

WORLD ECONOMIC SURVEY 1986

**CURRENT TRENDS
AND POLICIES IN THE WORLD ECONOMY**



**UNITED
NATIONS**

Department of International Economic and Social Affairs

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PREFACE

International economic policy in 1985 was marked by a more decisive response to the challenges still facing the world economy, in the search for sustainable long-term growth for all countries.

Last year's disappointing performance notwithstanding, new policy stances and a determination to work together have contributed to a change in the world economic outlook. A new commitment to growth, lower interest rates and a major realignment among reserve currencies are among the welcome developments. However, the world economy still faces serious imbalances and unsatisfactory growth in far too many developing countries.

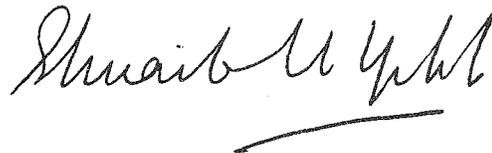
A narrowing of the unprecedented trade imbalances of 1985 and early 1986 is required to lessen protectionist pressures and reduce lingering uncertainties aggravated by the sharp fall in oil prices and instability in energy markets. A reversal of the overall negative transfer of resources from developing to developed countries, largely associated with the debt problem, also requires the urgent attention of the international community. A less unstable international economic environment is particularly important at this juncture to reinforce the still hesitant recovery of investment and reactivation of the development process in many countries.

The crucial importance of domestic policies to achieve these aims is now widely recognized. But so is the fact that the present imbalances in the world economy require concerted policy actions and a strengthening of international co-operation within multilateral frameworks.

The United Nations *World Economic Survey 1986* contains, in addition to the discussion of current trends and policies in the world economy, three special chapters, chapters V, VI and VII, which are relevant to a better understanding of the current situation and prospects. The interactions between systemic issues in trade, money and finance have become increasingly clear and are taken up in chapter V. The effects of adjustment policies on capital formation in developing countries, centrally planned economies and some major developed market economies are the subject of chapter VI. The major development challenge posed by the economic crisis in Africa is discussed in chapter VII. This chapter is intended to complement the background reports prepared for the timely special session of the General Assembly on the critical economic situation in Africa.

The *Survey* has been prepared by the General Analysis and Policies Division of the Department of International Economic and Social Affairs. It is based on data and information available up to 1 April 1986.

It is hoped that the *World Economic Survey 1986*, in addition to supporting the deliberations of the Economic and Social Council and other bodies of the United Nations, will be of interest to Governments and to the public at large.



Shuaib U. Yolah
Under-Secretary-General for
International Economic and Social
Affairs

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EXPLANATORY NOTES

The following symbols have been used in the tables throughout the report:

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

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

A hyphen indicates that the item is not applicable.

A minus sign (–) indicates a deficit or decrease, except as indicated.

A full stop (.) is used to indicate decimals.

A slash (/) indicates a crop year or financial year, e.g., 1970/71.

Use of a hyphen (-) between dates representing years, for example, 1971-1973, signifies the full period involved, including the beginning and end years.

Reference to “tons” indicates metric tons and to “dollars” (\$) United States dollars, unless otherwise stated.

Annual rates of growth or change, unless otherwise stated, refer to annual compound rates. In most cases, the growth rate forecasts for 1986 and 1987 are rounded to the nearest half of a percentage point.

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

The following abbreviations have been used:

CMEA	Council for Mutual Economic Assistance
DAC	Development Assistance Committee of the Organization for Economic Co-operation and Development
ECLAC	Economic Commission for Latin America and the Caribbean
ECU	European currency unit
EEC	European Economic Community
EMS	European Monetary System
FAO	Food and Agriculture Organization of the United Nations
f.o.b.	Free on board
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
ICOR	Incremental capital-output ratio
IDA	International Development Association
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
LIBOR	London Inter-Bank Offered Rate
MERM	Multilateral Exchange Rate Model
MFN	Most-favoured-nation
MIGA	Multilateral Investment Guarantee Agency of the World Bank
NMP	Net material product
ODA	Official development assistance
OECD	Organization for Economic Co-operation and Development

OPEC	Organization of the Petroleum Exporting Countries
Project	International Research Group of Econometric Model Builders,
LINK	with headquarters at the University of Pennsylvania at Philadelphia
SAF	Structural Adjustment Facility of the International Monetary Fund
SDR	Special drawing rights
UNCTAD	United Nations Conference on Trade and Development

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries.

The term "country" as used in the text of this report also refers, as appropriate, to territories or areas.

For analytical purposes, the following country classification has been used:

Centrally planned economies: China, Eastern Europe, Union of Soviet Socialist Republics

Developed market economies: North America, southern and western Europe (excluding Cyprus, Malta and Yugoslavia), Australia, Japan, New Zealand, South Africa

Developing countries: Latin America and the Caribbean area, Africa (other than South Africa), Asia (excluding Japan), Cyprus, Malta, Yugoslavia

For particular analyses, developing countries have been subdivided into the following groups:

Capital-surplus countries: Brunei, Islamic Republic of Iran, Iraq, Kuwait, Libyan Arab Jamahiriya, Qatar, Saudi Arabia, United Arab Emirates

Deficit countries (or capital-importing countries), subdivided into the following two subgroups:

Other net energy exporters (or deficit energy exporters): Algeria, Angola, Bahrain, Bolivia, Cameroon, Congo, Ecuador, Egypt, Gabon, Indonesia, Malaysia, Mexico, Nigeria, Oman, Peru, Syrian Arab Republic, Trinidad and Tobago, Tunisia, Venezuela

Net energy importers: All other developing countries

The designations of country groups in the text and the tables are intended solely for statistical or analytical convenience and do not necessarily express a judgement about the stage reached by a particular country or area in the development process.

Chapter I

THE UNITED NATIONS 1986 WORLD ECONOMIC SURVEY: AN OVERVIEW

The large imbalances in trade and payments that have in recent years characterized the world economy persisted in 1985 and early 1986. In particular, unprecedented disequilibrium prevailed in the trade and financial relations of major industrial countries, and there was a continued overall net transfer of resources from developing to developed countries, largely related to the international debt crisis. Both of these situations were, in the course of 1985, increasingly perceived as unsustainable, economically as well as politically.

Departure from the benign neglect of these imbalances was, therefore, one of the most encouraging developments of 1985. It was recognized that the only viable solution to the problem of imbalances required the resumption of growth and investment in the world economy as a whole, and in indebted developing countries in particular. It was recognized that there was a need for guidance and some official intervention in foreign exchange markets and for concerted policy action by major industrial countries if the frictions in international trade were to be reduced.

The shift in policy perceptions and the effective actions which resulted, were, however, only a partial response to mounting concern, in the course of 1985, about the disappointingly low increases in world output and world trade, both sharply revised downwards by mid-year and both contributing factors to growing protectionist pressures. Although short-term prospects have since improved, the need for further global adjustments remains, in early 1986, the major international economic policy challenge. It continues to pose difficult questions, such as how adjustments should be pursued, how rapid they can realistically be, how the burden of adjustment should be redistributed, and by what set of domestic and international measures an orderly rather than a disorderly unwinding of the disequilibria can be assured.

The interaction between the recent shift in perceptions and the domestic actions and co-operative international policy initiatives taken in 1985 with the changes in underlying economic conditions in the world economy is the general theme of this year's *Survey*. The present chapter presents an overview of the structure of the *Survey*, its content, and the general policy recommendations that emerge from the analysis.

Chapter II provides an overview of the world economy in 1985 and early 1986, as well as projections of the United Nations Secretariat for the years 1986 and 1987. The overview analyses the underlying reasons for the growth retardation of 1985, explains why large imbalances will continue in 1986 and part of 1987, and draws attention to the dangers of a complacent mood in developed market economies, based on their improved prospects for the short term. The interactions between policies and performances across major country groups are emphasized. Special attention is given to the diversity of experiences

among developing countries, the convergence of economic performance - at modest rates of growth and inflation - in developed market economies, and the main developments in centrally planned economies.

The short-term projections are discussed in terms of the risks and uncertainties which characterize the situation in early 1986. The results of two simulations to estimate the impact of a further decline in oil prices and of further depreciation of the United States dollar are summarized.

Chapter III deals with three fundamental issues in international trade policy. The first is the reduction in the responsiveness of international trade to world output growth observed in the 1980s in comparison with historical (post-war) experience. A brief analysis of changing patterns in the structure of world trade indicates that although the long-term relationship between world trade in manufactures and world manufacturing output has not changed significantly, a dramatic change has occurred in commodity trade and commodity production. Two separate sections are therefore devoted to the evolution of non-fuel commodity markets in the first half of the 1980s and prospects for 1986, and the trade and payments implications of falling oil prices in 1986 under two hypothetical scenarios linked to failure or success of producer co-operation.

Chapter IV discusses world payments imbalances among major industrial countries and between developing and developed market economies. The pattern of adjustment and its relation to exchange rate movements is given special attention in the section dealing with imbalances among industrial countries. The issue of net transfer of resources from developing to developed countries is the focus of the second section. The third section discusses current problems of developing country levels of official reserves and access to short-term international liquidity, focusing on the key role of the International Monetary Fund (IMF).

Chapter V deals with two system-wide issues which have come to the fore in international policy discussions in 1985 and early 1986: the strengthening of the international trading system and the reform of the international monetary system. The linkages between the two systems have been more clearly perceived and discussions gathered momentum during 1985. The section on the international trade system reviews basic reasons for the erosion of the system, past attempts at strengthening it, and some major issues likely to loom large in the new round of multilateral trade negotiations expected to start shortly.

The section on the international monetary system considers two issues that are at the core of any discussion about its improvement or reform - the exchange rate system, and the adequacy and management of international liquidity, including the role of special drawing rights (SDR). The focus of the discussion on the first issue is the

sources and causes of volatility and misalignment, the role of official intervention, policy co-ordination, and the prospects for reform, in particular the case for target zones. The discussion on the second issue focuses on the supply of liquidity in the present creditworthiness-constrained system and its implications for meeting the long-term demand for liquidity. The need for multilateral surveillance with regard to both exchange rate movements and international liquidity is emphasized.

Chapter VI considers the relationships between capital formation and adjustment in developing, centrally planned and major industrial countries. The discussion of developing countries, based on a sample of over 30 economies representing about 95 per cent of the total debt of the group, indicates the extent to which domestic imbalances are generated in the process of adjusting the balance of payments to stringent external financial constraints. Particular attention is given to the negative effects on capital formation of the reduction in domestic savings associated with net outward resource transfers. Efforts to initiate new economic programmes and strategies are briefly reviewed.

The discussion of centrally planned economies emphasizes the effects of the capital deepening observed in the recent past and its implications for the changing patterns of investment envisaged in the medium-term plans shortly to be implemented. The section on investment in the major developed market economies draws attention to the implications of the recent increase in investment in the

light of the overall decline in capital formation in advanced industrial economies.

Chapter VII addresses the critical economic situation in sub-Saharan Africa, which constitutes the major development challenge of the present decade. The chapter briefly analyses the current economic situation and the prospects for 1986, which are seen in the context of the long-term structural crisis in the region. The discussion focuses on trade issues and on the financial constraints that are the principal obstacles to the resumption of growth and have to be overcome if domestic policy measures aiming at economic rehabilitation and long-term development in sub-Saharan Africa are to succeed.

Annex I presents a brief comparative analysis of five series of commodity price indices. Annex II summarizes the significant changes that have occurred in the past decade in terms of changing patterns of production, consumption and world trade in energy. Recent changes in the structure of oil markets are briefly discussed. Both sets of issues are important background factors which should be kept in mind in analysing the medium-term to longer-term implications of the recent sharp fall in oil prices. Annex III defines net resource transfers as used in the *Survey* and explains how they have been measured. In annex IV, the results of a number of studies on the effects on trade of volatility in exchange rates are compared. Supplementary statistical tables are presented in annex V.

The world economy, 1985-1987

The world economy in 1985 was characterized by modest expansion of production and disappointingly slow growth in international trade, after the significant but uneven increases observed in 1984. The growth of world output fell back by nearly one third, from the rate of 4.6 per cent reached in 1984. The growth of world trade was only about one third of the near 9 per cent observed in 1984. Expected rates of growth of world output for 1986 and 1987 are of the order of 3.5 per cent. The rate of growth of world trade is expected to be somewhat above 4 per cent on average in 1986 and 1987.

The uncertainties surrounding market perceptions and the volatility of such key parameters as exchange rates, oil prices, and interest rates make meaningful projections for the end of the 1980s extremely difficult. However, recent changes in policy stances and lower oil prices have significantly improved the outlook for a large number of countries. Lower interest rates, the appreciation of other key currencies *vis-à-vis* the dollar and enhanced efforts in the United States to deal with its fiscal imbalance, have improved the investment climate. A significant acceleration of growth is expected in many economies. None the less, the rates of growth in world output and world trade are likely to be far below those observed in earlier decades. The implications of this slowing down for the crucial issues of underdevelopment and unemployment deserve closer attention than they tend to receive at a time when

concerns about payments and financial imbalances are so intense.

In developed market economies, current trends point to a convergence in growth performance, accompanied by a further consolidation of the gains against inflation after the sharp fall in oil prices, and given weak commodity markets, lower interest rates, and high unemployment. The rate of growth in those countries is likely to increase by 0.5 percentage points above earlier estimates and inflation is likely to decline further by more than one full percentage point in the current year, if oil prices turn out to be, on average, around 35 per cent less than in 1985. Rates of growth of output of 3 per cent or slightly higher are being projected for the rest of the decade.

The pace of expansion of production in the centrally planned economies is likely to be maintained, at least in the short term. However, the new five-year plans indicate that a significant acceleration of growth might take place by the end of the decade. The countries in Eastern Europe plan to continue their adjustment processes. To that end, co-operation among socialist countries has been strengthened in the areas of science and technology, trade relations and industrial production. They envisage further restructuring with a view to establishing the foundations for more rapid growth by the end of the decade. The Union of Soviet Socialist Republics is aiming at a sharp expansion of investment and output in certain sectors, particularly machinery. In China, policy makers are bent on moderating

the recent fast pace of economic growth in order to correct imbalances that have emerged in several areas and to carry out the contemplated industrial reform in an orderly manner.

In the developing countries, the situation is one of considerable diversity. Although some countries, notably in Asia, have fared well, the development crisis in much of Africa and Latin America is severe. Of a sample of 83 developing countries for which information was available, no less than 49 countries experienced zero or negative growth rates of real gross domestic product (GDP) per capita in 1985. These 49 countries account for more than 700 million people. The number of such countries would be even higher if GDP growth figures were adjusted for the effects of deterioration of terms of trade and net foreign capital income sent abroad, arriving at a concept of national income that is a better proxy for actual living standards.

In the largest developing economies (Brazil and India), output expanded at a considerable pace in 1985, but the combined income per capita of other developing countries declined for the fifth consecutive year in 1985. In sub-Saharan Africa, the food emergency eased in 1985, yet national income per capita is lower today than it was 15 years ago. In Latin America, excluding Brazil, national income per capita declined for the fifth year in a row. The situation in Asia is more favourable, but the more industrialized developing economies in East Asia slowed down abruptly in 1985 with the sharp deceleration in the rate of growth of imports in Japan and the United States.

Although there will be some bright spots, no major overall improvement is expected in 1986. The recent decline in oil prices promises to reduce the pressure on the balance of payments of the oil-importing developing countries. But there are secondary effects, which must be taken into account. Energy-exporting developing countries have, until recently, accounted for some 40 per cent of the combined GDP of developing countries. Their losses will be felt in terms of sharply falling imports from the rest of the world. Several energy-importing countries are already losing export sales and remittances from migrant workers to an extent that makes the net impact on them less positive than would be expected from the terms of trade gain alone. Moreover, concessional flows of finance from energy-exporting developing countries, in particular from countries members of the Organization of the Petroleum Exporting Countries (OPEC), are likely to decrease significantly in the near future.

Developing countries are expected to experience some acceleration in their growth rate, from 2.4 per cent in 1985 to 3 per cent in 1986 and to 3.5 per cent in 1987. However, the average growth rate projected for 1986 and 1987 is barely higher than that of the developed countries, where population growth is only about 0.7 per cent compared with 2.5 per cent in the developing countries. The energy importers as a group are projected to grow at an annual rate of 4.5 per cent in 1986 and 1987. Within this latter group, a few countries, mainly the larger exporters of manufactures, will be better placed to take advantage of

the improved international environment expected in the next year and a half.

The prospects for the major debtor countries, the energy-exporting countries, and most of the sub-Saharan African economies are not encouraging. Even the manufactures exporters of East Asia are expected to grow well below the rates they experienced in the late 1970s and early 1980s. In many developing countries, expected output growth will be insufficient to absorb the annual flow of entrants into the labour force, let alone deal with the legacy of accumulated unemployment and underemployment.

The medium-term outlook for the vast majority of developing countries is no less disturbing. It will remain so, unless concerted action is taken at the international level. There is today wide recognition in the developing countries themselves of the extent to which their future depends on their own efforts to cope with the challenges posed by a changing world environment, and to accelerate the modernization of their societies. None the less, recent reports by all international organizations draw attention to the fact that vigorous pursuit of appropriate adjustment policies by developing countries alone, whether in Africa, Asia or Latin America, will not suffice to restore their growth in the absence of healthy recovery in the world economy and a significant expansion over and above present levels of official and private lending to developing countries pursuing effective growth-oriented policies.

The basic channels of market interaction between developing and developed countries remain a key factor in the final outcome. Despite the wide diversity of experiences, performances, economic structures, size, institutions, and policies, these market-driven channels operate essentially through (a) the terms of trade; (b) the interest rate on past debt; (c) the volume, terms and costs of current borrowing; and (d) the level and rate of growth of world demand. The medium-term outlook for developing countries is thus determined not only by their own domestic policies but by the way in which these four channels will operate in the second half of the 1980s. The volume and terms of concessional flows of finance are crucial for a vast number of countries but are not market-driven. Their importance increases, however, when the other channels are not working well, as has been the case for most of the first half of the present decade.

Salient features in world trade

The growth of world trade in the 1980s has been weak and irregular, partly reflecting the sluggish and lopsided output growth during this period. Moreover, a marked slow-down in trade growth relative to output changes has taken place in recent years. The implied income elasticity of world trade has declined from nearly 2 in the period 1950-1973 to slightly above 1 at present. This reduction in the responsiveness of trade to output growth is apparent not only at the global level but also for each of the major country groups, although to different degrees. The sharpest declines have occurred among the energy-importing developing countries, the major debtors and Japan, while more moderate declines have occurred in the Federal Re-

public of Germany, the centrally planned economies and the United States.

The single most important factor behind the fall in the observed income elasticity of trade in the 1980s has been the sharp effect of price elasticity which has led to a contraction in mineral trade, particularly fuels, since 1979. However, other factors have also contributed to the decline, such as the reduction in the ratio of trade to output of agricultural commodities; the rising share of services in income, as services are less trade-intensive than goods in general; and the severe import compression effected by most capital-importing developing countries in the wake of the debt crisis. It should be noted that despite the overall decline in trade elasticity, in the case of manufactures the elasticity coefficient has not fallen in the 1980s.

The slow growth of trade in the 1980s is a reflection of the weak and unsteady trade impulses emanating from the recovery, as a result of the highly disparate rates of growth and of the stringent import restrictions adopted by a large number of developing countries and some centrally planned economies in response to their external financial difficulties. But it also reflects the impact of more general forces, such as the heightened instability in currency and financial markets, the slump in primary commodity markets, and rising protectionist tendencies, particularly in some of the larger trading partners. So long as these factors are not dealt with, the link between income and trade growth will remain weak, dimming the prospects for trade even if output growth in the world economy were to speed up. The larger concern is that a further erosion of this link would block the transmission of growth impulses throughout the world.

The pattern of trade balances projected for 1986 and 1987 indicates that there will be a slight narrowing of the trade deficit of the United States while the trade surpluses of the Federal Republic of Germany and Japan will actually increase before starting to decline. These developments may strengthen protectionism and impart a deflationary bias to world trade. The trade balances of the developing countries as a whole shifted only marginally in 1985, compared with the changes during 1980-1984, but the combined surplus of the energy-exporting developing countries is expected to fall sharply in 1986. The trade balance of the energy-importing developing countries is expected to show little change after the drastic reduction in their deficits during 1980-1984 brought about partly by a sharp compression of their imports. The trade balance of the centrally planned economies shifted abruptly from a surplus to a deficit in 1985, partly reflecting a large trade deficit for China and a fall in the value of the exports of the USSR due to weak oil prices. It is likely that the deficit of these economies as a whole will widen in 1986.

Commodity policy issues will remain high on the agenda. Despite the resumption of economic growth in 1983, commodity markets continue to be depressed. In 1985, the prices of primary commodities averaged 32 cent below 1980 levels when measured in current United States dollars and 11 per cent below 1980 levels when measured in SDRs. The fall in commodity prices since 1980 has

been persistent and fairly generalized among all commodity groups, although food items have fared worse than the rest.

A number of factors have contributed to the persistent imbalance between demand and supply in commodity markets in recent years. Relatively low levels of economic activity, high real interest rates and the high value of the dollar have tended to weaken the demand for primary commodities, as have longer-term factors, such as resource-saving innovations, competition from synthetic materials and shifts in consumers' preferences towards services. At the same time, attempts to reduce import dependence, to maintain export earnings in the face of falling prices, and to protect farmers' incomes by keeping domestic prices well above those prevailing in international markets have resulted in an expansion in the supply of commodities well ahead of the demand for them.

In the short run, the weakening of the United States dollar, the drop in international interest rates, and the projected rise in global economic activity are likely to translate into higher non-oil primary commodity prices measured in dollar terms. However, a significant and sustained recovery in real primary commodity prices in the near future is improbable, in view of the existence of ample stocks of most commodities, which will prevent prices from rising much even in the event of moderate output shortfalls or demand increases.

The plausible range of average oil prices in the coming months remains wide, and the effects on the patterns of production and trade that might ensue at both ends of that price range have been examined in the context of two scenarios. Scenario one is defined as a situation in which there is no producer co-operation. On the basis of current operating costs of the existing oil-producing capacity in developed and developing market economies, the hypothetical minimum price at which expected demand of some 48 million barrels a day in 1986 could be met would be of the order of \$8 a barrel. If maintained for the remainder of 1986, that would yield a lower bound for the average price for the year of about \$12 a barrel. At this price level, a massive redistribution of crude oil production would occur: the share of developed market economies in world oil production would decline by about 10 per cent, while that of the energy-exporting developing countries would increase by some 15 per cent.

Scenario two is defined as a situation of effective producer co-operation. Under these conditions, oil prices may, hypothetically, climb back to about \$25 a barrel. Should they remain at that level for the rest of the year, the upper-bound average price of oil in 1986 would be of the order of \$20 a barrel. At that level of prices most installed capacity would remain economically viable, so that market shares would only shift to the extent required by co-operative arrangements among producers to enforce that price level.

On the assumption that no major policy changes would be undertaken either at the macro-level or in the energy sector itself, and that neither producers nor consumers

would be insulated from changes in international oil prices, the trade implications of scenario one were contrasted with those of the baseline scenario used in the projections presented in chapter II, in which an average nominal oil price of \$18 a barrel in 1986 is assumed. One interesting finding of this simulation exercise is that the oil import bill for developed market economies would remain basically unchanged, as the price effect would be offset by a volume effect derived from a much higher ratio of imports to consumption. For energy-importing developing countries, scenario one would represent a saving of some \$8.8 billion in the oil import bill relative to the baseline scenario, while the export proceeds of energy-exporting developing countries would decline by nearly \$3 billion. When all trade effects are taken into account, the trade balance of developed market economies shows a \$2 billion decline relative to the baseline scenario, while that of the energy-importing developing countries shows a \$2.2 billion improvement. The trade balance of energy exporters remains basically unchanged, as their imports would be compressed in tandem with the fall in export earnings.

Financing balance-of-payments disequilibria

The current account surplus of developed market economies, excluding the United States of America, is forecast to rise to about \$130 billion in 1986 from \$80 billion in 1985. The United States deficit is expected to decline marginally but remain of the order of \$100 billion for the third year in a row. This sequence of current account deficits should make the United States the world's largest net debtor by the end of 1986, in contrast to its peak net creditor position of \$147 billion in 1982. The net credit inflow to the United States in 1985 was \$124 billion, its credit sources being primarily Japan and Western Europe.

The consequences of the vast shifts in financial flows in the past few years are beginning to emerge. Japanese banks supplanted those of the United States in 1985 as the world's largest source of credit, and foreign investment income is becoming a more significant component of Japan's foreign exchange earnings, especially as the growth of merchandise exports slows. If it had not been for valuation gains from a falling dollar exchange rate, the United States would already have become a net payer of foreign investment income. It is expected to become one soon.

Current account balances of energy-exporting countries, including developing countries and the Soviet Union, are expected to deteriorate sharply in 1986. Projections for energy-exporting developing countries indicate a combined current account deficit of \$60 billion compared with \$10 billion in 1985. The trade balance of the Soviet Union is forecast to swing from a surplus of \$4 billion in 1985 to a significant deficit in 1986. Major energy exporters of the Middle East and Africa are becoming a declining source of services earnings for developing countries and other countries as well. The growth of labour remittances has been stemmed and an accelerated repatriation of foreign workers is under way.

International capital markets continue to concentrate their lending on developed market economies, especially

the United States. However, commercial bank lending to Eastern Europe has resumed, after coming to a standstill in 1982. Both China and the USSR became active borrowers in 1985: external debt rose about \$5 billion in the Soviet Union and approximately doubled in China to about \$8 billion. Developing countries, in contrast, remain largely excluded from the private capital markets. Aside from involuntary lending arranged as part of debt rescheduling exercises, gross private lending commitments to developing countries were less than 40 per cent of what they were in 1981.

The correction of the dollar exchange rate in 1985 and early 1986 was due primarily to the conviction of financial markets of the seriousness of the efforts of the Group of Five to co-ordinate policies to that end. The actual magnitude of official intervention in currency markets was not very large. The prevention of a free fall of the dollar is thus seen to hinge on maintaining the confidence of financial markets in the co-ordinated adjustment process and in the prospects for economic stability and a more rapid growth of international trade.

The net transfer of resources of the capital-importing developing countries, which became negative after 1983, is estimated to have reached over \$30 billion in 1985. The positive inflow from official grants of about \$14 billion was overwhelmed by a net outflow related to credit operations of nearly \$40 billion, and the net transfer arising from direct investment deteriorated slightly to produce an outflow of \$4 billion. The increase in the negative net transfer, which was \$13 billion in 1984, was mainly the result of a fall in net credit flows. These flows are estimated at only \$13 billion in 1985, in contrast to \$32 billion in 1984 and \$62 billion at their peak in 1981. Latin America continues to be the most adversely affected region, with a negative net transfer estimated at \$30 billion. In sub-Saharan Africa, the net transfer was far below the transfers of close to \$10 billion received in the early 1980s. In a period of extreme economic hardship across the region, the net transfer has fallen to about \$1 billion in 1984 and 1985.

Capital outflows, or capital flight, from some developing countries, have become the focus of some attention and discussion but are estimated to have become smaller as countries make progress in adjustment processes. Given the high degree of integration and the progressive deregulation of international capital markets, this is an area in which debtor and creditor countries might intensify co-operation to stem illegal and unwarranted capital outflows.

The fall in interest rates in international financial markets in 1985, which by 1986 were reducing the interest cost of official as well as commercial bank debt, lowered the burden of interest payments in the balance of payments of debtor countries. But the falling price of oil, coupled with continued weakness in most commodity prices, raised the real cost of debt servicing in terms of the average volume of exports whose proceeds were needed to make interest payments. In this sense, the real interest rate

of the capital-importing countries is expected to rise again in 1986 to about 14 per cent.

The debt problem of low-income countries is less affected by interest rate fluctuations in financial markets as most of the debt of these countries is owed to official creditors. Many of these countries have nevertheless had a serious debt problem as export earnings are not increasing as expected. At the same time, their repayment obligations are rising steeply. For sub-Saharan Africa, principal repayments to official creditors are scheduled to triple during 1985-1987 compared with 1982-1984.

Official reserves of the capital-importing developing countries grew somewhat in 1985 but almost entirely as a result of the valuation gain from the fall of the dollar which accounted for \$6 billion of the estimated \$7 billion rise. At the end of 1985, estimated reserves still did not cover three months of imports of goods and services (including interest expense), despite continued restraint on imports. While reserve coverage of the capital-importing developing countries as a whole has improved from the 1982 low of 1.9 months, the reserve coverage of the least developed countries remains precarious.

Net IMF credit flows to the developing countries fell to almost zero in 1985 as repayments of past loans all but offset the flow of new credits. For the rest of the decade, repayment obligations to the Fund are heavy, exceeding \$32 billion from 1986 to 1990. Difficulties in making repayments have already caused certain countries to fall seriously into arrears. Many countries have repeatedly had to resort to Fund-supported adjustment programmes. Of the 26 developing countries with programmes in effect at the end of 1985, four were in their fifth programme since 1980, seven were in their fourth and nine were in their third. A new Structural Adjustment Facility at IMF will provide new funding to low-income countries; financing of the Facility is to come from repayments of IMF Trust Fund loans disbursed during the latter 1970s.

Systemic issues in trade, money and finance

There has been a serious erosion of the multilateral trading system in recent years. This has manifested itself in derogation of the rules on which the functioning of the system depends, growing bilateralism, and a general drift towards management of trade. The major areas where reform of the system is needed are well known and the urgency of reform is recognized and widely proclaimed, but international agreement in these areas has so far proved elusive.

The crucial issues include the safeguard mechanisms; bringing agriculture and textiles under normal discipline of the General Agreement on Tariffs and Trade (GATT); trade in services; graduation; and strengthening of GATT rules, surveillance, and dispute settlement procedures. Negotiations on trade in services will involve a complex set of issues, including those of national rules and policies which can hardly be characterized as protectionist. They are also likely to take a long time to complete.

The proper working of the international trading system also depends on the satisfactory functioning of the international monetary system. The performance of the system of floating exchange rates has fallen far short of expectations and has produced excessive fluctuation and misalignment of currencies, leading to costly misallocation of resources and increased protectionist pressures.

A stable exchange rate system depends crucially on the existence of institutional arrangements for co-ordination of macro-economic policies of the key currency countries which are consistent with the desired exchange rates. There is a need for a mechanism for generating the necessary pressure to ensure such consistency. A system of target zones could be one such mechanism.

The efficacy of a market-determined supply of liquidity has come to be questioned. The present creditworthiness-constrained system has not been able to meet the liquidity needs of the international economy in an equitable and entirely reliable way. Adequate provision of liquidity from the official reserve-supply mechanism should be an essential function of the international monetary system.

Effects of adjustment on capital formation

The adjustment that has taken place in the developing countries in the first half of the 1980s has been unprecedented. Current account deficits have been reduced dramatically and in several countries the current account balance has swung into a surplus. In a few countries, the balance-of-payments adjustment has been a gradual and orderly process, but in the large majority adjustment has caused or intensified domestic disequilibria. A distinctive feature of this adjustment has been the substantial cuts in imports. National savings have been reduced, partly as a result of falling or stagnant per capita incomes and increased interest payments abroad. As a consequence, there has been substantial retrenchment in private and public investment. In several countries, adjustment policies have also fuelled cost-push inflation and led to a major acceleration of inflation. Although additional corrective measures were instituted in 1985, the legacy of the first half of the 1980s weighs heavily on future growth prospects. Rapid growth requires an increase in the investment ratio, which is not possible as long as overall growth remains sluggish. Inflows of foreign capital under present policies are unlikely to take place before there is a distinct economic recovery in these countries.

The growth in gross fixed non-residential investment in the major industrial countries during the current recovery has been extremely varied: with strong growth in Japan, the United Kingdom and the United States; moderate growth in the Federal Republic of Germany; and weak growth in Canada, France and Italy. Weak growth in aggregate demand, resulting from the combination of restrictive fiscal and monetary policies since the second oil shock, has been a major obstacle to strong recovery in investment in the 1980s. In contrast, strong growth in aggregate demand due to expansive fiscal policy in the United States and the resultant booming growth of exports from

Japan has been the major factor in the strong growth of investment in these two countries.

More recently, monetary policies of all countries have become less restrictive. With the moderation of interest rates and the steep drop in oil prices, the aggregate demand growth of the European oil-importing countries is expected to strengthen, thus resulting in improved growth of investment in the medium term. In Canada and the United Kingdom, the net effect of declining oil prices is expected to moderate growth in overall investment. Investment growth in Japan and the United States is expected to have run its cyclical course. In the United States, it is not expected to deteriorate to recession levels in the short term, but in Japan a more serious slow-down is expected. In sum, contrary to the pervasive pessimism about investment recovery in the first half of the 1980s, there are now reasons for cautious optimism concerning investment growth in the major industrial countries, particularly in Europe.

There has been considerable diversity in the investment experience of the centrally planned economies in the early 1980s. Capital formation in China rose very rapidly. Although a moderate expansion in investment was planned in support of the adjustment and modernization policies starting in 1978, the actual implementation diverged markedly from the targets. In some years, near runaway capital formation had to be reined in by intervention in order to avoid exacerbating the bottle-necks and inflationary pressures that were building up. Yet capital formation still increased at an annual rate of 16.5 per cent in 1981-1985, more than double the rate of 1976-1980.

In the European planned economies, on the other hand, the capital formation policies of the early 1980s were affected by unexpected domestic and external growth constraints. Capital formation in the USSR grew at an annual rate of over 3 per cent in 1981-1985. This was above the planned rate, and was made possible in part by the favourable effects of the higher energy prices of the late 1970s. But this rate of investment was insufficient to bring about major changes in capital productivity through modernization. In the centrally planned economies of Eastern Europe, investment targets for the period 1981-1985, albeit modest, were not achieved. Some countries made strong efforts to shift additional funds to productivity-enhancing activities, but institutional constraints did not allow for a significant cut-back on projects in progress. Thus, there

The policy agenda: key issues

One of the main themes of the present *Survey* is that the large and persistent imbalances in the world economy, including the widening gap in living standards between richer countries and most of the poorer countries, cannot be tackled by national policies alone, but require effective international co-operation within multilateral frameworks and concerted policy actions cutting across a wide range of interrelated issues. Some of the key issues are presented below, with an indication, where appropriate, of the way in which current policies could be modified to

was limited success in concentrating funds on the most rewarding lines, including the non-material sphere. Mostly as a result of this, the broad co-ordination of investment activity within the Council for Mutual Economic Assistance (CMEA) suffered a set-back in the first half of the 1980s. By 1985, however, a distinctive increase in investment levels was taking place in most of these economies.

The development crisis in sub-Saharan Africa

In 1985, the drought receded in sub-Saharan Africa and agricultural and food production increased. None the less, close to 20 million people, among them displaced persons and refugees, continue to require emergency relief assistance. The long-term economic deterioration has not been halted. Sub-Saharan Africa continues to be extremely vulnerable not only to the weather but to changes in the international economic environment.

Prices of virtually all commodities exported from sub-Saharan Africa continued to fall in 1985. For the near future, there is little prospect of improvement in the aggregate terms of trade of the region, despite the benefits accruing to a number of countries from the coffee price increase. For the energy-importing countries in sub-Saharan Africa, the fall in oil prices will represent an addition to import capacity. But the aggregate effect on sub-Saharan Africa's balance of trade in 1986 is expected to be unfavourable as the energy-exporting countries in the region will experience a steep fall in export revenues. Prospects for increasing foreign exchange earnings continue to depend on export diversification.

The total external debt of sub-Saharan Africa is now over \$80 billion. Scheduled debt service is increasing steeply and reached over \$8 billion in 1984. As a combined result of the sharp fall in private credits, a decrease in disbursements of official loans, and the rise in debt service, sub-Saharan Africa suffered a net negative transfer with respect to its long-term credits of \$164 million in 1984.

Mounting debt service is competing with imports for scarce foreign exchange. Import cuts have resulted in unused capacity not only in agriculture and industry but in some social services. Most countries remain vulnerable to even a slight weakening of international commodity markets or in the inflow of financial resources.

improve the international economic environment.

The policy recommendations which are suggested by the analysis contained in the *Survey* are organized under three main headings: policy issues requiring international co-operation and action within a multilateral framework; policy issues requiring concerted policy action within country groups (developed market economies, developing countries and centrally planned economies); and policy issues requiring action at the national level.

Policy issues requiring international co-operation and action within a multilateral framework.

The international trading system and the international monetary and financial systems can no longer be seen in a compartmentalized fashion, given the prevailing interdependence among countries and among policy issues linking trade with monetary and financial arrangements. Major threats to the international trading system come not only from the erosion of its principles and rules but also from policies adopted in other areas and from the slowing down of growth in world output. Addressing system-wide issues in money, trade and finance requires, first, steady implementation of the decisions taken at the 1982 GATT Ministerial Meeting on the strengthening of the international trading system, without necessarily waiting for a new round of multilateral trade negotiations. The preparatory work for the negotiations should be stepped up, even if most of its results are not likely to emerge before the end of the decade. A number of major decisions were taken at the Meeting—for example, it was decided to ensure effective implementation of GATT rules and resist protectionist measures; bring agriculture more fully under the normal discipline of GATT; bring into effect a comprehensive understanding on safeguards; ensure increased transparency of trade measures and effective resolution of disputes; and examine ways and means of liberalizing trade in textiles and the eventual application of the General Agreement to it.

Also required is appropriate follow-up of the reports of the Group of 10 and the Group of 24 in the light of changes in policies and underlying economic conditions that have taken place over the past year. There is need for more systematic and structured discussion of the matters raised in both reports, exploring, in particular, the relationship with trade issues, developmental implications and areas of convergence. Systematic discussions in more structured settings may lead to consideration of the possible need for convening, in due course, an international conference on money and finance for development.

A third issue related to the current world-wide concern with the resumption of growth and investment and to the reactivation of the development process in developing countries is the role of multilateral financial institutions as a source of both balance-of-payments financing and financial resource flows for longer-term economic development, particularly for the least developed countries.

Given the poor prospects for a resumption of private lending in the short to medium term, there is an urgent need to pursue such current issues as: (a) increasing World Bank lending to the range of \$45-\$50 billion in 1986-1988; (b) starting negotiations, in early 1987, on a general capital increase of the World Bank, to allow the Bank to increase its lending to over \$21 billion a year by 1990; (c) achieving, by September 1986, the eighth replenishment of the International Development Association (IDA) at a level of at least \$12 billion; (d) increasing the lending capacity of the regional development banks; (e) reversing the present trends in the policy of enlarged access to IMF resources to allow the Fund to support an increased number

of countries through medium-term programmes of balance-of-payments adjustment; (f) enhancing the liquidity of the Compensatory Financing Facility through more flexible conditionality requirements for its potential users; and (g) a new SDR allocation, given the fact that a large number of countries do not have access to private financial markets and can only obtain reserves through official allocations or through running trade surpluses, excessive reliance on which would impart a deflationary bias to the world economy.

A fourth set of policy issues that require an enhanced multilateral framework are international commodity policy issues and co-operative solutions to the problems of more than 70 commodity-exporting developing countries. Although the essential problems here are located at the domestic decision-making level, there is a need for international co-operation in helping developing countries to diversify out of excessive dependence on a few commodities. Short-to medium-term export stabilization schemes must be designed in conjunction with longer-term structural adjustment programmes of diversification of the productive structure of these countries. In view of recent events in oil markets, it would be appropriate for Governments to consider the advisability of joint periodic assessment and of promoting broader international arrangements for the long-term stability of oil prices.

A fifth set of policy issues requiring international co-operation for their solution arises from the debt problem of developing countries, a broader view of which must be taken, and action on which should not be delayed. The debt problem must be dealt with in the spirit of the 1985 initiative which noted the need for co-operative action among Governments of debtor countries, creditor countries, commercial banks and international financial institutions with enlarged resources, in a framework of co-responsibility for its implementation. It is in this sense that the proposals for an intergovernmental dialogue between debtors and creditors should be understood. Countries recognize the unique peculiarities of each case. They acknowledge that, operationally, when it comes to specific debt negotiations, there is no alternative to considering each case on its own merits. None the less, there are identifiable issues related to the global environment in which domestic adjustment must take place and from which it cannot be divorced. It is on these issues that a more structured intergovernmental dialogue could facilitate and contribute to a more orderly, co-operative, mutually agreed, and lasting solution to the international debt problem.

Multilateral action on these five sets of issues along the general lines indicated above is called for if the widening gap between richer countries and most of the poorer countries in both present living standards and potential for future growth is to be reduced in the interests of a more stable international environment.

Policy issues requiring concerted policy action within country groups

Developed market economies are not the sole engine of world economic growth. There is great potential for trade

among developing countries and growth interaction as well as for an increase in the centrally planned economies' trade. But since developed market economies represent about two thirds of world output and world imports, they are important determinants of the level and rate of growth of world demand, not to mention their key role in financial intermediation and technological development.

What is called for from this group of countries at the present juncture is policy co-ordination for faster non-inflationary growth to reduce rates of unemployment that are still too high. The recent sharp fall in oil prices, weak commodity markets and lower interest rates offer a wider margin of manoeuvre for more growth-oriented policies in key countries. These are countries in which fears of rekindling inflation should have subsided by now, where the fiscal situation has been brought under control, and where huge trade and current account surpluses will be greatly increased by the recent change in oil prices. The realignments of exchange rates and the reduction in interest rates in the past 12 months have been in the right direction. But relative price effects must be accompanied by expenditure effects and lower real rates of interest if sustained growth and reduction of very high unemployment is to be achieved. This is in line with what has already been agreed by the international community with respect to the need to strengthen multilateral surveillance over the macro-policy interactions of larger market developed economies, with special focus on the international repercussions of their domestic policies.

The concerted policy action required to bring about an orderly unwinding of the unsustainable trade and current account imbalances among key industrial countries must not result in a convergence of economic performance at modest rates of growth, but in relatively faster growth in countries with large and growing trade surpluses while the high fiscal imbalances in the largest industrial economy are being reduced.

Regarding the centrally planned economies, the broad co-ordination of the national economic plans for 1986-1990 of the countries members of CMEA points to a strengthening of co-operation among socialist countries in the areas of science and technology, trade, and industrial production. Among the tasks ahead for these countries, given the relatively modest growth anticipated for the short-term and the acceleration envisaged by the end of the decade, three stand out: to utilize scarce capital funds to renew the existing capital stock, to concentrate funds on priority activities, and to support the drive towards greater capital efficiency by broad-based changes in the economic mechanisms of these countries. Some of these changes have already been dovetailed within the CMEA framework and others are on the agenda for the near future. The countries are also aware of the need to take account of greater integration in global trade and financial networks. This could offer an opportunity to increase the economic interaction with developing countries, particularly through trade and financial agreements. Because the key to the structural policy of the centrally planned economies is investment and the modernization of the capital

goods industry, closer co-operation with developed market economies in select product lines, particularly in the high technology fields, is a matter of more immediate priority at this juncture.

The policy issues that require concerted policy action on the part of developing countries have to be seen in the light of the enormous diversity of their economic conditions. None the less, there are some areas in which developing countries as a group do share common interests. In the field of trade, articles XXXVI to XXXVIII of the General Agreement on Tariffs and Trade (part IV) spell out the principles and objectives, the commitments and the joint action required by the Contracting Parties in matters related to trade and development that are of particular concern to developing countries, such as non-reciprocity and preferential treatment. Both in the implementation of the current work programme of GATT and in a new round of multilateral trade negotiations there seems to be need for concerted policy actions on the part of developing countries along the lines suggested in part IV of the Agreement. The United Nations Conference on Trade and Development (UNCTAD) remains a unique forum in which vital issues relating to trade and development can be addressed and pursued in a universal context.

In international monetary issues, the Intergovernmental Group of 24 on International Monetary Affairs remains a useful mechanism for ensuring that the interests and economic circumstances of the developing countries are taken fully into account in discussions about improvement and long-term reform of the international monetary system. Appropriate follow-up procedures leading to a more structured and systematic discussion of the issues raised in the Group's report on the functioning of the international monetary system could be pursued in 1986 and 1987.

In addition to increasing their participation in system-wide discussions about trade, money, and finance, developing countries could continue to explore ways and means of furthering intra-developing country trade among themselves and strengthening economic and technical co-operation, particularly in international commodity policy issues, technological development and payments arrangements. Ongoing co-operation at the regional level in Africa, in countries members of the Association of South-East Asian Nations (ASEAN) and in Latin America has already been strengthened. If these regional efforts are to succeed, however, they must be coherently linked not only to wider multilateral action but, in particular, to action at the national level in each developing country.

Policy issues requiring action at the national level

There is wide agreement that, however important a supportive global international environment is, ultimately the success or failure in achieving socio-economic progress and technological development depends on domestic policies in developed, developing and centrally planned economies alike.

Given the wide diversity of objectives, experiences, per-

performances and policies across countries, there is no single policy model or pattern of growth to which structurally diverse economies should be expected to conform. Operationally, there could be no such a thing as a general policy package, framed without regard to specific different structural conditions and the ways in which different economies work.

None the less, the policy dialogue of the recent past indicates some general directions for domestic policy action both of a macro-economic and of a more micro-economic nature, which should receive increased attention in the near future in each individual country.

For developed market economies, particularly those in which domestic policy actions have significant international repercussions, there is a need to recognize this fact fully when framing their short-to medium-term macro-economic policies. Older industrial countries are engaged in difficult processes of structural change. Their traditional industrial base is giving way to competition from new technologies and low-cost producers, and their populations are aging too. They have created, in the past few decades, welfare systems and entitlements involving security in employment, which are not quickly reconciled with the present needs for structural change. It is clear that at present a great premium accrues to countries that are able to reconcile these conflicting needs and sustain incentives to work and save, while striking an appropriate balance between the provision of public and private goods and services. In their own interest as well as in that of the international community, developed market economies should resist protectionist pressures and allow rapid structural change to take place in response to changes in international comparative advantage.

For centrally planned economies, a key priority, as expressed in the recently completed five-year plans for 1986-1990, is the modification of the economic mechanisms so as to achieve higher levels of efficiency, particularly for investment. The eventual adaptations are to be seen in the light of the recent changes in the national and international economic environments. In centrally planned economies attempting to make further headway with planned urban and industrial reforms, coherent monetary and fiscal policies supported by adequate institutions must be put in place. Recent policy steps have been in the right direction but the goal should be to effect changes in economic structure, maintaining internal and external balance. Fiscal, monetary and exchange rate policies appear essential to that end, as do micro-economic pricing policies and incentives within their overall planning framework.

For the vast majority of developing countries, the key policy issues for domestic action in the second half of the 1980s are: (a) to increase productivity in agriculture, not only in the internationally tradable agricultural sector but also in non-tradeable agriculture, especially food production; (b) to increase tradable production in general, that is, exportables and efficient import substitutes, which requires sustained change in the relative prices of tradables *vis-à-vis* non-tradables and careful attention to the level and composition of public and private investment in tradable-related sectors and activities; (c) to increase domestic savings, not through a reduction in the absolute level of consumption but through policies that increase marginal savings out of growing real incomes, and to channel these savings to more productive domestic investment; and (d) to increase the efficiency of their public sectors, recognizing that there must be a balance in the provision of public goods, social services, the enhancement of the social and human infrastructure and the production of private goods and services. There is no purely technical way to decide these matters, which depend on institutional factors as well as on the nature of the domestic policy environment in each country.

It is now widely recognized that, in any country, the effectiveness of short-to medium-term macro-economic policy depends to a large extent on the degree of diversification and flexibility of its productive structure. Whenever there is a low degree of both - or no excess capacity - the responsiveness to fiscal and monetary stimuli might lead to excessive spill-over into imports or rekindling of inflationary pressures.

The policy implication of this fact, which is particularly relevant for developing countries, in the mid-1980s, is that economic growth and structural change cannot be assured by macro-economic policies alone, important as they are. These policies must gravitate around some vision of the future or be anchored in some version of a medium- to long-term economic programme of public and private investment and technological development in different sectors concerned not only with the level and composition of investment but, in particular, with the efficiency with which those policies are carried out. This need not exclude all manner of compromises and devices by which public authority will co-operate with private initiative. Indeed, the most successful experiences of growth with structural change in the developing world have been marked by a high degree of co-operation between private initiative and public authority, in looking ahead and framing a coherent development strategy.

Chapter II

WORLD ECONOMIC CONDITIONS: MAIN FEATURES, POLICIES AND PROSPECTS

Although the world economy in 1985 was marked by disappointingly slow growth in world output and international trade, several important policy initiatives were taken, which have improved the environment for economic decisions of policy makers and private sector agents. As a result, short-term prospects for developed market economies appear more encouraging than a year ago. The steps taken to reduce the United States fiscal deficit, the downward trend in nominal interest rates and the fall of the dollar exchange rate have eased pressures in financial markets and improved the outlook for the correction of the high trade and current account imbalances among major countries. Since late 1985, oil prices have declined sharply, improving the growth prospects for energy-importing countries, but at the cost of a considerable

drop in the level of national incomes of energy-exporting countries.

In 1986-1987, the world economy is likely to grow faster and achieve a further deceleration in inflation than it did in 1985, but major uncertainties affect many critical parameters, and sluggish performance in the majority of developing countries is a main cause for concern. Key variables - interest rates, exchange rates, oil prices - remain unsettled, and virtually all institutional forecasts envisage an overall growth rate of gross national income for developing countries that is barely above population growth. Complacency on the part of developed market economies based on their improved prospects would be a threat to the orderly unravelling of the present historically unprecedented imbalances in trade and payments.

An overview of 1985 and early 1986

In 1985, the world economy entered the critical phase in its recovery from the great slump of the early 1980s. Many countries had a disappointing economic performance and, as the year progressed, projections for both output and trade were revised downwards. The revised growth rates were significantly lower than those of 1984 for nearly all country groups. For the year as a whole, world output grew slightly more than 3 per cent, which meant a sharp deceleration from 1984. International trade grew at only one third of the spectacular 9 per cent in 1984 (see table II.1).

Although the economic performance of the developed market economies in 1985 was well below the expectations of a year ago, for most countries in the group the recovery continued. For several countries, it entered its fourth year in early 1986. A remarkable feature of this recovery, aside from its durability, is that significant expansion of output has taken place simultaneously with a sharp reduction in the rate of inflation in nearly all countries in the group. In the period 1983-1985, for the group as a whole, real output grew by 10.5 per cent while the inflation rate fell by 3 percentage points.

Although the economic expansion of the developed market economies continued in 1985, in comparison with 1984 the real rate of growth of their combined GDP fell by more than 2 percentage points to only 2.7 per cent. There was greater balance in patterns of aggregate demand and output growth rates, particularly in comparison with the great unevenness of 1984, but the convergence was around a much lower average rate of expansion.

In general, events in 1985 demonstrated once again the vulnerability of many developing countries to external events, which has increased partly as a result of inadequate external financing. The slow-down in the growth of the developed countries was costly and untimely for all those developing countries whose fortunes are closely tied to international trade. After some progress in 1984, these

countries suffered a major set-back in 1985. The rate of increase in their export volume fell significantly, their terms of trade worsened and for many of them interest rates in real terms (i.e., nominal rates adjusted by the rate of change in their export prices) rose sharply. For the developing countries as a whole, the growth rate of GDP remained below 2.5 per cent for the fifth year in a row. Growth of net energy exporters remained insignificant and that of net energy importers fell from 3.8 per cent in 1984 to 3.3 per cent in 1985.

Aggregate growth figures mask the extent of the difficulties of the developing world, because there was a great diversity of experience between larger and smaller countries. Some of the largest developing economies (e.g. Brazil and India) grew at substantially higher rates than the average, but in the rest of the developing world the gains that were made in 1984 were nearly wiped out in 1985. As shown in table II.2, if economic performance is measured in relation to population growth, 1985 was not a good year for the developing countries. Nearly 60 per cent of them, representing just under a third of the total population and located mainly in Africa and Latin America, had either stagnant or falling real per capita GDP in 1985.

In contrast to the developed market economies, the developing countries made little progress against inflation. The weighted average inflation rate for the developing countries as a group more than tripled between 1982 and 1985, reaching 150 per cent a year. This is a distorted picture, influenced by the very high inflation rates of only a few countries, which are precisely the ones in which bold policy action was taken in 1985 and early 1986, as discussed below. The median inflation rate was only 10.5 per cent a year, about one percentage point less than in 1982. Only 10 developing countries had inflation rates in excess of 50 per cent a year in 1985 (see table A.V.3).

Table II.1. Growth of world output
and trade, 1971-1987

(Percentage)

	1971- 1975	1976- 1980	1981- 1985	1983	1984	1985 ^b	1986 ^c	1987 ^c
Output								
World	4.2	3.9	2.7	2.9	4.7	3.3	3.5	3.7
Developing countries	6.1	4.9	1.4	0.8	2.0	2.4	3.0	3.5
Net energy importers	5.2	4.8	2.3	1.9	3.8	3.3	4.5	4.5
Net energy exporters	7.7	5.1	0.1	-0.8	-0.3	1.2	1.0	2.0
Developed market economies	3.1	3.5	2.3	2.6	4.8	2.7	3.1	3.3
North America	2.8	3.6	2.6	3.7	6.6	2.4	3.3	3.6
Western Europe	2.9	3.9	1.3	1.5	2.2	2.4	2.9	2.8
Japan	4.6	5.1	4.0	3.3	5.1	4.2	3.0	3.7
Centrally planned economies ^d	6.2	4.5	4.5	5.2	6.2	5.3	4.9	4.8
Eastern Europe and USSR	6.3	4.1	3.0	4.1	3.8	3.1	4.0	4.0
China	5.5	6.0	9.8	9.1	14.6	12.3	7.5	7.0
Trade								
World trade volume ^e	5.0	5.1	2.8	2.5	9.0	3.2	4.0	4.5
Memorandum item								
Implicit income elasticity of world trade ^f	1.2	1.3	1.1	0.7	1.8	1.0	1.1	1.2

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

a Gross domestic product. The classification of countries into the various analytical groups is shown in the explanatory notes to the present Survey. Output data for these country groups and for each member country are aggregated with weights estimated on the basis of 1980 prices and dollar exchange rates. Developed market economies are aggregated with weights based on 1982 prices and dollar exchange rates.

b Preliminary estimates.

c Forecasts (based on Project LINK and other institutional forecasts). Projections for 1986-1987 are based on an average crude oil export price of \$18 a barrel.

d Net material product of China, Eastern Europe and the USSR.

e Arithmetic average of the growth rates of world volume of exports and imports.

f Ratio of world trade to output growth rates.

Table II.2. Countries with growth rates of real GDP
at or below the rate of growth of population,^a 1979-1985

	Total sample size		Number of countries with real GDP growth rate at or below population growth rate							Countries in 1985	
	Number of countries	Population in 1985 (millions)	1979	1980	1981	1982	1983	1984	1985 ^b	Population (millions)	Population as percentage of sample
World	113	4 687.7	27	40	51	67	60	46	54	777.0	16.6
Developing economies	83	2 467.1	25	32	38	55	51	45	49	718.3	29.1
Excluding India	(82)	(1 706.0)	-	-	-	-	-	-	-	(718.3)	(42.0)
South and East Asia	14	1 396.7	2	4	0	2	3	1	3	64.0	4.6
Excluding India	(13)	(635.6)	-	-	-	-	-	-	-	(64.0)	(10.0)
West Asia	10	97.7	3	4	5	7	7	8	7	75.0	77.0
Western hemisphere	23	399.3	6	8	12	21	19	11	18	163.3	41.0
Africa	32	497.4	14	15	21	25	21	25	21	417.0	84.0
Mediterranean	4	76.0	1	1	0	0	1	0	0	-	-
Developed market economies	22	766.2	1	6	11	10	8	1	3	38.0	5.0
Centrally planned economies ^c	8	1 454.4	1	2	2	2	1	0	2	19.8	1.4
Excluding China	(7)	(391.3)	-	-	-	-	-	-	-	(19.8)	(5.0)

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

a Population growth rates are based on "medium variant" estimates for 1980-1985 reported in *World Population Prospects: Estimates and Projections as Assessed in 1982* (United Nations publication, Sales No. E.83.XIII.5).

b Based on preliminary data.

c Per capita net material product.

In the centrally planned economies, despite a significant slow-down in output growth in nearly all major countries in 1985, aggregate growth was substantially above population growth. To a significant extent this reflects China's feverish growth in recent years. Excluding China, the group's average growth rate was lower than in 1983-1984, although there were still marked gains in per capita output. Eastern Europe's economic performance was adversely affected by exceptionally bad weather conditions. Agricultural gross output did not increase in the USSR, and it actually fell in Eastern Europe.

The growth retardation of 1985

The sharp rebound in 1983-1984 of the United States economy, which accounts for more than a quarter of the world economy, played a decisive role in initiating and spreading the recovery. The sharp deceleration from 6.8 per cent growth in 1984 to 2.2 per cent in 1985 affected world output significantly. The rate of growth of import volume in the United States, though still well above the world average, fell by nearly two thirds from 24 per cent to 8.5 per cent in real terms.¹ This contributed to the slow-down in Japan and a number of East Asian developing economies.

During the year no new growth pole emerged to compensate for the sharp slowing down of the United States economy. The rate of growth of import demand in developing countries and in Japan collapsed, and decelerated markedly in Western Europe. By mid-1985, there was world-wide concern about the sustainability of the growth process.

The world economy was beset not only by declining output growth rates but also by high and rising debt burdens in developing areas, continuing large internal and external imbalances in key industrial economies, highly volatile and misaligned exchange rates among key currencies, high unemployment rates in many European and developing countries and rising protectionism in key areas of international trade.

Most important, interest rates, despite declines in their nominal levels, remained by historical standards quite high in real terms (see table A.V.7). The real interest rates paid by the developing countries that export primary com-

modities increased as prices of primary commodities fell.² This made the debt problem particularly acute for scores of developing countries with declining or stagnant export volumes. Debt-service ratios rose in all developing regions, and the levels reached in 1985 were the highest in years for most debtor countries. Interest payments alone reached a record level, well in excess of \$70 billion.

The diversion of falling export earnings towards interest payment led to further cuts in imports of developing countries in 1985 with a contractionary impact on world trade. The net flow of private credit to developing countries also came to a virtual halt, while the overall net transfer of resources from the developing countries, which had emerged for the first time in 1984, reached \$30 billion in 1985 (see chap. IV). The developing countries that mainly export primary commodities were saddled with the additional burden of a deterioration in their terms of trade.

The relative decline of primary commodity prices in 1985 gave the developed countries a windfall gain at a critical time. It is estimated that perhaps as much as a fifth to a quarter of the growth of real output in the industrial countries during 1985 was due to gains in terms of trade.³ The deterioration in terms of trade that the industrial countries suffered in 1978-1981 was 6.5 per cent, but the improvements in their terms of trade in 1982-1986 is estimated at more than 15 per cent. For the large number of smaller developing countries that depend on exports of primary commodities as the sole source of foreign exchange earnings, the decline in their terms of trade during the 1980s has been devastating.

As the international economic situation deteriorated, the smaller and the more exposed developing countries experienced the greatest impact on their economic growth. An important feature of the world economy, which has not been emphasized enough in the discussions concerning the effects of greater economic interdependence, is the protection of the larger economies, regardless of their economic system, from disorders in the international economic environment. In 1985, the average growth rate for the seven largest developing countries (ranked by population size) was more than 2 percentage points higher than the average for the group as a whole (see table II.5).

¹ It is estimated that the United States recovery, through its widening trade deficit, may have contributed as much as 1.25 percentage points to world growth in 1984. This effect, though remaining favourable during 1985, significantly diminished in size and may have amounted to no more than 0.25 percentage points of the world growth rate.

² Even though international interest rates, such as the six-month LIBOR on dollar deposits, have fallen by as much as 270 basis points in nominal terms since early 1985, in *ex post* real terms, if deflated by the contemporaneous rate of change in prices of non-fuel primary commodities exported by the developing countries, it increased substantially. That is, although in nominal terms LIBOR fell from its average level of 11.3 per cent in 1984 to 8.6 per cent in 1985, in *real* terms, from the point of view of developing countries that export primary commodities, it increased from 8.6 per cent to 20.7 per cent. This is because the percentage change in the aggregate price of primary commodities (excluding fuel), used as the deflator here, was 2.5 per cent in 1984 and -10.5 per cent in 1985.

³ Prices of primary commodities exported by developing countries declined by about 6 per cent in terms of dollars in 1985. This consisted of an approximate 10.5 per cent decline in prices of non-fuel primary commodities and a 4 per cent fall in price of crude petroleum. Since primary commodities imported by the developed countries from developing areas constitute nearly 18 per cent of developed market economies' total imports and since the average ratio of imports to GDP in developed countries is about 20 per cent, then a 7 per cent improvement in developed countries' terms of trade *vis-à-vis* developing countries (assuming the export price of manufactures rose by 1 per cent in 1985) was equivalent to an increase in real national income of industrial countries of about 0.25 per cent ($7 \times 0.18 \times 0.20$). Taking into account both the primary and secondary effects, and assuming an international multiplier of 2, then the full impact might have been as much as 0.5 per cent of output or equivalent to almost a quarter of the growth rate of industrial countries in 1985.

As shown in table A.V.1, only eight developing countries had experienced output growth rates in excess of 5 per cent in 1985, while no less than 40 countries grew at more than 5 per cent on average during the period 1976-1980.

Persistent global imbalances: a critical concern

The configuration of macro-economic policy mixes of the developed market economies in recent years has produced a number of undesirable by-products. These policy mixes have generated serious disequilibria.⁴ They have resulted in high real interest rates and have been a major cause of the instability in expectations of economic agents, which in turn has amplified fluctuation in key international prices and made asset prices highly sensitive to the slightest change in perception of political or economic events.

The United States, which had a balanced current account in 1982, had a deficit of \$105 billion, excluding official transfers, in 1985 - the largest external imbalance ever reached by a single country. The Federal Republic of Germany and Japan recorded a combined surplus of more than \$70 billion. This made for massive capital flows out of Japan and Europe into the United States, which have had a number of significant repercussions, both short term and long term.

In the United States economy, total domestic demand has been significantly in excess of aggregate domestic supply of goods and services since 1982. The ratio of domestic demand to gross national product (GNP) has been rising and in early 1986 it was still significantly above unity. In the period 1983-1985, total domestic demand in the United States rose by more than 18 per cent in real terms while GNP rose by only 13.5 per cent. As illustrated in figure II.1, the rise in the ratio of demand to supply for the United States had as its counterpart the deterioration of its current account balance. On the other hand, the ratio of demand to supply for Japan had declined at a relatively

rapid rate and by late 1985 was substantially below unity. Although the ratio for Western Europe as a whole remained fairly stable during the period 1982-1985, it was almost invariably below unity.

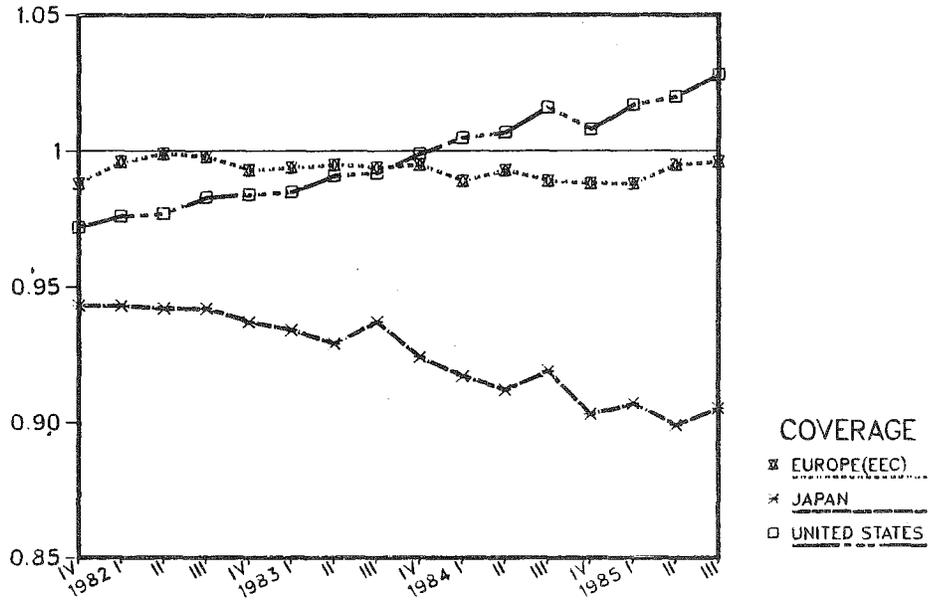
Part of the explanation of this lies in the mismatch of macro-economic policies among key countries. During the period 1982-1985, the United States policy mix consisted of a largely expansionary fiscal stance together with a relatively tight monetary policy, while both the Federal Republic of Germany and Japan took a fairly contractionary fiscal and monetary stance. In the United States, the policy configuration stimulated aggregate demand; in the Federal Republic of Germany and Japan it restrained demand. The main source of growth in the latter two countries during this period was external demand - mainly that of the United States. The lopsidedness of import demand patterns across these three countries in the period 1983-1985 is demonstrated in table II.3. Another consequence of the policy configuration of these key countries has been high nominal and real interest rates in recent years, particularly in the United States (see table A.V.7).

High real interest rate differentials in 1982-1984 in favour of dollar-denominated assets led to a precipitous rise in the value of the dollar. By early 1985, the dollar, in nominal effective terms, stood 60 per cent above its average value in 1980. The rise of the dollar, which began in 1983, had an increasing impact on the size of the United States deficit on current account. By 1984, nearly half of the deficit was due to the rise of the dollar. Thus the United States policy mix influenced the external account through two interrelated channels. The growing federal government budget deficit stimulated aggregate demand, which in turn engendered a rise in demand for imports; the tight monetary policy led to high interest rates, which attracted financial capital from the rest of the world, thus bidding up the value of the dollar while financing the growing gap between domestic savings and investments.

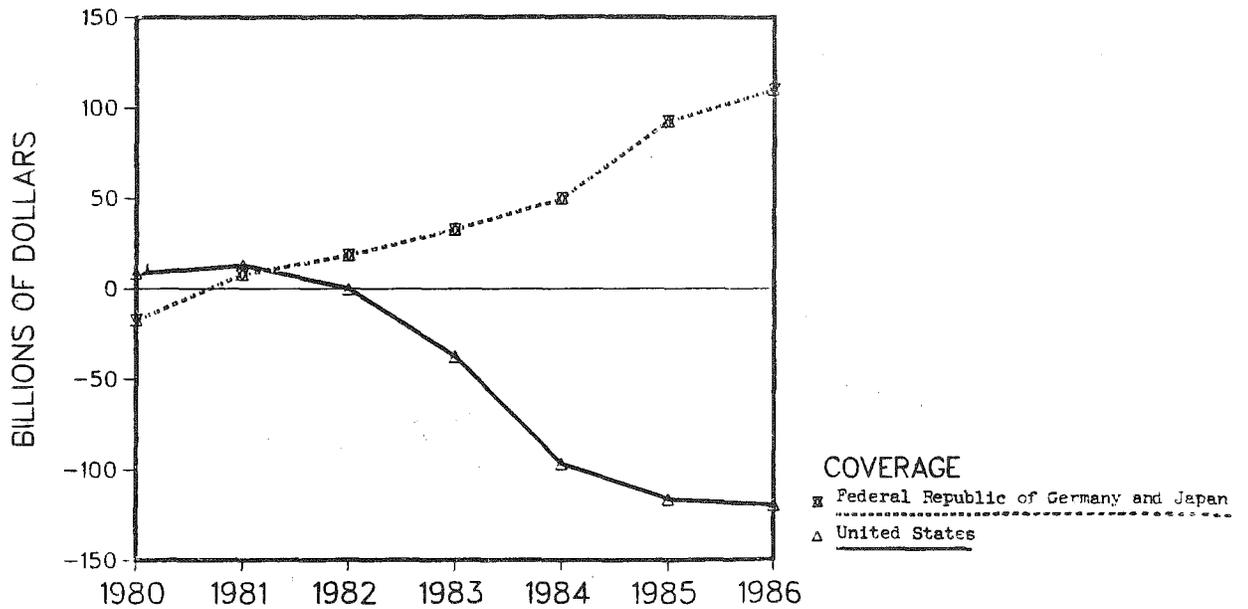
⁴ See Stephen Marris, *Deficits and the Dollar: the World Economy at Risk* (Washington, D.C., Institute for International Economics, Washington, D.C., 1985).

Figure II.1.
Key indicators of imbalances among developed market economies.

RATIO OF TOTAL DOMESTIC DEMAND TO GDP



CURRENT ACCOUNT IMBALANCES: DEVELOPED MARKET ECONOMIES



Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

The appreciation of the dollar led to a loss in competitiveness of United States goods both in international markets and in United States domestic markets. By making imports relatively cheaper, the rise of the dollar led to a feverish increase in import demand in the United States. The problem was compounded by the relatively weak domestic demand in both the Federal Republic of Germany and Japan, and by the collapse of import demand in the developing countries.

When real interest rates began to rise in the early 1980s, many developing countries were in a highly vulnerable position. Most of them had just experienced another sharp rise in the price of imported oil, which led to borrowing in

international commercial banks to finance purchases of required imports and the increased debt-service payments. Others had embarked on ambitious development programmes that required substantial external financing. They had assumed that there would be further improvements in the purchasing power of their exports, which, given the economic environment at that time, was not an erroneous assumption. When interest rates went up, however, recession took hold of the global economy and their export markets weakened; they were in the worst possible position. The ensuing adjustments required draconian cuts in imports. In fact, in 1985 the level of imports of developing countries in real terms was below the level attained in 1979.

Table II.3. World imports: geographical composition and quantum changes, 1983-1985

(Percentage)

Country or country group	Share in world trade ^a	Annual rate of change			
		Trend			
		1984	1970-1980	1983	1984
World	100.0	5.0	2.0	9.0	3.4
Developed market economies ^c	67.9	4.8	3.7	11.9	5.5
United States	17.7	4.5	10.4	23.9	8.5
Western Europe	38.9	5.0	2.7	6.1	5.2
of which					
Federal Republic of Germany	(9.7)	(4.9)	(3.9)	(5.2)	(4.2)
Japan	6.0	5.0	1.2	10.8	-0.3
Developing economies	22.4	6.5	-3.9	2.0	-3.5
Capital-surplus countries	4.3	12.7	-6.0	-9.0	-13.5
Capital-importing countries	18.1	4.2	-3.5	5.0	-1.1
Centrally planned economies ^d	9.7	4.8	3.7	5.0	4.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat; GATT, *International Trade, 1984/85* (Geneva, 1985); IMF, *International Financial Statistics and Direction of Trade*, various issues; and other official national and inter-national sources.

^a Shares are based on merchandise imports valued in terms of United States dollars at current prices.

^b Preliminary.

^c Including Australia, Canada, New Zealand and South Africa.

^d Eastern Europe and the USSR only.

The collapse of import demand of the developing countries hurt all industrial countries, particularly the United States. Western Europe depends on developing countries for only 20 per cent of its total merchandise exports; United States dependence is 36 per cent. Japan's dependence on the markets of developing countries is around 35 per cent, but the rest of its exports go mostly to the United States, a market that has been growing rapidly.

The most serious result of these events has been the sharp decline in the level of external financing for the developing countries. Many of them have been forced to embark on highly restrictive adjustment programmes in response to the sudden retrenchment in private international lending. As long as the developing countries are saddled with the creditworthiness problem, they are unlikely to obtain significant amounts of voluntary private external

financing. The contraction of the private markets undermined by itself the creditworthiness of many developing countries. In addition, high real interest rates and the weak demand for their exports have conspired against a drop in their ratios of debt service to exports.

Besides the configuration of macro-economic policy mixes among the largest developed market economies in 1980-1985, other factors have exacerbated the present imbalances.

One way to view these imbalances is to note that domestic savings plus foreign savings must add up to total domestic investment. Hence, if the counterpart of the United States deficit on current account is the combined surplus of the rest of the world, in which the surpluses of the Federal Republic of Germany and Japan loom very

large, the excess demand for investment in the United States is equal to the combined excess supply of savings in the rest of the world. In table II.4, some of the key parameters for these three large economies are summarized. It is clear from the table that the net saving rate of the United States is much lower than that of the others and less than a third of Japan's. Conversely, total consumption as a percentage of GNP is much lower in Japan than in the United States. This implies that there are important differences among these countries, which result in very different patterns of saving-consumption relations.

Since in the United States, the saving rate is low and the public sector's deficit is large, there is not much room for domestic investment to increase unless there is an adequate inflow of savings from abroad. In sum, if the required changes in macro-economic policy mixes were not

to take place, there would be a need to change certain incentives in order to affect the saving rates so as to eliminate imbalances.

One way to look at this phenomenon is to consider import and export propensities. Countries with a low income elasticity of imports and a high elasticity of exports to world output are bound to generate surpluses for a given rise in incomes throughout the world. Table II.4 indicates that the income elasticity of demand for Japan's exports, mainly because of successful export promotion efforts, is two to three times higher than that for the exports of either the Federal Republic of Germany or the United States. This, together with the recent pattern of import elasticities, would imply that for a given rise in world income, Japan is much more likely than the other two countries to generate trade surpluses.

Table II.4. Federal Republic of Germany, Japan and the United States: key economic parameters, 1960-1984

(Percentage, unless otherwise indicated)

Key parameter	Federal Republic of Germany			Japan			United States		
	1960	1973	1984	1960	1973	1984	1960	1973	1984
Ratio to GNP									
Private consumption expenditures	56.8	54.0	56.3	58.8	53.6	58.5	63.8	61.9	63.9
Public consumption expenditures	13.4	17.8	19.9	7.9	8.3	9.9	16.6	17.8	20.4
Total consumption expenditures	70.2	71.8	76.3	66.7	61.9	68.4	80.4	79.6	84.3
Imports of goods and services	16.5	19.2	30.6	10.3	10.0	14.1	4.4	6.8	11.7
Net saving ^a	21.1	16.3	9.3	22.2	25.5	16.9	8.7	10.1	5.2
<i>Elasticities</i>									
	1960-1973	1973-1984	1960-1984	1960-1973	1973-1984	1960-1984	1960-1973	1973-1984	1960-1984
Income elasticity^b									
Export volume	1.0	1.3	1.3	3.6	2.4	3.0	1.1	1.2	1.3
Import volume	2.1	1.8	2.0	1.3	0.6	1.3	2.2	1.6	2.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat; OECD, *Historical Statistics 1960-1983* (Paris, 1984), *National Income Accounts 1980-1983* (Paris, 1984) and *Quarterly National Accounts*, various issues; Commission of the European Communities, *European Economy*, No. 16 (July 1983).

^a Net saving is defined as national income plus net current transfers from the rest of the world minus final consumption.

^b Income elasticities of exports and imports are derived from regressions, taking into account the price effects. Import elasticities are with respect to own GDP and export elasticities are with respect to a weighted average of trading partners' GDP. Estimates for the Federal Republic of Germany are those of the Commission of the European Communities and refer to sample periods 1964-1973, 1973-1981 and 1964-1981. Estimates for Japan and the United States are by the Secretariat and refer to sample periods 1960-1973, 1973-1984 and 1960-1984.

Large disequilibria have resulted from the combination of different behaviour patterns and macro-policy configurations among major economies. The magnitude of these imbalances is unprecedented and there is much uncertainty about their precise impact on exchange rates and interest rates.

Recent policy developments, however, have altered the

outlook. Concerted domestic and international policy action taken in the second half of 1985 and early 1986 should affect the unwinding of current imbalances and might reduce the net transfer of resources from developing countries. The time required for the new policies to produce such effects is still uncertain, but they point in the right direction and partly explain the new mood among policy makers in a large number of developed countries.

Avoiding complacency: recent policy shifts

After a period of benign neglect, there has been a serious effort on the part of major developed countries, mainly initiated by the United States to take mutual action to improve the international economic environment, to prevent the slow-down in growth that occurred in 1985 from spreading further, and to counteract mounting protectionist pressures.

The direct and immediate aims of the new policy measures are to realign and stabilize exchange rates among key currencies, first through co-ordination of official intervention, but ultimately through changes in macro-economic policy stances; to lower international interest rates in an orderly and co-ordinated manner so as not to upset the process of exchange rate realignments; to initiate trade talks in GATT; and to mobilize a greater flow of private and official external capital not only for a number of highly indebted developing countries but also for some of the least developed countries in Africa, in order to allow them to step up their development efforts after several years of economic stagnation.⁵

Mainly as a result of the co-ordinated policy measures taken by the Group of Five in the second half of 1985 and early 1986,⁶ the dollar fell by about 25 per cent in nominal effective terms, and the Eurodollar interest rate on one-year deposits came down by about 280 basis points. In addition, and quite independently, the spot price of crude petroleum fell by about 40 per cent during the same period. The sharp decline in crude prices was due to a growing imbalance between the supply of oil and the demand, exacerbated by the action taken by Saudi Arabia in the latter half of 1985 to increase production levels in order to prevent a further erosion of its share in world oil markets.

Thus, in a relatively short time, three key global parameters have greatly changed. Since the declines in interest rates, particularly the long-term rates, have been somewhat more than the fall in inflation rates, *ex post* real interest rates have also fallen from their peak in the third quarter of 1984⁷ (see figure II.2 and table A.V.7).

These changes, which came at a time when the recovery was weakening, have already had major impacts on near-

term expectations. They have favourably influenced business and consumer confidence in the developed market economies. The final tally has not yet been made and there is always a possibility of reversals, but there is little doubt that the changes have been beneficial. In fact, as these events unfolded in rapid succession, they brought about near-euphoria in the major equity and bond markets in the developed countries. For the rest of the world, particularly for developing economies, the picture is mixed.

Of the three parameter changes, the generalized decline in interest rates is the most important. It benefits all countries, developed as well as developing, and is most critical to the sustainability of the global economic recovery in the medium term. Lower interest rates spur both consumption and investment expenditures; lower the public sector's budget deficit by reducing interest payments on public debt and increasing revenues induced by higher economic growth; and reduce the debt-servicing burden of the developing countries. It is important to note that during 1985 the decline in interest rates came about mainly as a result of weakening of demand for credit caused by the slow-down in economic activity and the perceived shift in the macro-economic policy mix of the United States.⁸

More recently, as oil prices have plummeted, the monetary authorities in the major developed countries and financial markets in general have had reason to believe that inflationary expectations have adjusted downwards. This has led to further declines in discount rates and the whole spectrum of market interest rates. Due to the turbulence of stock and bond markets caused by the decline in oil prices, average yields on these assets have declined sharply - more than 300 basis points in the United States - as their prices have increased. The wealth effects generated by the sharp rise in value of these assets have in turn resulted in a significant positive stimulus for both consumption expenditures and private investment.⁹

There is little doubt that lower interest rates benefit the world economy. The results of a simulation study of lower interest rates and their impact on the world economy indicate that a 2 percentage point co-ordinated interest rate reduction by all major developed market economies would

⁵ The effort to mobilize greater flow of capital to developing countries is also known as the Baker initiative, named for the United States Secretary of the Treasury after his speech at the annual meetings of the IMF and World Bank in April 1985, in which he outlined a proposed change in strategy in dealing with the international debt problem.

⁶ The Group of Five is composed of economic and monetary officials of the five largest developed market economies: France, the Federal Republic of Germany, Japan, the United Kingdom and the United States. The special meetings of the Group took place in New York in September 1985 and in London in January 1986.

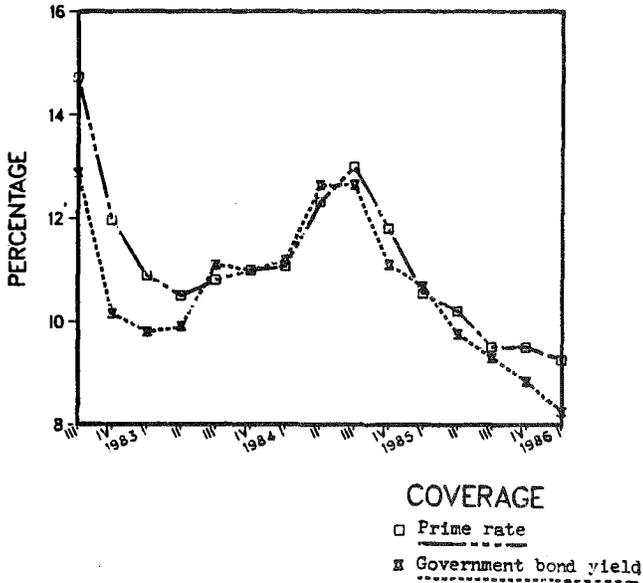
⁷ The real interest rate for the developed countries is defined as the nominal rate of interest adjusted (deflated) by the expected rate of inflation. The rate of interest derived by using the contemporaneous rate of change of price (rather than the expected rate of change of price) is usually referred to as the *ex post* real rate of interest.

⁸ The legislation recently passed by Congress (Balanced Budget and Emergency Deficit Control Act of 1985) mandates a sizeable reduction in the fiscal deficit by 1987. For a discussion of the impact of the change in United States macro-economic policy, see Andrew F. Brimmer and Allen Sinai, "The monetary-fiscal policy mix: implications for the short-run," paper presented at the Annual Meeting of the American Economic Association, New York, New York, 28-30 December 1985.

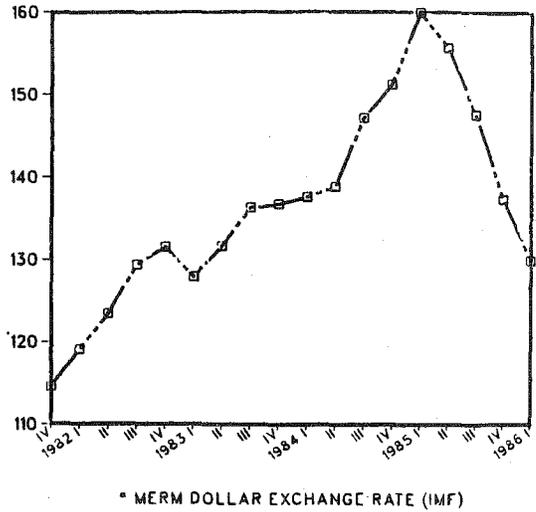
⁹ For an estimate by Goldman Sachs Economics about such gains in the United States, see "Optimists to the fore on U.S. economy", *Financial Times*, 29 February 1986.

Figure II.2.
Key global parameters

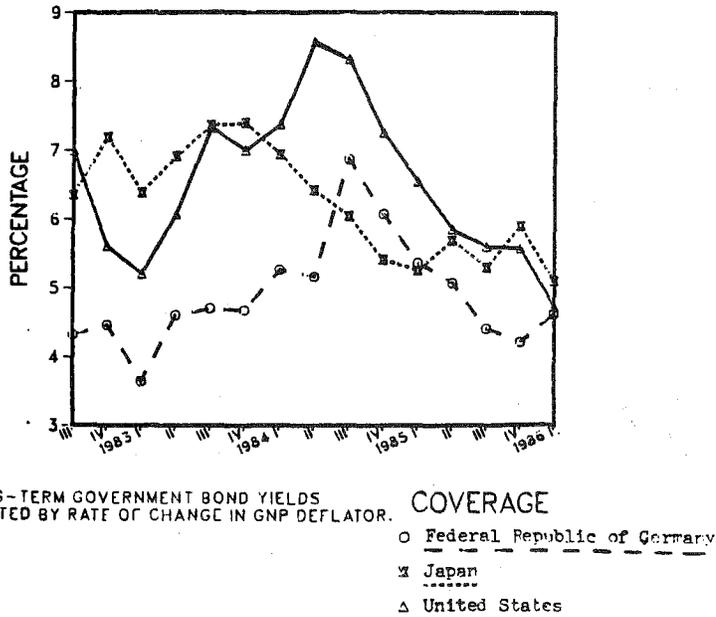
NOMINAL SHORT-TERM AND LONG-TERM INTEREST RATES IN THE UNITED STATES



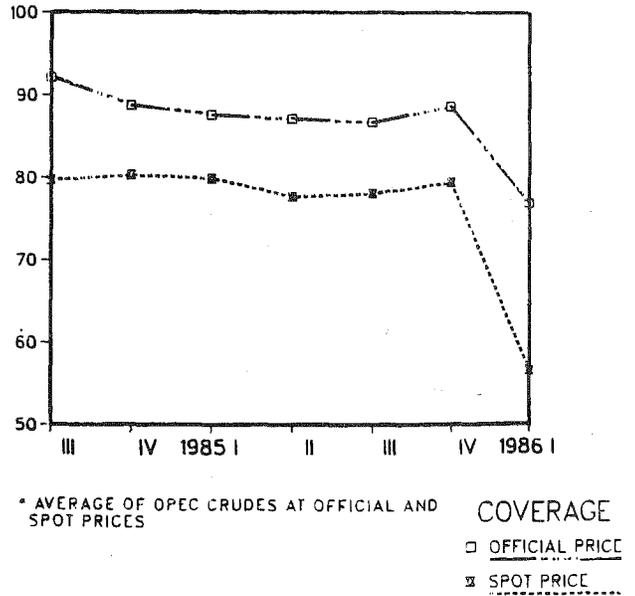
EFFECTIVE DOLLAR EXCHANGE RATE *
1980 = 100



LONG-TERM REAL INTEREST RATES*
SELECTED MAJOR DEVELOPED COUNTRIES



OFFICIAL AND SPOT * PRICES OF CRUDE PETROLEUM
1980 = 100



Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

increase the level of world real GDP by 1 per cent and the volume of world trade by 1.5 per cent over a period of three years.¹⁰ The study also shows that the benefits to the developed countries are generally greater than those to the rest of the world, and that the increased economic activity would come at no significant increase in inflation rates, as long as there was excess capacity in the major economies prior to the reduction of interest rates.

On the other hand, the impact of the dollar decline or of the fall in oil prices on the global economy is not clear cut. While lower interest rates are beneficial to all countries, a decline in the dollar or a fall in oil prices is costly to some countries and to certain sectors within each country. Although a decrease in the price of oil tends to raise world output, at an average oil price of \$18 a barrel, which represents a decline of nearly 40 per cent in comparison with the average price in 1985, energy-exporting developing countries would lose between \$70 billion and \$80 billion in export revenues a year. More than two thirds of this loss would be due to the fall in revenues from oil sales to the developed market economies.

At an average oil price in the range of \$10 to \$12 a barrel, the revenue losses of the oil-exporting developing countries could be in the range of \$120 billion to \$140 billion a year. Obviously, such a huge revenue loss, if actually realized, would lead to a sharp decline in imports of these countries from the rest of the world, even though capital-surplus countries could for some time draw on their reserves and maintain their import levels. Hence, at least part of what the energy-importing countries, developed as well as developing, could gain in real income transfers *vis-*

à-vis the energy-exporters could be lost from the fall in their exports to the energy-exporting countries. At any rate, a free fall of oil prices would have a devastating effect on the socio-economic conditions of oil-exporting developing countries, which, in 1985, as a group, accounted for a quarter of the population and over 40 per cent of total GDP of the developing countries.

