

# **WORLD ECONOMIC SURVEY 1987**

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



**UNITED  
NATIONS**

Department of International Economic and Social Affairs

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AND POLICIES IN THE WORLD ECONOMY**



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NOTE

Symbols of United Nations documents are composed of capital letters combined with figures.

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## PREFACE

The *World Economic Survey 1987* is the fortieth in a continuing annual series, the first of which was published in 1947.<sup>1</sup> At that time, it was among the first attempts to provide a comprehensive view of the global economic situation. The United Nations was thus a pioneer in this field. The Secretary-General was requested to provide "factual surveys and analyses of world economic conditions and trends" (General Assembly resolution 118(II)) to assist the Economic and Social Council and the Assembly in carrying out their responsibilities under the Charter of the United Nations to promote international co-operation in solving international problems of an economic character.

The task of each *Survey* has been to analyse the major current issues in the world economy that require attention and action by the international community. The analysis thus casts a wide net. Reflecting the complexity of international economic relations as well as the diversity of United Nations membership, the *Survey* analyses economic issues in developing countries, developed market economies and centrally planned economies and their interrelationships. It seeks to cover the broad range of issues at the forefront of international discussions, to identify emerging problems and to assess prospects. A discussion of plausible scenarios for the next few years has become an important feature of the overall analysis. In the present *Survey*, the topics raised are macro-economic policy co-ordination, international trade, international finance and debt, world energy markets, redirection of policies in planned economies, sources of economic growth in developing countries and persistent unemployment in some developed market economies.

Secretariat policy recommendations have changed through the years in response to changing economic conditions and the evolution of the political process in United Nations meetings. But a few themes run through the whole period and are as relevant today as they were when stated in the 1945-1947 *Economic Report*:

"Co-ordinated national and international actions are required which would take into account the factors limiting the volume of production in the world...

"The bulk of human, national and financial resources that will be required for an increased volume of production in any country, must necessarily come from that country itself. In the... [developing] countries, however, foreign financing and foreign goods are bound to play an important part in speeding reconstruction and in promoting economic development...

"Both in the interest of promoting 'higher standards of living, full employment and conditions of economic and social progress and development' [Article 55 of the Charter of the United Nations] as well as in the interest of creating and maintaining world economic conditions which would permit the eventual and orderly repayment of international loans that may now be extended for the purpose of promoting economic reconstruction and development, it is essential that national and international action be considered now ... so as to ensure that high levels of employment and economic activity are maintained."<sup>2</sup>

In 1987, "regained" would be more appropriate than "maintained" at the end of the quotation; as discussed in this *Survey*, regaining high levels of employment and economic activity are among the main priorities on the present global economic agenda.

The *Survey* was prepared in the Office of Development Research and Policy Analysis of the Department of International Economic and Social Affairs and is based on information available to the Secretariat as at early April. The information underlying the analysis is in part collected directly by the Secretariat and in part obtained from United Nations regional commissions, the specialized agencies, other international organizations and Project LINK. But the analyses and policy recommendations are based on a cross-sectoral approach to issues aimed at achieving a synthesis.

The *World Economic Survey 1987* and other recent issues of the *Survey* take a forward-looking, more analytical and less descriptive approach than earlier ones. The issues and policy prescriptions in the *Survey* are selected in the light of the needs and concerns of Governments, to whom the *Survey* is primarily addressed.



Rafeuddin Ahmed  
Under-Secretary-General for  
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<sup>1</sup> *Economic Report: Salient Features of the World Economic Situation, 1945-1947* (United Nations publication, Sales No. 1948.II.C.1).

<sup>2</sup> *Ibid.*, pp. 29-30.

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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, for example, 1981/82.

Use of a hyphen (-) between dates representing years, for example, 1984-1986, 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:

BIS	Bank for International Settlements
BTU	British thermal unit
CFF	Compensatory Financing Facility of the International Monetary Fund
c.i.f.	Cost, insurance, freight
CMEA	Council for Mutual Economic Assistance
ECLAC	Economic Commission for Latin America and the Caribbean
ECU	European currency unit
EEC	European Economic Community
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
IDA	International Development Association
IEA	International Energy Agency
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IMF	International Monetary Fund
LIBOR	London Inter-Bank Offered Rate
mbd	Million barrels per day
MERM	Multilateral Exchange Rate Model of the International Labour Organisation
MIGA	Multilateral Investment Guarantee Agency of the World Bank
NAIRU	Non-accelerating inflation rate of unemployment

NMP	Net material product
ODA	Official development assistance
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
pb	Per barrel
Project LINK	International Research Group of Econometric Model Builders, 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
UNDP	United Nations Development Programme

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 Darussalam, 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 GLOBAL ECONOMY: THE ROAD AHEAD

The modest expansion that characterized the world economy during most of the first half of the 1980s persisted in 1986. Inflation has decelerated considerably and industrial countries are entering their fifth year of expansion, though at a slow pace. Indeed, the world economy appears to be set in a slow growth path, which is likely to delay the great adjustments required at the national and international levels. The continuation in 1986 and early 1987 of the trade imbalances of the larger industrial economies has added to the strains on the world financial and trade systems.

