 have also declined. The maturity of bank lending to developing countries lengthened in 1984. A slight reversal occurred in the first half of 1985, but maturities are still longer than in the early 1980s. In some instances, this lengthening resulted from debt restructuring; in a few countries still commanding access to spontaneous lending it stemmed from their improved bargaining position.

The growth of international bond markets largely bypassed the developing countries, and their share in the world market fell from about 8 per cent in 1981 to about 4 per cent in the first half of 1985. In 1985, four countries (Algeria, Republic of Korea, Malaysia and Thailand) accounted for 80 per cent of the bonds issued by developing countries. Moreover, most developing countries have very restricted access to securities-related lending, and note issuance facilities and other back-up credit facilities have generally been arranged for prime borrowers from developed countries.

<sup>4</sup> A note issuance facility (NIF) is a medium-term arrangement enabling borrowers to issue short-term paper, typically of three or six months' maturity, in their own names. Usually a group of underwriting banks guarantees the availability of funds to the borrower by purchasing any unsold notes at each roll-over date, or by providing a standby credit. Revolving underwriting facilities (RUFs) differ from the note issuance facilities in separating the functions of underwriting and distribution. The leader manager acts as sole placing agent, while underwriters take up any unsold notes or extend loans of an equivalent amount. In Euronote facilities, the paper issued by the borrower is in the form of promissory notes (commonly known as Euronotes).

<sup>5</sup> Data exclude merger-related standbys and renegotiations of outstanding loans.

The fall in bank lending to developing countries in the last four years has been accompanied by a contraction in export credits<sup>6</sup> with respect to both gross and net flows (see annex table 24). The impact of the fall of export credits has been more widely felt by the low-income countries, which have a larger share of their debt in the form of export credits than higher income developing countries. The decrease in export credits reflects both lower import demand from developing countries and the response of export credit agencies to the deterioration in their creditworthiness by a general toughening of the terms and conditions for export credits.

Following the rise in interest rates on international capital markets in 1980 and 1981 and the adoption of more market-oriented attitudes towards export promotion, minimum interest rates under the OECD Arrangement on Officially-Supported Credits registered sharp increases at the end of 1981 and in 1982. Since 1983, when it was agreed by OECD governments to adjust minimum interest rates under the Arrangement every six months in accordance with changes in a weighted average of selected representative interest rates, those rates have tended to move closer to market rates. After remaining at high levels in 1983 and 1984, they declined by about 1 percentage point in January 1985 and again, by the same amount, in January 1986, in line with the general decline of interest rates on capital markets.

As to the other conditions on export credits and their overall availability to developing countries, the tighter stances of export credit agencies prompted by the world depression in the early 1980s and the world debt crisis have not been reversed. As of early 1986, a significant number of developing countries were being excluded from insurance cover or were subjected to various limitations on its availability or to higher premiums (or both). For instance, data concerning the terms on which insurance cover was available in early 1986 from the export credit agencies of two major developed market-economy countries to a sample of developing countries in Africa, East Asia, Latin America and the Caribbean indicate that such cover for medium-term credits was unobtainable or extremely difficult to obtain from one of the agencies for about 40 countries, and from the other for about 25. For only a very small number of

countries, mainly in East Asia, was cover available from these two agencies without any special conditions or surcharges.<sup>7</sup>

The policy debate among OECD countries in the area of export promotion and the external financing of developing countries has been highlighted more conspicuously in recent months by disagreements about "mixed credits" - a form of financing in which aid funds are combined with commercial lending. The scale of such lending is relatively small, but in a situation where excess capacity in major branches of manufacturing in many developed market-economy countries coexists with sharply restricted availabilities of foreign exchange and depressed levels of investment in the majority of developing countries, pressures for the widespread use of "mixed credits" are likely to persist. For the time being, they present the advantages for developing countries of softer terms in comparison with those available from the capital markets. However, it is doubtful whether they actually add to credit flows, either public or private, and whether the terms are softer, on average, than if public and private credits were kept separate. Moreover, they have the disadvantage of tying aid to considerations that may be unconnected to aid itself, and there is clearly a danger that in the process the objective of contributing to economic development may give way to other interests.

The picture as regards the overall growth of activity on international capital markets and the relative importance of different market compartments has not changed in early 1986. Activity in the bond market continued to be vigorous, while bank lending remained depressed. The share of developing countries in total borrowing on capital markets further declined, to about 6 per cent in the first quarter of 1986. Bank lending to those countries will be strongly influenced again by developments in the world economy, in particular regarding oil prices. For the time being, it is expected that, for developing countries as a whole, net financial flows from developed market-economy countries will continue to be small in 1986, and that only a limited proportion of these flows will be spontaneously provided by private creditors.<sup>8</sup> ■

<sup>6</sup> The export credits discussed in this section are loans linked to trade transactions with a maturity of at least one year, where a proportion of the loan is either provided directly or covered by insurance or a guarantee under national programmes established for this purpose. Such programmes usually also provide official support for shorter-term trade financing.

<sup>7</sup> It should be noted that the withdrawal of official insurance cover on occasion reflects the influence of factors outside the financial sphere.

<sup>8</sup> About 60 per cent of net external borrowing is projected as financed by long-term borrowing from official creditors in 1986 (derived from table 22).

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## Chapter V: Notes and references

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*Page*

- 95 Concerning India's requirements for external borrowing see ESCAP, *Economic and Social Survey of Asia and the Pacific 1985* (United Nations publication, Sales No. E.86.II.F.1), p. 33, footnote 6.
- 99 The movements in long-term interest rates in developed market-economy countries are discussed in *OECD Economic Outlook*, No. 38, December 1985, pp. 13-14.

*Annex*

- 113 The data on medium-term and long-term international lending in these paragraphs were taken from OECD, *Financial Market Trends*, No. 33, March 1986.
- 115 For the distribution of borrowing in the form of international bank credits see M. Watson *et al.*, "International capital markets. Developments and prospects", *IMF Occasional Paper No. 43* (Washington, D.C., February 1986), table 4.
- 115 Concerning differences in the coverage of OECD and BIS data on international banking corporations see "Special feature on international capital markets. Historical series" in OECD, *Financial Market Trends*, No. 27, March 1984, and BIS, *Manual on statistics compiled by international organizations on countries' indebtedness*, Basle 1979.
- 115 Concerning the proportion of bank lending to developing countries accounted for by "concerted lending" see Watson *et al.*, *op. cit.*
- 115 For interest rates on, and the maturities of, bank lending to developing countries see OECD, *Financial Market Trends*, No. 33, March 1986, and issues of BIS, *The Maturity Distribution of International Bank Lending* (Basle). The spreads in debt restructuring agreements are described in Watson *et al.*, *op. cit.*
- 115 The figures for bond lending to developing countries are taken from various issues of OECD, *Financial Statistics Monthly*. Part I. *International Markets*.
- 115 For a fuller discussion of recent trends in lending to developing countries in the form of export credits see UNCTAD, *Trade and Development Report, 1985*, Part Two, chap. III, paras. 278-294.
- 116 There is a more detailed discussion of the recent evaluation of the policies of export credit agencies in developed market-economy countries in the forthcoming study by the UNCTAD secretariat, "Trade financing for developing countries: Some aspects of current difficulties and policy responses" (TD/B/C.3/212). The statements concerning the availability of official insurance are based on data in *Euromoney Trade Finance Report*, issues of February, March and April 1986.
- 116 For further discussion of the prospects for financial flows to developing countries see Watson *et al.*, *op. cit.*

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## CHAPTER VI

### DEBT, GROWTH AND DEVELOPMENT: PROSPECTS FOR THE FUTURE

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#### Introduction

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The *Trade and Development Report 1985* drew attention to the weaknesses of the recovery process in industrialized countries and of the strategy being pursued with respect to the debt problems of developing countries. It saw the need for a co-ordinated shift of monetary and fiscal policies in the major developed market economies to bring about a more even pace of demand and output growth, and a depreciation of the dollar. Pointing out that adjustment by debtor countries had depressed investment, it emphasized that, unless growth revived in these countries, their capacity to service debt would fail to expand sufficiently; indeed, it might suffer further erosion. The intimate connection between recovery, on the one hand, and debt and development on the other, was also underlined. The 1985 Report further pointed out that policy reorientation was needed in the major OECD economies to bring about not only more balanced growth in the OECD area, but also a faster overall rate of growth and substantially lower interest rates, since, unless the latter objectives were met, the external trading and financial environment of developing countries would remain hostile, obstructing the revival of investment needed for development and debt servicing. At the same time, unless the debt prospects of developing countries improved, the international financial system, and hence recovery in OECD countries, would remain at risk.

Some elements of this line of reasoning became generally accepted in the course of 1985. It was recognized by the Group of Five developed market economies that the dollar was over-valued, and that the monetary and fiscal policies of the major developed market economies needed to be made mutually consistent to correct international imbalances. It was also acknowledged that debtor developing countries must grow faster in order to be able

to service their debts, and specific proposals designed to achieve this objective were put forward by the Government of the United States at Seoul.

In addition to these altered perceptions, a number of changes have occurred in the world economy and thus in the international environment facing debtor countries. During the past few months interest rates have declined in nominal terms, which will be of considerable benefit to debtor countries. On the other hand, prices of non-fuel primary commodities have continued to be weak while prices of traded manufactures have begun to rise. The most notable change, however, has been the sharp decline in the price of oil. This change, should it persist, will redistribute payments and debt difficulties among developing countries, and for many of them change the character of the problem. For some oil-importing debtor countries, the oil price change, taken by itself, will ease the trade-off between meeting current debt obligations and financing growth. For oil-exporting debtor countries the consequences are severe and call into question the capacity of some countries to meet current interest payments even if highly restrictive measures are taken.

The present chapter takes up some of the issues which arise in connection with events that have occurred since the publication of the 1985 Report. It begins with a brief review of the prospects for debt and development during the coming decade, updating the medium-term scenario analysis contained in that Report, and goes on to discuss some of the possibilities and limitations of policy action in the debtor countries themselves designed to restore financial viability and rapid growth. A third section then discusses issues related to policy orientation and co-ordination in developed market-economy countries. The final section draws a number of conclusions.

## A. Debt and growth: the medium-term outlook

Last year's Report presented scenario analyses, in Part Two, chapter IV, designed to explore the implications for debt and growth of the continuation over the medium term of trends that were in evidence in mid-1985. It reached the conclusion that the continuation of those trends would allow a gradual improvement in the major external financial variables of debtor developing countries, but only at the cost of constraining growth severely. For debtor countries as a group, GDP per capita in 1990 would be barely above the levels reached in 1980, and for the major Eurocurrency borrowers it would be below those levels. Moreover, for the latter countries, the continued net negative transfer of financial resources would mean that per capita domestic absorption in 1990 would be even less than per capita GDP.

The outcome of the scenario analyses reflected the set of assumptions adopted regarding the level and behaviour of major macroeconomic variables in the world economy. It was assumed, among other things, that annual GDP growth in developed market-economy countries would be about 2.8 per cent over the simulation period (1985-1995); that inflation would decline slightly, in line with recent trends; that the dollar would decline in value until 1988 at an average annual rate of 3 per cent, remaining unchanged thereafter; that interest rates would remain unchanged throughout the period at a level of about 11 per cent; and that private bank exposure to debtor developing countries would rise by about 6 per cent over the simulation period. The implicit assumption regarding the price of oil was that it would remain unchanged in real terms from the level at the end of 1984.

A number of these assumptions are no longer as indicative of "recent trends" as they were a year ago. The extent to which recent changes in these variables ought to be taken into account in a medium-term scenario designed to explore economic behaviour over the next decade is a matter of judgement. Some of the recent changes in major variables may well have brought them to levels that will prove to be sustainable over the medium term. Others, in particular the price of oil, may not be sustainable over the next decade as a whole. In such cases the magnitude and timing of further changes will obviously have an important impact on the outcome. In the following discussion, however, the recent changes in major variables have been assumed to hold through-

out the simulation period. This allows for a clearer understanding of their longer-run implications, illustrating the consequences for debtor countries of the continuation of the present world economic situation.

As compared with the scenario contained in the 1985 Report, the present exercise assumes: (i) lower interest rates (7 per cent, instead of 11 per cent); (ii) slightly lower rates of inflation in developed market-economy countries; (iii) a significantly lower value of the dollar; (iv) unchanged rates of growth in developed market-economy countries (2.8 per cent); and (v) substantially lower oil prices. The functioning of the underlying model is such that the first and third of these changes in assumptions improve the growth and debt situation of developing countries. The last change in assumption, on the other hand, has a net negative impact on growth in debtor countries, reflecting primarily the fact that all of the country groupings considered in the scenario analysis (with the exception of the least developed countries) are net oil exporters.

The results of these changes in assumption are shown in table 26, where it may be seen that growth rates and improvements in the external financial variables of developing countries (other than major oil exporters) would be modest. GDP growth could be expected to reach an average annual rate of 3.5 per cent during the period 1985-1990, and would accelerate to 4 per cent thereafter; there would be a widening of the current-account deficit relative to exports throughout the period. Nevertheless, the ratios of interest payments to GDP and to exports would decline. The compatibility of some expansion in deficits relative to exports with a reduction in interest payments relative to exports results directly from the assumption regarding the lower levels of interest rates.

The results differ substantially for the major regions, however. In Latin America, modest growth in output up to 1990 is accompanied by an improvement in the ratio of interest payments to exports, despite some widening in the current-account deficit relative to exports. Thereafter, the prospects appear decidedly more favourable. Two notes of caution need to be sounded, however. The model assumes that net financial flows to Latin America will rise more rapidly than these countries' export earnings between now and 1990, a prospect that is not suggested by their most recent experience. Second, substantial

Table 26

DEVELOPING COUNTRIES: MEDIUM-TERM SCENARIOS, 1985-1995  
(Percentage)

<i>Variable/period</i>	<i>1985</i>	<i>1990</i>	<i>1995</i>
<i>I. Non-oil-dominant developing countries</i>			
Average annual GDP growth rate <sup>a</sup>	---	3.5	---
<i>Ratio of:</i>			
Interest payments to GDP	3.2	2.6	2.0
Debt to GDP	40.6	37.5	31.6
Interest payments to exports	11.2	9.5	7.0
Debt to exports	142.5	135.6	110.9
Current-account balance to exports	-6.3	-11.3	-13.2
<i>II. Developing countries by regional grouping</i>			
<i>Latin America</i>			
Average annual GDP growth rate <sup>a</sup>	---	3.4	---
<i>Ratio of:</i>			
Interest payments to GDP	4.4	3.1	1.7
Debt to GDP	46.6	36.1	21.1
Interest payments to exports	20.7	15.7	8.6
Debt to exports	219.8	181.9	104.9
Current-account balance to exports	-4.1	-6.7	-2.2
<i>Africa <sup>b</sup></i>			
Average annual GDP growth rate <sup>a</sup>	---	2.7	---
<i>Ratio of:</i>			
Interest payments to GDP	3.8	5.9	8.0
Debt to GDP	74.4	112.4	139.3
Interest payments to exports	14.6	23.5	30.5
Debt to exports	283.5	444.9	529.1
Current-account balance to exports	-46.8	-64.9	-70.7
<i>Asia <sup>c</sup></i>			
Average annual GDP growth rate <sup>a</sup>	---	4.3	---
<i>Ratio of:</i>			
Interest payments to GDP	1.9	1.2	0.5
Debt to GDP	28.6	19.3	13.6
Interest payments to exports	5.2	3.2	1.3
Debt to exports	76.7	53.0	35.8
Current-account balance to exports	-1.8	-3.8	-8.2

*For source and notes, see end of table.*

negative net transfers, amounting to as much as 20 per cent of exports, must be maintained throughout the period, indicating that domestic absorption will continue to fall below levels of output.

The outlook for Africa is far from encouraging. Growth rates remain at relatively low levels throughout the period, and this performance is accompanied by a substantial worsening of all the external financial variables.

In Asia, on the other hand, relatively high growth and a slight widening of the current deficit relative to exports are compatible with a decline in the ratio of interest payments to exports which is, in any event, at a relatively low level.

In sum, when the assumptions regarding the behaviour over the medium term of major world economic variables are modified to reflect present conditions more closely, the out-

Table 26 (continued)

DEVELOPING COUNTRIES: MEDIUM-TERM SCENARIOS, 1985-1995  
(Percentage)

Variable/period	1985	1990	1995
<i>III. Developing countries by economic grouping</i>			
<i>Major developing country Eurocurrency borrowers</i>			
Average annual GDP growth rate <sup>a</sup>	--- 3.4	---	4.2 ---
<i>Ratio of:</i>			
Interest payments to GDP	3.8	2.6	1.3
Debt to GDP	41.0	29.7	16.7
Interest payments to exports	14.1	9.7	4.8
Debt to exports	152.2	110.2	60.3
Current-account balance to exports	-2.4	-2.9	-4.3
<i>Least developed countries</i>			
Average annual GDP growth rate <sup>a</sup>	--- 2.2	---	2.5 ---
<i>Ratio of:</i>			
Interest payments to GDP	1.8	2.2	2.4
Debt to GDP	64.0	71.4	76.8
Interest payments to exports	10.4	11.9	12.2
Debt to exports	367.5	393.9	386.3
Current-account balance to exports	-69.3	-60.5	-59.0
<i>Other non-oil dominant developing countries</i>			
Average annual GDP growth rate <sup>a</sup>	--- 3.9	---	3.9 ---
<i>Ratio of:</i>			
Interest payments to GDP	2.3	2.6	3.1
Debt to GDP	37.6	47.6	53.9
Interest payments to exports	7.0	8.8	10.2
Debt to exports	115.7	159.5	174.9
Current-account balance to exports	-8.6	-21.5	-24.8

*Source:* UNCTAD secretariat calculations based on SIGMA projections. (See *Trade and Development Report 1985*, technical annex to Part Two, chapter IV, section B.1.)

*Note:* *Non-oil dominant developing countries* comprise all developing countries other than the seven countries for which exports of fuel and lubricants (SITC 3) accounted for at least 85 per cent of total exports of goods and the share of mining and quarrying was over 35 per cent of GDP during the period 1980-1983 (or 1980-1982, when 1983 data were not available). The seven countries are: Iraq, Kuwait, Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia and the United Arab Emirates. *Major developing country Eurocurrency borrowers* are those countries with cumulative borrowings in the Eurocurrency markets exceeding \$2.7 billion, i.e., representing at least 1.5 per cent of Eurocurrency credits to developing countries over the period 1979-1983. *Exports* refer to both goods and services.

<sup>a</sup> Period average.

<sup>b</sup> Excluding Algeria, Libyan Arab Jamahiriya and Nigeria.

<sup>c</sup> Excluding the oil-dominant economies.

look for debt and development does not change significantly, although some improvements in particular situations can be detected. The examination of regional situations (which was not undertaken in last year's Report) reveals the potential for the emergence of a debt situation in Africa that can only be described as alarming.

A characteristic of the scenario analysis in table 26 is the increased diversity of the financial and growth situations of individual debtor countries that is hidden within the various aggregates. This diversity of experience mainly reflects the opposing impacts of the fall in oil prices on oil-importing and on oil-

exporting debtor countries. Under such circumstances the behaviour of aggregates or averages is less meaningful. Such aggregates, even when they show some improvement, can mask severe and worsening difficulties that can lead to a breakdown, triggering consequences that would not be suggested by the aggregates alone.

The above exercises suggest that a re-inforcement of existing policies and further policy adaptation will be required at the national and international levels if rapid growth and a viable external financial position are to be restored in debtor developing countries.