The recent changes, however, are beneficial to energy-importing developing countries. A better performance in industrial countries should impart some momentum to international trade. Moreover, the burden of the dollar-denominated external debt of these countries should decline, particularly for those countries that primarily export to non-dollar markets. The declines in interest rates and oil prices could mean as much as \$25 billion of savings a year in the combined import bill of these countries. This is equivalent to 1.5 per cent of their aggregate GDP.

Despite the significant improvement in the outlook, the world economy remains vulnerable. The danger of large and destabilizing variations in exchange rates and of increased protectionism has subsided, but has not disappeared. The trade imbalances among major industrial countries are likely to remain very wide. A normalization of the servicing of the external debt is not yet in sight for many developing countries. Commodity markets, particularly the oil market, remain volatile and add an element of uncertainty to the functioning of financial markets. The sluggish growth in the developing economies and further decline in volume of their imports may further exacerbate the drag they currently exert on the world economy.

Shifting policy stances and macro-economic performances

During 1985 and early 1986 there were major shifts in macro-economic policy in a number of developed and developing countries that will have important effects on the output and inflation performance of these countries. Moreover, the centrally planned economies unveiled their new five-year economic plans containing bold initiatives to improve their economic performance.

Policies in developing countries remained dictated largely by the external financial constraint. The substantial slow-down in the rate of growth of international trade in 1985, together with the difficulty of obtaining new external financial resources, particularly from private banks, led to widespread domestic retrenchments. As usual, there was considerable diversity and great differences in the degree of restrictiveness. As a rule, the more trade-dependent countries with a heavy external debt burden had to make a greater effort in curbing domestic absorption. In a large number of debt-ridden countries, efforts to narrow current account deficits while reviving domestic economic growth were frustrated by the slow-down in international trade and their export performance. In some of these countries, including several net-energy exporters, efforts to reduce

the size of the government budget deficit and gain control over the rate of expansion of domestic credit and prices were blunted. The dependence of fiscal revenues on international trade on the part of this group of countries and the need to transfer domestic savings to pay greatly increased debt service were major causes of the perceived lapse in discipline *vis-à-vis* agreed adjustment programmes. In other countries, Governments were more successful in reducing budget deficits and bringing the rate of growth of money supply within the desired range. Countries, such as Argentina and Brazil, which had very high inflation rates, introduced major monetary reform programmes aimed at greater financial stability and breaking inflationary expectations in order to contain inflation.

Among the developed market economies, the predominant objective of fiscal policies was, as before, to reduce government budget deficits and curb the growth of public sector spending. In several countries, tax reforms were introduced and the tax burden on the private sector was reduced. Monetary policy in most countries remained cautious as its primary objective continued to be the control of inflation and inflationary expectations. Given the sig-

¹⁰ See L. R. Klein, R. Simes and P. Voisin, "Co-ordinated monetary policy and the world economy", *Prévision et analyse économique*, vol. 2, No. 3 (Paris, Economica, October 1981).

nificant decline in inflation rates that had taken place in most of these countries since 1980, the overall stance of policy changed to allow some reduction in interest rates. In the early part of 1985 these reductions were uneven and caused wide fluctuations in key exchange rates, particularly a sudden weakening of the dollar. In the latter half of 1985, co-ordination of the monetary policies of the major developed market economies became an element in the strategy of the Group of Five for a collaborative reduction in interest rates and correction of exchange rate misalignments among key currencies (see chap. IV).

Diversity of experiences in developing countries

The change for the worse in the international economic environment in 1985 had an impact on the growth performance of a large number of developing countries.

What lowered the rate of output growth most in developing countries was the slow-down in the growth of the developed market economies. The deceleration in these economies was transmitted to the developing countries through two channels: lower demand for their exports and a sharp increase in real interest rates (measured in terms of the prices of their exports). A number of countries were also slowed down by the adoption of contractionary economic policies, either autonomously or as part of agreed adjustment programmes, in order to curb inflation and improve their external position. Thus, 1985 provided no relief to the development crisis that has prevailed since the early 1980s in the majority of middle-sized and small economies.

The room for manoeuvre that had resulted from the sharp increase in exports in 1984 proved to be short-lived. Export revenues of developing countries fell by about 3 per cent in 1985, and virtually all developing countries experienced a deceleration or an actual fall in export volumes. A further retrenchment of international banks affected more and more countries. Even Asian developing countries with comparatively low ratios of debt service to exports had some difficulty in obtaining new loans from private international banks in 1985. The unfavourable international environment forced import cuts in many countries, which caused significant reverberations in the domestic economy.

A difficulty faced by a large number of developing countries is their heavy dependence on fiscal revenues from trade. A fall in international trade, as in 1985, has an immediate impact on government revenues. The fall in income from import tariffs and related duties amplifies the decline in government revenues brought about by the fall in export taxes. Since most countries in 1985 were trying to contain their deficits, often in the context of a stand-by arrangement with IMF, expenditures, in particular public investment, had to be cut. This seems to have been effective in the sense that most developing countries either experienced a reduction or no change in the ratio of government deficit to GDP.

Likewise, developing countries in general continued efforts to improve the competitiveness of exports and the shift of resources from non-traded to traded goods sectors through real devaluations. Many developing countries devalued their currencies with the aim of effecting real exchange rate depreciation. Additionally, many developing countries that had pegged their national currencies to the dollar continued to do so during 1985. Since the dollar weakened significantly, currencies pegged to the dollar effectively depreciated.

Moreover, a drive towards liberalization and deregulation as well as an effort to strive for a more judicious mix of private and public activities has been seen in many countries in virtually all developing regions. In all continents, new actions have been taken to provide more latitude for private and local initiatives.

Among the energy-importing developing economies, those with the largest populations (Bangladesh, Brazil, India and Pakistan) grew at an average rate of 5.7 per cent - significantly above their population growth - while the other countries in the group grew by only 2 per cent. This difference in economic performance between large and small countries holds up across country groupings with different economic systems. The smaller countries tend to depend much more on international trade, and also tend to have higher external debt burden in relation to their output. Therefore, in periods of global economic difficulties, such as the early 1980s, smaller countries on average tend to do worse than larger countries in terms of output growth performance (see table II.5).

Brazil's performance in 1985 was buoyant. Despite a significant decline in its exports, Brazil, which accounts for close to 30 per cent of Latin America's aggregate GDP, grew by about 7 per cent mainly on account of a sharp rebound in its manufacturing and mining sectors. The main impetus to the growth of output came from a policy-induced increase in real wages and in employment, which favourably affected the level of aggregate demand.

For Latin America as a whole, however, real GDP growth rate fell from 3.1 per cent to only 2.8 per cent (see table A.V.1). In 18 countries (as against only 11 countries in 1984), real GDP per capita fell or was stagnant. Excluding Brazil, the group in 1985 grew by less than 1 per cent and real per capita GDP declined by 1.5 per cent - it was the fifth consecutive year of decline. The cumulative fall was nearly 11 per cent in the period 1980-1985. Most countries in the region have been adversely affected by the deterioration in their terms of trade and continuing debt-servicing problems. Net external payments of profits and interest for the region amounted to \$35 billion, which was over 28 per cent - more than 6 percentage points higher than 1984 - of the exports of goods and services.

Table II.5. Real GDP growth rate and ratio of trade and external debt to GDP, by population,^a 1967-1985

(Percentages, except where otherwise indicated)

Country group	Average annual growth rate of real GDP ^b				Ratio of trade to GDP ^c				Ratio of external debt to GDP, 1984	Average population ^d mid-1984 (millions)	Sample size (number of countries)
	1967-1973	1974-1980	1981-1985	(3) minus (1)	1967	1974	1981	(6) minus (4)			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)				
Developed market economies											
Large	6.5	3.0	3.5	-3.0	5.6	9.9	11.3	5.7	9.1	178.3	2
Medium	5.0	2.5	1.3	-3.7	17.1	24.5	26.2	9.1	18.7	46.4	7
Small	5.1	2.9	1.2	-3.9	28.9	33.3	41.0	12.1	42.6	7.9	13
Developing countries											
Large	5.4	5.4	2.3	-3.1	12.7	20.5	22.4	9.7	39.0	199.7	7
Medium	5.1	4.6	2.4	-2.7	23.0	36.0	33.9	10.9	59.0 ^e	34.6	16
Small	6.1	4.2	0.8	-5.3	51.1	75.7	77.7	26.6	58.9 ^f	6.5	60
Centrally planned economies											
Large	6.9	5.1	5.2	-1.7	11.6	13.1	13.9	2.3	2.6	663.3	2
Medium	8.2	6.0	1.9	-6.3	25.8	30.9	30.9	5.1	19.3	29.9	2
Small	6.4	4.9	2.8	-3.6	30.1	38.4	41.3	11.2	18.3	12.9	4

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

^a Large countries have a population of 70 million and above; medium-sized countries have a population above 20 million but less than 70 million; small countries have a population of less than 20 million. All population figures are based on 1984 data.

^b Arithmetic (unweighted) averages across countries and arithmetic averages of growth rates across years. Output growth rates for the centrally planned economies refer to net material product (NMP).

^c Arithmetic average of imports and exports of goods and services divided by GDP in current dollars. For centrally planned economies, the ratio is that of trade to NMP; the 1967 and 1974 ratios are calculated by applying estimated growth rates of trade volume and NMP to the numerator and denominator of the 1981 ratio.

^d Population of the group divided by the number of countries in the group.

^e Including 14 countries only.

^f Including 43 countries only.

Average growth of output for South and East Asia fell even more sharply than that of Latin America in 1985. The region as a whole grew by only 3.8 per cent which was nearly 1.5 percentage points below the rate for 1984. Excluding India, which grew by over 4 per cent, the region grew at an average rate just below 3 per cent. The most important factor in the slow-down in the region was the weakening of aggregate demand in Japan and the United States, which caused a precipitous fall in the rate of growth of their imports from the region. Some of the countries that in recent years have been growing very fast - Hong Kong, Malaysia, the Republic of Korea and Singapore - had either a significant decline in their growth rate or an actual fall in the level of economic activity. On the whole, however, in sharp contrast to Latin America, Asian countries have continued to make measurable gains in real per capita GDP. In the period 1980-1985, the region on aggregate had a more than 16 per cent cumulative gain in real per capita GDP.

India, in spite of a moderate slow-down in export and GDP growth, still grew at 4.5 per cent. In 1985, India's fifth five-year planning cycle ended with a reasonably favourable economic performance. The GDP growth rate achieved in 1985 owed much to a comparatively high rate of expansion in the industrial sector. The rate of growth of

agricultural output, however, was quite low. Even though the agricultural base of India has been strengthened in recent years, it remains highly dependent on weather conditions. On the other hand, after a relatively poor performance in recent years, the manufacturing sector recovered sharply as its growth rate accelerated from 4 per cent in 1984 to 7 per cent in 1985. Important measures to encourage private investment and overall deregulation of the economy are believed to have played a significant role in increasing the level of industrial production.

African developing countries have suffered serious economic set-backs. The standard of living of large numbers of poor people in Africa has declined further because of the severe adjustments imposed on their economies by a combination of falling terms of trade, drought and the debt burden.

In 1985, 21 countries, representing 84 per cent of the population of Africa, had declining or stagnant per capita GDP. In cumulative terms, real per capita GDP in the region fell by almost 16 per cent in the period 1980-1985. By 1985, the standard of living in much of developing Africa was worse than in 1960. The average rate of growth of Africa was only slightly above 1 per cent in 1985 (see table A.V.1).

Although the overall situation in Africa south of the Sahara is still cause for serious concern, there has been some progress in recent months. Policy makers are paying special attention to agricultural development, and strategies are being reformulated. Price policies have been changed in order to improve terms of trade for the agricultural sector, and government budgets have been revised so as to favour more rapid rural development. The severe drought that hit more than 20 countries in 1983-1984 has eased, with significant recovery in agricultural production. The crisis, however, is not over, as discussed in Chapter VII. The food situation in much of Africa is still fragile. Although most countries no longer face drought, they are still in need of emergency food aid. At the same time, a few countries remain affected by drought.

Energy-exporting countries in West Asia were affected by the gradual decrease in world oil demand and their declining share in world exports of fuels. In the second half of 1985, Saudi Arabia took action to prevent a further erosion in its share and, in early December, OPEC decided to secure a larger share of the world oil market.¹¹ This policy departure, at a time of generally weak energy markets, resulted in a large fall in oil prices and had an immediate and profound impact on the economies of energy-exporting countries. By early 1986, most of them were reassessing policies to cope with a large fall in exports and fiscal revenues.

Although the weighted average rate of inflation in developing countries increased, the median fell as inflationary pressures were reduced in a large number of developing countries. Tight fiscal and monetary policy stances, depressed economic conditions, high levels of unemployment that depressed real wages and, for energy-importing countries, falling oil prices, all contributed to a gradual decline in inflation rates. Only the Western hemisphere experienced a sharp acceleration in its average inflation rate, which itself resulted from the hyperinflationary situation in a few countries: Argentina, Bolivia, Brazil and Peru. The situation in this group of countries, however, changed dramatically starting in mid-1985 as several bold stabilization programmes were put in place.

On the other hand, South and East Asia as a group had the lowest average inflation rate among the developing regions. The inflation rate fell to 7 per cent in 1985 - only a third of its pace in 1980-1981 (see table A.V.3).

A major difference between the inflation performance of the developing and the developed market economies was the degree of convergence in the early 1980s. There was divergence in inflation rates of the developing countries. Of a sample of 76 developing countries in 1981, 24 countries had inflation rates above 20 per cent and 17 had inflation rates less than 10 per cent; by 1985, the number of countries had changed to 26 and 37, respectively. This divergence may narrow, however, as there has been a signifi-

cant redirection of policies in countries facing high rates of inflation.

Since mid-1985, several countries have adopted comprehensive policy packages to confront situations building up into hyperinflation. Although this has been mostly a Latin American phenomenon, Israel also took decisive steps to curb a rate of inflation that was hovering around 400 per cent until the third quarter of 1985. Argentina launched its stabilization programme -the Austral Plan - in mid-1985 as its inflation rate was exceeding 1,000 per cent. The main provisions of the Plan were the introduction of a new currency and exchange rate policy, an initial wage and price freeze, reduction of the budget deficit and a new system of compulsory savings from profits, capital gains and wealth. Thus far the Plan has led to a dramatic decline in the monthly inflation rate from nearly 30 per cent in mid-1985 to around 2 per cent in early 1986. The comprehensive monetary reform and stabilization package in Brazil was launched in late February 1986. Several of the features of the Brazilian programme resemble those of the Austral Plan: a new currency, de-indexation of all contracts, a temporary price freeze and a special system of wage stabilization that takes into account price expectations built into labour contracts agreed well before the programme was launched. Like Argentina, the stabilization package of Brazil has led to dramatic declines in the rate of inflation. Similar programmes in Bolivia, Israel and Peru have also resulted in a considerable deceleration in rates of inflation.

A common aim of the stabilization programmes described above was to produce an immediate change in explosive inflationary expectations. This was achieved, not by resorting to a stand-by arrangement with IMF but through a mix including wage and price freezes and a clear commitment by the Government to keep public expenditures in check. Contrary to past experiences and despite the wage freeze, these programmes have received significant popular support in their initial stages.

The recent United States proposal to restore development through growth-oriented adjustment has received broad support from policy makers in developing countries. However, there is concern about what would appear to be new conditionality requirements associated with the implementation of this initiative. At a time when the majority of developing countries have achieved substantial reductions in their current account deficits through unprecedented adjustment efforts, it seems to them paradoxical that the conditions for international support should be tightened.

Convergence in developed market economies: policies and performances

The macro-economic policy stance in most developed market economies during 1985 remained within the

¹¹ The seventy-sixth OPEC Conference (Geneva, 2-9 December 1985) considered the past and likely future developments in the world oil market and the persistently declining trend of OPEC production, and decided to "secure and defend for OPEC a fair share in the world oil market consistent with the necessary income for Member Countries' development". See OPEC Press Release No. 8 (Geneva, 9 December 1985).

framework set by the medium-term policy strategies adopted in the late 1970s or at the beginning of the 1980s. These policies were adopted mainly as a reaction to the perception that the so-called "fine-tuning" approach to policy-making of the 1970s had failed. The major aim of the new strategies has been to encourage private investment initiatives, reducing the relative size of the public sector, cutting budget deficits, and curbing inflation and inflationary expectations.

A range of structural policies have been pursued with vigour in some of these countries with the aim of deregulation of industries, privatization of publicly owned enterprises, financial deregulation and greater flexibility in labour markets. A significant portion of the high unemployment in these countries is believed to have been caused by labour market rigidities, which encouraged further investment in capital-deepening projects and labour-saving technologies.

Although the progress in reducing deficits has been mixed, a number of countries have been quite successful. The great unevenness in fiscal stance among the three largest economies has been striking. In the United States, the ratio of general government fiscal deficit to GNP increased from 1.3 per cent in 1980 to 3.5 per cent in 1985. In the Federal Republic of Germany and Japan the same ratio dropped by nearly two thirds to slightly above 1 per cent during the same period. In 1985, when budget deficits declined in most of the other developed market economies, in the United States the deficit rose to 3.5 per cent of GNP, from 2.9 per cent in 1984. In both the Federal Republic of Germany and Japan the deficit reduction amounted to about 1 per cent of their GNP.

Another measure of the fiscal policy stance is the change in the structural budget deficit. This measure is based on the cyclically corrected budget balance, that is, the budget balance that would result if the economy were to operate at or near full capacity output. If the cyclically adjusted budget deficit becomes smaller over time, it is an indication of a more restrictive, or less expansionary, fiscal stance. The opposite indicates a change in fiscal stance toward less restriction, or more expansion. Using this concept, table II.6 shows that the change in the overall fiscal policy stance in 1985 was neutral. The degree of fiscal expansion in the United States (-0.5 per cent of GNP) was of

more or less the same magnitude as the degree of fiscal contraction in the other major economies (0.4 per cent of their combined GNP).

This policy configuration is expected to change in the period 1986-1987. Announced policy intentions suggest that there will be less imbalance in the fiscal policy stances of the major economies. Behind this shift lies the major policy shift in the United States. According to the Gramm-Rudman-Hollings Act, the federal budget deficit of the United States, which reached \$212 billion in 1985, must, starting in 1986, be reduced each year in relation to a pre-set maximum allowable deficit in order to reach a balance by 1991.¹²

This expected change in the United States fiscal stance has already had an important impact on the monetary policy of developed market economies, including the United States itself. The combination of expansionary fiscal and tight monetary policy in the United States produced high nominal and real interest rates in the 1980s.¹³ With a shift in policy stance expected by the financial markets, interest rates have come down significantly in the United States since early 1985. The discount rate in the United States was reduced by 100 basis points between early 1985 and early 1986. The central banks of the Federal Republic of Germany and Japan also reduced their discount rates in a co-ordinated manner. After the Group of Five meeting in September 1985, Japan tightened its monetary policy, which temporarily led to higher interest rates, allowing the yen to appreciate against the dollar, but in the early months of 1986, after the dollar had depreciated even further against the yen and the deutsche mark interest rates were reduced in tandem in order to allow monetary easing without causing excessive change in exchange rates.

An additional substantial appreciation against the dollar was not considered desirable by the other major developed market economies, particularly Japan. The United States Federal Reserve Board wished to limit the further weakening of the dollar to avoid inflationary pressures from higher prices of imported goods and materials. However, further easing of monetary policy in the United States, even if temporary, would be appropriate in view of the substantial tightening of the fiscal stance expected in 1987.

¹² The Act, which is officially known as the Balanced Budget and Emergency Deficit Control Act of 1985, was signed into law by the President of the United States in December 1985. There is, however, a federal court ruling against a crucial provision of the Act that would automatically reduce the deficit through an across-the-board reduction in expenditures. The ruling states that such a provision violates the separation of power among the branches of the United States Government. The ruling has been appealed in the Supreme Court of the United States. A major requirement of the Act is that the mandatory reductions fall equally on domestic programmes and the defence budget - but certain programmes are exempt. Maximum allowable deficits for 1986 and 1987 are \$172 billion and \$144 billion. In 1986, however, the reduction in outlay is limited to \$11.7 billion.

¹³ See *World Economic Survey 1985* (United Nations publication, Sales No. E.85.II.c.1), chap. III, and V. Tanzi, "Fiscal deficits and interest rates in the United States: an empirical analysis, 1960-84", *IMF Staff Papers*, December 1985, pp. 551-576.

Table II.6. Major developed market economies: monetary and fiscal policy stance, 1976-1985

(Percentage)

	1976	1977	1981	1982	1983	1984	1985 ^a
Rate of change in real broad money supply (M2)^b							
Major industrial economies ^c	5.5	4.3	1.4	4.1	5.7	3.7	4.9
United States	8.5	4.8	0.3	5.1	8.1	3.9	5.6
Four major European countries ^d	1.5	3.0	-0.9	1.9	2.5	2.0	2.6
Rate of change in income velocity of money (M2)							
Major industrial economies	-0.2	-0.5	0.6	-3.0	-2.7	1.0	-2.6
United States	-1.8	-1.0	2.7	-5.0	-4.3	3.0	-3.0
Four major European countries	3.0	0.0	-0.5	0.3	-1.0	0.2	-1.0
Real interest rates^e							
United States							
Short-term	-0.2	-0.6	4.5	5.0	5.0	6.1	4.5
Long-term	2.5	1.0	4.1	6.5	6.6	8.4	7.5
Four major European countries							
Short-term	-0.1	-1.5	4.4	3.1	2.9	4.3	4.5
Long-term	0.7	0.3	3.8	3.7	4.3	4.9	4.6
Nominal interest rates							
United States							
Short-term	5.0	5.3	16.4	12.3	9.1	10.2	8.0
Long-term	7.7	7.5	13.7	12.9	11.3	12.5	11.0
Changes in structural financial balances of general government^f							
Average of major industrial economies (excluding the United States)	0.1	0.4	0.2	0.5	0.3	0.3	0.4
United States	1.3	0.2	0.9	-0.9	-0.7	-0.7	-0.5

Source: Department of International and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and *World Economic Outlook*, and OECD, *OECD Economic Outlook*, and other official national and international sources.

^a Preliminary.

^b Currency in circulation and demand deposits plus quasi-money. Percentage change from the end of the previous period deflated by the rate of change in the GNP deflator of the same period. M2 for all countries except the Federal Republic of Germany (M2 plus large time deposits), Japan (M2 plus certificates of deposit) and the United Kingdom (sterling M3).

^c Canada, Japan, the United States and the four major European economies (France, the Federal Republic of Germany, Italy and the United Kingdom).

^d Aggregated using nominal GNP in United States dollars.

^e *Ex post* real interest rate is defined as the average nominal rate of interest corrected for inflation as measured by the rate of change in GNP deflator of the same period. Short-term rates are the bank rate or the call money rate. Long-term rates are the yield on long-term government bonds.

^f First order change in structural budget balance as a percentage of nominal GNP. A positive value indicates a move towards restriction (surplus) and a negative value indicates the opposite (deficit).

The relative stability of money demand in the Federal Republic of Germany and Japan during 1985 allowed the monetary aggregates of these countries to achieve their targets. By contrast, in the United States, all the monetary aggregates exceeded their upper limits. The sharp decline in the income velocity of money in the United States that took place in 1985 contrasted with the experience in 1984, and suggested that important shifts in the demand for money were taking place in the face of declining inflation,

lower interest rates and financial deregulation. Monetary policy is rendered very difficult by such wide shifts in velocity.¹⁴

The economic performance of the developed countries during 1985 contributed in an important way to the policy shifts that had begun to take place. It was mainly the slowdown in the United States economy that lowered the group's average rate of growth from 4.8 per cent in 1984 to only 2.7 per cent in 1985. United States growth fell from

¹⁴ Regarding the volatility of the income velocity of money in the United States, see "Recent velocity developments in the United States", OECD, *OECD Economic Outlook*, No. 38 (December 1985), pp. 16 and 17.

6.8 per cent to only 2.2 per cent in 1985. This brought the United States growth rate near the average for Western Europe, which was just under 2.5 per cent a year in 1984-1985. Japan's growth rate also fell by about 1 percentage point in 1985, although it remained above the average of other countries in the group by about 2 percentage points.

There was also a marked convergence in inflation rates, as measured by consumer prices (see figure II.3). The average for the group dropped to below 5 per cent - their best performance since 1972. There was a significant drop in the inflation rates of France and Italy and a measurable, albeit smaller, decline in those of the smaller developed countries (see tables A.V.4). Among the larger economies, the best inflation performances - well below 2 per cent - were those of the Federal Republic of Germany and Japan. Cautious policy stances, declining commodity prices and moderate increases in average nominal wages were the key factors in the deceleration of inflation. The rate of increase in unit labour costs, that is, the difference between rates of change in nominal wages and labour productivity, was more than 5 percentage points below the average for 1982, and 8 percentage points below that of 1980. In some countries within the group, in particular the Federal Republic of Germany, unit labour costs actually fell.

Relatively high rates of unemployment in North America and Western Europe, which have persisted for several years, have played a critical role in moderating wage demands of organized labour in North America and de-indexation of wage demands in Western Europe. The deviation of actual real wages (nominal wages deflated by product prices) from equilibrium real wages consistent with high employment of the labour force has been recognized as an important factor behind the high unemployment rates in Western Europe in recent years.¹⁵

Despite a more than 11 per cent increase in real output during the period 1982-1985 in Western Europe, the aggregate unemployment rate rose by almost 2.5 percentage points in that period (see table A.V.5). In North America, although there was a significant reduction in the unemployment rate, in 1985 the average rate still stood at 7.5 per cent, which was still more than 2 percentage points above the average for the late 1970s. By the latter half of 1985, however, unemployment rates of most countries within the group had apparently stabilized (see figure II.3).

The youth unemployment rate has remained alarmingly

high without any sign of subsiding. The overall rate stood at more than 16 per cent in 1985 - twice the total rate of unemployment - and the decline was almost entirely due to a reduction in the rate for North America. The problem is particularly acute in Western Europe. With the exception of the Federal Republic of Germany, the youth unemployment rate, as conventionally measured, in all of the major economies is well in excess of 20 per cent; in other European countries, such as Spain, it is above 40 per cent.

In sum, a certain convergence around lower levels has been achieved in real output growth and inflation.¹⁶ The gap between the unemployment rate in Western Europe and North America appears to have stabilized, but it remains quite wide.

A major cause of the slow-down in the United States economy in 1985 was the worsening foreign balance, which brought the expansion to a near halt in the fourth quarter of 1985.¹⁷ By 1985, the stimulating impact of the highly expansionary fiscal stance and the earlier income-tax cuts and tax incentives for business investment had already begun to fade away.¹⁸ The declines in the growth of aggregate demand and the impact of the falling dollar reduced the rate of growth of import volume by some 15 percentage points, from about 24 per cent in 1984 to under 9 per cent in 1985. Even so, it remained well above the world average and continued to exert a significant pull on world trade in 1985 (see table II-3).

The slow-down in the United States had an adverse impact on its trading partners, particularly Japan. In 1984, more than half of Japan's growth stemmed from exports to the United States, while domestic demand remained level. During 1985, the contribution of the foreign balance to output growth, though still positive, became significantly smaller and was not fully offset by the increase in domestic demand due to increased public investment, so that the output growth rate fell by 1 percentage point to about 4 per cent in 1985.

The fact that Western Europe as a whole had a relatively low rate of output growth in 1985 - nearly identical to its performance in 1984 - disguises two important changes during the year. First, after the severe weather in early 1985, which set back economic activity in a number of countries, real output grew at a considerably faster pace than the year's average of 2.4 per cent. Secondly, the main source of output growth shifted from external to domestic

¹⁵ For a theoretical and empirical analysis of the so-called wage-gap explanation of unemployment rates in the major industrial economies, see M. Bruno and D. Sachs, *Economics of Worldwide Stagflation* (Cambridge, Massachusetts, Harvard University Press, 1985), pp. 178-197.

¹⁶ This is reflected empirically in the declining standard deviation of both output growth rates and inflation rates in 1985, in comparison with 1984. The following table summarizes the unweighted means and standard deviations of inflation rates (as measured by GDP deflators) and real GDP growth rates in 1984 and 1985 for the developed market countries; all figures are percentages.

		Inflation rate	Output growth rate
Mean	1984	4.1	6.5
	1985	3.7	5.9
Standard deviation	1984	3.1	1.8
	1985	2.4	1.5

¹⁷ The rate of growth of real GNP in the United States slowed down from an annual rate of 2.3 per cent in the first half of 1985 to 1.8 per cent in the second half. The growth rate in the fourth quarter was only 0.7 per cent at an annual rate.

¹⁸ There was also a fairly strong negative impact from a cyclical inventory de-stocking that amounts to -1.7 per cent of GNP.

demand as private consumption and investment began to strengthen considerably, particularly in the Federal Republic of Germany.

Main developments in the centrally planned economies

In nearly all European centrally planned economies the socio-economic plans for 1985 aimed at stabilizing expansion at about the pace attained in the preceding two years. The main objectives were to rectify the domestic imbalances and to continue to improve the external payments situation. The priority given to external payments was due not only to the need to deal with the short-term imbalance that had developed in the early 1980s, but also, to an increasing extent, to the objective of resuming rapid growth in the medium to long term.

The plans for Eastern Europe aimed at overall output growth of about 4.8 per cent for 1985, which was less than the actual growth rate of 5.3 per cent in 1984. Investment outlays were slated to grow by 3.5 per cent, somewhat more than in 1984. This moderate acceleration stemmed largely from the high targets of Bulgaria and Romania (about 6-8 per cent growth). Czechoslovakia and Hungary aimed at only 1-2 per cent growth, and the other Eastern European countries intended to stabilize their investment outlays at 1984 levels. The external situation of most of these countries was expected to be less tight than in 1984.¹⁹ This was expected to benefit industrial production and investment as well as domestic consumption.

The priorities of China, the other Asian centrally planned economies and the USSR were different. The USSR planned an acceleration of the expansion of aggregate output as a result of an expected pronounced recovery in agriculture and the repetition of the rate of industrial growth attained in 1984. Investments were set to pick up. Policy makers saw this as a prime requirement not only to support more rapid overall output growth but also to meet modernization objectives, especially in engineering sectors.

China's economic plan for 1985 sought to slow down the very rapid pace of expansion of the early 1980s.²⁰ Nevertheless, industrial and agricultural growth were set at 8 per cent and 6 per cent, respectively. No overall output target was specified, but it would have been around 7 per cent - a high rate by any standards, even though considerably below the 10-15 per cent growth recorded in the preceding two years. The moderation was meant to ease

strains in the economy, to make headway with the implementation of the industrial reforms announced in October 1984, and to keep on track the rural reform and more general adjustment programmes launched in the late 1970s. The other Asian centrally planned economies envisaged growth of the order of 6-7 per cent with substantial advancement in the agricultural sector, which had been especially weak in Mongolia. Whereas Mongolia envisaged a sharp increase in investment levels, Viet Nam was aiming at reducing the runaway investments of 1983-1984 by holding outlays at 1984 levels.

As shown in table A.V.6, the overall performance in most of the centrally planned economies in 1985 was below plan objectives. In Europe, the reasons for the adverse developments were largely exogenous: severe autumn and winter weather and prolonged drought, deteriorating terms of trade, energy bottle-necks and agricultural set-backs.

Severe weather conditions affected not only such basic industries as mining and energy but also transportation, electrical energy transmission and foreign trade. In addition, the weather conditions gave rise to above-plan imports, for example of fuels, in a number of Eastern European countries, and Soviet exports of fuels to the Western European market dropped sharply and came to a virtual halt. The set-backs sustained during the first quarter of the year on account of the unusually severe winter could in part be compensated by an acceleration of growth later in the year, especially in the German Democratic Republic and the Soviet Union. Prolonged drought also affected agricultural output - crops as well as livestock production - and had adverse effects on electricity generation, particularly in south-eastern Europe. Together with difficulties in procuring contracted volumes of petroleum, these bottle-necks interfered with attempts to increase capacity utilization rates in industrial user sectors.

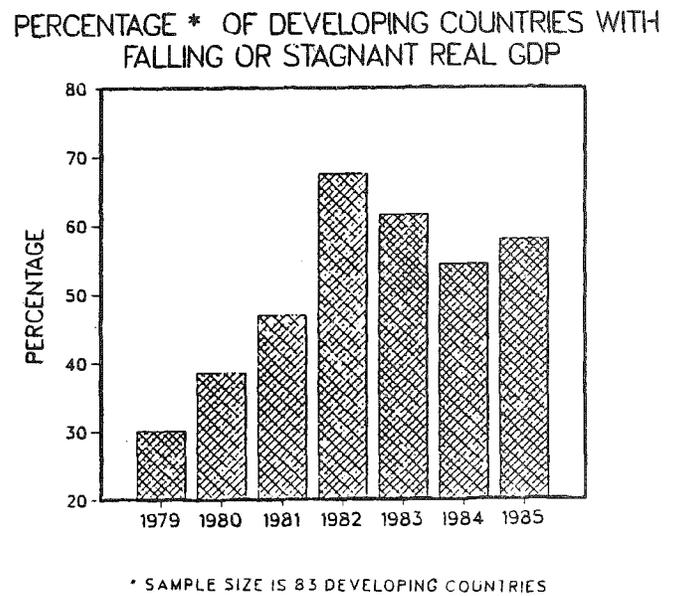
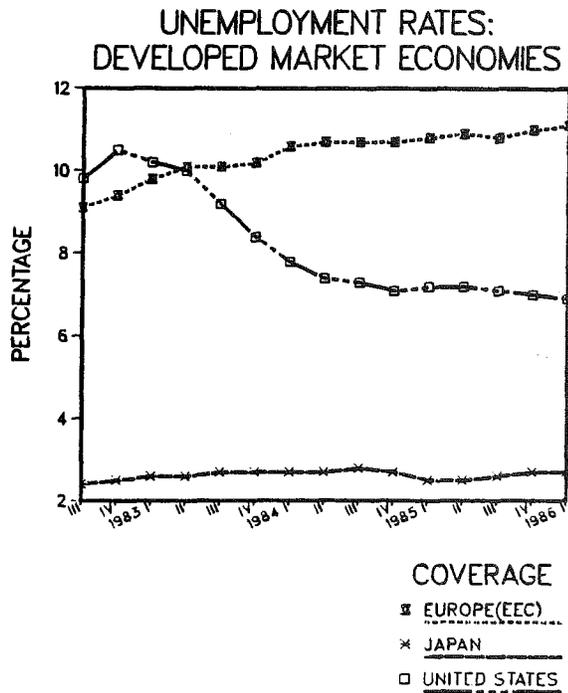
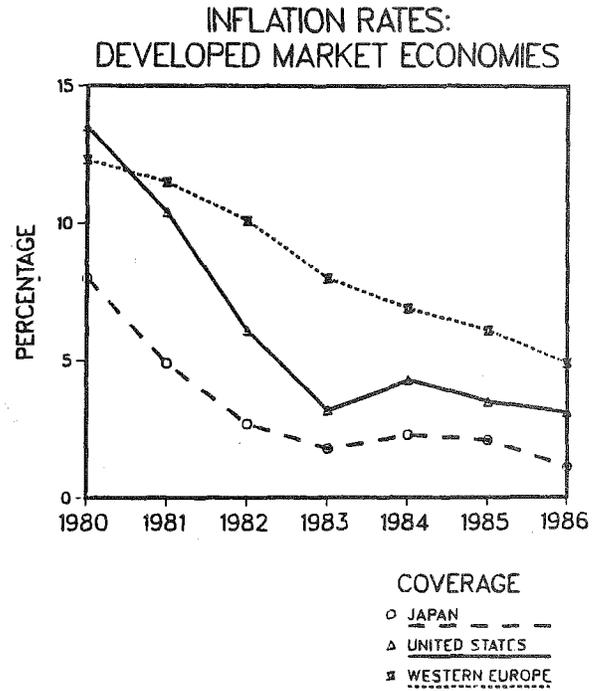
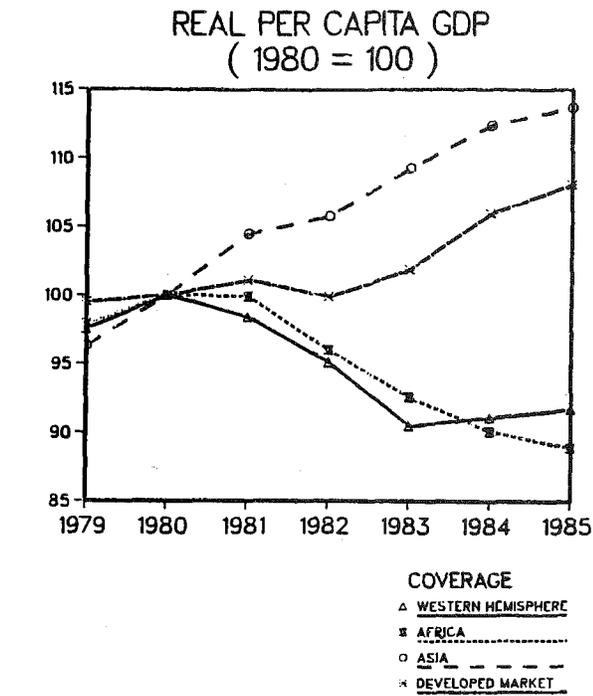
As a result of these and other developments, for the year as a whole aggregate output in all but Czechoslovakia and the German Democratic Republic lagged behind plan targets, in some cases by a substantial margin. Hungary experienced once again a contraction in overall product. In the USSR, according to a preliminary estimate, aggregate output in 1985 may have expanded by about 2.5 per cent, less than in 1984 and significantly less than expected by policy makers.²¹

¹⁹ See also chaps. IV and VI below.

²⁰ In fact, most of the aggregate indicators of output expansion for the first half of the 1980s were fulfilled in China by late 1983 or early 1984.

²¹ The plan fulfilment report (*Ekonomicheskaya gazeta* (Moscow), No. 6 (1985)), which is the sole source of the information required for analysis in the *Survey*, reports only the rate of growth of NMP uses at 3.1 per cent (as against 3.5 per cent planned). In the absence of detailed information, an estimate of NMP can be made according to standard Soviet national accounting methodology based on the growth rate of NMP uses, the value in current prices of NMP uses (as reported above), the reported data on foreign trade, the corresponding magnitudes for 1984 derived from national statistical yearbooks and assumptions on the relationship between domestic and foreign trade prices and on the evolution of the magnitude of errors and omissions in the national accounts. Assuming a relationship of domestic to foreign trade prices ranging from 0.6 to unity, and errors and omissions equivalent to those implicitly reported in 1984, the derived estimate of NMP produced ranges from 2.1 per cent to 2.7 per cent. In what follows, a rate of 2.5 per cent was selected for analytical purposes.

Figure II.3. Indicators of global economic performance



Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

In contrast to the European economies, economic activity in the Asian planned economies for which data are available appears to have expanded at or above plan levels. Aggregate output in Mongolia and Viet Nam seems to have increased by about 4-6 per cent. In China, economic activity was far more expansive than planned, which can be attributed to the continuing difficulties encountered by policy makers in controlling decentralized investments. In the area of external trade, difficulties also arose as a result of substantial loopholes for imports, which adversely affected foreign exchange reserves. However, the output growth decelerated only slightly to roughly 13 per cent from 14.6 per cent in 1984.

Plan fulfilment data for total crops or overall agricultural production are not yet available for most countries, but early estimates suggest that the aggregate grain crop in Eastern Europe was 5-7 per cent below 1984 levels. The grain harvests in all countries but the German Democratic Republic were reported either stagnant or well below 1984 levels, owing in part to bad weather conditions. This was especially the case in south-eastern Europe. Nevertheless, livestock output may have increased moderately, owing to the good grain harvests in 1984 and the relaxation of the import restraints.²² On the whole, however, agricultural growth for Eastern Europe is likely to have fallen short of plan targets - perhaps by up to 2.5 percentage points.

The agricultural performance of the USSR in 1985 was mixed. The grain crop improved substantially compared with that of the preceding year (about 190 million tons instead of the roughly 170 million tons obtained in 1984), but other crops (including sugar beets, potatoes and vegetables) were below 1984 levels. The tentative plan for 1985 was around 240 million tons.²³ In 1985, for the seventh year in a row, harvests were substantially below plan. However, large quantities of imported grains in 1985 permitted a modest upswing in livestock production.

Tight as the investment picture for 1985 was slated to be in the plans, actual performance deviated from it in important respects. In the USSR, the largest share of the 2.9 per cent expansion in gross fixed capital formation was absorbed by inventory accumulation, possibly on account of the extraordinarily harsh winter. A sharp deceleration in gross investment activity was reported in Poland in the first quarter, although it recovered to well above plan levels during the second half of the year. While in the end plan targets were met, this fuelled the debate about decapitalization and hence the effective output capacity available in the years to come. In Hungary, where plans called for a slight rebound in investment activity, outlays actually declined, owing in part to the unexpectedly adverse reaction to the introduction in 1985 of an investment tax designed to be a flexible tool for guiding investment demand according to economy-wide priorities. For

the European group as a whole, investment activity is likely to be nearly equal to the level planned (see chap. VI).

Due to the good results attained in 1984, not only in output levels but in trade and external payments as well, some countries had forecast a higher increase in consumption levels than had been possible since the late 1970s. In spite of the below-plan output performance, the trend towards a more relaxed attitude to consumption actually continued. Restoring the balance in important consumer markets, particularly for food, was of major concern to all countries in 1985. Good summer grain crops made it possible in some countries to enlarge grain reserves and improve supplies in the second half of 1985. Though the 1985 harvests were not so abundant as in 1984 in some countries, this did not lead to substantial short-term supply difficulties.

The set-backs in production growth are reflected in trade and external payments developments. The marginal gain in the export volume of Eastern Europe was more than offset by the contraction in that of the USSR. Import quantum, on the other hand, increased in both the USSR and Eastern Europe. This reflects a sharp departure from the rather strict import restraints of recent years, and a slow-down in the pace of export promotion, especially with respect to the market economies.²⁴

In China, the brisk pace of output growth in both agriculture and industry over the past several years has far surpassed the targets of both the medium-term plan and the annual plans. While this high pace of growth has had several salutary effects, it has also been accompanied by severe strains and given rise to fundamental problems of the direction of economic policy. Shortages have occurred in the supply of energy, primary goods and transportation; structural imbalances in the composition of output of industry have not been rectified; and excessive investments in fixed assets with a piling up of projects in progress continues. On top of this, from the second half of 1984 through mid-1985, there was very rapid growth in bank credit, wages and bonuses, and money supply; this raised inflationary pressures, which spread into the price system.

While the 1985 plan called for a cooling down of the overheated economy, this does not appear to have been attained. The runaway pace of industrial expansion in the first half of 1985 - 23.1 per cent - slowed down considerably in the latter part of the year.²⁵ Nevertheless, for the year as a whole, industrial expansion is likely to be of the order of 18 per cent - very fast indeed.

The policy measures introduced in the course of the year succeeded in bringing about greater synchronization in the output growth of heavy and light industry. However, some endemic problems of scale and consistency in the industrial sector remained. Thus, while oil production

²² But this is not so for all countries: in Hungary there was a pronounced contraction in livestock production.

²³ It should be recalled that the USSR has not published annual harvest plan data (or actual fulfilment levels) since the early 1980s. The data cited here are based on estimates of the harvest in 1984 and 1985 derived from the five-year plan data as well as from FAO and other sources.

²⁴ For further information, see chaps. III and VI below.

²⁵ On a monthly basis and at an annual rate, the pace had slowed to 14 per cent by October; by December, it was already down to 8 per cent.

increased significantly, the rise in domestic consumption was held back as the increase in exports received higher priority. For 1986, the Chinese authorities have already indicated that they will not be in a position to increase export levels of crude petroleum beyond those of 1985.

It is interesting, in this connection, that the big surge in industrial production has occurred not in the output levels of state enterprises but in co-operatives. This suggests that industrial reform was gathering steam at a much faster pace than had been anticipated in October 1984. Although the central authorities had hoped to restrict growth in investment activity so as to maintain better control over that sector in accordance with central priorities on growth and strategic development, investment for capital construction increased at a record 35.2 per cent in current prices.²⁶ The major force behind this unanticipated surge has been the non-state sector. Bank loans (which nearly doubled) and retained profits (which increased by 88 per cent over 1984 levels) enabled the decentralized segments of the economy to undertake capital construction. Discussions on how to rein in this investment activity were quite

Short-term outlook for the world economy

The near-term prospects for many countries, which only a short time ago were expected to repeat the mediocre performances of 1985, have recently improved measurably. The rate of growth of real output in industrial countries will accelerate while the average rate of inflation of the group is expected to continue to decline perhaps even to the low rates of the mid-1960s. This new optimism about general global conditions does not mean to imply that the economic situation in every country is expected to become far better than it has been in recent years, nor does it indicate that all countries are expected to benefit equally from better global conditions and the expected strengthening of the non-inflationary economic expansion in the industrial countries. The projected growth rates for developing countries are still low by historical standards, despite some expected improvement over 1985 figures. There is also a greater degree of uncertainty regarding their magnitude in comparison with industrial countries.

Several factors make projections of the developing countries' economic performance in 1986 and 1987 more complex than usual. The world economy is in a state of flux, as policies and key economic variables, such as oil prices, exchange rates, real commodity prices and interest rates, are changing. The changes have not only come in rapid sequence but have also been quite large, thus complicating the evaluation of their impact. The smaller developing countries in particular are highly vulnerable to changes in these external factors. Hence, although the projections presented below show a moderate acceleration in the rate of growth of world trade in 1986-1987, the outlook is quite uncertain. It is difficult to measure accurately

intensive, and firm counter-measures appear to have been put in place during the second half of the year. By the end of the year, as industrial growth was slowing down, there was also a drastic deceleration in capital formation.²⁷

Though no precise aggregate data are available as yet, agricultural output appears to have grown at a slightly more moderate pace than in recent years - 13 per cent compared with 17 per cent in 1984. This may not be an accurate reflection of the situation in agricultural production. Crop results are difficult to interpret. The summer harvests were reportedly the second highest ever (slightly down from those of the previous year), and China became a net exporter of grain for the first time. According to more recent reports,²⁸ however, grain crops appear to have fallen by about 7 per cent relative to the record performance in 1984. None the less, the reported overall gains give an indication of what the authorities have been able to achieve in other products from rural sectors as a result of changes in taxes, procurement policies and managerial decentralization.

the separate impacts of simultaneous changes in exchange rates, interest rates and oil prices, as well as of recent protectionist actions on the volume of world trade. Particularly difficult to foresee is the extent of the expected cut-back in imports by energy-exporting countries and its direct and indirect consequences for world trade and growth. It is also difficult to measure accurately the impact of the oil price decline on the level of remittances of the guest workers from other developing countries in the energy-exporting countries. Foreign exchange earnings of several major energy-importing developing countries are highly dependent on these remittances. It is unclear how the energy-importing developing countries will utilize their savings from lower oil prices.

Moreover, there is still considerable uncertainty about the level of private as well as official credit flows to developing countries in the next two years. Obviously, this is a critical variable in determining the import capacity of these countries in 1986-1987. Given all these uncertainties, the projections for developing countries are more tentative than those of the industrial countries. In any event, a disturbing feature that emerges from these projections, as well as from those of other multilateral organizations, is the very sluggish growth performance of the developing economies, with the exception of South and East Asia.

Main assumptions

The baseline projections for the period 1986-1987 are summarized in table II.7, and two scenarios concerning further oil price decline and dollar depreciation are presented in boxes II.1 and II.2. The baseline projections

²⁶ This signalled only a modest decline from the overheated investment sector at mid-year, when growth was running at about 43 per cent.

²⁷ It is worth stressing that investment expansion in the first half of 1984 was rather sluggish. The growth in early 1985 may well signal a cooling of the feverish pace of the last quarter of 1984.

²⁸ *China Daily* (Beijing), 9 January 1986, p. 1.

are strongly conditioned by the assumptions underlying the prospective macro-economic policies in the major developed countries and the values of key global parameters. The most critical assumption is the planned reduction in the real rate of growth of public sector expenditure in the United States, which implies a significant curtailment of

the federal budget deficit more or less in line with the spending cuts required by the Gramm-Rudman-Hollings Act. The fiscal policies in the other major industrial countries are assumed to follow their announced medium-term stances as at early 1986, which were still characterized by some caution.

Table II.7. Short-term outlook for the world economy, 1986-1988

(Average annual or annual percentages)

	Actual			Projections		1985-1987 ^a
	1976-1980 ^a	1981-1985 ^a	1985 ^b	1986	1987	
World volume of trade ^c	5.1	2.8	3.2	4.0	4.5	3.9
World real GDP	3.9	2.7	3.3	3.5	3.7	3.5
Real GDP						
Developing countries	4.9	1.3	2.4	3.0	3.5	3.0
Africa	4.6	-0.6	1.4	2.5	3.0	2.3
South and East Asia	6.1	4.9	3.8	4.5	5.0	4.4
West Asia	3.6	-1.1	-0.3	2.0	1.0	0.9
Western hemisphere	5.1	0.5	2.8	2.0	3.5	2.8
Mediterranean	4.3	2.7	3.3	2.5	3.0	3.0
Developed market economies	3.5	2.2	2.7	3.1	3.3	3.0
Western Europe	3.0	1.3	2.4	2.9	2.8	2.7
Japan	5.1	4.3	4.2	3.0	3.7	3.6
North America	3.6	2.6	2.4	3.3	3.6	3.2
Centrally planned economies ^d	4.5	4.5	5.3	4.9	4.8	5.0
Inflation rate						
Western Europe	10.0	7.6	5.3	4.1	3.9	4.4
Japan	4.4	1.3	1.0	0.5	1.0	1.0
North America	7.4	5.4	3.3	3.1	4.0	3.8
Unemployment rate^e						
Western Europe	5.5	10.0	11.5	11.5	11.4	11.5
Japan	2.1	2.5	2.6	2.6	2.6	2.6
North America	5.4	8.5	7.6	7.0	6.8	7.1
Memorandum items						
Value of developing country exports ^f	22.1	-3.3	-2.5	-5.0	9.5	0.5
United States 3-month Treasury bill rate	7.8	10.1	7.5	6.5	7.0	7.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on projections of Project LINK (12 March 1986), and other national and international sources.

^a Geometric averages, except unemployment rates and interest rate, which are arithmetic averages. Forecasts are based on an average oil export price of \$18 a barrel.

^b Preliminary figures for most countries and forecast figures for some.

^c Arithmetic average of the growth rates of world volume of exports and imports.

^d Output growth rates for the centrally planned economies (China, Eastern Europe and the USSR) refer to net material product for 1985 as contained in plan fulfilment reports and to Secretariat estimates for other years.

^e Number of unemployed persons as a percentage of the civilian labour force.

^f In terms of dollars.

Monetary policies in nearly all industrial countries are assumed to ease, particularly in 1986. The time path of the rate of growth of broad monetary aggregates in major developed market economies is assumed to be at or near the upper bounds of their respective target bands in 1986, while they are at their respective mid-ranges in 1987. Besides the deliberate easing of policy, the widespread reduction in discount rates and acceleration in the rates of growth of unborrowed reserves, an additional factor making for more expansionary monetary conditions is the decline in oil prices. For a given nominal rate of increase in

monetary aggregates, the significant deceleration in inflation that is expected to result from the fall in oil prices raises aggregate demand through the real balance effect. Monetary policy in some of the major economies is expected to be less loose in 1987 as inflation rates pick up when output expands and the effect of oil price declines on inflation begins to peter out.

The baseline results indicate that most key interest rates, including the prime rate and the three-month Treasury bill rate in the United States, will bottom out in 1986

and gradually increase in 1987.²⁹ The exchange rates among key currencies are assumed to be flexible (see box II.1). The baseline assumption for the average price of crude petroleum exported by developing countries is \$18 a barrel, which is fixed in nominal terms during the projection period. Finally, the rate of growth of external capital flows into the developing countries is assumed to be only 2-3 per cent a year.

Salient features of the projections

As summarized in table II.7, the baseline solution suggests that the rates of growth of the volume of world trade and world real GDP will accelerate moderately in 1986 and 1987. The expected average rate of growth of world output, about 3.5 per cent a year in 1985-1987, is only marginally lower than that of 1976-1980. However, the projected average rate of growth of world trade, at about 4 per cent in 1985-1987, is 1 percentage point lower than the average in 1976-1980. Even other, more optimistic, forecasts of world trade are not significantly above the rates achieved in the late 1970s.³⁰ An important reason for the sluggish recovery of trade is the weak recovery of the import volume of developing countries as a group. For example, in 1986, the energy-exporting developing countries are projected to cut back their imports of manufactures by 10-20 per cent in real terms. The developed market economies as a group are expected to have nearly the same rate of growth in import volume as in export volume in 1986-1987 and no great spillover of demand for traded goods is expected for the countries outside the group.

Developed market economies

The prospects for the developed market economies are comparatively good. As a group, they are expected to grow by an annual rate of 3-3.5 per cent in 1986-1987. This improvement over their average growth rate in the early 1980s is in line with the group's long-term historical performance and yields an average rate of growth of per capita real income of about 2 per cent a year during the projection period.³¹ Although the expected average growth rate is similar to that of the late 1970s, it would be achieved at less than half the inflation rate of the earlier period. In fact, a prominent feature of the baseline projections is the deceleration of inflation rates, particularly in Western Europe, in the face of an accelerating rate of growth of output.

Low inflation rates in Western Europe and Japan main-

ly result from appreciation of their currencies *vis-à-vis* the dollar and the fall in oil prices. Stronger national currencies lower the local currency price of non-fuel primary commodities and oil. The rate of inflation in the United States is expected to fall on account of lower oil prices, even though there is an upward pressure on prices of imported goods due to the weakening of the dollar. On the other hand, the unemployment rate in a number of industrial countries, including the United States and, in particular, countries of Western Europe, remains stubbornly high. Despite some projected decline, the United States unemployment rate is almost 1.5 percentage points higher than the average in the late 1970s. In fact, due to the difficult situation in the oil-producing regions of the United States, the unemployment rate may even inch up in the immediate future. The unemployment problem in Western Europe, despite the expected acceleration in the rate of output growth, is not projected to improve significantly before the end of the present decade. Recent studies have pointed out that the insufficiency of aggregate demand explains only a portion of the unemployment rate in Western Europe; the rest is due to a combination of relatively high real wages and the serious mismatch between the requirements of new job vacancies and the skills of the job applicants in a number of countries.³²

Western Europe as a group is expected to grow at slightly less than 3 per cent a year in 1986-1987, which is more than twice the average rate in the early 1980s. Both consumption and investment expand as a result of the terms-of-trade effect of the sharp fall in oil prices, particularly in terms of local currencies, and the easing of monetary conditions. The simulation results indicate that the negative impact of the dollar's fall (which makes Western European exports more expensive in United States markets) and the tightening of the fiscal stance in the United States are more than offset by the positive stimuli emanating from oil price declines and easing of monetary conditions.

Despite a sharp decline in the rate of growth of public sector expenditures, the United States economy is expected to grow at an average annual rate of about 3.5 per cent in 1986-1987. The main source of growth in the United States is expected to come from a gradual narrowing of the real foreign balance (i.e., the real trade balance on a national income account basis), the strengthening of consumption expenditures due to substantial wealth effects and a fall in interest rates, and inventory re-stocking. However, the fall in oil prices will have an adverse impact

²⁹ Besides the discount rate, which is directly controlled by the monetary authorities and whose level may be changed exogenously for simulation exercises, other interest rates are model-determined. In any of the simulations presented in the present chapter, interest rates are determined by the interaction between financial and real sectors within each country and by the interaction of different countries with one another.

³⁰ GATT estimates a rate of increase of world trade in 1986 between 4 per cent and 5 per cent (see GATT, "International trade in 1985 and current prospects: first assessment by the GATT secretariat" (GATT/1382, 21 March 1986), pp. 1 and 2). Estimates made by the National Institute of Economic Research (London) for growth in the volume of world trade are 5 per cent for 1986 and 5.5 per cent for 1987 (see *National Institute Economic Review* No. 115 (February 1986), p. 38). However, IMF estimates a rise in world export volume of about 3-3.8 per cent a year for 1986-1987.

³¹ According to an estimate by OECD, the average rate of growth of the group of countries now known as the industrialized countries over the period 1850-1960 had been about 2.7 per cent a year (see OECD, *Twenty-five Years of Development Co-operation* (Paris, 1985), p. 12).

³² See Commission of the European Communities, *Annual Economic Review 1985-1986* (Brussels, 12 December 1985), pp. 2.1-2.4 and 6.1-6.6.

on private consumption and investment in a number of oil-producing countries. Unlike Western Europe, Japan's economy is expected to experience a slow-down in its rate of growth, despite the benefits from lower oil prices. Its expected average growth rate in 1986-1987 is about 1.5 percentage points below that in 1976-1980. The sharp appreciation of the yen against the dollar, the expected slow-down in the rate of growth of imports of the United States and the energy-exporting developing countries are the main reasons for the lower growth rate of output projected for Japan.

Developing countries

Recent changes in the world economy have made the situation of developing countries at the same time more heterogeneous and more fragile. As already discussed above, the projections for the developing countries should be viewed with even more caution than those for other groups. The great changes in the world economy in 1985 and early 1986 will affect individual developing countries differently. It is expected, therefore, that there will be considerable growth diversity within the developing country group and within each of the developing regions. This is in sharp contrast to the expected performance of the developed countries, where convergence of output growth rates is a major feature of the projections.

As the level of financial resource flows into the developing countries is expected to grow at very low rates during the projection period, the economic performance of these countries has become increasingly dependent on traditional trade-output linkages, and on the movements of their terms of trade *vis-à-vis* the industrial countries.

The developing countries as a whole are expected to experience a slight acceleration in their growth rate from 2.4 per cent in 1985 to 3 per cent in 1986 and to 3.5 per cent in 1987. The average for 1986-1987 is barely higher than that of developed countries, where population growth is only about 0.7 per cent compared with 2.5 per cent in the developing countries. But there is much diversity among developing countries. There is, in particular, a considerable difference between the expected growth rates of energy-exporting and energy-importing developing countries. The energy importers as a group are projected to grow at an annual rate of 4.5 per cent in 1986-1987. This is 3.0 percentage points higher than the expected average growth rate for the energy exporters. Although the projected figure for the energy importers is somewhat lower than in the early 1970s, it nevertheless represents their best achievement since the late 1970s and an average real per capita gain of about 2 percentage points.

On the other hand, the energy exporters' average growth rate for 1986-1987 will be barely half of their average growth in the late 1970s, which implies almost no gain in real per capita GDP in the near future. National income in these countries will fall precipitously, because their terms of trade are expected to deteriorate by more than 30 per cent in 1986-1987.

Considerable diversity is also expected at the regional

level. While economic improvement is expected in Africa and South and East Asia, the performance of the Western hemisphere and the Mediterranean regions is expected to worsen before getting better in 1987. An expected slow-down in the rate of growth in Brazil, and a projected deterioration in economic conditions of the major oil exporters, such as Mexico and Venezuela, are the main factors behind the very low growth of only 2 per cent for the Western hemisphere.

The general weakness in South and East Asia (see table A.V.1) results from the expected further weakening of import demand in the United States. Most countries in East Asia are particularly dependent on United States markets for their exports, which mainly consist of consumer products. Nevertheless, as a group, they are expected to continue to have the highest gains in real per capita income among the developing areas.

The situation in Africa remains very serious. The region will be adversely affected by the expected difficulties of the oil exporters in northern and western parts of Africa. The positive margin of output growth for non-oil African countries over population growth - which is about 3 per cent a year - is too narrow to provide much relief: energy-importers in sub-Saharan Africa suffered a 10 per cent decline in average real per capita income between 1978 and 1985. Moreover, an annual growth rate of 3.5-4 per cent for the energy-importing African countries is highly dependent on a reversal in the decline of their terms of trade, as well as on a substantial increase in their volume of imports.

In sum, although the projections for the energy-importing developing countries indicate some improvement, the overall socio-economic condition of the smaller countries within the group and the energy-exporting countries remains extremely fragile. This is even more true for the heavily indebted energy exporters with large populations. As the projections for the Western hemisphere indicate, even the most favourable international economic environment since 1978 is unable to provide enough stimulus to pull up the average growth rate significantly. The debt burden will continue to weigh heavily on these economies in the years to come.

Even a significant increase in growth rate of real economic activity in industrial countries, as envisaged in the baseline projections, is insufficient to reduce the debt burden significantly. The changes in the ratio of debt service to exports, which is extremely important for the debt-affected countries, and which is also a rough indicator of creditworthiness, is particularly sensitive to the ratio of nominal international interest rates to the rate of increase of value of exports. A rate of interest higher than the rate of growth of export earnings usually spells trouble for the debtor countries. The required transfer of real resources to foreign creditors increases while their creditworthiness, which is important for obtaining foreign financing, suffers.

The baseline projections in table II.7 indicate that this ratio will increase in 1986 as interest rates will far exceed the expected percentage change in the value of exports

which, in fact, is projected to be negative. One reason for the expected decline in exports of the developing countries in 1986 is the assumed fall in oil prices; another is the relative weakness of import growth in the industrial countries. Even in 1987, when oil prices are assumed fixed in nominal terms and there is an expected acceleration in the rate of growth of the industrial countries, the debt situation will remain precarious. The few developing countries that will be able to take advantage of the better international environment expected in 1986-1987 are the large energy-importing, manufactures-exporting developing countries. For the rest of the developing world, the damage done to their economies and social fabric in the 1980s, and their adverse present condition, are such that it will require at least several years of high growth and low interest rates in the industrial countries to improve their situation.

Centrally planned economies

For a variety of reasons, the end of 1985 was a particularly important juncture in the economic development of the centrally planned economies. First, the year marked the conclusion of the five-year plan cycle for the first half of the 1980s. For some of the countries in the group the economic performance realized during this period deviated substantially from medium-term and annual plan targets, as they were buffeted by inauspicious external developments and domestic constraints that had not been fully anticipated in the plans. Secondly, with the start-up of the new five-year plans (1986-1990), countries were poised to embark on an acceleration of output performance. They attempt to do so by growth intensification strategies that have been on the policy agenda since the economic reform attempts of the mid-1960s.

Policy makers in the CMEA countries seek to step up economic performances through important shifts in economic policy instruments and transformations in supporting institutions. More buoyant trade and financial relations, particularly after a return to normalcy in East-West relations, would also facilitate the implementation of planned structural adjustment policies and permit realization of their intensification strategies.³³

The economic situation in the European planned economies in early 1986 is characterized by lingering internal and external imbalances in many countries, which are significant effects of the sharp decline in oil prices, and by the as yet undetermined goals and thrust of changes in economic policies, policy instruments and supporting economic institutions. The acceleration in economic performance is likely to emerge only towards the middle of the new medium-term planning cycle. For the near term, the focus will remain the restoration of internal balances, in conjunction with the fostering of further improvements in the external payments situation. Particular importance is attached to the role of consumer markets in supporting the current campaign favouring greater labour discipline

and the tailoring of wage increases to gains in factor productivity. In recognition of the importance of this problem, the Soviet Union has recently adopted a programme that envisions a 30 per cent increase in the production of consumer goods over the next five years and a significant improvement in the retail trade network of goods and services.³⁴ It is planned to bring the supply of these products into closer relationship with demand.

The plans for 1986 reflect this assessment. Overall growth in most countries is slated in the 2-4 per cent range. The only exception is Romania, where plan targets are very high. The growth projections for industry and agriculture are balanced. In industry, targets are in the 2-4 per cent range (except in Romania where the target is 8-9 per cent). In agriculture, some recovery in Eastern Europe can be anticipated after the negative experience of 1985. Perhaps the single most important feature of the 1986 plans is the planned sharp acceleration of investment activity. The USSR will step up its outlay by 7.6 per cent. The countries with weak investment performance in recent years (including Bulgaria and Romania) are aiming at a moderate acceleration. Elsewhere, growth is slated to remain more modest.

Although the 1986 plan has not yet been approved, it is apparent that China is hoping to eliminate flaws in the system of economic management; seek measurable gains in factor productivity; restore harmony in the pace of growth of interrelated sectors; come to grips with the supply shortages in consumer sectors; and stave off foreign exchange pressures. A more sustainable pace of economic growth is expected to eliminate severe strains in the economy. Investment in fixed assets is to be kept within restricted bounds in order to maintain balance between income and expenditures with respect to State revenues and foreign exchange. Better balance between demand and supply of credit and raw materials is also to be assured. Foreign trade will play an important role as well, with more pronounced export promotion than before. Imports of technology will be encouraged and imports of durable consumer goods reasonably limited. Officially, the planned growth of net material product (NMP) for the seventh five-year plan - including 1986 - is 7 per cent; for agriculture, the planned rate of growth is 6 per cent and for industry 7 per cent.³⁵

Risks and uncertainties

There are several risks in the baseline projections. They may be too low. Positive economic events have a way of reinforcing one another, boosting the confidence of consumers and businessmen around the market-oriented part of the world. If, for example, consumers and investors in Western Europe and Japan decide to spend on imports a good part of the spending power they are expected to gain by way of lower oil prices, economic activity in the industrial countries will be higher than anticipated and some of the developing countries will also benefit. Lower rates of

³³ For the implications with respect to investments, see chap. VI below.

³⁴ *Pravda* (Moscow), 9 October 1985, pp. 1 and 2.

³⁵ *China Daily* (Beijing), 21 September 1985, p. 1.

inflation might produce even lower interest rates than envisaged in the baseline scenario. Average growth rates for 1986-1987 would then be somewhat higher than those in table II.7.

Although the international environment has improved during the past year, there are also several important downward risks to the global economic prospects. The major concern is excessive instability of key global prices, including exchange rates, interest rates and commodity prices, particularly the price of oil. These are the same prices whose downward slide during early 1986 provided such euphoria in the industrial countries and resulted in record-breaking rallies in the stock and bond markets.

Oil prices have been moving up and down by 20-30 per cent on a daily basis. Falling oil prices adversely affect the economic condition of some 27 developing countries, including some major debtors that hold about a third of the total external debt of the developing countries to commercial banks. Further decline in oil prices, say to below \$10 to \$12 a barrel, may bring financial havoc to these countries and to the banks that lent to them. This outcome would not be conducive to high growth, even though some countries may greatly benefit from the lower oil prices.

There is still too much variation in exchange rates - on certain days a key exchange rate may change by as much as 10-20 per cent *vis-à-vis* other key currencies. Excessive fluctuations in exchange rate are particularly costly to small private traders in developing countries with little or no access to futures markets. Late in 1985, a study by the Group of 30 indicated that the size of the world's foreign exchange market has doubled in five years; the median estimate of average daily foreign exchange turnover reached \$150 billion in 1984.³⁶ The New York Federal Reserve Bank and the New York Clearing House process dollar payments valued in excess of \$1 trillion per day, which is equivalent to 40 times the reserve balance held at 12 Federal Reserve Banks by all commercial banks in the United States.³⁷ A rumour of an undesirable event in a key currency country can set off a massive flight of capital in a few hours, given the possibilities of the present international financial markets.

Massive capital flight, whatever its cause, could set off a sharp depreciation of currencies. If, for example, the dollar depreciates precipitously through capital flight from the United States or a massive sell-off of dollar-denomi-

nated assets, inflationary pressures in the United States would quickly build up. This would lead to a much tighter monetary stance, and thus higher interest rates. Higher interest rates would choke off private demand and eventually lead to recession and a further rise in the unemployment rate. Similar events could take place elsewhere, as exports to the United States begin to decline sharply and interest rates inch upwards. This kind of environment would be highly conducive to a further rise in protectionism of a kind that could lead to a fall in the exports of developing countries. In such a scenario there is also a possibility of widespread defaults by a number of major debtor developing countries. This is a worst case scenario. Obviously, chances of that happening are a lot less than a year ago, but the only insurance against such occurrences is a high degree of policy co-ordination among the major developed countries. The course that these countries have taken during the past nine months has been the correct one. They have to a large extent resisted protectionism, they have tried to lower exchange rate fluctuations, and they have brought interest rates down.

On a less dramatic scale, there is a possibility that the implementation of the planned sharp reduction in the size of the United States budget deficit, envisaged in the Gramm-Rudman-Hollings Act, could bring about a larger than anticipated decline in the level of economic activity. This would adversely affect the trading partners of the United States. The main countries affected in this case would be Canada, Japan and some of the developing countries in Latin America and East Asia - the major exporters of manufactures. What has lowered the probability of this scenario in early 1986 is the fall in oil prices which, despite the damage to the energy sector, has made possible some easing of United States monetary policy. In view of the fact that monetary policy has a much longer outside lag than fiscal policy, further monetary policy accommodation may be needed soon to counter the recessionary impact of a reduction in the federal government budget deficit in fiscal year 1987 of perhaps \$50 billion, as envisaged in the Gramm-Rudman-Hollings Act. There are, however, other ways for policy makers in key countries to reduce the downward risks, such as the adoption of more stimulatory fiscal policies on the part of the other major industrial countries. This type of multilateral action is still the most promising course of action to be taken if the opportunities that have arisen in 1986 are not to be lost.

³⁶ See *The Foreign Exchange Market in the 1980's: The Views of Market Participants* (New York: Group of Thirty, 1985), p. 11.

³⁷ See Leonard Silk, "The pressures on Fed to ease", *The New York Times*, 26 February 1985, p. D2.

Box II.1. *Impact of a decline in oil prices on the world economy*

The baseline projections are based on the assumption that prices of crude petroleum will average \$18 a barrel in the period 1986-1987. However, in view of the high volatility of oil prices and the possibility of further decline, a scenario is presented here that simulates the economic impact of a further 45 per cent decline in oil prices in 1986, from \$18 a barrel to \$10 a barrel. The nominal price of oil in terms of the dollar is assumed to remain unchanged thereafter.

The primary effect is that of the terms-of-trade change, which causes a real transfer of income from energy exporters to energy importers. The magnitude of the secondary effect depends on the macro-economic policies in both energy-exporting and energy-importing countries. If the policy stance in energy-importing countries remains neutral, as in the simulation presented here, then the deceleration

in the rate of inflation from the fall in oil prices, through the real balance effect and easing of monetary conditions, increases aggregate demand even further. There could also be positive supply-side effects in the energy-importing countries. The most important of these effects is a possible increase in productive capacity as some of the less energy-efficient machinery that lay idle during the high oil price era is brought back into operation. There is also some negative feedback, mainly because of the lower demand for imports of the energy-exporting countries. The net gain, however, as indicated in the table, is positive for the world. One reason for this result is the greater absorptive capacity assumed for the energy importing countries, compared with the energy exporting countries which raises global aggregate demand. This projection disregards the financial repercussions, which are difficult to anticipate.

Impact of a decline in oil prices from \$18 to \$10 per barrel, 1986-1988

	Year 1 (1986)	Year 2 (1987)	Year 3 (1988)
	<i>Percentage deviation from baseline level</i>		
Real GDP ^a			
World	0.7	0.9	0.9
Developed market economies	0.8	1.2	1.2
Energy-importing developing countries	0.7	0.7	0.8
National income of energy-exporting developing countries ^b	-9.0	-9.5	-9.7
Volume of world trade ^a	0.5	1.2	1.4
	<i>Percentage point difference from baseline</i>		
Developed market economies			
Inflation rate	-0.8	-0.5	-0.2
Unemployment rate	-0.2	-0.5	-0.5

Source: Project LINK.

^a Figures for output and trade represent a percentage change in scenario level relative to the baseline level. Year 1 figures may also be interpreted as additions to the baseline growth rates. For years 2 and 3, the additional growth may be calculated by taking the difference between one year's figure and that of the previous year. For example, in year 2, the level of real world GDP in the scenario is 0.9 per cent above the baseline level. The addition to the growth rate, relative to the baseline, is 0.2 percentage points, which is the difference between 0.9 and 0.7.

^b Estimates of the Department of International Economic and Social Affairs of the United Nations Secretariat, based on the simulation results.

Box II.2. Impact of a dollar depreciation on the world economy

The baseline projections presented in this chapter are based on floating exchange rates among key currencies, which are determined by a set of pertinent economic factors. The value of the United States dollar, in nominal effective terms, in the baseline simulations declines by about 20 per cent in 1986 compared with the average level in 1985, in nominal terms. There is a further decline of 5 per cent in 1987 and 2.5 per cent the following year. The scenario presented here assumes a further decline, relative to the baseline level, of 10 per cent, 15 per cent and 20 per cent in each of the years 1986, 1987 and 1988.

A major impact of a dollar depreciation is an immediate improvement in the competitiveness of United States exportables in international markets and import substitutes in United States domestic markets. It redistributes demand for output from countries with appreciating currencies towards the United States. It leads, therefore, to an increase in the level of United States exports and a fall in imports; other countries' exports to the United States fall and their imports rise. This sharp reversal in relative competitiveness raises the level of economic activity in the United States and lowers it in the other countries - chiefly the trading partners of the United States. There will be a build-up of inflationary pressures in the United States as the rate of increase in prices of imported goods and ser-

vices accelerates. As inflation rates rise, nominal interest rates respond and monetary conditions tighten. This chokes off some of the rise in aggregate demand as consumption and investment in the non-traded sector respond negatively to higher rates of inflation and rising interest rates. Conversely, there will be a disinflationary effect in countries with appreciating currencies *vis-à-vis* the dollar. There will be an easing of monetary conditions in these countries through the real balance effects. This by itself, however, is insufficient to reverse the tendency toward slow-down of economic activity as effected by the fall in exports and the rise in imports. There will be more room for monetary relaxation as the process of disinflation sets in. This latter possibility, however, has not been imposed on the scenario presented here. The developing countries benefit from the fall in value of the dollar. There are three linkage channels from the dollar change to the economic activity of developing countries: an improvement in dollar-denominated commodity prices; an increase in the level of exports of these countries to the United States - since many exporters of manufactures link their exchange rates to the dollar - thus capturing part of the market share of Japan and EEC; a lowering of the burden of dollar-denominated debt, particularly for those countries that export mainly to currency areas other than that of the dollar.

Impact of a further 20 per cent decline in the nominal effective dollar exchange rate over three years,^a 1986-1988

	Year 1 (1986)	Year 2 (1987)	Year 3 (1988)
	<i>Percentage deviation from baseline level</i>		
Nominal effective dollar	-10	-15	-20
Real GDP			
World	0.0	0.0	0.1
Developed market economies	-0.1	-0.2	-0.3
Japan	-0.6	-0.9	-1.1
United States	0.5	0.7	0.8
EEC	-0.8	-1.1	-1.3
Developing countries	0.5	1.0	1.3
	<i>Percentage point difference from baseline</i>		
Inflation rate			
Developed market economies	-0.4	-0.6	-0.8
United States	0.2	0.6	1.1

Source: Project LINK.

^a See note a to the table in box II.1 for interpretation of the figures.

Chapter III

CHANGING PATTERN OF INTERNATIONAL TRADE

Salient features in world trade

Three significant recent developments are examined in this chapter. The first section deals with the observed decline in the responsiveness of international trade to growth in world output, along with major shifts in the sources of import demand and the evolution of trade balances in different country groups. The weakening of the relationship between international trade and world output is shown to be largely due to sluggish commodity markets. The second section examines the continuing slump in non-oil primary commodity markets, which is contrary to expectations based on past cyclical recoveries. The third considers the trade and payments implications of the sharp fall in oil prices observed in 1986, which are examined under two alternative hypothetical scenarios.

These developments have important implications for future prospects of growth in world output and world trade, for the distribution of income and wealth among

countries and regions, and for the evolution of the international debt situation in the remainder of the decade.

The declining responsiveness of trade to output growth

The growth of world trade has slowed down perceptibly in recent years, especially in relation to the growth of world income, which has itself been slowing down. A major engine of economic growth seems not to be functioning properly. The elasticity of world trade with respect to world income during the period from the 1950s through the early 1970s was probably close to 2 but it declined to just over half that figure during the 1980s.

The trade elasticity has declined both for the world as a whole and for the major country groups, as shown in table III.1. The decline has been mildest in the centrally

Table III.1. Selected groups of countries: elasticities of real imports to output, 1965-1985^a

	1965-1985	1965-1973	1971-1979	1977-1985
Developed market economies	1.59	1.97	1.45	1.29
Germany, Federal Republic of	1.96	2.26	1.83	1.55
Japan	1.14	1.47	1.23	0.45
United States	1.88	2.77	1.68	1.76
European centrally planned economies	1.31	1.35	1.36	0.98
Energy-exporting developing countries	1.83	1.07	2.30	1.87
Energy-importing developing countries	1.02	1.23	1.06	0.53
10 large debtors ^b	1.03	1.27	1.21	-0.74

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national and international sources.

^a All elasticities are the estimated parameters of a double-logarithmic regression of real imports on real GDP data (NMP for the centrally planned economies) for the periods specified. With the exception of two parameters (elasticities of energy-exporting developing countries and the 10 large debtors in 1977-1985), all coefficients are statistically significant.

^b The 10 largest debtors with private bank rescheduling: Argentina, Brazil, Chile, Mexico, Nigeria, Peru, Philippines, Turkey, Venezuela and Yugoslavia.

planned economies and sharpest among the energy-importing developing countries and the largest debtor countries. There has been a significant but less pronounced decline among the developed market economies as well. There are, however, significant differences among countries in that group. The decline in responsiveness of imports to growth in income has been relatively modest in the United States, more significant in the Federal Republic of Germany and steep in Japan.

At the global level, there appear to be three major reasons behind the fall in the elasticity of trade. Two of them are related to the changing structure of world trade and output and the third to the process of adjustment in indebted developing countries.

While the growth of merchandise trade has been sluggish relative to income by past standards, this has been largely due to the stagnant or falling volume of trade in primary commodities. The growth of exports of agricultural products has declined from the already low annual rate of around 4 per cent during the 1960s to 2 per cent during the first half of the 1980s. Exports of minerals, mostly oil, increased at a rate of 7.5 per cent in the first period and declined at 4 per cent during the second. Trade in manufactures has continued to increase, though more slowly than in the past. The rate of growth of exports of manufactures declined from around 11 per cent during the 1960s to 5 per cent during 1980-1985. Even so, it was still much higher than the rate of growth of commodity trade

and higher than that of world income: in fact, the elasticity of trade in manufactures with respect to world income has increased somewhat in the 1980s compared with the 1970s.

Another part of the explanation is that the share of services in national income has grown, whereas it has remained practically unchanged in international trade. The share of services in income increased rapidly over the past decades in all developed countries and in some developing

countries. It has accounted for the bulk of the growth of income in most developed market economies in recent years. The share of trade in services in world trade, on the other hand, has remained constant over the past 10 years. The decline in trade elasticity is thus partly due to the fast growth of this component of income, and only partly due to the deceleration of trade growth as such.

Table III.2 illustrates the effects of the above two factors on elasticities of world trade.

Table III.2. Apparent elasticities of trade under different definitions of trade and output,^a 1950-1985

	1950-1965	1965-1973	1971-1979	1977-1985
Change in world trade Change in world income	2.04	1.83	1.37	1.25
Change in trade in manufactures Change in world income	2.56	2.50	1.90	2.40
Change in world trade Change in world output (excluding services)	1.70	1.77	1.41	1.28

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data in GATT, *International Trade, 1984/85* (Geneva, 1985), table A1, and "International trade in 1985 and current prospects: first assessment by the GATT secretariat" (GATT/1382, March 1986), table 1.

^a Apparent elasticities measured as the percentage change in merchandise trade divided by percentage change in output.

The decline in the responsiveness of total world trade to the growth of world income is also partly explained by the compression of imports of developing countries that took place during the first half of the 1980s due, largely, to the debt crisis. Though there was a significant expansion of exports from the large debtor countries, they were forced to curtail their imports as part of their domestic adjustment programmes. Imports of the largest debtor countries in 1985 remained almost 20 per cent below their 1980 level. This is reflected in the steep decline of their import elasticity from around 1.3 during 1965-1973 to -0.7 during 1977-1985.

The above analysis leads to a number of conclusions. First, the responsiveness of international trade in the future will partly depend on the revival of trade in primary commodities. Secondly, as trade in manufactures is now the most important source of world trade, it is essential to keep this trade free and to resist protectionist measures, if a further fall in the overall responsiveness of trade is to be prevented. Thirdly, since part of the problem arises from policy responses to the debt crisis, the restoration of a healthy relationship between trade and growth will in part depend on the success in the domestic adjustment process of the debtor countries and the support they receive from abroad.

Part of the explanation of the declining responsiveness of trade almost certainly lies in commercial policies of countries. As discussed in chapter V, there has been an erosion of the multilateral trading system over the years

through increased use of various forms of protectionist measures. Though the magnitude of the impact of these measures on the volume of trade is not clear, the policies of trade liberalization of the 1960s and the growing protectionism of the 1970s and the 1980s - despite some further liberalization efforts - probably account for a significant part of the difference in the performance of international trade in the two periods.

Shifting sources of import demand in the 1980s

The rate of growth of world imports declined significantly in the first half of the 1980s. The volume of imports, which had been increasing at an annual rate of around 5 per cent during the 1970s, grew at barely 3 per cent during 1980-1985. Behind these aggregate figures, there is a considerable diversity of experience of country groups, influenced by a wide variety of factors, including misalignments of exchange rates, the mounting debt service liabilities of a large number of countries and the falling prices of commodities, as well as changing international competitiveness.

Import demand in the developed market economies has been generally weak and highly uneven in the 1980s. On average, imports have grown by 3.5 per cent a year during the period 1980-1985, but this figure conceals the fact that between 1980 and 1982 imports to these countries actually declined in absolute terms, and that import growth over the past two years has been largely concentrated in the United States. Indeed, United States imports ac-

counted for 40 per cent of the total increase in imports for the group as a whole in 1984-1985. This reflects both the faster pace of economic activity in the United States *vis-à-vis* other industrial countries and the relative strength of the United States dollar during this period. Japan's imports, on the other hand, increased only marginally while imports of the EEC countries increased moderately (see Figure III.1).

Imports of the developing countries have declined every year since 1982, with the exception of 1984, when they registered a modest gain. While the largest declines in import volumes have occurred among energy-exporting and highly indebted countries, the contraction in imports in 1985 - of nearly 4 per cent - was fairly general, involving even countries in South and East Asia, which up to then had managed to keep their trade momentum. The loss of export earnings on account of precipitous falls in primary commodity prices and sluggish export volume growth, in conjunction with heavy debt servicing obligations and dwindling net capital inflows, have drastically reduced the capacity of these countries to import.

Imports of the centrally planned economies were also sluggish in 1981-1983, with actual declines registered in Eastern Europe in 1981 and 1982 and in China in 1982 and 1983, which were only partly offset by sustained import growth in the USSR. Over the past two years, on the other hand, while import growth in the USSR has remained below previous levels, in Eastern Europe imports picked up as these countries strengthened their external payments situation and regained access to international capital markets. Meanwhile, as a result of the overall modernization efforts and the liberalization of certain sectors of the Chinese economy, the volume of imports into China rose by nearly 50 per cent in 1985 (see figure III.2).

Partly as a result of the disparate import growth patterns among countries, substantial changes have occurred in the commodity composition of trade flows. The fact that main trade impulses came from North America and that this region is largely self-sufficient in a wide spectrum of primary commodities has led in a relatively short period to a different commodity structure in trade.¹ Over the past five years, trade in manufactures increased by nearly 5 per cent a year, trade in agricultural products expanded by less than 2 per cent a year, and trade in minerals and fuels contracted at an annual rate of 3.5 per cent. The resulting shifts in the commodity structure of trade in constant 1980 prices are presented in table III.3. In current prices, the shift in shares in favour of manufactures is even more pronounced, given the fact that both agricultural and mineral prices have declined much more than the prices of manufactures. This is discussed in greater detail below.

The rapid changes that have occurred in recent years in currency, financial, and primary commodity markets have also affected export flows. Differences in export performance among countries and country groups have also been considerable. The efforts of energy-importing developing countries to promote exports after the second oil shock led to a rapid growth, at 8 per cent a year of the exports of this group of countries in 1981-1985. On the other hand, both the United States and the energy-exporting developing countries had stagnant or falling exports. In the case of the United States, the strength of the dollar proved a powerful deterrent to export growth - its exports declined by 14 per cent over the period 1981-1985. In the case of energy-exporting countries, persistent weakness in the international oil market led to a sizeable decline in exports over this period (see table III.4).