Policy makers in major industrial countries have introduced some adjustments in their domestic policies to reduce present disequilibria, but results have proved elusive. Investors remain hesitant and capital formation sluggish. A high degree of uncertainty regarding exchange rates, interest rates and prices of key primary products prevails. The debt difficulties of many countries have intensified, and by early 1987 the solution of the debt problem appeared to be farther away than when the crisis erupted.

The present situation once again raises serious concern about the ability of the existing international economic system to cope with these strains. Political tensions have risen as domestic policy adjustments have, in some instances, been deemed insufficient by partner countries. Bilateral trade balances are increasingly being perceived as important targets, as the result of growing impatience about the lack of a quick resolution of the trade deficit of the largest economy. On the debt front, unilateral decisions have also affected financial markets. Some countries, after a few years of substantial reverse transfers, have started to tailor their debt-service payments — including interest to non-official creditors — to domestic growth requirements.

These challenges pose serious risks. Some progress towards meeting them has been made. Policy co-ordination among large industrial countries has been strengthened. Solutions are being pursued that involve action on an array of macro-economic policies, rather than focusing exclusively on exchange rate targeting. In developing countries with balance-of-payments difficulties, growth-oriented adjustment with increased multilateral support is gradually taking precedence over short-term measures designed to achieve an abrupt reversal in payment trends.

An important feature of the situation is the comparatively fast economic growth of several of the most populous developing countries. They have generally achieved output growth well above that of population. In 1986 and early 1987 their domestic growth impulses remained strong. Development strategies that rely on the mobilization of domestic savings and on a balance among primary, secondary and tertiary activities attuned to the stage of development and the human and natural resource endowment appear to have resulted in high and sustained growth. The more autonomous development path of these large developing economies is particu-

larly important at a juncture when growth prospects for the world economy are precarious.

Economic growth is normally expected to stem from increased and more efficient use of the factors of production, technological change being a major source. The continued implementation in 1986 of widespread changes in domestic policies — privatization and deregulation in the developed market economies, institutional reform in the centrally planned economies and structural adjustment, particularly through the realignment of prices, in the developing countries — was directed towards achieving increased growth from better utilization of available inputs. Some progress has already been made in this direction, the growth in the populous low-income countries being the most notable example.

For some countries, however, changes in per capita income in 1986 were the result of windfall transfers of income and wealth arising from changes in international prices. Changes in the prices of traded goods have caused shifts of billions of dollars in the distribution of income among countries, commodities, especially oil, being the main source of such transfers. It is estimated that the developing countries lost some \$94 billion as a result of such changes in the terms of trade in 1986.

Other key prices have had a similar effect. The earlier increase and more recent decline in nominal interest rates have resulted in large changes in the flow of financial resources among countries and remain one reason for the present net transfer of resources from developing to developed countries. Changes in exchange rates, particularly when they are of the magnitude experienced in 1986 and early 1987, also affect considerably the flow of resources across borders.

There are both winners and losers from such changes; countries may benefit in one area and lose in another, or they may be consistently fortunate or unfortunate. Over the medium term, the first outcome seems to have been the case. In the short term, however, much of the diversity in experience has been the result of the external environment and cannot be attributed to domestic performance. Some developing countries increased the volume of both production and exports of primary commodities in 1986, but are no better off and in many cases are in a poorer position. While the pendulum may swing for these countries and the external environment improve, there is a danger that the present damage to their economies may be such that they are no longer in a position to reap the benefits that a change might bring.

Since the unwinding of the major global imbalances is still ahead, it is quite possible that dramatic changes will occur before 1990. In this sense, the world economy is in uncharted waters. Resolution of the imbalances will involve substantial changes in the pattern of financial flows, and

changes in consumption and investment patterns across countries. Its effects on global production are by no means certain, but if the process is orderly there is scope for most countries to benefit. A gradual but decisive and co-ordinated effort to narrow the large current imbalances could lead to a more predictable world economy, lower real interest rates, faster growth in international trade, and perhaps some recovery in primary commodity prices.

The main themes of the present *Survey* are the need to reduce uncertainties and achieve more predictability, and the adverse consequences — particularly for most of the developing countries — of the continuation of current trends in world output and trade. This chapter presents an overview of the *Survey*, its content and the policy recommendations that emerge from the analysis.

Chapter II examines recent developments in the world economy. The assessment focuses on the reasons behind the slow-down of economic growth in 1986, paying particular attention to the diversity of the situations prevailing in all country groups. In the discussion of the policy setting as at early 1987, special emphasis is given to policy interactions among countries. A forecast based on current policies indicates the need for decisive national and international action to narrow present imbalances. The baseline scenario suggests the continuation of world economic expansion at a modest rate; the analysis, however, indicates that the downward risks are great. Accordingly, two alternative scenarios are presented. One assumes tighter co-ordination of policies among major industrial countries. The other analyses the global effects of a substantial reduction of interest costs in debtor developing countries. Both scenarios show an improvement in performance over the baseline scenario.