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## **B. The scope and effectiveness of domestic policies in debtor countries**

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Recent policy discussions, in particular concerning the United States initiative on debt of 1985, have tended to focus relatively more attention on measures that could contribute to lifting output and economic performance over the medium to long term. This is a welcome change from the previous approach, which tended to be restricted to questions of demand management. Improvements in domestic policies in debtor countries themselves have an important role to play in overcoming current difficulties relating to debt and development. Policy improvements to enhance growth in the longer term need to be sought over a broad front, but the central issue is the need to ensure that domestic resources are effectively mobilized for development and that the allocation of these resources is designed to maximize their impact in breaking development bottlenecks and laying the groundwork for rapid growth and development in the future.

The present section does not discuss in detail the various measures and actions that might contribute to achieving these broad objectives. Rather, it attempts to explore the interface between domestic measures and the external environment, highlighting the interaction between the likely success of domestic policy action and the external environment. In this perspective two broad areas of policy action are reviewed briefly: the effective mobilization of domestic savings for development and the role of supply-side measures in sustaining growth.

### *1. Improving savings performance*

The reduction in net financial flows to developing countries and the emergence of negative net transfers makes it all the more important to improve the effective mobilization of domestic savings. A more intense savings effort by developing countries themselves could offset, at least in part, the diminished financial possibilities resulting from lower net flows from abroad. A number of policy measures could

help enhance savings availabilities. These include (but are not limited to) raising real rates of interest; the adoption of a better fiscal posture by governments; and the maintenance over time of "realistic" exchange rates, which could help stem capital flight, thereby increasing the savings at the disposal of domestic investors. The question that arises is whether more intense domestic savings efforts, taken by themselves, could suffice to finance the higher levels of investment required to restore growth to adequate levels while ensuring normal (albeit reduced) financial relations with the outside world.

While there can be little doubt that increased efforts are needed in many countries to boost savings and growth performance, the fact that their scope and effectiveness often depend on the external environment is not always fully grasped. For one thing, in countries whose trading and financial environment has deteriorated substantially, of which there are many, the increase in domestic savings required to offset its adverse consequences may require a degree of social cohesion that is beyond any country's reach. Moreover, drastic import cuts depress income and thereby reduce the scope for increasing savings. Second, the impact on savings of the measures often recommended is not always certain, since it depends on their interaction with the external financing difficulties of these countries, and on whether these difficulties temper, or perhaps nullify, the expected results of domestic policy action. Third, even where the scope for mobilizing domestic savings is substantial, the extent to which investment can be raised in consequence depends on how far the forgone consumption helps to ease the balance-of-payments constraint. In many developing countries the import content of investment is high; unless the resources released through consumption cuts help to raise export earnings, increased savings may not result in increased investment but in lower output. The following paragraphs examine the first two aspects of this problem, and the last aspect will be taken up in the next section in the context of import substitution and export promotion.

The deterioration in the terms of trade of developing countries during the 1980s means that supply available for domestic use has fallen in relation to domestic output. Consequently, the maintenance of investment out of a given volume of domestic output would require the full brunt of the reduction in real output available for domestic use to fall entirely on current consumption. However, conventional measures of savings fail to allow for this. For instance, in a developing country with an import/GDP ratio of 25 per cent and a consumption/GDP ratio of 85 per cent, a 10 per cent decline in the terms of trade (and hence in import volume) would require real domestic consumption to fall by about 3 per cent if investment, output and exports are to remain unchanged. This would correspond to a rise in real savings of more than 15 per cent.

The consequences of a deterioration in the external financial environment are also serious. Since interest payments to non-residents are a first claim on domestic savings, an increase in interest rates on outstanding debt necessarily reduces national savings (defined here as domestic savings less net factor income payments to non-residents), and hence reduces the volume of investment that can be financed from domestic savings. Under such circumstances the maintenance of investment requires domestic savings to be increased. For instance, in a developing country with a debt/GDP ratio of 60 per cent and domestic savings/GDP ratio of 15 per cent, a 5-percentage point rise in interest rates on outstanding debt requires the domestic savings ratio to rise from 15 per cent to 18 per cent of GDP, i.e. by 20 per cent, in order to avert a decline in investment.

A cutback in lending aggravates the problem, since it too has to be compensated by increased domestic savings if investment is to be maintained. Its effect is symmetrical to that of increased interest rates: a 5 percentage point reduction in the rate of growth of the external debt of a developing country with a debt/GNP ratio of 60 per cent and domestic savings/GDP ratio of 15 per cent would require an additional 20 per cent increase in domestic savings.

A large number of developing countries have experienced a serious deterioration in both the external financial and the trading environments during the 1980s. While the order of magnitude may vary from country to country, the additional savings effort required to offset the adverse consequences of the decline in the terms of trade, the rise in interest rates and cut-back in lending has been substantial. On average, a rise in savings of at least 50 per cent over a short period of time would have been required - something that is far beyond the

reach of almost any country, whether developing or developed. It is therefore hardly surprising to find that in a number of countries investment fell drastically, and that the growth of real output (or in a number of cases even the absolute level of output) fell, further reducing the scope for increasing savings.

The difficulties experienced in their external accounts have led governments of debtor developing countries to adopt policies designed to redress external imbalances, but these policy responses have often had the unwanted side-effect of impairing the capacity of private business to save and invest. Thus, a frequent response has been currency devaluation. Where the required fall of the real exchange rate was sharp, the financial position of domestic firms that had borrowed substantial amounts in foreign currency was impaired, often very considerably, by the increase in the domestic currency equivalent of their foreign obligations; to the extent that these firms were engaged in exporting, this was offset by the increased domestic currency equivalent of net export earnings. Domestic firms that were highly indebted in terms of domestic currency were also hit by adjustment programmes that included sharp increases in interest rates. Firms' balance sheets and profits generally were also weakened where domestic demand was lowered. For these reasons, in many countries business lost, in whole or in part, the capacity to generate savings.

Such effects were strongly felt in a number of debtor developing countries and caused serious liquidity problems for a large number of domestic producers, even to the point of their becoming technically insolvent. This in turn had an impact on the viability of domestic financial institutions, through the effect on the quality of their loan portfolio. In a number of countries the financial difficulties of firms have so impaired the viability of the domestic financial system that it has come to depend on official intervention (involving charges on the government budget) in order to ensure its continued functioning. In some cases doubts about the viability of financial institutions have led domestic savers to seek outlets for their wealth abroad. The domestic financial system has thus been impeded from playing its role of mobilizing domestic savings and allocating it among alternative domestic users.

While financial rescue operations have increased the claims on the government budget, measures taken to deal with the crisis in the external accounts have also impaired the capacity of governments to generate public sector savings. Here, too, sharp currency depreciation has been an important factor, since it raised the



domestic currency cost of servicing the external public debt, and hence aggravated the budget problem created by high interest rates and debt-service obligations. Moreover, where domestic interest rates have been raised substantially in order to prevent a collapse of the currency and forestall capital flight, internal debt-service obligations have also risen. Except where the government was in a position to reduce other expenditure or raise taxes (both of which are extremely difficult undertakings in a situation in which real incomes are falling), the public sector budget balance deteriorated and public sector savings fell.

In many developing countries receipts from tariffs have been an important source of revenue for the central government. Where external payments difficulties required sharp cutbacks in imports, government revenues fell correspondingly, reducing public sector savings. The effect was exacerbated where tariffs were replaced by currency devaluations as part of an adjustment programme.

Capital flight, which has been important in some developing debtor countries, has also had a bearing on investment. In part, it constitutes an outflow of current savings, thereby reducing what is available for current domestic investment: capital flight that results from over- and under-invoicing trade transactions, for example, reflects part of the current savings effort. But capital flight has also occurred on the basis of domestic funds raised from the sale of domestic assets. Where this has taken place on a substantial scale, and in particular where it has involved "distress sales" of domestic assets, capital flight has often been associated with pressure on the real value of domestic assets. The resulting fall in the real value of assets, and in particular of equity, in the productive sector has created conditions which impeded productive investment.

Thus, the deterioration in the external financial and trading environment has enlarged the gap between aggregate (i.e., domestic and external) savings and investment necessary for steady and satisfactory growth, not only by reducing the availability of external savings and draining the domestically generated savings, but also by adversely affecting domestic savings performance. As may be seen from table 27, gross domestic savings relative to gross domestic product declined between 1975-1977 and 1982-1983; the decline was even sharper for Eurocurrency (i.e., major debtor) countries as a group than for developing countries as a whole. Over the same period, interest payments on external debt rose markedly, so that net factor income payments to non-residents more than doubled relative to GDP for developing countries as a group, and for major

debtor countries as a group. As a consequence, national savings fell more sharply than did domestic savings: for major debtor countries as a group the fall between 1975-1977 and 1982-1983 amounted to no less than 5 per cent of GDP. Since external savings did not compensate for the rise in net factor income payments and the decline in national savings, investment as a percentage of GDP also fell.

The impact of weaker savings performance and increased external claims on savings generated varied considerably among debtor countries, as may be seen from table 28. Although the figures for individual countries may be subject to a wider margin of error than the aggregates in table 27, they none the less illustrate the extent to which the savings ratio declined between the mid-1970s and the early 1980s. In some Latin American countries (Argentina, Brazil and Chile) the fall in national savings relative to gross domestic product has been of the order of 10 percentage points; in Chile, the fall has been such that national savings alone are now insufficient even to maintain the capital stock.

In most countries where efforts to increase domestic savings have been successful, national savings and investment as a percentage of GDP have nevertheless declined, or failed to rise, because of worsened external financial conditions. In countries such as Mexico, Peru, Ecuador and the Republic of Korea, domestic savings ratios were higher in 1982-1984 than in the mid-1970s, but investment ratios were not. Indeed, an examination of a broader sample of 44 developing countries indicates that investment as a percentage of GNP declined in 31 countries in 1982-1983 compared with 1976-1978, even though domestic savings were higher in 11 of them. Thus, in countries where domestic savings efforts were successful, they were not sufficient to compensate for the deterioration in the external environment, even during the recent period of recovery.

In sum, the current crisis has set in motion a number of forces that have reduced substantially the capacity of developing countries to finance development through their own efforts to mobilize domestic savings. The past few years have witnessed a situation in which an increased savings effort (in terms of consumption forgone) has not given rise to an increase in savings performance (savings as a proportion of GDP) and in cases where it has, the total savings available for domestic investment have failed to rise as capital flight and the negative net transfer took their toll. This experience also suggests that there are close links between the external financial and trading environment and the capacity of countries to



Table 27

**DEVELOPING COUNTRIES: TRENDS IN SAVINGS AND GROSS CAPITAL FORMATION, 1970-1983**  
(Percentages, based on values in current prices)

Country group	Period/ year	Ratio to GDP of:				
		Gross domestic savings	Net factor income	Gross national savings	External savings <sup>a</sup>	Gross capital formation
All developing countries	1970- 1972	19.0	-2.0	17.0	3.4	20.4
	1975- 1977	24.0	-1.2	22.8	2.8	25.6
	1981	21.7	-1.9	19.8	5.1	25.2
	1982	21.6	-2.5	19.1	4.3	23.8
	1983	21.8	-2.1	19.7	3.4	24.2
Major Eurocurrency borrowers <sup>b</sup>	1970- 1972	21.1	-2.7	18.4	3.4	21.8
	1975- 1977	26.8	-1.3	25.4	1.6	27.1
	1981	23.3	-2.6	20.7	4.4	25.2
	1982	23.1	-3.5	19.6	3.8	23.4
	1983	24.2	-3.2	21.0	2.5	23.5
Least developed countries	1970- 1972	6.9	-0.2	6.7	4.7	11.4
	1975- 1977	5.6	0.0	5.6	8.3	13.9
	1981	4.2	0.4	4.5	12.3	16.8
	1982	3.9	0.5	4.4	11.5	15.9
	1983	3.9	0.4	4.3	11.4	15.7
Other developing countries	1970- 1972	17.7	-1.3	16.3	3.4	19.7
	1975- 1977	21.1	-1.0	20.1	4.3	24.4
	1981	20.3	-0.8	19.5	5.7	25.2
	1982	20.2	-0.8	19.4	4.7	24.1
	1983	19.2	-0.5	18.8	4.3	23.0

**Source:** UNCTAD secretariat calculations, based on data provided by the United Nations Department of International Economic and Social Affairs.

<sup>a</sup> Defined as net imports of goods and non-factor services less net factor income.

<sup>b</sup> Algeria, Argentina, Brazil, Chile, Hong Kong, Indonesia, Iran (Islamic Republic of), Malaysia, Mexico, Morocco, Nigeria, Peru, Philippines, Republic of Korea, Venezuela.

mobilize savings internally. Most developing countries are unlikely to be able to make up, to any significant extent, through an improved savings performance, for the non-availability of external finance and the deterioration in

trading conditions, at least in the relatively near future. Rather, the success of such efforts will depend essentially on the resumption of growth, and hence on the improvement in the external environment.

Table 28

**SAVINGS AND GROSS CAPITAL FORMATION  
IN SELECTED DEVELOPING COUNTRIES, 1975-1977 AND 1982-1984**  
(Percentages, based on values in current prices)

Country	Period	Ratio to GDP of:				
		Gross domestic savings	Net factor income	Gross national savings	External savings <sup>a</sup>	Gross capital formation
Argentina	1975-1977	30.5	-1.1	29.4	-2.2	27.2
	1982-1984	18.7	-7.0	11.7	2.5	14.2
Brazil	1975-1977	25.7	-1.9	23.8	3.7	27.6
	1982-1984	20.2	-5.5	14.7	2.6	17.3
Cameroon	1975-1977	17.4	-2.5	14.9	6.1	21.0
	1982-1984	29.0	-3.7	25.3	0.3	25.6
Chile	1975-1977	13.8	-2.9	10.9	3.0	13.9
	1982-1983	9.8	-9.1	0.7	8.3	9.0
Colombia	1975-1977	20.6	-1.7	18.9	-1.0	17.9
	1982-1984	15.9	-3.4	12.5	7.1	19.6
Ecuador	1975-1977	22.3	-2.5	19.8	5.9	25.7
	1982-1983	23.8	-7.4	16.3	3.1	19.5
Kenya	1975-1977	21.5	-4.3	17.2	3.9	21.1
	1982-1984	18.3	-3.6	14.7	6.5	21.2
Malaysia	1975-1977	29.6	-3.7	25.9	-2.9	23.0
	1982-1984	29.5	-5.4	24.1	9.8	33.9
Mexico	1975-1977	21.8	-1.9	19.9	3.0	22.9
	1982-1984	29.0	-6.5	22.5	-1.9	20.6
Peru	1975-1977	11.3	-2.4	8.8	8.3	17.1
	1982-1984	15.3	-6.1	9.2	5.1	14.3
Philippines	1975-1977	24.2	-0.6	23.6	6.1	29.7
	1982-1984	19.9	-1.6	18.3	6.3	24.6
Republic of Korea	1975-1977	23.9	0.3	24.2	3.5	27.7
	1982-1984	26.7	-2.2	24.5	3.2	27.7
Venezuela	1975-1977	36.0	0.0	36.0	0.1	36.1
	1982-1984	24.7	-3.6	21.1	-3.3	17.8

Source: UNCTAD secretariat calculations, based on World Bank data.

<sup>a</sup> Defined as net imports of goods and non-factor services less net factor income.

## 2. *The possibilities and limitations of supply-side adjustment*

An issue that has received considerable attention in recent years is the extent to which growth in developing countries can be enhanced through various measures designed to increase the efficiency with which resources are allocated in debtor countries. Since activity and growth in many of these countries are constrained largely by the balance-of-payments situation, the impact of such measures on performance depends largely on how far they can help to ease the external constraint. This in turn depends partly on the scope for increasing the supply of tradeables, but also partly on demand conditions in world markets.

Since developing countries' imports serve as inputs into production and investment, a faster expansion of the economy typically requires the pace of import growth to quicken, or else the import content of output to decrease steadily. Where external finance is not forthcoming, a faster growth of imports requires the supply of exportables to be accelerated by reallocating resources from the domestic to the foreign sector, or by improving efficiency in the production of exportables. Similarly, a reduction in the import content of domestic output can be achieved by means of import substitution or greater efficiency in the use of imports.

A key policy instrument for increasing the rate of growth of exports and/or decreasing the import component of growth is the exchange rate. It is the impact of changes in exchange rates in expanding export earnings and enhancing growth possibilities per unit of imports that provides the main link between exchange rate policies and feasible growth paths. By raising the price of export goods and of imports in terms of domestic currency, depreciation of the real exchange rate serves to divert output from the home market to exports, and to provide incentives to increase exportable output by shifting resources to export sectors. At the same time, the increased cost of imports leads to the substitution of domestic goods for imports in both consumption and production and stimulates the production of such goods.

A further route through which enhanced efficiency in resource use can boost growth concerns the use of domestic inputs in the production of exports or import substitutes, and the use of imported inputs in domestic production. Where such improvements in efficiency can be obtained, both the rate of export

growth and the level of domestic output associated with any level of imports can be raised over and above the level that would be possible by resource reallocation as a result of depreciation. Any increase in the efficiency of resource use in sectors that neither use imports as inputs nor produce exports would also allow the relationship between imports and growth to improve. Such gains in efficiency can come about by changing the prices of domestic goods and services to make them reflect more accurately their scarcity value or by improving the organization of factors of production and of inputs via institutional changes.

The impact of changes in relative prices on domestic performance and external balance depends over the short term on a number of factors, including the share of tradeables in national output and the ease with which resources can be shifted to foreign trade sectors. In countries with large trade sectors, and having also substantial industrial capacity permitting output to be changed relatively easily or increased by shifting resources and utilizing installed capacity more fully and efficiently, a real depreciation of the currency will both affect a large proportion of national output and induce changes in its structure. It may then be possible to improve the external balance without undergoing "stagflation". However, as is the case in many commodity-producing countries, where tradeables constitute a smaller share of the total product and the technology in use does not allow a rapid and sizeable supply response, very large changes may be required in the exchange rate and in relative prices in order to attain a given improvement in external balance, and the improvement in the current account will entail a significant reduction of real wages, and/or a substantial loss of output and employment. Indeed, in most countries where external payments improved during the last few years by means of import cuts and export expansion, output and/or investment fell substantially.

When several developing countries simultaneously attempt to generate trade surpluses in order to service their debts and finance their development, the result can be to depress the terms of trade. This is particularly true for primary commodities with a low price elasticity. When a number of developing countries devalue their currencies or encourage production and export of commodities in various other ways, the impact on overall export earnings may even be perverse.<sup>56</sup>

The longer term provides greater scope for increasing the share of tradeables. This is

<sup>56</sup> See *Trade and Development Report 1985* Part Two, chap. III.F, and also chapter III above, sect. B.3.

partly because time itself enlarges the opportunities for substitution and the shifting of resources. But a more important reason is that new investments allow new priorities to be reflected in the production profile. For that reason, it is the level of new investments that plays the commanding role in the process of improving efficiency, changing the output mix, and increasing the supply of tradeables - i.e. adjustment. If a country cannot generate adequate foreign exchange earnings from its present production structure, it will be unable to transform that structure unless external finance is forthcoming, since the investment and growth that such a transformation depends on require increases in imports. If investment is depressed below a certain point, the supply of tradeables may not expand as rapidly as debt-servicing obligations and the needs of a growing population, eventually resulting in a further deterioration in the external balance. Avoiding such a spiral requires both internal and external conditions to be put right.