Import demand in different country groups will continue to be heavily influenced by the evolving situation in currency and financial markets, primary commodity markets including fuels, and the external debt situation of developing countries. On the whole, though, trade impulses in the near future are likely to be somewhat stronger than in the recent past, despite the fact that the financial strains of debtor countries and the efforts of many countries to become less import-dependent will continue to constitute a drag on international trade growth. Imports of developed market economies are expected to grow at close to 6 per cent in 1986 as a result of higher economic activity in those countries. A more moderate increase is envisaged for 1987 as the depreciation of the dollar slows down imports into the United States.²

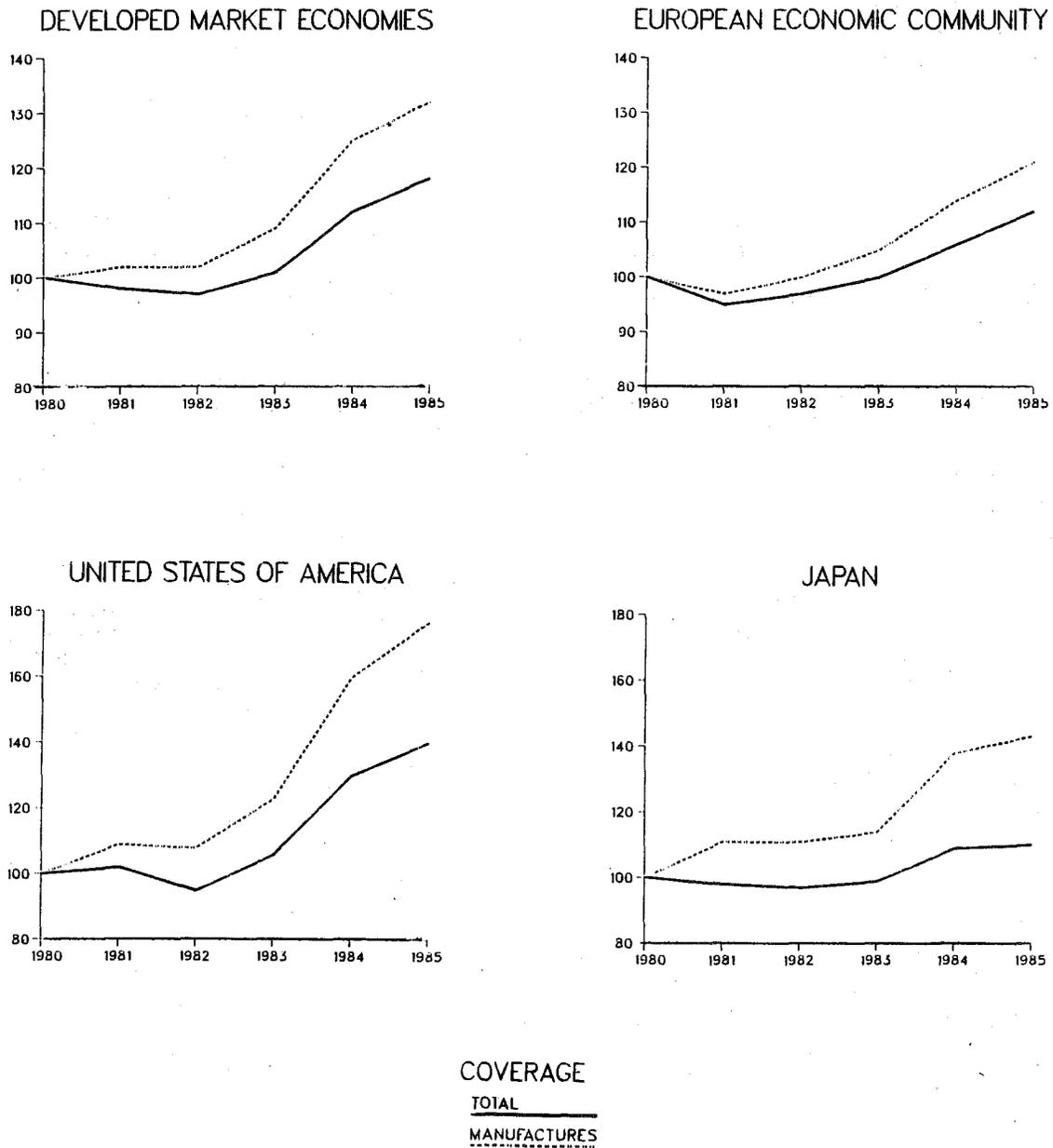
Imports of developing countries as a whole are unlikely to grow in 1986 and may even decline. In energy-importing countries, lower interest rates and a slight improvement in their terms of trade should enhance their import capacity and lead to a 4-5 per cent increase in import volumes in 1986-1987. On the other hand, energy-exporting countries are likely to experience a substantial reduction in their imports. The drop could well exceed 10 per cent in 1986 but should be much more moderate in 1987.

In centrally planned economies, import growth is expected to decelerate in the near term. Imports of the USSR will be negatively affected by the drop in oil prices and falling export revenues, and China has planned for a reduction of imports in the short term. For the centrally planned economies as a whole, the volume of imports is expected to increase by 3 per cent in 1986 and 1 per cent in 1987.

¹ In fact, Canada and the United States are net exporters of primary commodities.

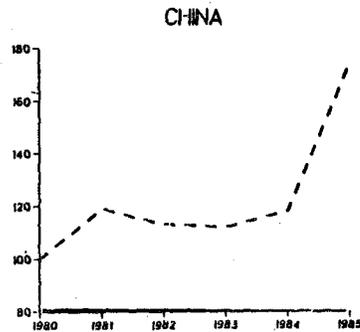
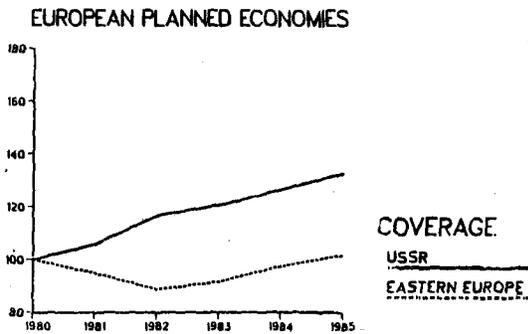
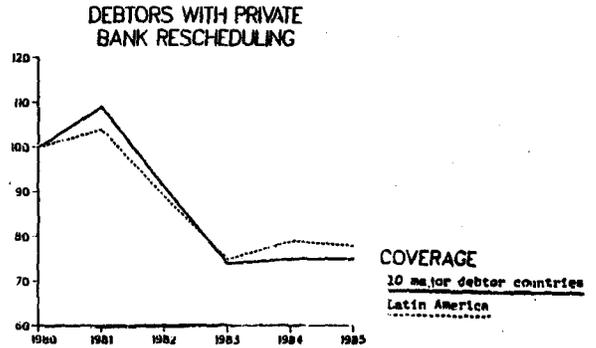
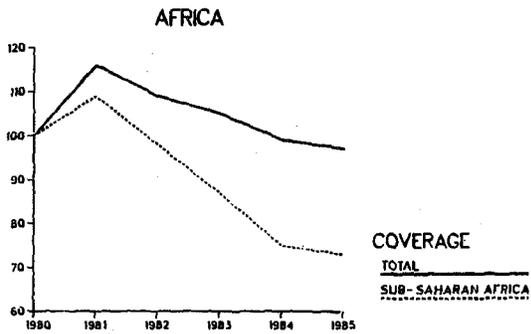
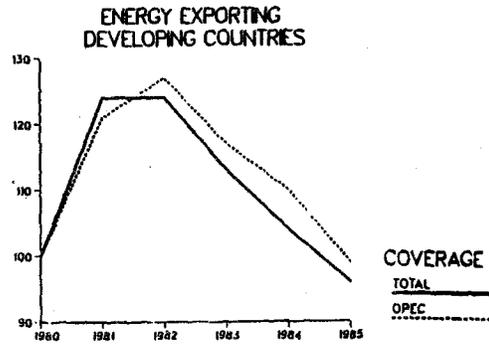
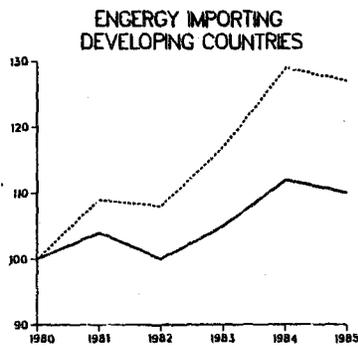
² There is usually a significant lag in the effect of dollar depreciation on the volume of imports. Moreover, while in countries whose currencies have appreciated imports should increase, the increase will not be as large because of the comparatively high price-elasticity of imports in the United States.

Figure III.1.
 Import volumes of developed market economies, 1980-1985



Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

Figure III.2.
 Import volumes of developing and centrally planned economies, 1980-1985



Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

Table III.3. Structure of world merchandise trade, 1980 and 1985^a

(Percentage, constant 1980 prices)

	Manufactures	Minerals and fuels	Agricultural products
1980	56.0	29.0	15.0
1985	63.0	22.0	15.0
Memorandum item 1985 share at current prices	66.0	21.5	12.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on GATT, *International Trade, 1984/85* (Geneva, 1985), and "International Trade in 1985 and current prospects: first assessment by the GATT secretariat" (GATT/1382, 21 March 1986).

^a Figures are rounded to the nearest half percentage point.

Overall, the volume of world trade in 1986-1987 is expected to grow by 4-4.5 per cent a year, largely on account of the acceleration in the rate of growth of world output, particularly in developed market economies, and the financial relief that lower interest rates should provide to heavily indebted countries. While the pace of trade envisaged for 1986-1987 implies a significant acceleration over 1985 and the early 1980s, it would still be insufficient to impart the required momentum to the exports of developing countries with balance of payments difficulties.³

Trade balances by country groups: projections for 1986

As analysed in chapter II, most of the pressures that had led to the considerable trade imbalances in the larger developed market economies in 1984 were still present in 1985 and therefore the imbalances generally widened. Among the smaller developed market economies, on the other hand, the picture was rather mixed: approximately the same number of countries experienced improvement in their trade balances as experienced deterioration. The overall effect was a fall of \$8 billion in the combined trade balance of the developed market economies (see table III.5).

The depreciation of the dollar and the fall in oil prices should narrow the very large trade deficit of the United States in 1986 and 1987. On the other hand, the trade surpluses of the Federal Republic of Germany and Japan are likely to widen further. Both will experience a substantial reduction in their oil import bill, while the appreciation of their currencies is expected to lead to a moderate increase in non-fuel imports. As a consequence, their combined surplus should well exceed \$100 billion in 1986.

The pattern of trade balances projected for 1986 and

1987 is cause for considerable concern. The narrowing of the trade deficit in the United States appears inadequate, particularly since that country became a net debtor in early 1985. Trade deficits of the magnitude expected for 1986 and 1987 imply an increase of the net external debt of the United States of well over \$100 billion a year. Moreover, the large magnitude of the deficit, despite the depreciation of the dollar, might intensify protectionist pressures. The increasing surpluses of the Federal Republic of Germany and Japan in 1986, precisely at a time when the United States deficit is falling, might impart a deflationary impact to world trade, although much will depend on how the additional surplus accruing to these countries is used.

Compared with the magnitude of the shifts in trade balances experienced by developing countries from 1980 to 1984, the change that took place in 1985 must be regarded as marginal. However, the balance of trade of these countries is expected to change markedly in the course of 1986, mostly as a result of the drop in oil prices (see table III.6).

The sharp decline of over \$100 billion in the trade surplus of energy-exporting developing countries between 1980 and 1985 was mostly due to the weakening of oil markets. Their export revenues fell by more than \$100 billion in this period, with virtually all the fall concentrated on the exports from surplus countries. The combined trade surplus of energy-exporting developing countries is expected to fall by \$55 billion in 1986, despite a projected drop in the volume of imports of more than 10 per cent. The reduction in the trade surplus of these countries could be even more pronounced if the actual price of oil for the remainder of 1986 remains considerably below the assumed level of \$18 a barrel.

³ As a rule, in order to reduce the burden of debt and expand the capacity to import, export revenues must grow at rates higher than the current rate of interest, i.e. 7-8 per cent (while this is true for countries whose initial condition shows a significant current account deficit, it is less true for countries that have undergone substantial adjustment and whose current account balance shows a negligible deficit or a surplus).

Table III.4. World trade: annual rates of change
in volume and prices, 1976-1986^a

(Percentage)

	1976-1980	1981-1984	1985 ^b	1986 ^c
Volume of exports				
World	5.1	2.0	2.6	3.5
Developed market economies	6.6	3.0	4.2	4.0
Developing countries	1.9	-1.6	-0.9	4.0
Capital-surplus countries	-1.7	-16.1	-6.0	3.0
Other net energy exporters	2.1	0.4	-2.0	4.0
Net energy importers	7.4	9.6	2.0	4.5
Centrally planned economies ^d	5.7	4.4	-0.8	0.0
Volume of imports				
World	5.5	2.8	3.4	4.0
Developed market economies	5.6	3.0	5.5	6.0
Developing countries	5.5	2.9	-3.8	-1.9
Capital-surplus countries	11.5	4.9	-13.5	-12.0
Other net energy exporters	5.9	1.6	-1.0	-10.0
Net energy importers	3.8	2.8	-1.7	4.5
Centrally planned economies ^d	4.8	2.5	4.8	3.0
Unit value of exports				
World	12.2	-3.3	-1.6	7.0
Developed market economies	9.8	-3.5	-1.1	14.0
Developing countries	19.1	-3.2	-2.7	-11.0
Capital-surplus countries	23.5	-1.9	-1.8	-33.0
Other net energy exporters	21.0	-1.4	-3.1	-23.5
Net energy importers	11.2	-4.9	-2.5	6.0
Centrally planned economies ^d	8.7	-1.1	-1.3	-2.0
Unit value of imports				
World	11.7	-3.7	-2.4	7.0
Developed market economies	12.1	-4.0	-2.6	7.0
Developing countries	12.5	-3.4	-1.8	8.0
Capital surplus countries	10.8	-3.7	-1.7	13.0
Other net energy exporters	11.1	-3.7	-1.9	11.5
Net energy importers	13.4	-3.3	-1.8	5.5
Centrally planned economies ^d	6.8	-1.7	-1.5	3.0
Terms of trade				
Developed market economies	-2.1	0.5	1.5	6.5
Developing countries	5.9	0.2	-0.9	-18.0
Capital surplus countries	11.5	1.9	0.0	-40.5
Other net energy exporters	8.9	2.4	-1.2	-31.0
Net energy importers	-1.9	-1.7	-0.7	0.5
Centrally planned economies ^d	1.7	0.6	0.2	-5.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, International Financial Statistics, and calculations and forecasts made by the Secretariat.

^a Rates of change in unit values on indices expressed in dollars.

^b Preliminary estimates.

^c Forecasts, rounded to the nearest half percentage point.

^d Eastern Europe and the Soviet Union only.

Table III.5. Trade balances of developed market economies,
1984-1987

(Billions of dollars)

	1984	1985	1986	1987
Total	-48	-40	21	13
Germany, Federal Republic of	23	30	43	38
Japan	44	56	78	70
United States	-114	-126	-120	-110
Others ^a	-1	0	20	15

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Project LINK and national sources.

^a Developed market economies whose trade balance was below \$20 billion in absolute terms in 1984-1985.

For virtually all energy-exporting developing countries, the trade balance will deteriorate markedly in 1986 and in a few of them (e.g., Nigeria), the trade balance will switch from a surplus to a deficit position. The effect of falling oil revenues will be particularly distressing to countries with comparatively large debts, such as Ecuador and Mexico. They need to generate a trade surplus in order to cover at least a significant part of the interest due on their external debt.⁴

The trade deficit of energy-importing developing countries narrowed by about \$50 billion between 1980 and 1985. This unprecedented adjustment was achieved through a considerable slow-down in the increase of their imports and a substantial increase in their exports.⁵ Be-

tween 1980 and 1985, their imports grew by less than 2 per cent a year. On the export side, sizeable devaluations and increased export promotion efforts led to export volume increases averaging 8 per cent a year in the first half of the 1980s. Had the prices of their exports remained at 1980 levels, energy-importing countries would have had a substantial surplus in their trade balance in 1985.

In 1986, the trade deficit of energy-importing developing countries is expected to change little with respect to 1985. Most of these countries are starved for imports. The increase in their export revenues and the reduction in their oil import bill should lead to an increase in non-fuel imports by a similar amount.

Table III.6. Trade balances of developing countries, 1980-1986

(Billions of dollars)

	1980	1984	1985	1986
Energy exporting countries	170.6	66.4	64.5	9.5
Surplus countries	137.8	31.3	33.5	3.5
Other energy exporters	32.8	35.1	31.0	6.0
Energy importing countries	-57.9	-15.2	-9.0	-8.0
Memorandum items				
Sub-Saharan Africa (37 countries)	9.1	5.5	6.8	2.0
Latin America	-1.7	38.5	34.0	29.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics*, Project LINK and national and regional sources.

⁴ In principle, it is not necessary for debtor countries to cover the full payment of interest - and remitted profits - out of export revenues. When total debt is high, the objective should be to reduce step by step the total debt in relation to exports and this can be achieved with small increases in the debt if exports grow at an adequate pace. However, when interest payments represent a large share of total export receipts (as in Ecuador and Mexico) the debt situation would tend to deteriorate rapidly unless such payments were covered at least partially by the trade surplus.

⁵ The domestic counterpart of the generation of trade surpluses and its effects on long-term growth are analysed in chap. VI below.

Table III.7. Trade balances of centrally planned economies,
1984 and 1985^a

(Billions of dollars)

	Total		Eastern Europe		USSR		China	
	1984	1985	1984	1985	1984	1985	1984	1985
World	19.0	-0.6	6.9	5.1	11.1	4.0	1.0	-9.7
Centrally planned economies	3.1	2.2	-0.2	0.0	4.0	3.8	-0.7	-1.6
Developed market economies	0.7	-8.8	4.0	2.6	2.2	-0.8	-5.5	-10.6
Developing countries	15.0	6.0	3.0	2.4	4.9	1.1	7.1	2.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on official national and international sources and independent estimates.

^a Trade balances are calculated on an f.o.b. basis for all countries except Hungary. Figures for 1985 are preliminary estimates.

As can be seen in table III.6, one of the most dramatic shifts in trade balances occurred in Latin America, where a \$1.7 billion trade deficit in 1980 was transformed into a trade surplus of over \$30 billion a year, beginning in 1983. The generation of these surpluses was largely determined by debt-servicing requirements; in particular, the substantial increases in interest payments. Since interest payments on external debt remain high - 36 per cent of exports earnings for the region as a whole but as high as 60 per cent in individual cases - the strenuous efforts made in the past to generate large surpluses are likely to continue in the future.

The combined trade balance of the centrally planned economies shifted abruptly in 1985 after experiencing very little change in 1984. From a combined surplus of nearly \$20 billion in both 1983 and 1984, the trade balance moved to a slight deficit - close to half a billion dollars - in 1985 (see table III.7).

Export revenues in Eastern Europe increased by 1 per cent while the value of their imports increased by 3 per cent in 1985. This led to a slight reduction - nearly \$2 billion - in their trade surplus. Exports of the USSR fell by almost \$5 billion in 1985 as a consequence of falling fuel exports. The fall was caused by below plan performance in oil production in conjunction with an increase in domestic fuel requirements. Since imports still grew significantly, the trade balance deteriorated by about \$7 billion in 1985. In the same year, the trade balance of China swung into a substantial deficit. While export revenues increased by more than 10 per cent, the value of imports increased by 50 per cent, resulting from a spurt in demand for foreign durable consumer goods as domestic output of consumer durables continued to lag behind.

The final details of the new five-year plans are not yet available to assess the outlook for external trade balances of the centrally planned economies. It is therefore necessary to take special account of uncertainties regarding three key aspects. First, developments in oil markets are bound to have important repercussions on the export earnings of China and the USSR. Secondly, the recently endorsed Comprehensive Programme for Scientific and Technical Co-operation, the purpose of which is to guide policy-making at the CMEA level, is likely to exert some impact, particularly on the direction of intra-CMEA trade. Thirdly, there is more scope at the present time for a positive adjustment policy in virtually all middle-sized centrally planned economies.

Given the above considerations, the combined trade deficit of the centrally planned economies in 1985 is likely to widen by about \$10 billion in 1986. The traditional trade surplus of the USSR might be reversed as a result of the significant deterioration in its terms of trade expected in 1986. The terms of trade of China are also expected to deteriorate and its trade balance to remain negative. However, while the USSR should increase its import volume considerably to accelerate technological innovation, China might reduce import levels so as to restore its international reserve position, which fell drastically in 1985. Since the recurrence of a boom in imported consumer goods such as occurred in 1985 will be discouraged, China might still be able to increase imports of capital goods to strengthen the modernization drive. The trade surplus of the centrally planned economies of Eastern Europe should vary little as the value of their imports and their export earnings will move at a roughly similar pace: 4-5 per cent growth in 1986.

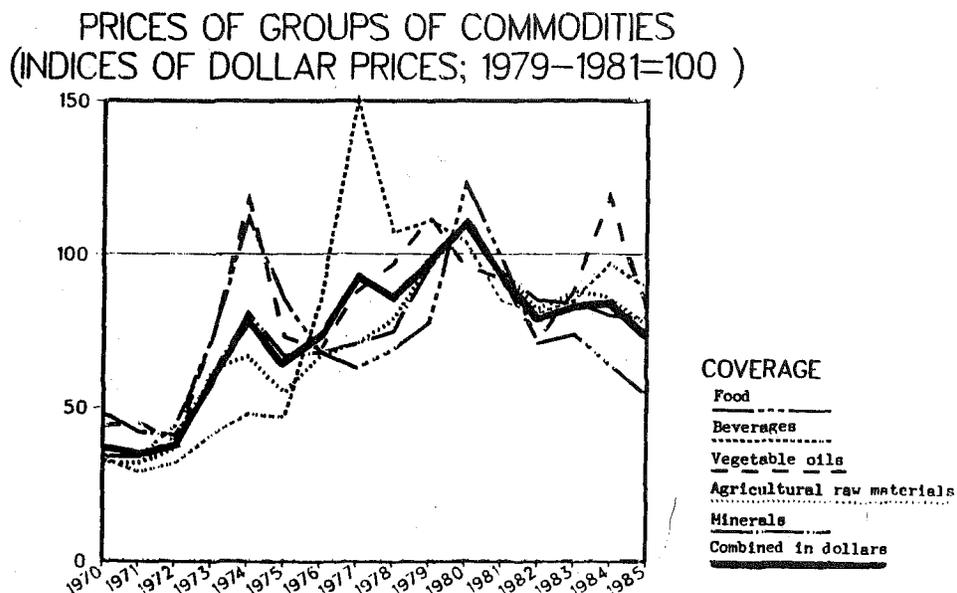
Non-fuel primary commodity markets in the 1980s

Recent developments in primary commodity markets

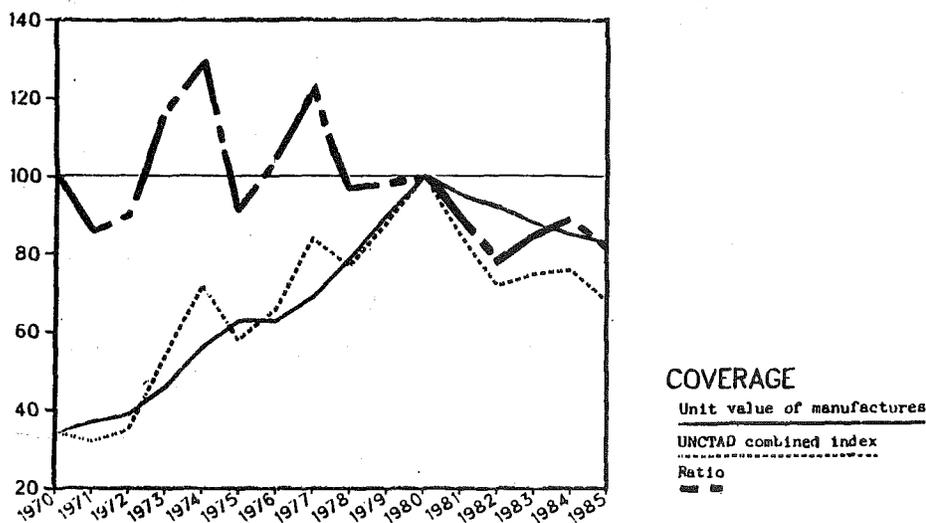
Primary commodity markets, which had been depressed since 1980, remained so in 1985. As measured by the UNCTAD combined index of non-fuel primary commodity prices in current dollars, average prices dropped by 10.7 per cent in 1985, reaching their lowest level since

1976⁶ (see figure III.3). While movements in the dollar price of commodities reflect in part changes in the value of the dollar itself - as will be discussed below - even when measured in terms of a composite basket of currencies such as the SDR, in 1985 primary commodity prices declined by 8.6 per cent relative to average 1984 levels (see table III.8).

Figure III.3. Prices of commodities and manufactured exports, 1970-1985



COMMODITY PRICES AND EXPORT UNIT VALUES OF
MANUFACTURES (INDICES OF DOLLAR PRICES, 1980=100)



Source: UNCTAD, *Monthly Commodity Price Bulletin*, and United Nations, *Monthly Bulletin of Statistics*.

⁶ For a set of five alternative indications of non-fuel primary commodity prices, see table A.I.1.

Table III.8. Price changes of commodity groups, 1971-1985^a

(Indices of dollar prices; 1980=100)

	1971- 1980	1981- 1985	1981	1982	1983	1984	1985
Food	13.8	-14.9	-19.6	-28.2	4.3	-13.6	-14.0
Tropical beverages	12.2	-3.1	-18.3	-4.7	4.9	14.2	-8.3
Vegetable oils and oilseeds	8.1	-3.1	-4.2	-21.7	22.3	35.2	-31.1
Agricultural raw materials	13.0	-6.7	-12.8	-13.8	7.3	-2.2	-10.5
Minerals, ores and metals	8.3	-6.2	-13.8	-10.6	-1.2	-4.8	-1.2
Combined index (\$)	11.5	-7.4	-15.5	-15.0	5.2	1.2	-10.7
Combined index (SDR)	11.1	-2.4	-6.6	-9.1	8.9	5.1	-8.7
Real commodity prices ^b	0.1	-3.8	-10.1	-13.2	10.0	4.8	-11.2
Memorandum item							
Unit value index of manufactured exports	11.3	-3.6	-6.0	-2.1	-4.3	-3.4	1.2

Source: Department of International Economic and Social Affairs, based on data from UNCTAD, *Monthly Commodity Price Bulletin*, and United Nations *Monthly Bulletin of Statistics*.

Note: At the end of April 1986, UNCTAD revised the price indices for food and minerals, which in turn modified the combined indices both in dollars and SDRs. Since the revision was made after the *Survey* was completed, it was not possible to incorporate the changes. However, the nature of the changes is such that the general thrust of the analysis presented here is not affected.

^a Annual percentage change in average annual prices.

^b Obtained by deflating the combined index in United States dollars by the United Nations index of unit values of manufactured goods exported by developed countries.

The slump in commodity markets appears even more dramatic when primary commodity price movements are compared with those of manufactures.⁷ In terms of United States dollars, the price of manufactured exports has declined every year since 1980 by an average of 3.6 per cent a year. Over the same period, the decline in primary commodity prices has been twice as large - at an average yearly rate of 7.4 per cent. Moreover, the erosion in the dollar price of manufactures was entirely due to the appreciation of the United States dollar: when measured in terms of SDRs, prices of manufactures have actually been on the rise throughout most of this period and currently stand some 6.5 per cent above 1980 levels. In contrast, by the end of 1985, primary commodity prices expressed in SDRs were 16 per cent below average 1980 levels. Indeed, in 1985 real non-fuel primary commodity prices (i.e., commodity prices deflated by the unit value index of manufactured exports) reached their lowest level in the post-war period.⁸

The decline in non-fuel primary commodity prices since 1980 has been sizeable, persistent, and fairly generalized among all commodity groupings (see table III.9). Except between the first quarter of 1983 and the first quarter of 1984, when most commodity prices rebounded from the very low levels reached at the height of the recession in late 1982, average commodity prices in dollar terms have declined in every single quarter since 1981. The four-point gain registered by the overall index in the last quarter of 1985 merits special mention. Rather than reflecting a generalized strengthening of commodity prices, it was largely

the result of the jump in coffee prices induced by the Brazilian drought and of modest advances in the prices of other foodstuffs which had been extremely depressed. Meanwhile, the prices of agricultural raw materials and vegetable oils and oilseeds continued to decline, while those of metals remained basically unchanged.⁹

From 1980 on, dollar prices for all commodity groups have followed a broadly similar cyclical pattern along a long-term declining trend, although their peaks and troughs have rarely coincided and the amplitude of the swings has been different (see figure III.4.). Quarterly data show a virtually uninterrupted price decline for all commodity groups throughout 1981 and 1982. At their trough in late 1982, minerals, agricultural raw materials and beverages had lost about one fourth of their 1980 value, while vegetable oils had lost one third and foodstuffs almost half. The price rebound that ensued was shortest and weakest for metals: metal prices regained only 5 index points before resuming their descent in the third quarter of 1983. They continued to drop until early 1985 and have since stabilized at around 73 per cent of their 1980 level. Agricultural raw material prices regained 10 index points before resuming their decline in early 1984; by the end of 1985, they were 31 per cent below their 1980 level. Beverage prices peaked in the first quarter of 1984, having nearly recouped their 1980 level, but slipped back almost 20 index points before their recent rebound. On average, beverage prices have dropped by 3.1 per cent a year since 1980.

As a group, vegetable oils and oilseeds showed the great-

⁷ As measured by the United Nations index of unit values of manufactured goods exported by developed countries.

⁸ World Bank, *Half Yearly Revision of Commodity Price Forecasts - December 1985* (Washington, D.C., 1986), tables 3-5.

⁹ See Note a to table III.9.

est price instability during the 1980-1985 period. After losing one third of their 1980 value by the end of 1982, vegetable oil prices more than doubled in the course of the following year and a half, only to plunge again over the next 18 months to virtually the same level they had reached at their trough in late 1982. Behind this volatility

lies the fact that vegetable oils are joint products of meal production and that in the case of the dominant element in the group -soybeans - while meal demand dominates production, the soybean oil produced as a by-product exerts a strong influence on the prices of other oils, since they are all largely interchangeable.¹⁰

Table III.9. Annual and quarterly indices of primary commodity prices, 1981-1985

(1980 = 100)

	Food	Tropical beverages	Vegetable oils	Agricultural raw materials	Minerals and metals	Combined index		Real prices ^b	Prices of manufactures (dollars)
						Dollars	SDRs		
1981	81	82	96	87	86	84	93	89	94
1982	58	78	75	76	78	72	85	78	92
I	67	83	83	78	82	77	89	82	94
II	59	77	83	77	78	73	85	78	93
III	53	75	70	76	76	69	83	76	91
IV	51	79	66	73	75	68	83	77	88
1983	61	82	92	81	77	75	92	85	88
I	54	78	68	75	76	70	84	77	91
II	62	79	78	82	80	75	91	84	89
III	65	81	106	84	77	78	96	90	87
IV	62	91	115	83	74	79	98	92	86
1984	52	93	124	79	73	76	97	89	85
I	56	97	132	84	75	81	101	93	87
II	55	96	143	82	75	80	100	92	87
III	49	91	113	76	71	73	95	87	84
IV	46	90	108	73	70	71	94	87	82
1985	45	85	85	71	72	68	89	79	86
I	46	89	101	70	69	70	95	87	79
II	44	82	97	73	73	69	91	83	83
III	44	78	75	71	73	66	84	76	87
IV	46	92	68	69	73 ^a	70	84	75	93

Source: *Handbook of International Trade and Development Statistics, Supplement 1985* (United Nations publication, Sales No. E/F.85.II.D.12); UNCTAD, *Monthly Commodity Price Bulletin*; and United Nations, *Monthly Bulletin of Statistics*.

^a The index excludes tin prices as from 24 October 1985, when tin trading in the London Metals Exchange was suspended. The inclusion of tin prices at levels similar to those prevailing in the Kuala Lumpur market would reduce the index by 3-5 points.

^b Commodity prices deflated by the unit value index of manufacture exports from developed countries.

By far, the worst overall price performance in the 1980s has been that of foodstuffs whose prices have dropped, on average, by 14.9 per cent every year since 1980. Between 1980 and the end of 1982, food prices fell by nearly 50 per cent, in the face of bountiful harvests and depressed import demand. Over the first three quarters of 1983, they recovered to a level equivalent to two thirds of their 1980 value, but have since dropped to their lowest level since 1972. In real terms, food prices currently stand at their lowest level since the late 1940s.

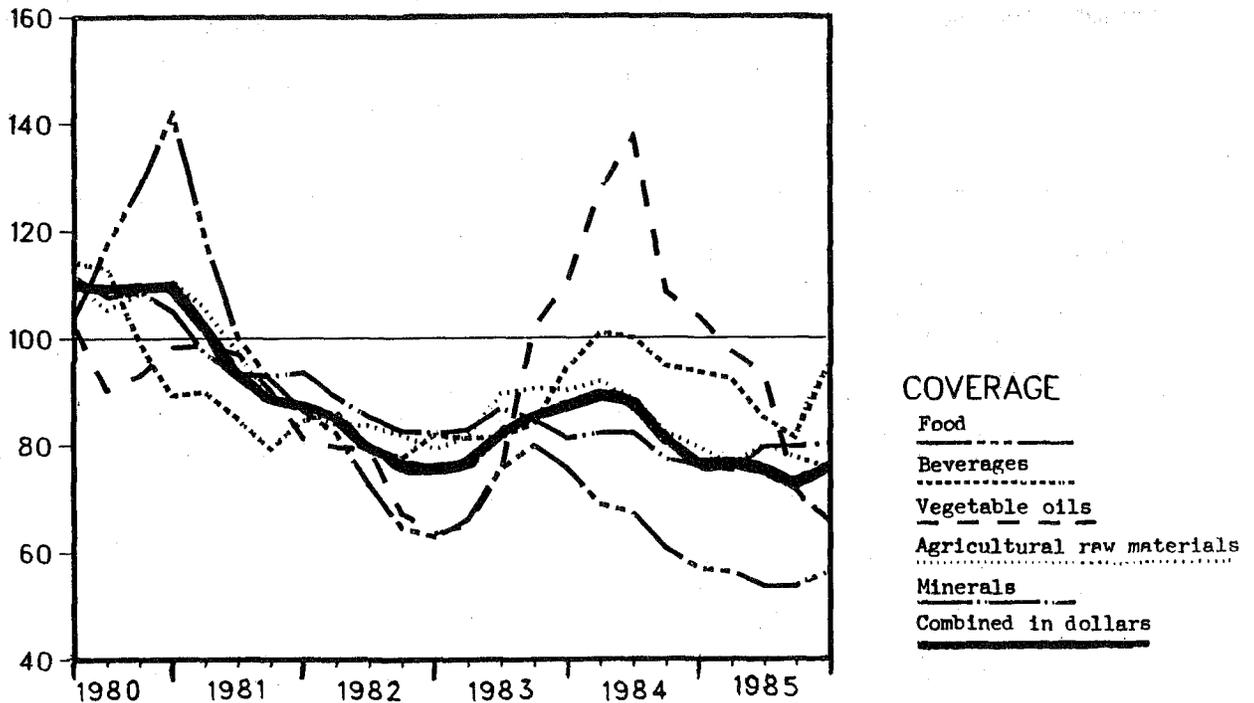
Main determinants of commodity prices

The drastic change in the pattern of primary commodity price movements in the 1980s relative to the 1970s strongly suggests that general forces have been conditioning the behaviour of primary commodity markets. Partic-

ular price developments in individual markets can, of course, always be traced to specific occurrences. The specific factors that trigger such price reactions are often natural phenomena - such as the drought in West Africa in 1983 and, more recently, the drought in Brazil, which caused the rapid increase in the price of coffee and (to a lesser extent) cocoa, or the floods in India and Bangladesh in 1983/84, which sent jute prices soaring. In other instances, policy decisions trigger market responses - for example, the introduction of the payment-in-kind programme in the United States in 1982/83, which led to drastic cut-backs in maize, soybean and cotton production, or the export embargo imposed by India in late 1983, which led to a trebling of tea prices in a matter of months. Institutional factors such as the recent collapse of the tin agreement are yet another source of market disturbance.

¹⁰ IMF, "Recent market developments and outlook for primary commodities" (DM/85/55, 12 September 1985), p. 35.

Figure III.4.
Prices of groups of commodities, 1980-1985
(Indices of dollar prices; 1979-1981=100)



Source: UNCTAD, *Monthly Commodity Price Bulletin*, and United Nations, *Monthly Bulletin of Statistics*.

Finally, it must be noted that while the cause of the disturbance may be market-specific, its consequences seldom are; they spill over into related markets, becoming themselves sources of disruption in those markets.

But the strong, persistent and generalized decline in primary commodity prices in both nominal and real terms, which has characterized the 1980s, cannot be entirely explained by the peculiarities of particular markets. Rather, the causes of the slump are related to a number of factors that can be grouped under three general headings: the legacy of the 1970s; the macroeconomic environment of the 1980s; and the changing institutional framework of international commodity exchanges.

The legacy of the 1970s

Commodity price developments in the 1970s induced profound changes whose effects on commodity markets linger to this day. After a long period of relative price stability, primary commodity markets exploded - not once but twice - in the course of the decade. Between 1972 and 1974, while non-fuel primary commodity prices doubled in terms of United States dollars, crude petroleum prices rose by nearly 500 per cent. The boom was led by food-stuffs and vegetable oils but all commodity groups, except

beverages, were involved. The second boom - a boomlet by comparison - occurred in 1979/80 when, in the wake of the 140 per cent increase in petroleum prices, non-fuel commodity prices rose by a third. Again, all commodity groups were affected except beverages - which had had a boom of their own in 1976/77 as a result of severe frost damage to the coffee crop in Brazil. Overall, in the course of the 1970s, non-fuel primary commodity prices advanced, on average, by 11.5 per cent a year, although in real terms they remained essentially stagnant. Crude petroleum prices, on the other hand, multiplied eightfold in real terms during this period.

Not only the sharp rise in prices but also their increased volatility induced major adjustments that tended, on the one hand, to reduce consumption and import dependence, and on the other, to expand capacity, supplies and exports. Most notable among these developments was the drive towards energy conservation and self-sufficiency triggered by the increase in oil prices. This translated into a marked shift towards less energy-intensive forms of production, the development of energy-saving consumer products, a switch from petroleum to other forms of energy and, where possible, the development of domestic oil supplies. To varying degrees, similar trends evolved in other

industries using natural resources:¹¹ processes aimed at saving natural resources were developed, recycling techniques were improved, synthetic substitutes and new materials were created, product design was made more resource-efficient and the trend towards miniaturization was intensified. These trends, reinforced by the switch from heavy to light and service industries, particularly in industrial countries, have led to a significant reduction in material input per unit of output.

The exposure to volatile international commodity prices and supply disruptions in the 1970s also led countries to deliberately attempt to reduce import dependence. As a result, in recent years, commodity trade has declined faster than commodity use. Table III.10 illustrates this. As can be seen, between 1980 and 1982, the share of imports in total apparent consumption of primary products in Japan, North America and EEC dropped by almost 6 percentage points, after having increased by 15 percentage points in the 1970s. During both periods, the sharpest shifts occurred in mining (a share gain of 19 points in the 1970s followed by a share loss of 11.5 points in 1980-1982) and petroleum (a gain of 16 points in the 1970s followed by a loss of 9 share points in 1980-1982). In addition to technical change and shifts in demand patterns, the sharp drop in the import-consumption ratio may have contributed to the marked trend decline in metals and mineral prices and in their responsiveness to economic activity reported in a recent OECD study.¹²

For their part, suppliers to international markets, perhaps suffering from money illusion, interpreted the price rises in the 1970s as a signal to expand. By the time most of the added capacity came on stream, however, the bubble had burst. By then, though, with the investment al-

ready made, it paid to produce as long as prices covered at least variable production costs. By then, also, countries experiencing balance of payments difficulties felt compelled to expand export volumes despite falling commodity prices, in order to offset the effect of deteriorating terms of trade on the purchasing power of their exports.

With the benefit of hindsight, it is easy to see how the adaptive behaviour of the various market participants inexorably led to a glut. At the time, however, individual producers reacting to price stimuli in what they deemed to be the appropriate manner, were unaware that, collectively, their actions would result in sizeable market surpluses. Moreover, very few foresaw that the world was about to enter into the longest and deepest recession of the post-war period.

The macro-economic environment of the 1980s

The sharp appreciation of the United States dollar against most other currencies since 1980 has been an important factor behind the decline in nominal primary commodity prices expressed in terms of United States dollars. However, the question of the magnitude of the impact of changes in the value of the dollar on commodity prices has not been settled. On the basis of data for the 1970s and early 1980s, the elasticity of dollar prices of primary commodities with respect to changes in the value of the dollar *vis-à-vis* other major currencies has been variously estimated to range between -0.6 and -1.0.¹³ However, one recent study has found that in the second half of 1984 when the rate of appreciation of the dollar was fastest - about 10 per cent - the implied elasticity of commodity prices with respect to the dollar exchange rate was much higher.¹⁴

Table III.10. Imports as percentage of apparent consumption of primary production in EEC, Canada, Japan and the United States, 1971-1982

	1971-1972	1980	1982
Primary products	20.5	35.1	29.2
Agriculture	11.7	12.2	10.7
Crude petroleum, natural gas	36.8	52.7	43.6
Other mining and quarrying	52.6	71.8	60.3

Source: *Handbook of International Trade and Development Statistics, Supplement 1985*, (United Nations publication, Sales No. E/F.85.II.D.12), table 7.1.

¹¹ For a more detailed discussion of some of these aspects, see John Toye, "The recession, the third world and the base metals industries", *World Development*, vol. 12, No. 9, (1984), pp. 923-934.

¹² The study found that quite apart from cyclical weakness, and in the absence of changes in real oil prices and interest rates, mineral prices showed a tendency to decline by 5-6 per cent a year. See OECD, *Commodity Prices in Interlink*, Working Papers, No. 27 (November 1985), pp. 25-26.

¹³ See, for instance, World Bank, *World Development Report, 1985* (Washington, D.C., 1985), p. 32, and IMF, "Recent market developments and outlook for primary commodities", p. 6.

¹⁴ Englander, A. S., "Commodity prices in the current recovery", *Federal Reserve Bank of New York Quarterly Review*, spring 1985, pp. 15 and 16. One reason for this could be that the effect of dollar appreciation on primary commodity prices is a function of the rate of appreciation itself, that is, the elasticity coefficient rises as the rate of change in the value of the dollar quickens. There is also the possibility that the effect of dollar value changes on commodity prices is asymmetrical, that is, dollar appreciation lowers commodity prices by more than depreciation raises them. If so, the difference in the elasticity coefficients could be explained at least in part by the fact that the earlier studies focused on a period during which the value of the dollar against other major currencies was mostly on the decline.

One important consequence of the rising value of the dollar *vis-à-vis* other currencies was that it led to asymmetrical responses in primary commodity markets. Since the rate of appreciation of the dollar against a number of currencies was faster than the rate of decline in dollar commodity prices, this translated into increases in the local currency price of commodities, discouraging their use. This was the case in such large consuming centres as the Federal Republic of Germany and the United Kingdom where, in terms of domestic currencies, commodity prices in 1985 were, respectively, 10 per cent and 22 per cent higher than in 1980. By the same token, in those places where the local currency was depreciating faster than the fall in the dollar price of commodities, production was encouraged, thereby putting additional downward pressure on international commodity markets. Since currencies depreciate at different rates against the dollar and since price elasticities and market shares differ among countries, shifts in the value of the dollar have been found to affect commodity prices not only in nominal but also in real terms.¹⁵

But the gathering strength of the dollar has been only one of the factors tending to depress commodity prices, for even when measured in a composite of currencies - SDRs - primary commodity prices fell on average by 2.4 per cent a year between 1980 and 1985.

The policy-induced deflationary environment that has prevailed in many industrial countries in recent years has been another factor exerting downward pressure on nominal commodity prices, since those countries together account for almost two thirds of all non-fuel primary commodity trade (both exports and imports).¹⁶ At the same time, declining commodity prices, particularly for food and fuels have been important factors contributing to the slow-down in inflation and inflationary expectations in industrial countries.¹⁷ After rising at an average annual rate of nearly 10 per cent between 1974 and 1980, the rate of increase of consumer prices in industrial countries decelerated rapidly to less than 5 per cent a year over the past three years and to a mere 1 per cent, if inflation is measured in terms of United States dollars (that is, taking into account the appreciation of the dollar). Empirical studies have shown a significant positive relationship between changes in domestic wholesale prices of the industrial countries and commodity prices with elasticity coefficients around or above unity.¹⁸

While the empirical evidence on the influence of inflation on real commodity prices remains inconclusive, it is a

fact, nevertheless, that throughout this deflationary period the prices of manufactures in dollar terms have declined at a much slower though somewhat steadier pace than those of primary commodities. As a result, real primary commodity prices have fallen, on average, by 3.8 per cent a year since 1980.

The marked slow-down in the pace of economic activity in industrial countries has been another significant factor behind the weakness of primary commodity prices in the 1980s. Indeed, short-run movements in real primary commodity prices have been found to be significantly related to changes in the pace of industrial production in developed market economies by impact-elasticity coefficients of the order of 2.¹⁹ Thus, the sharp drop in the rate of GDP growth in industrial countries - from an average annual rate of 3.3 per cent in the 1970s, to an average of only 0.7 per cent a year in the period 1980-1982 - constituted a powerful drag on primary commodity markets. The recovery in economic activity since then produced only a temporary strengthening of primary commodity prices, partly because the recovery has been weak, uneven and lopsided and because in conditions of considerable capacity underutilization, primary producers have tended to over-react to price increases.

Moreover, a number of factors have tended to accentuate the overall effect of the slow-down in economic activity on primary commodity prices. In the first place, the drop in the pace of expansion of the industrial sector - the main user of primary commodities - was even sharper than that of economic activity as a whole (from an annual average of 3.4 per cent in the 1970s to only 1.3 per cent in the 1980s). Secondly, the slow-down in industrial activity was strongest in Europe, where the import content of primary commodity usage is relatively high (41 per cent versus 17 per cent for the United States)²⁰ and where the impact on demand was compounded by the fact that in some cases, commodity prices in local currency were rising as well. Thirdly, average figures do not reveal the fact that in the 1980s, periods of recession have been more prolonged than in the 1970s, while recoveries have become progressively weaker. This may have acted as a further depressant of real primary commodity prices since it has been found that once on the downswing, the average duration of the decline in primary commodity prices is almost twice as long as that of manufactures, while the converse is true in the upswing.²¹ This may be a reflection of the fact that, in the short run, the supply of primary commodities is less elastic than that of manufactures, while the long-run sup-

¹⁵ OECD, *Commodity Prices in Interlink*, Working Papers No. 27 (November 1985).

¹⁶ See table III.11.

¹⁷ For a more detailed discussion of the effect of primary commodity prices on inflation, see, for instance, B. P. Bosworth and R. Z. Lawrence, *Commodity Prices and the New Inflation* (Brookings Institution, Washington, D.C., 1982), particularly chaps. 2 and 3.

¹⁸ *Federal Reserve Bank of New York Quarterly Review*, spring 1985, p. 15, and IMF, "Recent market developments...", p. 7.

¹⁹ IMF, "Recent market developments...", p. 9.

²⁰ *Handbook of International Trade and Development Statistics, Supplement 1985* (United Nations publication, Sales No. E/F.85.II.D.12), table 7.1.

²¹ A. P. Thirlwall and J. Bergevin "Trends, cycles and asymmetries in the terms of trade of primary commodities from developed and less developed countries", *World Development*, vol. 13, No. 7, pp. 805-817.

ply elasticity of most commodities is very high. Demand changes, therefore, tend to produce large but only temporary changes in commodity prices.

Finally, among the macro-economic factors impinging upon primary commodity prices, the persistence of high real interest rates should be mentioned. While the direct impact of interest rates on primary commodity prices is likely to have been less significant than that of the other factors discussed, they do appear to have led to a decumulation of consumer and trader commodity stocks and to have encouraged a shift towards investment in financial assets as opposed to commodities.²² Indirectly, of course, high real interest rates also affected commodity prices by contributing to retard growth and by discouraging capital investment in fixed assets.

The changing framework of commodity exchanges

For reasons not unrelated to the events of the 1970s and the macro-economic environment of the 1980s, important changes have taken place in the functioning of primary commodity markets over the past few years. For one thing, significant shifts have occurred in the relative position of the various country groups in primary commodity markets, as can be seen in table III.11. In general, throughout the 1970s, non-fuel primary commodity exports from developed countries rose faster than those originating elsewhere. In the 1980s, however, falling prices have generally tended to discourage exports from developed countries, while leading developing countries to expand export volumes in order to sustain export earnings.

Table III.11. Share of country groups in world non-fuel primary commodity trade values, 1970, 1980 and 1983

(Percentages)

	Exports			Imports		
	1970	1980	1983	1970	1980	1983
Primary commodities						
Developed market economies	58.4	65.2	64.0	75.6	68.5	65.8
Developing countries	32.6	28.3	29.3	14.3	20.3	22.5
Centrally planned economies	9.1	6.6	6.7	10.1	11.2	11.7
Agricultural products						
Developed market economies	57.9	64.6	64.1	72.0	64.2	62.3
Developing countries	33.0	29.3	29.8	17.1	23.3	25.2
Centrally planned economies	9.1	6.1	6.1	10.9	12.6	12.6
Minerals, ores and metals						
Developed market economies	59.5	66.8	63.5	85.1	81.2	78.4
Developing countries	31.5	25.3	27.6	6.6	11.5	12.6
Centrally planned economies	9.0	8.0	8.9	8.2	7.3	9.0

Source: *Yearbook of International Commodity Statistics, 1985* (United Nations publication, Sales No. E.85.II.D.24), tables 1.6 - 1.9.

On the import side, the tendency of trade to fall as a proportion of total commodity usage noted above in the case of developed countries has recently been reinforced by a similar trend among developing countries. Prompted by the need to save foreign exchange, an increasing number of developing countries have stepped up domestic production of previously imported primary products. For instance, slow output growth and rapid import absorption in the 1970s had, by 1981, turned developing countries as a group into net importers of agricultural products, whereas 10 years earlier their net exports of these products had amounted to some \$15 billion. Since then, developing countries have managed to regain their position as net exporters both through slower imports (3.6 per cent a year in

1981-1984 as opposed to 8.8 per cent in 1971-1980) and faster exports (2.9 per cent and 1.3 per cent a year in 1981-1984 and 1971-1980, respectively).²³

The aggregate figures presented in table III.11 do not reveal the significant structural transformations that have occurred in individual commodity markets or the shifts in the relative position of countries in those markets. The case of cereals is illuminating in this regard. In the 1970s, cereal production rose faster in developing countries than in developed ones. However, since in the developing countries domestic use outpaced production while the reverse was true in developed countries, impressive gains were made in the latter's relative market shares. Indeed,

²² "Commodity survey, 1980-1985: report of the UNCTAD Secretariat" (TD/B/C.1/274, 17 September 1985) p. 31.

²³ A most notable example of the drive towards self-sufficiency is that of China. Between 1971 and 1980, agricultural imports into China expanded at an average annual rate of 8.2 per cent, in volume terms. Since 1980, however, agricultural import volumes have declined by an average of 6.6 per cent a year. At the same time, agricultural export growth rose from an average of 2.2 per cent a year in the 1970s to 6.6 per cent a year since 1980.

according to the Food and Agriculture Organization of the United Nations (FAO),²⁴ United States net exports accounted for some 70 per cent of the total increase in world trade in cereals in the 1970s, while EEC switched from a large net-importing position in the early 1970s to a sizeable net-exporting one by the end of the decade. A similar switch was effected by EEC in the case of sugar (see below). On the other hand, the shares of developing countries have generally tended to increase in the case of the base metals - lead, zinc, copper, nickel, aluminium - as a result of restructuring in the metals industries, the expansion of low-cost capacity in those countries in the 1970s and the relocation of heavy metal-using industries towards those countries.

For a number of agricultural products, domestic policies, particularly in OECD countries, have been instrumental in shifting trade patterns, trade shares and overall trade volumes in world markets, as well as in determining the level and stability of prices in those markets. By isolating domestic producers and consumers from developments in world markets, those policies have exerted a marked differential impact upon participants on both sides of international markets. A recent OECD study,²⁵ has shown, for instance, that in 1978 producer prices for such cereals as soft wheat, corn and rice in Japan and EEC were 2 to 4 1/2 times above world levels, while the prices paid by consumers in those countries were also kept well above international levels. Such policies clearly impart a bias towards over-production and under-consumption in those countries, with the resulting imbalance being often transferred on to international markets by means of surplus-disposal-cum-subsidization schemes. In recent years, the size of both the surpluses and the subsidies has reached unprecedented levels and is at the root of the growing disputes between the United States, EEC and other grain exporters at GATT and in other forums.

Domestic protection in the United States and EEC has also had profound effects on the international sugar market, tending both to depress and to destabilize prices. A persistent price differential in favour of domestic producers since 1976 turned EEC from a net importer into a net exporter of sugar in the course of the 1970s, while a similar policy pursued since much earlier and buttressed by import restrictions has significantly reduced the net-importer position of the United States. The resulting "scissors" effect on the international market of simultaneously increasing supplies and restricting demand has been a major factor behind the collapse of sugar prices since 1980. It is noteworthy in this regard that while the free international market price of sugar was tumbling from over 40 cents a pound in late 1980 to a mere 2.8 cents a pound in June 1985, the ratio of domestic to free market prices - a rough

indicator of the degree of protection enjoyed by the commodity - actually rose from about 1 to 5 in the case of the EEC and from 1 to 7 in the case of the United States.²⁶

International policies, of course, also have a bearing on the behaviour of primary commodity markets. In this regard, the most notable development in recent years has been the virtual collapse of practically all commodity agreements. While international co-operation on specific commodities dates back to the period before the Second World War, the 1970s witnessed a ground swell of support for such co-operation as both producers and consumers thought it in their interest to curb the extreme instability rocking primary commodity markets in this period. This shared concern translated, *inter alia*, into the negotiation of some 15 agreements or arrangements covering 11 commodities (coffee, cocoa, sugar, tin, natural rubber, olive oil, wheat, jute and jute products, tropical timber, bovine meat and dairy products), the establishment by UNCTAD of the Integrated Programme for Commodities, the adoption of the Agreement Establishing the Common Fund for Commodities and the establishment of several study groups and consultative bodies under the auspices of FAO, among others.²⁷ By and large, such co-operation centred on schemes for the stabilization of commodity prices and export earnings and on measures for the longer-term development of the commodity in question, such as the generic promotion of its use and improvements in production and processing methods to avert widespread substitution. From the outset, it was clear that, while there and was a broad measure of support for the general objectives pursued, there was far less agreement among the parties regarding the priority to be accorded to the various objectives and the specific means of achieving them.

By the early 1980s, international co-operation for the purpose of stabilizing commodity prices was on the wane. One reason for this was the growing disenchantment over the ability of international commodity agreements to attain their price stabilization objectives. Indeed, only the coffee, natural rubber and, until recently, the tin agreements can be said to have succeeded in keeping prices largely within the stipulated ranges by means of either production or export quotas and buffer stock operations. Another reason was a growing perception that important trade-offs existed between domestic and international objectives in this area. Indeed, the failure of some of the agreements (notably the one on sugar) to stabilize prices was due in no small measure to the fact that they were undermined by the domestic policies of major producers and consumers, both within and outside the agreements. Finally, with commodity prices generally on the decline, consuming countries felt less committed to price-supporting schemes. Instead, the focus of international action in

²⁴ FAO, "International trade and world food security" (CCP 85/15, August 1985), pp. 11-13.

²⁵ OECD, *Agricultural Trade with Developing Countries* (Paris, 1984), p. 66.

²⁶ IMF, "Recent market developments...", p. 31.

²⁷ For a more detailed discussion, see "International action on individual commodities outside the framework of the Integrated Programme for Commodities - other commodity consultations and negotiations: report of the UNCTAD secretariat (TD/B/C.1/216, 9 September 1980); "International activities outside UNCTAD with respect to individual commodities: report of the UNCTAD secretariat" (TD/B/C.1/240, 20 January 1983); and FAO, "International action relating to agricultural commodities: developments in UNCTAD, GATT, Common Fund and other organizations" (CCP 85/12, July 1985).

this field shifted towards activities such as the gathering and exchange of information to ensure the orderly development of markets. It is significant in this regard that none of the new agreements adopted in recent years (on jute and tropical timber) contain economic provisions for the stabilization of prices or export earnings and that attempts to renegotiate existing agreements containing economic provisions that are due to expire (on cocoa and natural rubber, for instance) have so far failed. It is also noteworthy that six years after its inception, the Common Fund for Commodities has still not been ratified.

Short-term outlook

The slump in commodity prices in the 1980s ultimately reflects the chronic imbalance between demand and supply conditions that has prevailed throughout this period. Demand for primary commodities has been weakened by such factors as low levels of economic activity both in developed countries (the largest consumers of primary commodities in absolute terms) and in developing countries (the fastest growing markets for commodities); high real interest rates which induced downward stock adjustments among traders and users; and the rise in the value of the dollar, which translated into higher primary commodity prices in local currencies despite their decline in dollar terms. To these conjunctural factors must be added the impact of longer-term trends tending to reduce commodity use, such as resource-saving innovations in both products and processing, the onslaught of competition from new materials in certain traditional uses, and shifts in consumers' preferences associated with rising incomes, which tend to favour services.

Apart from the effect of these factors in limiting primary commodity use, import demand for commodities has been further constrained by the fact that a large number of countries have deliberately taken steps to increase domestic supplies so as to reduce import dependence. In the process, exportable surpluses have been generated, adding to the already sizeable supply overhang in world markets. The very pressing need for foreign exchange experienced by a large number of primary commodity producers on account of large foreign debt-servicing obligations and high import requirements has also contributed to the excess supply. In addition, the existence of considerable idle capacity in some sectors, notably metals, has tended to increase the short-run price elasticity of supply of those commodities. By over-reacting to modest price stimuli, producers have helped to weaken prices anew.

The outlook for primary commodities as a whole continues to appear rather bleak although for a number of commodities - notably coffee - prices have been on the rise lately and may well continue to do so for a while. The weakening of the United States dollar, the drop in international interest rates, the levelling off of inflation in industrial countries and the projected modest rise in economic activity in both developed and developing economies in

1986-1987 will undoubtedly remove some of the downward pressure on prices that opposite trends in these variables have exerted over the past few years. Although the full impact of these factors has not yet been translated into a general increase in prices, in nominal, dollar terms, non-oil primary commodity prices are poised for a rise.

However, the fundamental conditions for a significant and sustained recovery in real primary commodity prices are simply not there. In the short-run, barring unforeseen disasters, most commodity markets will remain in a situation of excess supply with ample stocks to prevent prices from rising much even in the event of moderate output shortfalls or modest demand increases. In the longer run, the thrust of technological change in end-using industries is likely to be directed towards saving natural resources, although persistently low primary commodity prices may slow down somewhat the pace at which conservation and substitution are effected. The level of oil prices is particularly important in this regard, as it has a heavy impact on the production costs of energy-intensive industries (e.g. aluminium) and the cost of synthetic substitutes, notably rubber, fibres and plastics. Meanwhile, the relatively low income-elasticity of demand for primary commodities *vis-à-vis* other goods and services will also tend to reduce the primary commodity share in total output. Most likely, then, barter terms of trade will continue to turn against primary commodity exporters.

This sombre outlook for primary commodity markets is particularly distressing for developing countries that are primary commodity producers, for while it is true that developing countries as a whole have significantly reduced their dependence on primary commodity exports, a large number of developing countries still rely on a handful of commodities for the bulk of their export earnings. Moreover, even those countries that have attained a measure of diversification in their primary commodity exports will not fare well under conditions of generalized downward pressure on commodity prices.

In order to improve the prospects for the developing countries that are primary commodity exporters, action is needed on at least three fronts. First, developing countries will have to redouble efforts to diversify their productive and export structure so as to reduce their vulnerability to shocks in specific markets. This would imply broadening the range of products, augmenting the degree of local processing, branching out into new markets and getting more actively involved in distribution. Secondly, developed countries will have to lower protective barriers, particularly those that restrict market access for developing country exports. A recent study²⁸ has estimated that if the agricultural trade restrictions imposed by members of OECD were reduced by half (from their 1977 levels), this would boost world agricultural exports by some \$8.5 billion a year (in 1977 dollars), with nearly 80 per cent of the gain accruing to developing countries. Developed countries should also shift the focus of their domestic agricul-

²⁸ A. Valdez and J. Zietz *Agricultural Protection in OECD Countries: Its Cost to Less Developed Countries*, (Washington, D.C. International Food Policy Research Institute, December 1980).

tural policies from the support of prices to the support of farmers' incomes, so as to reduce the destabilizing effect of those policies on world markets. In addition, they should lower tariff escalation so as to enable developing countries to increase the degree of processing incorporated in their

commodity exports. Finally, international co-operation in the area commodities should be revived, if only to ensure that actions taken to cope with the commodity problems of today do not engender even more serious problems in the years ahead.

Oil prices and oil trade in 1986: implications under two scenarios

Given the overall structure of the oil market, it is clear that there is no single pre-determined outcome with regard to the course of oil prices over the rest of the year. Much depends on the nature and effectiveness of the co-operative arrangements which leading producers may be able to maintain during the rest of 1986. Given the very small elasticity of oil demand in the short run, it is no exaggeration to say that the price of oil in 1986 will largely be determined by the degree of success of producers in achieving effective joint action. However, the kind and degree of producer co-operation that will, in fact, prevail depend on a complex array of political and economic factors that are difficult to assess with any confidence at the present juncture.

Although the degree of producer co-operation that will prevail during 1986 is impossible to predict, two polar degrees of co-operation can be envisaged on the basis of which a probable range of average crude oil prices might be specified. The two cases will be described, in a somewhat imprecise fashion, as "no producer co-operation" and "effective producer co-operation".

Scenario one: no producer co-operation

Consider first the effects of unrestricted competition among petroleum producers on oil prices and on the geographical pattern of oil production. Each producing economy, acting autonomously, would seek to maximize its profits given the petroleum capacity at its disposal. In a period as short as one year, the demand for crude oil, ultimately the demand for petroleum products, is very inelastic with respect to price. Not much more would be refined, on the whole, at substantially lower prices, nor would much less be refined at higher prices. This does not imply that the demand facing an individual crude oil producer might not be perceived by that producer as being highly elastic. Thus, even though total market demand may be approximately constant, an individual producer may increase its own sales by reducing the price at which it offers crude oil for sale. However, since the size of the market is more or less fixed in the short run, if some producers successfully expand output, others will necessarily have to curtail production.

Which oil producers can successfully expand their shares of the market through downward price adjustments depends on the relative marginal costs of the various industry participants. If a producing country can add much

more to revenues than to costs by expanding output, it will endeavour to expand. Moreover, if additions to revenues decrease only very gradually as output rises, and additions to costs increase only slowly, the output expansion may carry very far.

The attempt by low-cost oil producers to expand their market shares sets in motion a dynamic process of adjustment. As output from low-cost production capacity expands, the total supply of oil increases, and the market price declines until it no longer covers the unit operating costs of relatively high-cost production capacity.

The key question is how far prices could fall without reducing the economically operable capacity below that required to satisfy 1986 demand. table III.12 presents data on the amounts of crude oil production capacity available and their operating costs in developing areas and developed market economies. These are average operating costs, that is, the total costs of operating the existing production capacity in an area over some period divided by the number of barrels of oil produced during that period. In themselves, they do not reveal how total operating costs vary as the number of barrels produced is raised or lowered, that is, they are not, *per se*, data on marginal costs. However, given that in only a few areas actual rates of production already approach production capacity, operating costs as shown in table III.12 are rough approximations of marginal costs for existing wells.

Figure III.5 displays the data in table III.12.²⁹ It shows alternative levels of crude oil prices and the corresponding amounts of economically operable crude oil production capacity. A significant feature of the diagram is the high level of oil production capacity which is economically operable even at low prices and the rapidity with which operable capacity expands in some ranges as prices rise. A key aspect of the diagram for present purposes, however, is the floor price revealed. Figure III-5 indicates that, at a hypothetical price as low as \$8 a barrel, enough crude oil production capacity would be economically operable in the short run to satisfy the market economy demand in 1986 of about 48 million barrels a day³⁰ (see table A.II.2). Should the market price of oil reach this low in the next few months and remain at that level for the rest of the year, then the price of oil might average about \$10-\$12 a barrel for 1986 as a whole. This would represent the lowest bound for average oil prices in 1986.

²⁹ The upper bound data in table III.12 were used, partly because the dollar depreciation may raise somewhat the operating costs in 1986 when measured in dollar terms.

³⁰ Two observations are important with regard to these figures. First, it is assumed that the actual consumption in market economies, which was on average 48 million barrels a day in 1985, will not change much in 1986. Secondly, it is assumed that net exports of the centrally planned economies (i.e., China and the USSR) will remain constant at a level of slightly below 2 million barrels a day. Thus, the net demand of market economies will amount to only 46 million barrels.

Table III.12. Approximate oil production capacities and operating costs

(Millions of barrels per day; dollars per barrel)

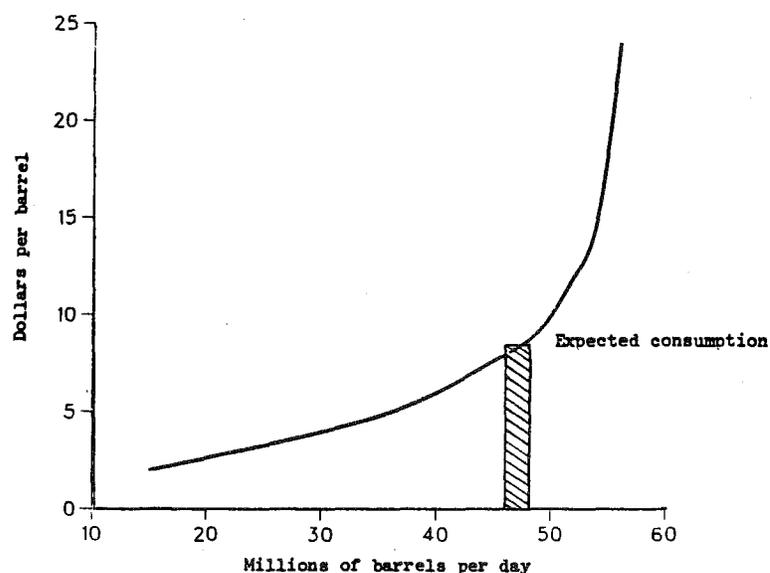
Location	Approximate production capacity	Approximate operating costs ^a
Persian Gulf	15	Less than 2
Persian Gulf, Africa, Indonesia, Mexico, North Sea ^b South America	15	2-4
North Sea, Africa, South America, United States	10	4-6
North Sea, United States, Canada		
South America, Asia	6	6-8
United States, Canada, Asia, Europe	4	8-10
United States, Canada, Europe	2	10-12
United States, Canada, Europe	2	12-14
United States, Canada, Europe	2	14-24

Source: Estimates of the Department of International Economic and Social Affairs of the United Nations Secretariat, based on a variety of industry sources.

^a Operating costs as at 1985 in current dollars.

^b It has been estimated that in 1985 about 60 per cent of total North Sea production capacity of about 3.6 million barrels a day could be economically operated at a price of \$2/barrel or less, 80 per cent at \$4/barrel or less, and 90 per cent at \$5/barrel or less. For example, in early 1986 the Forties field was producing nearly 300,000 barrels a day at an average operating cost of about \$1.50/barrel; Brent was producing about 480,000 barrels a day at \$2.40/barrel; and Statfjord (United Kingdom sector) about 85,000 barrels a day at \$3.75/barrel.

Figure III.5.
Economically viable oil production from
existing capacity in market economies, 1986



Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

Table III.13. Geographical distribution of crude oil production, 1985 and 1986^a

(Percentage)

	1985	1986 ^b		
		Baseline	Scenario one	Scenario two
Developed market economies	29.4	28.5	19.0	28.6
Energy-importing developing countries	3.8	4.1	2.3	4.2
Energy-exporting developing countries	39.9	41.6	54.9	41.4
Centrally planned economies	26.8	25.8	24.7	25.8

Source: Department of International Economic and Social Affairs of the United Nations Secretariat. Figures for 1985 are based on IMF technical papers for the spring meeting of the Interim Committee (Washington, D.C., 9 and 10 April 1986); and OECD, *OECD Economic Outlook*, December 1985.

^a Includes natural gas liquids and condensates.

^b Baseline: average price of \$18/barrel; scenario one: minimum average price of \$12/barrel; scenario two: maximum average price of \$20/barrel (scenario one implies an increase in oil production of nearly 4 per cent above the baseline scenario; in scenario two there is virtually no change in production *vis-à-vis* the baseline scenario).

Such a large drop in the average price of oil from about \$28 a barrel in 1985 to \$12 a barrel in 1986 would have profound consequences for the world pattern of crude oil production and for the pattern of international trade in oil, as shown in table III.13.

Table III.13 reveals that under scenario one, a large swing in oil production from the developed market economies to oil-exporting developing countries would occur. Specifically, output would shift mainly from relatively high cost areas in North America to relatively low cost areas in the States members of OPEC, Mexico and a few other developing countries. Roughly 15 per cent of total crude oil production in the United States is from "stripper" wells, that is, wells that produce less than 10 barrels of oil a day. These are not economic at prices lower than the high teens and would certainly cease to operate should prices decline below \$10 a barrel and remain there for several months. At that price level, the prolific Prudhoe Bay fields in Alaska are barely profitable, and Canadian oil sands production would probably be shut down. In the other major producing region in the developed market economies, the North Sea, production would remain, for the most part, economic even at \$6 a barrel, and only a few hundred thousand barrels a day of oil would cease to flow. Some producing areas in the energy-importing developing countries would be drastically affected, and a portion of production capacity there would no longer be economic to operate.

It must be emphasized that the scenario just examined depicts a purely hypothetical situation, in which individual crude oil producers, acting on their own, attempt to maximize exports in the short run.³¹ It does not suggest that this behaviour has been, or will be, adopted by oil producers. Indeed, even if such a course of action were to be initiated by some producers, it seems likely that a num-

ber of considerations would intrude to forestall the actual implementation of the policy to the logical extremes investigated here. The value of the scenario is to suggest a floor below which it would probably be unrealistic to expect crude oil prices to fall on average in 1986.

Scenario two: effective producer co-operation

The opposite situation would be one in which short-run profit maximization by individual producers is eschewed in favour of co-operative pursuit of longer-range goals. Producers whose short-run marginal costs permit greatly expanded rates of output, would forgo the opportunity to expand their shares of the market, and aggregate production would be allocated among producers by mutual agreement. In this scenario, co-operation would be effective in the sense that a sufficient number of oil producers would participate in co-operative arrangements to establish and maintain the market price of oil at an agreed level. The question considered in this section is what elements might influence the average price of oil in 1986 under such arrangements.

At first glance, it might seem that under these circumstances the price that oil might reach over the rest of the year could be very high. Since demand is inelastic in the short run, the total revenue of producers as a whole could be increased by decreasing oil production and steadily increasing oil prices.

There are, nevertheless, considerations which might limit the extent to which this strategy could be pursued in practice. One of these is the great stimulus to further energy conservation and substitution of alternative energy sources for oil that a rapid and far-reaching increase in the price of oil would provide. Investment in production capacity for both oil and alternative energy sources would be

³¹ The only constraint imposed is that production will cease when revenue falls below operation costs.

encouraged by a rapid jump in oil prices. Both developments would exert downward pressure on the price of oil in the longer run. The relative importance of the price of oil in the short versus the long run would very likely be evaluated differently by different producers. Hence, a very rapid rise in petroleum prices could be inconsistent with the continuation of effective co-operation among oil producers once established.

The existence of large governmental and company stocks of oil could also slow the rise of oil prices over the remainder of the year. At some point, with a substantial rise in petroleum prices, releases from these stocks to the market would probably occur.

Finally, the reduction in the aggregate rate of oil production required to produce unprecedentedly high prices later in the year might be so great as to imply unacceptably large reductions in the production rates of individual producers. In the past few years, there has been a slow but steady shrinkage of consumption of oil products, which has to be taken into account. From the point of view of the feasibility of actually effecting co-operative arrangements governing aggregate production and distribution shares, the number of producers participating in such arrangements would have to be limited. On the other hand, in order to have a sufficiently large share of total crude oil production capacity represented in the arrangements to effectively stabilize prices, the individual producers would have to be relatively large. Thus, a handful of relatively large oil-producing countries would have to absorb the total reduction in output needed to raise prices. In practice, the reduction in output must precede the rise in market price and if the magnitude of the cut-back required of a producer is large relative to its current rate of production, great difficulties of an economic and political nature could be experienced in effecting the required reductions.

The above discussion suggests that there is an upper limit to the rise in oil prices in 1986 even under conditions of producer co-operation. Under scenario one, a lower limit on the average oil price this year was provided by the empirical relationship between price and economically operable production capacity, given anticipated market demand. Under scenario two, no such clear figure suggests itself. Although a fairly broad range of views exists, the preponderance of expert opinion seems to hold that crude oil prices are unlikely to rise above \$25 a barrel in 1986, even given effective producer co-operation, on account of the factors noted above. If market prices reached \$25 a barrel during the next few months and remained at that level the rest of the year, the price of oil might average about \$20 a barrel for the year as a whole.

Once again, the geographical pattern of oil production in the market economies would be altered by the decline in the price of petroleum. The decline from \$28 a barrel in

1985 to an average of about \$20 a barrel in 1986 would be a much less severe fall than under scenario one but large enough to produce changes in the pattern of output. Table III.13 shows the geographical distribution of oil production among three broad groups of market economies in 1985 and, under scenario two, in 1986.³² With the price of oil rising to roughly \$25 a barrel later in the year, there would be no shifts in relative output levels due to the withdrawal of uneconomic production capacity. The production discipline hypothesized in this scenario would, however, engender slight shifts in relative shares of production.

Effects on trade balances in different country groups

The following discussion focuses on the effects on the trade balances of different country groups of a drop in the price of oil to the minimum average of \$12 a barrel in 1986, that is, scenario one. The trade implications of scenario two are not discussed since they are only marginally different from those of the baseline scenario examined in chapter II and in the first section of the present chapter.

In 1985, the developed market economies spent about \$160 billion on oil imports, including crude oil and petroleum products, of which about a tenth were exports from Canada, Norway and the United Kingdom. This figure should fall by about \$50 billion if the average price turns out to be \$18 a barrel, as assumed in the baseline scenario (see chap. II).

If oil prices were to drop to an average of \$12 a barrel, the import bill of the developed market economies would not differ significantly from that of the baseline scenario (see table III.14). The change in the import bill of the developed market economies would be the product of two opposing factors. On the one hand, the average unit value of the group's oil imports would decline by a third. On the other hand, the volume of oil imports of these countries would rise, as a larger share of consumption would be satisfied through imports, since some high-cost production capacity in the area would be withdrawn from operation. As discussed above, the latter effect would be especially marked in North America.

A somewhat surprising feature in this scenario is the slight increase in the oil import bill of the developed market economies, despite the drop in oil prices. The main reason behind this is the enormous switch in production that would take place: if prices fell enough to reach an average of \$12 in 1986, production might decline by as much as 30 per cent in developed market economies. In order to compensate for this decrease in production and to meet the likely increase in consumption that would result from lower prices, energy-exporting developing countries would have to increase their production by about 35 per cent.

³² Under scenario two, oil production in the market economies in 1986 would total nearly two million barrels a day less than in 1985. Given the projected level of oil consumption in 1986 about equal to the actual level in 1985, unchanged imports from centrally planned economies, and processing gain, inventories would need to be drawn down by nearly two million barrels a day. Speculation attendant upon the implementation of co-operative arrangements and the imbalance between consumption and production (and consequent resort to stock withdrawals) produce the rise in price in this scenario.

Among the secondary effects, there would be a reduction in the exports to centrally planned economies and energy-exporting developing countries, as in both of these groups export revenues would decrease. But there would be a positive effect on the exports of the developed market economies as energy-importing developing countries would use a significant part of the savings from the import bill in additional imports. On balance, however, there should be a slight fall in exports of \$1.4 billion.

The changes in the trade of the developed market econ-

omies discussed so far, both primary and secondary, would be exogenous from the point of view of this group of countries. They would, however, decrease income in the group and lead to a reduction in aggregate domestic expenditures and in the demand for imports. Thus, the combined effect of the increase in the oil import bill and the decrease in the demand for non-oil imports would amount to a change in imports of only \$0.6 billion. The resulting change in the trade balance would amount to a reduction of only \$2 billion.

Table III.14. Deviations from the baseline scenario under an average oil price of \$12 per barrel for 1986

(Billions of dollars)

	Developed market economies	Energy-importing developing countries	Energy-exporting developing countries
Net oil trade ^a	2.3	-8.8	-2.9
Total imports ^b	0.6	-3.7	-0.1
Total exports ^c	-1.4	-1.6	-0.2
Balance of trade	-2.0	2.2	-0.1
Memorandum item			
Balance of trade in 1986 under the baseline scenario	21.0	-8.0	9.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

^a For developed market economies and energy-importing developing countries: autonomous change in net oil imports. For energy-exporting developing countries: autonomous change in net oil exports. The sum of changes in imports is greater than the change in exports by the amount of the change in oil exports of centrally planned economies. Oil exports of the latter, although assumed constant in volume, are also reduced in value (figures are the sums of changes in value of crude oil, natural gas liquids, condensates, and petroleum products).

^b For developed market economies and energy-importing developing countries: autonomous change in oil imports plus induced change in general imports. For energy-exporting developing countries: induced change in general imports.

^c For developed market economies and energy-importing developing countries: changes in the general exports of the country group in question induced by changes in income in other country groups. For energy-exporting developing countries: autonomous change in net oil exports plus changes in the general exports of these countries induced by changes in income in other country groups.

The effect of lower oil prices on the oil import bill of energy-importing developing countries would be considerable: a saving with respect to the baseline scenario of \$8.8 billion. Exports would fall somewhat because of decreasing demand from other groups. None the less, the large oil import saving should stimulate the domestic economy, raising incomes and import demand. Non-oil imports should increase by \$5.1 billion and the trade balance should improve by \$2.2 billion in relation to the baseline scenario.

Energy-exporting developing countries, apart from a fall in oil export revenues of \$2.9 billion, should not experience any significant change in their trade accounts. Indeed, under scenario one, the most dramatic effect would be on the real side of the economy: an increase in oil production by at least a third and an even larger increase in the oil export volume.

Although the results in table III.14 are indicative of the

probable direction of the changes and the underlying forces, particularly trade, that influence the final outcome, there is an important caveat to these figures. The model assumes instantaneous shifts in production, which in reality might take place with some lag. Moreover, the model used has not made allowances for policy changes. Indeed, a drop in price as envisaged in scenario one is likely to lead to very significant redirection of policies, particularly in the energy field. Most countries would certainly revise their energy programmes affecting investments in the whole spectrum of energy sources. No less important from a global point of view will be the shift in policies of a macro-economic nature. As analysed in chapter II, the first quarter of 1986 witnessed important departures in monetary policies in key actors of the world economy as lower oil prices influenced inflationary expectations. Therefore, the figures in table III.14 should be interpreted with considerable caution.

Chapter IV

INTERNATIONAL FINANCE AND BALANCE-OF-PAYMENTS DISEQUILIBRIA

A sea change in international finance is taking place in the mid-1980s. At the institutional level, the nature of international financial intermediation has been radically altered by both structural factors and the progressive deregulation of financial markets, as discussed in the *World Economic Survey 1985*.¹ At the level of national economies, changes have also been dramatic. The world's largest creditor country until 1982, the United States, will have become the world's largest net debtor by the end of 1986. Unprecedented balance-of-payments surpluses have emerged in certain developed countries, particularly Japan and the Federal Republic of Germany. Developing countries continue to face serious debt-servicing difficulties, and a substantial inward transfer of resources from

abroad has been turned, since 1983, into a reverse transfer of resources. Most developing countries find it increasingly difficult to mobilize international liquidity through traditional channels of private and official finance. Important policy changes have also occurred. Their aims include reducing payments imbalances among major industrial countries and strengthening supply-oriented adjustment programmes in a context of faster economic growth. The initiatives taken point in the right direction. Nevertheless, current trends suggest the need for additional measures in the realm of international finance, in particular with respect to developing country debt and liquidity, as discussed in this chapter.

Payments imbalances, capital markets and exchange rates

In recent years, the flows of financial resources supporting the world pattern of international payments have become highly differentiated. Financial flows have also been responsible in part for wide swings in exchange rates, which, in turn, have significantly affected international flows of finance. In the process, the valuation of financial assets and the domestic cost of debt-servicing has become more uncertain than usual. As a result of concerted international policy actions in 1985 and early 1986, there has already been a major correction of exchange rate misalignment. Whether or not this will lead smoothly to a new equilibrium of international payments and exchange rates is a major focus of attention in the analysis that follows.

Current patterns in the balance of payments and capital flows

The significant trade and current-account imbalances observed among countries in recent years intensified in 1985. The outlook is for further differentiation in 1986. In particular, the unusually large asymmetries among the developed market economies continue to be accentuated. As seen in table IV.1, the developed market economies as a group continued to have a substantial current-account deficit owing, in essence, to the United States deficit, which rose by \$6 billion to \$105 billion. However, the combined surplus of the other developed market economies increased from \$54 billion in 1984 to \$80 billion in 1985. The United States is expected to experience a slight

payments correction in 1986, but the combined surplus of other countries may leap by over \$50 billion, to a level of \$132 billion.

The 1985 increase in the United States deficit was considerably smaller than in 1983 and 1984. However, other countries continued to increase their net surpluses, especially Japan, the Federal Republic of Germany and, to a lesser extent, the United Kingdom (see table A.V.9). These current-account developments largely reflected the changes in merchandise trade discussed in chapter III, but there have also been certain significant changes in service flows. In particular, the international flow of investment income has been changing in response to the build-up of the net foreign asset position of some major economies, notably Japan. In fact, Japanese banks supplanted those of the United States in 1985 as the world's largest source of credit.² Thus, the net interest earnings of Japan grew substantially in 1985 - more so, apparently, than in any other major developed market economy. This occurred despite the fall in interest rates in international capital markets during 1985, especially for dollar investments, on which interest rates fell almost 25 per cent. With the growth of merchandise exports slowing, foreign investment income is beginning to play a larger role in Japan's foreign exchange earnings. It rose from about 11 per cent of merchandise exports in 1983 and 1984 to 13.5 per cent in the first half of 1985 and will most likely rise to a higher share in 1986.

¹ United Nations publication, Sales No. E.85.II.C.1, pp. 64-67. See also "The changing institutional character of international financial markets in the 1980s", *Supplement to World Economic Survey 1985-1986* (forthcoming).

² More precisely, banks and the branches of banks whose parent country is Japan had international assets (cross-border loans and domestic loans in foreign currency) of \$640 billion in September 1985, in contrast to \$580 billion in United States-owned banks. In the first three quarters of the year, Japanese banks added over \$120 billion to outstanding loans, while United States international bank claims fell almost \$15 billion (see Bank for International Settlements, *International Banking Developments, Third Quarter 1985* (January 1986)).

Table IV.1. World balance of payments on current account, ^a
by country group, 1981-1986

(Billions of dollars)

Country or country group	1981	1982	1983	1984	1985 ^b	1986 ^c
Developed market economies	-7.2	-6.1	-5.8	-44.7	-25.0	32.0
United States	12.9	-0.3	-37.6	-98.8	-105.0	-100.0
Other countries	-20.1	-5.7	31.8	54.1	80.0	132.0
Developing countries	-40.6	-95.8	-66.8	-45.8	-40.0	-89.5
Capital-surplus countries	58.8	6.5	-5.9	-8.6	-4.5	-30.0
Other net energy exporters	-27.0	-34.9	-10.6	-1.1	-5.5	-30.5
Net energy importers	-72.4	-67.4	-50.3	-36.1	-30.0	-29.0
China	2.0	5.9	4.4	2.4	-7.5	-7.5
Centrally planned economies of Europe ^d	3.6	13.7	17.1	18.0	9.0	-4.5
Eastern Europe	-2.7	4.4	6.0	6.9	5.0	6.0
USSR	6.2	9.3	11.2	11.1	4.0	-10.5
Residual balance ^e	42.2	82.3	51.1	70.1	63.5	69.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics*, other official national and international sources and Secretariat forecasts.

^a Excluding government transfers.

^b Preliminary estimates, rounded to the nearest half-billion dollars.

^c Forecast, rounded to the nearest half-billion dollars.

^d Trade balances only (imports f.o.b., except Hungary).

^e The world current-account discrepancy reflects timing asymmetries, the balance on services of the centrally planned economies of Europe, errors in trade balances and under-recording in the receipts of services. Particularly large sources of discrepancy have been investment income channelled through off-shore financial centres and non-factor services exported by the developed market economies to OPEC member States.

Although the protracted and large United States current-account deficit has led to an unprecedented accumulation of net foreign debt, the United States nevertheless increased its surplus in net foreign investment income in 1985. The improvement came almost equally from a small reduction in investment income payments to \$66 billion, mainly owing to the fall in interest rates during the year, and from a rise in investment income receipts to \$90 billion. The rise was entirely caused by a more than 50 per cent increase in the income of United States direct investments, which reached \$35 billion. The strong 1985 swing in income on direct investment is largely the effect of a valuation loss in 1984 of over \$8 billion that resulted from the rising exchange rate of the dollar in that year and the fall in the dollar in 1985, which brought about a valuation gain in excess of \$5 billion.³ If the adjustment of the dollar exchange rate is more or less completed in 1986 and if exchange rates can then be made relatively stable (see chapter V), the large capital gains and losses from valuation adjustments will end. The continued growth of the United States net debt position then assures that the United States will be left with rapidly growing net outflows of the investment income required to service its external debt.

The capital-importing developing countries have also been facing such an adjustment problem and have succeeded in generating large surpluses in the balance of trade

in goods and non-capital services. As seen in table IV.2, the overall swing was well over \$60 billion between 1982 and 1984, from a deficit of \$33.8 billion to a surplus of \$29.6 billion. However, because of the large increase in interest payments, the current account remains substantially in deficit.

For 1985, the change in the current account balance of the major subgroupings of developing countries largely reflected changes in the balance of merchandise trade (see table A.V.10). This was the case for China as well. For some developing countries, however, changes in the current account largely reflected developments in the service sector, on which they rely heavily for foreign exchange inflows (e.g., overseas construction, labour remittances, tourism). Indications are that for such countries, foreign exchange earnings in 1985 were either of the same order of magnitude as in 1984 or declining, as was also the case for most countries exporting primarily merchandise.

In 1986, it is expected that largely offsetting tendencies will operate on the services account of the developing countries as a group. On the one hand, falling interest rates will exert a positive effect. On the other hand, services earnings of importance to a number of countries will probably fall. Changes in the current accounts of the various groups of developing countries will thus largely reflect the anticipated changes in trade balances, which are discussed in chapter III.

³ About half of the stock of United States direct investment is in countries whose currencies have experienced large swings *vis-à-vis* the dollar (based on data from United States Department of Commerce, "1982 benchmark survey of United States direct investment abroad", *Survey of Current Business*, December 1985, p. 42).

Table IV.2 Net foreign capital income in the current account of the capital-importing developing countries, 1979-1985

	1979	1980	1981	1982	1983	1984	1985 ^a
Balance on goods and non-capital services ^b	-21.4	-23.6	-45.1	-33.8	3.1	29.6	32
Direct investment income (net)	-11.4	-13.7	-13.5	-13.1	-11.6	-11.3	-13
Interest payments (net)	-17.2	-23.6	-34.8	-50.0	-48.3	-53.9	-54
Balance on current account ^c	-50.0	-60.9	-93.4	-96.9	-56.8	-35.6	-35

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics* and other national and international sources. Sample of 93 countries.

^a Preliminary estimate, rounded to nearest billion dollars.

^b Includes all non-factor services and labour-based services.

^c Excludes official transfers.