Chapter III identifies emerging trade patterns and discusses commercial policies. The working of the trading system and, in particular, the large trade imbalances among major industrial countries and their relation to exchange rate variations are paid particular attention. Two interrelated issues — the changing commodity structure of trade in the 1980s and the large fall in commodity prices, oil in particular — are also examined. A section is devoted to the increasing importance of services in international trade discussions.

Chapter IV reviews the recent changes in financial transfers. It assesses intercountry flows of financial resources in the 1980s, including the new reverse transfers from traditionally capital-importing developing countries. The analysis highlights the external debt crisis of a large number of developing countries and other key international financial developments. It focuses on the new pattern of trade flows of the largest economy. The financial flows required to balance its large trade deficit are not only large but are also

changing in character. The substantial changes in the structure of financial flows and the mechanisms being used to effect them are examined. The probable impact of this on the pattern of prospective flows to developing countries provides the starting point for policy recommendations.

Chapter V analyses the decline in oil prices in international markets, its causes and consequences. The changing energy consumption patterns and petroleum production shifts across countries that have come about as a result of the drop in the price of oil are examined. The review of new investment trends and the reduction in petroleum exploration and development leads to policy conclusions that emphasize the importance of a multilateral approach to avoid further market instability and prolonged under-investment in the energy sector.

Chapter VI reviews the 1986-1990 development plans of the European centrally planned economies and China. It examines past economic trends and their relation to target setting in the current plans. The analysis covers the structural changes envisaged and their relationship to the investment process and industrial programmes. In particular, it focuses on the modernization drive and the rapid expansion planned for the high technology branches. In the European centrally planned economies, CMEA integration efforts in scientific and technological development receive special consideration. The plans also emphasize the means to participate more actively in the global trade and financial framework.

The analysis of the medium-term plan of China centres on the efforts to reconcile a stable yet comparatively high rate of growth with widespread economic adjustments in the context of reforms launched at the end of the 1970s.

Chapter VII examines current employment trends and the persistence of high unemployment in most developed market economies. It analyses the social and economic dimensions of the unemployment problem and contrasts the situation in the different industrial countries. The main hypotheses that attempt to explain the phenomenon are reviewed and the key challenges faced by policy makers are identified. In this context, special attention is paid to the policy implications of the trends in unemployment, including the role of internationally concerted action.

Chapter VIII discusses the economic performance of the fast-growing developing countries in the 1980s. Several factors, including the role of agriculture, the export-orientation of the economy, the reliance on external savings, the trend in key domestic balances, and the variation in terms of trade are reviewed in an attempt to explain why these countries did better than other developing countries. The assessment probes the interaction between the changing international environment and domestic policy responses.

### **Economic growth in 1986: salient features**

In 1986, the world economy slowed down for the second year in a row. Global output grew by 3 per cent, which meant that the overall increase in per capita terms was some 1.5 per cent. Real gross domestic product in both the developed market economies and the developing countries grew by about 2.5 per cent, but the national income of the former

group grew more rapidly because of gains in their terms of trade. Net material product in the planned economies of Europe rose by more than 4 per cent. In China, despite a sharp deceleration in comparison with the previous year, net material product increased by 7 per cent (see table II.1).

Inevitably, these figures mask greater divergences within

the different groups of countries. They also fail to give an insight into the present qualitative characteristics of the world economy.

The diversity in performance is greatest among the developing countries. So far, despite their joint efforts, national Governments and the international community have been unable to devise ways and means of ensuring sustained growth for all the developing countries. In a small minority of them, acceptable rates of growth have been attained over the medium term; in only a handful has progress been consistently good.

The majority of developing countries have not enjoyed such sustained success. Periods of favourable growth have often been followed by a more mediocre performance. Many countries have stagnated over the medium term. The only encouraging element is the evidence that fortunes may change over time: a reversal in domestic policies, an improvement in weather conditions or a more favourable international economic environment have all served to reverse the deterioration that many developing countries have encountered in the past decade.

The performance of developing countries during 1986 conformed to this erratic pattern. The heavily indebted countries, with few exceptions, remained slow growers. They were joined by the energy-exporting countries after the collapse in the price of oil during 1986. The energy-exporting, heavily indebted countries found themselves in a dire predicament. The three most populous energy-exporting countries — Indonesia, Mexico and Nigeria — experienced a significant drop in per capita income; in several other energy-exporting countries, the fall in national income exceeded 10 per cent.