While there can be little doubt that an improved growth performance can be achieved in many developing countries by improvements in policies and resource allocation, the question arises as to what extent this is possible in the absence of an improvement in the external environment. In order to explore this question, models constructed in UNCTAD have been used to examine the magnitude of the changes in the growth rates of exports and in the statistical relationship between imports and growth in debtor economies that would be required to bring about a significant improvement in the growth performance of these economies. The exercise has been carried out on the assumption that there would be no change over the coming years in the net flow of financial resources to these countries as compared with recent trends.

The results of this exercise are illustrated for major Eurocurrency borrowers and for least developed countries in figures 5 and 6 respectively. For major borrowers, the exercise specifically asks what change would be required in the relationship between imports and growth or in the penetration of foreign markets in order to achieve a rate of growth of 5 per cent (the rate of growth in developed market-economy countries, the level of capital inflow and interest rates being held constant). In figure 5, point A reflects recent trends for major borrowers, and the two lines show the combinations of the two variables that would be required in order to reach the 5 per cent target growth rate on alternative assumptions regarding growth in OECD countries. As may be seen, the attainment of this target rate of growth would require a decrease of the import

elasticity of growth by one-third (assuming that the export penetration of major debtors remains constant) or a 20 per cent increase in the rate of export penetration by major debtor countries of OECD markets (assuming that the import elasticity of growth remained unchanged), if OECD growth is restricted to 3 per cent. Alternatively, the target rate of growth could be achieved through various combinations of changes in the two variables.

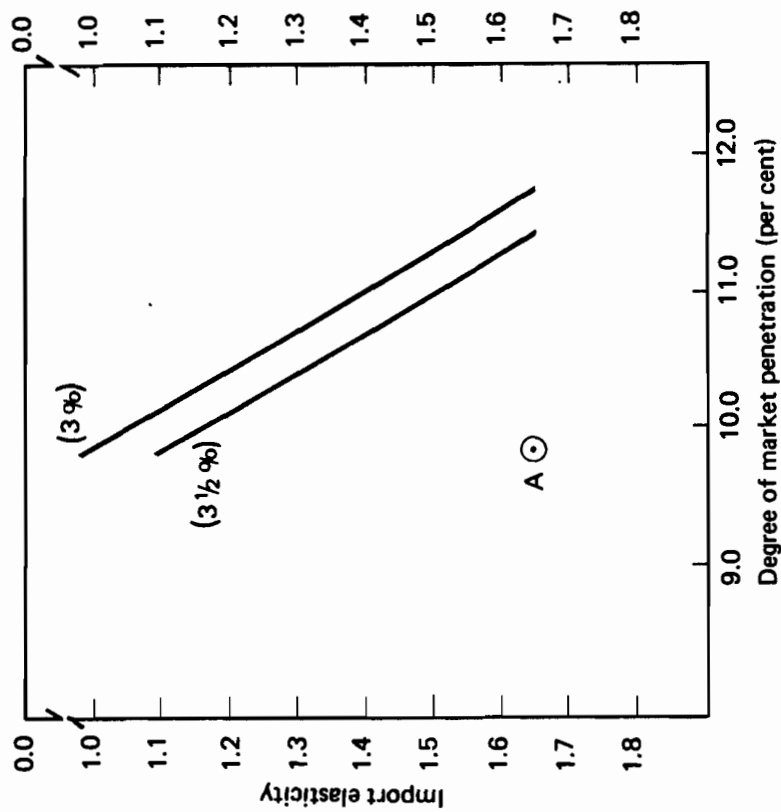
As may be seen from this analysis the magnitude of change required of major borrowers is substantial. There is, for example, no historical precedent for sustained changes of this order of magnitude in the Latin American countries. Looking outside the region, it is to be noted that in the Republic of Korea, Thailand and Malaysia, market penetration did rise substantially between the first and the second halves of the 1970s, by 90, 40 and 30 per cent, respectively. During that period, however, the import elasticity of growth rose in the Republic of Korea and Thailand and fell by only 7 per cent in Malaysia. The available historical evidence thus suggests that improved growth performance would depend primarily on the capacity of countries to increase rapidly export earnings by capturing a larger share of external markets. This, of course, would be possible only if an open and liberal trading regime is maintained and export efforts are not countered by import restrictions.

Figure 6 traces the results of a similar exercise undertaken for the least developed countries. However, the relevant measure of export performance for these countries is different: they are mainly exporters of primary commodities and collective efforts by them to expand the volume of their exports could be expected to result in reducing prices of at least some of the commodities concerned. The relationship between increased export effort and export earnings is thus ambiguous. Figure 6 consequently relates the rate of change of the terms of trade of these countries to their import elasticity and growth. As may be seen, achievement of the relatively modest annual rate of growth of 3 per cent over the period 1986-1990 would require a continuous improvement in their terms of trade of 5 per cent per annum compared with 2 per cent, which reflects recent trends (assuming that the import elasticity of growth remained unchanged) or a 40 per cent reduction in the import elasticity of growth (assuming no such improvement of the terms of trade).

The terms of trade of the least developed countries depend on the pace of growth of industrial countries. Various estimates suggest that a 1-percentage point increase in the latter's growth rate would improve the terms of trade

Figure 5

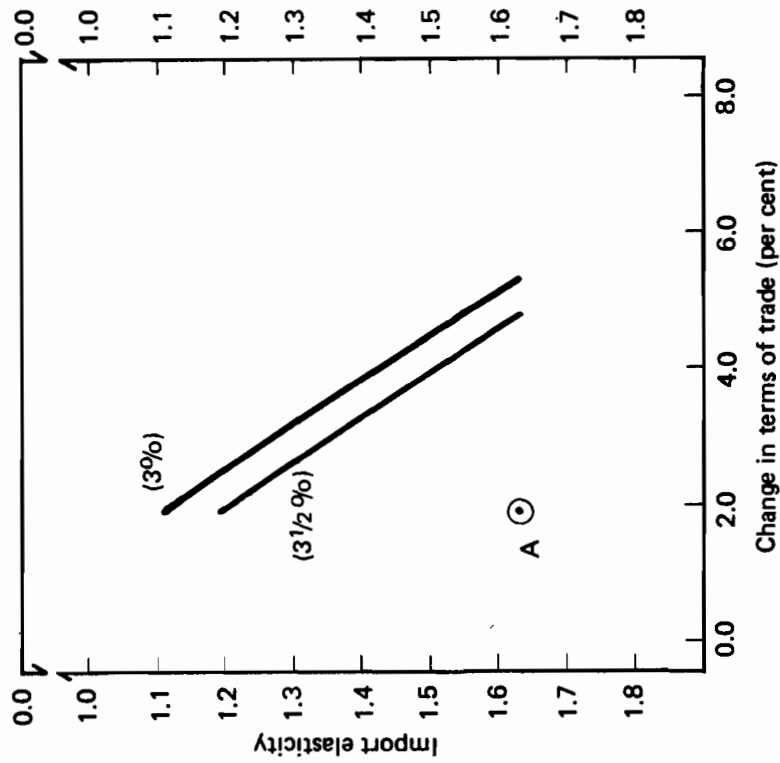
DEVELOPING COUNTRIES BORROWERS IN THE EURO CURRENCY MARKET: COMBINATIONS OF IMPORT ELASTICITIES AND MARKET PENETRATION REQUIRED TO ACHIEVE A 5 PER CENT ANNUAL GROWTH OF GDP FROM 1986 TO 1990



Source: As for table 26.  
 Note: Figures in parentheses are rates of growth of GDP of the developed market-economy countries. Point A represents the projection of recent trends. Market penetration is measured as the percentage share of the Eurocurrency borrowers in the imports of the developed market-economy countries.

Figure 6

LEAST DEVELOPED COUNTRIES: COMBINATIONS OF IMPORT ELASTICITIES AND CHANGE IN THE TERMS OF TRADE REQUIRED TO ACHIEVE A 3 PER CENT ANNUAL GROWTH OF GDP FROM 1986 TO 1990



Source: As for table 26.  
 Note: Figures in parentheses are rates of growth of GDP of the developed market-economy countries. Point A represents the projection of recent trends.

of the least developed countries between 1 and 2 per cent. Even taking the larger figure, an increase in the growth rate of the industrial countries from 2.8 per cent (the average for 1985) to 3.5 per cent would not improve the terms of trade sufficiently to make a 3 per cent growth rate in least developed countries possible. Therefore, in these countries, an improvement in efficiency would be needed in order to reduce the import requirements of growth and to expand export volumes, especially of non-traditional products. Such an effort would require substantial investment, leading to an initial deterioration in the current-account balance. Hence additional flows of external finance would be a prerequisite.

Although the options and possibilities obviously vary greatly among individual countries within these two groups, the overall impression that emerges from the above analysis is that an acceleration of growth in developing countries in the absence of an improved external environment would require far-reaching

changes in the relationship between these economies and the outside world. While such changes can undoubtedly be promoted by changes in relative prices, the development of entrepreneurship and institutional reforms, the process is one that is unlikely to be accomplished swiftly, even with the most vigorous efforts. In an unchanged external environment, programmes of supply-side reform are therefore unlikely to have a significant impact on growth performance in the near future.

The lesson to be drawn from all this is not that domestic policies do not matter, or that they cannot, or should not, be improved. Rather, it is that the scope for successful policy action and the benefits that can be expected from it are tightly constrained by the complex set of interrelations that exist between the external environment and domestic measures. Thus, to a large extent, improvements in domestic policies cannot be seen as a substitute for improvement in the external environment; rather, the two must go hand-in-hand.

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### C. Policy adaptation and co-ordination in developed market-economy countries

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#### 1. *The need for growth-oriented policies*

Previous chapters have shown that the world economy is presently characterized by substantial slack, with unemployment at record levels and capacity utilization in manufacturing still relatively low, despite three years of recovery. At the same time, the current-account imbalances among the developed market economies and the debt crisis of developing countries have been creating serious strains in the trading and financial systems. Non-oil commodity prices remain depressed, and oil prices have collapsed. Output growth has slowed down. These deflationary pressures are accompanied by continued disinflation of the price level, which is likely to continue in most countries due to the impact of lower oil prices. The dollar has fallen to more realistic levels, holding out the promise of lessened protectionism.

More importantly, the major industrial countries have now explicitly recognized the need for co-ordination of their policies in order to ensure that they are conducive to exchange rate stability and the reduction of trade imbal-

ances. For most governments, this marks a major change of view as to how exchange markets work and the extent to which exchange rates are in line with economic fundamentals. In particular, it indicates a readiness to accept that currency markets can be influenced and exchange rates altered by concerted action. Moreover, in recent months governments have put forward various ideas regarding the use of objective indicators to assess the need for policy action. However, despite the heightened awareness of the need for exchange rate management, and the renewed interest in exchange rate targeting, recent initiatives have not advanced towards reforming the international monetary system by institutionalized exchange rate management.

Nor, as yet, has the recognition of the need for co-ordination resulted in any concrete steps to provide the stimulus needed for a more rapid and balanced growth of economic activity. Indeed, although a sizeable cut in fiscal deficits is planned in the United States, a further withdrawal of fiscal stimulus is in prospect in Western Europe and Japan. Moreover, real interest rates remain high and it is possible that a further decline of the dollar will induce a re-

newed tightening of United States monetary policy.<sup>57</sup> The present mix of policies, combined with the depreciation of the dollar, may lessen the disparity in demand creation over the medium term and greatly reduce the United States trade deficit and Japanese surplus. However, it would do so at the cost of a downward convergence of growth paths, adding to unemployment and the financial pressures on developing countries.

In the United States, dollar depreciation will exert upward pressure on the price level while the fiscal contraction will add to unemployment. The latter, by reducing domestic demand, will tend to lessen inflationary pressures, but the impact of the depreciation will be stronger: empirical evidence suggests that a dollar depreciation of 10 per cent pushes up the price level by 2-2.5 per cent over a period of two or three years, whereas it would take the elimination of most of the budget deficit to reduce the inflation rate by the same amount. Dollar depreciation will reduce the leakage of demand abroad, and hence add to the growth in GNP, but this effect may be much weaker than the contractionary pressure from the cut in budget deficits. The combined effect of the depreciation of the dollar and cuts in budget deficits on the United States economy is therefore likely to be "stagflationary".<sup>58</sup> To the extent that there is an attempt to counteract the inflationary impact of the dollar's depreciation by further cuts in budget deficits and/or tighter monetary policy, the deflationary impact would be deepened. If, on the other hand, a further depreciation of the dollar is sought to avoid deflation, inflationary pressures would increase.

Dollar depreciation combined with budget cuts, by reducing the growth of demand in the United States and its rate of leakage abroad, would exert strong deflationary pressures on Japan and Western Europe. Inflationary pressures would be attenuated; but, since inflation has already been brought down to very low levels, the benefits of this impact cannot weigh heavily against the costs in terms of output and employment.

For developing countries the impact could be even more unfavourable. If the dollar depreciation prompted a tightening of United States monetary policy, interest rates would rise. Even if it did not, the slowdown in demand growth in OECD countries as a whole

would put downward pressure on commodity prices and export earnings generally.

The decline in oil prices must also be taken into account. It will reduce inflationary pressures in OECD countries as well as in non-oil-exporting developing countries, but the impact on output of the international redistribution of purchasing power that will result from lower oil prices will depend on a host of factors, including differences in national propensities to spend and to import (see chapter V, section A.5). The outcome for world trade and production is unlikely to be favourable unless oil-exporting countries refrain from taking adjustment measures by resorting instead to borrowing and/or a drawing down of reserves, or unless the major oil-importing countries take expansionary measures. In other words, the impact of the decline in oil prices will depend on policy responses in all the countries concerned.

In short, there is both scope and need for policies in the developed market economies to be reoriented towards growth, over and above what is necessary to correct their trade imbalances. If a substantial and lasting improvement in the overall performance of the world economy is to be attained, policy objectives must encompass the reduction of slack and unemployment in the context of a rapid and sustained growth throughout the world economy, including the developing countries. This requires both a further lowering of interest rates and a revival of capital flows and of trade finance. It also requires a strengthening of commodity prices. As already pointed out (see chapter III, section D), this will put some upward pressure on price levels in developed market-economy countries. But it would be both necessary and possible to accommodate such a once-and-for-all adjustment in the commodity terms of trade; what must be avoided is an inflationary spiral.

## 2. *Policy actions for faster growth in Western Europe and Japan*

To attain such a substantial and lasting improvement in the world economy calls for the goal of policy to shift from further disinflation

<sup>57</sup> These are indeed the assumptions behind the medium-term scenarios of IMF. See *World Economic Outlook*, April 1986, pp. 73-74.

<sup>58</sup> Some estimates for the United States suggest that a sustained decline in real government expenditure equal to 1 per cent of GNP would cause a fall in the rate of inflation of about 1 per cent and in output of about 1.5-2.0 per cent during a period of three to four years. A 10 per cent depreciation of the dollar might increase output by about one-half of a percentage point through its effect on the trade balance; but if interest rates rise, the impact on GNP would be substantially less, and in extreme cases even negative.



towards recovery, and for policy to be adjusted accordingly. The particular policy measures called for will differ in both nature and extent among different countries, depending on the cyclical positions and structural characteristics of their economies. In the United States, relaxation of monetary policy is needed to offset the impact of budget cuts on domestic demand and to lower interest rates. In Western Europe and Japan, on the other hand, there is a need to combine appropriate structural policies with macroeconomic management - in the former in order to ensure that the expansionary stimulus is more fully reflected in production and employment (rather than prices) and in the latter to improve the private sector's savings-investment behaviour.

As described in chapter II, the major Western European economies are presently characterized by rates of unemployment far above any estimate of the rates compatible with stable inflation, as well as by underutilized capacities in manufacturing. After three years of recovery, and in spite of scrapping of equipment, the rate of capacity utilization in manufacturing industry is still below the peaks reached in the early or late 1970s. The reduction in the United States budget and trade deficits will tend to widen both the output and the employment gaps. Hence, to offset the adverse impact of swings in the trade balance and to reduce the output and employment gaps, strong expansionary policies are needed so as to maintain the growth of the economy for several years at a rate faster than the potential rate. There is sufficient slack for such an expansion not to run the risk of accelerating inflation, and the scope is further enlarged by the recent declines in oil prices and the dollar. Over the longer term, supply capabilities themselves need to be enhanced through higher investment (and will be so enhanced, as improved capacity utilization rates stimulate investment) and by improving flexibility through the structural policies mentioned above.

The stimulus should come from a balanced mix of monetary and fiscal relaxation. If the ultimate objective is to put the economies of Western Europe on an expansionary course that is to be propelled mainly by private investment, the impetus to be given by macroeconomic policies must be large enough to improve investors' expectations, and targeted towards that end. The composition of the fiscal stimulus would vary from one country to another, and include tax cuts as well as investment in infrastructure, and employment and investment subsidies to the private sector. It could be designed to strengthen the supply side

of the economy as well as to provide demand stimulus. Since some of the major countries, such as the United Kingdom and the Federal Republic of Germany, are in structural surplus, and output is below its potential level, there is substantial scope for fiscal expansion without causing both fiscal deficits and public debt to rise continuously relative to GNP. In addition to fiscal measures, monetary policy needs to be adjusted in order to reduce interest rates, thereby encouraging private investment and reducing the cost of servicing government debt.

While the present rate of unemployment in Western Europe can be reduced substantially without generating inflationary pressures, the long-term objective must be to improve the trade-off between unemployment and inflation. This will require a re-examination of the scope for incomes policies, in order to ease the inflation constraint and to avoid a wage-price spiral being triggered by the rise in commodity prices accompanying recovery. Among various measures that have recently attracted attention are the tax-based incomes policy, restructuring of employment taxes, and introduction of employment subsidies. As pointed out by the Commission of the European Communities, tax cuts can be devised so as to reduce the "tax wedge" between the cost of labour to employers and the take-home pay of workers, by reducing the former without affecting the latter.<sup>59</sup> Combined with a tax on wage bills, they can encourage the hiring of labour while discouraging unwarranted wage claims and concessions. Moreover, a scheme of aggregate demand insurance could be introduced to form the basis of an agreement on wage/price moderation with social partners.

The second aspect of the inflation constraint is the emergence of a structural mismatch between productive capacity and labour force, which could become critical as expansion proceeded and unemployment fell. This problem of shortage of capital, however, can only be overcome in the context of expansion, and not of deflation (though the expansion must be accompanied by greater flexibility in the allocation of labour and investment).

In Japan policies need to be reoriented in order to reduce the dependence of growth on export markets, the more so in view of the withdrawal of the United States stimulus. If the present surplus in trade with the United States were to be eliminated entirely through budget cuts in that country and the depreciation of the dollar, the deflationary impact on the Japanese economy could amount to a cumulative 10 per cent of GNP by the end of the

<sup>59</sup> *European Economy*, No. 22, November 1984, pp. 25-27.

decade. On the other hand, whereas Western Europe needs to reflate over and above what is required to offset the swing in the trade balance, in Japan expansion would largely substitute domestic for foreign markets, and hence should cause no concern for inflationary pressures on production capacity.

A judicious combination of fiscal and monetary expansion and policies designed to increase private sector spending could succeed in bridging Japan's savings-investment gap. A reduction in interest rates could enhance personal spending, particularly on investment in housing, even under the present tax treatment of savings and interest earnings. Furthermore, tax-free savings provisions could be abolished and such investment encouraged by easing restrictions concerning maturities and downpayments, and increasing the availability of finance through specialized institutions. The reduction of high tax rates on personal incomes could help to restore the rate of growth of disposable income (under 2 per cent in 1980-1984) to the level of the growth rate of real GNP, and to increase domestic demand.