One major source of demand for service exports from both developing countries and developed countries is in the midst of a major contraction, namely, the group of major oil exporters in the Middle East and Africa. In the construction sector in particular, the sharp drop in contracts after 1981 appears to have continued into 1985. Major developing countries involved in construction work in the Middle East have seen the value of contract awards fall to a third or less of the contracts obtained in 1981. Although part of the reason for this trend is conjunctural, there are also structural and policy determinants. Some major infrastructure and industrial projects have been nearing completion and others have been scaled down or postponed. Saudi Arabia, which has accounted for about three quarters of construction contracts in recent years in the Middle Eastern energy-exporting countries, has programmed a shrinkage of almost 3 per cent annually in construction work in its new five-year plan. In addition, some countries have been making an effort to increase self-reliance in construction and to reduce dependence on expatriate labour in general. Coupled with the impetus from the recent sharp fall in oil prices, an accelerated repatriation of foreign workers is taking place. The impact will be severe on several countries in Asia and Africa that have been major sources of foreign labour.⁴

The reduction in remittance outflows from the capital-surplus developing countries, like the reduction in their merchandise imports, forms part of the contractionary adjustment that was made necessary by the fall in foreign exchange earnings. Although most of those earnings are from the export of petroleum, the surplus countries as a group have in recent years earned about 20 per cent as much from foreign investment income. Between 1982 and 1985, however, the latter fell by about a third. Adding to the effect of falling interest rates, the net asset position of

the countries has been falling as current-account surpluses turned into deficits that required financing.

The convertible foreign exchange earnings of the Soviet Union are also largely determined by its oil and gas exports. In 1985, foreign exchange earnings of the USSR declined because export volume fell and international energy prices weakened. Since oil is priced internationally in dollars and since most of the convertible currency imports of the USSR are from non-dollar markets, it did not benefit significantly from the fall in the dollar exchange rate when purchasing imports. All in all, the sharp deterioration in the Soviet balance of trade of about \$7 billion is estimated to have caused a substantial decline in its current-account surplus, particularly with convertible currency partners. In these relations, the surplus of just under \$7 billion in 1984 was reduced to about \$1.5 billion in 1985, and a substantial deficit is expected in 1986.⁵

For the Eastern European economies, the decline in the surplus in the overall balance of trade in 1985 was associated with a smaller decline in the current account. In particular, the current-account surplus with convertible currency trade partners fell by only about \$0.5 billion, to a level of roughly \$2.5 billion.⁶ The major reason for the relatively small decline was that foreign interest payments were brought down by the reduction in external debt levels achieved in preceding years and by the drop in international interest rates and variation in exchange rates. In 1986, a further decline in interest rates, coupled with an improvement in the overall balance of trade, are expected to lead to some strengthening of the current account.

In marked contrast to many developing countries whose lack of access to international finance put a stringent constraint on current-account deficits, some of the countries in Eastern Europe, the Soviet Union, China and many developed market economies, especially the United States,

⁴ Egypt alone, for example, has benefited from inflows from foreign labour earnings approaching \$4 billion a year; annual flows to India and Pakistan have been in excess of \$2.5 billion and those to Jordan and the Yemen Arab Republic have exceeded \$1 billion, to cite certain of the more significant cases. A potential difficulty also emerged in 1985 when South Africa drew up contingency plans to repatriate workers from Botswana, Lesotho, Malawi, Mozambique and Swaziland. About \$200 million a year in remitted labour earnings would be lost to those countries should the plan be put into effect.

⁵ As no official balance-of-payments statistics are published by the USSR, these estimates are, of necessity, approximate.

⁶ Data for Eastern Europe are partly estimated, as only Hungary and Romania have published payments data for recent years. (Poland has provided similar information to its private and official creditors.)

all succeeded in mobilizing financial resources in international capital markets.

The debt problem of developing countries continues to restrict their access to capital markets. The market, however, continues to view some developing countries as desirable credit risks, allowing them to raise funds by issuing securities and obtaining syndicated bank loans. Indeed, \$7 billion of the \$27 billion raised by developing countries in 1985 was in the form of bonds placed in one or more foreign markets; \$3 billion of the \$20 billion of bank credits were actually arranged in support of securities issuance. In addition, \$7 billion of the bank credits were involuntary loans, conceded by the banks as part of debt-rescheduling exercises. These loans helped countries to make interest payments that they might otherwise have had difficulty in making. In sum, the contraction in market financing of the developing countries was on the whole considerable (see figure IV.1). Excluding involuntary credits, gross private lending arranged for the developing countries in 1985 was less than 40 per cent of what it was in 1981.

Lending to the European planned economies, which had come to a standstill in 1982, resumed in late 1984 when several private commercial banks once again became very active in lending to Eastern Europe. In the interim, countries had sought to strengthen their current-account position so as to service their debt. In 1983, the gross external debt of Eastern European countries was reduced by over \$1 billion and in 1984 by \$2 billion more. In 1985, however, their gross debt appears to have risen by over \$3 billion.

Access to the financial markets gave the Soviet Union a measure of flexibility in 1985 as well. In contrast to previous years, the USSR did not offset its drop in convertible currency earnings by cutting back imports or drawing down foreign currency reserves. Instead, it entered the financial markets. Thus, in contrast to the decline in gross debt of over \$1 billion in 1983 and about \$1 billion in 1984, Soviet external debt rose by perhaps \$5 billion in 1985.

The sharp swing in the trade balance of China in 1985 also required a financial counterpart. Earlier, China had experienced substantial balance-of-payments surpluses for several years and had built up its foreign exchange reserves, reaching a level of about \$15 billion by 1983. An extraordinary short-term drain on reserves of over \$5 billion then occurred during the last quarter of 1984 and the first quarter of 1985. After some rebuilding, China was left with about \$13 billion in reserves in 1985. In addition to drawing on some of its foreign assets, China also borrowed abroad in larger volume. Gross foreign debt to international commercial banks rose from about \$1 billion in 1982 to \$3 billion in 1983 and \$4 billion in 1984; it then approximately doubled in 1985.

The United States demonstrated again in 1985 its capacity to attract foreign financing on a scale that dwarfs the inflows of all other countries. As seen in table IV.3, net fi-

ancial inflows into the United States reached \$124 billion in 1985. That inflow was \$32 billion higher than the one observed in 1984, a year in which the inflow had expanded by almost \$60 billion over that of the year before. The increased credit inflows originated primarily in Japan and EEC. Although about \$46 billion is recorded as having come from developing countries, a significant part of that too probably originated in developed market economies, having been routed through the off-shore centres of the Caribbean and Asia.

One striking aspect of United States borrowing in 1985 is that it occurred as the differential between United States and foreign interest rates was shrinking, as United States economic growth was slowing down and as the dollar itself was weakening. The falling dollar and slow growth - and perhaps falling oil prices - will begin to adjust the United States current-account balance, but most of the correction is not expected before 1987. Capital inflows on a scale comparable to that of 1985 will be needed again, at least in 1986, to finance a large deficit on current account. The required changes in exchange rates and interest rate differentials under which this financing is made available will determine how smooth the adjustment process will be.

Adjustment of exchange rates among reserve currencies

As discussed in chapter II, policy makers in key reserve currency countries took concerted action to bring about a major realignment of exchange rates in 1985. This followed several years in which a passive stance towards reserve currency exchange rates allowed an unsustainable pattern of current accounts and capital flows to develop. As international capital markets have become highly fluid and increasingly driven by financial asset trading and speculation on foreign exchanges, no automatic mechanism operated in the foreign exchange markets to correct the imbalances.⁷ Estimates of the degree of misalignment that were discussed in the world financial press, in academic circles and elsewhere suggested that the dollar was overvalued in early 1985 by up to 40 per cent on a trade-weighted basis.

At the same time, the stability of the European Monetary System (EMS) attracted increasing attention. The establishment of EMS in March 1979 by members of the European Economic Community (EEC) - Portugal, Spain and the United Kingdom have thus far not joined - has resulted in increased stability of member countries' effective exchange rates, both nominal and real.⁸ This system has developed in a highly integrated political arena of negotiations in which competitive currency devaluations have not been a significant factor. Indeed, between March 1983 and March 1986 there was only one EMS realignment, that of the Italian lira in July 1985. However, a realignment centred on a devaluation of the French franc relative to other EMS currencies is widely expected to take place in the second quarter of 1986.

The tensions generated in EMS by the recent and rapid fall in the United States dollar have been modest by past

⁷ The systemic implications of this point are discussed in chapt. V below.

⁸ See IMF, *The European Monetary System: The Experience, 1979-82*, Occasional Paper No. 19, (Washington, D.C., May 1983) and Commission of the European Communities, *Annual Economic Review 1985-1986* (Brussels, December 1985), chapt. 4.

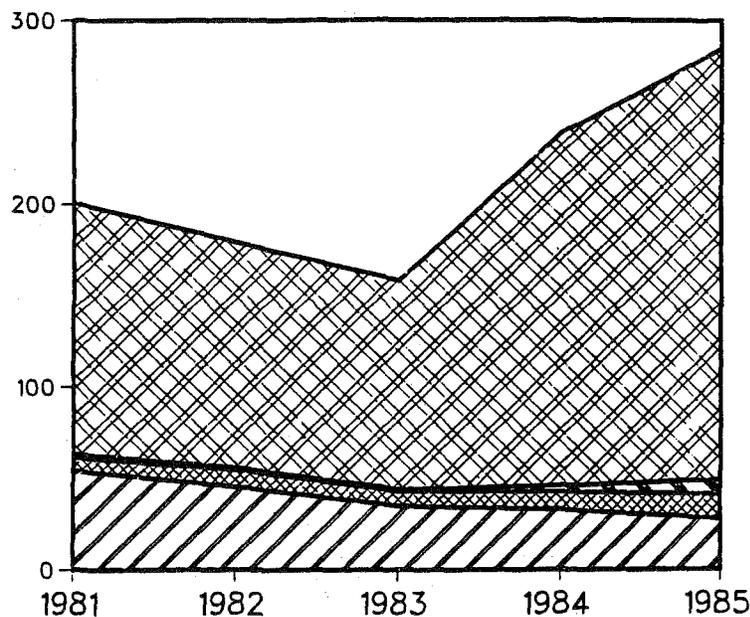
standards. EMS currencies have recently tended to move within ranges that do not require intervention, and relatively modest interest rate movements have been effective in maintaining exchange rates among participating currencies. The success of EMS in creating its intended zone of exchange rate stability is thus an important example of a process of successful policy co-ordination. Even to sceptical minds it is becoming evident that explicit exchange rate policy matters a good deal.

Co-operative efforts by the central banks of reserve currency countries to influence exchange rate movements thus re-appeared in 1985. Finance ministers and central bank governors of the Group of Five engaged in two campaigns to drive down the dollar. Each attempt entailed central bank intervention in foreign exchange markets and other measures.

The first episode involved combined dollar sales by the Group of Five central banks estimated at \$10 billion in the weeks between 21 January and the beginning of March 1985. The effort met with little success as the dollar continued to trade at increasingly high levels until the middle of March (see figure IV.2). Exchange rates were dominated by expectations of high economic growth in the United States and a tightening of United States monetary policy. However, between mid-March and July, expectations of United States economic growth became more uncertain, and the rate of growth expected by most analysts declined as emerging data indicated that the economy had weakened. After March, the dollar thus began to fall, albeit slowly, along with United States interest rates.

Figure IV.1.
Gross medium-term and long-term financing
arranged on international markets, 1981-1985^a

(Billions of dollars)



COVERAGE

- ▨ Developed market economies
- Centrally planned economies
- ▧ Development institutions
- ▩ Developing countries

Source: OECD, *Financial Statistics Monthly* (country data re-aggregated into *World Economic Survey* country groups).

^a Data are lending commitments which are often not drawn down fully in the year arranged (and sometimes are never drawn, as in lines of credit backing corporate mergers in the United States included in developed market economy loans).

Table IV.3 Net international financial flows to the United States, 1981-1985^a

(Billions of dollars)

Country or Country Group	1981	1982	1983	1984	1985 ^b
Canada	-9.7	-0.5	1.2	5.5	5.7
Japan	11.6	13.6	17.7	34.3	44.9
European Economic Community	-16.6	-14.2	-1.4	10.9	26.9
Other developed market economies ^c	-2.3	-0.6	2.4	0.6	2.5
USSR and Eastern Europe	-3.3	-3.0	-1.7	-2.1	-1.4
Off-shore banking centres and developing countries ^d	4.6	-0.5	17.3	43.3	45.8
Total	-15.7	-5.2	35.5	92.5	124.4

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on United States Department of Commerce, *Survey of Current Business*, various issues.

^a Excluding transactions in United States official reserve assets and direct investment; including statistical discrepancy in United States payments data, which incorporate, *inter alia*, transactions with third countries in United States liabilities and assets. Positive numbers in the table indicate net inflows; negative signs indicate net outflows.

^b Including preliminary fourth-quarter data.

^c Including smaller amounts for international organizations, United States-affiliated shipping companies operating under certain foreign flags and other unallocated flows.

^d Including China.

The second episode followed the announcement by the Group of Five on 22 September 1985, of its readiness to undertake joint policy actions. That effort had a much stronger and more immediate effect. The dollar fell quickly after the announcement and then continued to decline. In all, the dollar fell about 22 per cent and 27 per cent, respectively, relative to the deutsche mark and the yen, from mid-September to March 1986. The key central banks had again intervened heavily in the exchange markets, with about \$10 billion sold between 22 September and the end of October. The exchange markets were clearly convinced this time of the demonstrated resolve of the Group of Five to intervene in exchange markets. What gave the announcement force, however, was not the intervention itself - which was comparable in magnitude to the earlier episode and, in fact, was not mentioned explicitly in the announcement - but the Group's strong statement that current exchange values did not reflect underlying economic conditions and that the Group was prepared to implement macro-economic policies to stem growing international imbalances.⁹

The contrast between the late February and the late September episodes of intervention suggest some important lessons. In particular, there has been considerable scepticism about the capacity of central banks to manipulate currency values in a lasting way through intervention. The first problem is that the private currency markets have been so large - daily currency transactions are typically described as running up to \$150 billion per day - that the magnitudes of required transactions may give rise to fiscal pressures in the countries whose central banks wish to in-

tervene. Effective intervention requires that available reserves be so large as to obviate even the suspicion that the intervening authorities could run out of reserve currencies. In principle, commitments to co-ordinate intervention among the central banks concerned and to swap currencies can solve this resource problem since each central bank has unlimited access to funds in its own currency.

The tight integration of financial markets creates another set of problems. Shifts of the required scale in the outstanding supply of a country's currency may create sizeable financial spillovers affecting domestic economic activity. For instance, the sale of United States dollars to depreciate the dollar's exchange value, whether undertaken by United States, European or Japanese monetary authorities, adds to United States domestic bank reserves and could stimulate its domestic monetary expansion. The United States Federal Reserve can "sterilize" the domestic effects of the intervention by selling securities in United States markets. But each dollar absorbed in such sales might, in today's highly efficient and integrated financial markets, reduce the supply of dollars in the currency markets so that the exchange rate effect of the original intervention would be largely, if not completely, nullified.

The effectiveness of sterilized intervention therefore depends on an adequate separation of domestic financial and foreign exchange markets. While experts disagree on the current extent of separation, there is a near consensus that

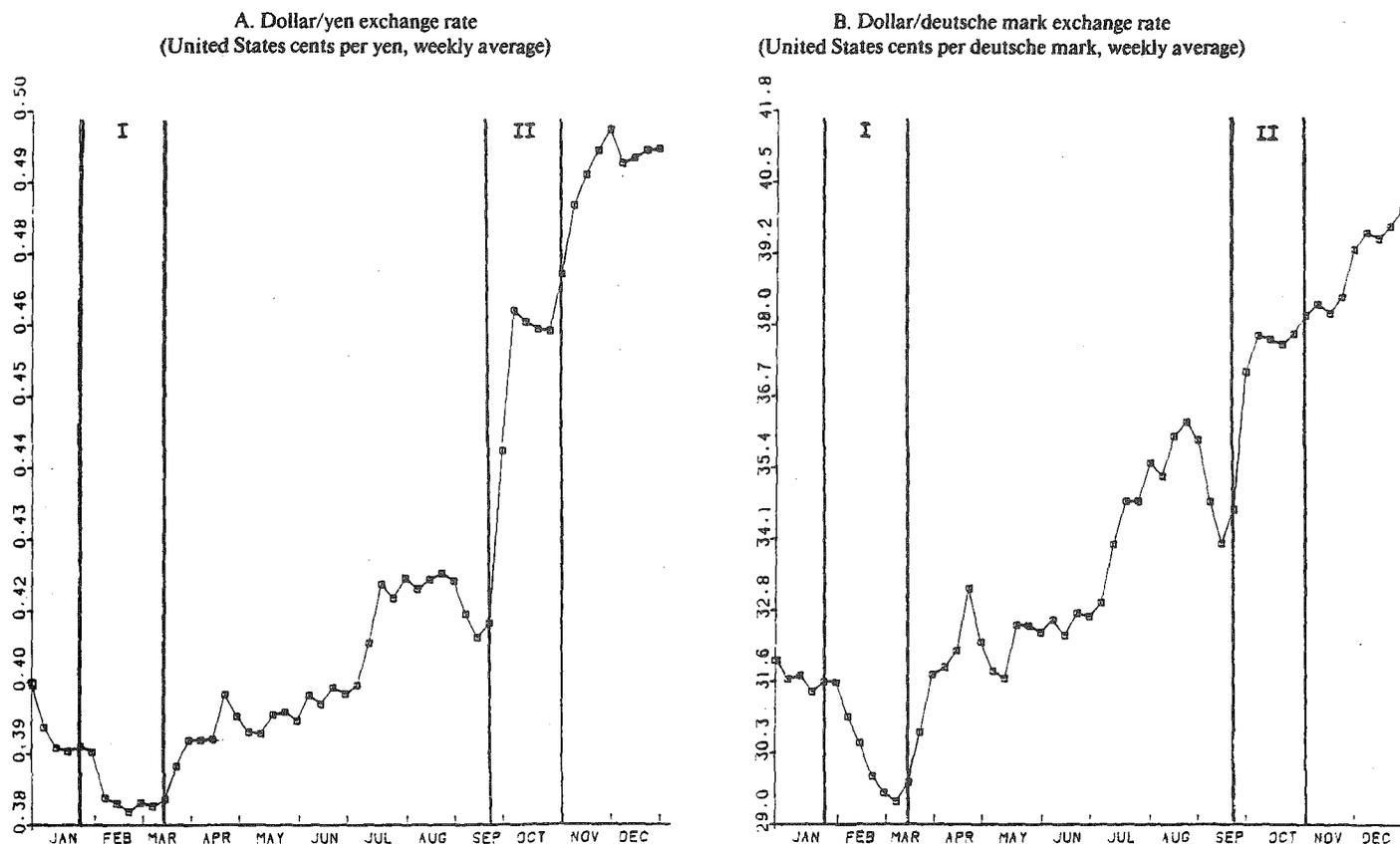
⁹ The communiqué was widely publicized by the press in major capitals of the world. For the text, see *IMF Survey*, 7 October 1985, pp. 296 and 297.

for major currencies the separation is, at most, short-term. Thus sterilized intervention would not be useful for more than short-run smoothing of exchange rate movements. Central bank activity in exchange markets can, nevertheless, provide a signal in the trading rooms of the currency markets of policy intent and resolve. This was apparently what happened in September and October 1985.

The intervention following the 22 September meeting seems to have entailed unusually heavy foreign currency

transactions on the part of the central banks involved. The United States accumulated substantial foreign exchange reserves and the Federal Republic of Germany and Japan drew down their exchange reserves sharply between September and October 1985.¹⁰ It also appears that the announcement of intent was made stronger by not sterilizing the intervention - at least that seems to be implied by the movement of domestic bank reserves in directions consistent with the intervention's desired effect on the value of the dollar.¹¹

Figure IV.2.
Selected bilateral exchange rates of the dollar, 1985



Source: IMF, *International Financial Statistics*.
I First intervention period
II Second intervention period

¹⁰ There are major conceptual problems in measuring the volume of central bank intervention, and in general, the net change in a country's foreign exchange reserves is a poor indicator. For example, monetary authorities frequently take advantage of a strengthening of their currency in the market to add to reserves of foreign exchange. Although the motive is then not intervention, the statistical effect on reserves is indistinguishable. Nevertheless, the October 1985 pattern of declines in official foreign exchange reserves of almost \$2 billion in the Federal Republic of Germany and over \$1 billion in Japan, coupled with the build-up of reserves in the United States of over \$3 billion, is sufficiently unusual to suggest the effect of concerted intervention to weaken the dollar.

¹¹ Here too, conceptual problems make it difficult to measure directly the degree to which intervention is actively sterilized. Unsterilized intervention by the central bank of a country, *ceteris paribus*, changes the stock of domestic bank reserves by an equal amount. Hence, an admittedly crude indicator of sterilization in the real world is the degree to which bank reserves do not move in the same direction as changes in foreign exchange reserves when the latter are thought to reflect mainly intervention activity. With these caveats, it is observed that bank reserves in October moved in the same direction as foreign exchange reserves in the Federal Republic of Germany, Japan and the United States. The change in bank reserves exceeded the change in foreign exchange reserves in the Federal Republic of Germany and Japan, which seems consistent with unsterilized intervention. In the United States, the change in bank reserves was almost 40 per cent of the change in foreign exchange reserves.

Nevertheless, the intervention, even in its relatively potent, unsterilized form, seems to have been too short-term to explain the substantial and nearly continuous fall in the dollar relative to other currencies since October 1985. Rather, exchange rate movement through early 1986 seems to have been dominated by private sector perceptions and expectations regarding underlying economic conditions and government policies.¹²

The underlying conditions, as seen in October, were slower-than-expected real growth in the United States, faster growth outside the United States, and evidence of continued success in reducing inflation in most developed market economies. That the dollar might still be overvalued by the market was also suggested by later developments, including agreement in the United States Congress on the Balanced Budget and Emergency Deficit Control Act of 1985 (the Gramm-Rudman-Hollings bill). As this Act signaled serious intent to reduce the federal budget deficit, it led to lower interest rates and to the realignment of long-term bond yields internationally. In early 1986, interest rates world-wide fell sharply with news that oil prices were falling more than expected. This created anticipations of downward pressure on United States interest rates relative to other interest rates, as well as more accommodative monetary policies, and the dollar continued to fall.

Before the joint official efforts to realign reserve currency exchange rates began in earnest, there was considerable concern in some quarters that market forces themselves would at some point bring about an adjustment, but in a way that would seriously disrupt real economic and financial activity.¹³ In particular, it was feared that exchange rates might change too rapidly and once again overshoot equilibrium levels so that, in consequence, international investors and producers of tradable goods would face different but still distorted and unstable market signals. The question was often posed in terms of whether the dollar was poised for a hard or a soft landing. Although the Group of Five is now attempting a process of international consultation and co-ordination of policies that includes an explicit focus on exchange rates, concern over the path of adjustment remains. It is likely that this issue will be a major focus of attention at the economic summit in Tokyo in early May 1986.

As noted previously, some exchange rates - specifically, those among the currencies of EMS - have been relatively stable during the turbulent 1980s. Indeed, the greater stability of the effective exchange rate of the deutsche mark

during this period, in contrast to the performance of the yen and the dollar (see figure IV.3), is owed in essence to the membership of the Federal Republic of Germany in EMS. But the process of co-ordination instituted by the Group of Five to realign and stabilize exchange rates is far less intensive than that among members of EMS. The latter is based on an announced grid of central exchange rates and acceptable variations; financial markets know it will be changed only periodically and will be defended through policy co-ordination and currency market intervention. In addition, potentially disruptive international capital flows are at least partly restrained by various restrictions on capital movements in several EMS countries. Policy co-ordination by the Group of Five, in contrast, is much less intensive. Target rates or bands for exchange rates are not set publicly, co-ordinated intervention is *ad hoc* and capital markets are virtually unrestrained.

The understanding in the world's financial markets since late 1985 that key currency countries will address emergency situations such as a destabilizing free fall of the dollar is itself a calming influence on the market. The question is whether other factors might nevertheless set off a flight from the dollar. That question is essentially about the potential volatility of the expectations of investors in dollar-denominated assets. Those expectations cannot be determined, however, as not only investors in assets originating in the United States but also purchasers of Eurodollar assets are involved.

It is clear that the United States has attracted a very large inflow of financial investments in recent years, the total value of which is now between four and five times the value in 1975. In all, about \$400 billion in securities issued in the United States were held in foreign portfolios at the end of 1985, and United States banks owed roughly \$380 billion to foreign depositors and other foreign creditors.¹⁴ Together, these assets accounted for more than three quarters of the total foreign-held investments in the United States which in 1985 reached \$1 trillion.¹⁵

Many of the foreign investors in the United States have already experienced a major capital loss. Since September 1985, Japanese investors have seen almost 30 per cent of the yen value of their dollar assets disappear as a result of exchange rate realignment, although some of the loss for certain assets was offset by rising dollar prices of equity shares and bonds. In 1985, such investors accounted for 80 per cent of the net foreign purchases of United States Treasury bonds.

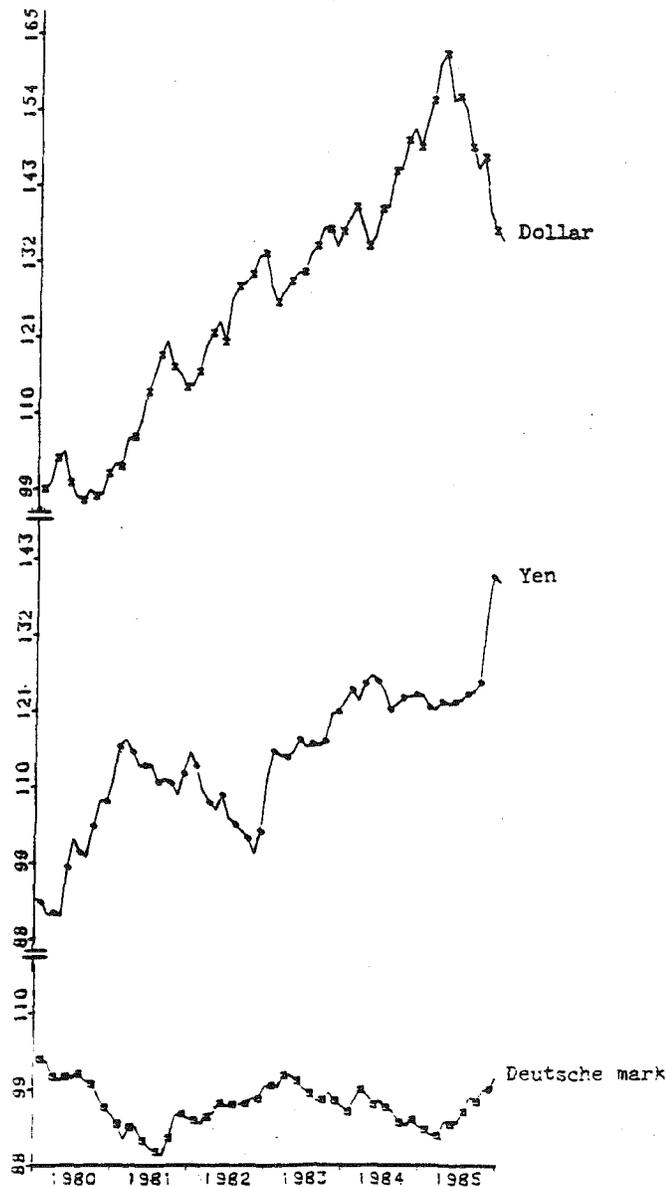
¹² For an analysis of the relative importance of news and expectations in explaining movements of reserve currency exchange rates in general, see "Exchange rate volatility in an interdependent world economy," *Supplement to World Economic Survey 1984* (United Nations publication, Sales No. E.84.II.C.2 and corrigendum), pp. 1-13.

¹³ The possibility of a free-fall scenario had in fact been taken into account by the United States authorities. For example, the minutes of the United States Federal Open Market Committee in 1985 repeatedly refer to the need to maintain confidence in the dollar in order not to discourage the inflow of foreign capital on prevailing terms.

¹⁴ The latter include foreign offices of United States banks, which, however, have their own off-shore dollar liabilities.

¹⁵ Data in this paragraph are estimated from United States balance-of-payments data for 1985 and the international investment position of the United States at the end of 1984, as published in United States Department of Commerce, *Survey of Current Business*, June 1985, pp. 25-33.

Figure IV.3.
Nominal effective exchange rates of major
reserve currencies, 1980-1985
(1980=100)



Source: IMF, *International Financial Statistics* (MERM index).

To prevent a free fall of the dollar, it will thus be necessary to maintain investor confidence in dollar assets through a moderate pace of exchange rate correction. This will allow an orderly net inflow of foreign savings to the United States to continue over the next few years. When foreign investors began to place large volumes of savings in the United States a few years ago, the dollar was rising and the United States was the world's largest creditor country, with a peak net asset position of \$147 billion in 1982. In 1986 the dollar is falling, the United States is about to become the largest debtor nation and investors have already built up large dollar balances in their portfolios. They will need to continue doing so given present

prospects for the United States current account, although the other main form of current-account financing - reducing United States foreign assets or at least their growth - also has considerable scope.

As shown in table IV.1, the 1986 current-account forecast for the United States points to a third year of deficit on the order of \$100 billion. The rate of decline of such deficits in subsequent years is highly uncertain, but even the more optimistic forecasts suggest deficits in excess of \$50 billion a year for the rest of the decade. A further build-up of the United States net debtor position is thus assured.

Maintaining confidence in dollar assets over the next

Box IV.1. *A preference for stability: the emergence of a new currency in Europe*

The importance that the private sector accords to reducing instability of exchange rates is well illustrated by a noteworthy development in EMS since 1982. This is the emergence of a private-circulation ECU (European currency unit), a composite unit of account comprising a weighted average of European currencies fashioned after the official ECU that is used in internal accounting by the institutions of EEC. Although still comprising a very small percentage of Eurocurrency loans, European bank assets denominated in ECUs grew more than four times between 1982 and 1984, a period of slow growth in Eurocurrency markets in general. By September 1984, the ECU had become the fifth largest denomination of the foreign currency assets of industrial country banks. By September 1985, ECU assets held by banks reached \$32 billion. In Eurobonds as well, the ECU is now a significant presence; in 1985 it became the third largest denomination when \$7 billion of securities were issued in ECUs.^a

Several factors appear to account for the rapid growth of the ECU in private markets. First is the encouragement it has received via official participation of EEC governmental institutions, public sector entities of EEC member States and the World Bank, all of which have issued substantial amounts of ECU bonds. The Bank for International Settlements is expected soon to begin interbank clearing of ECU transactions to supplement private arrangements.

A second factor is the suitability of the ECU as a hedge having low transactions-cost against exchange rate and interest rate risk. The ECU is of particular interest to EEC residents as it will not fluctuate as much against individual EEC currencies as will the bilateral rates among these currencies. Similarly, interest rates in ECU are more stable than those in individual currencies. With 50 - 70 per cent of the trade of member States being conducted within EEC, the ECU basket has proved useful for hedging against trade and commercial risks attendant on exchange

rate variations among EEC countries. In 1985 the ECU also began to be used at the retail level for customer accounts, credit card transactions and travelers checks.

For participants within and outside EEC, the ECU has also become an increasingly popular means of hedging or speculating against the dollar. It offers sharply reduced transactions costs compared to the traditional options of currency swaps and other forms of bundling assets and liabilities in different currency combinations. In this role, the ECU has already far outpaced the private SDR, mainly because the dollar is not included in the ECU, whereas it is a large share of the SDR.

While the history of the ECU suggests that its demand base will remain primarily regional, its continued growth could conceivably lead to a further role as a major reserve currency and an alternative to the dollar. However, for the ECU to achieve that status, some serious limitations would have to be overcome. The first is the continued presence of exchange controls in some EEC countries, which so far restrict private deposit growth and make the ECU market primarily an interbank one; non-bank borrowing has accounted for less than 30 per cent of total ECU-denominated bank assets. Apart from official prohibitions against holding ECU deposits, ECUs suffer the disadvantage, relative to national currencies, that they lack legal tender status.

Over time, the private ECU might increasingly displace the dollar as a unit of account and means of payment for intra-European trade. The prospect for its use by Europeans and others for hedging against exchange rate risk and as a unit of account seems tied up with the prospect for stabilization of international monetary relations as a whole. While reduced international exchange rate volatility might tend to dampen the use of the ECU as a global currency, the increasing convenience and availability of the composite currency seem certain to keep it competitive as an international money.

^a BIS, *International Banking Developments, Third Quarter 1985* (January 1986) and OECD, *Financial Market Trends* (March 1986).

few years requires that United States net foreign debt grow in a sustainable manner. The latter requires a major adjustment in the United States balance of payments on goods and non-capital services.¹⁶ Under the forecasts and scenarios discussed in chapter II, such an adjustment is not expected this year or next. Whether the current account as a whole will adjust at a sufficient pace depends on favourable developments in both interest rates and the growth of United States export earnings. Should there be a

collapse of confidence in the dollar, United States interest rates would have to rise, perhaps substantially, to maintain even a reduced capital inflow. This would have potentially hazardous effects on United States economic growth, world trade and the debt-servicing capacity of the developing countries. Thus the need for an orderly reduction in interest rates and a reactivation of trade are each a major focus of attention of national policy makers and of the international community.

Debt, capital flows and the transfer of resources from the developing countries

A serious anomaly has arisen in recent years in the international financial relations of capital-importing developing countries. In the late 1970s and up to 1981 these countries as a group had been receiving net resource transfers from abroad on the order of \$40 billion a year. In 1982, this net transfer fell drastically; in 1983, it disappeared. In 1984 the aggregate net transfer turned into a net outflow, which in 1985 exceeded \$30 billion (see table IV.4). The forecasts discussed in chapter II and current policies with respect to official flows suggest that the net transfer will be negative again in 1986 and, very likely, in 1987 as well. The negative transfer is thus not a short-run phenomenon.

Sources of the net transfer of resources

It is part of the dynamics of foreign financing of investment and growth that for any single project, there is first a period of relatively concentrated capital inflow used to finance construction, start up and other investment costs. Later capital inflows may be used for maintenance and expansion. Meanwhile, a portion of the increased output derived from the investment is used to make interest or dividend payments abroad. At the level of single projects, then, a period of positive net transfer may be followed by a period of negative transfer. What keeps the transfer positive at the aggregate level is the succession of new projects or programmes with foreign financing, and the transfer of official resources as grants for technical co-operation, food aid and other activities.

In the long-run, as economies mature and more investment is financed from domestic savings, the net transfer may change from positive to negative. What has been unusual about the current situation is that the swing from positive to negative transfer has been sudden, premature and of an unprecedented magnitude. Indeed, the negative transfer was unplanned and unexpected by borrowers and creditors alike.

When countries experience a negative net transfer, it

does not mean that there is no longer a net inflow of capital from abroad. It does mean that the foreign resources provided by the net capital inflow are less than the resources paid out to service the outstanding net stock of debt and direct investment. In 1985, for example, the capital-importing developing countries as a group are estimated to have received a net capital inflow of about \$36 billion, made up of net credit inflows (\$13 billion), net direct investment flows (\$9 billion) and official grants (\$14 billion). On the other hand, \$54 billion was paid in interest on the accumulated net foreign debt and \$13 billion in income on the stock of direct investment.

The consequence of the negative transfer is that some of the foreign exchange earnings that would otherwise be used to purchase imports for investment or consumption or to build up reserves are instead used to make a foreign transfer.¹⁷ Because of the reduction in per capita income caused by the recession of the early 1980s, which has yet to be overcome in most high-debt countries, and the continuing adjustments required by a slowly growing international economy, the economic burden of the transfer has been substantial in many cases (see chapter VI).

It is true, nevertheless, that the large majority of developing countries remain net recipients of resource transfers from abroad and that the burden of effecting the outward resource transfers for individual countries that have them is uneven. The burden of the transfer has been especially heavy in Latin America and the Caribbean, where the negative transfer from 1982 to 1985 has accumulated to \$96 billion (see table IV.4). It is also noteworthy that for sub-Saharan Africa, including countries receiving positive as well as negative transfers, net flows that had been on the order of \$10 billion a year in 1981 and 1982 have since dropped to a mere tenth of that figure. This occurred when the region was going through a most devastating drought and despite the international effort to meet the resulting food emergency.

¹⁶ The same has applied to the debtor developing countries. Nevertheless, United States debt servicing differs in one crucial respect from that of developing countries: it is almost entirely denominated in domestic currency (e.g., in 1985, 95 per cent of the foreign liabilities of United States banks, 90 per cent of the foreign liabilities of non-banking concerns and virtually all official liabilities held by foreigners were dollar-denominated). There is thus no foreign exchange constraint on the United States in making its debt-servicing payments (although world inflationary pressures might be stimulated if excessive dollar creation occurred). Put differently, creditors of the United States bear the exchange rate risk. The possibility that they might become unwilling to continue doing so is precisely what holds the potential for disrupting United States capital inflows. In the long run, in any case, the foreign debt of the United States poses the same requirement on the United States economy as that posed by the debt of developing countries on their economies: foreign investors must have their assets serviced with a transfer of real resources.

¹⁷ Different definitions of the net transfer of resources and their relationship to standard concepts of macro-economic analysis are given in annex III below.

Table IV.4. Net transfer of resources to the capital-importing developing countries, 1979-1985^a

(Billions of dollars)

	1979	1980	1981	1982	1983	1984	1985 ^b
Net transfer mediated through all credits ^c							
Net capital flow	47.9	54.2	62.5	50.8	39.7	32.0	13
Net interest paid	-17.2	-23.6	-34.8	-50.0	-48.3	-53.9	-54
Net transfer	30.7	30.6	27.7	0.8	-8.6	-22.0	-41
Net transfer mediated through direct investment							
Net flow of investment	10.1	9.8	14.2	12.0	8.9	8.5	9
Net direct investment income	-11.4	-13.7	-13.5	-13.1	-11.6	-11.3	-13
Net transfer	-1.3	-4.0	0.7	-1.1	-2.7	-2.8	-4
Net transfer mediated through official grants	12.0	12.7	13.1	10.7	11.0	12.3	14
Total net transfer	41.4	39.3	41.5	10.4	-0.3	-12.5	-31
Memorandum items							
Net transfer to Latin America and Caribbean ^d	15.6	11.9	11.4	-16.7	-25.9	-23.2	-30
Net transfer to sub-Saharan Africa ^e	6.4	6.0	9.5	10.1	7.9	0.8	1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics*, national data and estimates of the World Bank, regional commissions of the United Nations and other sources.

^a Net flow of foreign financial resources available for imports of goods and services (i.e., after payment of income on foreign capital outstanding). All flows are inflows minus outflows of residents and non-residents. Sample of 93 developing countries.

^b Estimate, rounded to nearest billion dollars.

^c Includes all official bilateral and multilateral credits, including use of IMF credit, and all private credits, short-term as well as long-term.

^d Thirty-one developing countries or territories, accounting for about 92 per cent of the trade of the region.

^e Thirty-seven countries, accounting for about 92 per cent of the trade of the full group.

The phenomenon of negative resource transfers has affected a large number of countries. When the *World Economic Survey 1985* discussed the emergence of a negative net transfer in 1984, the analysis was largely at the aggregate level, since it was based on preliminary estimates.¹⁸ Now, with more complete information available, it is possible to say that about one third of the capital-importing countries experienced a negative transfer in that year. With the preliminary estimate of the aggregate net transfer in 1985 indicating a much larger resource outflow in total, it is unlikely that the proportion of countries affected has fallen.

These countries include middle-income developing countries and lower-income countries, including two least developed countries. They include exporters and importers of petroleum, countries that are predominantly exporters of commodities and countries that are major exporters of manufactures. They include countries that have fallen into debt-servicing crises and have faced a continuing series of debt-rescheduling exercises. They also include countries that have been characterized as "success stories" of adjustment and that enjoy rather full access to international credit markets. In all, almost 30 countries were identified as having experienced negative transfers. A large number of countries are from Latin America and the Caribbean, but they account for less than half the total number. One third of the countries are African and four are in the region of East Asia.¹⁹

Checking and reversing the negative net transfer of re-

sources from developing countries requires examining the different components of the flow of capital, identifying those responsible for the swing in net resource transfers and investigating the possibilities of increasing various types of flow. A primary cause of the swing towards negative net resource transfers has been the fall in the net flow of credit to developing countries (see table IV.4). This has drawn some attention to one alleged source of that change, namely, capital flight from the debtor countries.

The expression "capital flight" has been applied to the build-up of reported and unreported foreign assets in excess of normal business activities by the non-banking sector of indebted developing countries. The most common image of capital flight is the legal or illegal transfer of wealth abroad to foreign bank accounts, securities holdings in international capital markets and the purchase of real estate in foreign countries, undertaken by the nationals of developing countries. It is extremely difficult to estimate or even define sharply this kind of capital flight. However, since information is available on changes in gross external indebtedness, current-account balances, flows of direct investment, official transfers and increases in official reserves, and domestic banks' foreign assets, a very rough indicator of unreported gross capital outflows can be obtained as a residual. Some analysts have equated this residual to capital flight.²⁰

The method is based on the fact that over a given period of time, the increase in gross external indebtedness must be equal to: (a) the accumulated current-account deficits

¹⁸ See *World Economic Survey 1985* (United Nations publications, Sales No. E.85.II.C.1), pp. 57-59.

¹⁹ The full list (based on a sample of 83 countries for which sufficient information was available) comprises Algeria, Argentina, Bahamas, Barbados, Brazil, Colombia, Congo, Côte d'Ivoire, Ecuador, Gabon, Indonesia, Republic of Korea, Malaysia, Mexico, Nigeria, Oman, Peru, Philippines, Sudan, Suriname, Togo, Trinidad and Tobago, Uruguay, Venezuela, Yugoslavia, Zaire and Zambia.

²⁰ For a discussion of this issue, including estimates which apply variants of this approach, see World Bank, *World Development Report 1985* (Washington, D.C., July 1985), p. 64; John Cuddington, "Capital flight: Issues, estimates and explanations", (World Bank Development Research Department, March 1985); Michael P. Dooley and others, "An analysis of external debt positions of eight developing countries through 1990", United States Federal Reserve Board, International Finance Discussion Paper No. 227 (August 1983); and Morgan Guaranty Trust Co., *World Financial Markets*, March 1986.

observed in the same period, less the part of it financed through non-debt creating flows; (b) the accumulated gross foreign official reserves in the same period; (c) the accumulated gross foreign assets other than official reserves; (d) errors and omissions or statistical discrepancies; and (e) valuation effects associated with exchange rate movements. For some countries there is a significant residual remaining after the sum of all the relevant identifiable flows is deducted from the observed increase in gross external indebtedness.

Yet this residual includes several items that might not be called capital flight proper, as it includes, specifically: (a) the increase in foreign-currency denominated working balances of public enterprises and private firms that are engaged in foreign trade; (b) the increase in trade credit extended directly by exporters to foreign importers; (c) the transfers of assets overseas by residents of developing countries that are not nationals; (d) all errors, omissions and statistical discrepancies present in balance-of-payments statistics; (e) any misreporting of imports, in particular, non-declared military purchases; (f) valuation effects due to exchange rate movements. Neither (a) nor (b) would normally be considered capital flight as they are part of normal business activities. The same applies to (c) and maybe part of (d). Moreover, valuation effects could understate or overstate the residual, depending on the currency composition of the stocks and flows of debt and assets during the period covered by the analysis.

Table IV.5 presents the residual for 10 of the largest indebted developing countries during the period 1981-1984.²¹ The figures in the table indicate the following: first, the magnitude of the residual varies significantly from country to country; second, the residual is not large for many of them; third, even if the combined residual for these 10 countries is deducted from the net transfers of this group, there is still a significant negative overall net transfer in 1983 and 1984.

However shaky the quantitative estimates of capital flight, the issue itself gained considerable attention in 1985 and early 1986. It appears, however, that aggregate capital flight - or at least the measured residual - has been declining as progress is made in the process of economic adjustment. More precisely, as estimated for a sample of 93 capital-importing countries, a valuation-adjusted residual of \$21 billion in 1982 fell to \$14 billion in 1983, \$10 billion in 1984 and roughly \$8 billion in 1985.²² One question is, then, why has the issue become more salient now?

In part the answer seems related to the general scarcity of international finance for development and the inability of the Governments of many developing countries to mobilize the foreign exchange with which to service their existing foreign debts. Any avoidable capital outflow has a high economic cost under present conditions.

Another part of the answer may have to do with current perceptions of the issue. Creditor country officials and bankers have discerned various indications of a build-up of privately held assets from developing countries. In part

these may reflect the proceeds of under-invoicing exports and over-invoicing imports, as well as other illegal activities. In part they may also reflect the success of sales personnel of the private or personal banking departments of major international commercial banks that have actively sought deposits from wealthy individuals in developing countries. In addition, the financial services sector in major capital markets has developed the expertise to invest such resources quietly in diversified portfolios of securities and other assets.

In other words, the present high degree of integration and the progressive de-regulation of international capital markets - not to mention the liberalization of controls over capital movements in some developing countries - have made it easier to move private wealth out of the developing countries. The greater integration of the world economy and the spreading familiarity of many residents of developing countries with world financial centres may have also served to reduce barriers to investing abroad for an increased proportion of the business and professional classes of those countries. In short, it has become more natural for individuals and firms - domestic and transnational - in developing countries as elsewhere, to shift resources abroad when economic or political developments generate a potential motive for doing so.

Removing the incentive for such capital flight is ultimately a matter for domestic policy in the affected countries, including, in particular, exchange rate policy and policies to promote domestic savings, channel them to domestic investment and ensure an overall climate of confidence and stability of rules for investors. This is widely recognized. What is new is the clamour in creditor countries about capital flight. Given the prevailing degree of financial market integration, the logical next step in the latter countries seems to be mobilization of support for assisting developing countries in their efforts to stem at least those outflows that contravene their existing foreign exchange controls over capital movements and other legal prohibitions as expressed in their national legislation. In short, dealing effectively with capital flight requires a much higher degree of international co-operation among Governments of both debtor and creditor countries and private financial institutions.

While enhanced joint international efforts to impede illegal capital flight would help to prevent large capital outflows during a period of economic difficulty, they would not *per se* treat the sources of the difficulties. Political instability aside, unsustainable economic policies raise speculative expectations. Protracted austerity may also provoke capital exports as opportunities for profitable investment are generally greater in economies with rising real incomes. Similarly, given the degree of integration of financial markets, large interest rate differentials will induce large capital movements wherever controls over such movements in developing countries are weak or non-existent.

²¹ As the exchange value of the dollar was rising throughout this period, the increase in debt underestimates the flow of lending; the greater the share of yen and European currency debt in total debt, the greater is the underestimate. As most of the recorded asset changes during this period involved official reserves, the data for which already includes the effect of valuation adjustments, the true asset flows are closer to the data reported in column 4 of table IV.5.

²² These residuals are based on flow data to the extent possible and valuation-adjusted changes in the foreign assets and liabilities of banks (based on data and estimates of the Bank for International Settlements, IMF and the World Bank). Public statements by the Managing Director of IMF point to a similar assessment of the trend in capital flight (see, for example, *Financial Times*, 23 April 1986).

Table IV.5 Residual of capital transactions for selected developing countries, 1981-1984

(Billions of dollars over period)

Country ^a	Accumulated increase in gross debt (1)	Accumulated balance of payments on current account ^b (2)	Accumulated non-debt creating flows ^c (3)	Accumulated recorded flow of foreign assets ^d (4)	Residual (1+2+3-4)
Argentina	18.5	-12.0	1.7	-4.5	12.7
Brazil	34.4	-34.9	7.9	4.5	2.9
Chile	7.8	-10.4	1.2	-0.7	-0.7
Mexico	40.2	-11.6	5.9	3.6	30.9
Nigeria	10.7	-17.2	1.4	-6.6	1.5
Peru	3.3	-5.2	0.9	-0.2	-0.8
Philippines	7.0	-10.2	1.2	-3.4	1.4
Turkey	3.0	-6.7	0.9	2.4	-5.2
Venezuela	4.7	9.6	0.5	-5.9	20.7
Yugoslavia	1.3	-0.7	-	2.2	-1.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics* and *International Financial Statistics* and World Bank, *World Debt Tables*, 1985-86 edition.

^a Ten countries with the largest external debt that have rescheduled their debt in the 1980s.

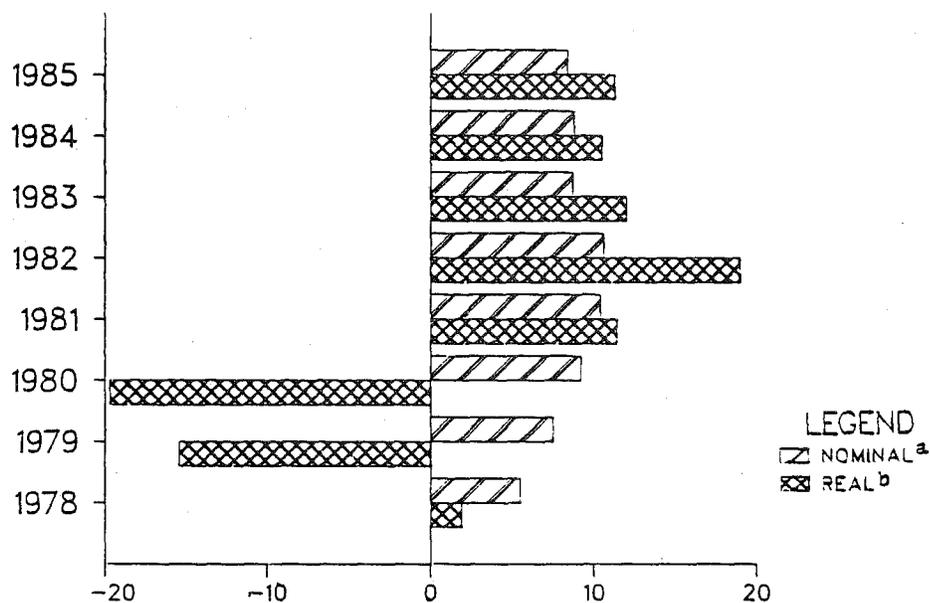
^b Balance on goods, services and private transfers.

^c Official transfers, net direct investment and allocations of SDRs by IMF.

^d Changes in official reserves and reserve-like assets (calculated as a flow from balance-of-payments data) plus change in stock of deposit-banks' foreign assets (including change in foreign assets of non-monetary financial institutions for Brazil, Peru, Philippines and Venezuela).

Figure IV.4.
Average rate of interest on the external debt of the capital-importing developing countries, 1978-1985

(Annual percentage)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data provided by IMF, the World Bank, OECD and national authorities. Sample of 93 countries.

^a Interest payments divided by average of debt at beginning and end of year.

^b Nominal rate deflated by change in unit value of exports.

Interest payments and the composition of capital flows

The institutional channel that was responsible for the greatest growth of resource transfers in the 1970s and the shift to negative transfers in the 1980s is international credit. As seen in table IV.4, a major portion of the shift from positive to negative transfer was brought about by the growth in net interest payments in the early 1980s.

The rise in net interest payments in the early years of the decade was a natural reflection of the rise in the net debt position of countries that were recipients of foreign credit on a large scale. The rising interest payments, however, were also a reflection of rising nominal interest rates. At first these affected mainly the interest charges on borrowings from international commercial banks, but eventually they came to be incorporated into the interest rates on most international credits, official as well as private. Taking account of total interest paid on credits of all types, concessional and non-concessional, official and private, long-term and short-term, the average nominal interest rate is estimated to have risen from under 6 per cent in 1978 to over 10 per cent at its peak in 1981 and 1982. Since then, the average rate has remained under 9 per cent.

The real burden of these interest payments - measured in terms of the export volumes which have had to be applied to pay interest per dollar of debt - has shown a strikingly different pattern.²³ Although the results for any individual country depended on its mix of export products, figure IV.4 shows how the real interest rate evolved for the aggregate of the capital-importing developing countries. Thus, with the rise in international commodity prices in 1979 and 1980, the average real interest rate turned strongly negative. This was especially the case for the energy-exporting countries; but even for the energy-importing countries, the average real interest rate was significantly negative (approaching -10 per cent in 1979 and -5 per cent in 1980), as their export unit values grew strongly in those years.

For countries with burgeoning demands for foreign credit, whether to finance higher bills for oil imports or for general imports, this may have seemed to be an advantageous development. What matters from the borrowers' perspective, however, is the relationship between nominal interest rates and export earnings over the life of a loan, and the change beginning in 1981 could not have been more dramatic. Since then, falling or weak commodity prices and a rising exchange rate for the dollar (the dominant currency for external debt) have kept real interest rates significantly above already high nominal rates. In fact, the average real interest rate is estimated to have risen in 1985, despite a modest fall in the average nominal rate (the latter the result of a much larger fall in market-

based interest rates). As a whole, the capital-importing developing countries had to devote more than a sixth of their foreign exchange earnings to making interest payments in 1985. This was not a significant improvement over 1982, in the trough of the world recession. It also compared unfavourably to the situation at the beginning of the decade, when interest payments absorbed only a tenth of foreign exchange earnings.

Relief in nominal interest payments may come in 1986, owing to the substantial fall in market interest rates taking place and the lagged decline in rates on such official credits as World Bank loans and official or officially guaranteed export credits of member countries of OECD. The average nominal interest rate on the foreign debt of the capital-importing countries as a group is expected to fall to roughly 8 per cent. The outlook for dollar export prices is, as discussed in chapter III, very much split between a substantial deterioration for energy-exporting countries and some improvement for other countries. The implications for real interest rates are correspondingly very different.

What is clear in any event is that even if average nominal interest rates fell to half the level of 1985, the net transfer of resources would remain negative unless there were a significant improvement in net credit flows. In 1985 net credit flows continued their persistent contraction, reaching a level of only some 20 per cent of their 1981 peak. Particular types of credit flows, however, have behaved differently.

The sharpest swings have occurred in private credit flows (see figure IV.5). The total net inflow of long-term and short-term private credit first maintained a fairly steady pace from 1978 to 1981, when it peaked at \$35 billion. To a significant extent, in those years net changes in long-term private flows were offset by changes in short-term flows. Starting in 1982, however, net private flows began falling rapidly and are estimated in 1985 to have become nil. Over this latter period, net long-term flows have fallen by more than 80 per cent, while short-term flows have been consistently and substantially negative.²⁴

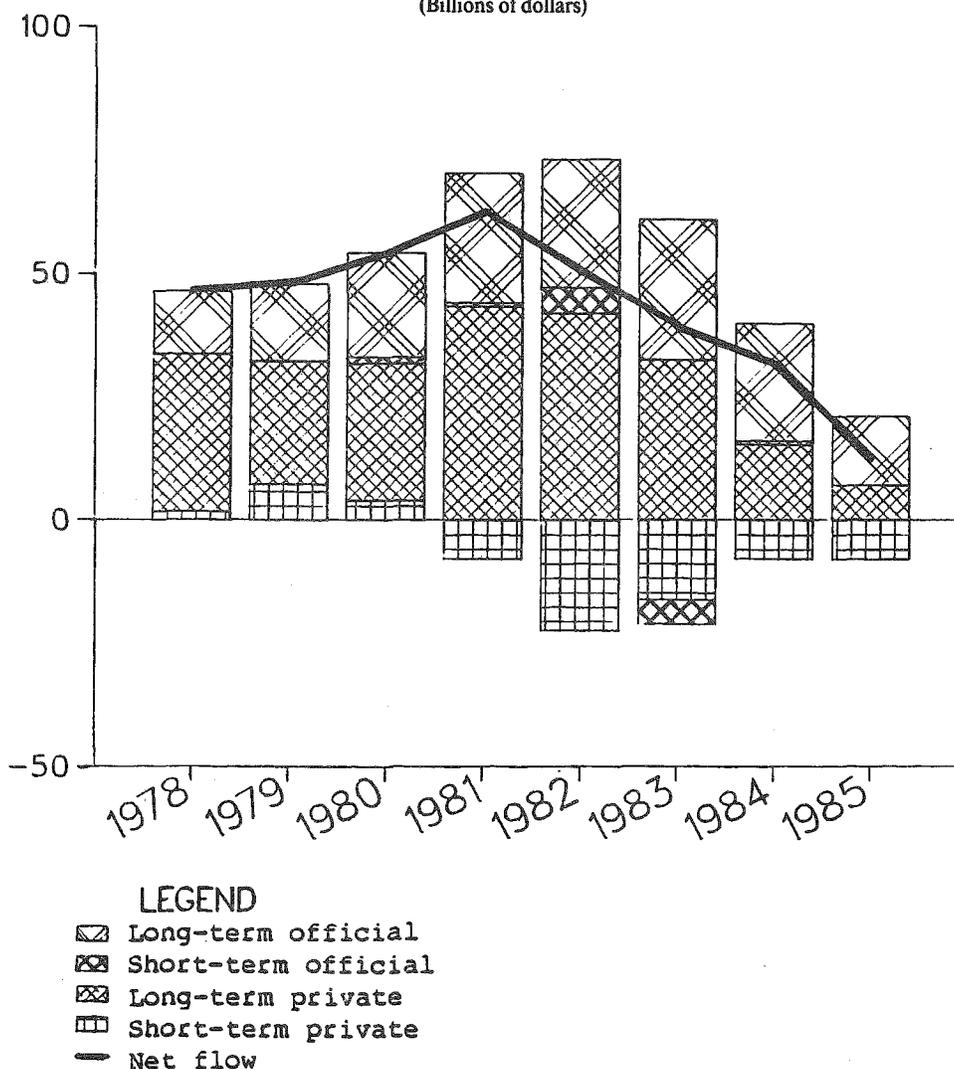
The countries with debt and adjustment difficulties still unresolved since the early 1980s have in essence not been receiving private credit inflows other than the involuntary credits provided by international commercial banks that fear the effect of a complete cut-off of credit on their already outstanding loans. Even these flows, however, have been declining, with only \$2 billion of such lending agreed to in principle or committed in 1985, compared to \$16 billion in 1984 and \$14 billion in 1983.²⁵ All in all, more financial flows are needed to increase investment in the context of adjustment efforts and to reach sustainable economic growth.

²³ The estimates in this paragraph pertain to the unit values of exports and the average rates of interest paid. Unit values reflect changes in the prices of manufactured exports as well as commodities; interest rates average the interest paid on concessional as well as market-related debt. For reference, various market interest rate and international price data series are shown in table A.V.8. As seen in that table and table A.V.7, the choice of deflator has a large effect on the measured "real" interest rate. Deflating by prices of developed market economies gives the real interest rate from the creditors' perspective as opposed to the real rate discussed here, which is from the debtors' perspective.

²⁴ Arrears in debt-servicing have been subsumed in long-term credit flows, despite the fact that arrears are formally a form of short-term (albeit involuntary) credit. Grouping arrears in short-term flows would artificially swell those flows when arrears are accumulated and shrink them when arrears are erased through debt restructuring exercises.

²⁵ IMF, *International Capital Markets: Developments and Prospects*, Occasional Paper No. 43 (Washington, D.C., February 1986), p. 105.

Figure IV.5. Net flow of credit to the capital-importing developing countries, 1978-1985
(Billions of dollars)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data provided by IMF, World Bank and national authorities. Sample of 93 countries.

In this regard, it is important to note the assessment of the staff of the World Bank: "Adequate financing will not come spontaneously from private lenders. The official sector must assist through a combination of strong leadership and greater lending of its own."²⁶ A similar perception appears to be behind the initiative of the United States Secretary of the Treasury at the annual meetings of IMF and the World Bank in October 1985 in Seoul. The proposal was, *inter alia*, to foster policy reforms for adjustment in developing countries and to support them by increased financial flows to be provided by accelerated disbursements of credits from the World Bank and the Inter-American Development Bank and by commercial bank creditors based in all major financial centres.

Details of the plan were still being worked out in the first quarter of 1986, but various commitments to it have been

announced, including statements of support by groups of commercial bankers in a number of countries, a joint pledge to intensify co-operation in the area of economic adjustment by the heads of IMF and the World Bank, and actions by the Executive Board of the World Bank in late March to step up lending to Latin America.

As a complementary effort to increase assistance to low-income countries, particularly in sub-Saharan Africa, negotiations began in January for the eighth replenishment of the International Development Association (IDA) at a level targeted by agreement of virtually all donors at \$12 billion for lending over three years. Progress was also made in early 1986 in resolving the long outstanding negotiations for the second replenishment of the International Fund for Agricultural Development (IFAD), which will, however, be at a reduced level (even including the Fund's

²⁶ World Bank, *World Debt Tables*, 1985-86 edition (Washington, D.C., 1986), p. ix.

separate, new Special Programme for Sub-Saharan Africa). At the same time, it is being increasingly realized that the World Bank and the regional development banks will need to be supplied with resources adequate to the key role they should play for the rest of the decade.²⁷

While these developments offer a hope for the long-run revitalization of international financial co-operation for development, they must also be seen against the backdrop of recent trends in official assistance. In the aggregate and over a period of many years, official grants measured in nominal dollars have been relatively constant. The outlook for official development assistance flows - about 80 per cent of which are in the form of grants - is for slow growth, perhaps under 2 per cent a year in real terms, especially in light of the difficulties of OPEC donor countries resulting from the sharp decline in oil prices.

The net flow of official credit, combining non-concessional and concessional flows, has been on a declining trend since 1983, after flows had been enlarged in 1982 as part of the response of the international community to the debt and recession crisis of the early 1980s (see figure IV.5). In addition to the short-term official bridging finance of 1982 (mostly repaid in 1983), there was also a significant expansion in IMF lending, discussed below, as well as other forms of adjustment assistance. This had essentially subsided by 1985.

In fact, the continuing economic crisis in many developing countries has itself had an adverse effect on the lending operations and country-assistance programmes of various multilateral institutions and the project financing of bilateral donors. Partial information currently available suggests that the aggregate amount of multilateral finance arranged for developing countries may have fallen slightly in 1985. Among the reasons for the decline in financing was that accumulated arrears of several countries raised issues of creditworthiness, limiting the ability of some institutions (notably, the World Bank and the African Development Bank) to expand lending to them. Also, as investment programmes in adjusting countries were either reduced or re-oriented, project financing that had already been arranged was affected. At IFAD, the delays in the payment of donor contributions and the slow progress in negotiations on the second replenishment caused a decline in lending in 1985. Financing decreased almost 15 per cent at the Asian Development Bank, reflecting an economic slow-down in the region and a reduced pace of borrowing activity. One of the reasons disbursements fell at the Caribbean Development Bank was the problem experienced by several member countries in providing counterpart financing for projects, thereby slowing their imple-

mentation. Comparable constraints were also faced by the Inter-American Development Bank and appear to have contributed to the stagnation of project finance (the major form of finance) provided by Arab national and regional development institutions (see table A.V.11).

Partly as a result of the development in overall credit flows, many developing countries have been revising their policies towards direct investment, relaxing restrictions on such investments and offering additional incentives. This notwithstanding, the inflow of investment in 1985 was still below the level of the late 1970s and early 1980s. In fact, as seen in table IV.4, it was even below the net investment income paid abroad, leading to a net outflow of \$4 billion.²⁸ As with the net transfer through credit flows, the transfer on account of direct investment must be interpreted with caution. It is the result of a comparison in a one-year period of the net inflows of investment and net outflows of investment income - repatriated earnings - that result from the accumulation of investment during several decades. In countries with a long history of association with foreign direct investment, a sizable accumulated stock generates a potentially large flow of earnings that represents claims of foreigners on the income of the host country. The reflection of this in the balance of payments may imply repatriation of earnings in any single year that bears little or no relation to new foreign investment flows in that specific year.

The more recent efforts of several developing countries to increase flows of direct investment have led them to negotiate bilateral investment treaties or investment insurance agreements with countries that are major sources of direct investment. Action has also been taken to help lower the non-commercial risks perceived by potential investors, most notably by the establishment of a new facility at the World Bank, the Multilateral Investment Guarantee Agency (MIGA). When it becomes operational, MIGA will complement investment insurance that is now available through government schemes in the major developed market economies, private insurance and the one regional scheme, the Inter-Arab Investment Guarantee Corporation. In addition to offering coverage to investors not currently having access to insurance, MIGA will engage in co-insurance and re-insurance, assess the investment conditions in host countries, supply technical assistance and engage in other promotional activities. In this context, the completion and adoption of the United Nations Code of Conduct on Transnational Corporations has become even more important, given the need for a universally agreed multilateral framework of principles, norms and rules for the behaviour of the actors in this field.

²⁷ See report of the Committee for Development Planning on its twenty-second session (*Official Records of the Economic and Social Council, 1986, Supplement No. 6 (E/1986/26)*).

²⁸ It should be noted that the direct investment data discussed here are based on information compiled for balance-of-payments purposes as reported to IMF. There is considerable under-reporting of at least one form of direct investment income, namely, reinvested earnings, which should be treated as an income outflow offset by an inflow of new investment. This source of error, however, does not affect the net transfer measure as the errors on the income and investment sides are offsetting. What the reporting practices do affect is the growth of the stock of foreign investment, which is larger than the historical sum of the flow data in balance-of-payments statistics. Inconsistencies in various data series on direct investment indicate that there are other major data shortcomings (see "Data on foreign direct investment, including capital inflows and outflows, on other aspects of the activities of transnational corporations, and containing suggestions for further action" (E/C.10/1986/3)).

While multilateral efforts will undoubtedly make a contribution to increasing direct investment flows, they will not be sufficient to overcome the major barrier to direct investment in many developing countries. As reported by the World Bank in discussing the 1985 performance of its affiliate, the International Finance Corporation, "The recent economic climate has not only restricted opportunities for new investments in developing countries, it has also exerted severe financial pressures on many existing companies."²⁹ In other words, in the many developing countries that are grappling with serious adjustment processes and continued balance-of-payments pressures, the investment climate does not seem propitious. Even with insurance, prospective profits would have to be unusually high to attract potential foreign investors away from more established alternative international locations having very little non-commercial risk and unrestricted repatriation of earnings.

Transfers and external debt: the case for lasting solutions

While the importance of increasing official international finance in support of development and adjustment cannot be over-emphasized, it is not a solution to the broader issue of the negative transfer of resources. That problem arose with the international debt crisis and will not be resolved without reaching a more lasting solution.

The first attempted solution sought to reduce borrowing needs by an austerity-intensive approach to adjustment while granting a temporary and partial respite from debt-servicing obligations through negotiated debt restructuring. This process was once thought to require up to three years. Those years have now passed and none of the countries that underwent debt crises have yet attained a sustainable balance-of-payments configuration with adequate economic growth. Indeed, 1985 was itself a record year for multilateral debt renegotiations. Thirty-one agreements were formally completed covering debts of \$93 billion (19 agreements with government creditors concerning \$6 billion, and 12 agreements with commercial banks on \$87 billion of debt). Another 11 commercial bank agreements on \$26 billion were agreed in principle but not completed during the year. These figures greatly exceed those for the previously most active year, 1983, when 31 agreements were completed, covering \$52 billion.³⁰

Despite rescheduling, debtor countries are no closer to a permanent resolution of their debt problems. For the sample of 93 capital-importing developing countries, the ratio of total debt to the exports of goods and services in 1985 is estimated to have reached its highest level ever, almost 200 per cent; it is expected to rise still higher in 1986. In contrast, the ratio was 174 per cent in the starting year of the crisis, 1982, and had been under 150 per cent in the immediately preceding years. It is also noteworthy that in

1984 many countries, particularly in Asia and Latin America, saw their debt-export ratio decline on the strength of their export growth. By and large, this progress was reversed in 1985. In Latin America, for example, the ratio fell from an estimated 303 per cent in 1983 to 289 per cent in 1984 but in 1985 climbed back above the 1983 level (see table IV.6).

The reason for the growth of the debt-export ratio is largely that the value of the exports of goods and services has been growing at a rate below the average interest rate on the debt outstanding. In fact, the dollar value of export earnings for the capital-importing countries as a group has actually fallen in three of the past four years. Not since 1980 has the aggregate growth in export earnings produced enough additional foreign exchange to cover the interest payments on external debt. Countries have had either to cut back expenditure on imports to pay interest or to borrow to pay interest or - what amounts to the same thing - to allow interest arrears to accumulate until creditors agree to advance new loans with which to meet the outstanding interest payments. In fact, countries have tried all of these options in varying combinations. None of them, however, can be repeated indefinitely.

In this regard, the fall in market-related interest rates in 1986 is a welcome development, especially if it presages a longer period of lower rates. Recent trends in other international variables - commodity prices, especially the price of petroleum, exchange rates and international prices of manufactures - have mixed implications, benefiting some debtor countries and causing major difficulties for others. It is also uncertain whether these new trends will persist or whether, on average, the growth in the value of exports will come to exceed the average interest rate on the debt. For some countries, including some of the largest debtor countries, this criterion will clearly not be achieved in the near term.

To move from an unsustainable to a more manageable debt situation, debtor countries can act on only a limited number of variables. They can improve their trade balance, or more precisely, the balance on current account exclusive of interest servicing. As has been noted earlier, this has been done extensively, indeed, in a number of cases to a degree that has already raised concern about lasting damage to social peace and recently re-invigorated democratic processes, let alone to physical production capacity. Many countries have the possibility of attaining further progress through domestic policy actions. For many others, however, the opportunity for additional improvements will have to come from favourable developments in the international economy. Even so, countries that do see an improvement in net availability of foreign exchange will also need to consider relaxing restraints on import volumes needed for investment and growth.

²⁹ World Bank, *Annual Report 1985*, p. 31.

³⁰ World Bank, *World Debt Tables*, 1985-86 edition, (Washington, D.C., 1986), pp. x and xiv-xv.

Table IV.6 Debt and debt-export ratios of the capital-importing developing countries, 1982-1985

	1982	1983	1984	1985 ^a
<i>Billions of dollars</i>				
Total debt (end-year)				
Capital-importing countries	703	762	789	825
Latin America	318	344	360	368
<i>Percentage</i>				
Debt in relation to exports of goods and services				
Capital-importing countries ^b	174	188	186	198
Latin America	269	303	289	308

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on World Bank, Debtor Reporting System; IMF, *Balance of Payments Statistics* and *International Financial Statistics*; national and other sources; and, for Latin American debt, ECLAC, "Preliminary Overview of the Latin American economy 1985" (December 1985).

^a Preliminary estimate.

^b Sample of 93 countries.

The international community has already agreed "that there are shared responsibilities in respect of which debtor and creditor countries, as well as multilateral financial institutions, have a role to play" and that developed and developing countries are pledged to "intensify their efforts towards solving the debt problems of the developing countries".³¹ There are two areas, in particular, in which action might be taken.

First, the highly indebted developing countries that repeatedly need to reschedule their debt to international commercial banks will not achieve a sustainable solution until the average interest rate on their debt falls below the prospective average long-term growth rate of export earnings. This has not been as explicit a part of debt-rescheduling negotiations as it should be. What has happened is that higher interest rates and fees imposed as part of initial debt-restructuring exercises have been reduced in subsequent debt reschedulings for countries judged to have been implementing adjustment policies successfully.³²

Similar considerations pertain to the debts of the low-income developing countries with debt-servicing problems. Their debts are overwhelmingly to official creditors and, for the lowest-income countries, are largely on a concessional basis. For example, the average interest rate of the developing countries of sub-Saharan Africa is about 5.5 per cent. While this rate is below the average for other developing countries, it is nevertheless still above the

growth in export earnings (especially for oil-exporting countries).

Besides the interest burden, amortization is threatening to become a heavy drain on foreign exchange earnings in low-income countries. As seen in table IV.7, sub-Saharan Africa is set to triple its annual repayments of principal to official creditors compared to the recent past. Repayment obligations for the rest of the decade are large because of an earlier accelerated pace of borrowing and because significant amounts of principal repayments have already been rescheduled or are in arrears and awaiting rescheduling. As in the case of interest payments, a lasting solution has yet to be found to obligations for repayment of principal.

As observed in a recent report of the Secretary-General:

Nearly 60 per cent of the present outstanding debt falls due during the next five years. It is obvious that, under present circumstances, contractual obligations for repayment of principal amounting to more than half a trillion dollars will not be met according to the original contractual terms. Further reschedulings, restructurings, roll-overs and write-offs for poorer countries will have to be agreed upon. It is also clear that the world does not need a slump for the debt problem to re-emerge as a system-wide issue of international concern.³³

³¹ Report of the Committee on the Review and Appraisal of the Implementation of the International Development Strategy for the Third United Nations Development Decade (Official Records of the General Assembly, Fortieth Session, Supplement No. 48 (A/40/48)), para. 22, "Agreed conclusions of the Committee...", para. 14. The General Assembly endorsed the agreed conclusions of the Committee in its decision 40/438 of 17 December 1985.

³² See IMF, *Recent Developments in External Debt Restructuring*, Occasional Paper No. 40, (Washington, D.C., October 1985), pp. 15-16.

³³ "International co-operation in the fields of money, finance, debt, resource flows, trade and development", (A/C.2/40/15), para. 59.

Table IV.7. Repayments of principal to official creditors by the developing countries of sub-Saharan Africa, 1979-1990

(Millions of dollars, annual average)

	1979-1981	1982-1984	1985-1987	1988-1990
Government creditors	465.5	617.8	2 110.1	2 158.6
Developed market economies	306.6	310.4	857.2	1 094.1
Centrally planned economies	80.6	105.5	385.8	381.2
Capital-surplus developing countries	45.5	137.4	730.1	581.1
Other countries	32.8	64.5	137.0	102.2
Multilateral institutions ^a	464.9	666.9	1 627.5	1 801.0
Total	930.4	1 284.7	3 737.6	3 959.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on World Bank, Debtor Reporting System and information provided by IMF.

Note: Data are for 42 countries reporting to the World Bank; data for 1979-1984 are actual payments; subsequent data are scheduled payments as of end-1984. Data for European Community institutions are grouped with developed market economies; similarly, data for Arab (or principally Arab) multilateral institutions are grouped with capital-surplus developing countries.

^a Includes IMF.

Official reserves assets and international liquidity of developing countries

The sources of international liquidity comprise foreign assets that can be quickly turned into convertible currencies by the monetary authorities and foreign credit available to Governments on an expeditious basis for use as balance-of-payments financing. The former constitute the official reserve assets of a country, which can be used without question and without delay to meet a balance-of-payments emergency. These assets consist of monetary authority holdings of foreign exchange, gold,³⁴ holdings of SDRs, and the reserve tranche at IMF.³⁵ As will be detailed below, official reserves of capital-importing developing countries, although increasing since 1983, have still not returned to the 1980 level. Meanwhile, many developing countries have lost the access to private commercial credit that was a major source of liquidity in the second half of the 1970s and up to 1982. The systemic implications of this shift are discussed in chapter V. For these developing countries, as well as for others that never enjoyed access to private credit, the only available sources of liquidity are their own official reserve assets and reliance on official sources of balance-of-payments credit, most prominently IMF.

The inadequacy of official reserve assets

A common rule of thumb for reserve adequacy is that the value of a country's official reserves should be suffi-

cient to provide the foreign exchange with which to cover at least three months of current-account expenses, primarily the cost of imports. Since imports are almost always purchased on credit, most of it short-term, maintaining such a supply of official reserves may be likened to an informal pledge of liquid collateral for import credits. In fact, the rule was a particularly cautious one for the 1970s, when central banks of several countries had opened credit lines with foreign commercial banks.

The capital-importing developing countries - although not all countries individually - held reserves that well exceeded the minimum criterion during the latter 1970s. In the recession years 1981-1982, however, over \$22-billion of official reserve assets were expended. The result was that even though there was a major fall in imports over the same period, the current expenditure coverage of reserves dropped to 1.9 months at the end of 1982, compared with 3.3 months at the end of 1979 (see table A.V.12).

Since then, a degree of world economic recovery allowed those developing countries that enjoyed resurgent exports to rebuild their reserve levels. By the end of 1984 more than \$22 billion in official reserves had been newly accumulated. However, while in aggregate the reserve accumulation in 1983 and 1984 equaled the reserve use in 1981 and 1982, the aggregate value of reserves at the end

³⁴ A further convention has been to value the gold component of reserves at the artificially low price of SDR 35 per ounce in recognition of the wild fluctuations that have occurred in the market price of gold since the early 1970s. While it might appear somewhat excessive to value gold reserves at less than 10 per cent of their market price, the convention can also be defended on the grounds that any attempt to sell more than a small portion of the gold reserves of most countries would seriously depress the market price itself. There is a valuation adjustment consequence of this convention which arises from the fact that when gold enters or leaves reserves, it is purchased or sold at market prices, but it is carried in reserve accounts at only SDR 35 per ounce; the significant size of the effect in 1980 and 1981 may be seen in table IV.8.

³⁵ The reserve tranche is, in effect, the amount of a country's IMF quota which has been paid in foreign exchange, gold or SDRs and which may be borrowed back virtually without restriction.

of 1984 was still \$15 billion below the level at the end of 1980. The reason is that while reserves are held in several currencies, they are valued here in the currency predominantly used by central banks when they operate in their foreign exchange markets, namely, the United States dollar. Measured against the dollar, the other currencies depreciated, causing the valuation loss.

In fact, exchange rate changes have had a major effect on the value of reserves throughout the current decade. As may be seen in table IV.8, in 1981 the level of reserves of the sample of the capital-importing developing countries fell over \$10 billion, while less than \$6 billion in reserve

assets were actually utilized. Similarly, in 1984 it was necessary to accumulate more than \$17 billion in reserve assets to raise reserves by less than \$13 billion. In contrast, the level of reserves rose by about \$7 billion in 1985, with only \$1 billion in net reserve accumulation. The primary cause of the difference in each of these cases was the change in the dollar value of non-dollar reserves arising from fluctuations in reserve currency exchange rates. While dollar assets themselves account for about two thirds of foreign exchange reserves, the wide swings in exchange rates have been sufficient to bring about annual valuation adjustments of non-dollar reserves of up to \$6 billion.

Table IV.8 Changes in official reserves of the capital-importing developing countries: a decomposition, 1980-1985

(Billions of dollars)

	1980	1981	1982	1983	1984	1985 ^a
Estimated purchases (+)/sales (-) of reserves resulting from balance-of-payments transactions	10.5	-5.6	-16.8	4.9	17.3	1.0
Minus expenditures needed to effect IMF quota increases ^b	-1.7	-	-	-1.5	-0.1	-
Equals estimated net purchases (+)/sales (-) of reserves, comprising	8.8	-5.6	-16.8	3.4	17.2	1.0
Foreign exchange	8.3	-6.8	-14.1	5.5	18.2	-0.2
Gold ^c	2.8	0.9	-0.8	-0.3	-0.5	1.1
SDRs ^d	-1.9	-	-1.3	-0.7	0.1	0.2
Reserve tranche ^d	-0.4	0.3	-0.6	-1.0	-0.6	-0.1
Flows in consequence of IMF policy decisions	3.1	1.3	-	1.5	0.1	-
SDR allocation	1.4	1.3	-	-	-	-
Generation of reserve positions through quota increases	1.7	-	-	1.5	0.1	-
Effects of valuation changes, comprising	-5.0	-6.0	-2.1	-2.7	-4.7	5.9
Reserve currency exchange rates	-2.1	-4.3	-2.2	-2.6	-4.3	6.2
Other ^e	-2.8	-1.7	0.2	-0.2	-0.4	-0.3
Change in stock of reserves ^f	6.9	-10.3	-18.8	2.2	12.6	6.9

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and information supplied by IMF. Sample of 93 countries.

^a Preliminary estimate.

^b Reserve tranche of each quota increase must be paid with foreign exchange, gold or SDRs.

^c Change in stocks during year valued at average London market price for year.

^d Net sales/purchases for year in SDRs, converted to dollars at average dollar/SDR exchange rate for year.

^e Arises from gold valuation adjustment and changes in the dollar value of SDR-denominated assets (SDR holdings and reserve position in Fund).

^f Change during year in level of reserves with gold valued at SDR 35 per ounce.

Despite the valuation loss during the period of the rising dollar, official reserves increased and at the end of 1984 reached 2.4 months coverage as restraint was maintained in the growth of imports. By the end of 1985, reserve coverage had risen to 2.6 months, largely because of valuation gains in reserves resulting from the fall of the exchange rate of the dollar and from the effect on the import bill of falling international commodity prices. In 1986, the continued fall of the dollar will have further valuation benefits for reserves. However, the cost of non-fuel imports should also increase considerably as the dollar depreciates.

Beyond the fact that the rule of thumb measure has not yet been met, additional evidence suggests that reserves remain at inadequate levels. First, the improvement in the aggregate reserve indicator has been in part a reflection of the continued restraint on the volume of imports. If the volume of imports had grown from 1983 to 1985 at the average rate of the 10 years to 1982 (i.e., 5.4 per cent per year) instead of having stagnated over the period, the coverage of reserves in 1985 would have been only 2.3 months, instead of 2.6 months.

Second, it is necessary to peer behind the aggregate data to the diversity of experiences comprising it. Thus, while the reserve coverage indicator for the capital-importing countries as a whole rose 0.7 months since the recession trough, the least developed countries have been unable to pull up their corresponding reserve coverage measure by even half that amount. Data at the country level are even more revealing, although complete data are available only with a considerable lag and sometimes not at all. Nevertheless, considering only the cost of merchandise imports, roughly 60 per cent of the capital-importing developing countries have had less than three months import coverage in each year thus far of the 1980s. There has, however, been some progress; in 1985 for the first time since the recession, less than 20 per cent of the countries had import coverage under one month.³⁶

Finally, reserves are inadequate because most developing countries now have very restricted access to other forms of liquidity, unlike the situation before 1982. In particular, international commercial banks no longer extend medium-term credit to the authorities of countries that have been in debt-servicing difficulties, except as forced lending which forms part of multilateral debt-restructuring agreements. Even including the credit lines that were opened as a result of those agreements, there has been a substantial decline in the availability of borrowed, private liquidity. One indicator of the trend at the aggregate level is the undisbursed credit commitments of banks to the capital-importing developing countries as a whole. As a share of outstanding debt to banks, undisbursed commitments have steadily fallen from 26 per cent in June 1980 to under 12 per cent in June 1985. As a share of foreign exchange expenditures on current account, undisbursed commitments fell from over 16 per cent before the decade began to a level that has fluctuated around 11 per cent since 1982.³⁷ In short, developing country holdings of reserve assets now have to carry more of the burden of providing official international liquidity.

Borrowed liquidity: the key role of the International Monetary Fund

With private markets receding as a source of liquidity, attention necessarily focuses on official credits and, in par-

ticular, on IMF, the institution established to be the major source of official liquidity for balance-of-payments adjustment.³⁸ Although IMF policy changes over the years have tightened the conditionality attached to the use of Fund credit³⁹ and thereby reduced its liquidity aspect, it remains a major form of balance-of-payments financing. Indeed, since 1980 IMF has provided over \$30 billion in net financial flows to the developing countries.

Throughout the 1980s, IMF has been very active in developing countries, as reflected by the number of stand-by or extended arrangements for Fund lending that were agreed in each year, as shown in table IV.9. Several important features emerge from this table. First, the average duration of IMF arrangements has been significantly smaller in the middle years of the decade than it had been in 1980-1981. In fact, no extended arrangements were agreed from 1983 until August 1985, when one agreement was reached for Chile. None have been arranged since. Second, commitments fell substantially after 1983, mostly because funds committed to higher-income countries in 1984 were only a sixth of what they were the previous year. Third, the average duration of arrangements for low-income countries has been disproportionately low compared to that of other developing countries, or compared to the adjustment capacity of low-income countries.

While the shortening of the duration of the arrangement suggests that IMF and the Governments of countries involved were expecting to complete their balance-of-payments adjustment at a relatively rapid pace, by the end of 1985 it was clear that adjustment programmes agreed with the Fund were not necessarily leading to sustainable balance-of-payments situations. Indeed, of the 26 developing countries that had IMF adjustment programmes in effect at the end of 1985, four countries were undergoing their fifth adjustment programme since 1980, seven countries were undergoing their fourth programme, and nine their third. Whereas IMF policy recommendations undoubtedly helped resolve the adjustment problems of many countries, others have been through a protracted series of adjustment efforts that have not spared the vulnerable groups of those countries and have not yet equipped the countries to operate successfully in a world environment that has repeatedly undercut economic expectations.⁴⁰

³⁶ Data in this paragraph are based on a sample of 96 developing countries for which sufficient data were available for estimation.

³⁷ Data pertain to undrawn commitments to all borrowers, not just official borrowers, but the trend indicated appears to result largely from the changed access of government borrowers. For the underlying data and methodological notes on its coverage, see Bank for International Settlements, "The maturity distribution of international bank lending", issued each June and December.

³⁸ Besides IMF, certain other official facilities have provided resources in amounts that have made a substantial addition to the liquidity of the individual country recipients, if not to the aggregate liquidity of the developing countries. These include the STABEX system of EEC (which was renewed in 1985 in the Lomé III Convention); the overdraft facility at the French Treasury, operated for a number of francophone African countries; the Arab Monetary Fund; the OPEC Fund; and oil-related facilities operated for several Latin American and Caribbean countries and established by Mexico, Trinidad and Tobago and Venezuela.

³⁹ See Sidney Dell, "On being grandmotherly: The evolution of IMF conditionality," Princeton University Essays in International Finance, No. 144 (October 1981) and "The fifth credit tranche," *World Development*, vol. 13, No. 2 (February 1985), pp. 245-249. See also Bahram Nowzad, "The IMF and its critics," Princeton University Essays in International Finance, No. 146 (December 1981).

⁴⁰ The literature on successes and disappointments in adjustment efforts has become massive. See, for example, UNICEF, *Within Human Reach: A Future for Africa's Children* (New York, 1985); IMF, *A Case of Successful Adjustment: Korea's Experience during 1980-1984*, by B. Aghevli and J. Márquez-Ruark, Occasional Paper No. 39 (Washington, D.C., August 1985); "Mauritius restores its financial stability, resumes strong growth based on exports", *IMF Survey*, 9 December 1985; John Williamson, ed., *IMF Conditionality* (Washington, D.C., Institute for International Economics, 1983); and Tony Killick, ed., *Adjustment and Financing in the Developing World: The Role of the International Monetary Fund* (Washington, D.C., IMF and Overseas Development Institute, 1982).

Table IV.9. IMF stand-by and extended arrangements for the developing countries, 1980-1985

	1980	1981	1982	1983	1984	1985
			<i>Number</i>			
Total arrangements	28	31	19	33	20	26
Low-income countries	12	14	9	12	8	12
Middle-income countries	9	13	7	14	9	8
Higher-income countries	7	4	3	7	3	6
			<i>Months</i>			
Average duration of arrangement	20	23	14	18	14	16
Low-income countries	20	23	12	16	13	14
Middle-income countries	24	22	16	14	16	16
Higher-income countries	20	24	15	25	14	20
			<i>Billions of SDRs</i>			
Total amounts committed	5.9	13.6	2.2	14.2	3.7	3.3
Low-income countries	2.7	7.4	0.6	1.3	0.4	0.6
Middle-income countries	2.3	3.6	1.4	2.2	1.5	1.0
Higher-income countries	1.0	2.5	0.2	10.8	1.8	1.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on announcements of IMF arrangements published in *IMF Survey*, various issues.