The misfortunes of the energy-exporters were mirrored in the gains of energy-importing countries from lower oil prices. Even for many of these countries, however, the year also brought bad news, in the form of a continuation of the decline in non-oil commodity prices that characterized the previous years of the decade. In real terms, commodity prices are at their lowest level in more than 50 years — since the Great Depression — and there are no signs of a general improvement.

The countries least affected by these changes in international markets tend to be the large and the diversified economies. Among the developing countries, Bangladesh, Brazil, China, India and Pakistan performed comparatively well during 1986 (see table II.9). Of these, Brazil is an exception in that it is a middle-income, heavily indebted country, whose outstanding performance in 1986 appears to have been temporary. The remaining four countries are among those with the world's largest populations and the lowest incomes. Their economic growth rates during the mid-1980s are encouraging, particularly when viewed against their prospects of a decade or two ago.

In contrast to this general picture, the economic situation in most countries in Africa is critical. Most of the countries in the region are small and lack the diversity of larger low-income countries. Their greater exposure to the international economy has been more of a cost than a benefit in

recent years, when prices for the commodities on which they are heavily dependent have been collapsing. Weather conditions improved for most sub-Saharan African countries in 1986, but civil strife in several countries continued to inflict unacceptable human suffering.

Latin America continues to be overwhelmed by problems emanating from its high level of indebtedness to foreign commercial banks. A number of countries in other continents are similarly afflicted. Most of them have suffered negative economic growth in one or more years in the recent past. There is widespread evidence that the poorest groups within these countries have borne the brunt of the contraction that has taken place. A continuation of the present economic hardship in these countries will have wide-ranging negative consequences, both within the countries themselves and for the world economy in general.

The diversity in economic performance among the developing countries contrasts with the similarity in the growth of per capita incomes in the industrial countries in 1986. The centrally planned economies of Eastern Europe and the USSR increased net material product by about 4 per cent in 1986, most countries falling in the range of 3 to 6 per cent. With population increasing by about 1 per cent, per capita net material product increased by some 3 per cent during the year.

The developed market economies as a group recorded a similar increase in per capita income. These countries are now in their fifth consecutive year of growth and no reversal is currently anticipated. This unusually long period of expansion of output has been maintained despite the existence of a number of basic disequilibria in this group of countries — disequilibria between members of the group as well as within individual countries.

#### **Global financial instability and market disequilibria: the dangers ahead**

The baseline scenario described in chapter II indicates that a continuation of current policies would increase world output by about 3.5 per cent during the period 1987-1988. Developed market economies are likely to grow at between 2.5 and 3.0 per cent in this period, so that their per capita income should increase at an annual rate of close to 2 per cent. However, there are no grounds for complacency. First, this rate is inadequate to revive world trade, to alleviate debt burdens, to reduce unemployment and to lead to a decisive narrowing of the trade imbalances among the major industrial countries. Crisis management is likely to continue to be a feature of the world economy under such circumstances. Secondly, and perhaps more important, there are considerable downward risks in this scenario. A slow growth path, accompanied by large domestic and external disequilibria, makes the world economy extremely vulnerable to new shocks. Lingering uncertainties regarding both the trade and fiscal deficits of the largest economy and the domestic and international policies to cope with them can lead to sudden changes in investment plans and consumer confidence. A deceleration of growth in the United States of America at a time when output in major partners is sluggish would have

serious repercussions on overall growth. The possibilities of a recession cannot be dismissed.

The fragility of the situation has also to be seen in terms of the room for manoeuvre of the largest economy. There is no scope for fiscal expansion; on the contrary, the required correction of the deficit calls for fiscal contraction. Monetary policy in the United States, which was not restrictive in 1986, had to confront a rapid depreciation of the dollar in early 1987. Partly because of this, the baseline scenario foresees an increase in the interest rate of about 1 percentage point in 1987. Persistent pressures on the dollar might lead to a further review of monetary targets, a reduction in the rate of growth of the money supply and even a larger increase in interest rates. In such circumstances, investment in developed and developing countries will decrease, with adverse effects on global output in both the short and the longer term.

These macro-economic imbalances are accompanied by disequilibria and instability in a number of markets for particular goods and services. Central among these are the international commodity markets, of which oil is the most important. The year 1986 saw very sharp fluctuations in the price of oil. During the first seven months, oil prices fell by two thirds, but then recovered following the reduction in oil output decided by OPEC in August 1986 and again in December 1986. At the end of the year, the price was about half the level of a year earlier.

The short-run effects of the price drop on oil demand and supply were considerable. The immediate effects on oil consumption surpassed expectations based on past estimates of the price elasticity of demand for oil. Oil consumption has ceased to decline and, at current prices, is expected to increase by about 2 per cent a year in the medium term. The supply situation is more complex since the change in oil production was a cause as well as an effect of the slide in oil prices. Lower oil prices have resulted in some production cut-backs, especially in the United States, but low operating costs have allowed other oil-producing countries and regions to continue full production. OPEC members and some other countries have nevertheless cut back production in an effort to maintain the new price level.