These measures, by increasing domestic demand, would help to reduce the dependence of business investment on external markets. But they would need to be accompanied by increased public spending which would help both to reorient private investment and to enlarge its total by expanding the domestic market. Investment in much neglected areas of infrastructure can provide the necessary expansionary stimulus without entailing wasteful use of resources. While the recently announced programme contains measures directed to some of these purposes, it has been widely criticized as falling short of providing the required stimulus to domestic demand.

The need for such a policy reorientation has been recognized in The Report of the Advisory Group on Economic Structural Adjustment for International Harmony, submitted to the Prime Minister, (Mr. Yasuhiro Nakasone) on 7 April 1986. After setting the medium-term national goal as one of "steadily reducing the nation's current-account imbalance to one consistent with international harmony" and stating that "the process of achieving this goal should also entail efforts to enhance the quality of the nation's living standard" and that "it is imperative that, along with striving for economic growth led by domestic demand, the Government promote basic transformations in the nation's trade and industrial structure", the report makes a number of recommendations, including those for the expansion of domestic

demand by "promoting housing policies and urban redevelopment, ... stimulating private consumption, ... promoting social infrastructure investment by local government."

### 3. *Policy co-ordination*

In a world in which national economies are interdependent through trade and finance, the outcome of any mix of policies in one country depends critically on the stance and mix of policies in other countries. Thus, while a global expansion may be feasible and desirable, no country may wish or be able to undertake unilaterally action to that end because it may have to bear a disproportionately high share of the costs while reaping a disproportionately low share of the benefits. In such a situation, only co-ordinated action can provide an outcome desirable from all countries' point of view.

Such co-ordination has been lacking; but that is not what explains the poor performance of the world economy in recent years. Co-ordination is conditioned by the policy goals of individual countries, which may be confined to combating inflation or reducing trade imbalances. If co-ordination is designed simply to resolve such conflicts, rather than to reach a common goal of expansion, it will not revive growth. Thus, for co-ordination to result in expansion, policies need to be directed to this goal.

For reasons already explained, fears that growth would rekindle inflation are not justified for the major industrial countries. If policy objectives were adjusted and actions co-ordinated in such a manner as to reduce pressures on output and prices on individual countries springing from external causes, imbalances in trade and financial flows among countries could be reduced in the context of a more rapid global expansion. Co-ordination would encourage each country to adopt the appropriate measures, since it would ensure that other countries would also do their share. The outcome for all countries could be far superior to the alternative of each country acting alone.

Budget deficit reduction in the United States should not go so far as to result in structural surpluses, since this would be unnecessarily deflationary.<sup>60</sup> Relaxation of monetary policy will help to reduce deficits by lowering interest rates and payments, and provide some

<sup>60</sup> Indeed, the Gramm-Rudman-Hollings Act provides for the suspension of cuts if a recession is under way.

stimulus to economic activity. But if the other major countries, and particularly Japan, do not follow suit, such a relaxation would accelerate the depreciation of the dollar and add to inflation in the United States. If Western Europe and Japan do not expand, the size and speed of the depreciation of the dollar required to correct the United States trade deficits would be substantially greater; if the dollar depreciated further, it would put further deflationary pressures on other developed market-economy countries, and more particularly Japan. The disinflationary impact of the oil price fall on the United States economy may permit that country to seek a further depreciation of the dollar. Alternatively, fear of inflationary consequences of dollar depreciation may induce the authorities to resist exchange-rate changes. In this case there could be increased pressures for trade restrictions if expansionary action is not taken abroad. Moreover if currency markets put downward pressure on the dollar, the United States response might be to tighten monetary policy and to raise interest rates.

Since half of the trade of the EEC countries is within Europe, the trade balances of these countries with each other are at least as important as their balances with the rest of the world. As recognized by the Commission of the European Communities in its annual economic report, co-ordination among the major Western European countries is essential for attaining expansion.<sup>61</sup> Experience in France in the early 1980s indicates the difficulties of unilateral attempts to reflate when other major Western European countries are unwilling to follow suit, and the strains that can consequently arise within the European Monetary System. Expansion could be initiated by the countries with relatively more stagnant domestic markets and tighter fiscal policies, which are also those that have more favourable current-account positions.

While Western Europe has some scope to expand on its own, a vigorous expansion unaccompanied by expansion in the United States and Japan would put pressure on exchange rates, and hence reduce the scope for lowering interest rates. Moreover, unlike the case in the United States, it might not be possible to prevent exchange rates from depreciating by a tightening of monetary policy. Thus, the scope for accelerating recovery in Western Europe in the context of reduced interest rates depends critically on the policies adopted in Japan and the United States.

These considerations point to the need for combining monetary relaxation in the United States with both monetary and fiscal expansion in Western Europe and Japan. This would entail an increase in aggregate demand in OECD countries as a whole, but alter its distribution among countries in such a way as to eliminate trade imbalances and reduce disparities in economic performance. In particular, it would reduce the share of the United States in the creation of demand but increase its share in its distribution through trade, and vice versa for Japan and Western Europe.

Such an approach, which was advocated in the *Trade and Development Report 1985*, is increasingly finding support in some official circles. The Commission of the European Communities has argued that "the counterpart to a necessary balance of payments correction of the United States should be carefully distributed between Japan and Europe to lessen present disequilibria . . . Europe and Japan should be prepared to support the buoyancy of world trade with adequate domestic growth."<sup>62</sup> Similarly, the OECD secretariat has suggested that "in countries where inflation and budget deficits have been brought under control, yet growth is too slow and unemployment too high, attention could usefully be paid to . . . appropriately designed tax cuts . . . to provide some support to demand."<sup>63</sup>

Moreover, a number of studies have suggested that such expansion could eliminate the trade imbalances within OECD by the end of the decade without generating destabilizing movements in exchange and interest rates or in prices. It could raise the average annual OECD growth rate to 4 per cent or more for the rest of the decade and reduce unemployment in Western Europe by one-third or so without generating inflationary pressures either there or in the United States. Interest rates could fall substantially in real and nominal terms, and large exchange rate movements would be avoided.

The outcome would also be very favourable for the developing countries. As indicated by the "accelerated growth scenario" of *Trade and Development Report 1985*, an average growth rate of 3.5 per cent in the developed market-economy countries, accompanied by substantial declines in real interest rates and more favourable flows of external finance, would raise the growth in developing countries to over 6 per cent by the end of the decade. Both interest payments and

<sup>61</sup> "A co-operative growth strategy for more employment", *European Economy*, No. 26, November 1986.

<sup>62</sup> *Annual Economic Report, 1984-85*, p. 35.

<sup>63</sup> *OECD Economic Outlook*, No. 37, June 1985, p. xvii.

debt outstanding as percentages of GDP would decline substantially, by about one-half and one-third, respectively. Similarly, debt as a ratio of exports would fall from 130 per cent in 1985 to 80 per cent in 1990, and the current-account deficits as a proportion of exports would decline by 25 per cent.

Whether or not an agreement on such co-ordinated action may be reached in the near future is uncertain. However, the present attitude of the governments of some major countries suggests that the result may fall far short of achieving the right objective. The bargaining outcome may indeed be confined to the reduction of trade imbalances within OECD, and the attainment of narrow financial objectives such as aligning exchange and interest rates, without providing the necessary expansionary stimulus. What may be suitable to the governments of a number of major countries may not be adequate for other countries, including many other developed market-economy countries and all developing ones; these countries may be excluded from the decision-making but they are not sheltered from its consequences.

It is noteworthy that policy actions to correct exchange rates and trade imbalances are

being decided outside IMF. However, by article IV, section 3, of its Articles of Agreement, the Fund is required "to exercise firm surveillance over the exchange rate policies of members" and to discuss with members, in accordance with the Principles of Fund Surveillance over Exchange Rate Policies, "the behaviour of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements." This procedure of taking the most important decisions concerning international monetary co-operation outside the Fund tends to increase the asymmetry in the Fund's surveillance function, and to undermine the fulfilment of its major purposes as defined in article 1: "To promote international monetary co-operation through a permanent institution, . . . to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income..." These purposes and the surveillance principles and procedures could be made to provide a framework for arriving at policy co-ordination with the participation of developed and developing countries alike.

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## D. Conclusions

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Governmental approaches to international policy formulation have been somewhat more positive over the past year. Explicit policy co-ordination has occurred among a small number of major developed market-economy countries, and it is now widely acknowledged that faster growth in debtor developing countries needs to be an integral part of the international strategy on debt. In this regard, recent discussion has focused on policy reform in developing countries, supported by increased financial flows from both private and official sources, as the principal means of achieving faster growth in developing countries. Such an approach, for example, lies behind both the recent creation of the structural adjustment facility in IMF and the Baker initiative for major debtor countries.

This approach has the merit of situating the debt and growth problem of developing countries in a longer-term perspective and of recognizing that current difficulties are not transitory and that their solution requires that structural factors be addressed. However, discussion has focused almost exclusively on policy reform in developing countries. In this connection attention has been given to encour-

aging the revision of strategies in accordance with a single view deemed applicable to all countries regardless of their structural characteristics and capable of being implemented in short order. While the formulation of an adequate long-term strategy for growth and development is of critical importance for any developing country, given the present international economic environment, a change in strategy alone is unlikely to raise growth rates to the extent required.

In any event, the improvement of growth that might result from the more efficient utilization of resources that is expected from the new approach would not materialize quickly, but rather over an extended period of time. The approach thus does not deal adequately with the problems faced by those responsible for formulating and applying economic policy, who are under intense pressure from electorates and the population at large to bring about swift and tangible improvements.

It is true that the additional external financing that is to accompany policy reforms would itself help loosen current constraints on growth and thereby help to resolve the dilemma of reconciling the need for longer-term reforms

with the requirements of improving economic performance in the short to medium run. However, the additional financial support that now seems likely to be associated with programmes of policy reform is inadequate, as regards both the flows likely to be available for poorer indebted countries, and, in particular, those flowing from commercial banks to the larger debtors.

A further shortcoming of the present approach is the reluctance of creditors to explore fully the possibilities for the more flexible and imaginative use of financial techniques to ease the debt problem. The range of financial practices available to deal with international debt problems is narrower than that available for dealing with troubled debtors in the domestic economies of some developed market-economy countries. In recent months, there has been some exploration of the possibilities for transforming fixed-interest debt into equity and some debtors have been purchasing their own debt on secondary markets at a discount.

Other innovative financial techniques put forward for discussion include the possible temporary reduction of interest rates below reference levels and the linking of interest payments to the price of the debtor's major export commodity (e.g. oil). So far, however, little progress has been made in bringing about financial innovations which, while maintaining the longer-run interests of creditors and debtors, could provide relief from debt-servicing obligations.<sup>64</sup>

The most significant shortcoming of the present approach, however, has been the failure to situate it adequately in the context of a coherent strategy for reviving growth in the world economy. The current willingness of major governments to explore further the possibilities for policy co-ordination needs to be encouraged. Such co-ordination must not continue to be limited to addressing questions of imbalances among a small number of countries, but needs to be broadened, as regards both the issues concerned and the participants, in order to secure a co-ordinated approach to faster growth throughout the world economy. ■

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<sup>64</sup> A more detailed discussion of the question of international debt reform is contained in the annex to this chapter.

## ANNEX TO CHAPTER VI

## Toward international debt reform?

Overcoming the debt and growth crisis of developing countries requires a combination of policy measures designed to increase world growth, lower world interest rates, and increase capital flows on appropriate terms. It also requires reinforcement of the policy efforts of debtor countries themselves. If these measures are inadequate, and in particular if new flows to developing countries fall significantly short of what is required, or if the world economy does not expand at a sufficient rate, some measure of debt reform will prove inevitable. Indeed, even if developments in these areas were to be favourable, debt reform might become desirable in one form or another.

The broad objective of debt reform should be to allow both creditors and debtors to deal in a sensible way with the accumulated damage inflicted by the events of the past three years. Reform should thus aim to reduce as required the debt obligations that cannot realistically be expected to be met, given the prospective evolution of the international economic environment and the need of debtors to restore growth. A reasonable specific objective in this regard would be to provide international debtors with the same opportunities to reorganize their obligations as are afforded domestic debtors in a similar position.

It is frequently thought that the major difference between an international sovereign debtor and a domestic firm is that the former cannot be declared bankrupt and its assets liquidated. This distinction is accurate and pertinent, but it overlooks the fact that liquidation is not the only, nor even the most frequent, means of dealing with severe debt difficulties of domestic firms. National legislations in virtually all developed market-economy countries recognize that it is in the interest of all parties concerned to allow debtors experiencing severe difficulties to work their way out of these difficulties and to rebuild the capacity to service their debt. To this end, protection from the requirement of prompt and full payment of debt is often afforded.

In the United States, for example, chapter 11 of the "Bankruptcy Reform Act of 1978" provides for judicial review of plans for reorganization negotiated between creditors and debtors in cases where debtors file in accordance with that chapter. The Act lays down guidelines that the courts are to follow in deciding whether particular plans for reorganization should be confirmed. Such guidelines include, for example, a requirement that reorganization plans should be feasible in the sense that they are not likely to give rise to a further need for reorganization. United States courts are endowed with broad equitable powers, and in evaluating the feasibility of the reorganization, they may decide whether the schedule

of payments and the associated charges are consistent with the purpose of the reorganization.

The procedures provided for under the United States Bankruptcy Code, and the principles which explicitly or implicitly underlie those procedures, are of wider interest in considering the degree of protection that might be accorded a troubled international debtor attempting to reorganize its affairs. In this regard, some of the more relevant characteristics of the Code are the following:<sup>1</sup>

(a) *Automatic stay*: An immediate effect of a bankruptcy petition is to automatically stay creditors and all other parties in interest from commencing or continuing lawsuits, perfection of liens and the enforcement or collection of claims or judgements against the debtor (section 362). The legislative history makes clear that the automatic stay is a fundamental protection intended to provide the debtor with "a breathing spell" from his creditors. The automatic stay permits the debtor the opportunity to formulate a reorganization plan and ensures that creditors be treated equally without the burden of racing to the courthouse to enforce claims. The Bankruptcy Code provides certain exceptions to the automatic stay (e.g., continuation of criminal proceedings or certain governmental actions) and permits the court to modify the stay when warranted.

(b) *Fixing of claims or interests*: The filing of a bankruptcy petition also fixes all claims against the debtor as of the petition date. Section 502(b) of the Bankruptcy Code provides that claims for unmatured interest on pre-petition indebtedness cease to accrue as of the petition date and may not be asserted against the insolvent debtor. For example, a financial creditor may file a claim against a debtor for the outstanding principal amount of a loan plus all accrued and unpaid interest through the petition date. However, interest on the outstanding debt ceases to accrue against the insolvent debtor as of the petition date and need not be treated under a plan of reorganization. The automatic stay, coupled with the fixing of claims as of the petition date, offers corporate debtors the crucial protection necessary to restructure the business and formulate a plan of reorganization.

(c) *Plans of reorganization*: Chapter 11 provides debtors and creditors with broad business and financial parameters around which a plan can be formulated. Furthermore, a plan need not receive unanimous creditor support

<sup>1</sup> The analysis contained in the following sub-paragraphs has been provided by the New York law firm Kramer, Levin, Nessen, Kamin and Frankel.

## BOX 5

**GUIDELINES FOR DEBT OPERATIONS: TRADE AND DEVELOPMENT BOARD RESOLUTION 222 (XXI):**

In section B of its resolution 222 (XXI) of 27 September 1980, the Trade and Development Board of UNCTAD endorsed the detailed features annexed to that resolution (reproduced below) and agreed that:

*"... States members of UNCTAD be guided by these agreed features in future operations relating to debt problem of interested developing countries."*

**DETAILED FEATURES FOR FUTURE OPERATIONS RELATING TO THE DEBT PROBLEMS OF INTERESTED DEVELOPING COUNTRIES****I. Preamble**

1. *In pursuance of Trade and Development Board resolution 165 (S-IX), and taking into account the work of the Intergovernmental Group of Experts on Debt and Development Problems of Developing Countries, the following features for future operations relating to the debt problems of interested developing countries are agreed upon.*
2. *It was further agreed that finding a means through which debt-servicing difficulties could be avoided was one of the most important tasks facing the international community. The avoidance of debt-servicing difficulties under conditions that are consistent with an orderly development process in developing countries is in the interest of both creditor and debtor countries.*
3. *Nevertheless, it was recognized that problems could arise and that it was important to have agreed arrangements for timely action.*

**II. Objectives**

4. *International action, which may vary according to the nature of the problem of the debtor country:*
  - (a) *Should be expeditious and timely;*
  - (b) *Should enhance the development prospects of the debtor country, bearing in mind its socio-economic priorities and the internationally agreed objectives for the development of developing countries;*
  - (c) *Should aim at restoring the debtor country's capacity to service its debt in both the short term and the long term, and should reinforce the developing country's own efforts to strengthen its underlying balance-of-payments situation;*
  - (d) *Should protect the interests of debtors and creditors equitably in the context of international economic co-operation.*

**III. Operational Framework****Initiation**

5. *International consideration of the debt problem of a developing country would be initiated only at the specific request of the debtor country concerned. Accordingly, the country concerned may request such a consideration at an early stage, when, in its judgement, the problem involving indebtedness exists or is likely to emerge.*

**Analysis**

6. *The nature of the problem may vary from acute balance-of-payments difficulties requiring immediate action to longer-term situations relating to structural, financial and transfer-of-resources problems requiring appropriate longer-term measures.*
7. *In all cases the following elements would be considered in determining appropriate international action:*
  - (a) *Examination of the domestic economic situation of the country, including an analysis of its use of both domestic and external resources for safeguarding its development process,*
  - (b) *Impact of external factors on the developmental and financial problems of the debtor country;*
  - (c) *Estimates of short-term and long-term developmental capital requirements and projected availabilities;*
  - (d) *Projection of debt-servicing requirements and review of measures adopted by the country concerned to avoid debt-servicing difficulties;*
  - (e) *Particular consideration of the structure and prospects of all items of the balance-of-payments, exchange rate and monetary policies.*

(Continued on the following page.)



## BOX 5 (continued)

9. *In the case of the acute balance-of-payments difficulties, the analysis would give special attention to the debtor country's short-term economic and financial policies, prospects and requirements. In the case of longer-term problems, the analysis would give special attention to the financing of long-term investment and associated resource transfers.*

**Action**

10. *In the light of the analysis described above, a comprehensive programme of action will be agreed upon aimed at meeting the objectives described in section II above. The action programme, which will include both domestic and international measures, will vary from case to case depending on the nature of the problem at hand and the development prospects of the debtor country.*
11. *International measures to be implemented by bilateral and multilateral sources would vary from debt reorganization to the provision of additional financial resources on appropriate terms and conditions.*
12. *In the case of acute balance-of-payments difficulties, in which debt servicing payments play a major role and which require immediate action, the debtor country will undertake an economic programme designed to strengthen its underlying balance-of-payments situation, having regard to its development prospects. This programme would be supported by interested parties. This support would, where necessary, include the reorganization of debts owed to or guaranteed by creditor Governments.*
13. *In the case of longer-term problems which require appropriate longer-term measures, the debtor country concerned will undertake viable domestic policies, supported by donor countries and appropriate international institutions, which would endeavour to increase the quantity of aid in appropriate forms and improve its quality.*
14. *In cases where both types of problems are present, actions involving both types of measures may be required and would have to be taken in a manner which ensures that they are consistent and mutually reinforcing.*
15. *In the multilateral forum agreed upon by the debtor and the creditors, the Chairman would conduct the debt operation in a fair and impartial manner, in accordance with the agreed objectives, so as to lead to equitable results in the context of international economic co-operation.*

but, rather, must be accepted by creditors holding 50 per cent in number and two-thirds in amount of the claims in each class of creditors voting on the plan. If a plan is accepted by the requisite majorities of creditors, the terms of the plan will be binding upon all creditors (including dissenting creditors) on the condition that creditors in each class receive more than could be recovered through a liquidation under chapter 7 (section 1129).<sup>2</sup> The basic intent and requirement of a chapter 11 plan is to provide creditors with a greater recovery than otherwise could be realized through a liquidation under chapter 7. Within that general guideline, a plan may propose to pay creditors all or a percentage of their claims, either in a single payment or through multiple payments. Distributions to creditors can assume a wide variety of forms, including cash, notes or debentures of the reorganized company or equity in the reorganized company. Moreover, through a plan, fixed claims (i.e., notes, debentures, accounts receivable, etc.) can be converted into claims evidenced by stock, warrants, convertible debentures or any combination of instruments to be issued by a reorganized company pursuant to a chapter 11 plan.