Note: Income groupings are defined according to whether per capita GDP in 1980 dollars was below \$500, from \$500 to \$1500, or above \$1500. For a listing of countries in each grouping see UNCTAD, *Handbook of International Trade and Development Statistics, 1985 Supplement* (United Nations publication, Sales No. E/F.85.II.D.12).

The international community is now seeking to give greater emphasis in adjustment programmes to raising the rate of economic growth more rapidly, stimulating investment and savings and improving sectoral policies. Co-operation is being intensified among IMF, the World Bank and the regional development banks, while the Fund itself has been reviewing the supply-side aspects of its adjustment programmes in connection with an internal review of conditionality criteria.

However, IMF is likely to be quite constrained in the finance that it offers to countries that approach it for assistance in the near term. As a result of the extensive drawings on Fund resources in previous years, developing countries now need to repay these credits if the revolving nature of IMF resources is to be preserved.

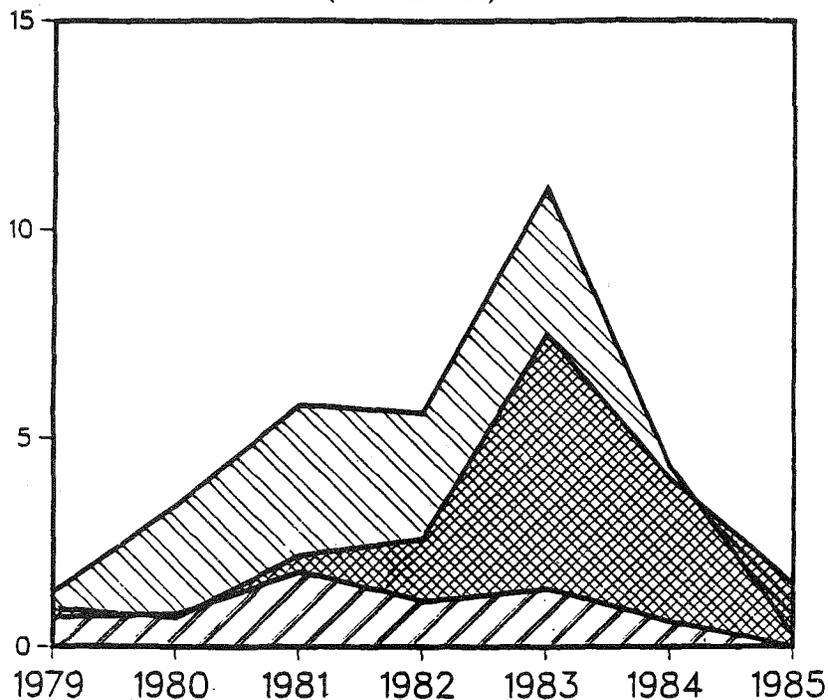
In fact, the net flow of IMF credit to the developing countries already fell almost to zero in 1985 and was almost \$500 million negative in the first two months of 1986. In 1985, net repayments of almost \$1 billion were made to the specialized windows - the Compensatory Financing Facility, the Buffer Stock Financing Facility and the Trust Fund. These reflows almost offset the continuing, albeit reduced, net flow of credit through regular facilities (see table A.V.13). The decline in net Fund flows has affected all regions of the developing world. Countries of Asia and Europe, which started their borrowing relatively early in the decade, began to make aggregate net repay-

ments already in 1985. Net lending to Africa fell virtually to zero, and only Latin America, whose borrowing had not been extensive before 1983, remained a net recipient of Fund resources in 1985 (see figure IV.6).

For the rest of the current decade, the repayment obligations of the developing States members of IMF are quite large. Including repayments of Trust Fund loans, developing countries are scheduled to repay over \$32 billion from 1986 to 1990, with annual payments averaging over \$7 billion from 1986 to 1989.⁴¹ Even if the world economy does not falter in this period and if the debt situation of the high-debt developing countries is successfully managed, the servicing of debt to IMF will still impose a significant burden on many developing countries. As of early 1986, two developing countries had already fallen so seriously in arrears to the Fund that they were declared ineligible to use IMF resources or any SDRs that they might subsequently acquire should there be new SDR allocations. The two are extremely poor countries which have been caught in especially difficult economic and political circumstances. They are not, however, the only countries in arrears. Indeed, in apparent concern about the possibility of a mounting problem of arrears, the Executive Board of IMF enacted a series of measures in February, March and June 1985 to establish official procedures for treating cases of overdue obligations to IMF.

⁴¹ Based on IMF, "Financial statements of the General Department" and related statements, quarter ended 31 October 1985 (figures in text include Trust Fund repayments; fiscal year data converted to calendar year basis through pro-rata adjustment; data in SDRs converted to dollars at end-December 1985 exchange rate).

Figure IV.6.
Net flow of IMF resources to the developing countries, 1979-1985
(Billions of dollars)



COVERAGE

- ▨ Asia and Mediterranean
- ▩ Latin America and Caribbean
- ▧ Africa

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*.

In recognition of the continuing balance-of-payments difficulties faced especially by low-income countries undergoing protracted adjustment, the Executive Board of the Fund established a new Structural Adjustment Facility (SAF) in March 1986. It is to be financed by repayments of Trust Fund loans, totaling SDR 2.7 billion due between the end of 1985 and early 1991.⁴² Like the original Trust Fund, the new credits will again be on highly concessional terms - loans will be for 10 years with a five-year grace period and will carry annual interest charges of 0.5 per cent.

Although all countries which are eligible to borrow from IDA would have access to the new SAF, both China and India announced that they would not draw on the new facility, making it possible to concentrate the resources on a number of countries most in need. Some of these might otherwise have difficulty in meeting repayment obligations on at least part of their debt, potentially including repayments to the Fund itself. To draw on SAF, countries will have to devise three-year adjustment programmes jointly with the staff of the Fund and the World Bank. The

programmes will embody the outline of structural adjustment measures and the expected path of macro-economic policies. SAF commitments will be for three-year periods, with resources to be made available under separately approved annual arrangements.

While the array of measures described above will ease somewhat the liquidity constraint faced by a large number of developing countries, many will still face a severe liquidity shortage, whether measured in terms of their own reserves or in access to the conventional forms of credit for balance-of-payments financing. In the 1982 crisis, two unusual forms of credit were brought to bear in response to the shortage of normal liquidity. One was the *ad hoc* emergency bridging operations organized by the Governments of several creditor countries in conjunction with the Bank for International Settlements. The other was, simply, not making contractual payments on credits and thus, in effect, obtaining forced credits through arrears.

Since 1981, accumulated arrears have grown by over

⁴² See *IMF Survey*, 31 March 1986, p. 109.

\$20 billion.⁴³ The announcement made in 1985 by certain countries that they would unilaterally restrict their debt-servicing to a fixed percentage of export earnings suggests that at least for those countries arrears might accumulate further. And although, as discussed above, developments in international prices, interest rates and exchange rates in 1986 will substantially ease the debt-servicing burden of most developing countries, numerous countries will remain in a precarious condition and in need of an infusion of liquidity in the short-run. Indeed, Latin American countries, meeting at the end of 1985, sought to emphasize the seriousness with which they viewed the debt situation by observing that under existing trends, they might be obliged to limit their "net transfers of resources in order to avoid greater social and political instability, which could reverse the process of consolidating democracy".⁴⁴

Developing countries have been attempting individually to construct a better cushion of liquidity as circumstances have permitted. Since this now has to be done almost entirely through the build-up of official reserve assets, it dampens the import growth of many countries. In a time of slow growth in world trade, this necessary cautionary bias robs the world economy of what had in the past been one major impetus to trade. In other words, whether or not there is a global shortage of liquidity, there are global implications arising from a shortage of liquidity in a major component of the world economy. The international community can and should deal with that shortage, and new arrangements in IMF would provide an opportunity to do so along the lines of the recommendations presented in chapter I.

⁴³ Based on an IMF estimate published in *World Economic Outlook*, April 1986, table A40.

⁴⁴ Montevideo Declaration, adopted on 17 December 1985 by the Ministers for Foreign Affairs and the Ministers of Economic Affairs of the States parties to the Cartagena Consensus, (see A/41/254 - E/1986/61, annex, p. 6).

Chapter V

SYSTEMIC ISSUES IN THE INTERNATIONAL TRADE AND MONETARY FIELDS

The current world economic situation and the medium-term prospects for the world economy cannot be seen in isolation from the framework of the institutional arrangements within which the international economy is supposed to function. These arrangements, largely established at the end of the Second World War, were designed primarily to ensure a degree of stability and openness in the international economy which were considered essential for the healthy growth of world output and world trade after the disastrous experience of the period between the two world wars. These arrangements are often referred to as the international trading system and the international monetary system.

While both systems are considered to have functioned reasonably well during much of the post-war period, their working over the past decade has been causing serious concern. The arrangements made in the field of trade were

aimed at creating and maintaining an open multilateral trading system, but in recent years they have increasingly failed in this. Similarly, the international monetary system, which was expected to ensure stable but flexible relationships between currencies and to satisfy the liquidity needs of an expanding world economy, has been marked since the early 1970s by excessive fluctuations and persistent misalignments of exchange rates and by its apparent failure to create adequate liquidity in an equitable way. Moreover, the malfunctioning of the international monetary system has been actually detrimental to the open multilateral trading system by contributing to the rise of protectionism in recent years.

The present chapter examines some of the basic issues of a systemic nature, as well as recent efforts at reform, in these two major areas of international economic relationships.

The international trading system

Concern about the working of the international trading system is not new, it has frequently been expressed over the past decade; recent developments, however, have heightened it.

It is widely accepted that the unprecedented growth of world output in the post-war period was closely associated with a rapid growth of world trade. Though the causal links between growth of production and expansion of trade are unclear, there is no doubt that they reinforced each other. There is no doubt either that the growth of trade during this period would not have been possible without the dismantling of some of the very high trade barriers that existed at the end of the war. Ample historical evidence exists showing that competitive erection of trade barriers by countries can lead the world into recession which, in turn, can contribute to further reduction in the volume of trade.

Concern over the working of the trading system derives partly from the fact that, in recent years, the responsiveness of international trade to the growth of world output appears to have been declining. Not only has the growth of trade been slowing but, as analysed in chapter III, each percentage change in world income is becoming associated with a slower change in trade than before. The increased protectionist tendencies evident in many countries have almost certainly contributed to such decline. Probably more important than any direct causal relationship between the two is, however, the fact that recent developments in trade relationships among countries have tended to erode the multilateral trading system which is essential for an expanding international economy.

National interest, trade and international rules

Although it is generally admitted that an open, multilateral system is essential for the functioning and prosperity of an increasingly interdependent world economy, this is not always reflected in national perceptions of the benefits to be derived from the system. The rhetorical commitments to it often fail to find expression in actual policy. Thus, while the long-term benefits of international specialization may not be questioned, the very development of industries in which an individual country could eventually specialize may require policies which conflict with the principles of free trade. Hence, for example, the infant industry arguments for protection.

Similarly, in a world where adjustments in industrial structure did not involve any short-term costs to the economy, changes brought about by trade and specialization would present no problem. In reality, the costs involved may be substantial even though the long-term benefits are higher. Furthermore, in particular cases, such as agriculture, perceived social goals rather than economic benefits may dictate national policies. Countries may also feel that their interests are best served by regional economic integration. The requirements of such schemes are almost by definition at variance with the concept of a truly multilateral system.

Many of the difficulties of international co-operation for expansion of trade arise from considerations such as these and a workable trading system has to be flexible enough to take them into consideration. At the same time, no system can work unless certain basic rules, mutually agreed upon, are obeyed.

There are several reasons why rules are needed. First, despite the acceptance of a liberal trading régime as a major plank of declared government policy in many coun-

tries, there remains a latent but powerful mercantilist sentiment in practically every country. To have exports growing faster than imports often appears to be a criterion for success of economic policy even though the absurdity of continuing of such a policy over an extended length of time is as obvious as the impossibility of all countries pursuing it simultaneously. Such a perception of national economic welfare leads to a quest for unfair advantages in export markets and unjustifiable protection for the home market. Rules are necessary to keep such tendencies in check and to ensure that balance-of-payments adjustment measures are taken not only by deficit countries but also by surplus countries.

Secondly, countries are not equal and are not at the same stage of development and hence do not have the same economic power. If all countries are to participate in international trade, it is necessary to devise rules that are equitable and that take account of the special needs of less developed countries. Thirdly, a workable multilateral system requires a degree of predictability and transparency of the participants' action affecting trade, and rules are needed to ensure both.

Finally, and closely related to the first reason, the impact of imports on domestic producers is concentrated and visible while their benefits to consumers are more diffuse. Producers therefore normally have a stronger voice in demanding protection than consumers have in urging liberal import policies. The power of producers' lobbies has often been able to influence national trade policies and their influence has increased in some countries in recent years. A set of binding international rules in support of liberal trade is a source of strength for national Governments in resisting domestic protectionist pressures.¹

The basic rules of international trade that a large majority of countries have come to accept are embodied in the General Agreement on Tariffs and Trade, the primary objective of which was the creation and maintenance of an open and multilateral trading régime. The principle of non-discrimination, reflected in the immediate and unconditional grant of most-favoured nation (MFN) treatment by each participant to all others, was to be the linchpin of the system. The rules prohibited quantitative restrictions to trade, leaving tariffs - which were themselves to be reduced to a minimum - as the only legal means of protection.

It was recognized that no single set of rules could be universally applied to all situations in a world of great diversity. Therefore exceptions to the general rules had to be built into the Agreement. It soon became apparent that, in order to enable the developing countries to participate in the system, their special needs had to be recognized. Provisions were therefore added, under which developed countries would not expect developing countries to undertake trade measures inconsistent with their development needs and would not ask for reciprocity from those countries in the course of trade negotiations. The generalized system of preferences was formulated under a waiver of

the MFN rules. The Tokyo Round of multilateral trade negotiations provided a firm legal basis for such preferential treatment under the so-called "Enabling Clause".

GATT principles were essentially designed for liberal economic systems, in which direct government participation in foreign trade transactions in particular was supposed to be rare. Except for Cuba and Czechoslovakia, which were among the earliest signatories to the Agreement, the centrally planned economies remained outside the system. Three others (Hungary, Poland and Romania) later acceded to the Agreement.

Erosion of the system

In examining the erosion of the international trading system in recent years, it is necessary to recall that a significant proportion of international trade was virtually left out of the system almost from its inception.

While agriculture was not excluded from the Agreement and negotiations on trade in agricultural products have taken place under its auspices, the special status of agriculture has been accepted from the very inception of the system. Historically, this was largely a reflection of the weight that the agricultural policies of the United States carried in the negotiations that resulted in the system. This, together with the evolution of the Common Agricultural Policy of the European Economic Community, and of protectionist policies in other countries, all justifiable under GATT rules, has insulated a vast area of world agricultural production and trade from international market forces. The rules of the system provide a number of exemptions for agriculture. Although quantitative import restrictions and export subsidization are permissible only under certain circumstances, justification for them can almost always be found.

A second major area practically left out has been trade in textiles. The GATT rules prohibit quantitative restrictions on trade in manufactures. By keeping textiles out of the system it has been possible to subject international trade in these products to such restrictions. Largely a response to what was seen as market disruption from "cheap" exports, the Long-term Arrangement Regarding International Trade in Cotton Textiles of the 1960s sought to regulate imports of textiles in the major developed market economies, and many parts of it were worked out bilaterally between the supplying and importing countries. The Long-term Arrangement was the precursor of a more comprehensive and restrictive series of agreements - the Arrangement Regarding International Trade in Textiles, known as the Multifibre Arrangement. This Arrangement also covered synthetic fibres which were becoming increasingly important in trade in textiles.

Agriculture and textiles are examples of two large areas in which application of GATT rules came to be avoided as a matter of policy. As shown above, the devices by which these sectors were protected have a long history. They involved various forms of quantitative restrictions which

¹ Frieder Roessler, "The Scope, limits, and functions of the GATT legal system", *The World Economy*, vol. 8, No. 3, (September 1985).

have become common practice in international trade relations.

Protectionism, already on the rise during the 1970s, has gone far beyond agriculture and textiles, and has become widespread in recent years. The nature of protection has, however, been changing. Tariffs as an impediment to international trade have become relatively less important. They were significantly reduced during the Kennedy Round, and as a result of the Tokyo Round of tariff cuts, average tariffs in the major industrial economies have been reduced to around 5 per cent. This, of course, does not mean that tariffs no longer impede or distort trade. The structure of tariffs in the developed market economies still distorts international trade through the high level of effective protection that it provides, particularly against exports from developing countries. Tariffs in many developing countries also remain very high. All the same, non-tariff measures have become a much more important barrier to trade. This is in part a result of the progress in tariff reductions: non-tariff measures are now the more effective instrument. Although they are, in principle, prohibited under GATT rules, they may be justified under escape clauses.

The erosion of the trading system has taken the form of derogation of rules, bilateralism, and resort to less transparent forms of protection. "Voluntary" export restraints, tariff quotas, anti-dumping and countervailing duties, and the use of subsidies on production and trade are the most important.² There has been a drift towards managed or organized trade.

The application of quotas and "voluntary" export restraints has become more frequent. While these restraints and some forms of surveillance were in the past limited to such items as textiles and footwear, they are now being applied to other products, for example steel, motor vehicles and certain electronic products. A large proportion of world trade in the last three categories of products is already subject to quotas or other forms of quantitative restrictions. The Multifibre Arrangement has become more stringent over the years. Quota restrictions have been imposed on exports of clothing from some newly emerging developing country exporters. In other cases, existing voluntary restraints have been strengthened and extended.

A recent GATT report lists 94 export restraint arrangements made outside GATT which were in existence in 1985 and covered a large number of products.³ Many of these arrangements have been in existence for a number of years. The use of other forms of restrictive measures is reflected in the number of anti-dumping and countervailing measures taken by various countries. During 1984-1985,

almost 200 anti-dumping actions were taken and reported to GATT on top of the 560 actions outstanding. Almost 80 countervailing actions were taken by the reporting countries and about 100 actions were outstanding.⁴

In an UNCTAD study,⁵ it is estimated that in 1984 almost 45 per cent of agricultural imports of the developed market economies was subject to some form of non-tariff restriction in 1984, compared with around 37 per cent in 1981.

According to another study, 15 per cent of the exports of manufactures from Japan and four newly industrializing countries to the OECD countries was subject to various forms of non-tariff barriers in 1980. By 1983, the share had risen to 30 per cent.⁶ In the same study, it is shown how the number of suppliers affected by the various forms of non-tariff barriers has increased over time: under the first Multifibre Arrangement, the United States had bilateral agreements with 19 supplying countries but these did not specify any explicit limits on imports of sensitive items. Under the second Multifibre Arrangement, specific limits were applied to 7 countries and, under the third, to 14 countries. For EEC, the number of countries covered by bilateral agreements increased from 33 under the first Multifibre Arrangement to 43 under the third.

Quantitative restrictions on developing country exports are much more widespread than those on developed country exports. In 1984, while 35 per cent of the former was subject to such restrictions, the corresponding figure for the developed countries was 21 per cent.⁷

A recent phenomenon, which is partly a reflection of the weakening of the multilateral system is the growing volume of countertrade. The resurfacing of this kind of trade in recent years has been mainly due to the persistent balance-of-payments difficulties of many developing countries. Though it still accounts for only a small proportion of total world trade, its growing importance appears to be further evidence of a trend towards bilateralism.⁸

Another recent tendency which is symptomatic of a certain dissatisfaction with the working of the existing system is an increased emphasis on what is perceived as "fair trade". It is argued, particularly in countries with persistent balance-of-trade deficits or a declining share of international trade, that foreign competitors often indulge in unfair practices.

The GATT system clearly recognizes the importance of maintaining a fair trading system. Nevertheless, recent initiatives at the national level appear to reflect a hardening of attitudes to what is perceived as a growing frequency of

² See also "Some notes on recent changes in commercial policy of developed market economies", *Supplement to World Economic Survey 1981-1982* (United Nations publication, Sales No. E.82.II.C.2).

³ Note by the GATT secretariat on developments in the trading system, April-September 1985 (L/5915, 21 November 1985).

⁴ GATT, report of the Committee on Anti-Dumping Practices (L/5901), 1 November 1985, and report of the Committee on Subsidies and Countervailing Duties (L/5902, 5 November 1985).

⁵ "Problems of protectionism and structural adjustment: report by the UNCTAD Secretariat" (TD/B/1039, Part I).

⁶ OECD, *Costs and Benefits of Protection*, (Paris, 1985).

⁷ "Problems of protectionism and structural adjustment: report by the UNCTAD Secretariat" (TD/B/1039, Part I), table 3.

⁸ For a detailed analysis, see *Countertrade in Developing Countries* (forthcoming United Nations publication).

unfair practices by competitors which the system seems to be unable to deal with effectively. One such measure is the United States Trade and Tariff Act of 1984. Among other things, the Act re-emphasizes reciprocity, makes it easier for the United States industries to obtain import relief through legal action, requires the administration to keep a stricter surveillance of the barriers to the country's exports and investment abroad and mandates a criterion for determination of material injury to domestic industry in anti-dumping and countervailing duty cases, which would increase the likelihood of their obtaining import protection.⁹ More recently, the United States Administration decided to subsidize credit to domestic industries in some cases as a measure to counter similar practices in other countries.

The legislation of a large number of countries concerning anti-dumping, subsidization, and countervailing measures is also under examination in the various committees of GATT. Action to combat unfair practices of foreign competitors does not violate GATT rules and partners who feel unfairly treated by such fair trade legislation can seek redress through the dispute settlement procedures of GATT. Nevertheless, the proliferation of unilateral measures and bilateral agreements called for in the national legislation of many countries is a reflection of the strain on the present system.

From its inception, elements of what some would call flexibility but what others would describe as weakness have been built into the rules of GATT. There are large numbers of exceptions to the general rules. Article XXV of the Agreement provides for waivers to be given to Contracting Parties in respect of particular obligations under special circumstances. It has been observed that, without this flexibility, the system would have broken down a long time ago.¹⁰

Such waivers and exceptions to the general rules are, of course, necessary. The circumstances in which escape clauses can be invoked then become important. Action under article XIX, for example, can be taken in circumstances that do not call for it. The distinction between legal action and derogation of the rules appears to have become blurred. GATT rules are being increasingly flouted in both letter and spirit.¹¹ It is almost always possible for a country to find in the rules an apparent justification for a restrictive trade measure even though the action may ultimately be declared illegal. The GATT dispute settlement procedure is time-consuming and a Contracting Party can continue to apply an illegal measure while the dispute remains unresolved.

Disregard of the rules, even by a single country or in an apparently unimportant case, creates a precedent and is

self-perpetuating. It breeds more trade impediments, gives rise to friction among countries and strengthens protectionist sentiments. All these lead to bilateralism and market segmentation, weaken market signals, distort resource allocation and make structural change more difficult. An overriding objective of any future multilateral trade negotiations must be to improve the rules and strengthen their implementation.

Reform and strengthening of the system: efforts and issues

Significant expansion of world trade could be expected from the removal of present barriers to trade. One study indicates that an MFN removal of tariff and identifiable non-tariff barriers from major exports of the developing countries to the major developed market economies would lead to a 10 per cent increase, or around \$30 billion at 1980 prices, of these exports.¹² It would also increase the total imports of these economies from all sources by a similar proportion. These figures are not insignificant, particularly in view of the current slow growth of world trade and their importance for the solution of the debt problem of the developing countries.

Commitments to a liberal trading system are often highly qualified. Of particular relevance to the erosion of the system in recent years is the fact that slow economic growth and high unemployment have made structural adjustment more difficult. Rigidities in labour and product markets have increased the difficulties. These factors have made for increased resistance to change, closer interaction between government and domestic group interests threatened by change, and a demand for reciprocity in trade barriers. Future negotiations for strengthening the system may well turn out to be unusually complex and, if past experience with previous trade rounds is any guide, it may be well into the 1990s before concrete results materialize.

Review of past attempts

The Tokyo Round of multilateral trade negotiations, besides seeking to reduce tariff barriers, also aimed at "improvement of the international framework for the conduct of world trade".¹³ The agreements of special importance in this regard were those relating to anti-dumping practices, and subsidies and countervailing measures. The Anti-Dumping Code and the Code on Subsidies and Countervailing Measures have been signed by most industrial countries and a few developing countries.

A major disappointment of the Tokyo Round was the failure to reach agreement on a revision of the multilateral safeguard clauses. Article XIX, which authorizes emer-

⁹ Eliza Patterson, "Features of the Omnibus Trade Act in the United States", *The World Economy*, vol. 7, No. 7 (December 1984).

¹⁰ Eric Wyndham-White, "Negotiations in prospect", *Toward a New World Trade Policy: The Maidenhead Papers*, C. Fred Bergsten, ed. (Lexington, Massachusetts, Lexington Books, 1975).

¹¹ GATT, *Trade Policies For A Better Future: Proposals for Action*, report of an independent group of experts, (GATT publication, Sales No. GATT, 1985-1). In a pointed reference to the working of the system the Group says that "the critical problem today is that trade rules are no longer seen as being fully effective, nor generally obeyed" (p. 18)

¹² "Problems of protectionism and structural adjustment: report by UNCTAD Secretariat" (TD/B/1039, Part I). UNCTAD, *op. cit.*

¹³ The Tokyo Declaration, *The Tokyo Round of Multilateral Trade Negotiations* (GATT publication, Sales No. GATT/1979-3), Annex B.

agency action of a temporary nature, has at times become a vehicle for protectionist practices, is sometimes circumvented by arrangements outside the Agreement and is often simply disregarded. The areas of disagreement were wide, for instance, on the criterion for the determination of serious injury, or threat of such injury, that would justify import restrictions. Article XIX as it stands at present specifies that such restrictions must be applied on a non-discriminatory basis. There were sharp differences of opinion on the subject, and many countries argued that import restrictions should be applied only to those exporting countries that were causing the injury. The negotiators also failed to agree on the role of structural adjustment as an instrument of policy for dealing with increased imports.

As in the past, agriculture was treated as a special case and there was little progress in bringing it under the normal discipline of the GATT system. Two opposing points of view were sharply in evidence. The United States wanted to treat agriculture on a par with manufactures in most negotiations for trade liberalization, while EEC emphasized the special place of agriculture and the need for a different approach. Although Tokyo the Round produced separate agreements on bovine meat and dairy products, there was no agreement on a multilateral framework for trade in agriculture.

The GATT Ministerial Meeting of 1982, which was held in an atmosphere of growing tension between the United States, Japan and EEC, underlined the danger to the system and the need for action. In the Ministerial Declaration adopted at the end of the Meeting, it was noted that "despite the strength and resilience which it has shown, the stresses on the system, which are reflected in the growing number and intensity of disputes between contracting parties, many of which remain unresolved, have made more pronounced certain shortcomings in its functioning".¹⁴ It was also noted that the "existing strains have been aggravated by differences of perception regarding the balance of rights and obligations under the GATT, the way in which these rights and obligations have been implemented and the extent to which the interests of different contracting parties have been met by the GATT ... Disagreements persist over the interpretation of some important provisions and over their application. Disciplines governing the restriction of trade through safeguard measures are inadequate".

The GATT Ministers took a number of important decisions on strengthening the system, including a pledge and a programme of work to ensure the consistency of trade policies; ensure effective implementation of GATT rules and provisions for the developing countries and special treatment for the least developed countries; bring agriculture more fully into the multilateral trading system; bring into effect a comprehensive understanding on safeguards; ensure increased transparency of trade measures and effective resolution of disputes through improvement in the procedures; and examine ways and means of liberalizing

trade in textiles and clothing and the eventual application of the Agreement to it.

The programme called for a comprehensive understanding among the Contracting Parties on the questions relating to transparency of safeguard measures, objective criteria for action, including determination of serious injury, the temporariness of such measures and their link with structural adjustment, and multilateral surveillance of national measures. However, no consensus on an understanding has so far been reached and informal consultations among the Contracting Parties continue.

A Committee on Trade in Agriculture was set up to carry out an examination of all major aspects of such trade, with a view to bringing it more in line with the objectives of the Agreement. The Committee has been examining the trade practices of individual countries, including subsidization, and has made recommendations which call for elaboration of a number of approaches as a basis for future negotiation.

In the Ministerial Declaration, the need for differential and more favourable treatment for the developing countries was reiterated; the Committee on Trade and Development was instructed to undertake consultations with the Contracting Parties on the ways in which individual Parties have responded to the requirements of the articles set forth in Part IV of the Agreement. These consultations are being undertaken and are considered to be a useful way of reviewing the implementation of this aspect of the Declaration.

The Group on Quantitative Restrictions and Other Non-Tariff Measures was asked to review all existing measures of this nature in order to eliminate practices that do not conform to GATT rules or to bring them into conformity, and to achieve progress in liberalizing these restrictions. The Group has decided, among other things, to invite complete national notifications of quantitative restrictions including an assessment of their trade effects, and to conduct a multilateral review in 1986.

Also called for in the Ministerial Declaration was a study of the trade prospects in textiles and clothing of developing countries, and of the possibilities of liberalizing trade in these products and bringing it under full GATT discipline. The Working Party on Textiles and Clothing has examined various options for fulfilling these objectives, but has not been able to develop a consensus on more than that GATT rules should ultimately apply to trade in these products.

A speedy dispute settlement mechanism is crucial to the working of the system. The understanding on notification, consultations, surveillance and dispute settlement negotiated in the Tokyo Round provided the essential framework. So far, however, it has not been possible to deal effectively with the growing number of problems in this area.

The results of efforts made so far to strengthen the work-

¹⁴ Ministerial Declaration, *GATT Activities in 1982*, (GATT publication, Sales No. GATT/1983-2), chap. II.

ing of the system have thus fallen far short of the high expectations expressed in the Ministerial Declaration. In some cases, the absence of action has been due to differences of opinion about the jurisdiction of GATT. In other cases, there have been differences on such basic questions as the universality of application of the MFN principle or the legitimacy of reciprocity in removing trade impediments which violate GATT provisions or of treating such impediments on a par with those that are legal under GATT rules.

A new round of trade negotiations: some major issues

What should be the next step in international efforts to strengthen the trading system? Many countries have taken the position that a successful resolution of the issues with which the 1982 GATT work programme was concerned remains a matter of top priority. Other countries have emphasized the need to go beyond the work programme and argued for considering it in the framework of a new round of trade negotiations. Some of the latter countries have also stressed the need for a new round of talks for combating the rising protectionism.

At the special session of the Contracting Parties to GATT held in September 1985, it was decided to initiate preparations for a new round of negotiations. At its forty-first regular session (November 1985), GATT set up a preparatory committee to determine the objectives, subject matter and modalities of the new round, taking into account the elements of the 1982 work programme.

It is clear that any forthcoming multilateral trade negotiations must be based on careful preparations and will take a long time to complete even under the most favourable circumstances. The Tokyo Round took six years and the Kennedy Round before it four years. It may therefore be preferable to seek resolution of the main issues within the current framework of the GATT work programme instead of waiting for the new multilateral negotiations.

The increased concern about the state of the multilateral trading system has led to renewed discussion of the major issues of international trade. The study prepared by an independent group of experts under GATT auspices entitled *Trade Policies for a Better Future: Proposals for Action*,¹⁵ contains recommendations which deserve serious consideration by policy makers and negotiators.

Most of the issues that will figure prominently in any future discussion, whether in the existing framework or under a new round of talks, have been highlighted above. They will include, in particular, an understanding on the safeguard mechanism, the bringing of agriculture and textiles under normal GATT discipline, the removal of quantitative restrictions in other areas, structural adjustment, and the strengthening of GATT rules and surveillance and dispute settlement procedures.

In addition, the issue of graduation has also been raised. While the need for differential treatment for the developing countries has been recognized under GATT, it was accepted, as in the Tokyo Round decision concerning differential and more favourable treatment, reciprocity and fuller participation of developing countries, that these countries would, as they become more developed, participate more fully in the system's framework of rights and obligations. From the point of view of the working of the system, any steps that strengthen the balance of rights and obligations under its existing rules should be welcome, including those that a more advanced developing country may be able to take to accept normal disciplines of the GATT more fully. Such an action may be in the interest of the country itself, to the extent to which it gains access to foreign markets and opens its domestic market to foreign competition.

Three important considerations should, however, be mentioned. First, even the most advanced of the developing countries still lack the strength to participate fully in the system. Secondly, developed country trading partners cannot unilaterally decide which developing country has the capacity to reciprocate, particularly if this is done on the basis of indicators that, of late, have proved to be highly volatile. To do so is to risk further erosion of the system through bilateralism and market segmentation. Thirdly, one way the power of precedence can be made to work towards the strengthening of the system is for the developed countries themselves to accept GATT discipline more fully than they have so far, setting an example for the less developed countries to follow.

Trade in services. The GATT Ministerial Meeting of 1982 recognized the importance of trade in services and called for national examination of the issues involved, exchange of information between countries and a review of that information. The initiative to include trade in services in discussions on the trading system has come from the developed market economy countries, especially the United States. Many developing countries have opposed the idea of negotiation on the subject within the GATT framework, partly on the ground that the Agreement's sphere of competence is restricted to trade in goods only and does not extend to trade in services. However, much more than a technical question of competence is involved.¹⁶

The difficulties start with the definition of services. These difficulties were discussed in the national studies called for in the Ministerial Declaration and are noted in an analytical summary of the studies prepared by the GATT secretariat. Some of these studies characterize services as intangible goods that cannot be stored, re-used or transported. Others do not attempt to define them but simply list activities which they consider services, and here the coverage varies greatly. A broad and generally ac-

¹⁵ GATT publication, Sales No. GATT/1985-1)

¹⁶ The literature on the subject is growing apace. For a discussion on the concepts of services and their role in trade and development see, for example, UNCTAD, *Production and Trade in Services: Policies and Their Underlying Factors Bearing Upon International Service Transactions* (United Nations publication, Sales No. E.84.II.D.2).

ceptable list would include activities such as accounting, advertising, banking, professional and technical services, communications, construction and engineering, health, information and legal services, motion pictures, tourism, and transport.¹⁷ The "tradability" of services varies widely among the categories.

The problems of definition coupled with the weaknesses of most balance-of-payments statistics make it difficult to assess with any degree of accuracy the importance in world trade of trade in services. Balance-of-payments statistics usually distinguish only broad categories of exports and imports of services, classified into factor services and non-factor services, the latter consisting of freight, passenger services, transport insurance, travel (tourists' expenditure in the foreign country), port services and other private services. Non-factor services together amounted to around 22 per cent of world merchandise trade in 1980. The share has remained practically constant over the 1970s or may have declined slightly.¹⁸ For more recent years and for the seven largest developed market economy countries, exports and imports of non-factor services as a proportion of their total merchandise exports and imports also remained practically constant at around 20 per cent between 1976 and 1983.¹⁹

The importance of services in international trade increases if factor services are included. This also increases the complexity of the issues. In balance-of-payments statistics, income from foreign direct investment and interest earnings on foreign loans are included under factor services and make up a large proportion (around 35 per cent) of world trade in services (around 13 per cent of total merchandise trade in 1980).²⁰

Although the share of services in total trade appears to have remained practically unchanged over the years, there are a number of reasons for the growing attention that the subject has been receiving recently. Some of the components of trade in services, not always captured in balance-of-payments statistics, have grown very fast, new categories of services have entered the field and new technologies are rapidly changing the nature of some services. Above all, the revolutionary developments in information technology involving collection, processing and storing of data have led to a sharp increase in transborder flows of information and trade in data services. They have also vastly facilitated international banking. In fact, the opening up of the banking sector to foreign competition underlies much of the discussion on expansion of trade in services. It is to these "growth poles" rather than to the traditional services that recent interest in services is directed.

Another major consideration is the close relationship between trade in services and foreign investment. As pointed out above, dividend income from foreign invest-

ment is an important component of income from trade in services. Given the large role and the growth of foreign direct investment, the inclusion of investment income in the category of service transactions obviously enhances the importance of the subject. For at least some countries, a large proportion of total services transacted is delivered through investment decisions. The inclusion of such foreign investment in issues related to trade in services raises a number of considerations which many countries do not consider as trade issues and which usually involve sector-specific legislation and regulation.

Conceptual difficulties also arise when, as in balance-of-payments statistics, investment income from service industries is considered as factor income while workers' remittances are not. This is not a matter of statistical definition alone. Countries with a large actual or potential immigrant labour force may not wish to treat payments for services of foreign workers in the same way as services of foreign banks or retail stores, and would prefer to discuss issues of immigration in other forums.

Trade in services also raises theoretical and empirical considerations relating to the development process itself. It has been observed that, as an economy grows, after a certain point the tertiary (service) sector assumes increasing importance. Services in fact account for by far the largest proportion of GDP of the advanced countries. It can be argued that a parallel shift in importance from trade in goods to trade in services should naturally be expected. Furthermore, patterns of comparative advantage among countries change over time, and such changes may be expected to extend to services as well, countries having a large service sector and serving a large domestic market presumably enjoying a potential advantage over others, due to economies of scale and externalities.

Less developed countries may view the process differently. In their economies, internationally traded services constitute a small proportion of their total output. The development of service industries is nevertheless a necessary concomitant, if not a precondition, of their overall economic and social development. National policies should therefore promote a balanced development of service industries even at an early stage of economic development and should not wait till a 'mature' stage is somehow reached. The impression has been created that developing countries are supposed to open up their markets for services in return for greater opportunities for their exports of goods to developed market economies. This is partly due to the way the case for expansion of trade in services has been put in developed countries with emphasis on their strong competitive advantage in this sector.²¹

Developing countries will naturally need an increasing

¹⁷ André Sapir, "North-South issues in trade in services", *The World Economy*, vol. 8, No. 1, (March 1985).

¹⁸ See *Production and Trade in Services...*, Chap. IV.

¹⁹ Computed from IMF, *Balance of Payments Yearbook, 1985* (Washington, D.C., 1985).

²⁰ See *Production and Trade in Services...*

²¹ The point was made by Jagdish N. Bhagwati in "GATT and trade in services: how we can resolve the North-South debate", *Financial Times*, 27 November 1985.

supply of services, and the development of indigenous service industries will call for national policies that may include various degrees of protection from foreign competition. Infant-industry arguments are valid for service industries too. As in the case of goods, the important question is the combination of domestic production and import of services to be chosen.²²

Any future negotiation on services must address the question of mutual advantage in expansion of exports of services from developing as well as developed countries, taking due account of the inherent weaknesses of the developing countries and their national development policies. Some developing countries already have considerable experience in the construction sectors overseas and may wish to expand these activities to developed countries.²³ Shipping is another area in which they may wish to increase their share of world trade.

Promotion of trade in services is not merely a matter of trade between developed and developing countries, although this aspect has received most attention in recent discussions. All developed countries are not enthusiastic about it. Many of the service industries in developed countries remain extensively protected. Banking and insurance, two of the major service industries with large scope for expansion of cross-border activities, are subject to detailed government regulation and are not fully open to foreign competition. But most of the expansion of world trade in services in the near future would occur in trade among the developed countries themselves if they opened their markets further.

One should be aware of the great variety of impediments, national attitudes and regulatory policies in the service sector which it would be simplistic to term protectionist. Government plays a large role in service activities for security, equity and other social considerations. Even in countries that are prominent advocates of liberalization of trade in services, there is a complex system of laws and regulations and a variety of agencies to regulate the production and distribution of services.²⁴

The above considerations are only a few of the many that will be germane to any discussion or negotiation on trade in services. They already emphasize the complex nature of the main issues involved and the need to study

them carefully. They also show the need to recognize that the questions involved are not only trade-related but encompass much broader issues.

Given the nature of the issues, it is clear that future negotiations involving services will take a long time. Although it has been suggested that it may be necessary to conduct trade talks on services in parallel with those on goods, the complexity of the issues involved and the rudimentary stage of the present preparations for the task make it doubtful that actual results from negotiations in this area can be achieved at an early date as envisaged by some Contracting Parties.

In the consideration of the issue of services and other broad themes which are likely to loom large in future discussions, such as the principle of reciprocity and the idea of graduation, it is worth recalling that the observance of existing rules is indispensable, even if wider political considerations are brought to the fore.

History shows that there are two dimensions in the political economy of international trade. One is the perception of trade as a vehicle for increasing specialization and enhancing competition, enabling each country to concentrate on what it thinks it does best. The theoretical hope is that this process will raise potential output, incomes and living standards throughout the world. The other dimension refers to the time-honoured role of trade as an instrument of foreign (or domestic) policy and of advancing perceived national interests (as defined by the domestic political process of each country). The puzzling paradox raised by the divorce between rhetorical commitments to free trade and the actual trade policies followed by most Governments indicates the extent to which this second dimension plays a role in current trade policies - as it is likely to do in future discussions on system-wide reform or improvement of the international trade system.

Be that as it may, future expansion of world trade will depend significantly on the success in bridging the usually large gap between these dimensions. It is now widely agreed that policies of positive structural adjustment will be far less difficult to pursue in an environment of an expanding world economy, a more stable exchange rate régime and a more adequate system of international liquidity creation.

The international monetary system

The international monetary and financial system has been plagued by instability for more than a decade. Initially, this was regarded as an inevitable reflection of unprecedented shocks to the world economy - especially from the supply side - which would subside after a process of learning and adjustment. In the 1980s, it has become obvious to all that the problem runs deeper. Exchange rates have shown great volatility, both in nominal and real terms, and have been seriously misaligned relative to eco-

nomics fundamentals, involving costly distortions in production and trade. The mechanism for providing liquidity, primarily through private capital markets and denominated in reserve currencies, has been insufficient, unstable and inequitable.

Recognition of these problems has led to a resurgence of calls for comprehensive re-examination of the system, in

²² Sapir, *loc. cit.*

²³ Bhagwati, *loc. cit.*

²⁴ Harald B. Malmgren, "Negotiating international rules for trade in services", *The World Economy*, vol. 8, No. 1, (March 1985).

both government²⁵ and academic circles. The functioning of the exchange rate system and the adequacy of the present system of international liquidity creation are the two most important elements in this re-examination. An attempt is made below to clarify the key issues and the nature of the underlying disagreements.

The exchange rate system

Instability of floating: volatility and misalignment

The floating rate system came into being in 1973. Its proponents argued that it had a number of advantages.²⁶ Purchasing power parity and the current account would be the chief determinants of the exchange rate. Nominal exchange rates would have to move so as to offset changes in relative national price levels, making real exchange rates stable apart from structural changes. Short-term capital movements were not expected to disturb foreign exchange markets because stabilizing speculators could be counted on to move the exchange market towards purchasing power parity. Changes in real exchange rates could still occur but primarily in response to movements in the current account - a deficit would prompt depreciation and a surplus appreciation, which would put the current account back into balance. This was the basis for the widespread notion that monetary policy could be undertaken without consideration of the external balance, and that monetary disturbances in one country would not be transmitted to another.²⁷

This idea influenced policy makers in the early years of floating. Alternatives to floating were viewed with considerable scepticism. A decade later the consensus is that such a paradigm was misleading. Nominal exchange rates, instead of offsetting inflation differentials, have moved independently of them for most of the past decade. Purchasing power parity has not held. Real exchange rates have not been stable, nor have they consistently moved to offset current account imbalances. Rather than insulating domestic economies from foreign disturbances and permitting greater independence of monetary policy, the floating régime has facilitated the transmission of disturbances.

Exchange rate volatility has been greater in the period of

floating rates (1973-1985) than in the past decade of the adjustable-peg par value system (1961-1971). The volatility of quarterly nominal exchange rates for seven major currencies was six times as great as under fixed rates.²⁸ Volatility in real rates was less, because of offsetting price movements, but was still three times greater than under the previous system.²⁹

Measured volatility is one thing. More important is that most of the variations in exchange rates have been unpredictable. Forward rates, for instance, have been poor predictors of the corresponding future spot exchange rates.³⁰ Moreover, there is empirical evidence that forecast errors tend to be larger when exchange rates are more variable and that the cost of buying insurance cover in forward markets seems to increase with increases in exchange rate variability.³¹

There has been no discernible tendency - as hoped for by the advocates of floating - of exchange rate volatility to decline over time. The rate of the Japanese yen to the United States dollar was fairly stable between 1974 and 1978 but has been considerably more volatile since. The pound sterling and the Italian lira underwent their greatest variations in the late 1970s and early 1980s. Experience with floating has simply not shown a perceptible diminution of exchange rate volatility.

Misalignment is defined as a persistent departure of the exchange rate from its long-run equilibrium level. The long-run equilibrium level, in turn, is that real exchange rate, obtainable without trade or exchange restrictions, which would generate a current account balance consistent with some notion of "normal" or underlying capital flow. That equilibrium is not directly observable, and considerable political judgement as well as technical skill is necessary to estimate it. Measuring normal capital flows, for instance, requires considerable judgement about what is appropriate and possible. International organizations have, however, made estimates of long-run equilibrium for policy recommendations. Estimates of the degree of misalignment were published recently.³² They indicate the extent to which the dollar was at the time significantly overvalued and the Japanese yen and deutsche mark seriously undervalued.

²⁵ See, for example, "The functioning of the international monetary system: a report to the Ministers and Governors by the Deputies of the Group of 10", (EBD/85/154 Supplement 1, June 1985), and "The functioning and improvement of the international monetary system: report of the Deputies of the Group of 24", (EBD/85/228, August 1985).

²⁶ M. Friedman, "The Case for Flexible Exchange Rates" in *Essays in Positive Economics* (University of Chicago Press), 1953; Harry Johnson, "The Case for Flexible Exchange Rates, 1969", *U.K. and Floating Exchanges: A Debate on the Theoretical and Practical Implications*, H.G. Johnson and J.E. Nash, eds., Hobart Papers, No. 46 (London, Institute of Economic Affairs, 1969); and E. Sohmen, *Flexible Exchange Rates* (2nd ed., Chicago, University of Chicago Press, 1969).

²⁷ M.L. Mussa, *Macro-Economic Interdependence and the Exchange Rate Régime*, *International Economic Policy: Theory and Evidence*, Rudiger Dornbusch and J.A. Frenkel eds., (Baltimore, the Johns Hopkins University Press, 1979).

²⁸ IMF, *Exchange Rate Volatility and World Trade*, Occasional Paper No. 28, (Washington, D.C., July 1984). For a brief earlier study of exchange rate fluctuations, see "Exchange rate volatility in an interdependent world economy", *Supplement to World Economic Survey 1984* (United Nations publication, Sales No. E.84.II.C.2 and corrigendum).

²⁹ IMF, *Exchange rate volatility...*

³⁰ B. Cornell, "Spot rates, forward rates and exchange market efficiency", *Journal of Financial Economics*, vol. 5, (August 1977); and M. L. Mussa, "Empirical regularities in the behaviour of exchange rates and theories of the foreign exchange market", *Theory, Policy, Institutions: Papers from the Carnegie-Rochester Conferences on Public Policy*, A. H. Meltzer and K. Brunner, eds. (Amsterdam, North-Holland Publishing Company, 1983).

³¹ IMF, *Annual Report, 1982*, (Washington, D.C., 1982) pp. 44 and 46.

³² John Williamson, *The Exchange Rate System*, 2nd. ed. (Washington, D.C., Institute for International Economics, 1985).

Less precise but perhaps stronger evidence of persistent misalignments can be gathered by following changes in real exchange rates. Long-run equilibrium real rates should not change frequently or greatly. Sources of variations would be differential productivity growth in different countries, new discoveries of natural resources, and other miscellaneous factors which might influence terms of trade in the long run. Such changes could hardly account for real exchange rate changes of more than 4-5 per cent a year over a recent period investigated (1977-1983).³³

Observed movements in real exchange rates, however, show changes far out of line with plausible movements in long-run values. The Japanese yen depreciated by 12 per cent in the first two years after March 1973, appreciated by 20 per cent in the next three and then depreciated by 22 per cent in the next four years up to 1982. The US dollar depreciated by about 5 per cent between 1976 and 1978 but later appreciated by 21 per cent between 1978 and 1982, then continued to deviate further in the same direction until, by the second quarter of 1985, it had moved 33 per cent away from its March 1973 level. The real effective exchange rate of the pound sterling appreciated by 29 per cent between 1978 and 1982 and then depreciated somewhat from that level, to end 29 per cent higher than the base level by the second quarter of 1985. These swings were excessively large by any standard.

Sources of volatility and misalignment. The factors that generate this volatility and misalignment in exchange rates are (a) the weight of capital flows in an exceptionally fluid and efficient capital market, (b) the volatility of expectations that motivates capital flows, and (c) the configuration and credibility of macro-economic policies that affect both flows and expectations.

The financial integration of the world economy has influenced the working of the floating exchange rate system fundamentally and irreversibly. The volume of international private capital movements has taken a quantum jump since the late 1960s. World trade in financial assets increased to a level of some \$50 trillion in 1985,³⁴ whereas trade in goods and services did not exceed \$2 trillion. Transactions on capital account dominate the foreign exchange market.

The role of exchange rates as the relative price of assets has become more important than its role as the relative price of tradable goods. The sensitivity of exchange rates to investors' preferences among assets denominated in different currencies has broken the traditional links between current accounts, purchasing power parity relationships and exchange rates.

Capital flows and floating exchange rates have proved to be highly sensitive to expectations. Like other financial as-

set prices, exchange rates adjust quickly to news affecting their perceived future values. It has been established empirically that unanticipated changes in the macro-economic environment explained most of the short-term fluctuations in exchange rates during the 1970s.³⁵ Further evidence consistent with the view that unanticipated events dominate exchange rate movements in the short run is that spot and forward rates tend to move closely together and in roughly equal amounts.³⁶

Floating rates have considerably complicated the expectational element affecting capital flows, which at the same time has led to increased volatility. To illustrate this point, consider the situation that would exist under a fixed exchange rate régime. When policy actions induce significant interest rate differentials between assets denominated in different currencies, capital would quickly flow to purchase the asset with the higher nominal yield. Even if the differential is caused by a temporary cross-border policy inconsistency (with the exchange rate target) private capital would move, which would bring interest rates back to equality and exchange rates back to the targets. Agents would be confident that Governments could and would meet the exchange rate targets, so the task of establishing the target rates would be aided rather than impeded by private markets.

Under floating rates, in contrast, the expected nominal yield on interest-bearing assets includes a forecast of the relative depreciation of one currency. The expectations of asset holders and changes in them then become as important as interest rate differentials in moving the capital flows. A country trying, for example, to arrest a depreciation of its currency by restrictive monetary policy finds that its policy hinges as much on convincing the market that the policy is relatively permanent (thus affecting future exchange rates) as in creating the favourable interest-rate spread.

The most important case of policy-mix mismatch is, of course, that of the United States and its trading partners in both the 1970s and the 1980s. In the late 1970s, US inflation rates were rising faster than those abroad. The Federal Republic of Germany and Japan had a stronger anti-inflation policy stance than the United States, which seemed wedded to a more growth-oriented approach. In fact, the United States was regularly exceeding its money supply targets (in both 1977 and 1978), giving the impression of loss of control. It was not until the United States announced its intention to intervene substantially and to tighten its monetary policy in November 1978 that the slide of the dollar was arrested. In fact the ensuing reduction in monetary growth in the United States proved to be relatively less significant than the dramatic decline in average money growth rates of the Federal Republic of Germany, Japan and the United Kingdom. To the extent that

³³ John Williamson, *op. cit.*

³⁴ Group of Thirty, *The Foreign Exchange Market* (New York, 1985).

³⁵ R. Dornbusch, "Exchange rate economics: where do we stand?", *Brookings Papers on Economic Activity*, No. 1 (Washington, D.C., The Brookings Institution, 1980).

³⁶ J. A. Frenkel and M. Mussa, "The efficiency of foreign exchange markets and measures of turbulence", *American Economic Review*, vol. 70, May 1980.

not only current money but also anticipated future money affect the exchange rate, the appreciation after 1979 could only be consistent with expectations of a substantially greater fall in future US money growth. Nevertheless, the actual monetary slow-down was relatively greater in the Federal Republic of Germany and Japan, so that shifts in monetary policy alone are unlikely to have been the reason for the sustained dollar appreciation.

What was crucial was the difference in fiscal policy. Fiscal expansion in the United States and net fiscal contraction abroad led to relatively higher growth and higher real interest rates in the United States. The IMF estimate of fiscal impulse, which measures the exogenous contribution of government fiscal policy to demand, confirms this. The cumulative expansionary fiscal impulse for the United States was 4.2 per cent of GNP over 1980-1985, while it was a contractionary -3.2 per cent of total GNP for the other six major industrialized countries.³⁷ The high interest rate differential and relatively higher growth prospects seemed to justify the implied exchange rate forecast in spite of the heavy government deficit, and asset holders expressed a clear preference for dollar-denominated assets.

The system of floating has allowed countries to pursue relatively independent fiscal and monetary policies but at the same time has created interdependence of a somewhat perverse type. Without the requirement to keep exchange rates continuously in line, policy makers have been freer to pursue domestic objectives. This freedom to conduct internal policies has, however, come at the expense of - and largely because of the system's tendency to transfer domestic shocks to - other countries. Like private agents, Governments have been free (and have perhaps felt obliged) to pursue domestic objectives with little consideration of the effects of their policies on external balances and on other countries. This has worsened the international environment with respect to the incoming shocks to which each country is exposed. Countries have faced the task of reaching domestic goals in the presence of increasingly heavy external shocks. As a result, countries have tried to meet domestic problems, at least in the short-run, by taking actions which send shocks elsewhere. A partial reflection of this is a doubling of inflation and trebling of average ratios of deficits to GNP in 1973-1985 compared with 1963-1972.

Eventually, unilateral and often over-expansionist policies have created such undesirable external balance and exchange rate effects that countries have been compelled to alter their macro-economic policies. The resulting policy changes, however, have been too late, and have often had effects that were not desired.

The key case of the United States *vis-à-vis* other countries serves to illustrate the perverse interdependence that is caused by freely floating rates. In the late 1970s, domestic priorities induced highly expansionary policies, the inflationary effects of which were transmitted to other coun-

tries. The disinflationary reaction of the United States in the late 1970s and early 1980s had serious repercussions. This time, the reaction of European and Japanese Governments to inflationary impacts on their countries of the rising dollar (which reduced inflation in the United States) was not to respond via restrictive monetary policies, a reaction which would have considerably reduced worldwide real growth. Combined with their choice not to compete by means of parallel deficit-spending, world output became partly dependent on the locomotive effect of United States external imbalances. By 1985, reaction to the distortions was evident as political pressures to correct effects of the dollar appreciation began to emerge from the United States tradable goods sector.

Trade effects of volatility and misalignment. Increased exchange rate volatility and persistent misalignments have had significant costs. While most of these costs are difficult to quantify, one important area in which they have arisen is international trade, which has probably been substantially affected by exchange rate volatility and certainly so by medium-term exchange rate misalignments.

The trade effects of increased exchange rate volatility have become of considerable concern since the advent of generalized floating. Directly observable is the cost of forward transactions cover. These costs have been especially heavy for developing countries which do not have well-developed capital markets and forward cover arrangements.

Exchange rate volatility has probably had negative effects on the volume of trade. If economic agents are risk-averse, increased risk is built into prices or results in reduced quantities (demanded and supplied) at given prices. If increased exchange rate variability is in fact an additional source of increased uncertainty and if there is no costless way for firms to counter, offset or avoid that increased uncertainty, theory would thus predict an adverse impact on trade flows. This conclusion has received substantial though not conclusive empirical support.

The empirical evidence is admittedly not clear-cut. Virtually all studies using nominal exchange rate variability as the explanatory variable and aggregated trade flows as the dependent variable have found no evidence of a negative impact. However, studies using real exchange rates against bilateral trade flows have come up with significant adverse trade effects. The proposition that changes in real exchange rates are a better proxy for changes in uncertainty than nominal ones is becoming generally accepted.³⁸ The results of a number of empirical studies on the trade effects of exchange rate variability are summarized in Annex IV.

Less controversial is the proposition that misalignments produce adverse trade effects. There is an emerging consensus that misalignments are a source of resource misallocation in the tradable goods sector and a potential im-

³⁷ IMF, *World Economic Outlook*, 1985, p. 221.

³⁸ IMF, *Exchange Rate Volatility and World Trade*, Occasional Paper No. 28, (Washington, D.C., July 1984).

pediment to free trade through the protectionist pressures it generates. The consensus on resource misallocation is based on the large theoretical and empirical literature on the impact of changes in real exchange rates on trade flows. The argument that misalignment is a spur to protectionism is based on evidence that has accumulated since the late 1960s.

An overvalued real exchange rate places the country at an across-the-board disadvantage in international trade because its prices in both export-and import-competing industries will be above equilibrium levels by the extent of the overvaluation. Its exports will be relatively dearer and its imports cheaper. Empirical estimates of export and import elasticities suggest that overvalued currencies induce firms in export-and import-competing sectors to scrap capacity that would be productively employed at equilibrium prices, reallocate investment to foreign countries or shift to foreign sources of supply. All of this leads to increased unemployment in the tradable-goods sector. In quantitative terms, these effects appear to be substantial. This is evident from the available estimates of the effects of exchange rate change on domestic aggregates. The estimates suggest, for example, that a 19 per cent overvaluation of the US dollar would have raised unemployment by 1.3 million in the United States if other factors had remained unchanged.³⁹ A much smaller overvaluation of the dollar in 1980-1982 has been estimated to have reduced employment by 0.5 million due to a decline in US exports.⁴⁰

An undervalued exchange rate improves both trade balance and employment. The problem here stems mainly from the eventual correction of the exchange rate level. With undervaluation, prices in domestic tradable goods industries would be below equilibrium levels. This would make export-and import-competing substitutes highly competitive. New resources would be encouraged to enter such industries, creating additional capacity and increasing employment as a consequence. However, when undervaluation is subsequently eliminated, demand for tradables falls, necessitating sharp cutbacks in capacity. Apart from the costs of excess capacity and unemployment, there are significant adjustment costs associated with shifting resources among industries within tradables and between the tradable and non-tradable sectors. The process of adjustment requires the retraining of labour and the construction of new capital equipment, both of which absorb resources. While such costs are worth incurring in order to effect a permanent improvement in the allocation of resources, they are not when imposed by inappropriate and misleading exchange rates.

Finally, floating rates have discouraged rather than encouraged free trade, as misalignments in exchange rates generated pressure for protectionist measures. Industries

and workers can plausibly blame the fall in demand and employment on foreign competition when the exchange rate is overvalued or when an undervaluation is eventually corrected. There are three factors that contribute to the strength and intensity of protectionist pressures generated by misalignments. First, firms and workers consider their demand for protection to have greater legitimacy, since the Government is seen to have acquiesced to the overvaluation that undermines their ability to compete. Secondly, since overvaluation also makes exports uncompetitive, reallocation of resources released by import-competing sectors cannot be easily undertaken. In fact, the export industries themselves add to unemployment. There is a threat of de-industrialization in the tradable sector. Thirdly, the political lobby for protection will be considerably greater in such situations since it is not confined to a few inefficient industries. Misalignment affects industries across-the-board, making previously efficient industries uncompetitive.

The dollar's overvaluation in the late 1970s and early 1980s has been shown to have contributed substantially to protectionist pressures in the United States.⁴¹ Similarly, it can be reasonably argued that the three major post-war episodes of tension in trade relations between the United States and Japan (1970-1971, 1977-1978 and since 1981) originated in periods of an overvalued dollar *vis-à-vis* the yen.⁴² It has also been suggested that the recent United States initiative (22 September 1985) for co-ordinated official intervention by the Group of Five to depreciate the dollar was prompted by the desire to pre-empt the adoption of protectionist measures by the United States Congress.

Prospects for reform

The experience of the past decade or so has made it clear that the old view of freely floating rates is no longer tenable. Whatever the differences in perceptions and evaluations of the working of the current exchange-rate system, four conclusions clearly do not appear controversial. First, floating exchange rates have suffered widespread instability and misalignments. Secondly, this was generated mainly by destabilizing speculation in the exchange market and international inconsistency in terms of choice, magnitude and timing of macro-policy mixes by the major countries. Thirdly, the system has not provided any built-in anchor either for medium to long-term expectations of exchange rates or for ensuring reasonable consistency of macro-economic policies. Fourthly, the costs of this unstable exchange rate system has been sufficiently grave to warrant policy activism to combat the instability.

This is reflected in the emerging consensus among Governments on the need for achieving greater stability of exchange rates of the key currencies. They have become

³⁹ John Williamson, *op. cit.*

⁴⁰ Robert Z. Lawrence, "The de-industrialisation of America", *Brookings Papers on Economic Activity*, No. 1, (Washington, D.C., The Brookings Institution, 1983).

⁴¹ C. F. Bergsten and J. Williamson, "Exchange rates and trade policy", *Trade Policy in the 1980s*, William Cline, ed. (Washington, D.C. Institute for International Economics, 1983).

⁴² *Ibid.*

more willing to adopt a view about the appropriate level of their exchange rates in the hope of guiding the market in the desired direction.

However, the implication of the foregoing discussion is that the exchange market only moves in that direction if the actual policies and the announced targets are consistent and credible. This means that for the market to produce the desired result any view of the appropriateness of exchange rates of major currencies has to be translated into a configuration of macro-policies and official intervention strategies that are consistent with the relevant exchange rates. Moreover, since the exchange market is concerned not only with the present but also with the future, the market would have to be assured of continued consistency.

The present exchange rate system has no automatic and dependable mechanism for generating the necessary pressure to ensure such consistency. There are no rules for initiating adjustment. There is a need for an institutional mechanism that would provide an anchor for exchange rate expectations and a basis for continued policy consistency across major countries. The nature and form of the mechanism must be the subject of immediate discussion, since its absence will continue to frustrate *ad hoc* attempts at stabilizing exchange rates. In fact, it would have to be the core of any successful multilateral surveillance of exchange rates. The proposal for having target-zones of exchange rates could be one possible mechanism.

Official intervention and policy co-ordination. Official market intervention has been, in principle, an integral part of the floating system. However, its ability to affect exchange rates in desirable directions has been handicapped by four factors. First, official reserves constitute an extremely small proportion of total foreign exchange market transactions. Thus the capacity to influence the stock of assets in the market by intervention is inherently limited. If it is to have a major role it must be through its signalling function, to the extent that intervention in a particular direction indicates an official view about the exchange rate. Secondly, most interventions have been sterilized with a view to using monetary policy solely for attaining domestic objectives. Sterilized intervention has been relatively less effective in altering and sustaining exchange rate changes than unsterilized intervention. Thirdly, unco-ordinated interventions by several central banks have often worked at cross purposes. Fourthly, the direction of interventions has not always been consistent with the exchange rate implications of the configuration of macro-economic policies. Central banks following a "leaning against the wind" intervention strategy have often moved the ex-

change rate further away from its long-run equilibrium level. While the markets have often ignored such intervention signals when they were inappropriate, there have been times when they have inappropriately responded to them.

Co-ordinated macro-economic policies for the present purpose imply policies that are rendered mutually consistent by explicit consideration of their external effects. Such multilateral co-ordination can be undertaken at regular intervals. To date, the most explicit attempts at co-ordination have been undertaken at the economic summit meetings of seven major industrial countries and have aimed mainly at world economic expansion. Success in implementing such co-ordination has been limited since agreements on policies were couched in terms of direction only, rather than in terms of both level and direction. As for explicit attention to the level of exchange rates, the system until very recently has been, as described in an IMF study in 1984, "a discretionary and decentralized system, with loose co-ordination among the main players but with tight co-ordination and disaster relief during crises".⁴³

Setting what may prove to be a precedent, the agreement of the Group of Five of 22 September 1985 provided the foreign exchange market with a consensus view of five Governments about the existing pattern of exchange rates, in particular the need for "orderly appreciation of non-dollar currencies"⁴⁴ *vis-à-vis* the dollar. More important, it indicated to the market the Group's resolve to move the exchange rates in that particular direction. There were strong suggestions that countries would "co-operate closely" to undertake co-ordinated official intervention and somewhat veiled hints at greater consistency of macro-policies that would "further improve the fundamentals". The market responded immediately to the mere announcement of the agreement. The depreciation of the dollar was sustained subsequently by official, though relatively limited, intervention. The event provides strong evidence of the efficacy of publicly announced intentions to implement consistent macro-policies.

Target zones. A more comprehensive and systematic means of producing exchange rate stability would be the adoption of target zones, that is, ranges of permissible deviation of countries' cross-rates around defined long-run equilibrium rates. While there exists a spectrum of proposals regarding the widths of the zones and countries' obligations to keep currencies within them, the central aim of the proposal is to induce countries to develop a view about appropriate exchange rates and adopt appropriate macro-economic policies for achieving these exchange rates.*

⁴³ IMF, *The Exchange Rate System: Lessons of the Past and Options for the Future*, Occasional Paper No. 30 (Washington, D.C., July 1984), p. 40.

⁴⁴ Communiqué of the Group of Five, *IMF Survey*, 7 October 1985.

* Proposals can be characterized by several dimensions of stringency. First, the width of the band might be quite narrow (hard target zones) to wide (soft target zones). Secondly, the central rate within the band may be adjustable frequently ("soft") or seldom and under strict conditions ("hard"). Thirdly, deviation of an exchange rate outside the zone can trigger different responses ranging from consultative meetings to obligatory and automatic exchange market intervention and employment of monetary policies to bring the rate back into line. Fourthly, the zone can be confidential ("quiet") or publicly announced.

In several respects the system of target zones would resemble the European Monetary System (EMS). In a "hard" target zone system, the width of the zone (or band) around the central rate, that is the computed long-run equilibrium rate, would be quite narrow, though in initial stages the zone would have to be wider to accommodate margins of error in calculating the central rates and to leave sufficient margin for exchange rate manoeuvres against sudden capital flows. A second similarity would be the fixed but adjustable nature of the zones. As with EMS, realignments would be based on appropriate relative real exchange rate levels, the target zones probably involving more frequent adjustments than currently under EMS. To balance this need with the need for avoiding continued negotiation, automaticity may have to be preserved by means of "crawling peg" formulas for the central rate in response to given deviation-patterns in real exchange rates.

On the other hand, there is as yet no mechanism implying rigid and automatic commitments to intervene, nor is there yet envisaged anything like the EMS credit facilities for undertaking these interventions. It is unrealistic in the short run to expect the target zone system to become a "global EMS", since the Group of Five lacks the European Economic Community's degree of political commitment, homogenous structural characteristics, and (when they fail) still functioning capital controls.

Three problems are often cited with respect to implementing such a mechanism. First, it will be difficult to identify the long-run equilibrium exchange rate for each currency and even more difficult to agree on a grid of target zones. That objection is probably exaggerated. While the difficulties of computing precise estimates of long-run equilibrium exchange rates are well known, the issue is not whether they are accurate but whether they substantially improve the existing volatile and frequently misaligned exchange rate structure. IMF has long used estimates of this type as a basis for stabilization programmes in a number of countries.

A second objection is that even if a consensus on the rates can be reached, negotiating a configuration of policies that are consistent with those rates and acting on the agreed obligations would be nearly impossible. Actually, this argument can be viewed as an argument for harder zones rather than an objection to targeting. The problem is a general one of macro-policy instruments having uncertain impacts. Indeed, there is little agreement about how macro-policies should be implemented to get the desired results. Under such circumstances, a firm anchor of expectations regarding exchange rates requires not only that the authorities set macro-policies in such a way as to produce the desired exchange rate outcome, but that they are prepared to change the macro-policy settings to keep exchange rates inside the target bands.

A third and more controversial complaint against target zones is that they would be redundant since co-ordinated macro-policies alone are deemed sufficient to guarantee stable exchange rates. In principle, authorities can adjust macro-policy settings to compensate for unplanned

macro-economic effects (including those on exchange rates) just as it would under a target zone commitment. The effective distinction in this context between an implicit or "quiet" target zone and an explicitly announced target has to do with the expectational element contributed by the latter. The announcement of target zones provides information to participants about the intention of the authorities, together with observed macro-economic data allowing participants to judge the consistency of the target with other data, and places moral and political pressure on participating Governments to keep policy setting at levels which maintain the targets.

In a significant sense, the difference between the economic and political structure behind EMS and that of a global system provides the fundamental argument for the need for publicly announced target zones and multilateral surveillance of countries' progress in setting exchange rates, as well as for more general macro-economic goals. In EEC, exchange rate alignment is part of a package which includes trade and macro-economic policy negotiations. In part, this has been due to the absence of a major intra-EEC political crisis which would interfere with such negotiations. Moreover, EEC exhibits more uniformity in unemployment trends, industrial structure, and growth rates. Its negotiations are often troublesome but, once established, negotiated settlements are relatively stable. In such a system, exchange rate policies are credible even when the negotiation and rationale behind their setting is secret. Market participants have reason to be confident that exchange rate alignments will not be easily changed, as Governments are committed to using trade, macro-economic policies and perhaps exchange controls to maintain exchange rate parities.

In a global system, however, the mechanisms for trade and policy negotiations are not tight and the factors which would call for frequent re-negotiation are more variable. In such a system, credible exchange rate targets require that participants not just observe the announced targets but that they adhere to the explicit macro-economic goals and objectives on which the exchange rate targets are chosen. Only then can the market judge the consistency of the policies.

In addition, it will be necessary to conduct multilateral surveillance of the data and domestic macro-economic targets to verify that economic targets are being reached. Periodic review and public announcement of key indicators (for instance, targets or notional ranges for inflation, balance of payments, real wages and exchange rates; and instruments such as fiscal and monetary policies and various structural measures) could be fashioned after the money supply data and target announcements currently made in several countries.

To supplement this process, a system of rules for correction would have the effect of placing public pressure on Governments whose macro-economic target variables and other data deviate from those used to formulate the exchange rate target. This consideration is especially important when the deviating countries are major ones, as the 1980s has revealed bias in traditional IMF surveil-

lance procedures towards strict discipline in the case of developing countries, especially when Fund support is requested, but rather benign neglect in the case of major industrial countries. In a global system, credibility and stable exchange rate expectations require a more visible process of exchange rate target selection as well as rules whose violation at least imposes the cost of exposure. The experience of EMS cannot be extrapolated to the global level, and global targeting would require a higher degree of multilateral surveillance over both exchange rate alignment and domestic macro-policy setting than is provided in EMS.

The system of international liquidity creation

Supply of liquidity: systemic shifts and new constraints

One of the most important functions of the international monetary system is its role in providing external adjustment liquidity to trading countries. Under the gold exchange standard of Bretton Woods, reserves were predominantly owned rather than borrowed. Most countries acquired them by running trade surpluses. To the extent to which countries were willing to hold assets denominated in dollars or sterling, the United States and, to a more limited extent, the United Kingdom were exceptions as they could finance deficits in large part by assuming liabilities in their own currencies. Growth in world reserves occurred through growth in the stocks of monetary gold, through increases in IMF drawing facilities and, after 1970, through allocation of SDRs but predominantly through the US dollar-financing its current account deficit. The cumulative US deficit was, however, constrained by the need to ensure the dollar's convertibility into gold at a fixed rate with the result that supply from this source could not adequately meet the growing demand without undermining the confidence in the free convertibility of the dollar into gold.

The 1970s witnessed three important changes that fundamentally altered the reserve-supply arrangement of the system. The first was the unilaterally decided suspension of the dollar's convertibility into gold in 1971. This freed the process of liquidity creation, in particular the supply of dollars as an international reserve, from the restraints of gold convertibility. The second important change was the emergence of the floating exchange rate system in 1973, which reduced the constraints that the previous régime had imposed on monetary and exchange rate policies of major countries other than the United States. The third change, which evolved over time, was the increasing financial integration and rapid expansion of capital markets which permitted many countries to add to their reserves by borrowing. A multi-currency reserve system emerged as a result of the first two changes, and the third vastly increased the share of countries' reserves that was borrowed in international markets. Under this régime, there are two basic sources of reserve supply, apart from what have

turned out to be insignificant SDR allocations and increases in IMF quotas. These are the currency-market intervention policies of the several reserve-currency countries, and commercial bank lending through the international financial markets; the latter has been by far the largest single source.

The result is that since the 1970s the monetary and fiscal policies of major countries have had an important bearing on the volume of reserves and the terms and conditions under which reserves could be supplied and borrowed in international private markets. Monetary and intervention policies not only affected the supply of a particular reserve currency, they also affected nominal interest rates by altering inflationary expectations. Configuration of fiscal policies across major countries affected savings-investment balances and thus real interest rates. In turn, they altered the rate of exchange between the major currencies. The process of reserve creation itself was thus no longer neutral with regard to the exchange rate structure, the terms and conditions of obtaining reserves and the patterns of behaviour of private international financial markets.

This market-determined supply of liquidity seemed to work reasonably well over the period 1973-1981. It came to be viewed by many as a flexible and dependable system capable of balancing demand and supply for world reserves. Since 1982, however, this optimism has come into question. A sharp downward shift in supply has occurred. While some view this as temporary, others fear serious inadequacy in reserve supply at least in the medium term. Since demand for reserves should continue to grow *pari passu* with world trade, a sustained downward shift in market supply, coupled with credit-rationing schemes, has significant implications. This has revived the discussion of alternative mechanisms for international liquidity creation.

Those who are sanguine about the future of the present system of liquidity creation emphasize that the current downward shift in market-supplied liquidity reflects, to a large extent, the loss of creditworthiness of many developing country borrowers. According to this view, for creditworthy countries, the supply of liquidity is determined by demand and creditworthiness is essentially a function of each country's own domestic policies.⁴⁵

A more balanced view of the present "creditworthiness-standard" system would recognize not only the obvious fact that domestic policies always matter but also that (a) the volume of reserves and the terms and conditions under which reserves can be borrowed in international markets - when they can be borrowed at all - depend, to a large extent, on the macro-economic and financial policies of key countries and their interactions; and that (b) the private international markets, when it comes to assessing creditworthiness, have shown a great propensity for herd-like, procyclical behaviour, which very often has under-

⁴⁵ The majority of the Group of 10 subscribes to this view, emphasizing that "sharp shifts in liquidity have generally reflected inadequate underlying policies (since) countries can obtain reserves from financial markets" "The functioning of the international monetary system: a report to the Ministers and Governors by the Deputies of the Group of 10" (EDB/85/154, Supplement 1, paras. 60 and 63).

mined the very creditworthiness that was supposed to be assessed.

In fact, the recent evolution of private international financial markets has been marked by a drastic shift away from bank intermediation and has revealed three major constraints on the future supply of liquidity from this source.

First, the change in the distribution of surpluses and deficits across countries has shifted the process of intermediation from bank lending to trading in securities. During the 1970s, OPEC countries ran huge surpluses. Their portfolio preference for bank deposits favoured the Eurocurrency market and vastly increased its lending capacity. In sharp contrast, the 1980s distribution of surpluses and deficits among Japan, the Federal Republic of Germany and the United States is being intermediated by trading in financial assets.

Secondly, the aftermath of the 1982 debt shocks produced a declining demand for bank deposits in general, including interbank deposits, which significantly increased the costs of bank intermediation. Moreover, the involuntary withdrawal of developing countries from the pool of spontaneous borrowers at a time of rising credit demand of corporate and sovereign borrowers who have access to securities markets has further diverted credit from the banking system. The dramatic shift towards bond issues in preference to loans is underlined by the fact that while in 1981 international bank loans were five times as large as international bond issues, by 1985 they were somewhat below the value of bond issues.

Thirdly, there has been a shift in the attitudes of the regulators. Whereas banks had been praised in the 1970s for their success in recycling funds, regulators in recent years have become stricter in monitoring the quality of bank assets. Demands for increased loan-loss provisions, elimination of the tax deductibility of those provisions, stricter categorization of liabilities of certain countries as problem loans, and automatic classification of further credits to them as potential write-offs have constituted a strong source of discouragement for increased lending.

Aggravating the liquidity access problem is the fact that the system has always been, and is increasingly, one of unequal access, especially in a general squeeze. Even today, despite the overall slow-down in international lending, developed countries' access to this source remains unimpaired. This is largely because they have had equal access to bond financing and bank borrowing while developing countries could tap only the latter.

On balance, both developing and major developed countries have an important role to play in stemming a further decline in market-supplied liquidity. Nevertheless, it is obvious that even with improved domestic policies in debtor countries, mutually more consistent macro-policies among major developed countries, and greater flexi-

bility in regulation of international banks, reserve supply from the private financial markets will continue to be at a lower level than in the past, while the demand for owned and borrowed reserves is likely to increase with the growth of international trade and payments, as well as with the need for adjustment to present untenable trade and current account imbalances.

Meeting the long-term demand for liquidity: policy options

As discussed earlier, there has been a sharp downward shift in the supply of market-based liquidity in the face of the growing demand for reserves. Though this acute imbalance mainly affects developing countries, a long-term global need to supplement the supply of reserves has been discussed in developed countries too.

What exactly constitutes a "long-term global need" for international liquidity has never been fully clarified. Past decisions on SDR allocations suggest that global need has not been equated with the need for reserves of only the major industrial countries. In the context of the underlying economic conditions of the second half of the 1980s, adequate provision of liquidity from official reserve-supply mechanisms should be made a more active part of the liquidity régime. SDR allocations, growth in IMF quotas and funds, and a substantial increase in official multilateral lending have to be used regularly, both to offset cyclical falls in market supply and as independent sources of reserve growth. Multilateral surveillance should therefore not only aim at monitoring and influencing policies that affect the market supply of reserves but also assess the extent to which official sources should contribute to financing adjustment and to liquidity creation on a long-term and systematic basis.

According to the Articles of Agreement of IMF, allocation of SDRs can be motivated either by a "long-term global need to supplement existing reserve assets in such manner as will avoid economic stagnation and deflation as well as excess demand and inflation" (art. XVIII, sect. 1 (a)) or by the objective of making the SDR "the principle reserve asset" (art. VIII, sect. 7). The issue therefore is whether current and prospective conditions of the world economy warrant an allocation. There can be no debate about the substantial growth in the demand for liquidity that is expected over the remainder of the 1980s. Disagreement centres on whether the current reserve-supply mechanism (i.e., international financial markets) can keep pace with that demand or not. Existing evidence strongly suggests that it cannot and that there is thus a need for substantial SDR allocations in the fifth basic period.

Since the emergence of international financial markets as a major source of liquidity creation, the international community has only once agreed to allocate SDRs.⁴⁶ That decision was taken in 1978 in spite of the fact that many countries had "a means for satisfying their need for

⁴⁶ The only other time was in 1969 under the fixed exchange rate system when a decision was taken to allocate SDRs over the first basic period, covering 1970-1972.

reserves”⁴⁷ since international capital markets were extremely free.

In addition, the decision established the new principle that “the decision to allocate SDRs does not depend on a finding that the long-term global need cannot be met except by allocation”.⁴⁸ This was justified by the need for increasing the proportion of owned reserves in total holdings in order to stabilize the world liquidity régime. It was argued that in “a system in which countries add to their gross reserves as their international indebtedness increases is that they are faced with the need for periodic refinancing (which can be avoided if) additions to net reserves are made through allocation of special drawing rights”.⁴⁹

In comparing the present situation with circumstances in 1978, the case for a new SDR allocation appears overwhelming. First, in 1978, the ratio of world reserves to import stood at 23 per cent; 20 per cent was recorded for 1985 and an average of 21.8 per cent was registered over the period of 1973-1979. Secondly, the financial markets were much stronger, with international commercial lending to developing countries rising rapidly; it has dwindled to a trickle over the last three years. Thirdly, in sharp contrast to the highly inflationary world of the late 1970s, today’s international economy faces low inflation and relatively low growth. Fourthly, borrowed reserves as a proportion of the total are now excessive in a large number of countries, to the point where net reserves are negative and the opportunity for periodic refinancing is virtually non-existent for the vast majority of developing countries. Deflation and retrenchment have already been carried to levels that have become politically worrisome. In such a situation, increasing the supply of borrowed liquidity, even if possible, would hardly solve either the problem of debt or that of reserve shortage.

In other words, there is a basis for SDR allocation in the fifth basic period, even in the unlikely event that the international financial markets can supply the additional demand in the form of borrowed reserves. The need to raise the proportion of owned reserves in order to enhance the stability of the system is strong. SDR allocations will not necessarily lead to excess supply to the extent to which they are made more expensive to use and more attractive to hold. Issue of SDRs will mainly reduce the demand for reserves from the international market. Countries will substitute most of the SDR allocations for increases in non-SDR reserve holdings that would otherwise have occurred, so that total borrowing from the market may even fall. The flexibility of market-based reserve creation (if it exists) will permit market supply to adjust to the reduced demand as a result of the allocation.

The other basic reason of a systemic nature which favors new SDR allocations is the deflationary bias which

may be imparted to the world economy if the large number of developing countries which do not have access to borrowed reserves are forced to generate trade surpluses as the only way of increasing their owned-reserve and liquidity needs.

Increased net flows of funds from IMF facilities is yet another source of potential reserve expansion under official auspices. This mechanism was used very effectively in the 1970s. However, most of the increases in IMF lending capacity came from the addition of new and the expansion of old facilities. Quotas, which provide the basic pool of lending resources, have not been increased as fast as world trade.⁵⁰ Thus growth in IMF lending that took place over the period 1974-1983 period was sustained by allowing borrowing in amounts that were some multiple of the quotas, through the policy of enlarged access.

This policy is now being reversed as part of a long-term strategy which considered it a temporary device, to be phased down and terminated as soon as the situation permitted, since it was inconsistent with the monetary character of IMF.

Despite the policy reversal, there is considerable controversy whether this constitutes the most appropriate line of action. The arguments for the enlarged access policy of IMF still hold. Moreover, developments since the late 1970s have contributed to blurring the distinction between short-term liquidity requirements and the demand for longer-term financial resources. Present debt levels and the continuous instability of primary commodity prices and financial markets call for a more flexible approach to provide an adequate cushion to countries that are making an effort to improve their payment situation and face unanticipated changes in the external environment. The unexpected retrenchment in many developing countries in 1985 could have been avoided to a large extent if official credit had been made more readily available.

This regrettable situation is accentuated by the repayment obligations to IMF which are expected to be very substantial over the remainder of the 1980s. Net flows from the Fund to many countries could well become negative, unless a concerted effort to expand IMF facilities and quotas is made. Such an effort is essential if the Fund is to make an effective contribution to the framing of growth-oriented adjustment policies and to the revival of bank-supplied liquidity.

In addition, substantial expansion in official multilateral lending is needed not only as counter-cyclical relief for countries that have access to private financial markets but, more important, for countries that have never had such access. Low-income countries have been at a disadvantage, even in the era of rapid expansion of commercial lending. They have had to depend on trade surpluses and

⁴⁷ IMF, *Annual Report, 1979* (Washington, D.C., 1979), p. 124.

⁴⁸ *Ibid.*, pp. 124 and 125.

⁴⁹ *Ibid.*, p. 125.

⁵⁰ In fact, IMF quotas as percentage of imports fell throughout the 1960s and 1970s to a level of 3.3 per cent in 1982, recovering somewhat to 4.9 per cent in 1984 (after the Eighth General Review of Quotas) - a level much lower than that prevailing in the 1950s.

official funding to add to their liquidity and have been strictly subject to Bretton Woods reserve constraint even when no others were. A deflationary bias arises in the world economy when developing countries have to rely on trade surpluses to acquire reserves.

Systemic considerations thus suggest that there is a need for more owned international reserves, as discussed in chapter IV and also a strong case for better multilateral

surveillance of international liquidity, as foreseen in the Articles of Agreement of IMF (art. VIII, sect. 7). The renewed interest in strengthening multilateral surveillance over exchange rates and international effects of policy interactions among key countries must encompass surveillance over the system of international liquidity creation. These are two of the core issues to be considered in any attempt at international monetary reform.

CHAPTER VI

CAPITAL FORMATION AND GROWTH IN THE 1980s

One of the most important features of the global development experience since the mid-1970s has been the sluggishness of capital formation. This slow-down in the pace of investment activity in virtually all groups of countries has been widespread and deep. It has affected the majority of developed and developing market economies and many centrally planned economies as well. There have been palpable differences, however, both within each group and among the various groups. This diversity stems from a number of circumstances, general as well as specific.

Among the largely shared circumstances are the economic recessions of the mid-1970s and 1980, and the one that started in late 1981; the international debt crisis; the two price shocks caused by the rise in fuel prices in the 1970s; much more flexible use of global savings through accelerated capital mobility; and rising uncertainty and risks associated with a much more integrated global economy and financial networks. All those circumstances have affected investment behaviour and complicated decision-making at the central and local policy levels. The effects on capital formation and growth have clearly varied, especially when the experiences of the energy exporters are contrasted with those of the energy importers.

As far as the specific factors influencing aggregate investment behaviour in the past 10 to 15 years are concerned, it is useful to separate the institutional and structural aspects of the capital-formation process from considerations and key parameters of the investment decision-making environment, which stem largely from specific monetary and fiscal macro-economic policies. It is especially important to look at these different factors in order to explain the specific investment path typically pursued in most of the centrally planned economies and the determinants of investment decisions in market economies. Within the latter group of countries, there is a considerable degree of domestic policy autonomy, particularly in the large developed market economies. This is in sharp contrast to the constraints of external financial and economic factors in the developing countries due to the relatively high import content per unit of investment and the important role of external sources of financing.

In the present chapter, some of the key aspects of the recent capital-formation process in various groups of countries are highlighted. No attempt is made to be exhaustive for the world as a whole or for any of the three major groups of countries dealt with. The diversity of experiences in growth and investment is particularly pronounced in the developing countries. Roughly between the two oil-price shocks of the mid- and late 1970s, this diversity could, to a large extent, be explained by the differences in the fortunes of the energy-exporting and energy-importing developing countries. A discussion of the capital-formation processes in the first half of the 1980s, however, requires other distinctions. A useful one can be made between countries that resorted to shifts in policies and supporting institutions at an early stage, when there was room for measurable gains in export revenues, and coun-

tries that had to adopt stringent domestic adjustment policies in consequence of the deterioration in the 1980s of the external economic and financial environment.

The first section of the chapter is essentially concerned with the countries most severely affected by the recent external payments crisis. It deals with the 33 largest debtors among the developing countries - energy exporters and energy importers, large and small countries. Their recent investment experience, essentially since the mid-1970s, is placed in the context of global savings and investments, particularly the drain on their domestic savings resources sustained since 1982 in consequence of external payments constraints.

Most of the centrally planned economies essentially deferred adjustment to the changing global environment until about 1980. Although the command of policy makers over resources in these economies is very considerable, institutional and policy changes within CMEA as well as in the market economies, in conjunction with less favourable domestic sources of growth, made it imperative to come to grips with the external debt, especially its convertible currency component, and structural payments imbalances. But changes in policies and institutions also emerged for domestic reasons. In the second section of the chapter, the capital-formation experiences of China, six Eastern European centrally planned economies and the USSR are contrasted, as are the different degrees of economic autonomy in those countries, their involvement in global trade and finance, and room for policy flexibility afforded by domestic resources. Because of the weakness of investment in the European countries, recent capital formation in those countries is explored in greater detail.