An important implication of the 1985-1986 oil price drop was the shift of income from oil exporters to oil importers, largely reversing the income effects of the two oil shocks of the 1970s. The longer-run implications of the fall in oil prices depend on how long prices remain depressed. Energy investments however have already been affected. Expenditures on oil exploration and development, as well as on other sources of energy, declined in 1986 and there are few indications that they will recover soon. As a result, developed market economies will become increasingly dependent on oil supplies from the developing countries, particularly from the low-cost producers of the Middle East.

If the world economy is to avoid the adverse consequences of oil price volatility, it will be necessary to seek ways and means of promoting international co-operation in this crucial market. Investments in energy are long term in nature and excessive gyrations in the market render price signals

unreliable, resulting in periodic market upheavals.

Another major area of imbalance between supply and demand is the market for labour in the developed market economies. Unemployment rates in these countries nearly tripled, from about 3 per cent in 1970 to about 8 per cent in 1986. Today, the number of unemployed exceeds 29 million. The problem is particularly severe in Western Europe, where the unemployment rate rose from 2.5 per cent in 1970 to 11 per cent in 1986 and where some 17 million people are currently unemployed.

The high level of unemployment has some special characteristics. Young adults have become the principal victims of reduced entry-level recruitment opportunities; in many European market economies, youth unemployment exceeds 20 per cent. The duration of unemployment has also increased: over 40 per cent of the unemployed have been out of work for 12 months or more. The combination of higher youth and long-term unemployment, especially in Western Europe, makes the social costs of labour market disequilibria particularly pervasive and debilitating. A large part of an entire Western European generation is living with the prospect of being unable to secure a full-time job with meaningful security.

The economic, psychological and social problems of the unemployed aged 50 or over are also prominent. Involuntary retirement and various incentive schemes favouring early retirement have reduced the reported number of unemployed in many countries. This group has to cope with unfulfilled personal and economic expectations at a time when longevity is on the increase and active life is being prolonged.

The rapid expansion of service sector employment in developed market economies has produced jobs that are often low-paying and are held on a part-time, temporary or sub-contracted basis. Many of these jobs are held by women — another group that is bearing a disproportionate share of the adjustment costs of structural change and increased labour market flexibility.

Despite the increased flexibility of labour markets in recent years, in terms both of the easing of real wages relative to productivity growth and of the stabilization of non-wage labour costs, employment growth has been very modest. Unemployment rates in Western Europe appear to have stabilized, but the prospects of a large increase in employment levels are not very encouraging. After almost five years of uninterrupted growth, no major reduction in the millions of unemployed is in sight.

The fact that employment has not been boosted by real wage cuts lingers over some of the critical domestic policy dilemmas in developed market economies. Policy makers in most Western European countries have been reluctant to engage in expansionary demand policies because it is widely believed that Governments cannot do much to reduce unemployment without touching off renewed inflation and balance-of-payments deficits. However, recent findings show that there is a tendency for the future trade-off between inflation and unemployment to worsen when demand stimulus

is weak. There is mounting evidence of this "hysteresis" effect in Western European economies. According to this hypothesis, the cost of government inaction is not zero; it means a more difficult policy choice for the future.

### Current trends in international trade

World trade grew slowly in 1986. The only significant stimulus was the increase in the volume of imports of the developed market economies, part of which was accounted for by the rise in oil imports. Exports of these economies increased only marginally because of the sharp reduction in the volume of Japan's exports, the failure of exports from the United States to grow, and the 20 per cent fall in the imports of the energy-exporting developing countries.

The volume of exports of this last group increased by about 10 per cent. Imports of the energy-importing countries increased a little, but were limited by the continuing balance-of-payments constraints of the heavily indebted countries. Exports of the energy-importing countries rose by over 6 per cent; much of this increase was accounted for by the sales of the major exporters of manufactures to the developed market economies.

Coupled with the changes in international prices, these shifts in the pattern of trade led to important changes in the balance of trade. The developed market economies' trade deficit of \$40 billion in 1985 turned into a small surplus in 1986. Within the group, the United States deficit and the surpluses of the Federal Republic of Germany and Japan all increased, and an important feature of international trade in 1986 was the apparent failure of the large exchange rate movements during the year and in 1985 to correct these imbalances. The developing countries' overall trade surplus shrank, the energy exporters' surplus declining by considerably more than the energy importers' deficit. The overall balance of trade of the Eastern European planned economies deteriorated, but a drastic reduction in imports and a large increase in exports led to a decline in China's trade deficit.

Some of the current features of international trade are reflections of the continuing long-term changes in the structure of production and demand in the world economy. The composition of the world product is changing along a historical trend, with a shift from the primary sector to manufacturing and, in developed countries, a sharp increase in services. Much of the output of any country is not tradable; in world trade, however, manufactures have long grown faster than primary commodities and at present account for over 60 per cent of world merchandise trade.