Most other industrial countries, although not necessarily going as far as the United States in safeguarding the well-being and rehabilitation of the domestic debtor, have also rejected rigid and legalistic approaches to indebtedness and have put in place measures that give considerable weight to the needs and interests of the domestic debtor.

Similar arrangements do not exist at the international level and there is no judicial, or even quasi-judicial, authority empowered to assess the feasibility of programmes of rescheduling and to ensure that such programmes restore the financial and productive viability of the debtors as quickly as possible and are so structured as to avoid any need for repetition of such rescheduling. An attempt was made in UNCTAD several years ago to address this shortcoming by establishing a set of internationally agreed guidelines (formally designated as "agreed features") that would shape debt reorganization. These guidelines had the merit of setting debt reorganization in the context of development and of the need of the debtor country to continue on a development path (see box 5). However, they were not generally understood to be applicable to reorganization of debt owed to private creditors, and there are widely differing views between creditors and debtors as to the adequacy of their implementation with respect to debt owed to, or guaranteed by, official creditors.<sup>3</sup>

<sup>2</sup> In the event a plan is not accepted by each class of creditor, the debtor nevertheless may "cram-down" a plan on creditors if at least one class of creditor accepts the plan and specific requirements for all junior classes of creditors and stockholders are satisfied.

<sup>3</sup> For more detail see the report by the UNCTAD secretariat "Review of the implementation of section B of Trade and Development Board resolution 222 (XXI)", (TD/B/990), Jan. 1984) and "Conclusions drawn by the UNCTAD secretariat following consultations in pursuance of Conference resolution 161(VI)", (TD/B/890, 26 March 1984.

The lack of a well-articulated, impartial framework for resolving international debt problems creates a considerable danger, which has in part already materialized, that international debtors will suffer the worst of both possible worlds: they may experience (and many are experiencing) the financial and economic stigma of being judged *de facto* bankrupt, with all of the consequences that this entails as regards creditworthiness and future access to financing. At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a *de jure* bankruptcy handled in a manner similar to chapter 11 of the United States Bankruptcy Code.

Such a situation could be improved in two ways. One would be to provide foreign debtors who so wish with access to relief through the courts on the same footing as domestic debtors. A United States Court of Appeals, in entering a judgement in favour of certain foreign debtors that had been sued for default on a loan extended by a United States bank, has used the argument that protections of the type afforded by chapter 11 should, under appropriate conditions, be extended to such foreign debtors. In so doing, it based itself on a finding by the United States Supreme Court dating back to 1883. However, the Court of Appeals subsequently reversed itself (see box 6). An alternative approach would be to approximate, through international financial diplomacy, the kinds of solutions reached through the judicial system in the case of domestic debtors. At the very least, there would appear to be a case for ensuring that policy-makers have at their disposal for dealing

with international debt the same panoply of techniques and instruments as are available for dealing with similar problems of domestic debtors.

It needs to be recognized that analogies between procedures and instruments available for dealing with debt problems domestically and those that could be used internationally have limitations. Reorganization of domestic debtors takes place within the framework of national law, and all aspects of the reorganization are enforceable through the courts. Moreover, reorganization of a domestic debtor is primarily a legal and commercial matter, although political considerations may also enter in, especially if large numbers of workers or shareholders are involved. Reorganization of international debt, on the other hand, inevitably has a substantial political dimension, and problems of securing adherence by all parties to debt agreements are therefore necessarily more complex. Nevertheless, experience with domestic debt reorganization can be a guide to the sort of financial operations that could in principle be available internationally without departing from accepted practice.

Against this background, the remaining paragraphs of this annex discuss briefly some proposals for debt reform having strong analogies with procedures used domestically in the United States. For convenience, the proposals are grouped according to whether their primary purpose is to change the character of the claims held by creditors, to change the ownership of those claims, or to change the value of the claims.

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### A. Changing the character of claims held by creditors

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A number of proposals that have been discussed recently have in common that they seek to change the nature of the claims held by creditors. Such proposals are motivated primarily by the desire to align better the stream of future debt payments with the expected future profile of earnings from which those payments would have to be made. Where there is a general expectation that the external earnings of debtors would be greatly improved in the future as compared with the present, claims that explicitly recognized this would provide a basis for normalizing the external financial situation of the debtor. From the standpoint of debtor countries considerable gains could accrue from changing the time profile of debt payments, even if in the process the nominal value of debt were increased.

The basic rationale of proposals of this type is fully consonant with approaches that have been followed in the past, namely to lighten the present debt burden by providing new loans to meet interest payments, thereby postponing a substantial part of the debt burden. This approach, however, has recently tended to break down and there would be merit in proposals designed to institutionalize these features. Some proposals having these characteristics also build flexibility into the future payments profile i.e., they ensure that full payment will resume only when export earnings have recovered. Consequently, such

proposals bring the maturity of claims into closer harmony with the time frame of the investment processes that the external debt is financing, thereby avoiding financial disturbances that could result when long-term investments or economic processes are financed on the basis of short-term borrowing. Proposals that build in this flexibility serve to shift from debtors to creditors some of the risk that export earnings would fail to recover.

Despite the financial and regulatory obstacles facing these proposals, banks might be willing to accept them in the context of a defensive lending strategy. Such a strategy would entail the provision of new money and/or changes in the nature of existing claims in order to protect the value of banks' claims on the debtor country concerned. This strategy implies an increase in exposure, with the concomitant risk of non-payment by the borrower. In fact, the change in the features of current loans is akin to an increase in exposure, and it would therefore be weighed against the improvement in the value of existing claims stemming from such a change. The change would alter the repayment schedule, but it might well increase the probability of repayment in that such repayments would be closely linked to the country's capacity to pay. The benefit to the creditors would therefore be the increase in the expected repayments on existing debt.

## BOX 6

**RULING OF A UNITED STATES COURT OF APPEALS**

In April 1984 the United States Court of Appeals for the Second Circuit in New York upheld a lower court ruling in favour of three Costa Rican banks which, under orders from the central bank of the Republic, had suspended payment in 1981 on a loan from a 39-bank syndicate, and dismissed claims by a United States bank which had declined to accept a rescheduling agreement reached by the other 38 banks. The Court of Appeals held that:

- The actions of Costa Rica that resulted in the prohibition of payments on external debt are consistent with the law and policy of the United States. In *Canada Southern Railway Co. v. Gebhard*, 109 U.S. 527 (1883), the Supreme Court bound New York bondholders to the Canadian Government's reorganization of the debts of the Government owned Canada Southern Railway. In ordering the dismissal of the bondholders' suit on the old bonds, the Court stated:
- '(The plan) is in entire harmony with the spirit of bankruptcy laws, the binding force of which, upon those who are subject to the jurisdiction, is recognized by all civilized nations. It is not in conflict with the Constitution of the United States, which, although prohibiting states from passing laws impairing the obligation of contracts, allows Congress "to establish ... uniform laws on the subject of bankruptcy throughout the United States." ... Under these circumstances, the true spirit of international comity requires that schemes of this character, legalized at home, should be recognized in other countries.'
- Similarly, Costa Rica's prohibition of payments of its external debt is analogous to the reorganization of a business pursuant to chapter 11 of our Bankruptcy Code, 11 U.S.C. §§1101-74 (1982). Under chapter 11, all collection actions against a business filing an application for reorganization are automatically stayed to allow the business to prepare an acceptable plan for the reorganization of its debts. 11 U.S.C. §§103(a), 362, 901(a) (1982). See in re *Frigitemp Corp.*, 8 B.R. 284 (S.D.N.Y. 1981) (purpose of §362 is to give insolvent debtor opportunity to formulate plans for repayment and reorganization with protection from mad scramble of creditors for assets). Costa Rica's prohibition of payment of debt was not a repudiation of the debt but rather was merely a deferral of payments while it is attempted in good faith to renegotiate its obligations.

In March 1985, after rehearing the case, the same court reversed itself and found for the plaintiff. It explained the reversal as follows:

- In our previous decision, we affirmed the district court's dismissal. We did not address the question of whether the act of state doctrine applied because ... we determined that the actions of the Costa Rican Government which precipitated the default of the Costa Rican banks were fully consistent with the law and policy of the United States. We therefore concluded that principles of comity compelled us to recognize as valid the Costan Rican directives.
- Our interpretation of United States policy, however, arose primarily from our belief that the legislative and executive branches of our Government fully supported Costa Rica's actions and all of the economic ramifications. On rehearing, the Executive Branch of the United States joined this litigation as *amicus curiae* and respectfully disputed our reasoning. The Justice Department brief gave the following explanation of our Government's support for the debt resolution procedure that operates through the auspices of the International Monetary Fund (IMF). Guided by the IMF, this long established approach encourages the cooperative adjustment of international debt problems. The entire strategy is grounded in the understanding that, while parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable. Costa Rica's attempted unilateral restructuring of private obligations, the United States contends, was inconsistent with this system of international co-operation and negotiation and thus inconsistent with United States policy.
- The United States Government further explains that its position on private international debt is not inconsistent with either its own willingness to restructure Costa Rica's intergovernmental obligations or with continued United States aid to the economically distressed Central American country. Our previous conclusion that the Costa Rican decrees were consistent with United States policy was premised on these two circumstances.
- In light of the Government's elucidation of its position, we believe that our earlier interpretation of United States policy ... was wrong.

Source: Sidney Dell, "Crisis management and the international debt problem", *International Journal*, Vol. XL, Autumn 1985, pp. 665-668.

### 1. Interest capitalization

As mentioned above, interest capitalization i.e., the granting of new loans for the sole purpose of paying current interest due, has been a part of the international debt strategy pursued in the past. It has been suggested that this process should be formalized and made more automatic, and hence more explicitly form part of the strategy which must continue in the

future. One advantage of interest capitalization is that it avoids frequent renegotiations regarding roll-overs and new money which absorb an inordinate amount of the time and energies of senior officials and which also present a constant risk of breakdown. A second advantage is that an explicit process of interest capitalization would ensure the full participation in the provision of new money of all commercial banks that are creditors of the debtor concerned.

One disadvantage of explicit interest capitalization is that, under current bank regulations in the United States, interest that was automatically capitalized could not be counted as part of a bank's current earnings. Thus, banks operating under such regulations would see their reported income drop. Some creditors also find it desirable and necessary to keep the adjustment programmes of debtors under frequent and close scrutiny. For these creditors explicit interest capitalization would have the disadvantage of not allowing for such frequent review.

## 2. *Conversion of debt into equity-like claims*

Proposals under this heading seek to relate debt-service payments to future growth in the debtor's capacity to pay. If foreign debt is transformed into equity or quasi-equity instruments, the outflow of returns to investors or lenders would take place only when earnings have been generated by the project or activity being financed. A number of schemes aimed at converting external debt into equity have been proposed in the last few years and a few countries have taken concrete steps to effect such conversions (see box 7). While schemes of the sort implemented so far may contribute to reducing developing countries' heavy debt burden, their potential is limited by the sheer size of the debt in relation to the amount of foreign investment that can be easily accommodated in a given debtor country.

Other proposals for conversion are more far-reaching. One suggestion, for example, is that fixed-interest debt should be replaced by shares in a country's export earnings, to be reflected in a new instrument called "exchange participation" notes. The advantage of such a scheme is that when exports are expected to grow the value of exchange participation notes that a creditor regards as equivalent to the expected earnings on debt outstanding is a smaller proportion of export earnings than are interest payments on the debt itself. This is because the time profiles of the two sets of payments are different: fixed-interest debt gives rise to interest payments that decline through time as a proportion of export earnings (as those earnings grow). The equivalent stream of earnings from exchange participation notes would be ensured by a claim on export earnings equal to the average of that produced by fixed-interest debt (after allowing for discount to achieve equivalent present value). In brief, exchange participation notes would create a breathing-space for the debtor in the near term at the cost of higher payments in the future.

A number of disadvantages are associated with this proposal. It is relatively far-reaching in character and it is unclear what accounting changes would be necessary as regards both the banks themselves and their regulatory bodies. The immediate impact of such a scheme would be to lower the earnings of creditors, which might require some writing down of debt in the banks' books. Questions have also been raised as to whether the commitment to transfer to

creditors a fixed proportion of export earnings would be credible when such earnings rose rapidly.

For highly indebted oil-exporting countries a more limited application of this concept might be achieved by linking debt payments to the price of oil. Here, too, the overall objective would be to achieve some reduction in debt service during the period in which oil prices remain at current levels, in return for higher debt payments when oil prices recover. This is a more narrowly focused proposal in that it is restricted to changes in prices (rather than earnings) of exports and is limited to a particular export commodity, with special marketing characteristics and price prospects.

One specific instrument for linking debt payments to export prices is the commodity bond, which has so far been used to link financial returns to prices of energy and precious metals (see box 8). This may be explained by the good price prospects for these products at the time of issue, coupled with their low storage costs and, in some instances, the possibility of keeping reserves in the ground. These considerations would also apply to future issues of commodity bonds, at least until such a market becomes fully fledged. Fuels would thus, most probably, be the initial candidates for the issue of such bonds, followed by minerals and metals at a later stage. The major question that issuing countries would face in the present conditions of depressed oil prices is whether the provision of new money, coupled with lower coupon rates, would compensate for the higher future costs of servicing debt that would occur if oil prices should rise.

A renewed interest in oil-linked bonds has recently emerged. It has been reported that a United States-based oil company is planning to raise \$250 million by issuing petrobonds and that Mexico would issue \$1 billion worth of long-term bonds indexed to the price of oil, in order to meet part of its 1986 borrowing requirements. The existence of a secondary market for these bonds would make the scheme more attractive to banks, since they would be able to sell their bonds at a discount smaller than that obtainable at present when they sell or swap their loans in a very limited, informal inter-bank market. In view of the expected volatility in oil prices, speculators, as well as major commercial consumers abroad, such as airlines, shipping companies and utilities, would be possible buyers of these bonds in the secondary market, in order to hedge their own exposure to energy costs for longer periods than those available under futures contracts. However, it has been suggested that a prerequisite for large-scale floating of commodity bonds by developing countries would be the establishment of an official intermediary, endowed with multilateral funds, and acting either as an issuer or as a guarantor. This proposal is further discussed in section B) below.

In general, the proposals discussed above have the effect of shifting risk between debtors and creditors, the outcome and consequences of which could be only imperfectly perceived at the time the proposals would be implemented. There are few indications that creditors are prepared to assume even greater risks with regard to their claims on troubled

## BOX 7

**CONVERTING DEBT INTO EQUITY**

There are two ways of converting debt into equity. Conversion can be direct, as in the case of a lending bank cancelling part of the debt owed by a financial institution in a debtor country in exchange for an equity stake in such an institution. Alternatively, conversion may take place indirectly, with the intervention of a third party. As an example, the creditor bank would sell its loans at a discount to a foreign investor; that investor may be able to exchange the foreign exchange claim for local currency at its full face value or at a smaller discount than the one he obtained at the time of purchase, and use the proceeds to finance the local costs of his investment. In essence, most conversion schemes imply a preferential exchange rate for foreign direct investment. It may be argued that the conversion is merely a de jure recognition of (a) the de facto equity stake of foreign banks in major debtor countries with heavy debt-servicing difficulties which had led to a series of bank debt restructurings; and (b) the de facto equity nature of external debt incurred by subsidiaries of transnational corporations.

A small number of developing countries have already taken steps in this direction:

- Turkey pioneered in this field in 1980 by enacting legislation for settling foreign suppliers' arrears amounting to some \$2.5 billion. Creditors were offered two options: to be paid either in foreign exchange over ten years or in local currency on demand. Local currency payments could be used to increase working capital in existing investments or payment of the equity portion of new investments. These debts are currently being bought in various unofficial markets at less than one-half of their face value by foreign investors paying in foreign exchange.
- Since 1982, the Mexican Government has allowed foreign banks to acquire up to 15 per cent equity interest in a Mexican firm, in lieu of an equivalent amount of debt repayment. Under its latest scheme, Mexico would allow only government debt to be used for conversion, redeeming it in local currency at the free market exchange rate at a discount of up to 15 per cent depending on the type of investment. Disinvestment would be prohibited until January 1998 and no preferential shares or fixed dividend shares can be obtained.
- Since 1983, the Brazilian Government has been offering cash rewards to companies that convert debt into equity. Firms converting principal or interest on investment loans or medium-term import financing would receive cash grants from the Government ranging from 5 per cent to 10 per cent of the value of the conversion. In the late 1970s, the Brazilian Government had already tried to encourage companies to convert debt into equity with tax advantages, but without appreciable results.
- In 1985, the Chilean Government instituted a scheme under which holders of Chilean foreign debt notes, which now sell at about 30 per cent discount, may cash them in for their full value in pesos. The pesos must be used to pay domestic debts, purchase local assets or, in the case of foreigners or Chileans residing abroad, for foreign investment in the country. In the latter case, foreign capital must remain in the country for at least 10 years and profit remittances are not allowed for the first four years. The scheme has so far generated debt/equity swaps amounting to some \$600 million, or about 3 per cent of Chile's external debt.

foreign debtors. In fact, there is some evidence that they are seeking to reduce the risks. Their willingness to consider such proposals is therefore open to ques-

and may only be forthcoming when they assess the risks of failing to act to be even higher than those they would assume under the proposals sketched above.

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### B. Changing the ownership of claims

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A further category of proposals involves policy action to shift some or all of the ownership of claims of major debtor countries from private banks to an official entity. In such proposals an existing or new entity would use funds, derived either by direct borrowing from the market, and backed by official guarantees, to purchase the claims from private banks or would issue long-term bonds directly to the banks in exchange for those claims. Such proposals usually foresee that claims held by banks will be purchased at a discount, thereby imposing moderate capital losses on the banks in question and allowing the entity to offer some interest forgiveness to debtor countries. It is also proposed that the new financial entity should extend the maturities of the debt owed to it, thereby in effect funding that debt.