The sluggishness of new capital formation has been most protracted in the developed market economies, although experiences again differ. In the period since 1973, the trends in most of the European developed market economies differed in many respects from the processes observable in the developed market economies of North America and the Pacific. There are a host of possible explanations but two stand out: the degree of policy autonomy in the various developed market economies and the institutional setting of these economies. The third section of the chapter focuses on this diversity of experiences by juxtaposing the capital-formation process in Japan and the United States to that of the major European developed market economies. Over the period as a whole, a downward trend in net additions to the capital stock can be observed in most of the European industrial economies, in marked contrast to the experiences of Japan and the United States. While investment expenditures in those two countries suffered because of the global disturbances, economic recovery there has been comparatively swift because institutional features accommodated fairly flexible adjustment to changes in the fundamentals of the capital-formation process, thereby returning investment behaviour to the pace typical of the early and late 1970s.

Adjustment, investment and growth in indebted developing countries

For the vast majority of indebted developing countries, the first half of the 1980s marked a significant turning point in their economic conditions and prospects. After two decades of flexible access to favourable external credit, growing trade opportunities, fast capital formation, robust economic growth, and rising per capita income and levels of living, these countries had to face a drastically changed global environment in the early 1980s. The convergence of cyclical and structural factors led to a sharp deterioration of their debt-servicing capacity, which triggered an abrupt curtailment of access to commercial capital; in some instances, it even led to an outflow of private capital. The only option under the circumstances was far-reaching adjustment. The twin challenge of generating large trade surpluses in order to service foreign debt and of maintaining growth and internal balance has proved a formidable one. In most countries, the former has been fairly successfully achieved but only at the expense of the latter: economic growth has slowed down, imports and investment have been slashed, inflation has accelerated and per capita incomes have regressed to the levels of the mid-1970s or even earlier.

The experience of the past few years has raised serious concern about the prospect of surmounting the current debt and adjustment problems. At this juncture, there are four basic interrelated questions. First, what are the implications for internal macro-economic balance of the adjustment required to meet debt-service obligations? Secondly, how will world trade and finance evolve and influence debtors' disposable foreign exchange and capacity to import? Thirdly, what are the policy options available to debtor countries seeking to apply growth-oriented policies and to revive domestic investment? Finally, what are the prospects for a resumption of private voluntary lending as a key element in the transition to a more viable external payments position? Seen as a whole, these questions yield a sense of the complexity of the current debt problem and its relationship with the broader issues of global trade and finance.

Just as the eruption of the debt problem in the early 1980s reflected a fundamental shift in the costs of financial capital and global saving-investment relationships, its resolution ultimately depends on the evolution of world capital formation and its distribution between creditor and debtor countries. This interpretation places the debt problem in a medium-term perspective and emphasizes the crucial role of the relationship between savings and investment in debtor countries in determining the potential for growth and prosperity. Given the basic saving-investment identity, future debt-servicing payments can be effected at the expense of domestic investment, as in fact has been the

case to date, or through higher domestic income and savings. The first alternative cannot be sustained for long, as the ensuing reduction in the level of domestic investment tends to undermine productive and export capacity. This leaves the second alternative, which depends on the successful mobilization of domestic resources.

These issues are elaborated below for a sample of 33 large debtor developing countries, including energy exporters, diversified exporters of manufactures and non-fuel primary commodity exporters, as identified in table VI.1. These countries accounted for about 95 per cent of the total external debt of capital-importing developing countries in 1984.

External adjustment: salient features and internal implications

The sharp swing in the trade and current account balances of indebted developing countries during the past four years emerged as a result of the efforts of these countries to come to grips with the unsettled global environment of the early 1980s. Compelled by external financial constraints, the debtor countries managed to reduce significantly, and in some instances to eliminate completely, the deficit on their current accounts. Between 1982 and 1984, the combined payments deficit of the selected 33 debtor countries declined by \$63.8 billion, or 80 per cent of the initial deficit. Almost two thirds of this decline was due to the improvement in the external imbalance of the seven major borrowers, whose aggregate balance on current account swung from a deficit of \$40.7 billion in 1982 to a surplus of \$1.1 billion in 1984. Thus, during this period, these major debtors managed to shift their overall external payments position from a situation of dependence on external savings to one of supplying capital to the rest of the world. This shift, as a percentage of GNP, was from a deficit amounting to 5.3 per cent to a surplus of 0.3 per cent (see table VI.1).

Given their high interest payments, this improvement in the current account of the indebted developing countries, as shown in figure VI.1, stemmed from an even greater improvement in their trade position. Thus, by 1984, the large debtor countries as a whole were running a trade surplus of \$22.4 billion, which contrasts with a deficit of \$49.1 billion in 1981. Expressed as a share of exports of goods and non-factor services, this enormous shift of \$71.5 billion over a time span of three years represented a turn-around in their net transfer of resources from an inflow of 15.8 per cent in 1981 to an outflow of 7.4 per cent in 1984 (see table VI.1).¹

¹ The definition of the net transfer of resources employed in the present chapter differs from that discussed in annex III below. Using the symbols employed in that discussion, the net transfer used here is defined as $-(X-M)$, which may be considered a variant of $-(X-M+L)$. The source of the difference is that labour earnings from abroad, L , are treated in this chapter as part of the foreign transfer (which is standard treatment in national income accounting), while they are grouped with export earnings in annex III. Therefore, to the extent that countries treat labour remittances as a form of export earnings, the estimates of resource transfers shown in table VI.2 are overestimates of the positive resource transfer and underestimates of the negative transfer. This caveat affects especially Egypt, India, Morocco, Pakistan, the Philippines, the Sudan, Turkey and Yugoslavia, all of which have had labour earnings in recent years ranging from more than 20 per cent of merchandise exports up to roughly 100 per cent.

Table VI.1. Selected debtor developing countries: indicators of balance-of-payments adjustments, 1979-1984

(Billions of dollars)

	1979	1980	1981	1982	1983	1984
Current account balance, deficit (-) or surplus (+)						
All countries	-40.7	-48.4	-77.6	-80.6	-38.7	-16.8
Major seven	-21.0	-25.7	-34.4	-40.7	-10.6	1.1
Trade balance on goods and non-factor services, deficit (-) or surplus (+)						
All countries	-28.5	-31.4	-49.1	-38.4	-4.1	22.4
Major seven	-7.6	-6.9	-6.1	-1.6	23.4	36.6
Ratio of trade balance to exports of goods and non-factor services (percentage)						
All countries	-12.6	-10.6	-15.8	-13.2	-1.4	7.4
Major seven	-7.8	-5.4	-4.2	-1.3	17.9	25.1
Memorandum item						
Ratio of current account deficit to GNP (percentage)						
Major seven	3.2	3.3	3.9	5.3	1.6	-0.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics and Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

All countries: Algeria, Argentina, Brazil, Cameroon, Chile, Colombia, Costa Rica, Côte d'Ivoire, Dominican Republic, Ecuador, Egypt, India, Indonesia, Israel, Jamaica, Kenya, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Republic of Korea, Senegal, Singapore, Sudan, United Republic of Tanzania, Thailand, Turkey, Venezuela, Yugoslavia and Zambia.

Major seven: Argentina, Brazil, Indonesia, Mexico, Philippines, Republic of Korea and Venezuela.

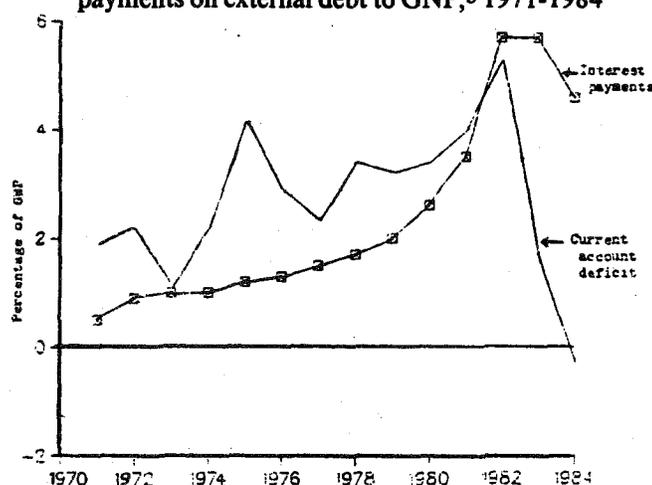
This pronounced swing in the trade positions of debtor countries entailed a large transfer of real resources abroad, which had important implications for their domestic resource balance, and thus for their macro-economic performance. The magnitude of these transfers, however, has varied across the debtor countries, the large Latin American and small developing countries generally experiencing a relatively large outflow of real resources averaging 3-7 per cent of GDP in 1982-1984 (see table VI.2). This contrasts sharply with a net inflow of about 2-8 per cent of GDP in 1976-1981. In a sense, then, over the past few years these countries have experienced a massive supply shock. For countries such as Cameroon, Costa Rica, Côte d'Ivoire, Ecuador, Venezuela and Yugoslavia, this supply shock amounted to 5-8 per cent of GDP.

The policy response to a supply shock of this kind

should preferably have included a reallocation of resources towards the tradable sector. This would have alleviated the need for compression of demand and moderated the contraction of domestic output and income. However, the abrupt curtailment of external lending in 1982 in the midst of the global recession left many countries no option but to cut back imports, including those of essential intermediate and capital goods. Since this stringency persists even today, the severe constraints on imports and capital formation have serious implications for future economic growth and debt-servicing capacity. Real imports declined at an average annual rate of 10-20 per cent in 1982-1984 in a large number of countries, including Argentina, Brazil, Chile, Mexico, Nigeria, Peru, the Sudan and Zambia. From 1981 to 1984, real imports in these countries fell by at least 30 per cent - in some of them by up to 60 per cent.²

² For the 33 countries as a group, the average annual rate of growth of real imports in 1982-1984 fell by about 10.5 per cent below the corresponding rate for 1976-1981. The estimated standard deviation for the import slow-down is 12.41, which indicates a high degree of non-uniformity with regard to import changes.

Figure VI.1.
Major debtor developing countries:^a ratios of the
combined current account deficits and interest
payments on external debt to GNP,^b 1971-1984



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics and Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

^a Argentina, Brazil, Indonesia, Mexico, Philippines, Republic of Korea and Venezuela.

^b Based on the ratio of the current account deficit and interest payments on external debt to GNP for individual countries weighted with three-year moving averages of GDP shares.

Relationship between real domestic output, demand and exports

The need to curtail imports in debtor countries in the early stages of their adjustment process unavoidably entailed a sharp compression in the level of domestic demand. As shown in table VI.3, real aggregate domestic demand fell in many debtor countries, particularly in Latin America. In Chile, Mexico, Peru and Venezuela, real aggregate demand declined at an average annual rate of 5-8 per cent during the 1982-1984 adjustment period. In contrast, in Asian countries such as India, Malaysia, Pakistan, the Republic of Korea and Singapore, domestic demand continued to grow during this period, but at a slower pace than had been experienced in the late 1970s.

Accompanying these changes in domestic demand in debtor developing countries have been movements in the level of their aggregate output. The rate of growth of output is associated, in an almost one-to-one relationship, with the rate of change of domestic demand over the period 1982-1984. This is illustrated in figure VI.2, which plots the average annual rate of change in real output on the vertical axis against the average annual rate of change in real domestic aggregate demand on the horizontal axis for a sample of large debtors. It is apparent that most of the observations are grouped, for the Asian countries, in the north-eastern quadrant and, for other countries, in the

south-western quadrant, which points to the sharp differences in macro-economic performances. In such Asian countries as Malaysia, Pakistan, the Republic of Korea and Singapore, both domestic demand and output expanded during the adjustment period. In some other countries, for example Chile, Côte d'Ivoire, Mexico, Nigeria, Peru, the Philippines, Venezuela and Zambia, both domestic demand and output contracted.

The relationship between domestic demand and output in debtor countries is more complex, however, than the simple illustration in figure VI.2 suggests. Export behaviour, especially, needs to be taken into account, for the rapid expansion of exports in many debtor countries during 1983-1984 helped to stimulate domestic economic activity and thus provided an important source of domestic growth. In fact, the dynamic interaction between export expansion and domestic growth, as exemplified by the recent experience of East Asian countries, has emerged in the past few years as the overriding feature of some of the countries that successfully weathered the global recession of 1980-1982. There are also indications that the relatively vigorous growth of these countries during the recovery phase of 1983-1984 was propped up by their buoyant export performances.³ Furthermore, it can be argued that the rapid growth of exports of major Latin American debtors during 1983-1984 served, to a certain degree, to coun-

³ In the Republic of Korea, for example, the robust recovery of 1983 was strongly dependent on the rapid expansion of exports - 14 per cent. For further details, see B. B. Aghevli and J. Márquez-Ruarte, *A Case of Successful Adjustment: Korea's Experience during 1980-1984*, Occasional Paper No. 39 (Washington, D.C., IMF, August 1985).

Table VI.2. Selected debtor developing countries:
transfer of real resources^a

(Average annual percentage rates)

	1976-1981 (i)	1982-1984 (ii)	Percentage point change (i) minus (ii)
Algeria	-2.0	2.3	-4.2
Argentina	1.1	4.6	-3.5
Brazil	-1.6	1.3	-2.9
Cameroon	-2.9	2.8	-5.7
Chile	-2.9	0.5	-3.4
Colombia	1.0	-3.7	4.7
Costa Rica	-8.1	0.1	-8.2
Côte d'Ivoire	-0.6	4.4	-5.0
Dominican Republic	-5.8	-3.7	-2.1
Ecuador	-1.9	3.2	-5.1
Egypt	-13.1	-10.2	-3.0
India	-1.3	-2.2	0.9
Indonesia	3.9	-1.4	5.3
Israel	-15.4	-13.5	-1.9
Jamaica	-2.8	-8.3	5.5
Kenya	-5.8	-3.1	-2.7
Malaysia	4.5	-4.5	9.0
Mexico	-1.3	7.1	-8.4
Morocco	-10.2	-9.2	-1.0
Nigeria	0.2	-3.3	3.5
Pakistan	-11.1	-12.2	1.1
Peru	0.7	0.5	0.2
Philippines	-5.8	-5.2	-0.6
Republic of Korea	-3.2	0.3	-3.5
Senegal	-14.1	-18.2	4.1
Singapore	-6.8	-4.2	-2.6
Sudan	-4.3	-2.9	-1.4
Thailand	-5.6	-4.6	-1.0
Turkey	-5.9	-3.8	-2.1
United Republic of Tanzania	-9.4	-11.1	1.7
Venezuela	-0.9	6.5	-7.4
Yugoslavia	-8.2	-2.9	-5.3
Zambia	0.1	-1.5	1.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and *Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

^a Ratio of the trade balance of goods and non-factor services to GDP. A negative value implies that a country is experiencing a net positive transfer of real resources from the rest of the world: a positive value signifies that the country is transferring real resources abroad.

terbalance the contractionary impact of their restrictive domestic demand measures. Without strong export expansion, economic recession in Latin American debtor countries would have been deeper and possibly longer than it was.

Assessment of the potential contribution of exports to domestic growth in debtor developing countries requires that account be taken of both the direct effect and the policy-induced effect as two distinct aspects of that relationship. The direct effect refers to the usual multiplier impact of export expansion on output. This can be measured by the elasticity of output with respect to the volume of ex-

ports. Such elasticity, measured on the basis of a broad cross-section of developing countries, is typically between 0.08 and 0.2. In other words, for each percentage point of export growth, aggregate growth is likely to improve by between 0.08 and 0.2 percentage points. The precise magnitude depends, of course, on the time horizon specified and on the influence of other determining factors.⁴ Thus, for the sample of 33 debtor countries considered here, the estimated export elasticity is 0.1 when exports alone are considered and declines to a value of 0.08 when domestic aggregate demand is also included. In comparison, output

⁴ A. Fishlow, "The state of Latin American economies", Inter-American Development Bank, *Economic and Social Progress in Latin America, 1985 Report*, in which a range of 0.1 and 0.2 is quoted for the estimated export elasticity in developing countries; the wider range reported here is based on the regression analysis of the relationship between output, exports and domestic demand for the sample of 33 countries considered.

Table VI.3. Selected debtor developing countries: rate of change of real domestic aggregate output and demand, 1982-1984

(Average annual percentage rates)

	Real aggregate domestic demand ^a	Real aggregate domestic output ^b
Algeria	2.9	1.6
Argentina	2.1	0.2
Brazil	-0.7	0.3
Cameroon	0.9	5.0
Chile	-5.4	-3.1
Colombia	0.8	1.6
Costa Rica	-0.9	0.4
Côte d'Ivoire	-3.5	-3.6
Dominican Republic	3.1	2.2
Ecuador	-1.1	0.1
Egypt	4.0	4.9
India	4.7	5.0
Indonesia	6.2	3.7
Israel	1.0	1.3
Jamaica	-2.4	0.3
Kenya	0.4	2.6
Malaysia	3.7	6.3
Mexico	-5.3	-1.1
Morocco	3.2	3.2
Nigeria	-2.8	-2.7
Pakistan	5.8	5.4
Peru	-5.7	-2.1
Philippines	-2.7	-0.2
Republic of Korea	5.7	7.5
Senegal	-1.1	1.3
Singapore	8.0	7.5
Sudan	-3.9	-0.6
Thailand	5.7	5.3
Turkey	2.3	5.1
United Republic of Tanzania	-0.3	-0.1
Venezuela	-8.4	-2.2
Yugoslavia	5.2	0.4
Zambia	-6.2	-2.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics and Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

^a Total domestic consumption plus domestic gross capital formation deflated by implicit GDP deflator.

^b GDP deflated by implicit GDP deflator.

elasticity with respect to domestic aggregate demand is 0.63, which is considerably higher than the corresponding export elasticity.⁵

The second aspect of the relationship between the growth of exports and domestic output in debtor countries pertains to the implications of policy measures associated with the strategy of export promotion. These policy measures refer in particular to exchange rates, interest rates,

trade and internal price flexibility. They should strengthen the economy's capacity to adapt to changing environments, and thus render it more resilient to external shocks. The goal should be to foster an allocation of resources between the internal and external sectors that minimizes the need to have recourse to measures to reduce expenditure as the principal means of adjusting to unfavourable exter-

⁵ For the sample of 33 developing countries, the following regression results were obtained:

$$Gy = 1.1 + 0.101 Gx \quad \bar{R}^2 = 0.11$$

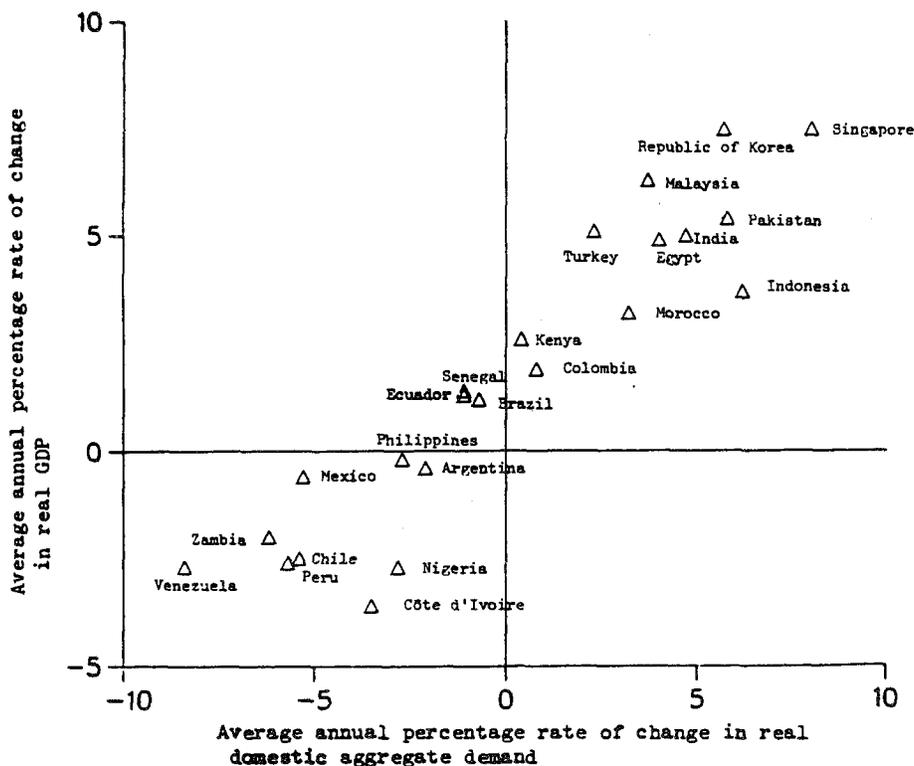
(1.91) (1.97)

$$Gy = 0.98 + 0.63 Gd + 0.08 Gx \quad \bar{R}^2 = 0.82$$

(3.7) (11.1) (3.6)

where Gy , Gd and Gx denote the average annual rate of growth of real output, real domestic demand and real exports, respectively, during the period 1982-1984.

Figure VI.2.
Selected debtor developing countries: real domestic
aggregate demand and real output, 1982-1984



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics and Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

nal shocks. Thus, by bolstering expenditure-switching, these policy measures tend to be supportive of economic growth and stability.⁶

Exchange rate management: a crucial element

Exchange rate management has been a decisive factor underlying the contrasting experience of major debtors, particularly between the East Asian and Latin American countries. The ability to establish and maintain a stable and competitive exchange rate régime in the 1970s, partic-

ularly in the aftermath of the oil price increase of 1973-1974, subsequently proved to be critical in coming to grips with the global shocks of the early 1980s.⁷ Such countries as Indonesia, Malaysia, the Republic of Korea and Thailand by and large succeeded in maintaining their competitive edge by reining in domestic inflation or by depreciating their currencies, or both. This enabled them to surmount the recent global shocks without running into a severe liquidity crisis. Other countries that experienced acute financial difficulties in 1982-1984 had unstable and often overvalued exchange rates in the late 1970s and early 1980s.⁸

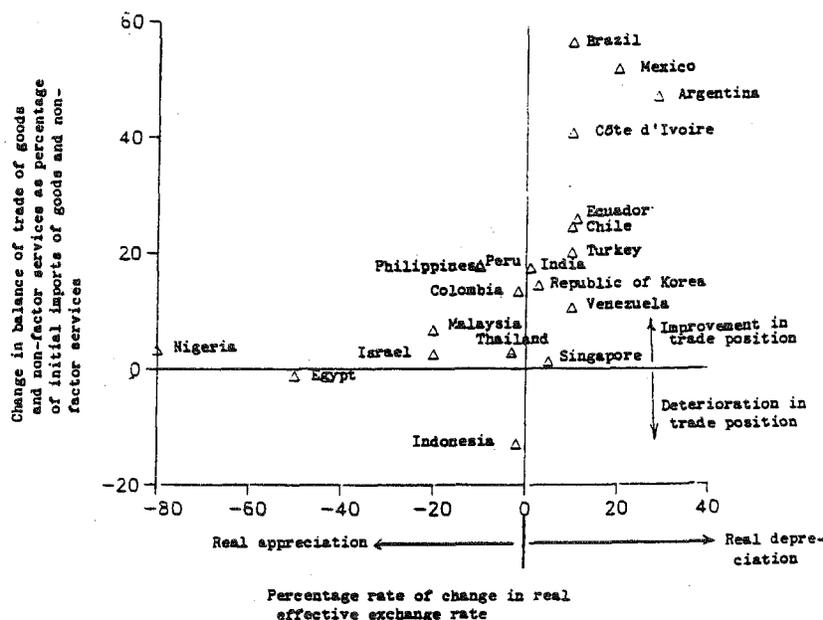
⁶ B. Balassa, "Policy response to exogenous shocks in developing countries", paper presented at the Annual Meeting of the American Economic Association, New York, N. Y., 28-30 December 1985.

⁷ For a detailed elaboration of this point of view, see J. D. Sachs, "External debt and macroeconomic performance in Latin America and East Asia", *Brookings Papers on Economic Activity*, No. 2 (Washington, D.C., The Brookings Institution, 1985).

⁸ For example, the currencies of Argentina, Chile, Mexico and Venezuela appreciated in real terms by 42.0, 4.5, 13.0 and 7.0 per cent in 1979-1981 relative to 1976-1978 (based on data in Inter-American Development Bank, *Economic and Social Progress in Latin America, 1985 Report*, p. 66).

Figure VI.3.
Selected debtor developing countries: relationship
between change in the real effective exchange
rate and improvement in the trade balance

(1984 over average 1980-1981)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and *Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary Overview of the Latin American economy during 1984" (LC/G. 1336, 17 January 1985).

This points to the significance of exchange rate policies for the overall macro-economic performance and external balance of debtor developing countries as shown in figure VI.3. It also holds an important key to the proper management of exchange rates. Exchange rate policy needs to be geared to the establishment of a viable balance-of-payments position. Attempts to utilize the exchange rate for other purposes, for example to combat domestic inflation, are likely to be self-defeating as the experience of the southern-cone countries in the mid-and late 1970s demonstrated. In Chile, for example, the use of the exchange rate to dampen domestic inflation could be sus-

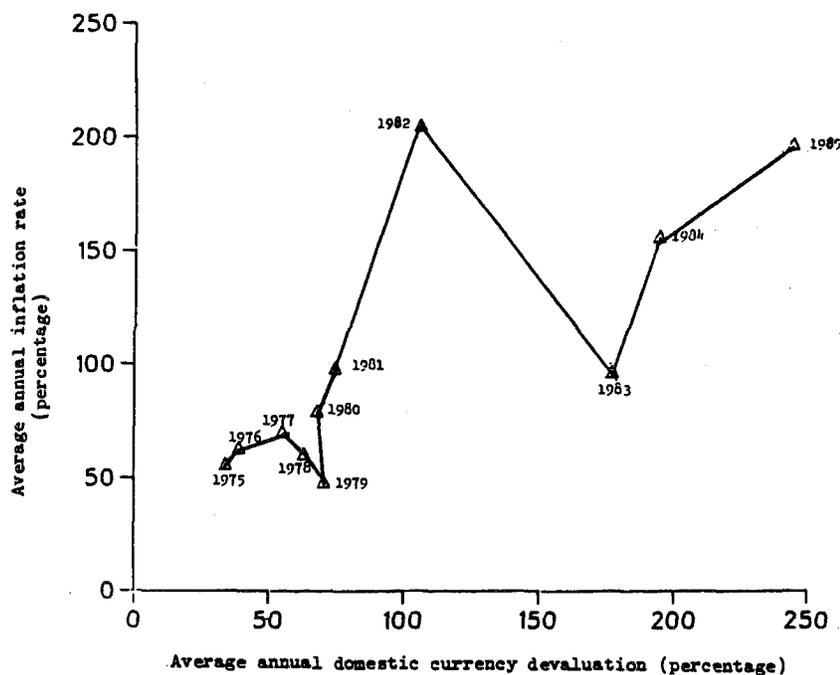
tained as long as net capital inflows continued at a rapid rate. When capital inflows declined in 1982, the economy was left with an overvalued exchange rate and the worst recession since the 1930s.⁹

Maintaining an appropriate exchange rate policy is not in practice an easy task. There are institutional and political obstacles. Internal factor market rigidities, the possibly contractionary effect on output and the implications for income distribution need to be taken into account.¹⁰ Moreover, the duration and intensity of external shocks

⁹ For details, see V. Corbo, "Reforms and macroeconomic adjustments in Chile during 1974-1984", *World Development*, No. 8 (1985).

¹⁰ Depending on the initial trade position and the difference between the marginal propensity to consume gross wages and profits, currency devaluation can have adverse impacts on income distribution and on the level of output and employment. For details see P. Krugman and L. Taylor, "Contractionary effects of devaluation", *Journal of International Economics*, No. 3 (1984).

Figure VI.4.
Major Latin American debtor countries:^a dynamics of
inflation and currency devaluation,^b 1975-1985



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and *Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

^a Argentina, Brazil, Mexico and Peru.

^b Averages of the individual country rates of inflation and currency devaluations weighted with three-year moving averages of GDP shares.

affecting the balance of payments are known only with the benefit of hindsight.¹¹ This weakens the argument for an adjustment in the value of the exchange rate based only on balance-of-payments considerations. Furthermore, given the high import propensities of capital goods and intermediate inputs in debtor countries, currency devaluation translates directly into higher domestic costs and prices. Depending on the degree and nature of wage indexation, this may set off an inflation-devaluation spiral as authorities attempt to establish or maintain a competitive exchange rate system. Aided by the inertia of inflationary expectations, this process can quickly build up into an acceleration of inflation and a need for a draconian currency devaluation, as the experience of several Latin American debtor countries in the past four years attests.

Figure VI.4 illustrates this dynamic interaction between inflation and currency devaluation for four major Latin American debtors with high inflation (Argentina, Brazil, Mexico and Peru) taken together over the period 1975-1985. It is apparent that the dynamics of inflation gained considerable momentum in 1979 and continued to surge until 1982. During that period, exchange rates remained relatively unchanged, which resulted in real appreciation and some loss in trade competitiveness. This was partly corrected in late 1982 by the massive currency devaluations undertaken in the midst of the debt crisis. Although these devaluations entailed a downward adjustment in real terms, at the same time they set in motion renewed inflationary tendencies, which continued unabated until very recently. Thus, between 1981 and 1985, the average

¹¹ M. S. Khan, "Exchange rate responses to exogenous shocks in developing countries", *American Economic Review*, No. 2 (1986).

Table VI.4. Selected debtor developing countries: ratio of gross capital formation to GNP, 1976-1984

(Percentage)

	1976-1981, annual average	1982	1983	1984
Algeria	46.4	38.5	38.9	38.6
Argentina	24.4	19.1	16.2	14.8
Brazil	24.6	22.3	20.8	17.9
Cameroon	23.8	25.9	27.5	28.4
Chile	18.4	12.3	10.8	15.1
Colombia	18.9	21.0	20.0	19.7
Costa Rica	27.2	27.8	29.3	28.7
Côte d'Ivoire	30.1	25.4	25.9	27.0
Dominican Republic	23.7	21.0	22.5	22.8
Ecuador	26.6	24.7	18.1	19.5
Egypt	28.7	30.6	28.4	27.7
India	23.0	24.4	23.9	24.2
Indonesia	21.6	23.4	25.3	22.5
Israel	25.3	24.4	24.3	22.5
Jamaica	17.9	23.1	23.4	26.0
Kenya	26.3	23.6	21.6	22.3
Malaysia	28.2	37.9	37.0	32.8
Mexico	26.0	22.9	18.9	18.5
Morocco	25.5	23.0	21.5	22.0
Nigeria	26.9	23.3	25.9	25.9
Pakistan	16.3	15.7	15.9	15.7
Peru	17.7	23.9	20.8	15.2
Philippines	30.3	28.9	27.7	19.0
Republic of Korea	30.7	27.6	28.2	30.4
Senegal ^a	17.0	15.7	16.6	16.2
Singapore	40.8	46.5	45.7	48.5
Sudan	16.3	17.8	13.8	13.1
Thailand	26.6	21.3	23.1	23.4
Turkey	21.6	20.4	19.7	20.0
United Republic of Tanzania	21.1	20.1	16.7	18.4
Venezuela	33.1	26.7	14.7	15.4
Yugoslavia	40.9	38.5	36.0	35.3
Zambia	23.5	18.1	14.8	15.4

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on various sources, including IMF, *International Financial Statistics*, and other regional and national resources.

^a Ratio of gross capital formation to GDP.

annual rate of inflation in these countries as a whole more than doubled and the currency devaluation more than tripled.

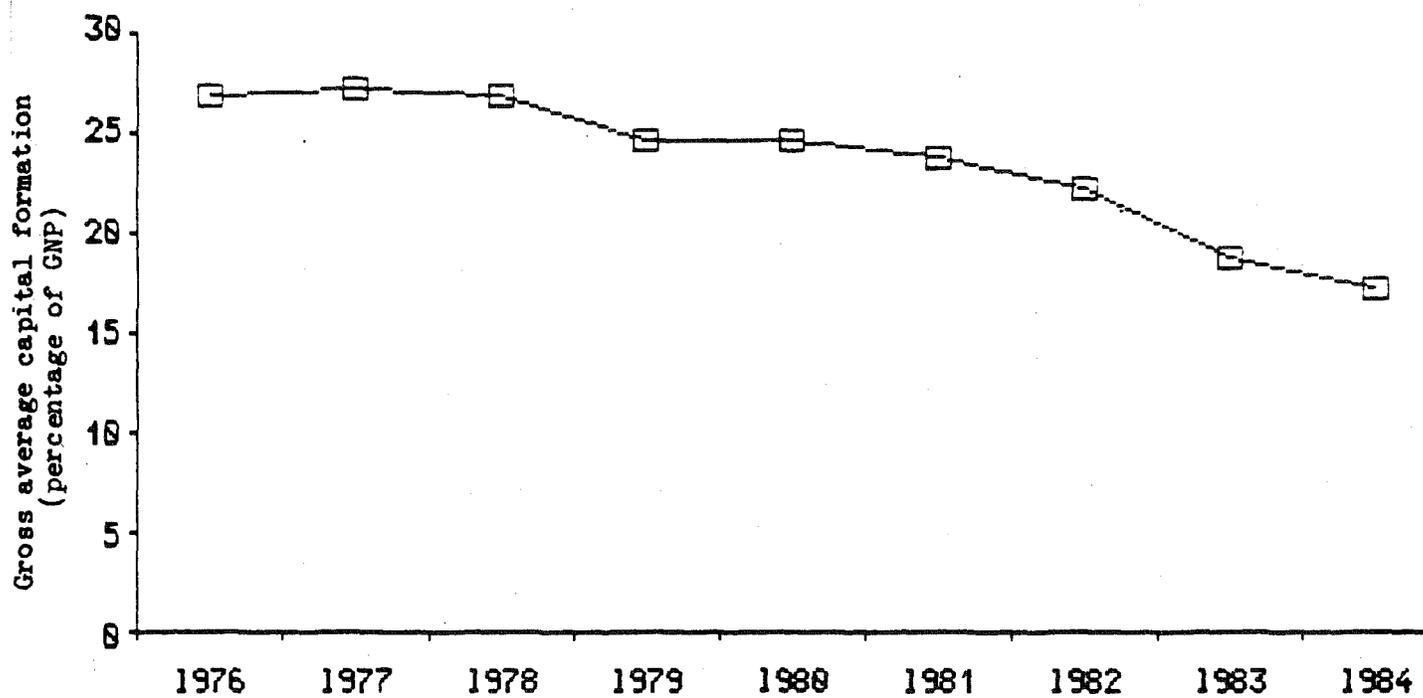
Until quite recently, this process appeared well entrenched in the economic system of these countries. For example, by mid-1985, inflation had accelerated to a critical level in Argentina, pushing the country to the verge of hyperinflation. The authorities then initiated a new set of economic programmes and strategies geared to securing a drastic reduction in the rate of price increases. Subsequently, Brazil and Peru also adopted a set of wide-ranging anti-inflationary measures involving a tightening of the fiscal stance and rigid wage and price freezes. These policies were launched with a view to bringing about a drastic break in inflationary expectations, which had built up through a long period of lax fiscal and accommodating monetary policy and had been consolidated through a

wide range of indexation mechanisms into a substantial "inertia" component in the inflationary process.¹²

The objective of breaking inflationary expectations appears to have been achieved, at least up to now, in Argentina, Brazil and Peru. In Argentina, by the end of 1985, the rate of inflation, as measured by changes in the consumer price index, had declined to a monthly average of about 2 per cent, compared with a monthly rate of about 30 per cent in June of that year. Similarly, the anti-inflationary policies in Peru began to bear fruit from the last quarter of 1985, when the rate of inflation dropped to an average monthly rate of about 3 per cent, compared with a corresponding rate of 10 per cent in previous months. In the case of Brazil, whose programme was initiated only in February 1986, early indications point to a similar reversal of the past trend of accelerating inflation. At this stage, however, a definitive assessment needs to be deferred until policies are more firmly in place.

¹² For a comprehensive analysis of the effect of indexation on inflation in Argentina and Brazil, see J. Williamson, ed., *Inflation and Indexation* (Washington, D.C., Institute for International Economics, March 1985).

Figure VI.5.
Major Latin American debtor countries:^a gross
average capital formation,^b 1976-1984



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics and Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

^a Argentina, Brazil, Mexico and Venezuela.

^b Average of individual country ratio of investment to GNP weighted with a three-year moving average of GDP shares.

Over the longer run, the evolution of inflation and exchange rates in major debtor countries depends not only on the efficacy of policies for the management of domestic demand but also, and increasingly, on the prospects for an early and sustainable improvement in domestic supply conditions. What matters in the long run is the balance between the level and rate of growth of domestic aggregate demand and supply, and the mechanism through which that balance is achieved. But the net inflow of real resources from abroad has traditionally made an important contribution to aggregate supply in the developing countries. The relative significance of that inflow has varied

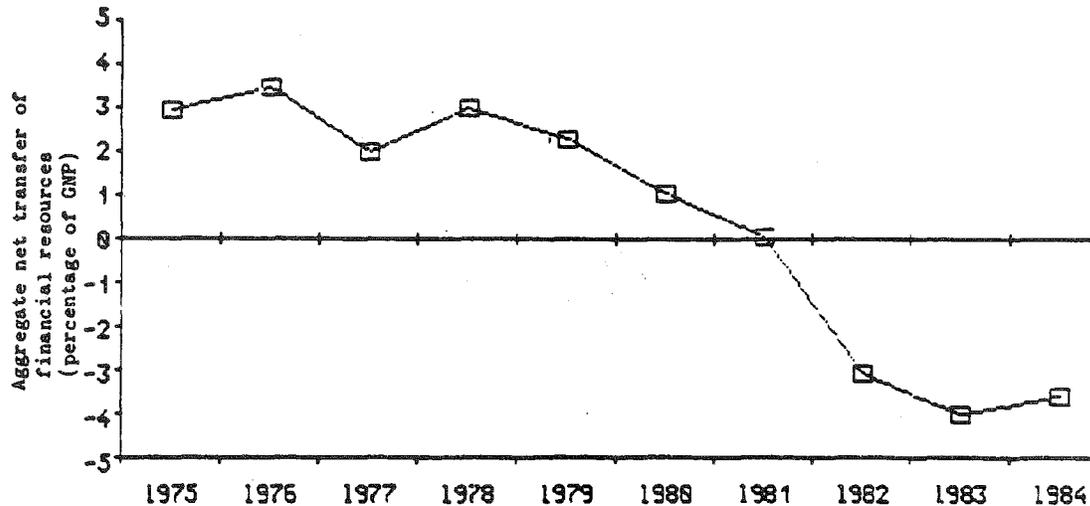
from country to country, depending on the size and the degree of openness of the economy. For a small country like Costa Rica, for example, the inflow of real resources averaged 7.4 per cent of the total domestic supply of goods and services in 1976-1981. That inflow virtually disappeared in the 1982-1984 adjustment period. In fact, it was reversed for many other countries, including Argentina, Brazil, Côte d'Ivoire, Mexico and Venezuela.¹³ Under these circumstances, the policy responses in Costa Rica, as in many other debtor countries, were drastic compressions of imports and sharp reductions in the level of domestic investments, including private ones.

¹³ The total domestic supply of goods and services (i.e., aggregate supply) is defined as the sum of domestic real output (i.e., real GDP) and the real trade balance. Formally,

$$S = Y + e(M - tX)$$

where S is domestic aggregate supply, Y is real GDP, e is the real exchange rate, M is the volume of imports of goods and non-factor services, X is the volume of exports of goods and non-factor services and t is the terms of trade. The relative contribution of foreign resources to domestic supply is then $e(M - tX)/S$.

Figure VI.6.
Major Latin American debtor countries:^a aggregate^b
net transfer of financial resources,^c 1975-1984



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics and Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

^a Argentina, Brazil, Mexico and Venezuela.

^b The ratio of the net transfer of resources to GNP of individual countries weighted with a three-year moving average of GDP shares.

^c Net capital inflow including IMF special financing, less interest payments on foreign debt.

Adjustment through a sharp reduction in investment

The recent decline in domestic aggregate demand associated with external adjustment efforts has fallen to a large degree on investment. In many debtor countries, including Argentina, Brazil, Chile, Ecuador, Mexico, the Philippines, Venezuela, Yugoslavia and Zambia, the ratio of gross capital formation to GNP has declined substantially since 1982. By 1984, it had dropped by at least 5 percentage points relative to the average of the second half of the 1970s (see table VI.4). The decline has been particularly dramatic for the Latin American countries. For example, in the four major debtor countries (Argentina, Brazil, Mexico and Venezuela) the investment ratio, which had

been relatively stable in the second half of the 1970s at 26 per cent of GNP, had declined to about 17 per cent of GNP by 1984 (see figure VI.5).

This dramatic decline in the level of investment in most debtor countries over the past four years has ominous implications for future growth and productive capacity, including capacity to export. The cost in terms of lost output has already been quite substantial. Just for the four major Latin American debtor countries, an approximate estimate of the cost in 1980 prices amounted to \$42 billion in 1982, \$89 billion in 1983 and \$116 billion in 1984.¹⁴ Thus the cumulative cost of output forgone during 1982-1984 amounted to about \$247 billion, which is nearly

¹⁴ For each country, forgone output was calculated as the difference between the actual level of output and the output that would have been obtained had the investment ratio remained at its average 1980-1981 level. The latter was estimated by applying estimates of the incremental capital-output ratio (ICOR) to the average ratios of investment to GDP for 1980-1981. The estimated ICORs are: 8.8 for Argentina, 4.7 for Brazil, 3.7 for Mexico and 6.8 for Venezuela.

equal to the total gross external debt of these countries at the end of 1982.

To account for the various factors that led to plummeting investment activity in debtor countries, variations in both the intensity and the extent of the external shocks, and in the scope and mixes of domestic policy responses have to be taken into account. Two sets of common factors appear to have dominated the pattern of investment experiences over the past four years. First, the combination of escalating interest payments and the curtailment of commercial bank lending since 1982 squeezed the funds available for domestic investment. Secondly, the scope for domestic anticyclical policy measures in response to the deflationary forces of the global recession of 1980-1982 was very limited, at best. In combination, these two factors imparted a sharp bias against domestic investment and growth during the recent adjustment process. This contrasts with the adjustment experience of the mid-1970s, when most developing countries managed to maintain, or even to accelerate, the pace of their domestic investment and growth. The required downward adjustment in domestic demand at that time fell mostly on consumption rather than on investment.

The weakness of domestic policy in debtor countries in dealing effectively with the latest global disturbances is partly structural in nature. It stems largely from the close link between the government's budget and the external sector. As in many developing countries, a high proportion of government revenue comes from taxes on foreign trade, either directly through duties on imports and exports or indirectly through corporate income taxes related to the export industry.¹⁵ On the expenditure side, there are also important components that depend directly on developments in the external sector, including changes in capital flows and in interest payments. Among these, the most burdensome in recent years has been the escalated cost of interest payments on foreign public debt, which has burdened the government budget and exerted pressure on domestic interest rates. Higher domestic interest rates have, in many cases, "crowded out" private sector investment and have added further pressure on government budgets. Moreover, given the limited room for reducing current public sector expenditures, the brunt of fiscal pressure has been borne by capital formation. Public capital expenditure as a share of GDP in such countries as Argentina, Mexico and Peru fell by as much as 3 percentage points from 1980 to 1984. The corresponding figure in Venezuela was particularly dramatic: a fall of more than 15 percentage points.

Moreover, rising interest payments on foreign debt in

combination with the continuing retrenchment in commercial financial flows since 1982 has affected the ability of debtor countries to muster domestic savings for capital formation. Since interest payments in the past four years exceeded the net inflow of capital, some of these countries have experienced a net outflow of resources that otherwise could have been allocated to investment. For example, for the seven major debtors as a whole, such an outflow of resources amounted to 3.5 per cent of GNP (18 per cent of domestic investment) in 1983-1984, in contrast to an inflow of 2.8 per cent of GNP in 1980-1981 (10 per cent of domestic investment) (see figure VI.6).

At the same time, with domestic saving propensities remaining generally unchanged over the past few years, the substantial growth in interest payments on foreign debt has resulted in a corresponding reduction in national savings available for investment purposes. As shown in table VI.5, national savings declined in many countries; in some, this took on dramatic proportions. For example, in Chile, the ratio of national savings to GNP declined from an average of 11.2 per cent in 1979-1981 to an average of 3 per cent in 1982-1984. Moreover, Argentina, Brazil, Indonesia, Nigeria, Venezuela and Zambia experienced a large decline in their national savings ratios.

Restoring growth in capital formation and output

For many developing countries, a return to growth rates that ensure increases in per capita incomes and an expansion of export supplies as well is predicated on mobilizing a considerable increment in investment and more effective use of the existing capital stock. While overall efficiency is mostly determined by micro-economic policies and a judicious mix of private enterprise and public sector activities, a country's aggregate investment level depends largely on macro-economic policies, its current economic situation and the international trade and payments environment. But raising investment to levels similar to those attained before the current recession is, in many countries, going to be very difficult.

At the domestic level, reduced per capita incomes, the weak financial situation of private corporations, the burden of interest payments on foreign debt and rather high fiscal deficits continue to hamper efforts to raise private and public savings. Even so, the further realization of adjustment efforts under way in some countries is likely to lead to a gradual increase in savings. In other countries, policy changes geared to decreasing the fiscal deficit on current account and to making private savings more attractive to potential savers are called for.

¹⁵ Roughly about 50 per cent of the tax revenue of developing countries can be directly related to the foreign sector, see V. Tanzi, "LDC fiscal policy responses to exogenous shocks", paper presented at the meeting of the American Economic Association, New York, N. Y., 28-30 December 1985.

Table VI.5. Selected debtor developing countries: domestic savings, national savings and net factor payments, 1976-1984

(Average annual percentage of GNP)

		Domestic savings	National savings ^a	Net factor payments ^b
Argentina	1976-1978	30.6	29.5	1.1
	1979-1981	20.9	19.2	1.6
	1982-1984	22.3	17.2	8.8
Brazil	1976-1978	25.2	23.2	2.0
	1979-1981	21.1	18.0	3.0
	1982-1984	21.8	17.4	4.4
Chile	1976-1978	15.2	12.0	3.2
	1979-1981	15.3	11.2	4.1
	1982-1984	13.3	3.2	10.1
Colombia	1976-1978	21.7	10.1	1.6
	1979-1981	19.0	18.2	0.8
	1982-1984	17.5	14.3	3.2
Costa Rica	1976-1978	17.9	15.0	3.0
	1979-1981	20.8	10.0	10.8
	1982-1984	19.9	16.6	13.2
Côte d'Ivoire	1976-1978	31.9	21.6	10.2
	1979-1981	24.2	11.0	13.2
	1982-1984	17.2
Ecuador	1976-1978	23.6	20.5	3.0
	1979-1981	26.7	21.5	5.2
	1982-1984	25.4	17.8	7.6
Indonesia	1976-1978	25.2	21.6	3.6
	1979-1981	27.8	23.4	4.4
	1982-1984	19.1	14.7	4.4
Mexico	1976-1978	33.3	20.4	2.4
	1979-1981	32.5	23.9	3.3
	1982-1984	31.1	24.4	7.0
Morocco	1976-1978	12.5	15.9	-3.4
	1979-1981	11.0	13.3	-2.3
	1982-1984	10.2	11.9	-1.7
Nigeria	1976-1978	26.5	25.6	0.9
	1979-1981	26.5	25.4	1.1
	1982-1984	16.9	15.6	1.4
Peru	1976-1978	14.4	10.4	4.0
	1979-1981	23.3	17.4	6.0
	1982-1984	21.0	14.2	6.8
Philippines	1976-1978	24.2	23.8	0.4
	1979-1981	24.9	24.4	0.5
	1982-1984	22.1	19.4	2.8
Republic of Korea	1976-1978	26.4	25.0	1.4
	1979-1981	25.6	22.4	3.1
	1982-1984	27.6	23.5	4.0
Venezuela	1976-1978	33.2	32.8	0.4
	1979-1981	31.8	31.5	0.2
	1982-1984	30.9	27.6	3.3
Yugoslavia	1978-1978	33.9	38.9	-5.0
	1979-1981	36.5	40.7	-4.3
	1982-1984	31.8	34.8	-2.9

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics and Balance of Payments Statistics*, and various national and regional sources including ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985).

^a Defined as the difference between GNP and total domestic consumption.

^b Net payments of profits and interest and labour remittances, from the balance-of-payments accounts. In principle, net factor payments should be equal to the difference between domestic and national savings; they may not be equal, however, because of averaging over the sub-periods and the use of balance-of-payments data which do not always coincide with those of the national income accounts. The balance-of-payments data were converted into local currency using official exchange rates.

The external constraints are to a large extent a legacy of the early 1980s. For most countries, debt-service requirements are equivalent to up to a fourth of aggregate domestic savings. At the same time, they need to compensate for dwindling capital inflows, to increase their imports of machinery and equipment and to allocate a growing share of total investment to the expansion of tradable goods. However, the precise impact of these constraints depends to a great extent on global developments, including international economic co-operation policies.

Adjustment, investment and structural change in centrally planned economies

The mid-1980s marks a very important juncture in the development process of the centrally planned economies for a number of reasons. Three stand out. First, new medium-term socio-economic development plans for 1986-1990 have recently been introduced.¹⁶ These blueprints of policy intentions and goals regarding desirable economic structures are normally drafted after taking stock of past achievements, assessing prevailing development conditions and attuning objectives to the evolving socio-economic environment. Secondly, the sharp external and internal growth constraints encountered by the majority of these countries in the first half of the 1980s have been instrumental in reassessing what is expected to be feasible. Finally, most countries have recently debated in depth the introduction of pivotal changes in domestic and regional economic policies, policy instruments and their supporting institutions, and economic organization. Some have already initiated such domestic changes,¹⁷ while others have announced their intention to do so in the near future.

Perhaps what marks the present as an unusual moment is above all the recent development experiences of these countries. During the first half of the 1980s, divergences from intended medium-term plan targets,¹⁸ as well as from successive annual plan targets, which sometimes already deviated substantially from the medium-term planning framework, manifested themselves in many economic aggregates and sectors throughout the group. Most of the impact was borne by investment. Whereas plans in the European members of the group¹⁹ tended to be under-

Lower interest rates and an early implementation of the Baker initiative should go a long way towards easing the external constraints. Likewise, faster growth in international trade, rising primary commodity prices and a rollback of protectionism would widen the range of policy options and enhance investment levels in many countries. In sum, at the present juncture, restoration of investment in the developing world, which is the key factor in growth-oriented adjustment, is a challenge that has not only a fundamental domestic dimension but also an international one of at least equal importance.

fulfilled, especially during the first three years of the 1981-1985 planning cycle, in several of the Asian centrally planned economies economic growth accelerated to levels well above those planned.

At the end of the 1970s and early 1980s, several Eastern European economies had to take emergency adjustment measures because of external payments problems. But the need to seek far-reaching structural changes and adaptations in organization, management, policies and instruments in these countries, as well as in the Soviet Union, also arises from domestic developments, such as the exceedingly modest increments in the supply of production factors and in factor productivity. China's motivation to embark on structural adjustment measures has a complex origin and differs significantly from what underlies the policies of the European countries. The impact of the evolution of investments in the first half of the 1980s on the past and prospective economic performance of the centrally planned economies²⁰ is examined below.

Economic policies in the 1980s

The post-war development strategy of the centrally planned economies has been overwhelmingly an "extensive" one. By the steady absorption of idle, underutilized or reallocated production factors in the modern manufacturing sectors, aggregate economic growth has been paced in particular by comparatively high rates of capital forma-

¹⁶ On the occasion of each country's congress of the Communist Party the final version of the plan is usually formally endorsed. The first congress was held in February 1986 in the USSR, and the last is scheduled to take place before the middle of that year. The Democratic People's Republic of Korea is the only country with a planning cycle of its own. It concluded a seven-year plan in 1984 and has been debating the introduction of a new medium-term plan of similar duration. Neither the plan nor its timing has been announced to date.

¹⁷ The process of such transitions in economic mechanisms, once embarked upon, is by its very nature a protracted and evolving one, and is therefore not expected to be concluded for at least the next few years.

¹⁸ Details of the medium-term plans for 1981-1985 are discussed in "Medium-term growth and trade in the light of the socio-economic development plans of Eastern Europe and the Union of Soviet Socialist Republics for 1981-1985", *Supplement to World Economic Survey 1981-1982* (United Nations publication, Sales No. E.82.II.C.2), pp. 15-35.

¹⁹ The overall approach to economic adjustment under external constraints for the Eastern European centrally planned economies is clarified in *World Economic Survey 1985* (United Nations publication, Sales No. E.85.II.C.1), pp. 89-101.

²⁰ Finalized five-year plans were available for only Hungary and the USSR at the time of writing (end of March 1986). A more comprehensive examination of the implications of all plans for the policy framework, growth and trade in the second half of the 1980s is currently under way. It is slated for publication in a future issue of *Supplement to the World Economic Survey*.

tion.²¹ Numerous construction projects, especially projects related to manufacturing capacities, enabled most countries to establish a broad industrial structure. But this rapid build-up occurred without adequate attention to the efficient allocation of scarce resources, capital in particular.

The obstacles associated with extensive investment policies became especially apparent when aggregate output growth started to decelerate during the second half of the 1970s. The dispersion of resources over many projects, the excessive expansion of productive capacity in breadth rather than in depth, and the lengthening cycle of investment projects in progress all compressed the increment in capacity available for current production operations. At the macro-economic level, the widening of investment entailed losses and delayed returns on investments; it was not very conducive to technological progress; it disregarded in a number of respects the transformation in intermediate and final demand; it restrained consumption growth; and, as capital-output ratios rose, it adversely affected the expansion of aggregate output of the economy as a whole.

Towards the end of the 1970s, policy makers adopted as their overriding goal the rapid promotion of more efficient capital use in conjunction with curbing the further expansion of physical supplies, in some cases by lowering the share of accumulation (i.e., net investment in fixed assets and inventory changes) in income uses.²² The expected gains in efficiency and qualitative characteristics of capital utilization, especially in the material production sphere,²³ were expected to offset the adverse impact of decelerating growth of available funds. Efforts to obtain a more efficient contribution of capital to growth, to improve the sectoral distribution and efficiency of investment, and to accelerate structural and technological change were placed at the centre of investment policies.

These qualitative improvements in the investment process were to result in part from modifications in economic management and resource allocation. Whether the restraints on the quantum growth of capital would facilitate or inhibit the drive towards greater efficiency has been a

controversial topic of policy debates. Switching to an intensive growth strategy is not a simple manoeuvre even in a favourable internal and external environment. Precisely because of the priority given to easing bottle-necks and capacity constraints in the appropriation of investment funds in the 1970s, the ability of the centrally planned economies to supply the engineering goods required for renovation and modernization of plant and equipment had weakened.²⁴ The process of intensification depends critically on the best utilization of additions to the existing capital stock. But it is also contingent on fostering full use of existing and incremental production capacities, accelerating the pace of technological change, more rational use of all material inputs and improving the range and quality of output.²⁵

Most of the Asian centrally planned economies are still in the process of establishing basic manufacturing activities and are therefore seeking to further round off their economic structure. Nevertheless, their condition, too, necessitated paying greater attention to productivity as a source of further growth. This was a particularly crucial concern in China for two basic reasons. On the one hand, with the inauguration of the period of adjustment and reform in 1978, policy makers stressed the need to obtain growth chiefly by increasing efficiency. Another important consideration was the need to curb investment. In 1978, the accelerated capital formation, in part through massive imports, quickly demonstrated that the country lacked the capacity to absorb effectively such a voluminous injection of new equipment. The widespread market shortages and ineffective project construction that ensued failed to be reversed quickly²⁶ through policy measures because of strong inertia, difficulties in cancelling projects and the reluctant response of local governments. All this called for cautious economic policies in the early 1980s to avoid jeopardizing the reform and adjustment process.

Under the circumstances, the centrally planned economies adopted rather modest growth targets for the first half of the 1980s (see table VI.6). Most plans were oriented towards structural adjustment and establishing more balanced economic growth. In many countries, the quinquennium was to be the crucial test of whether the managerial

21 The post-war trend of gross fixed investment in Europe exceeded that of aggregate output by 1.5 to 3 percentage points (see "Trends in fixed investment and capital stock in the ECE region", paper prepared for a seminar on the interrelationships between structural changes and investment policies (July 1985) p. 12), with a consequent rising share of accumulation (i.e., total net capital formation plus changes in inventories) in aggregate income uses or total domestic absorption at least until the mid-1970s. For China, the share of accumulation doubled between 1950 and 1960, but then declined to about 34 per cent in 1975 and to around 30 per cent in the mid-1980s (see *Statistical Yearbook of China, 1984* (Hong Kong, Economic Information Agency, 1984), p. 32).

22 For a more comprehensive explanation, see "Medium-term growth and trade in the light of the socio-economic development plans of Eastern Europe and the Union of Soviet Socialist Republics for 1981-1985", *Supplement to the World Economic Survey 1981-1982* (United Nations publication, Sales No. E.82.II.C.2), pp. 18-20, 23 and 24.

23 Economic policies in these countries are usually formulated in terms of a disaggregation of the overall economy into productive (or material) and non-productive (or non-material) sectors. The latter sector comprises all services that are not related, either directly or indirectly, to the production of goods.

24 One set of domestic problems can be traced to the relatively weak capital expansion in construction, metallurgy and machine-building sectors, because investment funds had been appropriated particularly for agriculture, energy, raw materials, social programmes and infrastructure.

25 It was recently estimated that a 1 per cent reduction of the material intensity of production yields 2.4 times the benefits in terms of aggregate output of a 1 per cent reduction of the wage fund and nearly 4 times that of a 1 per cent reduction in capital expenditure (see L. Gramoteeva, "Ratsionalnoe i ekonomnoe ispolzovanie materialnykh resursov", *Ekonomicheskoe sotrudnichestvo stran-chlenov SEV* (Moscow), No. 9 (1985), p. 69).

26 Total actual investment even increased slightly in both 1979 and 1980.

and planning experiments then introduced would support the envisaged adjustment or whether more fundamental changes would be required to foster intensive development. Most of the European countries firmly anticipated that a more moderate expansion, or even a contraction, of investment would not unduly constrict aggregate output growth. Policy measures were taken to improve the utilization of production factors, especially capital; to channel funds into modernization, conservation and the more efficient use of primary and intermediate inputs; to reduce frozen assets; and to economize on material inventories through improvements in the planning and organization of the investment process. These policy concerns were, however, quickly replaced in the course of plan implementation by efforts to come to grips with a rapidly changing external environment.²⁷

China's moderate medium-term plan was anchored to structural adjustments in heavy industry and shifts in product mix and material inputs. The major tasks were to co-ordinate better the relationship between accumulation and consumption; to correct the balance between agriculture and industry; to curb the wide scale of capital construction projects²⁸ and, more generally, tailor output objectives to available resources; and to let the external balance widen only marginally. In order to speed up economic restructuring, the responsibility system in agriculture was to be improved and elements of urban reforms were to be gradually introduced.

In the European planned economies, unlike what had been intended during the first three years of the 1981-1985 plans, actual policies were mostly oriented towards coming to grips with short-term internal and, especially in Eastern Europe, external imbalances. The pace of aggregate output growth could be slightly accelerated only by the second half of 1983, but it none the less remained well below the post-war trend. This growth performance was in some ways mirrored throughout the manufacturing sectors. Agricultural performance, of course, depended in good measure on events beyond the control of planners. But there was pronounced synchronization in the overall performance of industry, agriculture, and construction.²⁹

In contrast, developments in China and several other Asian planned economies far exceeded planned magnitudes. Helped in part by favourable weather conditions, the rural reform in China accelerated agricultural output growth and led to burgeoning "side" activities, which provided a powerful impetus to construction demand. Furthermore, industrial output in some years soared at unprecedented rates. However, acute imbalances emerged on several fronts: domestic raw material and energy sup-

plies failed to keep pace with industrial and export demand; growth in light industry lagged behind that in heavy industry; and, perhaps more important, growth in consumer supplies trailed increments in money incomes - a discrepancy that gave rise to open and concealed inflationary pressures, and to sharp import surges whenever trade constraints were eased.

Capital formation in the early 1980s: plans versus achievements

In sharp contrast to their comparatively mild, chiefly indirect, effects in the mid-1970s, the global economic and financial constraints typical of the early 1980s had a direct and severe impact, especially on investment activity, in the European economies. All countries had envisaged a reduction in the rate of growth of investment by several percentage points compared with the preceding five years (see table VI.6). Growth was to average approximately 1.5 per cent in the European countries and 1.7 per cent in China - the lowest targets since post-war reconstruction. Actual investment policies in Eastern Europe generally followed this path of slow growth, though performance was mixed. The decline was sharper in countries that were pressed to shift resources away from domestic uses in order to improve external balances, especially during the period of restraint on absorption, 1981-1983. The necessity of structural change, the re-equipment of the economy with resource-saving technology and the reduction of the capital cost of growth were heeded in the more expansive policies of 1984-1985.

The average annual growth of gross investments in Eastern European countries during the first half of the 1980s, relative to the preceding five years, ranged between -7.5 per cent for Poland and 4.3 per cent for Bulgaria, with large year-to-year fluctuations.³⁰ These performances contrast with the 3.4 per cent annual growth in the USSR and an estimated 10 per cent in China. In an apparent break with long-term trends, a feature of this mixed picture in several countries was the continued decline of the ratio of gross investment to aggregate output,³¹ with a sharper decline for the share of net accumulation in overall income uses. In some countries (Bulgaria, China, Czechoslovakia, the German Democratic Republic and the USSR) investment activity exceeded plans.

The compression of investment activity, which was generally strongly correlated with the state of the external imbalance, took the form of restrictions on the authorization of new projects, postponement or scrapping of projects already approved but not yet far along in the implementation phase, and changes in the direction of ongoing investment projects. Some of these measures had been

²⁷ The successive measures adopted are discussed in *World Economic Survey, 1985 . . .*, pp. 93-95.

²⁸ Investment policies also envisaged a concentration of funds for key energy and transportation projects.

²⁹ The construction sector remained especially weak, owing to the priority accorded to modernization in preference to capacity expansion in breadth.

³⁰ The Polish case is, of course, exceptional. The extreme of the range, leaving Poland aside, starts with -2.1 per cent for Hungary.

³¹ It dropped from 34.8 per cent in 1976-1980 to 29.2 per cent in 1984 in Eastern Europe, and from 30.3 per cent to 29.9 per cent in the Soviet Union; it declined further in 1985. These shares, however, are well above those implicit in the plans, largely because the growth of aggregate output and domestic absorption lagged considerably behind the modest plan targets.

Table VI.6. Centrally planned economies: basic economic growth indicators, 1976-1990

(Annual percentage changes)

Country or country group	1976-1980	1981-1985 ^a	1981-1985 ^b	1986-1990 ^a	1981	1982	1983	1984	1985 ^b	1986 ^a
China										
Net material product	6.0	4.0	9.8	..	4.8	8.3	9.3	14.6	12.3	7
Gross industrial output	9.2	4.0	10.8	..	4.1	7.7	10.5	14.0	18.0	8
Gross agricultural output	5.1	4.0	11.5	..	6.6	11.1	9.9	17.1	13.0	6
Gross fixed investment ^c	6.5	1.7	16.5	..	-10.5	26.6	12.6	24.5	35.0	9
Export volume	20.3 ^d	8.1 ^e	7.1	..	20.8	11.6	-2.8	6.1	1.4	10
Import volume	21.2 ^d	9.2 ^d	13.0	..	18.8	-4.8	-0.7	5.0	56.4	10
Soviet Union										
Net material product	4.3	3.4 ^f	3.4	3.8 ^f	3.3	4.0	4.2	3.2	2.5	3.8 ^f
Gross industrial output	4.5	4.7	3.7	4.2	3.4	2.9	4.2	4.1	3.9	4.3
Gross agricultural output	1.6	2.5 ^c	1.1 ^c	2.8 ^c	-1.0	5.5	6.1	-0.1	0	4.4
Gross fixed investment	3.4	2.1 ^c	3.3 ^c	3.7 ^c	3.8	3.5	5.6	1.9	2.9	7.6
Export volume	4.8	..	1.6	..	1.9	4.5	3.3	2.5	-4.2	..
Import volume	5.8	..	5.9	..	6.4	9.7	4.0	4.4	5.0	..
Eastern Europe ^g										
Net material product	3.9	3.3	2.2	4.7 ^h	-1.9	0.1	3.9	5.3	3.5	5.1
Gross industrial output	5.6	3.8	2.7	4 ^h	-0.6	1.2	4.4	4.8	3.7	4.4
Gross agricultural output	0.8	2.9 ^c	1.1 ^c	2 ^{c,h}	1.8	1.6	0.9	6.7	-0.8	3.0
Gross fixed investment	2.7	-0.1 ^c	-1.4 ^c	3.5 ^{c,h}	-7.1	-4.4	2.3	2.2	3.2	4.0
Export volume ^h	6.5	..	4.9	..	1.2	5.5	7.4	8.4	2.1	..
Import volume ^h	3.9	..	0.3	..	-5.2	-5.8	3.4	5.5	4.5	..
Bulgaria										
Net material product	6.1	3.7	3.7	4.3	5.0	4.2	3.0	4.6	1.8	4.0
Gross industrial output	6.0	5.1	4.5	5.0	4.9	4.6	4.3	4.2	4.0	4.5
Gross agricultural output	0.9	3.4 ^c	1.3 ^c	1.4	5.9	5.2	-7.2	7.0	-9.0	7.4
Gross fixed investment	4.0	3.6 ^c	4.3 ^c	4.3	10.5	3.6	0.7	0.3	2.5 ^h	5.8
Export volume	12.8	..	7.9	..	8.4	11.3	4.4	11.6	4.1	..
Import volume	3.2	..	5.9	..	9.3	3.2	5.2	5.6	6.5	..
Czechoslovakia										
Net material product	3.7	2.4	1.8	3.4	-0.1	0.2	2.3	3.5	3.1	3.5
Gross industrial output	4.7	3.1	2.7	3.1	2.1	1.1	2.8	4.0	3.4	2.6
Gross agricultural output	1.8	1.7 ^c	1.9 ^c	1.3 ^c	-2.5	4.4	4.2	4.4	-1.6	0.4
Gross fixed investment	3.5	-1.1 ^c	-0.4 ^c	2.1 ^c	-4.6	-2.3	0.6	-4.2	5.5	0.8
Export volume	6.3	..	4.6	..	0.5	6.1	5.7	8.5	2.4	..
Import volume	2.9	..	1.1	..	-6.9	2.9	2.0	4.8	3.1	..
German Democratic Republic										
Net material product	4.2	5.1	4.5	..	4.8	2.6	4.6	5.5	4.8	4.4
Gross industrial output	5.0	5.1	4.1	..	4.7	3.2	4.2	4.2	4.4	3.8
Gross agricultural output	1.2	0.8 ^{c,i}	1.6 ^c	..	1.6	-4.0	4.1	6.2	3.0	0.3 ⁱ
Gross fixed investment	3.4	0.5 ^c	0.1 ^c	..	2.7	-5.2	0.0	-5.0	4.5	1.8 ^h
Export volume	5.6	..	5.9	..	8.4	5.4	10.6	3.7	1.7	..
Import volume	4.9	..	1.3	..	-1.3	-4.7	5.3	5.7	2.1	..
Hungary										
Net material product	3.2	2.9	1.4	3.0	2.5	2.6	0.3	2.5	-1.0	2.5
Gross industrial output	3.4	3.8	2.1	2.8	2.4	2.7	1.4	3.2	1.0	2.2
Gross agricultural output	2.5	2.5	0.6	1.6	2.0	7.3	-2.7	2.9	-6.0	3.2
Gross fixed investment	2.4	0.0 ^c	-2.1 ^c	5.6 ^c	-4.3	-1.6	-3.4	-4.4	-3	0.0
Export volume	7.0	..	5.1	..	2.6	7.3	9.4	5.8	0.7	..
Import volume	3.9	..	1.2	..	0.1	-0.1	3.9	0.1	1.8	..
Poland										
Net material product	1.2	-1.3 ^h	-0.8	3.5	-12.0	-5.5	6.0	5.6	3.0	3.2
Gross industrial output	4.7	-0.3 ^h	0.3	..	-10.8	-2.1	6.4	5.2	3.8	3.4
Gross agricultural output	-1.7	2.2 ^h	-0.5 ^c	..	3.8	-2.8	3.3	5.7	0.9	1.9 ^h
Gross fixed investment	-3.0	-6.4 ^{c,h}	-7.5 ^c	5.9 ^c	-22.3	-12.1	9.4	11.4	5.2	4.2
Export volume	4.0	..	1.5	..	-19.0	8.7	10.3	9.5	1.5	..
Import volume	1.7	..	-2.6	..	-16.9	-13.7	5.2	8.6	6.9	..
Romania										
Net material product	7.3	7.1	4.4	7.9	2.2	2.7	3.7	7.7	5.8	11.0
Gross industrial output	9.5	7.6	3.8	6.3	2.6	1.1	4.7	6.7	3.8	8.5
Gross agricultural output	3.8	4.7 ^c	2.0 ^c	5.6	-0.9	7.6	-1.6	13.3	0.4	6.5
Gross fixed investment	8.5	5.2 ^c	1.3 ^c	3.7	-7.1	-3.2	2.4	6.1 ^h	0.7 ^h	7.0
Export volume	5.8	..	4.6	..	13.6	-7.6	0.9	16.5	1.6	..
Import volume	8.3	..	-3.8	..	-7.2	-22.8	-5.0	9.6	10.3	..

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national statistical publications, plans and plan fulfilment reports.

^a Medium-term and annual plan targets. In the case of planned ranges, the mid-point is retained in the table.

^b Preliminary estimates of actual performance based on plan fulfilment reports and other partial information.

^c Change in the five-year average output from the average of the preceding five years expressed as an annual compound rate.

^d In current dollars.

^e Based on plan data expressed in local currency.

^f Net material product utilized.

^g Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland and Romania.

^h Estimate.

ⁱ Net output of agriculture, forestry and food industry combined.

Table VI.7. Centrally planned economies: changes in total and sectoral gross investments, 1976-1985

(Annual percentage changes)

	1976-1980 ^a	1981-1984 ^a	1981	1982	1983	1984	1985 ^b
Bulgaria^c							
Total	6.1	2.9 ^d	9.0	3.2	0.4	-0.2	2.5 ^e
Material sphere	4.8	3.9	10.3	2.4	-1.2	3.0	..
Industry	7.1	4.7	8.0	10.1	-3.2	4.4	..
Agriculture	2.7	-7.5	9.1	-19.3	0.4	2.2	..
Construction	-4.3	10.2	18.7	8.1	17.6	-2.6	..
Non-material sphere	9.6	3.0	5.8	5.3	4.7	-8.6	..
Czechoslovakia							
Total	3.5	-0.9 ^d	-4.6	-2.3	0.6	-4.2	5.5
Material sphere	4.7	-2.5	-2.2	-2.1	0.6	-3.8	..
Industry	5.8	-3.4	-1.4	-4.4	-3.1	-4.8	..
Agriculture	0.7	5.9	5.0	4.6	12.6	1.6	..
Construction	14.9	-4.8	-12.2	3.6	1.3	-10.8	..
Non-material sphere	1.2	-4.3	-9.6	-2.6	0.4	-5.0	..
German Democratic Republic							
Total	3.4	-0.7 ^d	2.7	-5.2	0.0	5.0	4.5
Material sphere	3.3	-2.1	2.3	-5.1	0.5	-5.8	..
Industry	5.6	-0.6	3.2	-1.5	4.0	-7.6	..
Agriculture	-0.4	-6.3	2.9	-7.6	-9.3	-10.6	..
Construction	-2.8	-15.5	-11.3	-19.1	-34.4	8.1	..
Non-material sphere	4.0	-1.4	4.3	-5.6	-2.1	-1.9	..
Hungary^b							
Total	2.4	-3.7 ^d	-5.1	-2.2	-2.7	-3.3	-5.0
Material sphere	2.5	-4.5	-5.0	-2.6	-4.9	-5.4	..
Industry	3.6	-3.2	-8.1	0.2	-2.5	-2.2	..
Agriculture	-0.4	-5.0	8.0	-1.0	-15.4	-9.7	..
Construction	6.2	-16.3	-24.2	-19.8	-6.6	-13.6	..
Non-material sphere	2.0	-0.6	-5.4	-1.1	2.7	1.5	..
Poland							
Total	-3.0	-2.6 ^d	-22.3	-12.1	9.4	11.4	5.2
Material sphere	-4.7	-3.0 ^d	-23.5	-15.3	8.2	13.8	7.7
Industry	-7.2	-2.8 ^d	-27.2	-12.9	6.2	13.7	13.6
Agriculture	-0.7	-3.7 ^d	-12.5	-15.3	5.6	4.0	1.7
Construction	-5.6	-14.2 ^d	-42.7	-47.9	19.3	30.5	0.0
Non-material sphere	2.4	-1.9 ^d	-19.8	-5.7	11.4	7.2	0.6
Romania							
Total	8.5	-0.3 ^d	-7.1	-3.2	2.4	6.1 ^b	0.7 ^b
Material sphere	9.4	0.4 ^c	-2.9	3.0 ^c	8.7 ^c	2.9 ^c	..
Industry	9.6	3.8 ^c	-1.6	-3.7 ^c	10.0 ^c	11.4 ^c	..
Agriculture	8.6	10.0 ^c	17.2	2.6 ^c	11.3 ^c	9.3 ^c	..
Construction	5.7	-0.4 ^c	-25.0	15.2 ^c	-2.1 ^c	16.9 ^c	..
Non-material sphere	4.6	-5.1 ^c	8.3	-2.1	-2.9 ^c	6.5 ^c	..
USSR							
Total	3.4	3.5 ^d	3.8	3.6	5.7	1.9	2.9
Material sphere	3.7	3.3	3.5	3.3	5.3	1.4	..
Industry	3.7	3.8	4.0	2.8	5.5	2.3	..
Agriculture	2.9	1.0	2.6	1.6	3.5	-3.1	..
Construction	4.6	0.4	-0.9	9.8	-0.9	-1.4	..
Non-material sphere	2.6	4.6	4.6	4.6	6.9	3.3	..
China^c							
Total	6.5	16.5 ^d	-10.5	26.6	12.6	24.5	35.0
Material sphere	3.5	12.5 ^d	-29.7	20.0	14.4	27.9	..
Industry	4.7	11.8 ^d	-21.6	20.6	8.3	21.0	..
Agriculture	7.3	0.0 ^d	-43.9	16.8	3.9	4.7	..
Construction	8.7	9.5 ^d	-18.6	15.9	-1.3	9.6	..
Non-material sphere	14.7	12.7 ^d	-4.6	32.6	-2.0	20.8	..

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national statistical publications, plans and plan fulfilment reports.

^a Annual averages as measured between end-years.

^b Preliminary.

^c Current prices.

^d 1981-1985.

^e Estimate.

planned but others were taken in response to emerging developments.³² This experience suggests that the relationship between aggregate output and investment growth is rather stable and cannot be altered in the short to medium run without adverse effects on output growth. Thus, though the USSR plan had called for a faster growth of output than of investments, it proved necessary to expand investments much more than the rate envisaged in order to reach the output target. In those countries where investment declined in absolute terms, aggregate output growth trailed noticeably behind plan magnitudes. Only in the German Democratic Republic, Hungary and Romania was incremental output considerably less investment-intensive than in the previous quinquennium.

In most countries, the compression of investment activity was on the whole greatest in the so-called material sphere, but this tended to be reversed (except in the USSR) as activity picked up in the latter part of the early 1980s (see table VI.7). Given policy makers' intentions as regards modernization and factor productivity, this paradoxical development has two explanations. The non-productive component comprises outlays for the non-civilian sector, whose buoyancy depends on domestic and international political factors only weakly related to the state of the economy. In addition, it includes appropriations for social and related programmes that could not be reversed quickly because of the strong political commitments to improving rapidly the social infrastructure, made at a time of buoyant growth in the late 1960s and early 1970s.

Trends in the allocation of investment between end-users varied among countries. Within the material sphere, appropriations for industry accounted for between 40-50 per cent (Hungary, Poland and the USSR) and 60-70 per cent (Bulgaria and the German Democratic Republic). The share has remained fairly stable in all countries during the past five years. Although there were sharp variations in the comparative expansion of investment in the material sphere and industry, no clear trends can be distinguished. But a marked change in investment allocation patterns common to nearly all the countries of the group was the shift in the course of 1981-1983 towards investment in the fuel and energy-producing branches, chiefly because of foreign exchange constraints, at the expense of investment in light industries, textiles and building materials.

Agricultural investment developed faster than overall

investment between 1981 and 1983 in Czechoslovakia, Hungary and Romania; in Poland the decline in agricultural investment was not so pronounced as that for overall investment;³³ elsewhere non-agricultural investment grew faster than overall investment. However, its share in the material sphere remained fairly stable because of the perceived need to maintain a large degree of self-sufficiency in agriculture, which places an important constraint on industrial development. Even so, fluctuations in output were considerable and domestic food supplies did not rise smoothly in most countries.

China's investment experience in the early 1980s diverged markedly from plans: total outlays were twice the volume planned, in spite of central policy measures to curb nearly run-away construction activity.³⁴ Only in 1981 were planners able to prune capital outlays, although measures to come to grips with the 1978 investment crisis had been initiated by 1979. In fact, the crisis recurred in late 1982 and late 1984 as a result of soaring extrabudgetary investment activity, which consisted of investment in renewing and transforming industrial enterprises (most of which is now financed from retained earnings and bank loans), urban and rural collective investment, and individual investment. These extrabudgetary expenditures resulted in part from the reform policy, particularly in the rural sectors. In the absence of a comprehensive monetary and fiscal policy,³⁵ these reforms have made it difficult to regulate decentralized investments.

Efficiency of capital utilization

The particularly heavy burden of the adjustment measures shouldered by investments in the European countries has given rise to a vexing dilemma: how to improve the structure of final output in favour of technologically advanced products at a time of slower growth in the availability of production factors and rising operating costs. The experience of the early 1980s testifies that the development plans could not have been fulfilled even if more expansive industrial investment had been an option, chiefly because factor productivity growth remained uneven and industrial structures did not improve much in most countries - the German Democratic Republic being a notable exception - since traditional "reserves" (including material inventories, projects in progress and fuller utilization of the available capital stock) could be mobilized only in part.

³² Whereas in 1976-1980 the differences in the average annual rates of change in aggregate output relative to gross investment ranged from a low of -1.1 per cent in Romania to a high of 4.3 per cent in Poland, the 1981-1985 plans called for a range of 0.1 per cent in Bulgaria to 11.7 per cent in Poland; actual results in 1981-1984 ranged between -0.7 per cent in the USSR and 6 per cent in Hungary (see *Economic Survey of Europe in 1984-1985* (United Nations publication, Sales No. E.85.II.E.1), p. 98).

³³ Agriculture's share in the total for investment in the material sphere rose in Poland from 24.6 per cent to 30 per cent and decreased by 2 to 4 percentage points in Bulgaria and the German Democratic Republic. In other countries, it remained fairly stable with fluctuations of 0.5 to 1 percentage point on either side.

³⁴ To counter the crises, the Government applied a series of stern policies, including in 1982-1983 re-checking all projects under construction, re-centralization of the State's financial functions by disbanding investment trust companies, and other devices, especially of a fiscal nature, to discourage financial outlays. More recently, even stronger measures have had to be taken, including pre-depositing of all construction costs and taxes for six months prior to project start, placing the capital construction funds at the disposal of the new People's Construction Bank of China, and higher interest rates. But results to date have been ambiguous at best.

³⁵ In response to recent reforms, the traditional banking sector is expected to solidify soon and to play a strong and self-confident supervisory role that will not conflict with the devolution of economic autonomy to the lower planning rungs or give rise to financial confusion or inflation.

To assess the full scale of the above dilemma, it is important to stress that the slow-down in investment activity stemmed only partly from external pressures. Many high-level decision makers in the European planned economies contended at the outset of the 1981-1985 plans that lower, or even negative, growth in investment activity would force an upturn in capital productivity by concentrating funds, by better project organization and management, and by emphasizing modernization. The evolution of annual activity levels (see table VI.6) tends, however, to confirm the view held by others that rapid accumulation provides the essential means to eliminate disproportions and effect structural changes so as to raise product quality and factor productivity. Since the share of appropriated investment funds that, in the short to medium run, can be easily redistributed is small, given the institutional and behavioural features of these economies, a cut-back in accumulation tends to fragment new investment and add to the stock of frozen assets or investment projects in progress, contrary to policy intentions.

While the cut-backs in appropriations in the productive sphere could have been expected to affect aggregate output adversely, adherence to the contemplated modernization and factor productivity drives would have had the reverse impact. The compression of material inventories and the accelerated completion of projects in progress could in principle offset the curbs on growth of the productive capital stock called for by the adjustment policies. The experiences of the early 1980s have demonstrated that destocking cannot be relied upon excessively without causing severe supply bottle-necks, and hence idling of productive capacities and imbalances in specific consumer markets. As for shortening the gestation period of investment projects, experience has shown that previously appropriated funds can be redistributed only within narrow margins and, in most countries, gestation lags cannot be reduced appreciably. There are a number of reasons for this, including decentralized investment decisions, "locally" financed projects even if in principle discouraged by central policy makers, competing pressures for investments by the lower tiers of the planning machinery and the loose coordination of the emergency adjustment measures. Finally, at a time of sharp shifts in the composition of the desired output structure and in material inventories, fuller utilization of capital resources can be attained in only a few segments of the economy as projects in progress are generally not very fungible and social commitments inhibit, say, increasing the number of shifts.

One of the important qualitative indicators of investment performance is the decrease in gestation periods,

which can actually raise the increment to the capital stock in the short term. The ratios of the value of fixed capital put on stream to gross investment outlays measured over an appropriate period of time indicate that some improvement was recently achieved in this respect, except in Poland.³⁶ This can be attributed to the reduction in new starts and the concentration of resources on the completion of projects in progress. But the data unambiguously suggest that fixed capital brought into operation rarely exceeded gross fixed capital formation; when it did, it was usually by a rather small margin and reversed the following year. Consequently, the stock of unfinished investment continued to rise, though at more moderate rates than typical in the 1970s, except in the German Democratic Republic. In other words, the concentration of resources on the completion of projects needs further improvement.

An indirect indicator of progress in the completion of projects under construction is the change in the share of machinery and equipment in total investment. Since this share has varied only slightly during the past five years,³⁷ the restrictions on new starts were not so binding as envisaged and projects were not completed fast enough, owing in some cases to a shortage of capital goods, and in others to import constraints and the dispersion of funds over too many projects. Some countries, especially those experiencing balance-of-payments constraints, decreased the share of machinery for payments reasons, which delayed the completion of projects since imports are, by definition, not easily offset by domestic production.

The volume and precise allocation of available capital funds, net additions to the capital stock in particular, are crucial determinants of technical change and hence the feasible pace of growth with given resources. But there are a number of other determinants of aggregate economic efficiency, including labour, capital replacement and renewal, trade policies, management and organization. In most countries, no significant upturn in the trend of average labour productivity or a reversal of the upward trend of the aggregate and many sectoral capital-output ratios, which emerged conspicuously in the 1970s, has been reported. Measures addressing the stagnation in labour productivity and the steadily increasing capital-output ratios incurred during the 1970s yielded some success. However, in some countries (including Poland, Romania and the USSR) average annual increments in utilized national income throughout the past five years lagged behind those in fixed assets. In several of these countries, production has become even more capital-intensive at the aggregate level. At the same time, labour productivity growth has continued to trail behind the upward movement in capital-la-

³⁶ This ratio generally improved by between 2 and 5 percentage points for total investments, but in some countries the relationship for industrial investment improved hardly at all. Except for the German Democratic Republic, no country succeeded in delivering to productive capacity in 1981-1984 more than total investment outlays; in industry, only Hungary attained this. For a discussion of the disappointing performance of Czechoslovakia, see V. Klaus, "Rozestavěnost investiční výstavby, model i empirická analýza", *Finance a Úvěř* (Prague), No. 3 (1985), pp. 158-161.

³⁷ It rose in both total and industrial investments only in Bulgaria; in industrial investment only in the German Democratic Republic. Elsewhere, the share stagnated (in Czechoslovakia and the USSR) or it dropped, in some cases precipitously (especially in Poland and Romania) (see *Statistichesky ezhegodnik stran-chlenov SEV, 1982*, p. 148; *ibid.*, 1984, p. 144; and *ibid.*, 1985, p. 168).

bour ratios,³⁸ implying a rise in the average capital-output ratio. Elsewhere, however, growth rates in aggregate income uses have on the whole exceeded those for capital accumulation, sometimes (especially in Central Europe) by a significant margin. Because of the negative or very slow growth in capital and labour with positive, if not very large, gains in labour productivity, these countries appear to have improved their performances in relation to the set-backs of the 1970s. The key question in this connection is whether these gains resulted from the temporary emergency measures or whether they signal sustainable shifts in the production structure.

During 1981-1985, labour productivity (i.e., output per employee) in the European planned economies rose at an annual rate of about 2.5 per cent, and the share of the growth of industrial output accounted for by labour productivity gains reached 93 per cent. This share increased, particularly in countries where the rate of growth of industrial employment had declined or where it was negative; in these countries, the buoyancy of output is evidently the key determinant of average labour productivity. With strict limits on restructuring the labour force in most of the CMEA countries,³⁹ labour productivity can be increased by resolving the problem of supply bottle-necks in order to secure output growth and by improving material incentives. A number of measures adopted in recent years in the field of labour organization, incentives and training may become important determinants of productivity in the years to come.

One key factor behind the unsatisfactory pace of factor productivity growth has been the inability to decrease the material intensity of production from the rather stable levels of the past 25 years. It remains very high by contemporary technological standards, in spite of successes in recent years in such countries as the German Democratic Republic. In view of the drastically increased cost of material inputs, the emphasis throughout the European region has been on effectively lowering the material intensity of production. This has been accomplished in the short to medium term mainly by improving existing technologies, and in the long term chiefly by introducing new resource-saving technologies and far-reaching changes in the struc-

ture of output and resource use through new capital formation.

In the quantitative assessment of structural change, considerable difficulties are encountered. Such assessment appears to be most important at the sub-branch level, for which systematic, comprehensive data are lacking. However, the measurement of shifts in the structure of investment at the macro-economic level, by expressing the change over time in the percentage share of individual sectors relative to the total for the material sphere, and in individual industrial branches relative to the total for industry, suggests a generally uninterrupted trend away from the standard structural pattern in place around 1970. In other words, investments have on the whole been allocated more and more so as to deepen rather than to diversify further the production structure. Measurements over successive medium-term periods suggest in fact an accelerating pace,⁴⁰ the fastest change being recorded in Bulgaria and Romania, and the slowest in Hungary and the Soviet Union.