Despite the increased global importance of trade in manufactures, most developing countries still depend heavily on primary commodities to generate foreign exchange. Almost three quarters of the developing countries depend on primary commodity exports for over three quarters of their export earnings. This high degree of dependence means that the continued declines in commodity prices in 1986 had serious consequences for many countries. While some developing countries gained, there was a 30 per cent decline in the

terms of trade of the developing countries with the developed market economies in 1986, and the group as a whole suffered an unprecedented terms-of-trade loss estimated at \$94 billion for the year.

The continuing weakness of non-fuel commodity prices during the 1980s is a result partly of the slow growth of the world economy and partly of some fundamental changes in the developed countries. The shift to services has meant a pattern of production that is less material intensive. At the same time, the quantity of materials required per unit of output of goods has been declining. These two irreversible changes have reduced the use of primary products per unit of gross domestic product.

A further reason for the weakness of commodity prices is that supply has failed to adjust adequately to the level of demand. Even in a sector where demand has increased and will continue to do so, namely food, there is a sharp mismatch between supply and demand at the global level. Some large developing countries have achieved the goal of self-sufficiency in food and their demand for imports has fallen accordingly. These efforts have not been matched by adjustments in the policies of the developed countries, leading to global overproduction of some products.

The developing countries still account for only 12 per cent of total manufactured exports but were responsible for the bulk of the increase in this trade in 1986, when manufactured exports of the developed market economies remained practically stagnant and those of the planned economies increased only slightly. There is an increasing concentration of manufactured exports within the developing countries, 10 countries and areas accounting for 80 per cent of the group's total. In 1986, exports from these few countries increased by 15 per cent, mostly to the developed market economies since demand from the developing economies, especially the energy exporters, had contracted.

International trade in services has matched the growth of trade in goods, non-factor services remaining at about 20 per cent of total merchandise trade for the past decade. However, the proportion of traditional services, such as shipping and other transportation, has been declining, while the share of information-based business services has been expanding rapidly.

An acceleration in the pace of international trade is critical to the solution of the debt problem and to a smooth unwinding of the trade imbalances of industrial countries. The outlook, however, is for a rather modest growth of trade in the next few years. This vulnerability exposes the world economy to grave danger from a number of threatening sources. With constrained export growth, debt servicing might become irregular in more debtor countries. Protectionist pressures in large industrial countries might intensify and exacerbate present tensions, any action precipitating widespread retaliation. In addition to the strains under which it is already struggling, the international trading system seems certain to face further difficulties unless a number of major policy decisions are taken.

## The transfer problem in the second half of the 1980s

Many capital-importing developing countries, particularly oil exporters, had to draw heavily on their foreign exchange reserves to finance larger current account deficits in 1986. For the capital-importing developing countries as a group, it is estimated that there was a net outflow of financial resources — net capital flows minus net investment income — of \$24 billion in 1986; this is the same as the revised estimate for 1985. In each of those years, 24 countries experienced negative net resource transfers. In such countries as the Republic of Korea, this was the result of the strong growth of export earnings; in most cases, it reflected mainly import limitations and constrained economic growth brought about by the inadequate availability of external financing. In 1986, net inflows of official financing continued to be insufficient to offset the negative net transfers arising from private flows.

Net credit flows to the United States, in contrast, expanded by \$24 billion in 1986, reaching \$147 billion. States members of the European Economic Community, especially the Federal Republic of Germany, were again a major source of these inflows but flows from Japan were more than twice as large, reaching \$53 billion. Of significance for the future course of capital inflows to the United States and for the exchange rate of the dollar, net private credit flows were \$11 billion lower in 1986 than in 1985. This decrease was more than offset by an expansion of foreign official inflows into the United States, mainly the result of official intervention in the foreign exchange markets to slow the fall in the value of the dollar.

The institutional changes in international finance that have been under way in recent years reached dramatic proportions in 1986. Net international purchases of securities by Japan were almost \$70 billion, while net sales of securities abroad by the United States were almost \$90 billion. Three years earlier, these flows were virtually non-existent. Developing countries are largely bypassed by such flows: they were able to arrange \$7 billion of new international bond issues in 1985, a peak year, but only \$3 billion in 1986.

Total international bank lending continued to grow strongly in 1986. It was concentrated on borrowers in the major financial markets and especially in support of, or as part of, international securities operations. International commercial banks continued their withdrawal from medium-term lending to developing countries; this accounted for only 6 per cent of new bonds and medium-term bank financing in 1986, in contrast to roughly one quarter in the early 1980s.

Developing countries have not been favoured by recent trends in foreign direct investment. Net flows to the capital-importing countries have stagnated at between \$8 billion and \$9 billion since 1983. Direct investment flows among developed market economies continue to flourish, the most pronounced recent trend being the growing net investor position of Japan in foreign manufacturing and in services, especially financial services.