Several advantages are cited for the creation of such a new financial intermediary. First, proponents

of such schemes believe that the creation of a new intermediary would play a useful role in insulating the international financial system from the effects of any major repudiation, write-down or extreme non-performance of developing countries with regard to their debt. Secondly, it is argued that the concentration of claims of developing country debtors in a single institution would eliminate problems currently encountered in securing the participation of many individual creditors in debt management operations. Thirdly, it is argued that, should debt relief prove necessary or advisable at some point in the future, the concentration of claims in a single institution would facilitate the operation. Indeed, some proposals explicitly foresee such debt relief. In this connection, it is also pointed out that lodging the claims in a new institution would remove the present accounting and regulatory objections to unconventional schemes for



## BOX 8

**COMMODITY BONDS**

A commodity bond is a security whose returns (either interest or redemption value, or both) vary with the price of a commodity or a specified basket of commodities. During the past decade, there has been a small number of issues of commodity bonds. Some of these issues have originated in developing countries, namely in Mexico and the Philippines (see table below). Most have included covenants to maintain commodity reserves on hand and to fund interest and redemption obligations. In some cases, reserves in the ground, i.e., the mine, have been used as a security covenant. These bonds have been linked to prices of energy commodities (petroleum, coal) and precious metals (gold, silver). It should be noted that most of them were launched in 1980-1981, at a time of unusually high world inflation.

There are three parameters that determine the return on a commodity bond: the coupon rate, the redemption value and the amount of the underlying commodity to be included in the reference bundle. These three parameters have to be considered together to arrive at the overall pricing of commodity bonds. As an example, in 1980 Sunshine Mining Company, operator of the largest silver mine in the United States, launched a \$25 million bond issue backed by silver. Each \$1,000 bond is linked to 50 ounces of silver, and carries a coupon of 8.5 per cent, with a maturity of 15 years. At maturity, the company would pay the bondholders either the \$1,000 face value or the market value of the 50 ounces of silver, whichever is greater. At the time of the first issue, the price of silver was \$16 an ounce, so that the value of 50 ounces was \$800, while the coupon rate on straight bonds was about 13 per cent. This is an example of a borrower seeking funds in the financial markets and being willing to share the potential price appreciation of the underlying commodity with the purchaser of the bond, in exchange for a lower coupon rate. It has been argued that although the initial minimum yield offered by commodity bonds has been below market interest rates, these bonds would need to carry a higher expected yield when issued than conventional bonds, in order to compensate the investor for the uncertain stream of payments (risk premium). To the extent that the lender, because of either a greater ability to diversify a specific risk or a greater financial resilience for bearing risk, demands a smaller premium than the maximum the borrower is willing to pay, both parties will be better off by transferring the risk. The lender would also benefit from protection against the default risk by use of the underlying commodity as a collateral.

**COMMODITY BONDS ISSUED BY DEVELOPING COUNTRIES**

*Issuer: Mexican Government as trustee.*

*Terms: In earlier issues, redemption value indexed to market value of crude oil on maturity date. In the 1983 issue both redemption price and interest indexed to the price of oil.*

Date	Maturity	Amount	Coupon	Underwriter
1977-1983	1980-1986	66 billion pesos	10% net 9.48% net	Nacional Financiera SA, Grupo Financiero Internacional

*Issuer: Semirara Coal Corporation, Philippines.*

*Terms: Convertible in four years to either common shares at value of issue or market value of 30 tons of coal per 10,000-pesos share.*

Date	Maturity	Amount	Coupon	Underwriter
1980	1984	\$17 million convertible preferred securities	16 per cent	Jalandoni, Jayme, Adams and Company, Inc.

*Source: N. Budd, "The future of commodity-indexed financing", Harvard Business Review, July-August 1983, p. 45.*

dealing with debt such as interest-capitalization or conversion to equity-like claims.

Several disadvantages have also been cited for such schemes. One is that, once the commercial banking system has been relieved of its claims on debtor developing countries, it would no longer have an incentive to continue to lend to them and to that extent new flows from banks might be impaired. A second concern is that the end result might turn out to be a bail-out for the commercial banking system.

Although claims would be bought at a discount from commercial banks, the appropriate size of that discount will necessarily be difficult to determine. A negligible discount would be extremely advantageous to the banks, while larger discounts could so impair their earnings as to preclude their voluntary participation in the scheme. A further concern is that, once developing country claims were concentrated in an officially-backed institution, the pressures for outright relief to debtor countries would intensify.

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### C. Changing the value of claims

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Debt relief, i.e., the reduction in the present value of claims held against a debtor, has been a fairly common occurrence as regards debt resulting from official development assistance and has also been granted for some other forms of claims held by official creditors. As regards private creditors, however, debt relief as such has not occurred; even where banks have judged it necessary for internal accounting or regulatory purposes to set aside high loss provisions for certain types of foreign loans, the claims on the creditors concerned have normally been kept in the banks' balance sheets at face value.

There have in fact, been few proposals calling explicitly for relief of debt owed to banks, the reason being that banks are highly leveraged (i.e., their capital is a small proportion of their total deposits) and so cannot extend relief in amounts that would be significant to major debtors. At the same time, it is understood that governments cannot be expected to assume or participate in such losses. It has also been pointed out that action which imposes major losses of income and/or capital on banks may preclude further lending by those banks to the debtors concerned for an extended period.

The question remains, however, whether operations designed to give temporary relief on interest

payments would have a role to play in providing a breathing space for debtors in difficulty. Such procedures might, for example, allow debtors to pay interest for one or two years at levels that might be 2 or 3 percentage points below LIBOR. Since this would be understood to be a temporary and reversible arrangement, there might be no need for the banks to write down the face value of the debt concerned. While such procedures would impose losses on some banks, these would not be unmanageable and in certain circumstances might be recognized to be the best outcome available.

In this connection, the Bradley proposal is pertinent. United States Senator Bill Bradley has proposed that annual debt relief be granted within the context of a broad programme covering a three-year period. Each year interest rates would be reduced by 3-percentage points on debt owed to governments or to commercial banks and the outstanding principal would be written down by 3 per cent. This relief would be accompanied by additional capital flows in support of structural adjustment. These flows would be conditional on the adoption of certain policy measures by the debtor countries, and each successive year's debt relief would be dependent on satisfactory performance during the previous year. ■



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## Chapter VI: Notes and references

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**STATISTICAL ANNEX**


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Annex table 1

**GROWTH OF WORLD OUTPUT BY COUNTRY GROUPS, 1960-1985**  
(Average annual percentage change or change over previous year)

Country group	1960- 1969	1970- 1974	1975- 1979	1980- 1984	1980	1981	1982	1983	1984	1985
World	5.3	4.9	4.4	1.9	1.9	1.7	0.4	2.1	4.2	2.9
Developed market-economy countries <sup>a</sup>	5.2	4.3	4.0	1.9	1.3	1.6	-0.2	2.4	4.5	2.8
North America	4.8	4.1	4.7	2.2	-0.2	2.7	-2.3	3.6	6.7	2.5
Western Europe	4.6	4.1	3.2	1.0	1.3	0.0	0.5	1.4	2.2	2.3
Japan	10.2	5.4	5.1	3.7	4.4	3.9	2.8	3.1	5.8	5.0
Others	5.7	5.0	2.2	1.9	3.8	3.9	0.2	0.2	5.3	2.8
Developing countries and territories <sup>b</sup>	5.5	6.8	5.6	0.8	3.2	1.3	0.9	-0.5	2.5	2.0
Latin America	5.2	6.6	5.0	-0.4	4.9	0.5	-1.3	-2.4	2.9	2.8
North Africa	5.7	5.4	9.1	1.7	5.0	-0.3	2.3	1.4	3.3	2.3
Other Africa	4.3	5.9	2.7	-1.1	3.4	0.4	0.4	-3.3	-1.5	1.9
West Asia	7.7	10.6	5.4	-1.9	-3.9	-2.8	2.1	-5.8	-1.0	-2.8
South Asia	3.7	1.5	4.0	4.6	6.9	5.1	2.2	6.8	4.2	5.0
East Asia	6.6	8.8	8.9	5.4	5.7	6.9	3.5	6.0	5.8	2.6
China <sup>c</sup>	5.1	4.7	6.7	6.9	6.1	4.8	7.5	7.1	7.9	13.0
Socialist countries of Eastern Europe <sup>d</sup>	6.6	6.4	4.5	3.4	3.1	2.4	3.0	4.2	3.8	3.2

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

*a* Gross domestic product or gross national product.

*b* Gross domestic product.

*c* National income.

*d* Net material product.

Annex table 2

GROWTH OF GDP PER CAPITA FOR SELECTED GROUPS OF DEVELOPING COUNTRIES, 1960-1984  
(Annual average rate of percentage increase over previous year)

<i>Developing countries</i>	1960- 1969	1970- 1974	1975- 1979	1980- 1984	1980	1981	1982	1983	1984
Total	2.9	4.2	3.1	-1.5	0.9	-1.2	-1.5	-2.8	0.2
<i>By major category</i>									
Major petroleum exporters	3.7	5.7	2.7	-4.0	-1.5	-2.6	-2.1	-7.6	-2.5
Other developing countries	2.4	3.1	3.0	0.0	2.4	-0.4	-1.3	0.2	1.7
<i>of which:</i>									
Major exporters of manufactures	2.9	5.6	4.0	-0.5	2.3	-2.4	-1.5	-0.5	2.9
Least developed	1.1	-1.0	2.0	-0.6	-0.4	0.2	0.0	-0.8	-1.7
Other	2.2	1.6	2.5	0.7	3.0	1.7	-0.8	1.2	1.3
<i>By income group</i>									
GDP over \$1500	3.6	5.4	3.6	-2.4	0.0	-2.6	-2.1	-4.4	0.4
GDP from \$500 to \$1500	2.3	3.9	1.8	-1.7	0.9	-0.2	-0.8	-3.5	-1.6
GDP less than \$500	1.2	0.5	2.3	1.7	4.4	2.8	-0.1	3.0	1.5
<i>By region</i>									
Latin America	2.4	3.9	2.5	-2.7	2.5	-1.8	-3.5	-4.6	0.7
North Africa	3.1	2.9	6.1	-1.0	2.3	-3.0	-0.5	-1.2	0.7
Other Africa	1.6	2.9	-0.4	-4.1	0.4	-2.8	-2.7	-6.2	-4.3
West Asia	4.6	7.3	2.4	-4.7	-6.4	-5.6	-0.8	-8.4	-3.7
South Asia	1.3	-0.9	1.7	2.4	4.7	2.9	0.0	4.6	2.1
East Asia	4.0	6.2	6.6	3.3	3.6	4.6	1.5	3.9	3.8

*Source:* Based on data of the United Nations Statistical Office, and United Nations Economic Commission for Africa, Economic Commission for Europe, Economic Commission for Latin America and the Caribbean, and Economic and Social Commission for Asia and the Pacific, OECD, World Bank and other international and national sources.

Annex table 3

<b>DISTRIBUTION OF DEVELOPING COUNTRIES BY RATES OF GROWTH OF OUTPUT, 1960-1985 <sup>a</sup></b> (Number of countries)					
<i>Period</i>	1960- 1969	1970- 1974	1975- 1979	1980- 1984	1985 <sup>b</sup>
<b>Growth of GDP</b>					
<i>5.5 per cent and above</i>					
Total	42	48	48	15	7
Latin America	10	12	10	-	1
North Africa	1	3	6	1	-
Other Africa	15	18	14	4	3
West Asia	8	5	8	2	-
South Asia	1	-	2	2	2
East Asia	7	10	8	6	1
<i>3.5 per cent to 5.4 per cent</i>					
Total	38	16	22	17	22
Latin America	13	6	10	1	2
North Africa	3	1	-	2	3
Other Africa	16	7	7	7	9
West Asia	1	1	1	3	1
South Asia	3	1	4	2	3
East Asia	2	-	-	2	4
<i>0.5 per cent to 3.4 per cent</i>					
Total	20	31	19	35	35
Latin America	2	7	2	10	11
North Africa	2	1	-	2	1
Other Africa	11	15	14	17	13
West Asia	-	2	-	-	6
South Asia	3	5	1	3	1
East Asia	2	1	2	3	3
<i>0.4 per cent or below</i>					
Total	5	10	16	38	22
Latin America	-	-	3	14	11
North Africa	-	1	-	1	2
Other Africa	4	6	11	18	4
West Asia	1	2	1	5	3
South Asia	-	1	-	-	-
East Asia	-	-	1	-	2

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

<sup>a</sup> Based on available statistics for 105 countries.

<sup>b</sup> Preliminary. No data available for one country in South Asia, one country in East Asia and 17 countries in "Other Africa".

Annex table 4

**GROSS CAPITAL FORMATION AS A SHARE OF GDP FOR SELECTED COUNTRY GROUPS, 1960-1985**  
*(Percentages based on values in current prices)*

<i>Country group</i>	<i>1960- 1969</i>	<i>1970- 1974</i>	<i>1975- 1979</i>	<i>1980- 1983</i>	<i>1980</i>	<i>1981</i>	<i>1982</i>	<i>1983</i>	<i>1984</i>	<i>1985</i>
World <sup>a</sup>	21.9	23.5	23.1	21.6	22.9	22.4	20.6	20.6	..	..
Developed market-economy countries	22.4	23.8	22.6	20.9	22.4	21.7	19.8	19.7	19.9	20.0
North America	19.6	19.5	19.7	17.8	18.6	19.4	16.4	16.9	17.9	16.9
Western Europe	23.7	24.8	22.1	20.2	22.2	19.8	19.4	19.3	19.3	18.8
Japan	35.4	37.2	32.0	30.8	32.6	31.6	30.4	28.6	28.2	28.2
Others	26.2	26.6	24.7	24.7	25.3	27.8	23.9	21.9	23.9	..
Developing countries and territories	19.3	21.7	25.2	24.5	25.0	25.2	23.8	24.2	23.2	23.1
Latin America	21.0	23.3	24.7	21.4	23.5	22.7	20.6	17.9	17.2	17.9
North Africa	18.5	23.5	32.7	29.6	29.4	30.1	28.6	30.1	..	..
Other Africa	14.1	18.5	22.6	22.5	23.6	24.3	21.8	19.8	..	..
West Asia	19.2	19.6	24.2	27.0	23.7	27.6	25.7	30.9	27.5	25.9
South Asia	16.8	18.2	22.1	23.4	24.4	23.6	23.2	22.6	..	..
East Asia	17.7	23.6	26.9	27.7	28.4	27.7	27.0	27.7	..	..

*Source:* UNCTAD secretariat, based on data of the United Nations, OECD and IMF.

<sup>a</sup> Excluding socialist countries of Eastern Europe and China.



Annex table 5

**WORLD <sup>a</sup> TRADE SUMMARY: ANNUAL RATES OF CHANGE IN VOLUME AND PRICES,  
BY MAIN COUNTRY GROUPS IN 1984 AND 1985 AND FORECASTS FOR 1986 AND 1987  
(Percentage)**

Country group	1984	1985	1986	1987
	Actual	Estimated	Forecast	
World				
Export volume	7.8	2.8	3.7	3.1
Developed market-economy countries				
Export volume	9.7	4.0	3.5	3.3
Terms of trade	-1.0	1.0	7.0	0.5
Purchasing power of exports	9.2	5.6	10.7	3.8
Import volume	11.6	4.8	4.8	5.1
All developing countries				
Export volume	6.5	-0.4	4.1	3.6
Terms of trade	2.4	-0.9	-19.0	-1.4
Purchasing power of exports	6.9	-1.3	-15.7	2.2
Import volume	1.3	-3.3	-4.7	-0.4
Oil-exporting developing countries <sup>b</sup>				
Export volume	0.0	-3.3	4.7	3.0
Terms of trade	1.0	0.3	-40.8	-3.8
Purchasing power of exports	0.7	-3.0	-38.0	-1.0
Import volume	-6.2	-5.7	-18.0	-5.4
Net oil-importing developing countries <sup>c</sup>				
Export volume	11.5	2.7	3.5	4.0
Terms of trade	3.3	-1.9	2.5	-2.0
Purchasing power of exports	15.4	0.7	6.1	1.9
Import volume	7.1	-1.9	4.0	2.0

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

**Note:** The terms-of-trade calculations for groups of countries have been made by the UNCTAD secretariat using a methodology briefly described in the UNCTAD *Handbook of International Trade and Development Statistics, Supplement 1985* (United Nations publication, Sales No. E F.85.II.D.12), p. 536.

**a** Excluding China and the socialist countries of Eastern Europe.

**b** Major petroleum exporters *plus* Bolivia, Egypt, Malaysia, Peru and Tunisia.

**c** All developing countries *less* oil-exporting developing countries as defined above.

Annex table 6

**DEVELOPING COUNTRIES: EXPORTS BY DESTINATION, 1975-1985**  
(Annual percentage change)

<i>Exports to</i>	<i>1975- 1980</i>	<i>1980- 1981</i>	<i>1981- 1982</i>	<i>1982- 1983</i>	<i>1983- 1984</i>	<i>1984- 1985<sup>a</sup></i>
Developed market-economy countries	21.5	-7.4	-14.5	-6.7	7.7	-11.8
EEC	19.3	-12.7	-14.0	-15.5	1.4	-17.4
United States	25.1	-6.6	-17.7	8.1	14.5	-8.1
Japan	22.5	-1.9	-8.4	-8.8	5.8	-8.7
Socialist countries	15.4	7.3	5.9	0.4	-0.9	-6.2
Developing countries	23.1	9.6	-5.0	-7.5	7.1	-14.4
World	21.5	-2.8	-11.0	-6.5	7.1	-12.2
<i>Memo item: imports from world</i>	18.3	9.5	-6.1	-7.7	1.1	-8.4

*Source:* UNCTAD secretariat calculations.

<sup>a</sup> First half of each year.

Annex table 7

**DEVELOPING COUNTRIES: INTRATRADE, 1975-1985**  
(Annual percentage change)

<i>Region</i>	<i>1975- 1980</i>	<i>1980- 1981</i>	<i>1981- 1982</i>	<i>1982- 1983</i>	<i>1983- 1984</i>	<i>1984- 1985<sup>a</sup></i>
All developing countries	23.1	9.6	-5.0	-7.5	7.1	-14.4
<i>of which in:</i>						
Africa	8.7	2.5	-11.0	-10.2	12.2	-3.4
Latin America	19.0	0.0	-4.0	-10.3	-0.1	-4.7
West Asia	23.0	41.6	1.5	-12.7	10.0	-23.8
South and East Asia	27.3	9.5	4.3	4.8	10.0	-9.7

*Source:* UNCTAD secretariat calculations.

<sup>a</sup> First half of each year.

Annex table 8

**TRENDS IN WORLD MARKET PRICES FOR MAJOR AGRICULTURAL PRODUCTS  
AND MINERALS EXPORTED BY DEVELOPING COUNTRIES, 1980-1985**

Period	Nominal <sup>a</sup>			Deflated <sup>b</sup>		
	Agri-cultural products	Minerals	Total	Agri-cultural products	Minerals	Total
<i>Indices, 1980 = 100</i>						
1981	85	86	85	89	91	89
1982	70	78	72	76	85	78
1983	75	77	75	85	88	86
1984	77	73	76	91	86	90
1985	67	72	68	79	85	80
<i>Percentage change</i>						
1980-1982	-30	-22	-28	-24	-15	-22
1982-1985	-4	-7	-5	4	0	3
1980-1985	-33	-28	-32	-11	-15	-20

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

*a* In terms of United States dollars.

*b* Nominal index deflated by United Nations index of unit values of exports of manufactures from developed market-economy countries.