In contrast with investment, the structural change in output, as measured by the same technique, showed evidence of a marked deceleration. It appears that, in the short term, output patterns do not depend significantly on structural change in investment.⁴¹ Instead, they are a function chiefly of the available capital stock, fluctuations in agriculture, variations in capacity utilization rates due to supply shortages, differences in sectoral and branch gestation periods, and a host of other organizational and material supply factors.

One plausible explanation is that the rate of retirement of obsolete equipment has slowed down, in spite of the recent revisions of the traditionally exceedingly conservative amortization rates in a number of countries.⁴² This reflects a major feature of the economic mechanism of the CMEA countries: the transformation of the structure of fixed assets can be carried out mainly through additions to the capital stock, because a much more rational redeployment of capital, as in the case of labour, and the timely physical scrapping of plant and equipment are rather difficult to undertake. Rapid replacement and retooling inevi-

³⁸ For example, whereas in the USSR labour productivity in industry in 1979, measured against 1970 as 100, lagged behind the rise of the capital-labour ratio by 30 points, in 1980 the gap had increased by 37 points, in 1982 by 55 points, in 1983 by 66 points and in 1984 by 70 points (see *Narodnoe khozyaistvo SSSR v 1984g*, pp. 146 and 153). Thus, the capital intensity of growth for each percentage point of labour productivity rose continuously.

³⁹ Because of the high priority socialist policy makers accord to social stability and the lifetime job guarantee enshrined in the constitution of most of these countries.

⁴⁰ See *Economic Survey of Europe in 1984-1985* ..., pp. 136 and 137.

⁴¹ Even allowing for the deferred transmission of the influence of structural change in investment on output due to the effect of lags between investment and changes in fixed assets, the above discrepancy cannot be fully accounted for. There appear to be other reasons that may help to explain why the adjustment in investment behaviour did not appreciably affect final output.

⁴² For example, the rate of retirement of equipment due to physical disrepair in 1984 was 2.3 per cent of the total value of equipment in USSR industry (*Narodnoe khozyaistvo SSSR v 1984g*, p. 157), but much lower in key sectors (2.1 per cent in machine-building and metal working, 2.1 per cent in the chemical industry, 1.6 per cent in ferrous metallurgy and 0.3 per cent in electric power production). The rate of retirement of all physical plant and equipment was only 1.3 per cent. These rates are considerably lower than the amortization schedules under current regulations. According to the prescribed service life and norms of amortization, no less than 4-4.5 per cent should have been withdrawn from industry and more than that from agriculture, construction and transportation (see *Planovoe khozyaistvo* (Moscow), No. 3 (1985), p. 47). A significant increase in the rate of retirement of equipment in the near future to 7-8 per cent, with further transitions to even higher levels is currently being debated (see K. Valtukh, "Tekhnichesky progress i razvitie investitsionnogo kompleksa", *Kommunist* (Moscow), No. 10 (1985), p. 30). For similar observations pertaining to selected Eastern European countries, see A. Chudrov, "Amortizatsia kak istochnik finansirovania kapitalovlozheny stran-chlenov SEV", *Finansy SSSR* (Moscow), No. 11 (1985), pp. 60-61.

tably require a temporary decline in the enterprise's capacity or the closing of production facilities for some time. Since plan regulations do not normally allow for these eventualities, it is impossible to count on the dynamic replacement of obsolete equipment, the retooling of production and the retraining of the labour force according to shifts in technological requirements as key mechanisms forging factor productivity growth.⁴³ Under these conditions, certain lines of output, though obsolete or costly, are not withdrawn from production or not as rapidly as justified from an economic point of view. The retention in service of obsolete equipment at the time of a sharp slowdown in investment activity, such as that experienced in recent years, entails a deterioration in the age structure of the capital stock and hampers structural change in output. This could also have been a major factor behind the acceleration of the decline in capital productivity recorded in most of the European planned economies in the 1980s. The repair and reconditioning of obsolete equipment is usually more costly than replacement and is associated with extensive underutilization of existing capacity because of frequent repairs, lack of spare parts, stoppages and so on.

The recent upturn in labour productivity appears to stem from the acceleration of overall growth. To some degree, it was also stimulated by removing organizational obstacles, by revising administrative methods, by eliminating critical bottle-necks in the supply of energy and raw materials, and by enforcing more strictly austerity measures in their utilization. The direct contribution of changes in economic mechanisms, where they have occurred, has been marginal so far. But policy makers are counting on them to play a more decisive role in the future.

Investment policies in the second half of the 1980s

The realization that it is difficult to stabilize marginal capital-output ratios at a time of austerity at a rate commensurate with standard production conditions may have influenced the selection of adjustment measures in the mid-1980s and is having a particularly important impact on plans for 1986-1990. For the CMEA countries, those plans envisage more buoyant investment activity than in the recent past. This is a reflection of the admitted urgency to modify industrial structures, especially at the micro-economic level, and to accelerate the modernization of the engineering sectors in particular. The more expansive policy stance on investment is most pronounced in countries

that sustained the sharpest cut-backs in the preceding five years or so. Thus, planned average annual growth rates for investment for 1986-1990 in Hungary and Poland are in the range of 5-6 per cent relative to the preceding five years, when the decrease, as measured between end-years, averaged between 2 and 6 per cent (see table VI.6). In some countries, however, investment policies continue to be very cautious.⁴⁴

At the forefront of medium-term investment policies stands the concentration of investment in selected manufacturing branches at the expense especially of the extractive sectors. The accelerated development of high technology products is clearly of key concern in virtually all countries, but especially in the USSR. The latter's draft plan envisages increasing investment appropriations for machine-building and engineering by 12.5-15 per cent annually in 1986-1990 - a very marked acceleration when placed against the backdrop of the past 10 years.⁴⁵ Priorities in Eastern European investment policies are quite diverse. In some cases, they project a cautious stance with emphasis on maintaining internal and external balance (in Czechoslovakia and Romania); while others buttress the more expansive economic policy. Current policy discussions stress the need to concentrate on priority sectors, especially machine-building. Preference is given to small, export-oriented enterprises that employ foreign technologies on the basis of compensation agreements, industrial co-operation or joint ventures, and to electronics (in Bulgaria); to food-processing and manufacturing, with particular preference accorded to speeding up the development of high technology production (in Hungary);⁴⁶ to eliminating severe bottle-necks (in Poland); or to projects with reasonably short gestation periods that are certain to be profitable (in the German Democratic Republic).⁴⁷ Throughout the European group, a considerable shift in the composition of investments with further increases in the share of machinery and equipment is anticipated in order to enhance modernization and re-equipment. At the same time, a significant devolution of the administrative and organizational framework of investment decision-making appears to be in the offing. Its realization depends on resource availability, the success in the balance-of-payments readjustment and the degree to which the evolving economic mechanisms help to forge a closer link between supply and demand.

As pointed out, like many developed and developing market economies, the European centrally planned economies have been aiming at putting in place, or have already

⁴³ In the USSR, retirement of fixed assets in enterprises that underwent reconstruction in 1971-1975 was less than 30 per cent; in 1976-1980, this dropped to approximately 20 per cent (A. Tsygichko, "Spisanie ustarevshikh sredstv truda", *Planovoe khozyaistvo* (Moscow), No. 4 (1985), p. 89).

⁴⁴ In Czechoslovakia, for example, where investment during the past five years did not exceed the 1980 level, the planned average annual growth rate is about 2 per cent.

⁴⁵ This may require a decrease in the volume of investment outlays in other branches, according to some estimates, of the order of 6-8 per cent during the next few years. But planners count on beneficial productivity effects of modernized machine-building offsetting any negative consequences of this cut-back in the short to medium term.

⁴⁶ See *Népszabadság* (Budapest), 21 August 1985, p. 10. Growth in the productive infrastructure, however, is planned to be at least on a par with that of gross capital formation in industry.

⁴⁷ A new law to that effect was put in place as at 1 September 1985. It specifies that projects initiated by enterprises must be targeted for completion within two years, decrease labour intensity and production cost, and raise the efficiency and technological level of fixed assets.

commenced, a planned structural adjustment policy designed to foster productivity growth. A crucial component of such a policy is the rational exploitation of the room for manoeuvre as regards economic structures embedded in investment requirements, opportunities and overall appropriations. Poland has recently experienced a sharp loss in its capital stock. Plant and equipment have been scrapped or have deteriorated for lack of domestic and imported inputs - a lack caused by the sharp change in development strategy and priorities in the 1980s compared with the buoyant 1970s. This "decapitalization", while extreme, is by no means unique, especially if official capital and investment data are corrected for various statistical problems⁴⁸ and all unsatisfied capital requirements are taken into account. Nevertheless, current policy concerns in Poland may help to focus attention on the more general aspects of the investment problem throughout CMEA.⁴⁹ Though a renewal of the economic structures requires investment and the country is now able to muster more funds than in recent years, Poland's capital allocation flexibility in the second half of the 1980s is subject to severe constraints.

The first and foremost constraint on the room for manoeuvre in Poland is the volume of savings. There is little hope that the share of accumulation in overall disposable resources can be raised significantly without jeopardizing present consumption levels or the external balance. The room for manoeuvre elsewhere in Eastern Europe is somewhat wider, but not by very much.⁵⁰ The second constraint emerges from the funds tied up in unfinished projects that are still deemed worth while.⁵¹ These construction projects are becoming increasingly obsolete as time passes, and it is therefore necessary either to complete them now or to consider the implications of abandoning them altogether. Present requirements to bring such capital projects into the production stream amount to about one third of the total investment funds available for 1986-1990 and to about 85 per cent of the funds earmarked for 1986-1987. A third crucial constraint is decapitalization in the strict sense. Over the past several years, particularly since 1980, not enough funds could be allocated to replace or maintain in good working order buildings, machinery, equipment and so forth subject to normal wear and tear. Halting this process is estimated to require about half of the capital fund appropriated for the second half of the 1980s. Hence more than three fourths of the funds earmarked for the current five-year plan in Poland have already been administratively captured. A far-ranging restructuring of the economy through the injection

of capital, however up to date, will therefore not be possible until the next five-year plan cycle in the 1990s.

Whereas policy makers may have few options as regards a radical restructuring of the planned economies at the present time, there is ample room for more rational planning of capital replacement, for accelerating the investment process, for ensuring optimal use and proper maintenance of existing facilities, and for reapportioning productive capacity, which is usually not fungible. Though modifications in economic mechanisms are currently contemplated in virtually all countries, clear-cut choices have been revealed to date only by Hungary with regard to investments. A key feature of the policy of Hungary is the promotion of indirect controls over the investment behaviour of enterprises, including intensive use of tax rebates, accelerated write-offs, capital allocations based on risk distribution and so forth. More latitude will be given to the formation of resources and finances of enterprises and to their circulation among enterprises, as well as to the role of commercial factors in granting bank credit. The consistent decentralization of decision-making is considered to be an indispensable condition for eliminating imbalances and fostering economic efficiency in a comprehensive way.

The dovetailing of investment activities has been a central preoccupation of CMEA discussions essentially since the early 1970s, but the share of overall investments that these countries co-ordinate has remained rather small. The constraints on forward-looking development policies in the early 1980s became so severe that it proved to be too cumbersome to pursue comprehensive internal and external adjustments by way of synchronized CMEA plans, as originally envisaged. A new start is to be made in conjunction with the new medium-term plans. These are co-ordinated at the CMEA level and linked to the Third Concerted Plan of Multilateral Integration Measures. The recently endorsed Comprehensive Programme for Scientific and Technical Co-operation is to provide the critical framework for such co-operation.⁵²

Factor productivity and economic efficiency

The prime objective of growth intensification is to raise the contribution of factor productivity to growth, which is the resultant of the complex interaction of many quantitative and qualitative changes in the production process. Their relative contribution to economic performance varies with respect to the time horizon of the evaluation exercise. Most studies of the growth deceleration observed over the past two decades or so in the majority of the Eu-

⁴⁸ Including physical retirement rates that are far too low and the capital losses resulting from the changed cost of primary inputs, as argued above.

⁴⁹ For a revealing discussion, see K. Krauss, "Sprawiedliwie' czy w oparciu o rachunek?", *Trybuna Ludu* (Warsaw), 4 July 1985, p. 3.

⁵⁰ For a discussion, see *Rudé Právo* (Prague), 22 October 1985, p. 2.

⁵¹ That is, the returns that can be achieved by appropriating the further capital required to complete the projects, when properly discounted, are positive and exceed the expected social rate of return on alternative projects.

⁵² In December 1985, the forty-first session of the CMEA Council, in an extraordinary meeting, adopted the Comprehensive Programme for Scientific and Technological Co-operation, which is a policy blueprint until the end of the century. This important declaration of intentions regarding intra-CMEA scientific and technical co-operation concerns five key areas (electronics, automation, nuclear energy, biotechnology and the development of new materials and technology) that are expected to double average labour productivity by the year 2000 and to reduce significantly the material intensity of output.

ropean planned economies have focused on the immediate determinants of economic growth that can be measured with some degree of accuracy. These include changes in the physical volume and quality of capital and labour, shifts in the direction of resource allocation and the scope and pace of technological progress.

Though capital accumulation and renewal are essential in advancing factor productivity, a more holistic perspective on economic policy, including the role of the economic mechanism,⁵³ can help to evaluate the policies partially implemented in recent years. This is especially the case in the European planned economies, where extensive expansion under the strictly centralized planning mode has been accompanied by reserves that could be mobilized if either the growth strategy or the economic mechanism, or both, were changed. Reaching the economy's potential output pattern and intensity is seen by policy makers as an objective of equal importance to extending the output frontier and altering its trade-offs. This applies in particular to the more qualitative factors of economic performance. As recently emphasized in the Soviet Union and, to a lesser extent, in many of the Eastern European economies, labour discipline needs to be reinforced. This stricter mobilization is basic to attaining greater intensity of work, reversing the perceived deceleration or even deterioration of factor productivity of the past two decades,⁵⁴ and halting the slow-down in technological progress. The channels through which the quality of labour may affect growth are intimately intertwined with broad social, political and cultural developments that induce changes in one or more of the immediate and quantifiable growth determinants singled out above.

The discussions of prospective economic policies by planners and political leaders in the various European planned economies have been very wide-ranging and couched in terms of individual country objectives and resource availabilities. None the less, the economic policy debates suggest the standard long-, medium- and short-term plans as useful analytical devices for the discussion of factor productivity processes. Their primary long-term determinant would appear to be twofold. Basic long-term structural decisions need to be reached largely through the political process. The chosen development path should accommodate not only currently available and prospective resources but also opportunities in world trade and finance. Ideally, economic decisions should reflect much more closely the state of demand and supply, and the need to maintain balanced growth not only in production but also in consumption and between private consumption and accumulation. These policy debates stress the implementation process (i.e., the economic mechanism) as an integral element of this structure determination. Pivotal issues are embedded in the domain of policy decisions that affect the way in which agents can interact so as to move production patterns more closely towards the econ-

omy's capacity level. This long-term task of reshaping the economic mechanism therefore concerns primarily the micro-economic sphere, and includes economic structures as well as organization, behavioural rules, material incentives and the like. Widely varying ways and means of achieving different concrete features of the economic mechanisms currently being envisaged have been advocated. At the same time, the long-term development strategies of these economies individually and in the CMEA context have been under review, but no definitive decisions appear to have been adopted to date.

The primary objective of economic policy in a more medium-term perspective is to attain greater efficiency largely with the economic mechanisms in place. Policy discussions therefore emphasize that productivity gains result largely from the distribution of resources, the promotion of technological progress and resource-saving, the elimination of major distortions and rigidities in prices and price-formation mechanisms, and so on. Choices among alternative allocations of available resources are of key importance. This is especially the case for the distribution of funds appropriated for capital accumulation purposes, modernization, renovation, amortization and physical retirement policies.

At this juncture, when manoeuvrability of overall capital accumulation and its distribution appears to be sharply restricted and when wide-ranging revisions in economic mechanisms are deemed neither feasible nor appropriate, the primary means of fostering productivity growth in the relatively short run is the streamlining of existing economic regulations. To this end, the measures available include selective endorsement of technological progress in key industrial sectors, better mobilization of labour and capital resources, gearing rewards more closely to results attained and so on.

Growth potential, capital formation and economic mechanisms

The prevailing view of policy makers is that investment activity, while central, does not by itself fully determine the character of the capital-formation process and even less its degree of efficiency. It is also necessary to modify economic control and regulation in several respects simultaneously. Some centrally planned economies argue that the emphasis in investment policy could be shifted from sectoral or intersectoral development programmes that are centrally organized and controlled to the selection of development directions on the basis of enterprise initiatives. They stress the need for a more selective approach to the reproduction of fixed assets, linking this process more closely to the efficiency of production. A view common to virtually all policy debates is that obsolete, ineffective and non-competitive fixed assets need to be renovated or scrapped, and idle resources reappropriated. Finally, guiding the allocation of investments -financed in part by en-

⁵³ For an instructive perspective on the economic mechanism with special reference to the USSR, see M. Bornstein, "Improving the Soviet economic mechanism", *Soviet Studies*, No. 1 (1985), pp. 1-30.

⁵⁴ In Bulgaria, for instance, the contribution of factor productivity to growth in 1981-1985 reportedly dropped significantly to between 10 per cent and 20 per cent (see *Trud* (Sofia), 20 September 1985, p. 1).

terprise resources, bank credit and budget allocations - chiefly on the basis of the social rate of return on development projects is increasingly viewed as a means of enhancing capital efficiency and aggregate factor productivity.⁵⁵

The flexibility with which economic structures, especially in industry and manufacturing, can be adjusted to changing economic conditions and the role therein of the economic mechanism⁵⁶ are now viewed as critical factors in fostering intensification. The mechanism cannot be improved simply by improving capital formation or structural policies. The ongoing policy debates increasingly advocate a two-pronged strategy. Certainly, structural adjustments *per se* need to be enacted by directing resources towards priority sectors at the expense of other claims on resources, chiefly on the basis of comparative advantage indicators and factor endowments. But relieving the resource scarcity by raising factor productivity is of at least equal importance. A recurrent critique in the evolving policy debates concerns two major weaknesses of directive planning: insensitivity to excessive costs on the part of economic agents and exceedingly long gestation lags.⁵⁷ These can be ascribed to features such as insufficient flexibility; the unwillingness or inability of central authorities to deny resources to entrenched ministerial interests;⁵⁸ the lack of adequate incentives to promote quality, innovation and efficiency; and the inclination of economic units to overspend; all of which became major liabilities in the already convoluted situation in the first half of the 1980s.

As a result of the experiences of the early 1980s, policy makers stress even more than before that increases in factor inputs can no longer counterbalance the rigidities of traditional planning and management systems in reaching a desired rate of aggregate output growth. More weight needs to be allotted to efficiency considerations not only in investment decisions but in the mobilization of all production factors. The traditional management methods of centralized planning are not very well suited to that task, especially on account of the very weak transmission of proper signals about the behaviour of demand and supply,⁵⁹ and of uncertainties with respect to whether price or quantity adjustments should be enacted in response; these features impede structural adjustment.

The ongoing policy debates have also stressed the reluctance to divest as another feature of the traditional economic mechanism with a strong bearing on the implementation of structural policies. To be effective, a positive adjustment policy must envisage the destruction as well as the creation of productive units. Modernization cannot simply envisage additions to existing investment programmes, as has been standard practice in most centrally planned economies until recently. In the absence of incentives to divest, any policy that upsets the hitherto prevailing order of priorities encounters strenuous resistance on the part of economic units that are likely to lose resources. This explains why scarcer investment resources tend to be scattered over too many product lines.

Due to the high degree of centralization of decision-making, it is often difficult for planners to adhere to long-term structural goals. In an environment of shifting short-term priorities and of incremental constraints that are often inconsistent, the fulfilment of long-term objectives is repeatedly impeded by the *ad hoc* rechanneling of resources into the resolving of urgent problems. As a result, the scope of priority status has often become overextended and the degree of resource concentration has decreased in the recent adjustment period.⁶⁰

Decision makers in many of these economies have increasingly come to accept that sluggish diffusion of technical progress, excessively slow retirement of obsolete machinery and failure to quickly expand the output of modern equipment of the requisite quality are key causes of the growth slow-down observed in recent years. The relative lack of incentives to innovate, notably in the machinery and engineering sectors themselves, is widespread.⁶¹ Policy makers now recognize that the still widespread reliance on enterprise success criteria anchored to gross output targets prompts managers to divert resources towards increasing current output and to maintain excessive employment. Furthermore, such criteria are a disincentive to restructuring at the micro-economic level and hinder a quick reversal of investment decisions that turn out to have been faulty. The excessively centralized system of decision-making leaves neither enough room nor sufficient funds to assist in worthwhile innovative investments

⁵⁵ For a useful discussion relative to Hungarian policy concerns, see I. Bélyácz, "Investment policy and structural transformation in Hungary", *Acta Oeconomica* (Budapest), No. 3-4 (1984), pp. 273-291.

⁵⁶ For a detailed discussion of the case of Bulgaria, see *Trud* (Sofia), 20 September 1985, pp. 1 and 3.

⁵⁷ In 1984, normal lead times could have been achieved in the USSR only at the cost of abandoning half of the projects then under construction (see S. Bulgakov, "Metodologicheskaya osnova, problemy sozdaniya edinoy sistemy planirovaniya kapitalnogo stroitelstva", *Ekonomika stroitelstva* (Moscow), No. 10 (1984), p. 12).

⁵⁸ That the economic mechanism does not provide effective leverage to curb ministries' demands for resources can be illustrated by the experience of the USSR. During the preparation of the draft investment plan for 1983-1985, the ministries suggested starting twice as many new projects as in 1982, whereas investment for technical retooling and reconstruction was to remain at the average level of 1976-1980 (*Planovoe khozyaistvo* (Moscow), No. 10 (1984), p. 78).

⁵⁹ One cannot satisfactorily explain output growth and structural change in centrally planned economies chiefly by variations in aggregate and sectoral demand; they result primarily from planners' preferences and mandatory government policies regarding the allocation of production factors and the composition of output.

⁶⁰ For instance, due to the continuous enlargement of priority targets in Poland, around 70 per cent of all industrial enterprises commanding 82 per cent of all industrial investments received preferential status in the second half of the 1970s (see J. C. Brada and J. M. Montias, "Industrial policy in Eastern Europe: a three-country comparison", *Journal of Comparative Economics*, No. 4 (1984), p. 389).

⁶¹ See, for example, *Pravda* (Moscow), 12 April and 24 April 1985.

by enterprises.⁶² This is particularly so in the promotion of modern export-oriented technologies, which require a greater number of decentralized measures; central control and decision-making systems are much easier to operate in energy, metallurgy, mining and other such comparatively "simple" processes. The introduction of advanced technology is contingent on the constant reorganization of enterprises, improvement of managerial practices and shifts in organizational set-up. But these are difficult to carry out when there is very slow retirement of obsolete equipment; excessively protracted decision-making and construction times; price inflexibility; absence of competition and therefore of customer choice; and deficiencies in material supply procedures, which often make it impossible even for the well-motivated producer to obtain inputs of the requisite specification. Mandated investments are therefore frequently undertaken with proved or available equipment rather than with more experimental processes. This is one principal reason for the weak influence of additional investment on output and factor productivity growth.⁶³

The stress on achieving a few output targets in a select group of industries strongly fosters production autonomy. At the enterprise level, this tendency results in the creation of integrated plants with their own semi-products and tool shops that rely minimally on other producer units, thereby impeding specialization in equipment for auxiliary processes, assemblies and parts for branch and inter-branch use, and the production of tools and production accessories. Thus, many large and medium-sized plants produce their own auxiliary equipment, components, sub-assemblies, parts, tools and almost all production accessories needed to fulfil plan targets. These products are often of inferior quality and costly.⁶⁴ Neither economies of scale nor high quality can be obtained in component production. At the macro-economic level, this legacy is reflected in a strong tendency to emphasize import substitution whenever external difficulties are encountered. As a result, the already excessive diversity of engineering products has recently increased in a number of countries.⁶⁵

The comprehensive reformulation of economic mechanisms has recently emerged as a major preoccupation of decision makers in virtually all planned economies. Modifications are sought to raise productivity by bolstering the decision-making role of enterprises,⁶⁶ by loosening central controls over enterprises, and by introducing indirect co-ordination instruments, though to a different degree in different countries. Policy discussions increasingly endorse the following as the most important levers to be activated:

wholesale prices, the anchoring of wholesale prices to trade prices, effective exchange and interest rates, wage compensation according to performance, much more flexible consumer prices, and a greater role for indirect co-ordination instruments under macro-economic guidance to ensure social profitability criteria. Pivotal is the setting of unambiguous, predictable decision-making rules and behavioural indicators for all economic agents. This requires the clear-cut delineation of the room for lower-level decisions and appropriately reorganized domestic and regional institutions as well. Increasing emphasis is being placed on gearing central planning primarily towards medium-to long-term structural policy issues, while appropriate income, monetary and fiscal policies, among others, provide the framework for short-to medium-term enterprise decisions. Similarly, external trade could be regulated through indirect instruments, including an effective tariff policy, the abolition of non-parametric subsidies and taxes that buffer domestic from foreign prices, and an active exchange rate policy.

This possible agenda for modifying the economic mechanisms has been widely debated. But thus far it has been adopted only partially and to greatly varying degrees in the various countries. The most ambitious effort has been launched by Hungary. Investment policies *per se* are only one aspect of the avowed need to improve management and central guidance by way of significant revisions in price systems, income regulations and organization, so as to encourage the innovation process. With regard to investment policies for the years ahead, the main emphasis is placed on achieving a more consistent separation of central and enterprise decisions, except in activities related to energy, infrastructure and the non-productive sphere in general. The profitability of enterprises is slated to become a major allocation criterion especially in capital formation, except in priority sectors. Enterprise investment will depend critically on market signals. In order to boost the potential financing of investment opportunities, the flow of capital between enterprises is to be facilitated, more flexible credit and interest policies are to be pursued, and state subsidies are planned to be considerably reduced.⁶⁷

The process of structural adjustment, even when already initiated, is by its very nature an evolving one, requiring a considerable amount of time under the most favourable domestic and external development conditions. This evolutionary feature is even more pronounced when key decision makers are still deliberating about the nature and objectives of the modifications in economic mecha-

⁶² The overcentralized decision-making and allocation system appears to be responsible too for the typical preferential treatment accorded to capital-intensive branches in the distribution of investment resources and for investing in products that do not embody the most desirable technology.

⁶³ For a discussion with respect to the USSR, see *Planovoe khozyaistvo* (Moscow), No. 8 (1985), pp. 17 and 18.

⁶⁴ *Ekonomika i organizatsiya promyshlennogo proizvodstva* (Novosibirsk), No. 6 (1984), pp. 89-112.

⁶⁵ L. Csaba, "Industrial structural policy in Czechoslovakia, 1970-1985", *Economics of Planning*, No. 3 (1982), p. 132.

⁶⁶ For example, prior to 1982 in Poland, investments financed by enterprises from their own means accounted for a mere 5 per cent of the overall investment outlays in the socialized sector of the economy, but at the beginning of 1985, this share rose to 34 per cent (see *Trybuna Ludu* (Warsaw), 13 June 1985, p. 6). A noticeable increase in the autonomy of investment decision-making at the enterprise level is among the planned changes of the management system in the USSR (see O. Yun, "Razvivaya planovy mekhanizm khozyaistvovaniya", *Kommunist* (Moscow), No. 13 (1985), pp. 45 and 50).

⁶⁷ *Ipargazdaság* (Budapest), July 1984, pp. 4 and 5.

nisms to be formulated with a view to raising factor productivity. Since these processes cannot be expected to be concluded soon, the second half of the 1980s, and perhaps even the first phase of the next medium-term planning cycle, are bound to be affected by gradual changes in organi-

zation, management, policy instruments and development objectives. Their impact on factor productivity, especially the efficiency of capital utilization, will therefore materialize only very gradually.

The recent recovery and investment in the major market economies

The growth of private fixed non-residential investment in most of the seven major industrial countries began to decline in the early 1970s. Recovery did not generally begin until the mid-to late 1970s and was interrupted by the second oil shock in 1979 and the recession of 1981-1982 (see figure VI.7). By 1982, investment levels in most countries had stagnated at or had fallen below 1980 levels. In the oil-importing countries, except the United States, aggregate investments were substantially below the levels reached before the first oil shock. The strength of investment growth in the current recovery has been extremely varied across countries: very strong growth in Japan, the United Kingdom and the United States; moderate growth in the Federal Republic of Germany; and weak growth in Canada, France and Italy. This trend in investment, especially its behaviour during the current recovery, has led to renewed concern about the ability of the developed market economies to sustain growth in investment in the near term and thus strengthen the foundations for medium-term to long-term economic expansion.

The assessment of investment performance in the seven major industrial countries since the last recession needs to be made in terms of both cyclical factors and structural trends. The present section focuses on the performance of gross private fixed non-residential investment in the current recovery and discusses the outlook for investment growth in the next two years in the light of recent declines in oil prices, the value of the United States dollar and interest rates.

Determinants of investment demand

Although considerations of a micro-economic nature related to patterns of competitiveness in specific markets loom large in investment decisions, there is growing evidence that expected aggregate demand growth plays an important role in the decision of individual businesses to invest in productive capital. Strong aggregate demand growth raises expectations of entrepreneurs that their sales of goods and services will benefit too and thus enterprise profits will increase, as will the availability of funds to self-finance fixed capital assets. Investment in capital to produce such goods may thus expand, provided the rate of utilization of existing productive capacity is not very low. Factors such as the price of capital goods, interest rates and the rate of depreciation of the existing capital stock all influence the cost of capital goods too. Other significant factors that affect the cost of production, and therefore profits, include the cost of other inputs, particularly labour, energy and other materials. Growth in real wages in excess of that warranted by labour productivity improve-

ments, for example, causes a profit squeeze and discourages investment spending. Real interest rates also affect the attractiveness of fixed capital investment relative to financial investment. Since the early 1970s and through the last recession in 1981-1982, adverse movements in these factors, particularly in many European countries, contributed to the slow-down in investment.

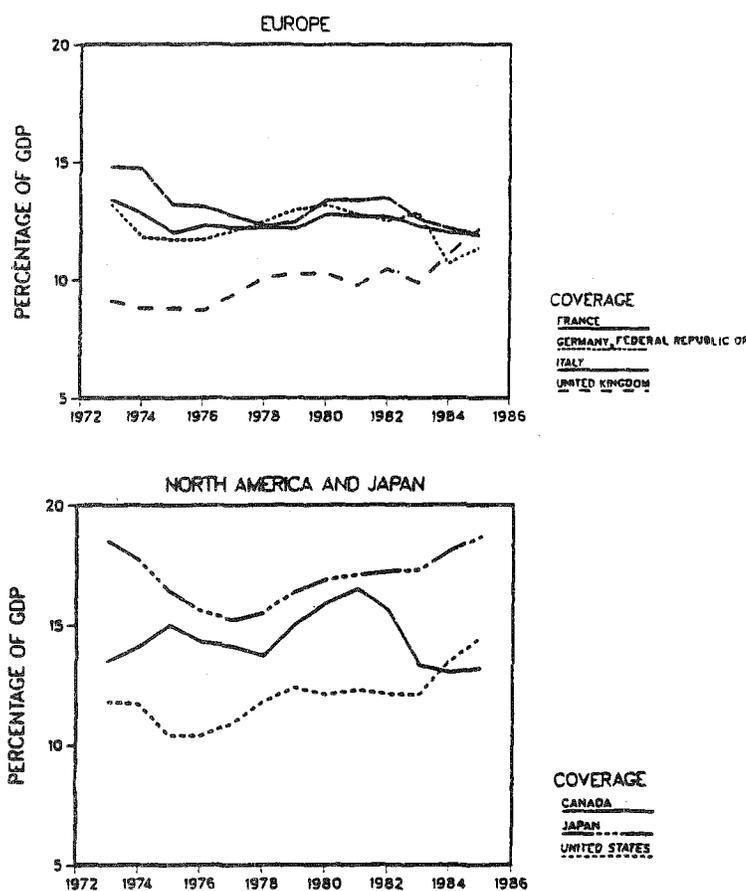
The macro-economic environment

Aggregate demand depends importantly on the macro-economic policy environment fostered by government fiscal and monetary stances. After the second oil shock, macro-economic policy in the seven major industrial countries was primarily a response to the acceleration of inflation without the real gains in economic activity observed in the 1970s. Thus, the primary objective of policy at the beginning of the 1980s was the reduction of inflation at the cost of much slower output and employment growth. In the United States, because of the expansionary fiscal policy, a very restrictive monetary policy was necessary to accomplish this end. This policy mix led to very high interest rates and affected the stance of other countries to a considerable extent. The combination of restrictive fiscal and monetary policies in Europe, which was maintained through 1985, has resulted in weak domestic demand throughout the recovery, except in the United Kingdom. Although the strong recovery in the United States and the high value of the dollar bolstered total output in those countries, weak domestic demand in Europe remained the major obstacle to a strong upswing in economic activity, including investment.⁶⁸

In contrast, investment growth in Japan and the United States did not decelerate as much after the second oil shock and has recovered more strongly in the current upturn. This can be attributed to more moderate real wage growth in the 1970s, more responsive structural adjustment to the first oil shock, less contractionary demand policies and improved competitiveness *vis-à-vis* Europe. While domestic demand in Japan has remained weak in the current recovery, Japan's competitiveness in world trade has enabled the country to benefit from export expansion as the force behind the growth of aggregate demand. The trend in the factors that negatively affected investment in Europe has been gradually reversed since the last recession, particularly since 1985. The more important of these factors were declining real interest rates, weak commodity and energy prices, and greater moderation - in some cases concessions - in wage demands. As a result, investment in Europe may be entering an era of much stronger growth.

⁶⁸ M. Bruno and J. Sachs, *Economics of Worldwide Stagflation* (Cambridge, Massachusetts, Harvard University Press, 1985), and OECD, *OECD Economic Outlook*, No. 37 (Paris, June 1985).

Figure VI.7.
Gross fixed non-residential investment^a
as a ratio of GDP, 1973-1985^b



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data provided by OECD and country data.

^a Private investment only, except for Italy.

^b Data for 1985 are estimates.

Certain sectors, particularly petroleum and high-technology goods,⁶⁹ were not adversely affected by the stagflation of the 1970s. Profits in oil-related industries benefited from the increase in oil prices and investment growth in these industries out-performed that of the economy as a whole. The growth in investment in high-technology industries also exceeded that of the economy as a whole, owing primarily to the rapid rate of technological change in micro-electronics. A reallocation of capital funds among sectors in response to price and technological changes has also affected the recent trend in investment performance, especially in the current recovery.

Industrial and labour policies

Besides macro-economic policy, both industrial and employment policies in the major industrial countries have had a substantial impact on the path of adjustment to the two oil shocks. Differences in adjustment between

countries set the stage for differences in competitiveness in world trade and the need for restructuring production in the 1980s. Following the first oil shock, industrial and employment policies in many countries sought to protect declining industries and to prevent a loss of jobs and a decline of real wages that would otherwise have emerged as a result of domestic and foreign competitive pressures. The degree of protection, however, varied greatly across countries.

Japan and the United States adopted relatively narrowly focused employment policies, directed towards providing retraining assistance and temporary compensation to redundant workers. In the United States, policies were not directed towards the preservation of declining industries or the prevention of labour-shedding. Existing wage-determination mechanisms were responsive to economic conditions and, consequently, the growth of real wages slowed with the declining growth in labour productivity.

⁶⁹ Following the OECD concept, high-technology industries are defined as aerospace, office machines, electronics and components, drugs, instruments and electrical machinery.

While import restrictions provided, and continue to provide, some protection to industries subject to comparatively large foreign competition, direct sector-specific subsidies to ailing industries in substantial amounts were the exception rather than the rule. In Japan, government grants assisted declining industries, such as basic steel, ship-building and textiles, in their internal rationalization and the retraining of workers. These industries were suffering from the effects of the sharp increase in oil prices and/or competition from newly industrializing countries. Although substantial lay-offs in these industries were avoided, output and employment declined significantly over time under government guidance.

Although the process of structural change inexorably advanced in Europe also, most countries supported their declining industries in different ways in order to minimize labour and income dislocations. Existing employment policies restricting the ability of employers to shed redundant workers were enforced and in some cases strengthened. At the same time, wage indexation was institutionally upheld, tax and social insurance contributions of employers increased the real cost of labour, and the costs of labour-shedding rose because of severance and other provisions. As a result, real labour costs grew faster than average labour productivity, which induced a loss in the competitiveness of European countries in world trade and encouraged businesses to substitute capital for labour in production. After the second oil shock and especially in the light of the positive performance of Japan and the United States in the 1970s, European countries perceived that they would have to reverse those policies if they were to adjust to the increase in energy prices and international competition without creating major distortions or rigidities in their economies. Efforts to eliminate the rigidities that had accumulated during the post-war period got under way first in the Federal Republic of Germany and the United Kingdom and then in France and Italy. Moreover, as a result of several years of very high unemployment since 1980, wage settlements were more favourable to employers. Real wage growth has slowed substantially to rates well below those of labour productivity growth in the recent recovery, making for higher enterprise profitability and investment. However, the labour-shedding by businesses started in the last recession has continued into the current recovery. If recovery is sustained and if it leads to significant employment growth in Europe, capital formation will eventually be reinforced since the wage bill is a substantial component of overall demand.

Another important aspect of industrial policy concerns the development of high-technology industries. These industries have experienced very strong growth in global demand in the past two decades, in contrast to the slowing growth in demand for other industrial goods. Most indus-

trial countries have, directly or indirectly, encouraged the development of the electronics industry. In the initial stages, when the United States was far ahead of the other industrial countries, most countries used a combination of trade and other restrictions to protect their electronics industries. But the course of development of these industries differed substantially between countries. In Japan, the dominant manufacturers of electrical goods became the major producers of new electronic products and components as part of the overall government strategy for the rapid development of the industry. In the United States, the industry also grew rapidly primarily with the entry of many small firms, which were often the leaders in new, innovative electronic products and components. Growth of the industry in Europe, while much less buoyant than in other developed market economies, has depended importantly on development through subsidiaries of United States firms and joint ventures between large established companies in Europe and United States producers. It appears that the established companies have not yet succeeded in fostering the large-scale production of electronics to the extent that Japan has. In addition, existing links between Government and industry appear to have prevented new firms from entering the market. The rapid development of the industry in Japan and the United States is reflected in their competitiveness in world trade.⁷⁰ As a result, Europe has benefited less in output and employment growth than it could have from the strong growth in world demand for high-technology goods in the last decade and a half and in the current recovery.

Recovery in investment

Patterns of change since 1973

The current recovery in investment has been marked by variations in its strength and timing among the major industrial countries. It has been substantially stronger in Japan and the United States than in Canada and the European countries as a group. The strong and extended recovery in the United Kingdom has been the striking exception among the European countries (see table VI.8). It appears that, in general, the current recovery in investment in the major industrial countries in Europe has not been sufficiently robust to reverse the downward trend in investment that began in the early 1970s. The ratio of investment to GDP in France, the Federal Republic of Germany and Italy, which had been declining since 1973, made some recovery towards the end of the 1970s. It contracted again with the recessions in 1980 and 1981-1982. By the end of 1985 it had not re-attained either the 1973 or the 1980 level (see figure VI.7). In contrast, after initial declines, investment in Japan recovered strongly in the late 1970s and had exceeded the 1973 level by 1985. After two

⁷⁰ OECD, *The Semi-Conductor Industry: Trade Related Issues* (Paris, 1985), and Commission of the European Communities, *European Economy*, No. 25 (Brussels, September 1985), chap. 1.

Table VI.8 Major developed market economies, growth of gross fixed non-residential investment, 1973-1987^a

(Average annual percentage change)

	1973-1979	1980-1985	1980	1981	1982	1983	1984	1985 ^b	1986 ^c	1987 ^c
Canada	4.5	-1.7	7.3	7.7	-9.1	-13.0	0.6	5.1	4.2	8.7
France	1.4	0.2	6.6	-1.0	1.9	-2.3	-0.9	0.0	3.5	2.8
Germany, Federal Republic of	2.1	0.8	3.5	-2.9	-3.7	4.7	0.9	4.9	8.1	4.5
Italy	0	-1.6	10.9	0.6	0	-7.4	-0.1	-1.0	4.0	4.3
Japan	1.5	6.2	8.0	5.6	3.7	3.4	11.0	7.3	2.8	4.2
United Kingdom	3.2	5.0	-3.0	-5.6	9.4	-2.1	13.5	10.0	4.5	4.0
United States	3.2	6.5	-2.4	5.2	-4.7	2.5	19.8	9.6	6.0	4.5

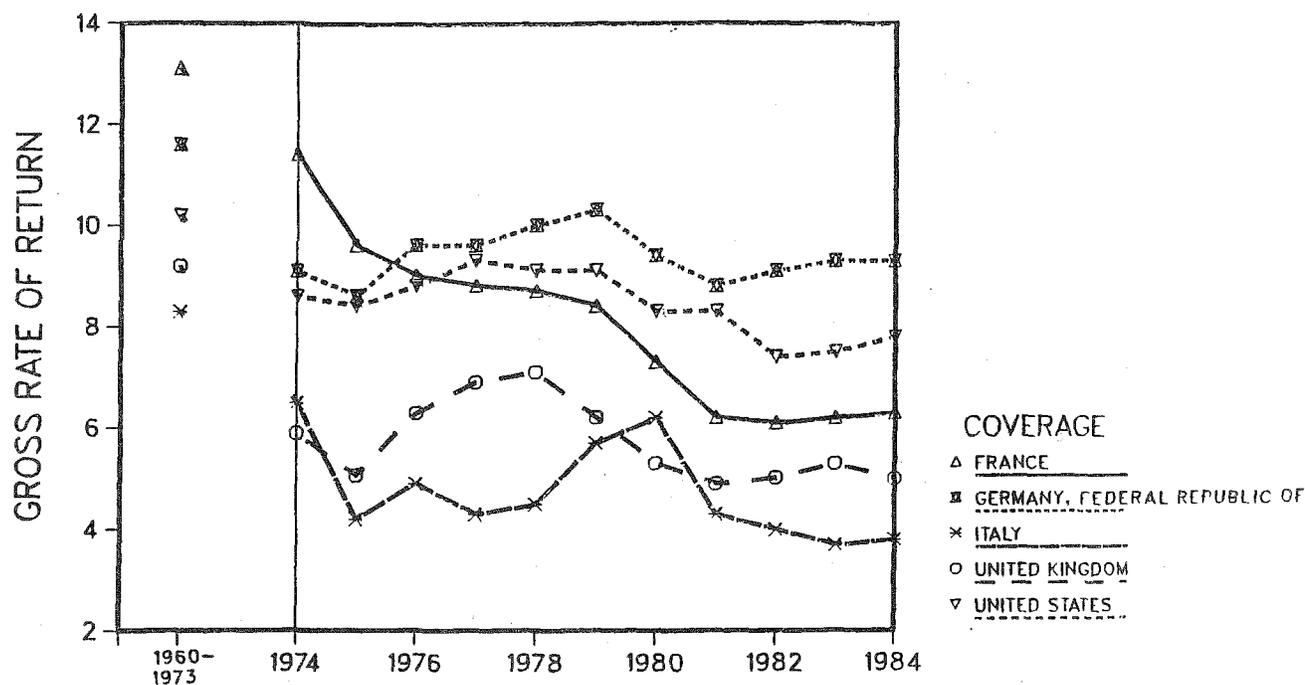
Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD and country data.

^a Private investment only, except for Italy.

^b Estimate.

^c Forecasts based on Project LINK (12 March 1986) and OECD and various individual country forecasts. Forecasts for Italy include residential investment.

Figure VI.8.
Profitability^a of fixed non-residential investment, 1973-1984



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Commission of the European Communities, *Annual Economic Review, 1985-1986* (Brussels, 12 December 1985).

^a Gross operating surplus as a percentage of gross capital stock at replacement cost.

years of strong investment growth, the ratio of investment to GDP in 1985 in the United States, which had also experienced a strong recovery in the late 1970s, registered a historic high. The United Kingdom, an oil-exporting country, experienced an increase in the investment ratio in the 1970s. As a result of the current strong rebound in investment, the ratio for 1985 exceeded the ratios for both 1973 and 1980.

The recovery in investment in the United States began in the last quarter of 1982. Investment grew by almost 20 per cent in 1984, and about 10 per cent in 1985, owing to slower growth in the latter half of the year. The recovery in investment in Japan followed that of the United States, with very strong growth of 11 per cent in 1984 and weaker growth of 7 per cent in 1985 due to the negative effect on Japanese exports of the slow-down in the United States economy. Investment in Canada began to recover from steep declines in 1984, and 1985 was the first year of substantial growth. The duration of the investment slump in the last recession was lengthened by an investment contraction in the energy sector in 1983 in response to weakening prices.

Among the European countries, recovery in investment in the United Kingdom has been strongest, despite a deep and prolonged recession. Recovery began much earlier in the United Kingdom than in all the other major industrial countries, and has been strong and sustained since 1982, with an interruption in 1983 on account of sharp declines in investment in the oil sector in response to a drop in profits. Recovery in the Federal Republic of Germany began later and has been weaker than in the United Kingdom. Since 1983, investment growth has none the less been sustained, although there was a temporary interruption in 1984 on account of labour disputes. France and Italy have yet to show any sizeable recovery in investment, which continued to stagnate in 1985 after a steady decline since 1981.

Although profits and the rate of return on fixed assets improved after 1982 in all countries (see figure VI.8), other factors most immediately affecting the recovery in investment differed between countries. In the United States, improved profits reinforced by strong domestic demand provided the major impetus. Increased depreciation allowances for equipment and machinery resulting from changes in tax laws in 1981 also moderated the negative effect of high real interest rates on the cost of investment. The current recovery in investment growth has been significantly higher than the recovery of 1975-1979. In contrast, the recovery in investment in Japan, which has been somewhat stronger than in 1975-1979, was largely due to booming growth of exports, domestic demand having remained very weak. It should be noted, however, that this recovery began from a relatively high base since investment merely slowed in the last recession. Domestic demand growth in the European countries, with the exception of the United Kingdom, was weak at the beginning of the recovery. In the Federal Republic of Germany, the

growth in exports bolstered growth in total demand in 1984 and 1985, but high real interest rates and uncertainty concerning profits in the export sector, due to the exchange rate situation, dampened growth in investment. Temporary investment incentives in 1983 only brought investment forward, but had no sustained effect. In contrast to other major industrial countries, the economic recovery in the United Kingdom was led by growth in private investment in both the oil and non-oil industries. The upswing in investment was largely due to rising profits resulting from cyclical recovery and restructuring of companies during the recession of 1979-1981. The continued strong growth of demand into the recovery sustained the growth in profits in all sectors, resulting in continued investment growth. Temporary capital allowances, which are being phased out in 1986, had an impact on capital formation in 1985 by bringing forward investment scheduled for later implementation. The very weak growth in investment in France and Italy has been primarily due to weak aggregate demand and very large excess capacity resulting from the recession. In Italy, the recovery in the rate of return on investment lagged behind that of other countries as significant restructuring of firms did not get under way until 1983.

Composition of investment

The composition of investment growth in the current recovery has differed greatly between Japan and the United States on the one hand, and Europe on the other (see table VI.9). Investment growth in machinery and equipment exceeded investment in structures in all countries, and has thus continued the recent trend in the share of this component in fixed business investment. In most European countries, there has been an almost total lack of growth in investment in structures. During the earlier phase of the recovery in the United States, growth in machinery and equipment substantially exceeded growth in non-residential construction. By the latter phase of the recovery, the growth rates of the two components had converged, which suggested that investment in both capacity expansion and capital improvement was growing. In Japan, such investment was also growing.

In contrast, the investment growth in European countries, except the United Kingdom, was mainly in machinery and equipment. Persistent high unemployment, weak output growth, obsolescence of the capital stock, the high cost of labour relative to capital goods and relatively high capacity utilization may, in this phase of the cycle, have called primarily for capital improvement and deepening, rather than capacity expansion. The weak growth in domestic demand and the uncertainty concerning the sustainability of the high value of the dollar, and hence the continuation of recent export performances, do not favour capacity expansion in these countries.⁷¹ This may be one crucial reason for diverging trends: while unemployment in the United States declined substantially between 1983 and 1985, it remained very high in the European countries despite economic recovery.

⁷¹ Commission of the European Communities, *Annual Economic Review 1985-1986* (Brussels, 12 December 1985).

Sectoral differences

Sectoral patterns in the recovery of investment reflect ongoing structural changes as well as cyclical fluctuations. Since the first oil shock, investment growth in the fuel sector has outpaced that of the non-oil sector as a result of relatively higher profits.⁷² Although there were some disruptions in investment growth in the oil sector in Canada and the United Kingdom in response to the initial decline in oil prices, growth during the recovery has basically continued the trend of the 1970s as the effects of recent sharp declines in oil prices are just beginning to be felt.

Investment growth in non-energy sectors has tended to reflect national responses to structural change in the 1970s and the resultant shifts in competitiveness of countries. By 1982, the European countries had experienced almost a decade of decline or little growth in investment in manufacturing (see figure VI.9). Although investment growth had recovered somewhat by 1980, it declined again after 1980 and very steeply in the last recession. Thus, the recent recovery was one of growth after an extended period of stagnation in investment in total manufacturing and in general, the level of investment remaining about the same as it was at the time of the first oil shock. In contrast, investment growth in manufacturing in Japan and the United States had recovered from the first oil shock by the late 1970s. The last recession was therefore an interruption of a trend of investment growth that has been resumed during the current recovery.⁷³

Within the manufacturing sector, high-technology industries have experienced strong growth in world demand

since the late 1960s. The oil shocks may have reduced their buoyancy somewhat, but growth in these industries continued to be strong in spite of the sluggish overall economy. Since the early 1970s, investment in these industries has been expanding as a result of both growing demand and rapidly changing technologies. While all of the major industrial countries have participated in these rapidly changing industries, investment growth in this area in Japan and the United States has far exceeded that in the European countries. In the latter countries, investment in high technology has been fluctuating at about the same level for almost a decade and a half (see figure VI.10). As a result, the European countries have steadily lost competitiveness in these industries, particularly in electronics, electronic machinery and information systems, to Japan and the United States.

The recovery in investment growth in the electronics, electronic machinery and information systems industries was particularly strong in Japan in 1984 and 1985; it accounted for almost a quarter of total investment in 1984. A strong dollar and booming export demand, particularly from the United States, have thus strengthened Japan's competitiveness in these industries. Although the introduction of electronic machinery and equipment was also proceeding at a strong pace during the recovery in the European countries, the domestic market remained small and part of domestic demand growth was met through imports from Japan and, to a lesser extent, the United States. Thus, because of the lagging development of their high-technology industries, the European countries reaped limited benefits, in terms of output growth, from the continued strong world demand for high-technology goods.

Table VI.9 Major developed market economies: components of gross fixed non-residential investment, 1983-1985

(Average annual percentage change)

Country	Machinery and equipment	Structures
France	1.4	-3.9
Germany, Federal Republic of	5.2	0.2
Italy	4.0	1.5
United Kingdom	5.5	5.4
United States ^a	14.0	6.8

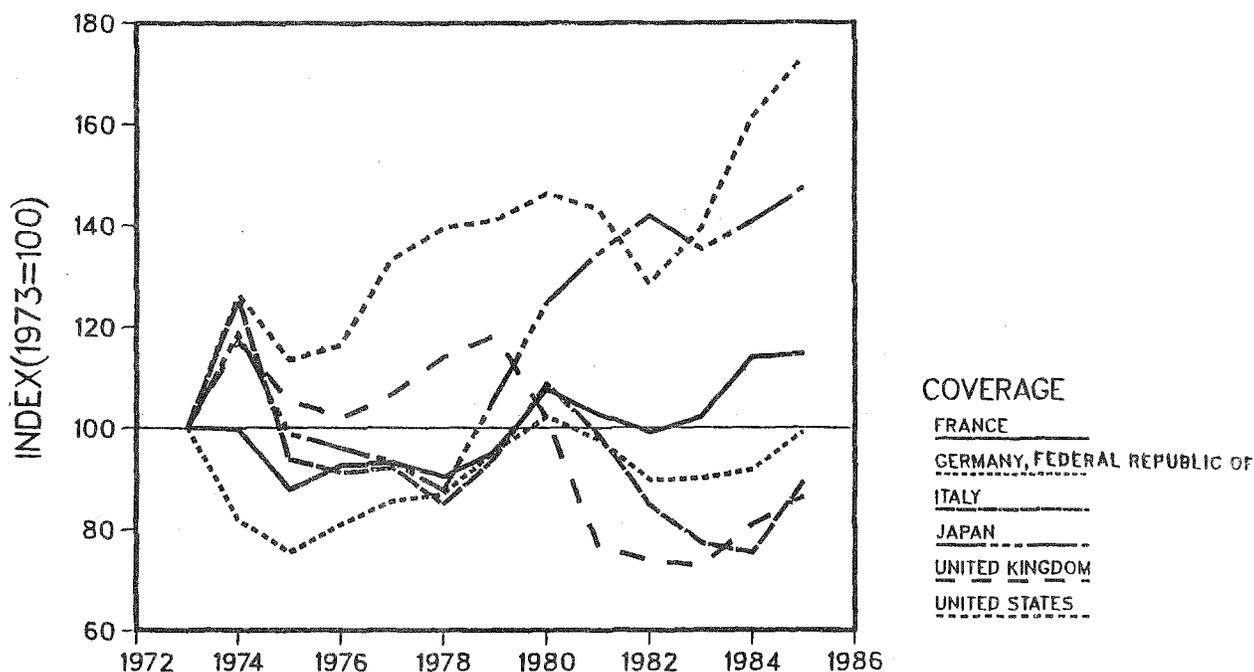
Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data provided by the Commission of the European Communities and country data.

^a Fourth quarter of 1982 through 1985.

⁷² Economic Commission for Europe, "Trends in fixed investment and capital stock in the ECE region", paper prepared for a seminar on the interrelationships between structural changes and investment policies, July 1985.

⁷³ Commission of the European Communities, *European Economy*, No. 25 (Brussels, September 1985), chap. 2, and *Annual Economic Review 1985-1986* (Brussels, 12 December 1985).

Figure VI.9.
Gross fixed non-residential capital formation
in manufacturing industries, 1973-1985



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Commission of the European Communities, *European Economy*, No. 25 (Brussels, September 1985), statistical annex, table 18.

Efficiency of investment

It is difficult to measure precisely the contribution to output of new, possibly highly productive assets. As conventionally measured, the efficiency of investment in creating output has declined much more steeply in the European countries than in the other major industrial countries since the 1960s. By the first half of the 1980s, the inverse of the incremental capital-output ratio (ICOR) - that is, the ratio of output growth to the share of gross investment in output - in the European countries had declined to about half that of Canada, Japan and the United States (see table VI.10). One factor is the much greater increase in capital intensity in response to the increased relative cost of labour in the 1970s. This change in relative factor costs, however, was the result of price distortions rather than of shifts in real relative factor scarcities. One important factor was the rise in real wages. Moreover, the legislation favouring capital investment in the 1970s and early 1980s artificially lowered the relative price of capital and resulted in investments that yielded low output growth.

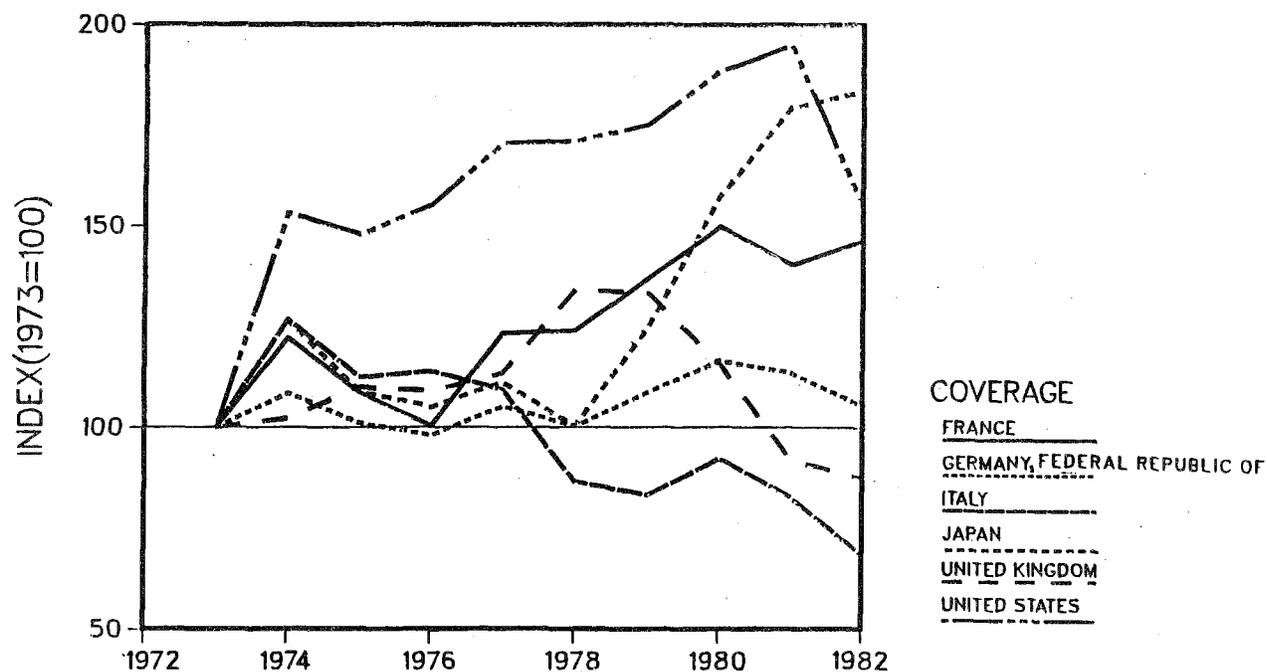
Another factor is that capital has been used less efficiently in Europe, owing to both weaker demand growth throughout the 1970s and into the 1980s and less efficient application. Further, the quality of new capital equipment in Europe tended to be below that of Japan and the United States, yielding less output than in those two countries.⁷⁴

Outlook

The near-term outlook for investment in the major industrial countries is strongly affected by three events: declines in interest rates, a steep drop in oil prices and substantial depreciation of the United States dollar in terms of other major vehicle currencies. If these ongoing shifts can be stabilized, the outlook for output growth to 1990 in all major industrial countries is very positive. Growth in Europe is expected to be in the range of 2.5-3 per cent with the possibility of slightly slower growth in the latter part of the decade chiefly because the favourable impact of lower oil prices fades away. Growth in North America is ex-

⁷⁴ Commission of the European Communities, *European Economy*, No. 20 (Brussels, July 1984), pp. 9-27 and 33-67.

Figure VI.10.
Gross fixed capital formation in the
high-technology sector,^a 1973-1982



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Commission of the European Communities, *European Economy*, No. 25 (Brussels, September 1985), statistical annex, table 18.

^a Following the OECD concept, high-technology industries are defined as aerospace, office machines, electronics and components, drugs, instruments and electrical machinery.

Table VI.10 Major developed market economies: inverse ICORs

(Average percentages over the period)

	1961-1973	1974-1979	1980-1984	1985 ^a
Canada	25.5	15.1	8.3	19.5
France	24.9	14.1	5.4	5.6
Germany, Federal Republic of	18.4	11.8	4.5	11.4
Italy	24.6	15.2	5.8	13.9
Japan	33.9	11.3	13.6	16.3
United Kingdom	16.1	7.8	4.9	18.0
United States	20.9	14.6	10.2	12.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data provided by OECD.

^a Estimate.

pected to be in the range of 3-4 per cent, also with the possibility of a slow-down after 1987. The Japanese economy is forecast to grow much more slowly - about 3 per cent - in 1986 and 1987 but growth is expected to recover after that to about 4 per cent. These prospective rates of output growth should have a positive effect on investment expansion. Declines in energy costs and interest rates further improve the profitability of businesses and reduce the cost of financing, thereby increasing the attractiveness of capital investment. The outlook for oil-importing countries is especially positive, with sustained growth in investment expected in most of the countries that have experienced substantial recovery in investment and good prospects for investment growth where recovery has just begun. By the end of the decade, according to recent forecasts, the European countries will have had an extended period of investment growth at a pace much higher than that of the 1970s and the first half of the 1980s. Of course, there are major uncertainties in the outlook: a reversal of the decline in the price of oil, the extent and speed of the fall of the dollar and the effect thereof on inflation rates in the United States, and the degree of protectionism in trade policies. The stability and gradualism of further shifts - positive or negative - in major parameters of investment decisions will also influence the outlook.

In the United States, where recovery in investment seemed to have run its cyclical course in the second half of 1985, the slow-down is now forecast not to deteriorate to recession levels in 1986 as a result of the beneficial effects of lower interest rates, lower energy costs, a gradual improvement in export performance and the resultant stronger demand growth. Investment is forecast to grow at 6 per cent in 1986 and 4.5 per cent in 1987 (see table VI.8) and to continue to grow in the 5-6 per cent range to 1990. The outlook for Japan is for the downturn in investment growth in 1985 to deepen and to slow to under 3 per cent in 1986, recovering somewhat to just over 4 per cent in 1987. The negative effects of the appreciation of the yen on export prospects, continued weak domestic demand and the downturn of investment at this stage of the cycle are the main factors behind this pronounced slowing. Easier monetary policy and a planned tax revision in 1987 will entail a slight increase so that investment growth will recover during the latter part of the decade. The outlook for the Federal Republic of Germany is for much stronger growth in investment in 1986 of about 8 per cent but slowing to 4 per cent in 1987, arising primarily from strong overall domestic demand, much lower oil prices and lower

interest rates. Investment growth will be sustained at slightly lower rates through the end of the decade. After stagnating since the recession, investment growth in France and Italy is expected to strengthen to the 3-4 per cent range in 1986 and 1987, a pace that can possibly be sustained to 1990.

As major net exporters of oil, Canada and the United Kingdom will be adversely affected by the decline in oil prices to some extent but their non-oil sectors stand to benefit from it. The likely resultant effect on investment growth will be positive. The forecast for Canada is that total investment growth will slow down in 1986 to just over 4 per cent from the rapid recovery of 1985. The forecast for the United Kingdom is that while oil industry profits will decline, profits in non-oil industries will increase, with investment growth in non-oil industries around 5 per cent in 1986. Overall investment growth, however, is forecast to slow down to about 4 per cent owing to the cyclical downturn in an already extended recovery and the phasing out of investment incentives in 1986.

With the much stronger growth in aggregate demand in Europe, incremental investment can be expected to be redirected towards capacity expansion from the current emphasis on replacement of or additions to machinery and equipment. In contrast, with slowing growth in demand resulting from the appreciation of the yen, investment in capacity expansion in Japan is likely to ease considerably. Correspondingly, unemployment in the European countries is expected to improve somewhat, while in Japan it will inch up, but from an exceedingly low level.

In sum, after the pervasive pessimism about investment recovery in the past few years, there are now reasons for cautious optimism as far as the medium-term prospects of major industrial countries are concerned. However, this assessment is tempered by several crucial uncertainties in the economic environment. As expectations about the behaviour of markets play an important role in investment decisions, unsettled conditions in interest rates, exchange rates and national trade policies, as well as the external debt burden of developing countries, may adversely affect private investment. Unless such conditions stabilize and improve, recent forecasts may turn out to have been too optimistic and investment growth in the major industrial countries may fail to achieve the level required for a higher and sustained non-inflationary pace of growth in the medium term.

Chapter VII

THE DEVELOPMENT CRISIS IN SUB-SAHARAN AFRICA

There was ample rain, the best in a decade, across much of the African continent in 1985. Total agricultural production and food production increased during the year. For the first time since 1980, some GDP growth was achieved in sub-Saharan Africa. None the less, famine still threatens millions of its people. The region continues to be

extremely vulnerable not only to the level of rain but also to fluctuations in commodity prices and in international financial flows. The long-term economic deterioration in sub-Saharan Africa has not been halted. On the contrary, it has been aggravated by increasingly severe import curtailment in the past few years.

The long-term roots of the emergency

After a decline in 1981-1983 and virtual stagnation in 1984, total GDP increased in 1985 by a modest 2.3 per cent. The net energy-importing economies in the sub-Saharan region continued to grow faster than the aggregate of the energy exporters in 1985: on average, GDP grew by 2.9 per cent in the first group, against 1.7 per cent in the second (see table VII.1). In a few countries, there was significant improvement, with GDP growth near 7 per cent in Cameroon, around 5 per cent in Côte d'Ivoire, Senegal

and Uganda, and about 4 per cent in Kenya and Malawi. Nevertheless, for sub-Saharan Africa as a whole and for most individual countries, the trend of declining per capita GDP since the 1970s was not halted in 1985 (see table VII.2). The decline in per capita national income in 1985 was even more pronounced than the decline in per capita GDP as a result of the deterioration in the terms of trade and the toll taken by net foreign capital income, particularly interest payments on foreign debt.

Table VII.1. Sub-Saharan Africa: average annual rates of increase in key variables, 1971-1985

(Percentage)

	1971-1975	1976-1980	1981-1985
Real GDP			
Total	4.7	2.6	-0.4
Energy importers	2.6	2.1	0.7
Energy exporters ^a	7.3	3.0	-1.6
Agricultural production^b			
Total	0.0	1.9	2.0
Per capita	-3.0	-1.2	-1.1
Food production^b			
Total	2.2	2.0	1.9
Per capita	-0.8	-1.1	-1.2

Source: Department of International Economic and Social Affairs of the United Nations Secretariat and data provided by FAO.

^a Angola, Cameroon, Congo, Gabon and Nigeria

^b Based on FAO net indices at 1974-1976 prices.

Table VII.2. Sub-Saharan Africa: GDP, agriculture and food production per capita, 1976-1985^a

(Annual rates of growth)

	1976-1985	1981	1982	1983	1984	1985
GDP	-2.3	-4.4	-4.5	-5.0	-2.9	-0.9
Agriculture	-1.2	1.7	-2.0	-4.8	1.4	0.6
Food	-1.1	1.8	-1.9	-7.4	1.5	0.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, and FAO, *Production Indices*.

^a Country indices weighted by 1974-1976 gross value added in agriculture, expressed in 1975 prices and dollars.

Box VII.1 Aggregate indicators for Africa: what they reveal, what they conceal

The African continent defies easy generalizations. While it includes only 8 countries with population above 20 million and 1 with close to 100 million, 11 of its small countries have population of less than or slightly above 1 million. Averages for Africa hide as much as they reveal. While the average per capita GDP is somewhat below \$600 and a tiny number of countries have a per capita GDP above \$2,000, most of the countries have a per capita GDP near the level of \$300, and for a few it is even below \$200. While Africa north of the Sahara has lower and declining population growth rates, sub-Saharan Africa has higher and increasing population growth rates. Some African countries depend on oil for more than two thirds of their export earnings, but in others oil represents over a third of their import bill. Any regional or subregional averages are heavily affected by Nigeria, which has a share of more than 20 per cent of the GDP of developing Africa as a whole and approximately 40 per cent of the GDP of sub-Saharan Africa. The weight of Egypt, which has about 9 per cent of the GDP of developing Africa and 20 per cent of the GDP of North Africa, also strongly affects averages.

A word of caution is necessary on the statistical data on Africa. Considerable variations in estimates of the main

economic variables according to different sources are one of the main difficulties in analysing economic trends in Africa. Sometimes the figures available can be taken only as rough indicators. Moreover, analysis and data for Africa emanating from different institutions do not cover the same aggregate. Thus, in general, the IMF aggregate "Africa" excludes Egypt and the Libyan Arab Jamahiriya, but includes South Africa. The United Nations aggregate "developing Africa" covers all countries in the African continent except South Africa. The World Bank "Africa" aggregate in some Bank studies, covers only 29 low-income countries in sub-Saharan Africa, eligible for assistance from IDA. Sub-Saharan Africa in the IMF aggregates usually excludes Nigeria. The discussion in the present *Survey* focuses on sub-Saharan Africa defined as the African continent and nearby islands, excluding the Republic of South Africa and northern Africa. Sub-Saharan Africa has been affected by a prolonged development crisis, expressed in the decline of per capita income of its population for almost two decades. In this crisis, the countries of the region, despite the apparent diversity, face a set of common problems of a structural nature.

Africa: some basic indicators

	Africa ^a	Northern Africa ^b	Sub-Saharan Africa	Sub-Saharan oil exporters ^c	Sub-Saharan oil importers
Population, millions (1985)	521	101	421	117	304
Annual rate of growth, 1985-1990 (percentage)	3.1	2.8	3.1	3.3	3.0
GDP, billions of 1980 dollars (1985)	306	123	184	89	95
Annual rate of growth, 1981-1985 (percentage)	-0.5	-1.2	-0.4	-1.6	0.7
GDP per capita, 1980 dollars (1985)	590	1 200	440	760	310
Annual rate of growth, 1980-1984	-0.8	-0.1	-1.4	-1.2	-1.7
Merchandise imports billions of dollars (1984)	68	35	33	14	19
Annual rate of growth, 1980-1984 (percentage)	3.1	7.7	-0.7	0.3	-1.5
Debt, billions of dollars ^d (End of 1984)	139	59	80	27	53

Source: Department of International Economic and Social Affairs of the United Nations Secretariat and World Bank, *World Debt Tables*, 1985-86 edition.

^a Excluding South Africa.

^b Algeria, Egypt, the Libyan Arab Jamahiriya, Morocco and Tunisia.

^c Angola, Cameroon, Congo, Gabon and Nigeria.

^d Public and publicly guaranteed long-term debt, IMF purchases and partial information on private non-guaranteed long-term and short-term debt.

The drought receded during 1985 and, after good autumn harvests, the severe emergency of 1984-1985 subsided. In early 1985 the situation was severe. Twenty African countries with a total population of some 200 million were identified by the Food and Agriculture Organization of the United Nations as facing severe food shortages at that time.¹ It was estimated that the lives of some 30-35 million people were severely threatened. Of these, 10 million had abandoned their homes and lands in search of food, water and pasture for their herds.

In sharp contrast, only four countries - Angola, Ethiopia, Mozambique and the Sudan - but with a total population of over 80 million, still required immediate emergency relief as at March 1986.² More than 18 million people will need relief aid well into 1986; of this number, an estimated 2.6 million people are displaced, most of whom have few resources to meet their basic needs. In addition, there are almost 1 million refugees and returnees in Ethiopia, Somalia and the Sudan who continue to require emergency relief assistance. In the countries where the food emergency continues, agricultural recovery has been hampered not just by vagaries of the weather in 1985, but by disruptions caused by armed conflicts, continuing rural insecurity and shortage of inputs - seeds, tools, draught animals, fertilizers and pesticides. In addition to the 4 most seriously affected countries, 11 other countries - Botswana, Burkina Faso, Cape Verde, Chad, Lesotho, Mali, Mauritania, Niger, Rwanda, the United Republic of Tanzania and Zambia - require emergency non-food aid for logistical operations to provide food, medical supplies, water, agricultural inputs and numerous other items.

The recent drought focused attention on the nexus between emergency aid and long-term development and on the long-term nature of the African food crisis. Most countries in the sub-Saharan region had total food production levels higher in 1985 than in 1984. A decline in 1985 over 1984 seems to have taken place in four countries: Benin, Gabon, Ghana and Guinea-Bissau. In eight other countries, production remained flat. For the aggregate of sub-Saharan Africa, total food production increased about 2

per cent. But to reverse the long-term trend of declining per capita food production, food output growth of about 4 per cent a year will be required for a sustained period. Of 44 countries in the region, 31 had lower or about the same per capita food production in 1985 as in 1984. For the aggregate of sub-Saharan Africa, per capita food production in 1985 was only slightly above 1984. Following a decline of about 7 per cent in 1983 and a small rise of 1.5 per cent in 1984, 1985 levels are still below the 1980-1982 average and about 7 per cent lower than the 1970 average. Per capita agricultural production increased by less than 1 per cent in 1985 but its level is still about 8 per cent below the 1974-1976 average (see table VII.2).

In a number of countries, including Kenya, Malawi and Zimbabwe, good harvests produced a maize and sorghum surplus available for export. But this does not necessarily mean that food deficit countries will be able to import those cereals.

Over the years, sub-Saharan Africa's need for food has been outpacing food production. Widening food shortages have increased the dependence on food imports. In the 1970s, the volume of food imports almost quadrupled and, as a result, the share of food in total imports increased. As long as the share of food imports keeps growing, it will be at the expense of other imports such as spare parts, fuel and fertilizers. With restrictions on these imports, as has been the rule, production increases, including increases in food production, will be hindered.

A core issue for the future is how to use relief activity to support long-term agricultural development. The acute emergency was a low point in a prolonged process of structural deterioration. The need for emergency food aid might increase again, since the extreme vulnerability of African domestic agricultural supply to the rainfall level has not yet changed, and balance-of-payment difficulties have only worsened. If the long-term trend of agricultural decline is not halted and reversed, there could be famine without drought.

Continued vulnerability to external shocks

In 1985, sub-Saharan Africa managed to bring about a trade surplus of some \$4 billion, higher than the trade surplus of 1984. Total exports were approximately the same as in 1984. Imports continued to decline, but at a slower pace in 1984 and 1985 than in 1982 and 1983. Average annual exports of sub-Saharan Africa in 1984-1985 were about \$35 billion, a drop of more than 20 per cent from the level of \$45 billion in 1980-1981. While the drop was about 5 per cent for energy importers, it was almost 27 per cent for energy exporters (see table VII-3).

Given the fact that net external lending to sub-Saharan

Africa declined in 1985 and that debt service continued to increase, the import constraints on African countries persisted. In many African countries, there has been a permanent deterioration in import capacity and the quantum index of total imports is now lower than levels reached in the 1970s. Per capita imports in low-income countries have been declining since 1970, and the rate of decline accelerated in the 1980s.

The collapse of import volumes in the 1980s has caused significant under-utilization of existing capacity in industry and agriculture, and even in the social sector, where

¹ Although agricultural and food production increased in sub-Saharan Africa as a whole in 1984, for those 20 countries there was a significant decrease that year. A fall in agricultural and food production had also been experienced in those countries in 1982 and 1983. See *World Economic Survey 1985*, (United Nations publication, Sales no. E.85.II.C.1).

² United Nations, Office for Emergency Operations in Africa. *Status Report on the Emergency Situation in Africa as of 1 March 1986* (Report No. OEOA/3/9).

Table VII-3. Developing countries in Sub-Saharan Africa: international trade, reserves and ODA, 1980-1985

	1980	1981	1982	1983	1984	1985 ^b
	<i>Billions of dollars</i>					
Merchandise exports						
Total	50.8	39.8	32.6	30.0	35.2	35
Energy importers	18.4	15.4	14.0	13.9	14.6	14
Energy exporters	32.4	24.4	18.7	16.1	20.6	21
Merchandise imports						
Total	46.7	49.3	44.3	36.9	32.8	31
Energy importers	25.5	24.1	21.7	19.6	18.8	18
Energy exporters	21.1	25.2	22.7	17.3	14.0	13
	<i>Months</i>					
Import coverage of reserves						
Total	3.8	1.8	1.2	1.3	1.8	2.1
Energy importers	1.6	1.4	1.3	1.6	1.9	2.4
Energy exporters	6.6	2.2	1.1	1.0	1.7	1.7
	<i>Billions of dollars</i>					
Real net ODA disbursements ^a	7.6	8.0	8.1	8.0	8.4	..

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*; OECD, *Development Co-operation: 1985 Review* (Paris, 1985) and *Geographical Distribution of Financial Flows to Developing Countries* (Paris, 1986); and estimates of the Economic Commission for Africa and national and other sources.

^a In 1982 prices and exchange rates (nominal dollar values deflated by the ODA deflator of DAC member countries).

^b Preliminary estimates.

hospitals and educational centres have been affected. The decline in imports has contributed to the deterioration of infrastructure in sub-Saharan Africa. Industry is heavily dependent on imports not just for capital goods but for a wide range of inputs necessary for current production.³ Prolonged import strangulation in the region is having more serious consequences than would recurrent temporary import shocks alone because it is leading to a longer-term setback to development progress that will take many years of rehabilitation to overcome.⁴ The World Bank, citing its country experience, considers that a minimum GDP growth of 3 per cent or 4 per cent, which just keeps per capita GDP constant, cannot be achieved if the decline in import capacity is not reversed.⁵

Import strangulation in the 1980s is being forced upon sub-Saharan Africa by the combined effect of a decline in commodity prices and the worsening of external financing conditions. This mechanism continued to operate in 1985. As shown in table VII.4, after a modest recovery in 1984, average prices for the year of practically all commodities exported by sub-Saharan Africa fell in 1985. The exceptions were increases in the price of spices, which are important exports for Comoros, Madagascar, Seychelles and the United Republic of Tanzania; stable tobacco prices, relevant for Malawi and Zimbabwe; and some minimal respite for Zaire and Zambia arising from the

marginal recovery in copper prices after the collapse in 1984. Prices of four main agricultural exports from the region - coffee, cocoa, cotton and sugar, which together represent about 70 per cent of total agricultural exports - continued to be extremely depressed in 1985. The same occurred with tea, vegetable oil, wood and metals. The instability and long-term decline in commodity prices is especially damaging in sub-Saharan Africa because most of the countries depend on only one, two or three commodities for more than 60 per cent of their foreign exchange earnings (see table VII.5). For 19 sub-Saharan countries, 80 per cent or more of their export earnings are derived from the export of three or fewer commodities.

Price deterioration has not been the only problem faced by African producers. They are often comparatively weaker participants competing for markets and therefore suffer most from the decline in the share of developing countries in world total primary commodity exports. Africa's share in world commodity exports has been falling continuously, from 9.0 per cent in 1966 to 6.6 per cent in 1975 and 4.9 per cent in 1983, while the share of other developing regions increased or remained constant.

The deterioration of sub-Saharan African terms of trade represents an accumulated loss of approximately \$11 bil-

³ See United Nations Industrial Development Organization, *Industry and External Debt in Africa: A Preliminary Analysis* (Vienna, 1985).

⁴ See G. K. Helleiner, "Conditionality in sub-Saharan Africa", paper prepared for the Institute for International Economic Conference on African Debt and Financing, Washington, D.C., 20-22 February 1986.

⁵ World Bank, *Financing Adjustment with Growth in Sub-Saharan Africa, 1986-90* (Washington, D.C., February 1986), p. 2.

Table VII-4. Prices of main non-fuel primary commodities exported by sub-Saharan Africa, 1981-1985

(1980 = 100)

Commodity	1981	1982	1983	1984	1985
Cocoa	80	67	81	92	87
Coffee	70	76	84	94	82
Copper	80	68	73	63	65
Cotton	90	77	90	86	64
Groundnut oil	121	68	83	118	105
Sugar	86	82	80	73	72
Tea	91	87	104	155	89
Tobacco	113	128	130	130	130

Source: IMF, *International Financial Statistics*. Indices are of prices in the markets that are more important for African commodities.

lion in the period 1980-1985.⁶ For the near future, there are no prospects of an improvement in the aggregate terms of trade of the subregion. Even the impact of expected higher average coffee prices in 1986 and the depreciation of the United States dollar cannot offset the declining trend for the aggregate of commodities from sub-Saharan Africa, in particular the decline in oil prices.

A number of countries in the region will, however, benefit in 1986 from the rise in coffee prices resulting from

drought damage to the Brazilian crop. Coffee is the principal or the second export product for 10 countries in the sub-Saharan region and as many as 24 countries in the region export some coffee. It represents two thirds of the total exports of four countries: Burundi, Ethiopia, Rwanda and Uganda. For five countries, Central African Republic, Côte d'Ivoire, Kenya, Madagascar and the United Republic of Tanzania, it represents nearly one third of export earnings. And it is close to 10 per cent of exports for Angola, Cameroon, Sierra Leone, Togo and Zaire.

Table VII.5. Share of main commodities in total agricultural exports of sub-Saharan Africa, 1944-1984

(Percentage)

Commodity	1944-1966	1969-1971	1978-1980	1984
Coffee, cocoa and cotton	46	54	63	66
Coffee, cocoa and sugar	51	58	69	72
Coffee, cocoa, cotton, sugar and tobacco	56	61	72	78

Source: OECD Development Centre, *Crisis and Recovery in Sub-Saharan Africa* (Paris, 1985), p. 51, and FAO, *Trade Yearbook*, vol. 38, (Rome, 1985).

⁶ Estimated using the UNCTAD net barter terms of trade index until 1984 and an estimated decline of 2 per cent in terms of trade in 1985. The UNCTAD index corresponding to the sub-Saharan region was applied to imports. The result reflects the difference between actual imports and what they would have been if 1980 volumes had been maintained and terms of trade had not changed. Caution is needed in interpreting an aggregate index of terms of trade as it might obscure the fact that, for instance, a modest loss for the group is in fact the result of gains for one subgrouping of countries and heavy losses for another subgrouping (for terms of trade estimates see *Handbook of International Trade and Development Statistics, Supplement 1985*, United Nations publication, Sales No. E/F.85.II.D.12, tables 2.5 and 7.2).

The shortfall in Brazilian exports and the decision of 19 February 1986 to suspend export quotas of the International Coffee Agreement leaves African and other producers competing to increase their market share. The quotas of coffee-producing countries in sub-Saharan Africa represent about 25 per cent of the International Coffee Agreement's total quotas.

Very roughly, the benefit from the coffee price increase could be as high as some \$1.5 billion extra export earnings for sub-Saharan countries, if the average 1986 price is 200 cents a pound and if they are able to export the same volume as in 1985.⁷ But this gain is likely to be short-lived, as was the price increase in 1976/77 after frost damage to the Brazilian crop. Moreover, it might be difficult to re-establish the Coffee Agreement after the present suspension of quotas.

Sub-Saharan Africa's economic performance has been highly dependent on oil in the aggregate. The total GDP of the five oil-exporting countries in sub-Saharan Africa represents about half of the total GDP of the region. The aggregate effect of lower oil prices on projections of sub-Saharan Africa's balance of trade in the current year is expected to be unfavourable.

The balance of trade gain of the energy importing countries will be less in dollar value than the loss incurred by the oil exporters. Energy-importing countries in sub-Saharan Africa will have a drop in oil import expenditures between \$1 billion and \$2 billion. For sub-Saharan oil exporters, including Zaire which exported a marginal amount in 1985, however, the loss may be \$6 billion to \$7.5 billion, primarily concentrated in Nigeria.

There are great disparities in the impact of oil prices in African oil importing countries. At least a dozen countries in sub-Saharan Africa have crude and oil product imports near or above 20 per cent of total imports. For Ghana, Kenya, Liberia, Senegal, the United Republic of Tanzania and Zimbabwe, they are nearer 30 per cent. For these countries, a halving of the oil prices can represent a 10-15 per cent addition to sorely needed import capacity. But, in a few cases, the beneficial effect on the balance of payments may be counteracted by lower oil-related foreign direct investment, if oil companies can no longer expect sufficient returns. Guinea, Liberia, and Sierra Leone are among the African countries thought to have offshore oil deposits whose development will be delayed by the price declines. Investment in oil-producing countries that do not yet satisfy all of their domestic needs, for example Côte d'Ivoire, could be similarly affected. Niger, dependent on

uranium exports, will continue to suffer because of the ongoing reduction in nuclear energy programmes reinforced by lower oil prices.

A small number of countries in sub-Saharan Africa have benefited from remittances of their nationals employed in the oil-exporting countries. These countries are already facing a decline in worker's remittances and the need to reabsorb returning labourers. Moreover, the need to sharply cut imports in oil exporting countries, particularly in Nigeria, will negatively affect trade in some of the neighbouring countries.

Indirect benefits will come about particularly from lower transportation costs. In many countries, there were times when even existing transport equipment could not be used given the expense and scarcity of petrol. Cheaper petroleum could also slow down the use of wood as fuel for cooking and heating.

A second type of indirect benefit could be reaped by African economies if lower oil prices translate into higher growth in industrialized countries, particularly in Europe, since the latter absorbs about 60 per cent of sub-Saharan Africa's exports. The extent of the benefit, however, will depend on the incremental growth rate in Europe, the growth in import demand for African commodities associated with it and the ability of African countries to take advantage of the increase in demand for their exports. In the case of some of the crops affected by drought, the responsiveness of supply to increased demand might be limited. In general, the elasticity of sub-Saharan African exports with respect to OECD growth tends to be lower than for the other developing country groups.

Given the decline in oil prices and the downward trend in other commodity prices, a new decline in the terms of trade of sub-Saharan Africa can be expected in 1986, of the order of 2 per cent if Nigeria is excluded and of some 15 per cent if it is included. Thus in the short-to medium-term, countries of sub-Saharan Africa in the aggregate cannot be expected to improve their external accounts through an improvement of export prices, but only through higher export volumes. This will extract a domestic welfare cost in terms of domestic consumption forgone and may reduce food production in some cases. Trade surpluses in the past two years were achieved at the expense of imports. But further contraction of imports and scaling down of growth to cut current account deficits is increasingly more difficult, socially disruptive and ultimately irrational. Very narrow margins for manoeuvre are left to sub-Saharan Africa in the near future.

The financial squeeze

In the past few years, sub-Saharan Africa reached a situation of crisis in its external financing. At the end of 1984,

20 out of 43 developing countries which had external payment arrears on their debts were from sub-Saharan Africa.

⁷ Calculations assume total exports from sub-Saharan Africa of 18 million 60 kilos bags and an average coffee price of 200 cents a pound in 1986 and 130 cents in 1985. The price on 19 February was 186 cents a pound, when quotas were suspended. Predictions on future price behaviour vary according to the assessment of the real Brazilian loss and quantity and quality of world stocks. The possible benefit of the coffee price increase is roughly equivalent to the expected disbursement of the World Bank Special Facility for sub-Saharan Africa over a three-year period.

The total amount of sub-Saharan African arrears was \$11.6 billion. Two thirds of these countries, holding some 85 per cent of the debt of the group, experienced debt-servicing difficulties in 1980-1985. Of 44 IMF members in sub-Saharan Africa, only 14 had neither debt rescheduling nor external arrears during 1980-1985. Eight countries were in arrears to the IMF at the beginning of 1986. The debt-export ratio of sub-Saharan Africa almost doubled in five years to approximately 230 per cent in 1983 and remains at that level. For the subgroup of low-income countries that had little or no access to commercial borrowing and that depend on concessional loans, the debt-export ratio increased from about 200 per cent in 1978 to about 390 per cent in 1983.⁸ As shown in table VII.3, reserves in sub-Saharan Africa cover only two months of already sharply contracted imports. They are zero in many of these countries.