The international growth of Japanese banks, fuelled in

part by domestic funds and in part by resources mobilized in foreign markets, raised Japan to the status of the world's largest international banking nation in 1985. By September 1986, Japanese banks held over \$1 trillion in international assets, equivalent to almost one third of the world total; the next largest was the United States, with a share of less than 20 per cent. Japanese investment banks have also assumed a major role in international securities markets.

While the large current account surpluses of some of the developed market economies should naturally flow to capital-scarce countries, this is not occurring. Recently, concern about this state of affairs in various countries, Japan in particular, has led to initiatives to recycle a larger part of those surpluses to developing countries. Such initiatives appear promising, but the progress achieved has been overwhelmed by other developments.

Indeed, the dynamism in international financial relations among the developed market economies stands in sharp contrast to the stagnation of North-South financial flows. Not only has there been diminished interest in private sector investment in the developing world, but official flows have also weakened. Non-concessional bilateral credits, primarily export credits, have decreased, but so too have credit flows from the International Monetary Fund; indeed, repayments to the Fund of earlier loans (excluding payments of Fund charges) exceeded new credits to developing countries by almost \$3 billion in 1986.

The strongest component of official flows to developing countries — aside from grants, which largely reflected the generous international response to the African food emergency — has been the flow from the multilateral development institutions. This component was strong mainly in comparison with a seriously weakened situation elsewhere. In 1985, the net transfer of resources associated with total official lending had become negative or was very small for all major categories of creditors except the multilateral institutions. The net transfer associated with those institutions, however, peaked in 1982.

There are no indications of any recharging of official financial flows for development. A widely shared assessment of the prospects for official development assistance is that it will grow by no more than 2 per cent annually in real terms during the remainder of the decade. Nominal gross resource commitments of the multilateral development institutions — a rough proxy of current and forthcoming disbursements and operations — recovered from an earlier fall by increasing 15 per cent in 1985, but then grew only 4 per cent in 1986.

Under current trends, private flows to developing countries will be limited at best; the reductions that have already taken place are unlikely to be replaced by official flows. In any event, the weak expectations for the growth of world trade raise doubts about the volume of new net credit inflows that many developing countries could service. The growth of only 4 per cent in the total debt of the capital-importing developing countries in 1986 may itself have been excessive in that the level of debt of many countries already exceeded what they could service. The ratio of debt to foreign ex-

change earnings of the capital-importing countries as a whole is estimated to have reached a new high of 213 per cent in 1986 — about one quarter more than at the beginning of 1982.

The economic burden of servicing debt has grown correspondingly for many countries. Sub-Saharan Africa (excluding Nigeria) has recently had to pay almost 4 per cent of its GDP in interest charges alone, compared with well under 2 per cent in the late 1970s. These countries' interest payments since 1984 were equivalent to about 25 per cent of investment spending and almost 20 per cent of the value of imports, both of which are alternative uses of the resources involved. For a group of 15 middle-income, heavily indebted developing countries, interest payments absorbed less than 2 per cent of GDP in 1978, over 5 per cent in 1982 and still over 4 per cent in 1986. Since 1983, interest payments have been over 25 per cent of investment and over 50 per cent of imports for these countries. Current expectations are that the ratio of interest payments to GDP for this group of countries will fall, but will remain in the neighbourhood of 3.5 per cent in 1990.

### **Redirections in policy in the centrally planned economies**

In the centrally planned economies, the second half of the present decade promises to be a time of major economic restructuring stemming from far-reaching institutional readjustment. This process, which is already under way in the majority of these countries, was fostered by the pressing need to overcome the slow-down in growth and the persistent economic imbalances of the previous quinquennium, and has been stimulated further by the ongoing reassessment of development priorities, policies and practices in the Union of Soviet Socialist Republics.

The exhaustive policy discussions on the formulation of the socio-economic strategy for the current medium-term plans in the Eastern European countries and the USSR centred on the identification and elimination of the fundamental causes of the sluggish economic performance of recent years and aimed at shaping the ways and means of generating a more buoyant and sustainable pace of expansion. The decision makers had to come to grips with slowly expanding productive resources, embedded rigidities in management and planning systems, slow productivity growth and inadequate export performance. The remedy to those problems was sought in a strategy of resource-efficient growth through consistent systemic changes and more vigorous investment and structural policies, bolstered by an acceleration of technological progress.

The medium-term plans for 1986-1990 of all the European planned economies stress the need for more rapid capital formation in order to buoy the growth of output and to undertake structural change so as to increase productivity in the years ahead. The new plans emphasize the further correcting of the external sector through positive adjustment policies that envisage marked structural changes in the composition and quality of production and the material and energy intensity of output. The objective is to re-equip the

productive structure through more rapid growth of investment, the accelerated replacement of obsolete fixed assets and cuts in gestation periods and construction costs.