Annex table 9

**DEVELOPING COUNTRIES: CONTRIBUTION OF EXPORTS TO GROWTH OF REAL GDP,<sup>a</sup> 1981-1985  
(Percentage)**

Region	<i>b</i>	1981	1982	1983	1984	1985
North Africa	I	-2.8	0.0	0.2	0.1	1.0
	II	0.9	2.0	-0.2	-0.2	0.3
Other Africa	I	-3.2	0.1	-0.1	4.2	1.5
	II	-3.0	-1.2	-2.3	2.5	-1.5
Latin America	I	0.6	-0.1	0.6	1.8	0.6
	II	0.2	-1.2	-0.6	0.8	-1.3
West Asia	I	-2.1	0.4	-1.1	-1.1	-0.2
	II	4.5	7.7	1.1	1.4	1.4
Other Asia	I	2.5	0.6	2.9	4.9	1.6
	II	0.9	-1.6	1.7	4.9	0.8
All developing countries	I	0.0	0.2	0.9	2.5	0.9
	II	0.8	0.2	0.1	2.2	-0.2

*Source:* UNCTAD secretariat calculations.

*a* Changes in real exports expressed as a percentage of previous year's GDP.

*b* I = exports unadjusted for terms of trade changes; II = exports adjusted for terms of trade changes, i.e., purchasing power of exports.

Annex table 10

**PRODUCTION OF MAJOR AGRICULTURAL COMMODITIES,  
1978-1980 TO 1983-1984**

Commodity group	Developing countries			Developed market-economy countries		
	Value in 1978-1980	Volume (1978-1980 = 100)		Value in 1978-1980	Volume (1978-1980 = 100)	
	Per cent	1981-1982	1983-1984	Per cent	1981-1982	1983-1984
Food and tobacco <sup>a</sup>	66.9	107	114	76.8	107	102
Tropical food and beverages <sup>b</sup>	11.7	109	108	0.2	103	102
Vegetable oilseeds and oils <sup>c</sup>	8.3	112	117	10.9	105	92
Agricultural raw materials <sup>d</sup>	13.1	97	97	12.1	101	98
Total	100.0	107	111	100.0	106	100
<i>Billions of dollars</i>						
Total value in constant prices <sup>e</sup>	245	261	272	179	190	180

**Source:** *FAO Production Yearbook*, 1978 and 1984; UNCTAD, *Yearbook of International Commodity Statistics*, 1985 (United Nations publication, Sales No. E.85.II.D.24).

**Note:** All data in this table are derived from quantities produced, valued at average world export unit values in 1978-1980.

**a** Wheat, rice, maize, sugar, beef, tobacco.

**b** Cocoa, coffee, tea, bananas.

**c** Copra, groundnuts, linseed, olive oil, palm oil, palm kernels, soya-beans, sunflower seed.

**d** Cotton, jute, sisal, wood, natural rubber, industrial roundwood.

**e** Valued at average world export unit values in 1978-1980.

*Annex table 11*

**VOLUME OF WORLD <sup>a</sup> PRODUCTION OF MINERALS, ORES AND METALS IN RELATION TO  
INDUSTRIAL PRODUCTION IN DEVELOPED MARKET-ECONOMY COUNTRIES, 1980-1984**  
(Indices, 1980 = 100)

	1980	1981	1982	1983	1984
Production of minerals, ores and metals <sup>b</sup> in:					
Developing countries	100	101	100	99	105
Developed market-economy countries	100	98	83	83	93
Total	100	99	89	89	97
Industrial production in developed market-economy countries					
Total	100	100	96	100	107
of which:					
Basic metals	100	99	85	87	94
Metal products	100	101	97	100	110

*Source:* UNCTAD, *Yearbook of International Commodity Statistics, 1985*; United Nations, *Monthly Bulletin of Statistics*, November 1985.

<sup>a</sup> Excluding China and the socialist countries of Eastern Europe.

<sup>b</sup> Indices based on quantities valued at 1980 export unit values of individual ores and metals (separately for developing countries and for developed market-economy countries). For individual minerals, ores and metals included, see annex table 12.

Annex table 12

**PRODUCTION OF MAJOR MINERALS, ORES AND METALS IN DEVELOPING COUNTRIES  
AND IN DEVELOPED MARKET-ECONOMY COUNTRIES, 1980-1984 <sup>a</sup>**

Commodity	Value		Indices			Value	
	1980	1981	1982	1983	1984	1984	1980-1984 cumulative change <sup>b</sup>
	\$ billion		1980 = 100			\$ billion	
<b>Developing countries</b>							
Bauxite/alumina/aluminium	4.26	97	79	88	101	4.29	-1.53
Copper <sup>c</sup>	6.88	84	75	81	77	5.30	-5.71
Iron ore	4.11	107	104	98	94	3.88	0.10
Tin	2.96	83	72	65	59	1.75	-3.57
Others <sup>d</sup>	4.77	100	85	77	91	4.33	-2.23
Total	22.98	94	83	82	85	19.55	-12.94
<b>Developed market-economy countries</b>							
Bauxite/alumina/aluminium	19.45	86	59	66	82	15.90	-20.88
Copper <sup>c</sup>	7.20	89	70	74	64	4.58	-7.48
Iron ore	6.03	98	78	66	77	4.65	-4.90
Others <sup>d</sup>	10.76	97	75	75	87	9.39	-7.10
Total	43.44	91	67	70	79	34.52	-40.36

**Source:** See table 12 of the text.

<sup>a</sup> Production in each of the years 1980-1984 has been calculated by valuing quantities produced at unit values of exports in the year in question.

<sup>b</sup> Aggregate value of production in 1981-1984 less four times the value of production in 1980.

<sup>c</sup> Ore and metal.

<sup>d</sup> Lead, manganese ore, nickel and phosphate rock (plus tin for developed market-economy countries).

Annex table 13

**CHANGES IN COPPER AND IRON ORE PRODUCTION AND CAPACITY IN DEVELOPING COUNTRIES  
AND IN DEVELOPED MARKET-ECONOMY COUNTRIES, 1980-1990**  
(Millions of tons)

Commodity	Year	Developing countries		Developed market-economy countries	
		Production	Capacity	Production	Capacity
Copper	1980	3.47	4.08	2.57	3.19
	1984	3.87	4.69	2.50	3.37
	1990	..	5.56	..	3.27
Change	1980-1984	0.40	0.61	-0.07	0.18
	1984-1990	..	0.87	..	-0.10
Iron ore	1980	136	186 <sup>a</sup>	200	266 <sup>a</sup>
	1984	132	196	159	240
	1990	..	209	..	216
Change	1980-1984	-4	10 <sup>b</sup>	-41	-26 <sup>b</sup>
	1984-1990	..	13	..	-24

**Source:** UNCTAD, *Yearbook of International Commodity Statistics 1985*; International Wrought Copper Council, *Survey of planned increases in world copper mine, smelter and refinery capacities, 1980-1987.*, London, 1983; Intergovernmental Council of Copper Exporting Countries, *Survey of Mine, Unrefined and Refined Copper Capacities*, Paris, 1985; United States Bureau of Mines, *Mineral Facts and Problems*, 1982 and 1985, Washington, D.C.

<sup>a</sup> 1981.

<sup>b</sup> 1981-1984.



Annex table 14

**NET DEBTOR DEVELOPING COUNTRIES: <sup>a</sup> OUTSTANDING DEBT, DEBT SERVICE AND  
DEBT-SERVICE RATIOS IN 1984 AND 1985 AND FORECASTS FOR 1986 AND 1987**  
(Billions of dollars)

<i>Debt and debt ratios</i>	1984	1985	1986	1987
	<i>Actual</i>	<i>Estimated</i>	<i>Forecast</i>	
Debt outstanding, end of year <sup>b</sup>	760.4	796.7	825.0	852.0
<i>of which:</i>				
Medium- and long-term debt	612.3	655.3	698.0	728.0
IMF credit	31.6	35.3	35.5	33.0
Debt service on medium- and long-term debt <sup>c</sup>				
Medium- and long-term loans	88.7	91.1	93.3	99.6
IMF lending	4.6	6.1	8.4	10.4
Total	93.3	97.2	101.7	110.0
<i>of which:</i>				
Debt amortization	41.3	46.7	50.3	53.0
<i>Ratio (percentage)</i>				
Medium- and long-term debt outstanding to exports <sup>d</sup>	178.6	194.2	223.9	223.3
Interest on medium- and long-term debt to exports <sup>d</sup>	14.5	14.2	14.9	15.2
Debt service to exports <sup>d</sup>	25.9	27.0	30.3	30.9

**Source:** UNCTAD secretariat calculations, based on international sources.

<sup>a</sup> See note *a* to table 22 of the text.

<sup>b</sup> Short-, medium and long-term, including IMF drawings outstanding.

<sup>c</sup> Estimates of debt amortization for 1984 reflect actual payments. The estimates for 1985 and forecasts for 1986 and 1987 have been adjusted to take into account restructuring agreements that had been agreed, in principle, up to the end of 1985.

<sup>d</sup> Goods and services.

Annex table 15

**CENTRAL GOVERNMENT EXPENDITURE  
IN DEVELOPING COUNTRIES: TOTAL AND SHARES OF EDUCATION AND HEALTH, 1977-1983**

<i>Category of expenditure</i>	<i>1977- 1979</i>	<i>1980</i>	<i>1981</i>	<i>1982</i>	<i>1983</i>
<i>Percentage of total central government expenditure</i>					
<i>On education</i>					
Latin America	11.8	10.9	10.5	9.3	9.0
West Asia	11.3	15.1	11.9	11.0	..
South and East Asia	9.6	9.0	9.2	9.9	11.0
<i>On health</i>					
Latin America	5.6	5.0	4.9	4.8	4.7
West Asia	4.6	5.5	4.8	5.0	..
South and East Asia	3.0	2.7	2.9	3.1	3.3
<i>Percentage of GDP</i>					
<i>Total</i>					
Latin America	18.3	19.2	21.3	23.9	22.4
West Asia	35.2	32.7	33.4	35.6	..
South and East Asia	16.4	17.6	18.8	18.5	18.4

*Source:* IMF, *Government Finance Statistics Yearbook*, vol. IX, 1985.

Annex table 16

**EVOLUTION OF REAL WAGES IN SELECTED LATIN AMERICAN COUNTRIES, 1975 AND 1981-1985  
(Annual averages, indices, 1980 = 100)**

<i>Country</i>	<i>1975</i>	<i>1981</i>	<i>1982</i>	<i>1983</i>	<i>1984</i>	<i>1985<sup>a</sup></i>
Argentina <sup>b</sup>	119.6	89.4	80.1	103.6	131.5	117.2
Brazil <sup>c</sup>	87.5	106.0	116.4	106.3	106.2	116.5
Chile <sup>d</sup>	69.5	109.1	108.7	97.1	97.4	93.2
Colombia <sup>e</sup>	86.5	101.4	105.2	110.4	118.7	113.4
Mexico <sup>f</sup>	98.8	102.4	107.7	77.9	74.6	68.4
Peru <sup>g</sup>	119.9	91.4	93.2	86.4	74.7	59.5
Uruguay <sup>h</sup>	136.5	107.5	107.2	85.0	77.3	86.8

*Source:* As for table 2 of the text.

<sup>a</sup> Preliminary.

<sup>b</sup> Wages for manual workers in manufacturing; 1985: average January-August.

<sup>c</sup> Average wages in industry in general, deflated by the Rio de Janeiro consumer price index; 1985: average January-June.

<sup>d</sup> Wages of manual and non-manual workers in non-agricultural sectors except large-scale copper mining and pulp and paper industries; 1985: average January-September.

<sup>e</sup> Wages for manual workers in manufacturing; 1985: average January-May.

<sup>f</sup> Average wage in manufacturing; 1985: average January-April.

<sup>g</sup> Wages of private sector manual workers in the metropolitan area of Lima; 1985: average January-August.

<sup>h</sup> Index of average real wages; 1985: average January-October.

Annex table 17

**EXTENT OF OPEN UNEMPLOYMENT**  
**AS MEASURED ON DIFFERENT BASES IN SELECTED DEVELOPING COUNTRIES, 1973-1984**  
*(Indices, 1980 = 100)*

<i>Country</i>	<i>Basis <sup>a</sup></i>	<i>1973</i>	<i>1975</i>	<i>1978</i>	<i>1980</i>	<i>1982</i>	<i>1983</i>	<i>1984</i>
Burma	<i>EOS</i>	40	41	85	100	135	89	83
Egypt	<i>LFSS</i>	27	44	66	100	..	..	113
India	<i>EOS</i>	50	58	77	100	122	136	150
Indonesia	<i>EOS</i>	38	49	67	100	158	..	..
Jamaica	<i>LFSS</i>	65	65	85	100	97 <sup>b</sup>	..	..
Madagascar	<i>EOS</i>	40	31	89	100	62	69	..
Malaysia	<i>EOS</i>	212	171	147	100	95	..	..
Mauritius	<i>EOS</i>	84	66	53	100	231	228	219
Pakistan	<i>EOS</i>	117	142	103	100	100	106	108
Philippines	<i>LFSS</i>	79	66	79	100	125	97	140
Republic of Korea	<i>LFSS</i>	62	68	59	100	88	82	76
Singapore	<i>LFSS</i>	112	115	103	100	88	409	100
Syrian Arab Republic	<i>LFSS</i>	94	109	110	100	..	131	..
Thailand	<i>LFSS</i>	35	33	85	100	450	..	..
Tunisia	<i>EOS</i>	56	44	89	100	118	..	..

*Source:* International Labour Office, *Yearbook of Labour Statistics*, 1983 and 1985.

*a* LFSS: labour force sample survey; EOS: employment office statistics.

*b* 1981.

Annex table 18

## UNITED STATES: MACROECONOMIC INDICATORS, 1978-1985

Year	Growth of		Unemployment rate (per cent)	Structural budget balance <sup>b</sup> (per cent of GNP)	Money supply (M1) <sup>a</sup>	Increase in		GNP deflator <sup>a</sup>	Three-month Treasury bill rate (per cent)		Effective exchange rate (March 1973 = 100)
	Real GNP <sup>a</sup>	Final domestic purchases <sup>b</sup>				Consumer prices <sup>c</sup>	Nominal		Real <sup>d</sup>		
1978	5.0	4.8	6.0	-2.2 (0.9)	8.3	7.7	7.4	7.2	-0.2	92.4	
1979	2.8	2.6	5.8	-1.6 (1.2)	7.1	11.3	8.6	10.1	1.4	88.1	
1980	-0.3	-0.4	7.1	-2.2 (0.7)	6.5	13.5	9.2	11.4	2.0	87.4	
1981	2.5	2.0	7.6	-1.9 (1.6)	6.5	10.4	9.6	14.0	4.0	102.9	
1982	-2.1	0.3	9.7	-3.0 (0.3)	8.8	6.1	6.0	10.6	4.3	116.6	
1983	3.4	4.4	9.6	-3.7 (-0.2)	9.8	3.2	3.9	8.6	4.5	125.3	
1984	6.5	6.4	7.5	-4.7 (-1.4)	6.0	4.3	4.0	9.5	5.3	138.2	
1985	2.2	4.5	7.2	.. (-1.9)	12.2	3.6	3.3	7.5	4.1	143.0	
1979 IV	0.7	1.5	5.9	-2.0	5.0	12.2	7.3	11.8	4.2	87.4	
1980 I	1.9	-0.1	6.1	-2.2	5.8	16.5	9.6	13.4	3.5	87.4	
1980 II	-9.0	-9.6	7.5	-2.2	3.0	15.4	10.9	9.6	-1.2	87.8	
1980 III	0.8	2.9	7.5	-2.3	13.9	7.5	8.9	9.2	0.3	85.4	
1980 IV	3.8	4.6	7.5	-2.1	10.8	11.1	11.3	13.6	2.1	89.0	
1981 I	10.0	5.5	7.3	-1.5	4.6	10.8	11.0	14.4	3.1	94.5	
1981 II	-0.5	7.4	7.4	-1.5	9.2	9.7	6.5	14.9	7.9	103.1	
1981 III	2.8	2.6	7.4	-2.0	0.3	11.9	10.1	15.1	4.5	110.0	
1981 IV	-5.4	-3.0	8.4	-2.5	5.7	5.8	8.3	11.8	3.2	105.4	
1982 I	-4.6	0.7	8.8	-2.2	10.5	3.6	4.6	12.8	7.8	109.9	
1982 II	-0.8	-1.3	9.5	-2.2	3.2	6.1	5.6	12.4	6.4	114.0	
1982 III	-0.9	2.0	9.9	-3.2	6.1	7.8	3.4	9.3	3.7	119.8	
1982 IV	0.5	6.0	10.7	-4.3	13.1	1.0	3.4	7.9	4.4	122.2	
1983 I	3.3	1.4	10.4	-3.4	14.1	-0.3	5.0	8.1	3.0	119.4	
1983 II	9.4	9.1	10.1	-3.3	11.6	5.1	2.6	8.4	5.7	123.0	
1983 III	6.8	5.4	9.4	-4.4	9.5	4.7	3.1	9.1	5.8	128.7	
1983 IV	5.9	6.9	8.5	-3.7	4.8	3.7	4.4	8.8	4.2	130.2	
1984 I	10.1	6.3	7.9	-4.2	6.2	4.3	4.4	9.2	4.6	131.6	
1984 II	5.1	11.0	7.5	-4.5	6.5	4.6	3.8	9.8	5.8	132.8	
1984 III	2.1	2.0	7.5	-4.9	4.5	4.5	3.8	10.3	6.3	141.7	
1984 IV	0.6	5.2	7.2	-5.4	3.2	2.9	3.7	8.8	4.9	147.2	
1985 I	3.7	2.7	7.3	-4.2	10.6	2.5	3.0	8.2	5.0	156.5	
1985 II	1.1	4.5	7.3	-5.4	10.5	5.1	3.3	7.5	4.1	149.1	
1985 III	3.0	7.0	7.2	-5.1	14.5	2.8	2.9	7.1	4.1	139.2	
1985 IV	2.4	2.9	7.0	..	10.7	3.7	3.3	7.2	3.8	128.2	

Source: Survey of Current Business; Federal Reserve Bulletin; P. Muller and R.W.R. Price, "Structural Budget Deficits and Fiscal Stance", OECD Working Paper, No. 15, Paris, July 1984.

<sup>a</sup> Seasonally adjusted annual percentage rates of change.

<sup>b</sup> Federal government budget balances, cyclically adjusted, as percentage of trend GNP; in brackets, structural budget balance as percentage of potential GNP.

<sup>c</sup> Annual percentage rates of change.

<sup>d</sup> Nominal rate adjusted for GNP deflator.