At the root of these worsening debt indicators is a balance-of-payments deterioration caused by declining terms of trade that made an initially precarious situation worse: the current account deficit of sub-Saharan Africa was approximately 3 per cent of GDP in 1970-1974, 6 per cent of GDP in 1975-1979, and more than 7 per cent in 1980-1984. The gradual increase in indebtedness initially permitted the maintenance of a minimum level of imports. But in the 1980s import capacity declined more rapidly. In sub-Saharan Africa, import volumes fell at an annual rate of almost 6 per cent between 1980 and 1984. Mounting debt service is competing with imports for scarce and declining foreign exchange earnings, and is becoming an aggravating factor in the process of import strangulation suffered by the region.

The changes in sub-Saharan Africa's debt situation can be summarized as follows:

Total debt increased very rapidly in the 1970s; it rose nearly eightfold between 1970 and 1980, reaching almost \$65 billion. Thereafter it continued to increase although at a slower pace, and it currently amounts to over \$80 billion.⁹

Until 1982 the debt of countries with access to com-

mercial loans rose fastest, leading to an increase in the proportion of private and commercial loans in the overall debt of the region. For the region as a whole, the share of soft loans, or loans on concessional terms, in total public and publicly guaranteed debt fell from 48 per cent to 37 per cent between 1970 and 1984. During the same period, the share of loans at variable interest rates increased from 1 per cent to 22 per cent.¹⁰

The changes in the composition of the debt implied a hardening of the borrowing terms, in particular an increase in the average rate of interest. The average nominal interest rate on new public debt commitments for sub-Saharan Africa went up from 5.8 per cent in 1976-1978, to 8.1 in 1979-1981. In 1982-1984, the average interest rate declined to 7.3 per cent, reflecting the considerable reduction in the average interest rate of new loans contracted during the year 1984.¹¹

All of these elements - higher overall indebtedness, changes in the structure of the debt and, given the deterioration in the terms of trade, much higher real interest rates - led to an uninterrupted increase in external debt-servicing obligations. Interest payments have been growing every year. For the aggregate of sub-Saharan Africa, actual interest payments on long-term debt rose nearly fivefold between 1975 and 1981, reaching \$2.4 billion; they had risen to nearly \$3.3 billion by 1984. Actual principal repayments on long-term debt also increased steeply, from about \$1 billion in 1975 to nearly \$3 billion in 1981 and more than \$4.6 billion in 1984.

Actual debt service on long-term credits for sub-Saharan Africa (including IMF repurchases) reached over \$8.4 billion in 1984, nearly 50 per cent higher than actual debt service in 1981. Debt service increased from about 12 per cent in 1981 to about 25 per cent in 1984 relative to export earnings.¹² If the debt service on short-term credits were known, the figures for total debt-service would be considerably higher. Moreover, actual debt service payments made in 1984 were certainly far lower than the amount that fell due the same year.¹³

The need for development finance

To reverse the decline in per capita income, sub-Saharan Africa has to overcome the present import strangulation. Although a consensus exists on the need for rais-

ing imports to a level compatible with the resumption of growth in sub-Saharan Africa, no precise estimate can be given of what this level of imports should be. No meaning-

⁸ See World Bank, *World Debt Tables* 1985-86 edition (Washington, D.C., 1986). Data on debt and debt-servicing obligations of African countries are in some cases imprecise. Some Governments are currently in the process of ascertaining what the exact debt situation of their countries is. Estimates of the debt and debt service vary, however, depending on the inclusion of short-term credit, private nonguaranteed long-term debt, use of IMF credit, arrears, or items such as external liabilities on account of nationalized properties.

⁹ At the end of 1984, according to World Bank, *World Debt Tables* 1985-86 edition, total debt of sub-Saharan Africa including Nigeria was \$78.4 billion. This comprised \$57 billion of public and publicly guaranteed debt, \$3.6 billion of private non-guaranteed long-term debt, \$12.2 billion of short-term debt, and \$5.3 billion of IMF purchases.

¹⁰ World Bank, *World Debt Tables* 1985-86 edition..., p. 27.

¹¹ World Bank, *Financing Adjustment with Growth in Sub-Saharan Africa, 1986-90* (Washington, D.C., February 1986), table 17.

¹² Basic data from World Bank, *World Debt Tables* 1985-1986 edition ...

¹³ Taking into account only public debt outstanding at the end of 1984, the World Bank has estimated that the scheduled 1984 debt service as a percentage of goods and services was 6 percentage points higher than the actual debt service (World Bank, *Financing Adjustment with Growth...*, table A. 3.

ful figures for import elasticity of GDP growth can be derived from the prolonged period of decline in both GDP and imports. At present, unused capacity is at high levels owing to lack of raw materials and other inputs for current production, from spare parts to fuel for transport.

When foreign exchange shortage has led to import cuts in developing countries, these cuts have usually affected in the first place imports of capital goods. In sub-Saharan Africa, however, the cuts in imports have reached a stage beyond that in which production capacity cannot be expanded owing to constraints on capital good imports. The share of machinery and transport equipment in total imports has remained at a level of almost 40 per cent, reflecting imports of capital goods linked to project financing. At the same time, imports necessary to put to work existing productive capacity could not be made. Estimates of the level of imports necessary to resume growth would have to start with the needs for rehabilitation of existing capacity at the country level. Increasing the level of utilization of existing capacity should be the focus in the short run, rather than the importation of additional capital goods.

To restore their imports to the per capita levels of 1980-1982, sub-Saharan countries as a whole would have to be able to reach a yearly average of imports on the order of \$56 billion in the period 1986-1990. For such levels to be reached, imports would have to grow from 1985, when they were about \$31 billion, by more than 20 per cent a year until the end of the decade. By implication, those figures illustrate how sharp import strangulation has been in the first half of the 1980s.

When corrections are made to eliminate the effect of the oil price increases of the 1970s on the import capacity of sub-Saharan Africa, the corresponding level of imports still reaches a yearly average of \$43 billion for the period 1986-1990. To reach this average, imports would have to grow 11 per cent yearly from 1986 to 1990. However, even with such an ambitious increase, energy exporters would only have import levels almost 25 per cent below the average for 1980-82, and most of the energy importers, despite having the 1980-1982 per capita levels restored, would remain at per capita import levels below those of the early 1970s.

The figure of \$43 billion worth of imports a year in 1986-1990 is not to be regarded as a target, but just as a rough estimate of the minimum import level compatible with the resumption of growth in per capita domestic product. There is certainly an element of arbitrariness in the figure, but it cannot be regarded as excessive. It can be

considered as a lower-range for the calculation of the overall need for foreign exchange in sub-Saharan Africa. Given past experience, the implicit import growth rate cannot be associated with a specific GDP growth rate. This does not imply that a minimum GDP growth of 3-4 per cent, barely enough to keep per capita GDP constant, is necessarily associated with that import growth or considered to be satisfactory. Total GDP growth rates have to be at least 4 per cent if per capita consumption levels are to increase in sub-Saharan Africa. Rates of growth above 5 per cent were achieved by the region in the past, in the period 1968-1974. With GDP growth of 5 per cent from 1986, the per capita GDP of 1980 could be restored by the beginning of the next decade and an annual increase in imports at a rate of 11 per cent appears as a plausible figure associated with that rate of growth.¹⁴

In addition to the foreign currency needed to pay for intermediate imports that will expand capacity utilization, sub-Saharan Africa and its creditors face a scheduled debt service of at least \$16 billion yearly in the same period, 1986-1990, if no further debt rescheduling agreements are reached.¹⁵ Reserves are already at extremely low levels so that there is in fact no room for further reduction. On the contrary, there is a need for African Governments to build up enough reserves to cover a few months of essential imports, so that their vulnerability to volatile commodity prices can be reduced and medium- and long-term development programmes are not disrupted by sudden changes in the behaviour of banks and official creditors.

Under present circumstances, overall exports of sub-Saharan Africa are unlikely to grow significantly in the next few years. A growth of 10 per cent in the value of exports of oil-importing countries in sub-Saharan Africa, partly on the basis of higher coffee prices, is possible in 1986. But a decline of at least 25 per cent in the value of exports of oil exporters in sub-Saharan Africa is projected for the same year. To obtain significant export growth, substantial diversification will be needed. But such a change cannot be effected in the short run.

Since Europe is the destination of some 60 per cent of sub-Saharan Africa's exports, a continuing depreciation of the dollar will have an upward effect on the dollar value of the region's exports. However, the proportion of total imports coming from outside the dollar zone is not much different from the proportion of exports going outside the dollar zone. Therefore, the net impact of the devaluation of the dollar on the trade balance might be small.¹⁶

¹⁴ In most countries an acceleration of growth leads to import elasticities, in the short run, well above one. In this case it would be about two.

¹⁵ The projected debt service of sub-Saharan Africa in the period 1986-1990 is \$9.5 billion yearly, on the basis of data in *World Debt Tables* 1985-86 edition. Projected debt service payments, as defined in *World Debt Tables*, are estimates of payments due on existing debt outstanding, including undisbursed. The concept of scheduled debt service does not appear in *World Debt Tables* but was used by the World Bank in its study entitled *Financing Adjustment with Growth in Sub-Saharan Africa, 1986-90*. While projected debt service is estimated at \$9.5 billion yearly, scheduled debt service is estimated at \$16 billion yearly. The scheduled debt service is higher because it includes debt service on anticipated new borrowing, but not new rescheduling.

¹⁶ A continuing devaluation of the dollar will also reduce the dollar value of the debt, in proportion to its non-dollar denominated share. The share of currencies other than the United States dollar in total public and publicly guaranteed debt of sub-Saharan Africa is below 50 per cent (World Bank, *World Debt Tables*, 1984-85 edition, p. xxiv). On the other hand, reserves are so low, both in dollar and other currencies, that the dollar devaluation will have no relevant effect on them.

Table VII.6. Sub-Saharan Africa: sources of external finance, 1980-1984

(Billions of dollars)

	1980	1981	1982	1983	1984
Gross medium-and long-term finance	18.3	20.2	22.2	23.0	18.9
Gross flows of grants and concessional loans	7.6	7.6	7.1	7.0	7.2
Grants	4.8	4.7	4.4	4.4	4.8
Concessional loans	2.8	2.9	2.7	2.6	2.4
Gross flows of non-concessional loans	7.9	7.8	9.7	9.6	5.4
Official	1.6	1.7	1.9	2.3	1.7
Bilateral	0.9	0.9	0.9	1.3	0.6
Multilateral	0.7	0.8	0.9	1.0	1.1
Private	6.3	6.1	7.8	7.3	3.7
Other flows	2.8	4.8	5.4	6.4	6.3
Foreign direct investment ^a	0.8	1.4	1.4	1.3	1.0
Gross use of IMF funds	2.0	3.4	4.0	5.1	5.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

^a 1984 data are preliminary. See *The CTC Reporter*, No. 21, (spring 1986).

Under the lowest assumption for the needed yearly average of imports in the period 1986-1990, estimated at \$43 billion, the value of exports would have to increase by 7 per cent annually between 1986 and 1990 for merchandise trade to be balanced. This would still leave the scheduled yearly debt service of \$16 billion uncovered. It is well known that the reduction of debt-service ratios hinges critically on the differential between export growth rates and the interest rate on debt. The implicit average interest rate paid by sub-Saharan Africa on outstanding debt, in the 1980s, has been 5.5 per cent. The implication of meagre opportunities to increase traditional exports of the region is that, in addition to policies to diversify exports, considerable financial support to change the structure of the economies of the region is necessary if exports are to grow significantly.

Future financial flows are difficult to predict with exactitude, but some troublesome trends can be identified. Total gross financial flows to sub-Saharan Africa grew somewhat in the 1980s up to 1983, but fell in 1984, despite some growth in grants that was related to emergency food aid operations (see table VII.6). The complete picture, however, is worse than shown by gross flows. As a combined result of the sharp fall in disbursements of loans and the rise in debt service, in 1984, for the first time, sub-Saharan Africa suffered a net negative transfer with respect to its long-term debt: debt service was higher than disbursements of loans by the amount of \$164 million.¹⁷ Because trends in grants and direct investment flows did not mirror those for credits, the overall net transfer remained positive at about \$1 billion - a tenth of the level of the early 1980s (see Chapter IV, Table IV-4).

The worsening of debt ratios was accompanied by a virtual withdrawal of private banks from voluntary lending to sub-Saharan Africa in the past two years, leading to a net resource transfer to private creditors in 1984. Interest and principal repayments to private creditors have been considerably higher than disbursements of private loans since 1984. Net external borrowing from commercial banks was negative to the amount of \$2.2 billion in 1984. It was again negative in 1985.¹⁸

Another worrisome situation arises from the use of IMF funds. Facing increased balance-of-payments difficulties in the early 1980s, many sub-Saharan African countries sought assistance from the IMF. The net use of IMF funds by sub-Saharan Africa went up from a yearly average of \$163 million in 1975-1977 to \$524 million in 1978-1980 and to \$1,036 million in 1981-1983. However, after this peak, the net use of IMF fell sharply to \$434 million in 1984 and was virtually zero in 1985. This could be considered normal, since the purpose of IMF drawings is to provide short-term support for balance-of-payments adjustment and temporary shortfalls in export earnings, and repayments are due after two or three years. But such a drying up of IMF finance at a time of continuing balance-of-payments difficulties indicates that short-term finance is not an adequate form of support for the majority of the countries of sub-Saharan Africa. Given the factors limiting their ability to earn foreign exchange and the downward limit reached on import cuts, the majority of these countries are unable to overcome their balance-of-payments difficulties in a short period of time.

Over the next few years, some of the countries in sub-

¹⁷ World Bank, *World Debt Tables*, 1985-86 edition..., p. 28.

¹⁸ See World Bank, *World Debt Tables*, 1985-86 edition..., pp. 26-28, for data up to 1984. Alternative calculations on the basis of IMF balance of payments data show a negative net transfer to commercial banks of \$700 million in 1983, \$2 billion in 1984 and \$700 million in 1985. See Eduard Brau, "African debt: facts and figures on the current situation", International Monetary Fund, 17 February 1986, table 6.

Saharan Africa will be eligible to make use of funds from the newly created IMF Structural Adjustment Facility. About 80 per cent of the total, or nearly \$2.5 billion may be available for countries in sub-Saharan Africa. Therefore, a yearly average of \$500 million of IMF funds will be available for countries in sub-Saharan Africa eligible for assistance from IDA. Borrowing rights are based on IMF quotas. The largest potential borrowers are Ghana, Kenya, the Sudan, Zaire and Zambia. Countries that wish to avail themselves of the new IMF facility will have to agree on a policy framework and prepare an economic programme jointly with IMF and the World Bank. Given the stringency of the economic conditions in those countries, it is likely that full use will be made of these new IMF resources. But with repurchases of IMF funds scheduled to be above \$1 billion on average in 1986-1990, the Structural Adjustment Facility is only a partial response to the trend towards a negative flow of IMF funds looming at the beginning of 1986. There is a danger that loans from other sources will have to be used to repay IMF.

Too much hope should not be pinned on foreign direct investment as a source of new capital flows to sub-Saharan Africa. Foreign direct investment in Africa since the 1970s has mainly flowed to the energy exporting countries and potential oil exporters. Other big flows of foreign direct investment have gone to a few exporters of minerals, in particular Botswana and Zaire, but these flows have been declining since 1981. Africa's least developed coun-

tries have received only insignificant amounts of foreign direct investment. If oil-related flows are excluded, the volume of foreign direct investment flows to sub-Saharan Africa has remained quite modest.¹⁹ The implication of depressed oil prices is that foreign direct investment will probably decline in the sub-Saharan region as a whole before the rehabilitation of the infrastructure and the diversification of economies will make prospective rates of profit more attractive.

For the remainder of the decade, sub-Saharan Africa, in particular the least developed countries in the region, will continue to rely even more than in the recent past on concessional flows to meet the requirements of external finance to return to a path of growth. National resource mobilization and policy reform to revitalize the economy will have to be supported not only by a substantial increase in external resources but also by changes in the international economic environment. The shock of the emergency in sub-Saharan Africa focused attention on the need for international co-operation. The task ahead for the international community is to mobilize the internal and external resources necessary for a long-term development programme. A special session of the United Nations General Assembly on the critical economic situation in Africa was convened in New York from 27 to 31 May 1986, with the crucial responsibility of enhancing international co-operation in tackling the long-term development problems of the most depressed developing region of the world.

¹⁹ See *The CTC Reporter*, No. 21 (spring 1986).

Annex I

A COMPARISON OF FIVE COMMODITY PRICE INDICATORS

The Statistical Office of the United Nations Secretariat, the United Nations Conference on Trade and Development, the World Bank, the International Monetary Fund and *The Economist* publish regularly a series of primary commodity prices. The evolution and coverage of these indices is compared below, followed by a brief comment on each index and on possible reasons for the differences observed (see table A.I.1).

The IMF commodity price index is based on wholesale prices expressed in dollars and indexed 1980=100. The "All commodities" index includes 35 wholesale price series chosen as representative of 30 commodities (exclud-

ing oil and gold) exported by primary producing countries and weighted by average export earnings during 1968-1970 in 98 countries (excluding industrial and major oil-exporting countries). **Food** (31.4 per cent of total) includes fats and oils - groundnut oil, copra, groundnut cake, fish-meal, palm oil, soybean meal and soybeans; cereals - maize, wheat and rice; other foods - sugar, beef, lamb and bananas. **Beverages** (18.2 per cent) includes coffee, cocoa and tea. **Agricultural raw materials** (22.5 per cent) includes cotton, wool, rubber, hides, jute and sisal. **Metals** (27.9 per cent) includes copper, iron ore, tin, aluminium, zinc, nickel and lead.

Table A.I.1. Five non-fuel commodity price indicators, 1981-1985

(1980=100)

	Index of dollar prices					Percentage annual change				
	1981	1982	1983	1984	1985	1981	1982	1983	1984	1985
1. IMF										
All commodities	84.8	74.3	80.1	82.0	72.4	-15.2	-12.4	7.8	2.4	-11.7
(31.4%) Food	86.4	68.4	74.6	73.6	62.9	-13.6	20.8	9.1	-1.3	-14.5
(18.2%) Beverages	77.7	79.7	85.7	98.4	87.6	-22.3	2.6	7.5	14.8	-10.0
(22.5%) Agricultural raw materials	90.3	77.9	85.4	88.8	75.7	-9.7	-13.7	9.6	4.0	-14.8
(27.9%) Metals	83.4	74.7	78.0	72.5	68.9	-16.6	-10.4	4.4	-7.1	-5.0
2. WORLD BANK										
All commodities	87.0	77.8	81.5	82.4	74.1	-13.0	-10.6	4.8	1.1	-10.1
(52.9%) Food (including beverages)	86.9	77.6	82.2	86.9	76.6	-13.1	-10.7	5.9	5.7	-11.9
(19.5%) Non-food agriculturals	83.9	76.8	82.1	80.1	68.2	-16.1	-8.5	6.9	-2.4	-14.9
(27.5%) Metals	88.0	78.7	81.5	75.9	72.2	-12.0	-10.6	3.6	-6.9	-4.9
3. UNCTAD										
All commodities	84.5	71.8	75.5	76.4	68.2	-15.5	-15.0	5.2	1.2	-10.7
(25.1%) Food	80.4	57.7	60.2	52.0	44.7	-19.6	-28.2	4.3	-13.6	-14.0
(6.8%) Vegetable oils and oilseeds	95.8	75.0	91.7	124.0	85.4	-4.2	-21.7	22.3	35.2	-31.1
(27.1%) Beverages	81.7	77.9	81.7	93.3	85.6	-18.3	-4.7	4.9	14.2	-8.3
(19.3%) Agricultural raw materials	87.2	75.2	80.7	78.9	70.6	-12.8	-13.8	7.3	-2.2	-10.5
(21.7%) Metals	86.2	78.0	77.1	73.4	72.5	-13.8	-10.6	-1.2	-4.8	-1.2
4. THE ECONOMIST										
All items	86.2	74.7	84.3	83.4	74.8	-13.8	-13.3	12.9	-1.1	-10.3
(48.8%) Food	87.9	78.4	86.5	91.5	80.7	-12.1	-10.8	10.3	5.8	-11.8
(21.0%) Non-food agriculturals	89.4	76.6	90.2	83.0	73.5	-10.6	-14.3	17.8	-8.0	-11.4
(30.2%) Metals	81.1	67.2	76.2	70.6	65.7	-18.9	-17.1	13.4	-7.3	-6.9
5. STATISTICAL OFFICE OF THE UNITED NATIONS SECRETARIAT										
Primary commodities	87.8	76.7	80.2	82.6	72.1	-12.2	12.6	4.6	3.0	-10.1
(53.8%) Food	83.0	69.9	72.2	72.7	63.1	-17.0	-15.8	3.3	0.7	-10.5
(31.5%) Non-food agriculturals	89.2	76.3	85.5	90.9	74.7	-10.8	-14.5	12.1	6.3	-14.2
(14.7%) Minerals	111.3	114.5	105.6	110.5	114.5	11.3	2.9	-7.8	4.6	2.9
Non-ferrous base metals	83.1	71.4	74.1	66.7	66.7	-16.9	-14.1	3.8	-10.0	4.2

The WORLD BANK commodity price index is based on current dollar prices of 33 primary commodities (excluding energy) and weighted by 1979-1981 developing country export values (for purposes of comparison, the index was shifted to a 1980 base). **Food** (52.9 per cent) includes beverages - coffee, cocoa and tea - accounting for

22.2 per cent of the total; cereals - maize, rice, wheat and grain sorghum - accounting for 9.3 per cent; fats and oils - palm oil, coconut oil, groundnut oil, soybeans, copra, groundnut meal and soybean meal - accounting for 9.2 per cent; and other foods - sugar, bananas and oranges - accounting for 12.2 per cent. **Non-food agriculturals** (14.3

per cent) includes cotton, jute, rubber and tobacco. **Metals and minerals** (27.5 per cent) includes copper, tin, nickel, bauxite, aluminium, iron ore, manganese ore, lead, zinc and phosphate rock. **Timber** has a weight of 5.2% in the overall index (for purposes of the comparative table, timber was included in non-food agriculturals and the index adjusted accordingly).

The UNCTAD index is based on monthly indices of free market prices of principal commodity exports of developing countries (40 items in all) weighted by dollar value of exports from developing countries in the years 1979-1981 (for purposes of comparison, the index was shifted to a 1980 base). **Food*** (25.1 per cent) includes wheat, maize, rice, sugar, beef, lamb, bananas, pepper, soybean meal and fishmeal. **Vegetable oils and oilseeds** (6.8 per cent) includes soybeans, soybean oil, sunflower oil, groundnuts, groundnut oil, copra, coconut oil, palm kernels, palm kernel oil, palm oil and linseed oil. (These two groups together (31.9 per cent) are roughly equivalent to the IMF "Food" category; when beverages are included, they come close to the World Bank "Food" category.) **Tropical beverages** (27.1 per cent) includes coffee, cocoa and tea. **Agricultural raw materials** (19.3 per cent) includes cotton, wool, sisal, jute, rubber, hides and skins, and tropical timber. **Minerals, ores and metals*** (21.7 per cent) includes phosphate rock, manganese ore, iron ore, aluminium, copper, lead, zinc, tin and tungsten (tin prices were excluded as at 24 October 1985, when tin trading was suspended in the London Metal Exchange).

THE ECONOMIST index (in dollars, 1980=100) is constructed using as weights the value of 28 commodity imports into OECD countries, excluding intra-EEC trade in commodities affected by the Common Agricultural Policy. The weights are updated and the index chain-linked annually. 1985 weights are based on imports for 1980-1982; for previous years, 1978-1981 import values were used. **Food** (48.8 per cent) includes wheat, maize, sugar, beef, lamb, soybean meal, soybeans, soybean oil, groundnut oil, coconut oil, palm oil, coffee, cocoa and tea. **Non-food agriculturals** (21.0 per cent) includes wool, cotton, jute, sisal, hides, rubber, timber, soybeans, soybean oil, coconut oil and palm oil. **Metals** (30.2 per cent) includes copper, lead, zinc, tin, aluminium and nickel.

The STATISTICAL OFFICE OF THE UNITED NATIONS SECRETARIAT constructs indices of world export prices of primary commodities and non-ferrous base metals for "Total market economies", "Developed market economies" and "Developing market economies". The prices entering into the calculation of the indices are market quotations - exports, imports, producer and wholesale prices expressed in dollars - which are weighted by 1975 export values. **Food** (53.8 per cent) includes cereals - wheat, maize, rice and barley; beverages - coffee, tea and cocoa; meats - beef, pork, bacon, mutton and lamb and poultry, dairy products - butter, milk, cheese and eggs;

fruits - oranges, lemons, grapefruit, bananas and apples; animal feeds - oilseed cake and meal, fishmeal; and other foods - tomatoes, onions, fish, pepper, wine and sugar. **Non-food agriculturals** (31.5 per cent) includes fats and oil - soybeans and soybean oil, copra, groundnuts, groundnut oil, coconut oil, linseed, cottonseed oil, linseed oil, palm kernels and palm kernel oil, sunflower oil, olive oil, palm oil and animal fats; textile fabrics - cotton, wool, sisal, jute and flax; forest products - logs, lumber and wood pulp; natural rubber, tobacco; and hides and skins. **Minerals** (14.7 per cent) includes coal, natural gas, iron ore, manganese ore, chrome ore and crude fertilizer. **Non-ferrous base metals** (a separate index) includes copper, nickel, aluminium, lead, zinc and tin. (The indices shown in table A.I.1 are for developing market economies; petroleum is excluded; and the base has been shifted to 1980=100. For 1985, the figures shown are for the third quarter and the variation relates to the third quarter of 1984).

The discrepancies in the indices derive from differences:

(a) In the prices entering into the calculation; that is, whether they are wholesale or producer prices or "composite" prices indicative of the average price of the item;

(b) In the number of commodities taken into account in the construction of the index; apart from a core of 18 commodities common to all the indices (see table A.I.3), the product coverage of the various indices is quite different;

(c) In the weights given to the various commodities in the index, depending on product coverage, the base year chosen, whether the weighting factor is the value of exports or the value of imports and how many primary producers are taken into account as sources.

Considering the factors mentioned above, observed differences in the overall indices are not unduly large. A composite of the five indices examined for all commodities would yield the results shown in table A.I.2.

There does not appear to be any systematic bias towards overestimation or underestimation of yearly changes in any of the overall indices, although *The Economist* index shows the largest deviations from the group's average. Comparisons of sub-indices are difficult to make in view of the significant differences in the groupings of commodities under the various headings.

Over the five-year period, the UNCTAD index shows the largest cumulative change (-31.8 per cent) mostly on account of the larger registered changes in food prices, while *The Economist* index shows the smallest overall variation (-25.2 per cent). The cumulative change in the IMF index is closest to that of the estimated mean value, although, on a yearly basis, the changes recorded by the IMF index are not the ones closest to the average or median rates for the group.

* At the end of April 1986, UNCTAD revised the price indices for "Food" and "Minerals, ores and metals" which in turn modified the combined indices, in both dollars and SDRs. Since the revision was made after the *Survey* was completed, it was not possible to incorporate the changes.

Table A.I.2. Composite index of five commodity price indicators, 1981-1985

(1980 = 100)

	1981	1982	1983	1984	1985	1981-1985
Estimated mean value	86.1	75.1	80.3	81.4	72.3	-
Standard Deviation	1.3	2.1	2.8	2.5	2.3	-
Percentage annual rate of change						
Estimated mean	-13.9	-12.8	6.9	1.4	-11.2	-27.7
Median ^a	-13.8(4)	-12.6(5)	5.2(3)	1.2(3)	-10.3(4)	-27.6(1)

Source: Table A.I.1.

^a Numbers in parentheses refer to indices in table A.I.1.

Table A.I.3. Commodity coverage of the various indices

	IMF	WORLD BANK	UNCTAD	THE ECONOMIST	STATISTICAL OFFICE OF THE UNITED NATIONS SECRETARIAT
Cereals					
Wheat	x	x	x	x	x
Maize	x	x	x	x	x
Rice	x	x	x		x
Barley					x
Sorghum		x			
Beverages					
Coffee	x	x	x	x	x
Tea	x	x	x	x	x
Cocoa	x	x	x	x	x
Meat and dairy products					
Beef	x	x	x	x	x
Lamb	x		x	x	x
Pork					x
Bacon					x
Poultry					x
Butter					x
Milk					x
Cheese					x
Eggs					x
Fruits					
Oranges		x			x
Lemons					x
Grapefruit					x
Bananas	x	x	x		x
Apples					x

Table A.I.3. (continued)

	IMF	WORLD BANK	UNCTAD	THE ECONOMIST	STATISTICAL OFFICE OF THE UNITED NATIONS SECRETARIAT
Oils and fats					
Soybeans	x	x	x	x	x
Soybean meal	x	x	x	x	
Soybean oil			x	x	x
Copra	x	x	x		x
Groundnuts	x	x	x		x
Groundnut oil	x	x	x	x	x
Olive oil					x
Palm oil	x	x	x	x	x
Coconut oil		x	x	x	x
Linseed					x
Linseed oil			x		x
Cotton-seed oil					x
Palm kernels			x		x
Palm kernel oil			x		x
Sunflower oil			x		x
Animal fats					x
Fishmeal	x		x		x
Oilseed cake					x
Other foods					
Sugar	x	x	x	x	x
Pepper			x		x
Tomatoes					x
Onions					x
Fish					x
Wine					x
Fibres					
Cotton	x	x	x	x	x
Wool	x		x	x	x
Sisal	x		x	x	x
Jute	x	x	x	x	x
Flax					x
Other agricultural raw materials					
Rubber	x	x	x	x	x
Tobacco		x			x
Hides and skins	x		x	x	x
Forest products		x	x	x	x
Minerals and metals					
Iron ore	x	x	x		x
Phosphate rock		x	x		
Manganese ore		x	x	x	x
Chrome ore					x
Bauxite		x			
Aluminium	x	x	x	x	x
Tungsten			x		
Copper	x	x	x	x	x
Nickel	x	x		x	x
Lead	x	x	x	x	x
Zinc	x	x	x	x	x
Tin	x	x	x	x	x
Coal					x
Natural gas					x
Crude fertilizer					x

Annex II

CHANGING PATTERNS IN THE STRUCTURE OF WORLD OIL MARKETS

Developments in world oil markets since late 1985, particularly in early 1986, have included a sharp downward movement in the price of crude oil and refined products. As a consequence, the exporting countries have sustained substantial reductions in oil revenues and the oil-importing countries have enjoyed commensurate savings on their oil-import bills. In fact, the latter's benefits have been raised on balance by the drop in the value of the United States dollar, the currency in which most international oil trade is transacted, relative to other major currencies. Price quotations on the spot market declined from about \$30 a barrel in November 1985 to as low as \$12 a barrel in late March 1986. Prices under other oil-trading arrangements have also declined but not so dramatically; they currently hover around \$15 a barrel. Such a dramatic reduction in the price of oil had not been generally anticipated.

The recent volatility of oil prices has once again focused world attention on the inherent instability of oil markets.

Energy consumption, production and trade

The oil price rises of the early 1970s set in motion a variety of structural changes in energy consumption, production and trade. These trends were further accentuated by the oil price increases of 1979-1980. Changes in the patterns of energy consumption and production in the developed market economies in particular have had a profound impact on world energy trade. These countries decreased the pace of growth of energy consumption as a result of slower economic growth and a significant reduction of their energy intensity (see table A.II.1). The latter was achieved through investments in energy conservation and efficiency, as well as through the restructuring of the energy-intensive industrial sectors. On the production side, considerable capital resources were also allocated to the development of indigenous oil, gas and alternative energy sources, including coal and nuclear power, which enabled these countries to magnify the degree of import-substitution. As a result, by 1984, total energy consumption (66.2 million barrels a day (mbd) of oil equivalent) in the developed market economies stood at about the 1974 level (65.1 mbd) despite an increase of 29.6 per cent in their combined GDP. As regards oil used for energy purposes, consumption in the developed market economies decreased by 3.2 mbd, from 34.4 mbd in 1974 to 31.2 mbd in 1984. Additional nuclear power and coal, mostly indigenous, was substituted for about another 4.8 mbd of oil. Furthermore, indigenous production of oil increased by 3.3 mbd to 16 mbd in 1984. As a result, between 1974 and 1984, oil import requirements shrank by 11.3 mbd (see table A.II.2) which had a pronounced impact in particular on the oil exports of the developing countries. These changes in the developed market economies were achieved in part because investment decisions had been based on consensus forecasts of high oil prices on the as-

Any forecast of future trends has to be viewed with a great degree of caution. The outcome depends to a large degree on decisions by sovereign States with regard to restraints of future oil output and export levels. Because developments in oil markets in 1986 and their macro-economic implications can be understood only in the context of long-term trends in overall energy consumption and production, a brief analysis of the broad geographical diversification of energy supplies is provided below, especially with regard to oil, and the general decrease in energy intensity per unit of output in the world economy is discussed. Future developments are also a function of the changes in the structure of oil markets. The increasing importance of competition and its impact on global investment, the build-up of stocks and the programming of production need to be examined too. This is particularly important because the international energy dialogue has not yet led to an effective agreement, in spite of the considerable volatility exhibited by international energy markets.

sumption that oil scarcity would be sustained through control over production levels.

In the centrally planned economies, both energy production and consumption increased considerably. Production rose from about 32 mbd of oil equivalent in 1974 to just over 47 mbd of oil equivalent in 1984. But consumption rose even faster, from 29 mbd of oil equivalent in 1974 to just under 42 mbd in 1984. As a result, energy intensity remained at a much higher level than in any of the other country groupings. While exports of oil, refined products, gas and coal from the centrally planned economies, especially China and the USSR, have had some impact on the world energy situation, they have not changed the fundamental nature of global energy markets. But their importance for particular countries and regions should not be ignored.

Oil and gas have continued to dominate the energy consumption, production and trade of the developing countries. Their energy intensity has been rising. This stems in fact from inadequate investments in energy conservation and efficiency, largely owing to severe constraints on the availability of affordable capital. But lack of awareness of the existing possibilities for cutting energy intensities and of managerial capabilities in the context of very difficult economic conditions has also played a role. By far the most significant development has been the reduction of oil production of OPEC members from about 31 mbd in both 1973 and 1979 to about 17 mbd in 1985. However, oil production in non-OPEC developing countries increased from 4.3 mbd in 1973 to 10.7 mbd in 1985. These production gains in non-OPEC countries were achieved through an extraordinary exploration and development effort in increasingly more difficult areas, where costs tend to be

Table A.II.1. Energy intensities, 1960-1984

(Barrels of oil equivalent per \$1,000 of GDP)

	Energy	Oil	Coal	Gas	Electricity
World					
1960	6.82	2.52	3.22	0.93	0.14
1974	6.48	3.24	1.85	1.21	0.18
1979	6.31	3.15	1.80	1.16	0.20
1984	5.78	2.55	1.80	1.18	0.25
Developed market economies^a					
1960	6.01	2.53	2.25	1.07	0.16
1974	5.79	3.20	1.17	1.24	0.19
1979	5.39	3.00	1.10	1.08	0.22
1984	4.46	2.17	1.09	0.95	0.26
Centrally planned economies					
1960	13.59	2.46	10.16	0.87	0.10
1974	10.83	3.46	5.54	1.69	0.14
1979	10.86	3.50	5.27	1.93	0.16
1984	11.06	3.22	5.22	2.42	0.20
OPEC members					
1960	3.66	2.80	0.12	0.73	0.01
1974	3.32	2.30	0.05	0.93	0.04
1979	4.04	2.80	0.03	1.16	0.05
1984	4.98	3.55	0.04	1.33	0.06
Other developing countries^b					
1960	3.81	2.38	1.18	0.13	0.12
1974	4.89	3.43	0.90	0.36	0.21
1979	5.16	3.49	0.98	0.44	0.26
1984	5.24	3.26	1.15	0.51	0.32

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Mohamed-Tahar Tabti and Wolfgang Mandl, "Energy indications", *OPEC Review*, winter 1985.

^a Including Turkey and Yugoslavia, but excluding South Africa.

^b Excluding Turkey and Yugoslavia.

relatively high. None the less, these efforts have weakened the traditionally dominant position of the Middle East with regard to proved oil reserves. Aside from centrally planned economies and the Middle East, only Latin America improved its reserve position during the past decade (see table A.II.3). The position of North America deteriorated significantly, while Western Europe (mainly the North Sea) remained unchanged. Though there was a slight decline in relative terms, OPEC continues to possess more than two thirds of the world's proved oil reserves.

The relatively successful efforts of energy-importing developing countries to raise output from indigenous energy resources also stemmed from expectations of high oil prices. This led to a significant exploration and development effort by the countries concerned (including Brazil and India) undertaken from their own resources, as well as from multilateral financial institutions and world capital

markets. In addition, transnational oil corporations expanded their activities considerably in order to explore and develop new oil and gas resources in the developing countries.

Lower energy import bills in energy-deficient developing countries should in principle free financial resources which could be used for oil and gas exploration and development. However, the current financial fragility and external indebtedness of many developing countries would make such an appropriation of savings difficult. In addition, transnational oil corporations have already announced deep cuts in their exploration and capital budgets which are bound to affect their activities in the developing countries. In view of these circumstances, the need remains for international co-operation to provide financial support for exploration and development of indigenous energy resources.

Changes in the structure of the oil market

The oil price increases of the 1970s set the stage for a variety of changes in the structure of the energy industry,

particularly oil. Compared with the traditional concession régime prior to 1970, whereby oil companies determined

Table A.II.2. Oil balances, 1973 and 1985^a

(Millions of barrels per day)

	1973	1985
Developed market economies		
Consumption	40.3	33.9
Production	13.8	16.8
Net imports	26.2	16.1
Energy-importing developing countries		
Consumption	4.5	5.8
Production	1.2	2.2
Net imports	3.3	3.6
Energy-exporting developing countries		
Consumption	2.2	5.7
Production	32.8	27.8
Net exports	30.1	17.0
of which OPEC:		
Consumption	1.0	3.3
Production	31.1	17.1
Net exports	29.6	13.6
Centrally planned economies		
Consumption	9.4	13.7
Production	10.4	15.3
Net exports	1.0	2.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Technical Papers* prepared for the spring meeting of the Interim Committee (April, 1986).

^a For each country group, consumption equals production plus net imports (or less net exports) less adjustments for stock additions, bunker sales, processing gains and so on.

Table A.II.3. World crude oil reserves, 1974 and 1984

(Millions of barrels)

Region	1974	1984
North America	43 650	34 375
Latin America	30 548	83 097
Western Europe	17 711	17 091
Middle East	403 358	430 400
Africa	62 316	56 249
Asia and Far East	20 003	16 872
Oceania	2 375	1 586
Centrally planned economies	74 141	103 960
World	654 103	743 628
Memorandum item		
OPEC share (percentage)	74.5	68.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *OPEC Annual Statistical Bulletin, 1984*, p. 12.

both the output and price of oil from each of the host countries, the Teheran and Tripoli Agreements of 1971 between oil companies and host countries specified the price level. After the Middle East conflict of October 1973, and in the absence of a new agreement with the oil companies, several host countries began to determine both their output and prices. Subsequent nationalization and similar measures led to a substantial reduction in the share of transnational oil companies in global oil markets.

In host countries, there was an increase in the number of national oil companies. One result was that the companies became increasingly responsible for the marketing abroad of crude oil supplies. Some limited forward integration into refining and distribution of petroleum products in foreign markets was achieved, especially by Kuwait, Saudi Arabia and Venezuela. Similar institutions in oil-importing countries have become increasingly involved in purchases of crude oil and refined products from the exporting countries. In view of generally perceived expectations of higher oil prices and continued profitability, a significant number of new entrants chose to get involved in all aspects of the petroleum industry, particularly in exploration and development in both developed and developing countries.^a But this trend has recently been tempered by oil company mergers, particularly involving companies operating in the United States and the North Sea. These shifts have led to an increasing volume of crude oil and refined products being traded outside the traditionally integrated channels provided by the major oil companies and to expanding competitive spot and futures markets.

Prior to the 1970s, the role of the spot market was limited because only 5-10 per cent of international petroleum trade was involved. From the mid-1970s until late 1985, however, the significance of this market was growing rapidly. The volume traded comprised about half of world petroleum trade in 1985. As a result, spot market events have gradually, especially since 1980,^b begun to affect the decision-making of the industry as a whole. Recently, there may have been some erosion in the importance of the markets as a result of the emergence of so-called "net-back" or "realization" contracts between oil-exporting countries and purchasers of crude oil since the fourth quarter of 1985. These changes involve the determination of crude oil prices, 40 or 50 days after the crude is lifted, according to the actual prices of products in consumer markets (net of tanker transportation costs and refiner fees). This implies that refineries are being rewarded with a margin that is built into the products' yield. Refineries are therefore, in fact, acquiring part of the upstream rent in compensation for taking crude on a term basis.^c This partial recoupling of an industry that was extensively decoupled since the mid-1970s has made a sharp dent in

the role of the spot market. The share of the spot market in world trade may have declined to less than one third in early 1986. Nevertheless, spot prices of crude oil have more recently been used in a number of contracts between oil companies and exporting countries.

Production programming

The objective of the founders of OPEC in 1960 was to prevent further reductions in the posted prices of crude oil, which constituted tax-reference prices and thus affected their revenues directly. In March 1983, OPEC instituted a production programme after oil prices had begun to decline from their apex in 1981 and crude oil exports had declined from about 27.6 mbd in 1977 to 14.2 mbd in 1982. The quota system agreed to by OPEC countries in 1983 was further revised downwards in October 1984 (see table A.II.4).

In the absence of growth in oil demand and because of the increase in non-OPEC oil supplies, the share of OPEC continued to decline in the summer of 1985 to the point at which Saudi Arabia, in its role of swing producer, was limited to about half of its quota. During the fourth quarter of 1985 that country increased its production and other countries also increased their output, thus exerting a downward pressure on oil prices. Subsequently, at the seventy-sixth OPEC Conference (Geneva, 2-9 December 1985) it was decided to "defend for OPEC a fair share in the world oil market consistent with the necessary income for Member Countries' development".^d This decision was interpreted by the oil market as a relaxation of the quota arrangements of oil production among OPEC countries and was followed, as mentioned above, by the drastic decline in prices in early 1986. No decision on production levels emanated from the seventy-seventh OPEC Conference (Geneva, 16-24 March 1986), where a reduction in output levels in non-OPEC countries was also explored with Angola, Egypt, Malaysia, Mexico and Oman. This meeting was scheduled to reconvene between 15 and 21 April 1986.

Inventory formation

After the oil embargo of late 1973 and the establishment of the International Energy Agency, OECD countries formulated and implemented policies of building up both government and commercial stocks, which at present could meet about 99 days of consumption (see table A.II.5). While government stocks do not appear to have unduly influenced the market, commercial stocks have done so both during periods of apparent supply shortage and consequent rising prices, and during periods of apparent oversupply and falling prices. Actors in this market

^a It should be noted that for several decades the oil market usually operated under conditions of surplus capacity of crude oil production. This became particularly pronounced after the extensive reserve discoveries in the Persian Gulf which took place primarily after the Second World War. Much of this was never brought into production, in an attempt to slow down the rate of decrease in the price of oil, especially during the 1960s.

^b See J. Roeber, "The oil industry and the spot markets: an elephant riding a bicycle", *Middle East Economic Survey*, No. 22 (1986).

^c "OPEC, supply and demand, and prices", an address by P. F. Holmes, Chairman of the Shell Transport and Trading Company, to the Sixth Occasional Luncheon of the Institute of Petroleum, London, 20 February 1986.

^d OPEC Press Release No. 8 (Geneva, 9 December 1985).

Table A.II.4. OPEC: oil production quotas and capacities

(Millions of barrels per day)

Country	Agreed quotas		Sustainable capacity in 1980
	March 1983	October 1984	
Algeria	0.725	0.663	1.0
Ecuador	0.200	0.183	0.2
Gabon	0.150	0.137	0.2
Indonesia	1.300	1.189	1.6
Iran (Islamic Republic of)	2.400	2.300	4.5
Iraq	1.200	1.200	3.5
Kuwait ^a	1.050	0.900	2.8
Libyan Arab Jamahiriya	1.100	0.990	2.1
Nigeria	1.300	1.300	2.2
Qatar	0.300	0.280	0.6
Saudi Arabia ^a	5.000	4.353	10.8
United Arab Emirates	1.100	0.950	2.4
Venezuela	1.675	1.555	2.4
Total	17.500	16.000	34.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on "OPEC cuts production quotas in bid to hold prices", *Petroleum Economist*, December 1984, p. 444 and E. A. Deagle, Jr., B. Mossavar-Rahmani and R. Huff, *Energy in the 1980s: an analysis of recent studies*, Occasional Papers 4 (New York, Group of Thirty, 1981), sustainable capacity denotes the maximum level of production that can be sustained for at least several months.

^a Including half share of Neutral Zone.

Table A.II.5. Oil stocks on land in OECD member countries, 1 April 1986

Year	Millions of tons			Days of forward consumption		
	Total	Government	Companies ^a	Total	Government	Companies ^a
1974	333	-	333	75	-	75
1975	376	-	376	85	-	85
1976	359	3	356	75	1	74
1977	381	4	376	76	1	75
1978	393	10	383	77	2	74
1979	383	24	359	74	5	70
1980	453	27	426	95	6	89
1981	464	36	429	104	8	96
1982	445	58	388	103	13	90
1983	420	67	353	102	16	85
1984	415	79	335	98	19	79
1985	412	90	322	101	22	79
1986 ^b	406	97	309	99	23	75

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, International Energy Agency, *Oil Market Report* (Paris, 3 March 1986), p. 8.

^a Including about 16 million tons (3-4 days) of stocks held by stock-holding entities in some European countries.

^b Preliminary.

usually seek to avoid having to pay expected higher prices in the future. They therefore make additional purchases during a rising market which give rise to yet another round of upward price adjustments. The opposite occurs during falling prices, with de-stocking putting additional downward pressure on prices.

The quantities involved in inventories are considerable and so is the amount of capital requirements. It may be estimated that about \$80 billion of capital is locked up in stockpiling. At a rate of interest of between 8 per cent and 10 per cent, annual capital costs, therefore, amount to between \$6.4 billion and \$8 billion. Decisions to raise or lower the average stock level can increase or reduce short-term market demand at any one time by 3 mbd, which exerts a decisive influence on decisions affecting crude oil production and prices. This was clearly demonstrated during the 1979-1980 oil price boom and the 1982-1983 decline in world demand.^e Similarly, during the first quarter of 1986 world-wide inventory draw-downs averaged 1.5 mbd, which is much larger than normal seasonal withdrawals.^f

Market instability and international co-operation

The lack of stability in the world oil market has led to large investments in exploration and development of relatively high-cost energy sources such as coal, nuclear and hydroelectric power, and oil and gas reserves mainly outside the low-cost resources of the developing world. For example, in the United States \$318 billion was invested in exploration and development of oil and natural gas during the period 1973-1982.^g Similarly, mainly in the developed countries, considerable investments have been made in energy conservation and efficiency, in part through the restructuring of industries. At the same time,

capacities for crude oil production have remained idle, particularly in OPEC member countries (see table A.II.4). Similarly, petroleum refineries in the developed countries have been under-utilized, which has entailed investment losses and additional pressures on oil prices.

If the price of oil stabilizes below \$15 a barrel, it is expected that exploration and development of oil resources in several non-OPEC areas will be discouraged since the unit cost of new capacity has been estimated by various authorities to be in the range of \$15 to \$20 a barrel.^h However, after a few years of stable or even decreasing oil prices, the decline of production capacities outside OPEC will again make the world market strongly dependent on Middle East production.

Expert geologists agree that the oil discoveries in the Persian Gulf countries are unlikely to be repeated anywhere else. Given the lower long-term marginal cost of producing oil in the Gulf, competition should result in a higher share of the Persian Gulf countries in both world production and exports for many years to come. In a general sense, this happened during the 1950s and 1960s until the well-known events of the 1970s led to dramatically higher oil prices and a massive effort at energy conservation, as well as the development of oil and gas resources and alternative energy sources elsewhere.

Despite the costs implied by the lack of agreement among oil producers and consumers over the past 15 years, attempts to arrive at co-operative arrangements have not led to any results. Once again, therefore, the question arises whether the present condition of the world oil market and future prospects as currently perceived offer an opportunity for a constructive international dialogue in this crucial field.

^e For more details, see *World Economic Survey 1981-1982* (United Nations publication, Sales No. E.82.II.C.1), pp. 48-53; *World Economic Survey 1983* (United Nations publication, Sales No. E.83.II.C.1), pp. 99-102; and *World Economic Survey 1984* (United Nations publication, Sales No. E.84.II.C.1), pp. 104-108.

^f "Oil inventories drying up in volatile market", *The Wall Street Journal*, 10 April 1986.

^g L. T. Byrd and others, "U.S. oil and gas finding and development costs, 1973-82 - lower 48 onshore and offshore", *Journal of Petroleum Technology*, November 1985.

^h P. S. Desprairies, X. Boy de la Tour and J. J. Lacour, "Progressive mobilization of oil resources: a factor in ensuring modest price rises", *Energy Policy*, December 1985.

Annex III

DEFINITION AND MEASUREMENT OF THE NET TRANSFER OF RESOURCES

The fact that resource transfers to developing countries have turned negative has attracted considerable attention in recent discussions. However, the concept has given rise to some confusion and has been measured in different ways as analysts have focused on different economic problems. The different definitions of the term can be disentangled and measurement differences explained using the standard terminology of macro-economic analysis.

The net transfer concept, as used in the *World Economic Survey* and other reports of the Department of International Economic and Social Affairs, as well as in publications of the Economic Commission for Latin America and the Caribbean, is based on the standard macro-economic identity that relates total supply (gross domestic product plus imports) to aggregate demand (domestic consumption and investment expenditure and foreign purchases of domestic output). A standard representation of this relationship is

$$(1) \quad GDP = C + I + X - M,$$

where *GDP* is gross domestic product, *C* is public and private consumption expenditure, *I* is gross public and private investment and *X* and *M* are, respectively, exports and imports of goods and non-factor services.

The difference between gross domestic product and gross national product is net factor payments, which may be divided into net income payments to foreign capital and net payments to other factors. The major components of net income payments to capital are interest payments to creditors, profits, dividends and other income accruing to foreign investors. The sum of those net income payments to foreign capital may be denoted *i*, which will be defined as a positive number for the typical capital-importing developing country. For simplicity, all other factor payments - in developing countries, principally net labour remittances - may be grouped together and denoted *L* (taken to be a positive number representing a net source of foreign exchange, which is the case for many developing countries). With these definitions specified, equation (1) may be rewritten in terms of gross national product:

$$(2) \quad GNP = C + I + X - M + L - i.$$

The current account of the balance of payments is defined in this *Survey* and many other publications as the balance on goods, services and private transfers:

$$(3) \quad CA = X - M + L - i.$$

Putting equations (2) and (3) together gives the fundamental "absorption" equation:

$$(4) \quad GNP = C + I + CA.$$

Equation (4) shows that the sum of consumption and in-

vestment in a country (i.e., domestic absorption) may exceed the national product when the current-account balance is in deficit; if there is a surplus, the domestic absorption will be less than the national product.

A current-account deficit is generally financed by a net capital inflow, *F*, although the latter can also be used to help accumulate official international reserves. Alternatively, official reserves can be drawn upon to finance a current-account deficit. In sum, and letting *VR* represent the change in reserves, balance-of-payments accounting requires that:

$$(5) \quad CA + F = VR.$$

Using this last relationship, equation (4) can be rewritten as

$$(6) \quad GNP + F = C + I + VR.$$

The right-hand side of equation (6) thus indicates the uses of absorption (consumption, fixed investment, and changes in inventories of goods and foreign exchange), while the left-hand side indicates from where the resources for absorption arise. Recalling that gross national product equals gross domestic product less net factor payments (i.e., $GNP = GDP + L - i$), equation (6) can be written as

$$(7) \quad GDP + L + (F-i) = C + I + VR.$$

The term $(F-i)$ is the concept of the net transfer of resources used here. In other words, the resources for absorption can arise from gross domestic product, *GDP*, the net foreign earnings of labour, *L*, and the net transfer of resources. Equation (7) thus indicates that the motivation for the definition of the net transfer of resources is in absorption analyses and suggests looking for the domestic economic consequence of a sharp reduction in the net transfer in terms of its effects on consumption, investment and the decumulation of reserves.

The net transfer of resources as derived in equation (7) is the difference between net capital inflows and net income payments to capital. With this approach, it is possible to decompose the net transfer into various financial components as is done in table IV.4. It is also possible to focus on the contribution to the overall net transfer of any particular component of capital flows. The World Bank, for example, publishes in its *World Debt Tables* figures for the net transfer attributed to various sources of foreign lending to developing countries. OECD formerly published, in the statistical annexes to *Development Co-operation* (the annual report of the Chairman of the Development Assistance Committee) figures for the net transfer arising from official development assistance (i.e., combining grants and credits).

Table A.III.1. Two measures of the net transfer of resources and reserve changes: capital-importing developing countries, 1979-1985

(Billions of dollars)

	1979	1980	1981	1982	1983	1984	1985 ^a
Net transfer of resources as measured by:							
Net capital inflow less net income payments to foreign capital (<i>F-i</i>)	41.4	39.4	41.4	10.4	-0.3	-12.5	-31
Balance of trade and non-capital services $-(X-ML)$	21.4	23.6	45.1	33.8	-3.1	-29.6	-32
Net change in reserves and reserve-like assets ^b	20.0	15.8	-3.7	-23.4	2.8	17.1	1

Source: Tables IV.2 and IV.4.

^a Preliminary estimate, rounded to the nearest billion dollars.

^b Differs from estimated flow of reserves derived from stock data (see table IV.8) owing to asymmetric treatment of particular official flows in balance-of-payments and reserve data of certain countries and different procedures for making and recording valuation adjustments.

An alternative approach to measuring the net transfer is to subtract net income payments to foreign capital from the current-account balance. The resulting balance on goods and non-capital services indicates the relationship between foreign exchange earnings and payments for imports of goods and non-capital services. That balance was shown in table IV.2 as an indication of the degree of balance-of-payments adjustment achieved by the developing countries. More generally, when such a balance shifts from a deficit to a surplus, it may be interpreted as a shift from a positive to a negative net transfer of resources. In other words, in earlier years, foreign exchange earnings did not pay for all imports; developing countries were thus absorbing real resources from the rest of the world and, at the same time, importing capital from abroad to finance the resulting deficits. After 1983, in contrast, imports fell below foreign exchange earnings which allowed some of the latter to be used to make a foreign transfer. This concept of net transfer may be represented in symbols as $-(X-M+L)$.

The two concepts of resource transfer are closely related, as may be seen by combining equations (3) and (5) above, leading to:

$$(8) \quad (F-i) - VR = -(X-M+L).$$

It is clear that the transfer of resources defined as (*F-i*) is equal to the balance on goods and non-capital services with the sign reversed, except for variations in interna-

tional reserves. As table A.III.1 indicates, in years such as 1983 and 1985 in which the net changes in international reserves were very small, measurement of net resource transfers by the two approaches yields virtually the same results. In years in which there were large variations in reserves, for example 1982 and 1984, the two measurements differ substantially.^a

Whether measured by net capital inflows less net income payments to foreign capital (*F-i*) or by the balance of trade and non-capital services, $-(X-M+L)$, the figures in table A.III.1 indicate that a sharp reversal in the direction of such transfers took place and that in the aggregate, developing countries have been engaged in a major net outward transfer of resources to developed market economies since 1984. This notwithstanding, the accumulation or use of official international reserves must be taken into account in interpreting the figures. Otherwise, it would be necessary to argue, for example, that most of the impact on net transfers of the debt crisis of 1982 did not occur until 1983 despite the fact that new capital inflows fell sharply in 1982. The reason was that reserves were heavily drawn down in 1982 after the cut-off of credit. By the same token, the 1984 surplus in the balance on goods and non-capital services showed a very large negative transfer for that year but this surplus was partly used for reserve accumulation efforts in many developing countries.

^a The change in reserves has a dual nature: it is simultaneously a form of investment and a transfer of resources. Depending on the analysis being undertaken, it would be desirable to use one definition of resource transfer or the other.

When the monetary authorities of a country add to reserves, they generally purchase highly liquid foreign assets. In other words, they extend a foreign credit and, as such, reserve changes are considered part of the resource transfer under the $-(X-M+L)$ definition. This is analogous to the concept of "net foreign investment" in national income accounting, in which the net flows of all international liabilities and assets of a country are grouped together, including reserve changes, and where the concept of "investment" in an economy is restricted to fixed investment and the change in material inventories.

In contrast, the measure of resource transfer denoted (*F-i*) treats reserve changes as a possible use of a resource transfer. Of course, a country might borrow from abroad and use the proceeds to accumulate reserves. The borrowing is an inward transfer and the investment in reserves is an offsetting outward transfer. However, the reason for keeping the two transfers separate in the (*F-i*) approach is that reserve accumulation is a unique form of foreign investment; it builds the central bank's inventory of foreign currency assets, thereby enhancing the official international liquidity of an economy. Applying the (*F-i*) definition of resource transfers is tantamount to treating the change in reserves as a form of domestic investment.

Annex IV

TRADE EFFECTS OF EXCHANGE RATE VOLATILITY: EMPIRICAL EVIDENCE

As mentioned in chapter V above, a number of empirical investigations have been undertaken to assess the impact of exchange rate variability on trade. The table below summarizes the results and specific features of the 12 studies examined. All of them have used regression analysis with trade flows as the dependent variable and an index of exchange rate uncertainty as one of a number of independent variables. Most of these regressions have attempted to explain changes in trade volume over time (time series) but some have compared the level or rate of growth of trade across countries in a given period of time (cross-section).

The choices in respect of the crucial variables have differed. The trade flow variable has been represented either

by aggregate or by bilateral trade and the uncertainty variable has been proxied either by nominal or by real exchange rate variability.

The empirical evidence is admittedly not clear-cut. Virtually all studies using nominal exchange rate variability as the explanatory variable and aggregated trade flows as the dependent variable have found no evidence of a negative impact. Studies using real exchange rates against bilateral trade flows have, however, come up with significant adverse trade effects. The proposition that changes in uncertainty are more appropriately proxied by changes in real exchange rates rather than nominal ones is becoming widely accepted.^a

^a See, for example, IMF, *Exchange Rate Volatility and World Trade*, Occasional Paper No. 28 (Washington, D.C., July 1984).

Table A.IV.1 Empirical studies on the trade effects of exchange rate volatility

Study ^a	Dependent variable	Proxy for exchange rate uncertainty	Effect on trade	Data/period	Country
Clark and Haulk (1972)	Aggregate real imports and exports	Standard deviation of forward exchange rate of previous four quarters	No effect	Quarterly 1952-1962	Canada
Makin (1976)	Aggregate real imports	Standard deviation of spot exchange rate	No effect	Quarterly 1960-1973	Canada, Federal Republic of Germany, Japan, United States
Hooper and Kohlhaugen (1978)	Bilateral export volume and price	Average absolute difference between previous forward and current spot exchange rate	No volume effect except United States and United Kingdom Adverse price effect	Quarterly 1965-1975	France, Federal Republic of Germany, Japan, United Kingdom, United States
Kenen (1980)	Growth of aggregate real exports	Mean and standard deviation of absolute percentage change in nominal and real spot rates	No effect	Annual (cross-section) 1974-1976	33 countries
Abrams (1980a)	Bilateral export volume	Variance of: previous year's spot rate; monthly changes in previous year's spot rate	Adverse effect	Annual (pooled data) 1973-1976	19 developed countries
Abrams (1980b)	Bilateral export volume	Variance of previous year's real exchange rate	Adverse effect	Annual (pooled data) 1973-1976	19 developed countries
Coes (1981)	Export/production (disaggregated)	Integral difference in cumulative distribution of real exchange rate and "certain" exchange rate	Adverse for all except two industries	Annual 1957-1974	Brazil
Thursby (1981)	Aggregate export-GNP ratio	Variance of nominal and real effective exchange rates	No effect	Quarterly (cross-section)	15 developed, 4 developing countries
Cushman (1983)	Bilateral export volume and prices	Standard deviation of currency relative to previous real exchange rate	Adverse volume effects (price-offsets in few cases)	Quarterly 1965-1977	France, Federal Republic of Germany, Japan, United Kingdom, United States
Akhtar and Hilton (1984)	Aggregate export and import volume	Standard deviation of effective exchange rate	Adverse except United States import volume	Quarterly 1974-1981	Federal Republic of Germany, United States
Thursby and Thursby (1986)	Change in ratio of bilateral exports to GNP	Mean and standard deviation of absolute percentage change in real exchange rate	Adverse effects	Annual (pooled data) 1973-1977	20 countries (including Portugal and Turkey)
Gotur (1985)	Aggregate export and import volume	Standard deviation of effective exchange rate	No effect	Quarterly 1975-1983	France, Federal Republic of Germany, Japan, United Kingdom, United States

Note: Exchange rate or spot rate refers to nominal bilateral rate, unless otherwise indicated.

^a For complete bibliographical information, see the list of references below.

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Annex V

STATISTICAL TABLES

Table A.V.1. Rates of growth of output, 1976-1986

(Annual percentage change)

	1976- 1980	1981- 1985	1981	1982	1983	1984	1985 ^a	1986 ^b
Developing countries ^c	4.9	1.3	1.3	0.3	0.8	2.0	2.4	3.0
By analytical grouping								
Net energy exporters	5.1	0.1	0.4	-0.2	-0.8	-0.3	1.2	1.0
Net energy importers	4.8	2.3	1.7	0.6	1.9	3.8	3.3	4.5
By region								
Western hemisphere	5.1	0.5	0.7	-1.2	-2.6	3.1	2.8	2.0
West Asia	3.6	-1.1	-3.6	-0.8	2.6	-3.5	-0.3	2.0
South and East Asia	6.1	4.9	6.8	3.5	5.6	5.1	3.8	4.5
Africa	4.6	-0.6	-1.4	-1.0	-1.0	-0.7	1.4	2.5
Mediterranean	4.3	2.7	2.7	2.6	1.0	3.9	3.3	2.5
Distribution of growth rates (number of cases)								
Zero or below	9	33	26	41	34	26	18	..
0.1 - 2.5	16	25	14	17	17	21	29	..
2.6 - 5.0	17	14	12	11	18	19	28	..
5.1 - 7.5	27	10	17	9	8	13	5	..
7.6 and over	14	1	14	5	6	4	3	..
Developed market economies ^c	3.5	2.3	1.8	-0.4	2.6	4.8	2.7	3.1
North America	3.6	2.6	2.6	-2.3	3.7	6.6	2.4	3.3
Western Europe	3.0	1.3	0.0	0.5	1.5	2.2	2.4	2.9
Others ^d	4.7	3.9	4.0	2.7	2.6	5.2	3.9	2.9
Centrally planned economies ^e	4.5	4.5	2.3	3.9	5.2	6.2	5.3	4.9
Eastern Europe	3.9	2.2	-1.9	0.1	3.9	5.3	3.5	5.1
Soviet Union	4.3	3.4	3.3	4.0	4.2	3.2	3.0 ^f	3.8
China	6.0	9.8	4.8	8.3	9.3	14.6	12.3	7.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

^a Preliminary estimates.

^b Forecasts for developed market economies and developing countries are based on Project LINK and other institutional forecasts; for centrally planned economies, the data are based on current plan targets.

^c Country growth rates aggregated with 1980 output values in dollars.

^d Australia, Japan, New Zealand and South Africa.

^e Net material product, 1980 weights.

^f Provisional figure (mid-range of the rate of output growth estimated on the basis of data published in the plan fulfilment report (*Ekonomicheskaya gazeta* (Moscow), No. 6 (1985)) and a figure of 3.5 per cent reported by the Central Statistical Office to the Economic Commission for Europe).

Table A.V.2. Developed market economies: annual rates of growth of real gross national product, 1976-1987^a

(Annual percentage change)

Country or country group	1976-1980	1981-1985	1982	1983	1984	1985 ^b	1986 ^c	1987 ^c
All developed market economies	3.5	2.3	-0.4	2.6	4.8	2.7	3.1	3.3
Excluding United States	3.4	2.0	0.8	2.0	3.3	3.0	2.9	3.0
Major industrial countries	3.7	2.4	-0.6	2.9	5.0	2.7	3.2	3.4
Canada	3.1	2.2	-4.4	3.3	4.7	4.5	3.6	3.5
France	3.3	1.2	1.8	0.7	1.6	1.3	2.8	2.8
Germany, Federal Republic of	3.4	1.1	-1.0	1.6	2.7	2.4	3.9	3.0
Italy	3.8	0.8	-0.5	-0.4	2.6	2.3	3.4	3.3
Japan	5.1	4.3	3.3	3.3	5.1	4.2	3.0	3.7
United Kingdom	1.7	1.8	1.5	3.4	1.8	3.6	2.4	2.9
United States	3.7	2.6	-2.1	3.7	6.8	2.2	3.3	3.6
Smaller industrial countries	2.8	1.6	0.5	1.2	3.1	2.6	2.2	2.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

^a Country growth rates aggregated with 1982 output values in United States dollars. For France, Italy, the United Kingdom and all the "smaller industrial countries", the measure used is GDP.^b Preliminary estimates.^c Secretariat forecasts, based on Project LINK country projections (March 1986) and other institutional forecasts.Table A.V.3. Selected country groups: rates of inflation, 1976-1985^a

	1976-1980	1981-1985	1981	1982	1983	1984	1985 ^b
Developed market economies							
All countries	9.0	6.8	10.3	7.8	5.6	5.4	4.9
North America	8.8	5.6	10.6	6.5	3.5	4.3	3.6
Western Europe	10.1	8.5	11.5	10.1	8.0	6.9	6.2
Others	6.5	4.4	6.2	4.7	3.7	3.3	4.0
Developing countries							
All countries	33.2	63.6	37.8	40.1	65.1	93.7	152.4
(Median)	(11.6)	(12.0)	(13.6)	(11.5)	(11.5)	(11.8)	(10.5)
Net energy exporters	15.2	28.0	18.5	22.8	36.2	34.9	113.2
Net energy importers	46.1	89.3	51.6	52.5	85.9	136.0	180.6
Western hemisphere	60.2	131.7	64.5	78.9	135.8	198.4	352.7
(Median)	(12.9)	(16.9)	(16.2)	(11.8)	(16.7)	(19.8)	(24.9)
West Asia	15.4	21.6	20.3	17.8	19.3	33.1	24.2
South and East Asia	9.1	9.4	13.6	8.0	8.9	10.1	7.1
Africa	17.6	17.6	22.0	12.4	22.7	23.4	10.5
Mediterranean	31.7	42.2	37.5	31.3	35.4	50.8	58.5
Frequency distribution ^c							
5 per cent or lower	4	9	2	5	15	18	19
5.01 - 10 per cent	23	24	15	23	18	15	18
10.01 - 20 per cent	36	20	35	28	22	17	13
20.01 - 50 per cent	5	15	19	13	12	14	16
50.01 - 100 per cent	7	3	1	4	2	7	4
Over 100 per cent	1	5	4	3	7	5	6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *OECD Economic Outlook*, Commission of the European Communities, *Annual Economic Report*, and IMF, *International Financial Statistics*.^a Annual percentage change in consumer prices.^b Preliminary estimates.^c Number of cases from a sample of 76 countries.

Table A.V.4. Developed market economies: rates of change of GNP deflator and consumer prices, 1976-1986^a

(Annual percentage change)

Country or country group	1976-1980	1981-1985	1982	1983	1984	1985 ^b	1986 ^c
GNP deflators							
All developed market economies	8.2	5.8	7.1	5.0	4.3	3.8	3.3
Excluding United States	8.8	6.1	7.8	5.9	4.6	4.2	3.4
Major industrial countries	7.9	5.4	6.7	4.5	3.8	3.4	3.0
Canada	9.1	6.5	10.3	5.5	3.0	3.2	2.9
France	10.2	9.3	12.1	9.5	7.1	6.0	4.2
Germany, Federal Republic of	4.1	3.1	4.4	3.3	1.9	1.7	1.0
Italy	17.6	13.9	17.5	15.1	10.6	9.0	8.5
Japan	4.4	1.3	1.7	0.5	0.6	1.0	1.0
United Kingdom	14.6	6.9	7.5	5.5	4.6	4.9	3.5
United States	7.2	5.5	6.0	3.8	4.1	3.3	3.1
Smaller industrial countries	9.8	8.1	10.1	8.1	7.3	6.3	5.4
North America	7.4	5.5	6.4	4.0	3.7	3.3	3.1
Europe	10.2	7.6	9.5	7.5	5.9	5.3	4.1
Others	5.6	2.7	3.5	2.3	2.0	1.7	1.8
Consumer prices							
All developed market economies	9.0	6.8	7.8	5.6	5.4	4.9	..
Major industrial countries	8.8	6.2	7.2	4.8	4.8	4.2	..
Canada	8.8	7.4	10.9	5.8	4.3	3.9	..
France	10.5	9.6	11.8	9.6	7.4	5.8	..
Germany, Federal Republic of	4.0	3.9	5.3	3.3	2.4	2.2	..
Italy	16.3	13.8	16.5	14.7	10.8	9.3	..
Japan	6.5	2.7	2.7	1.8	2.3	2.1	..
United Kingdom	14.4	7.1	8.6	4.6	5.0	6.1	..
United States	8.9	5.5	6.1	3.2	4.3	3.5	..
Smaller industrial countries	9.9	9.7	11.0	9.4	8.4	8.1	..

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*, OECD, *OECD Economic Outlook*, Project LINK, and other official national and international sources.

^a Country growth rates aggregated with 1980 output values in dollars.

^b Preliminary estimates.

^c Forecast.

Table A.V.5. Selected developed market economies: unemployment rates, 1976-1986^a

(Percentage)

Country or country group	1976-1980	1981-1985	1981	1982	1983	1984	1985 ^b	1986 ^c
All developed market economies	5.3	8.2	6.8	8.0	8.9	8.3	8.2	8.1
Major developed market economies	5.3	7.5	6.4	7.8	8.2	7.6	7.4	7.1
Canada	7.7	10.5	7.5	10.9	11.9	11.3	10.5	9.7
France	5.3	9.2	7.3	8.1	8.8	9.9	10.2	10.4
Germany, Federal Republic of	3.4	7.0	4.4	6.1	8.4	8.4	8.4	8.0
Italy	7.1	9.7	8.3	9.0	9.9	10.4	10.7	11.0
Japan	2.1	2.5	2.2	2.4	2.7	2.7	2.6	2.6
United Kingdom	6.4	11.0	7.3	8.1	11.5	11.8	12.0	11.8
United States	5.4	8.5	7.5	9.5	9.6	7.5	7.2	6.5
Smaller developed market economies	5.3	10.0	6.6	9.5	10.8	11.3	11.6	12.0
North America	5.4	8.4	7.6	9.2	9.8	7.9	7.5	7.0
Western Europe	5.5	9.8	8.1	9.2	10.1	10.8	11.5	11.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *OECD Economic Outlook*, and Commission of the European Communities, *Annual Economic Report*.

^a Number of unemployed persons as a percentage of the civilian labour force.

^b Preliminary estimates.

^c Forecasts, based on Project LINK country projections (March 1986) and other institutional forecasts.

Table A.V.6. Centrally planned economies: basic economic growth indicators, 1976-1990

(Annual percentage changes)

Country or country group	1976-1980	1981-1985 ^a	1981-1985 ^b	1986-1990	1981	1982	1983	1984	1985 ^b	1986 ^a
China										
Net material product	6.0	4.0	9.8	..	4.8	8.3	9.3	14.6	12.3	7
Gross industrial output	9.2	4.0	10.8	..	4.1	7.7	10.5	14.0	18.0	8
Gross agricultural output	5.1	4.0	11.5	..	6.6	11.1	9.9	17.1	13.0	6
Gross fixed investment ^c	6.5	1.7	16.5	..	-10.5	26.6	12.6	24.5	35.0	9
Export volume	20.3 ^d	8.1 ^e	7.1	..	20.8	11.6	-2.8	6.1	1.4	10
Import volume	21.2 ^d	9.2 ^e	13.0	..	18.8	-4.8	-0.7	5.0	56.4	10
Soviet Union										
Net material product	4.3	3.4 ^f	3.4	3.8 ^f	3.3	4.0	4.2	3.2	2.5	3.8 ^f
Gross industrial output	4.5	4.7	3.7	4.2	3.4	2.9	4.2	4.1	3.9	4.3
Gross agricultural output	1.6	2.5 ^c	1.1 ^c	2.8 ^c	-1.0	5.5	6.1	-0.1	0	4.4
Gross fixed investment	3.4	2.1 ^c	3.3 ^c	3.7 ^c	3.8	3.5	5.6	1.9	2.9	7.6
Export volume	4.8	..	1.6	..	1.9	4.5	3.3	2.5	-4.2	..
Import volume	5.8	..	5.9	..	6.4	9.7	4.0	4.4	5.0	..
Eastern Europe^g										
Net material product	3.9	3.3	2.2	4.7 ^h	-1.9	0.1	3.9	5.3	3.5	5.1
Gross industrial output	5.6	3.8	2.7	4 ^h	-0.6	1.2	4.4	4.8	3.7	4.4
Gross agricultural output	0.8	2.9 ^c	1.1 ^c	2 ^{ch}	1.8	1.6	0.9	6.7	-0.8	3.0
Gross fixed investment	2.7	-0.1 ^c	-1.4 ^c	3.5 ^{ch}	-7.1	-4.4	2.3	2.2	3.2	4.0
Export volume ^h	6.5	..	4.9	..	1.2	5.5	7.4	8.4	2.1	..
Import volume ^h	3.9	..	0.3	..	-5.2	-5.8	3.4	5.5	4.5	..

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national statistical publications, plans and plan fulfilment reports.

^a Medium-term and annual plan targets. In the case of planned ranges, the figure shown is the mid-point.

^b Preliminary estimates based on plan fulfilment reports and other partial information.

^c Change in the five-year average output from the average of the preceding five years expressed as an annual compound rate.

^d In current dollars.

^e Based on plan data expressed in local currency.

^f Net material product utilized.

^g Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland and Romania.

^h Estimate.

Table A.V.7. Major developed market economies: *ex post* real short-term and long-term interest rates, 1975-1985^a

(Percentage)

Country	1975	1976	1981	1982	1983	1984	1985 ^b
Canada							
Short-term	-3.1	-0.5	6.9	3.6	4.0	8.3	6.0
Long-term	-1.6	-0.3	4.2	3.7	6.2	9.7	7.3
France							
Short-term	-4.8	-1.1	3.0	1.8	2.6	4.1	3.8
Long-term	-2.6	-0.5	3.5	2.7	3.7	4.7	4.7
Germany, Federal Republic of							
Short-term	1.7	0.8	7.5	3.8	2.4	4.0	3.2
Long-term	3.9	4.3	5.8	5.6	4.5	5.8	4.7
Italy							
Short-term	-6.5	-1.0	1.6	1.9	2.6	5.8	5.4
Long-term	-5.2	-4.0	1.0	2.6	2.6	3.8	3.7
Japan							
Short-term	2.2	1.0	4.7	5.1	6.2	5.7	5.0
Long-term	1.2	1.5	6.0	6.4	7.3	6.7	4.7
United Kingdom							
Short-term	-13.7	-1.0	3.0	4.7	4.6	5.5	6.8
Long-term	-10.5	-0.5	2.5	5.3	5.2	6.2	5.3
United States							
Short-term	-3.2	-0.2	4.5	5.0	5.0	6.1	4.5
Long-term	-1.0	2.5	4.1	6.5	6.6	8.4	7.7
Memorandum item							
Nominal rate of interest in the United States							
Short-term	5.8	5.0	16.4	12.3	9.1	10.2	8.0
Long-term	8.2	7.7	13.7	12.9	11.3	12.5	11.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Morgan Guaranty Trust Company, *World Financial Markets*, and IMF, *International Financial Statistics*.

^a Both short-term and long-term rates are *ex post* real rates and are period averages net of the change in the GNP deflator of the same period. The short-term rate is the bank rate in Canada and the United Kingdom; the call money rate in France, the Federal Republic of Germany, Italy and Japan; and the federal funds rate in the United States. The long-term rate for the Federal Republic of Germany is the yield on public authority bonds and, for others, the yield on long-term government bonds.

^b Preliminary estimates.

Table A.V.8. Nominal and real rates of interest, 1975-1985

	Nominal rate of interest		Price deflator		Real rate of interest ^c			
	LIBOR ^a	United States prime rate ^b	GDP of developed market economies ^c (1)	Non-fuel commodities exported by developing countries ^d (2)	LIBOR adjusted by		United States prime rate adjusted by	
					(1)	(2)	(1)	(2)
	Percentages		Percentage change		Percentages			
1975	7.8	7.9	11.1	-19.0	-3.0	32.9	-2.9	33.1
1976	6.1	6.8	7.3	14.1	-1.1	-7.0	-0.5	-6.3
1977	6.3	6.8	7.2	26.0	-0.8	-15.7	-0.4	-15.2
1978	9.1	9.1	7.4	-7.6	1.6	18.1	1.5	18.0
1979	11.9	12.7	8.0	14.1	3.6	-1.9	4.3	-1.3
1980	14.0	15.3	9.3	13.4	4.3	0.6	5.5	1.7
1981	16.7	18.9	8.9	-15.5	7.2	38.0	9.2	40.6
1982	13.6	14.9	7.2	-15.1	6.0	33.7	7.1	35.2
1983	9.9	10.8	5.3	5.1	4.4	4.6	5.2	5.5
1984	11.3	12.0	4.6	1.2	6.4	10.0	7.1	10.7
1985	8.6	9.9	4.0	-10.7	4.5	21.7	5.7	23.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*, UNCTAD, *Monthly Commodity Price Bulletin*, and other official national and international sources.

^a Six-month London Inter-Bank Offered Rates on United States dollar deposits.

^b Interest rate that the largest U.S. banks charge their most creditworthy business customers on short-term loans.

^c Implicit price deflator of aggregate GDP of developed market economies.

^d UNCTAD index of dollar prices of non-fuel commodities exported by developing countries.

^e One plus nominal rate of interest divided by one plus rate of change in the specified price deflator.

Table A.V.9. Developed market economies: balance of payments on current account, 1981-1986^a

(Billions of dollars)

Country or country group	1981	1982	1983	1984	1985 ^b	1986 ^c
Developed market economies	-7.2	-6.1	-5.8	-44.7	-25.0	32.0
Excluding United States	-20.1	-5.7	31.8	54.1	80.0	132.0
Major industrial countries	20.8	15.5	1.6	-44.5	-27.0	19.0
Canada	-5.5	1.7	1.2	2.0	-0.5	-3.0
France	-2.8	-9.4	-3.1	1.0	2.5	10.0
Germany, Federal Republic of	1.7	10.5	10.6	13.4	20.0	33.0
Italy	-7.9	-5.1	0.8	-2.6	-3.5	3.0
Japan	6.2	8.1	22.2	36.4	51.0	70.0
United Kingdom	16.3	10.0	7.6	4.3	7.5	6.0
United States	12.9	-0.3	-37.6	-98.8	-105.0	-100.0
Other countries	-28.0	-21.5	-7.4	-0.2	2.0	13.0
Surplus countries ^d	7.9	9.6	8.0	13.2	13.5	15.0
Others	-35.9	-31.1	-15.5	-13.4	-11.5	-2.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*, and Secretariat forecasts.

^a Excluding government transfers.

^b Preliminary estimates.

^c Forecast, rounded to the nearest half-billion dollars.

^d Netherlands, Norway and Switzerland.

Table A.V.10. Developing countries: international trade and current account balances, 1980-1985

(Billions of dollars)

	1980	1981	1982	1983	1984	1985 ^a
Capital-surplus countries						
Exports	216.9	198.6	152.5	120.0	108.5	99.0
Imports, f.o.b.	-79.1	-91.4	-94.4	-86.4	-77.2	-65.5
Balance of trade	137.8	107.2	58.1	33.6	31.3	33.5
Net services and private transfers	-36.3	-48.4	-51.6	-39.5	-39.9	-38.0
Current account	101.5	58.8	6.5	-5.9	-8.6	-4.5
Capital-importing countries						
Exports	319.8	329.3	306.1	306.1	340.6	334.0
Imports, f.o.b.	-344.9	-376.0	-344.5	-316.2	-320.7	-312.0
Balance of trade	-25.1	-46.7	-38.4	-10.1	19.9	22.0
Net services and private transfers	-41.3	-52.7	-63.9	-50.8	-57.1	-57.5
Current account	-66.4	-99.4	-102.3	-60.9	-37.2	-35.5
Deficit energy-exporting countries						
Exports	140.6	139.6	125.6	121.5	131.8	125.5
Imports, f.o.b.	-107.8	-128.5	-115.7	-97.0	-96.7	-94.5
Balance of trade	32.8	11.1	9.9	24.5	35.1	31.0
Net services and private transfers	-30.6	-38.1	-44.8	-35.2	-36.3	-36.5
Current account	2.2	-27.0	-34.9	-10.6	-1.1	-5.5
Energy-importing countries						
Exports	179.2	189.7	180.5	184.6	208.8	208.5
Imports, f.o.b.	-237.1	-247.5	-228.8	-219.2	-224.0	-217.5
Balance of trade	-57.9	-57.8	-48.3	-34.6	-15.2	-9.0
Net services and private transfers	-10.7	-14.6	-19.1	-15.6	-20.9	-21.0
Current account	-68.6	-72.4	-67.4	-50.3	-36.1	-30.0
Memorandum item						
20 largest debtor countries^b						
Exports	201.6	209.9	193.2	192.8	212.9	212.0
Imports, f.o.b.	-210.0	-231.7	-207.4	-184.0	-185.6	-187.5
Balance of trade	-8.4	-21.9	-14.2	8.8	27.3	24.5
Net services and private transfers	-30.5	-45.0	-55.5	-42.1	-44.2	-42.0
Current account	-38.9	-66.9	-69.7	-33.3	-16.9	-17.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics*, national sources and Secretariat estimates.

^a Preliminary estimates, rounded to the nearest half-billion dollars.

^b Algeria, Argentina, Brazil, Chile, Colombia, Egypt, India, Indonesia, Israel, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Republic of Korea, Thailand, Turkey, Venezuela and Yugoslavia (as at the end of 1981).

Table A.V.11. Arab national and regional development institutions:^a
development finance commitments for developing countries, 1982-1985

(Millions of dollars)

	1982	1983	1984	1985
Functional composition				
Project finance (loans or equity)	2 085.8	1 410.2	1 158.2	999.6
Technical assistance (grants and loans)	52.9	24.2	20.9	42.1
Import financing (grants, loans and leasing)	436.4	506.0	768.3	603.9
Balance of payments (OPEC Fund loans)	83.5	25.5	3.7	--
Other (grants) ^b	35.0	6.4	7.4	6.1
Total	2 693.6	1 972.3	1 958.5	1 651.7
Geographical distribution				
Africa	1 458.4	841.7	864.5	616.4
West Asia	425.6	424.1	544.0	485.8
Other Asia and Pacific ^c	655.0	507.3	393.4	393.6
Other ^d	154.6	199.2	156.6	156.0
Total	2 693.6	1 972.3	1 958.5	1 651.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of the Co-ordination Secretariat of Arab National and Regional Development Institutions (Kuwait).

^a Abu Dhabi Fund for Arab Economic Development, Arab Bank for Economic Development in Africa, Arab Fund for Economic and Social Development, Iraqi Fund for External Development (1982), Islamic Development Bank, Kuwait Fund for Arab Economic Development, OPEC Fund for International Development and Saudi Fund for Development. The funds included here account for roughly a third (1982) of ODA commitments by developing countries as reported by OECD (that is, data exclude contributions to most multilateral institutions and bilateral ODA outside the listed institutions and ODA by non-Arab donors).

^b Including contributions to the International Fund for Agricultural Development (IFAD), subscriptions to the UNCTAD Common Fund on behalf of low-income countries and research projects to be undertaken by various institutions.

^c Including China.

^d Including international agencies and organizations.

Table A.V.12. Capital-importing developing countries:
official reserves and ratios of reserves to current expenditures, 1979-1985

	1979	1980	1981	1982	1983	1984	1985
	<i>Billions of dollars</i>						
Level of reserves ^b	101.7	108.6	98.1	80.2	81.7	93.7	99.4
of which:							
Energy exporters	34.4	44.5	39.8	28.8	31.3	36.3	38.4
Energy importers	67.4	64.1	58.4	51.4	50.4	57.4	61.0
Twenty major debtor countries ^c	70.7	76.1	65.3	47.5	49.5	62.3	66.1
	<i>Number of months</i>						
Coverage of current expenditures ^d	3.3	2.7	2.2	1.9	2.1	2.4	2.6
of which:							
Energy exporters	3.2	3.2	2.4	1.8	2.4	2.7	2.8
Energy importers	3.4	2.5	2.1	1.9	2.0	2.2	2.5
Twenty major debtor countries ^c	3.5	2.9	2.2	1.7	1.8	2.5	2.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics and International Financial Statistics*, and national and regional estimates.

^a Partly estimated.

^b Total reserves, end of period (with gold valued at SDR 35 per ounce).

^c Algeria, Argentina, Brazil, Chile, Colombia, Egypt, India, Indonesia, Israel, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Republic of Korea, Thailand, Turkey, Venezuela and Yugoslavia (based on total debt as at the end of 1981).

^d Expenditures on goods and services (including interest payments) for given year relative to total reserves at end of year, sample of 93 countries.

Table A.V.13. Net flow of IMF lending to the capital-importing developing countries, 1980-1985

(Billions of dollars)^a

	1980	1981	1982	1983	1984	1985
Regular facilities	2.3	5.7	4.2	8.8	4.3	1.1
Credit tranche drawings	1.5	3.3	1.9	4.0	1.2	1.0
Extended Facility drawings	0.7	2.4	2.3	4.9	3.2	0.0
Special facilities	1.2	--	1.4	2.2	-0.2	-0.8
Buffer stock financing	--	--	0.1	0.3	--	-0.2
Compensatory financing	0.3	0.6	1.7	2.1	--	-0.3
Oil Facility	-0.7	-0.7	-0.4	-0.1	--	--
Trust Fund	1.6	0.1	--	--	-0.2	-0.3
Total flows	3.4	5.7	5.7	11.1	4.2	0.2

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and *IMF Survey*, various issues.

^a Net flows in SDRs converted to dollars at yearly average exchange rates.

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