Annex table 19

## MACROECONOMIC INDICATORS IN THE MAJOR WESTERN EUROPEAN ECONOMIES AND IN JAPAN, 1978-1985

Country	Year	Growth of		Unemploy- ment rate (per cent) <sup>c</sup>	Structural budget balance <sup>d</sup> (per cent of GNP)	Money supply (M1) <sup>b</sup>	Increase in		Short-term interest rate (per cent)	Exchange rate <sup>e</sup> (currency per US dollar 1973 = 100)
		Real GNP <sup>a</sup>	Real total domestic demand <sup>b</sup>				Consumer prices <sup>b</sup>	GNP deflator <sup>b</sup>		
		Nominal					Real			
France	1978	3.3	3.1	5.2	-1.7	11.0	9.1	9.9	8.1	101.3
	1979	3.3	3.9	5.9	-0.8	11.8	10.8	10.3	9.4	95.5
	1980	1.0	1.8	6.3	0.8	6.2	13.6	11.5	12.2	94.9
	1981	0.5	-0.6	7.3	-0.2	15.9	13.4	12.1	15.3	122.0
	1982	1.8	4.1	8.1	-0.6	10.9	11.8	12.6	14.6	147.6
	1983	0.7	-0.4	8.3	-0.7	12.5	9.6	9.5	12.4	171.1
	1984	1.5	0.7	9.7	-0.3	9.0	7.4	7.1	11.7	196.2
1985	1.2	2.0	10.1	-0.2	8.1 <sup>f</sup>	5.8	5.9	9.9	9.9	201.7
Germany, Fed. Rep. of	1978	3.5	3.9	3.5	-1.7	14.5	2.7	3.9	3.7	75.2
	1979	4.0	6.1	3.2	-2.3	3.0	4.1	3.8	6.6	68.6
	1980	1.5	1.7	3.0	-2.5	3.9	5.5	4.8	9.5	68.0
	1981	0.0	-2.5	4.4	-2.4	-1.4	6.3	4.2	12.1	84.6
	1982	-1.0	-2.0	6.1	-0.9	7.2	5.3	4.4	8.8	90.8
	1983	1.6	2.0	8.0	0.5	8.5	3.3	3.2	5.7	95.6
	1984	3.0	2.0	8.5	0.7	6.0	2.4	1.8	6.0	106.5
1985	2.4	1.4	8.6	1.2	5.2	2.2	2.1	5.4	110.2	
Italy	1978	2.7	1.7	7.1	-9.1	26.2	12.1	13.3	11.4	145.8
	1979	4.9	5.6	7.6	-9.7	23.7	14.8	15.2	11.9	142.8
	1980	3.9	7.4	7.5	-8.6	12.9	21.2	20.4	17.5	147.1
	1981	0.2	-2.1	8.3	-12.0	9.8	17.8	18.3	20.0	195.3
	1982	-0.5	-0.5	9.0	-12.0	16.3	16.6	17.8	20.0	232.4
	1983	-0.4	-1.1	9.8	-9.7	13.0	14.6	14.9	19.0	261.0
	1984	2.8	3.3	10.2	-10.7	12.3	10.8	10.8	17.1	301.8
1985	2.3	2.4	10.5	-10.7	15.0	9.2	8.8	14.9	328.1	
United Kingdom	1978	3.8	4.0	6.0	-3.8	16.3	8.3	10.3	9.2	127.7
	1979	2.2	3.9	5.1	-3.2	9.1	13.4	14.6	13.6	115.6
	1980	-2.3	-3.0	6.6	-1.1	3.7	18.0	18.9	16.6	105.4
	1981	-1.4	-1.5	9.9	1.8	17.1	11.9	11.8	13.9	121.9
	1982	1.5	2.5	11.4	3.3	12.4	8.6	7.4	12.2	140.3
	1983	3.4	4.5	12.6	1.6	11.2	4.6	5.1	10.1	161.6
	1984	2.8	2.5	13.0	2.0	15.6	5.0	3.9	9.9	184.1
1985	3.2	2.4	13.2	2.4	16.2	6.1	6.1	12.2	190.9	

For source and notes, see end of table

Annex table 19 (continued)

## MACROECONOMIC INDICATORS IN THE MAJOR WESTERN EUROPEAN ECONOMIES AND IN JAPAN, 1978-1985

Country	Year	Growth of		Unemploy- ment rate (per cent) <sup>c</sup>	Structural budget balance <sup>d</sup> (per cent of GNP)	Money supply (M1) <sup>b</sup>	Increase in		Short-term interest rate (per cent)	Exchange rate <sup>e</sup> (currency per US dollar 1973 = 100)
		Real GNP <sup>a</sup>	Real total domestic demand <sup>b</sup>				Consumer prices <sup>b</sup>	GNP deflator <sup>b</sup>		
							Nominal	Real		
OECD Europe	1978	3.0	2.3	5.6	-2.7	.	9.3	8.6	.	96.7
	1979	3.3	4.2	5.7	-2.9	.	10.6	8.6	.	89.9
	1980	1.4	1.6	7.0	-2.2	.	14.3	11.6	.	88.5
	1981	-0.1	-1.8	8.2	-2.4	.	12.2	10.3	.	110.3
	1982	0.6	0.9	9.2	-2.1	.	10.5	9.9	.	125.7
	1983	1.5	1.1	10.2	-1.7	.	8.2	8.0	.	138.4
	1984	2.6	1.9	10.8	-1.1	.	7.4	7.2	.	155.7
1985	2.4	2.3	11.0	..	.	6.6	7.1	.	160.9	
Japan	1978	6.0	6.1	2.2	-4.9	13.4	3.8	4.8	4.8	77.5
	1979	5.3	6.4	2.1	-4.3	3.1	3.6	2.0	6.1	80.7
	1980	4.3	1.2	2.0	-4.1	-1.9	8.0	3.2	11.5	83.5
	1981	3.7	2.1	2.2	-3.5	10.0	4.9	2.7	7.6	81.3
	1982	3.1	3.2	2.4	-2.8	5.6	2.7	1.7	6.8	91.7
	1983	3.2	1.8	2.6	-2.2	-0.1	1.9	0.8	6.5	87.5
	1984	5.1	3.8	2.7	-1.7	6.9	2.2	1.3	6.3	87.5
1985	4.6	3.7	2.6	-0.5	3.6	2.1	1.7	6.5	87.8	
Total OECD (excl. United States)	1978	3.6	3.5	4.9	-3.1	.	8.1	7.5	.	.
	1979	3.8	4.8	4.8	-3.0	.	8.9	7.9	.	.
	1980	1.9	1.2	5.8	-2.5	.	12.5	9.8	.	.
	1981	1.2	-0.2	6.7	-2.4	.	10.6	8.5	.	.
	1982	0.9	0.9	7.6	-2.1	.	8.8	8.0	.	.
	1983	2.1	1.4	8.5	-1.8	.	6.6	6.1	.	.
	1984	3.5	2.6	8.8	-1.3	.	5.9	5.5	.	.
1985	3.2	2.9	8.9	..	.	3.9	5.5	.	.	

Source: OECD Economic Outlook; IMF, International Financial Statistics; Federal Reserve Bulletin; Muller and Price, *op. cit.*; Morgan Guaranty Trust Company, *World Financial Markets*, December 1985.

<sup>a</sup> Percentage change over previous year; for France, Italy and the United Kingdom the figures are for real GDP.

<sup>b</sup> Percentage change over previous year.

<sup>c</sup> Standardized by OECD.

<sup>d</sup> General government budget balances adjusted for fiscal impact of built-in stabilizers as percentage of potential GNP.

<sup>e</sup> Exchange rate under "OECD Europe" is for the ECU/US dollar rate.

<sup>f</sup> Estimate.

## Annex table 20

UNITED STATES: LOSS IN UPSTREAM EARNINGS <sup>a</sup> COMPARED WITH 1985  
OF 13 MAJOR AND INTEGRATED OIL COMPANIES

Company	Earnings in 1985 from exploration and production		Loss from price decline from \$24 per barrel to			
	\$ million	\$ million	\$ 19		\$ 15	
			\$ million	Per cent of 1985 earnings	\$ million	Per cent of 1985 earnings
Amoco	824	180	22	432	52	
Arco	1 257	110	8	518	41	
Chevron	1 258	265	21	629	50	
Conoco	142	50	35	118	83	
Exxon	2 122	210	10	694	33	
Marathon	263 <sup>b</sup>	75	29	183	70	
Mobil	715	185	26	441	62	
Phillips	449	160	36	376	84	
Shell	1 430	240	17	572	40	
Sohio	1 254 <sup>b</sup>	.	.	452	36	
Sun	419	90	21	210	50	
Texaco	858 <sup>c</sup>	235	27	627	73	
Unocal	325 <sup>d</sup>	70	21	194	60	
Total	11 316	1 870	19 <sup>e</sup>	5 446	48	

Source: *International Petroleum Finance*, March 1986.

- <sup>a</sup> Basically from exploration and production.
- <sup>b</sup> Estimated earnings after tax.
- <sup>c</sup> Partly estimated.
- <sup>d</sup> Total earnings.
- <sup>e</sup> Calculated after excluding Sohio from total.

*Annex table 21*

**UNITED STATES: EFFECTS IN 1986 OF FALLING PETROLEUM PRICES  
ON 25 COMPANIES' CAPITAL AND EXPLORATION SPENDING PLANS**

<i>Company</i>	<i>Capital and exploration outlays (\$ million)</i>		<i>Percentage change</i>
	<i>1985 Actual</i>	<i>1986 Forecast</i>	
Amerada Hess	699	365	-48
Amoco	5 400	3 500	-35
Atlantic Richfield	3 800	2 000	-47
British Petroleum	2 560	2 940	+15
Chevron	4 000	3 500	-13
Diamond Shamrock	586	350	-40
El du Pont (Conoco)	3 079	2 900	-6
Enserch	438	262	-40
Exxon	10 800	8 000	-26
Kerr-McGee	384	287	-25
Lousiana Land	295	200	-32
Mobil	3 513	3 000	-15
Murphy Oil	345	225	-35
Occidental Petroleum	1 598	1 100	-31
Pennzoil	590	298	-49
Philips Petroleum	1 060	1 000	-6
Royal Dutch Shell	8 743	7 980	-9
Santa Fe/Southern Pacific	1 100	1 100	-
Standard Oil Company	3 177	2 000	-37
Sun Company	1 600	1 430	-11
Tenneco	1 719	1 300	-24
Texaco	2 800	2 300	-18
Union Pacific	1 067	800	-25
Unocal	1 850	1 200	-35
U.S. Steel (Marathon)	2 143	1 430	-33
Total	63 346	49 467	-22

*Source: International Petroleum Finance, March 1986.*



Annex table 22

CLAIMS <sup>a</sup> OF UNITED STATES BANKS ON DEVELOPING COUNTRIES AS A PERCENTAGE OF THEIR CAPITAL, 1978-1985 <sup>b</sup>

Region/country	All United States banks									
	1978	1979	1980	1981	1982	1983	1984	1985		
All developing countries <sup>c</sup>	144.9	159.4	169.2	191.7	183.3	165.9	138.9	117.6		
Latin America	93.6	99.6	109.4	125.0	118.8	106.0	93.5	80.4		
Africa	11.4	11.4	10.8	11.3	10.2	9.2	6.6	5.1		
West Asia	15.3	12.5	11.1	12.0	9.8	10.3	7.8	6.0		
South and South-East Asia	24.5	35.9	37.9	43.4	44.5	40.4	31.0	26.1		
Ten largest debtor countries										
Mexico	22.7	22.6	27.6	36.3	34.4	32.1	27.9	24.3		
Brazil	28.4	27.9	28.7	30.3	31.0	27.3	26.9	23.4		
Republic of Korea	8.5	11.8	13.3	14.9	17.6	15.6	11.8	10.2		
Venezuela	15.9	16.6	16.4	16.8	15.9	13.7	11.4	9.7		
Argentina	5.8	9.7	12.7	14.0	12.1	11.1	9.1	8.3		
Philippines	5.7	7.2	7.7	8.3	7.8	7.0	5.5	5.1		
Chile	3.2	4.8	6.5	9.5	8.3	7.4	6.9	5.7		
Indonesia	4.3	3.6	3.1	3.5	3.8	4.1	3.4	2.6		
Colombia	3.5	4.7	4.9	5.0	5.2	4.5	3.3	2.5		
Peru	3.4	2.7	2.9	3.0	3.5	2.8	2.3	1.6		

For source and notes see end of table.

Annex table 22 (continued)

CLAIMS <sup>a</sup> OF UNITED STATES BANKS ON DEVELOPING COUNTRIES AS A PERCENTAGE OF THEIR CAPITAL, 1978-1985 <sup>b</sup>

	Nine largest banks			Fifteen next largest banks			All other reporting banks					
	1982	1983	1984	1985	1982	1983	1984	1985	1982	1983	1984	1985
All developing countries <sup>c</sup>	284.0	263.4	221.7	191.8	189.6	179.9	146.7	115.0	76.8	66.0	54.2	45.4
Latin America	176.5	162.9	146.4	129.2	124.0	117.0	97.5	76.0	56.8	46.4	39.8	34.4
Africa	19.3	17.4	12.2	9.6	6.9	7.6	5.7	3.8	2.3	2.0	1.6	1.1
West Asia	16.7	18.4	13.7	11.4	10.8	9.3	7.4	4.6	2.6	3.1	2.2	1.2
South and South-East Asia	71.5	64.7	49.4	41.6	47.9	46.0	36.1	30.6	15.1	14.5	10.6	8.7
Ten largest debtor countries												
Mexico	45.2	43.6	38.9	34.2	37.5	35.3	29.3	24.6	21.8	19.5	16.5	14.3
Brazil	48.8	43.6	44.2	39.3	31.8	31.5	28.2	22.6	12.3	9.5	9.3	8.3
Republic of Korea	25.8	21.3	15.8	14.2	20.0	21.7	16.0	13.7	7.7	7.4	5.7	4.6
Venezuela	26.2	23.8	19.9	17.4	15.2	13.4	10.8	8.3	5.5	4.1	3.4	2.9
Argentina	19.1	18.3	15.1	14.6	13.3	12.7	10.5	8.1	4.3	3.4	2.6	2.2
Philippines	13.1	11.5	9.6	8.8	8.1	6.7	6.0	5.8	1.9	2.6	1.3	1.1
Chile	11.0	10.3	9.8	8.8	9.5	8.4	7.4	5.0	4.9	4.2	3.7	3.0
Indonesia	7.5	8.4	6.7	5.3	2.9	2.7	2.9	1.8	0.4	0.4	0.4	0.3
Colombia	8.9	7.5	6.0	4.5	3.7	4.0	2.5	1.8	1.9	1.6	0.9	0.8
Peru	4.5	4.0	3.1	2.4	5.1	4.0	3.2	1.8	1.5	1.1	0.9	0.8

Source: Statistical releases of the Federal Financial Institutions Examination Council (Country Exposure Lending Survey).

<sup>a</sup> Claims cover cross-border and non-local currency lending. The geographical distribution of claims is adjusted to reflect liabilities due to guaranties by non-residents of regions and countries.

<sup>b</sup> Situation at the end of December, except for 1985 (end of September).

<sup>c</sup> Excluding offshore banking countries overseas: Bahamas, Bahrain, Bermuda, Hong Kong, Lebanon, Liberia, Macao, Netherlands Antilles, Panama and Singapore.

Annex table 23

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA AND OF CERTAIN  
OFFSHORE BRANCHES OF UNITED STATES BANKS VIS-A-VIS DEVELOPING COUNTRIES, 1974-1985

Area	1974- 1980 Average	1981	1982	1983	1984	1985	Stock at end 1985 (\$ million)
	Percentage rate of increase <sup>a</sup>						
Developing countries and territories <sup>b</sup>	23.2	14.7	8.0	5.4	0.7	3.6	463 767 <sup>c</sup>
Major oil exporters	39.0	15.2	8.1	8.6	-2.0	1.4	199 039
Others	17.1	14.2	7.9	3.0	3.3	5.4	264 728
<i>By region:</i>							
Latin America: Total	20.0	20.0	6.1	3.1	-0.1	2.7	249 955
Major oil exporters <sup>d</sup>	36.5	24.6	4.7	3.8	-3.0	2.1	105 479
Africa: <sup>e</sup> Total	34.0	8.0	9.8	1.6	-5.0	12.7	49 058
Major oil exporters <sup>f</sup>	39.0	7.2	17.1	4.5	-6.4	18.0	22 565
West Asia: <sup>e</sup> Total	31.7	-0.3	9.9	20.0	3.1	-2.0	64 357
Major oil exporters <sup>g</sup>	42.7	0.6	10.8	23.6	0.7	-5.8	54 892
South and South-East Asia: <sup>h</sup> Total	27.0	13.1	13.8	7.9	4.1	6.1	99 532
Major oil exporters <sup>i</sup>	21.8	5.8	35.9	19.2	8.6	7.1	15 315

*Source:* Bank for International Settlements, *International Banking Statistics, 1973-1983* (Basle, April 1984) and *International Banking and Financial Market Developments* (Basle, May 1986).

- <sup>a</sup> Based on data for end-December. There are discontinuities in the time series of BIS in 1981 and 1983. The revised and unrevised totals provided by BIS for those years have been used as appropriate in estimating rates of growth.
- <sup>b</sup> Excluding offshore banking centres, i.e.: in Latin America: Barbados, Bahamas, Bermuda, Netherlands Antilles, Cayman Islands and Panama; in Africa: Liberia; in West Asia: Lebanon; in South and South-East Asia: Hong Kong and Singapore.
- <sup>c</sup> Including a small amount not shown under the regions.
- <sup>d</sup> Ecuador, Mexico, Trinidad and Tobago and Venezuela.
- <sup>e</sup> Libyan Arab Jamahiriya is included in West Asia up to 1982 (since it could not be separated from this area in the BIS series). Since 1983, it is included in Africa.
- <sup>f</sup> Algeria, Angola, Congo, Gabon, Nigeria and (since 1983), Libyan Arab Jamahiriya.
- <sup>g</sup> Bahrain, Iran (Islamic Republic of), Iraq, Kuwait, Libyan Arab Jamahiriya (up to 1982), Oman, Qatar, Saudi Arabia, Syrian Arab Republic and United Arab Emirates.
- <sup>h</sup> Including Oceania.
- <sup>i</sup> Brunei Darussalam and Indonesia.

Annex table 24

**OFFICIAL AND PRIVATE EXPORT CREDIT FLOWS FROM DAC MEMBER COUNTRIES TO DEVELOPING COUNTRIES, 1974-1984**  
(Gross and net, millions of dollars, at current prices)

Country group	1974	1975	1976/1978 <sup>a</sup>	1979	1980	1981	1982	1983	1984
Developing countries and territories									
Gross	10 074.1	13 724.9	20 859.4	25 077.0	31 608.1	30 694.7	31 045.4	30 373.4	26 418.9
Net	2 978.2	5 202.2	9 166.8	9 023.8	13 037.8	11 241.5	9 205.7	7 344.6	5 823.8
<i>By major export category:</i>									
Major petroleum exporters									
Gross	3 476.9	6 590.2	9 663.3	10 612.5	11 548.4	13 551.6	13 206.1	14 366.6	12 108.4
Net	1 230.6	2 689.8	4 591.5	3 997.0	3 843.0	3 587.8	2 938.0	4 398.6	3 813.1
Other developing countries									
Gross	6 597.2	7 134.7	11 196.1	14 464.5	20 059.7	17 143.1	17 839.3	16 006.8	14 310.5
Net	1 747.6	2 512.4	4 611.3	5 026.8	9 194.8	7 653.7	6 267.7	2 946.0	3 010.7
<i>of which:</i>									
Major exporters of manufactures									
Gross	2 308.4	3 261.9	3 887.6	5 308.0	7 825.2	5 946.7	6 132.4	4 709.1	4 487.1
Net	659.7	1 142.3	1 768.3	2 559.3	4 377.8	2 543.2	2 201.9	802.1	1 007.5
Least developed countries									
Gross	185.7	451.1	497.3	772.7	1 118.1	821.8	922.7	582.4	508.7
Net	30.7	207.4	262.4	478.5	872.8	218.7	140.0	89.2	78.4
Remaining countries									
Gross	4 103.1	3 421.7	6 811.2	8 383.8	11 116.4	10 374.6	10 784.2	10 715.3	9 314.7
Net	1 057.2	1 162.7	2 640.4	2 016.0	3 944.2	4 891.8	3 925.8	2 054.7	1 924.8

Source: OECD, *Geographical Distribution of Financial Flows to Developing Countries*, various issues, and other data of OECD.

<sup>a</sup> Annual average.

<sup>b</sup> Including unspecified developing countries and territories.

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