Industry is to be the fastest growing sector in all of these economies. Structural changes are expected to bring about a sharp rise in productivity, particularly in high-technology branches. The output of energy and material-intensive production is to increase moderately, even though extensive renovation of fixed assets in those sectors is also contemplated. The medium-term targets for the agricultural sector and the food industries are designed to ensure greater self-sufficiency and, where feasible, exports. Eliminating vulnerability to weather fluctuations, curtailing losses and improving the agro-industrial infrastructure appear to be the major objectives. Construction activity will expand only modestly, but more emphasis will be placed on shortening gestation periods and improving both the quality of output and labour productivity. Important features of the new plans are greater attention to environmental policy and modernization of infrastructure.

The plans remain firmly committed to steady, if modest, increases in personal consumption levels. Gains in this area will be linked more closely to growth in overall output and efficiency by making remuneration more dependent on productivity gains. All plans highlight the need for consumer price and income policies to be more active and flexible in balancing supply and demand for goods and services.

The measures envisaged to promote these objectives are twofold. First, each country has been re-examining its developmental priorities and the ways and means of implementing its objectives. In several countries, further decentralization of decision-making is to proceed by way of market-like instruments of indirect economic co-ordination and their supporting institutions. One set of changes envisaged involves the enhancement of the role of indirect economic levers and incentives by appropriate modifications in management, pricing and procurement systems. Secondly, the intra-group institutions and policies, especially within the context of CMEA, are to be recast.

Greater importance is being attached to the steady development of East-West trade and economic co-operation, which will be decisively influenced, first, by the international political and strategic climate and, secondly, by the adaptation of contractual and institutional mechanisms to the commercial and financial changes. In this context, the plans emphasize more active participation in global trade and financial frameworks and the need to promote exports of manufactures with a substantial value added content. They accordingly stress the need to reshape the trade mechanisms of these countries.

Trade among CMEA members is to expand sharply — increasingly by means of direct ties among economic agents at different levels of the planning hierarchy. One focus of CMEA integration efforts is the implementation of the comprehensive programme for co-operation in science and technology, which seeks to promote direct and permanent intra-group links in research, development and production. The steady development of trade and economic co-operation with other groups of countries is also emphasized.

## Structural adjustments in China

The key objective of the current medium-term plan of China is to stabilize the economy, while continuing with the widespread economic adjustments in the context of reforms launched since the late 1970s. The 1986-1990 plan calls for further progress in the reform of the enterprise, pricing and finance systems; a more pronounced shift away from capital-intensive production is emphasized. To gain room for reform and yet eliminate imbalances in the domestic economy and in external trade and payments, a deceleration in the growth of aggregate output is planned. At the same time, the composition of output should shift from the primary to the tertiary sector. The adopted moderation in growth targets serves the purpose of easing bottle-necks in energy, transport, intermediate goods, consumer durables and, in particular, the external sectors.

Agricultural growth and rural industrialization are to continue at a steady pace, though well below the highly dynamic pace of the early 1980s. The sector's buoyancy is becoming increasingly dependent on an upturn in capital formation and improvement in production and distribution systems. Industrial policies recognize the need to bolster growth in ba-

## Policy conclusions

World economic growth is at present weak and fragile. The prevailing uncertainties point downwards: the simultaneous occurrence of only some of the latent negative influences could readily move the world economy into global recession. Unless international trade prospects improve, it is unlikely that significant progress will be made towards solving the debt crisis or speeding up the reduction of the large trade imbalances of the industrial countries; the economic stagnation in most medium-sized and small-sized developing countries could continue, widening the income gap between most developing countries and the industrial world; high unemployment might persist in developed countries.

To change this scenario, domestic efforts are required in all countries. But some measures clearly require joint action. Mutually supportive measures are necessary in the interdependent world economy of the 1980s. The economic and political interrelationships among issues have to be taken into account.

In any assessment of the international situation, the first priority must be the stabilization of economic relations among the major actors in the world economy. No plans for the organization of the international economic system have seriously considered a situation of major conflict of interest among the most advanced economies of the world. It has been assumed, over the years, that their interests in the management of international economic affairs would fundamentally coincide, as in many matters they have.

The present situation is one in which the Governments that command decisive influence over the world economy find themselves in dispute over the economic policies they ought to adopt. The conflict is real and serious. There is broad agreement on principles, but there are great obstacles. Long-term commitments regarding some key domestic policies, public opinion and the views of smaller but influential

sectors, such as energy and primary industrial inputs, and to foster consumer goods industries in order to meet the pent-up demand that has resulted from gains in personal incomes in recent years. A brisk pace of investment in productive capacity, infrastructure and housing is projected, although at a lower rate than realized in recent years and with greater control over the extrabudgetary investment of enterprises and local government. The immediate focus of trade policy is to reverse the foreign trade and payments deficit, while acquiring the technology and materials essential for economic growth and promoting exports of manufactured goods. At the same time, China's policy regarding foreign direct investment and foreign credit is rather cautious.

The current schedule of ongoing economic reform centres on the reshaping of urban enterprise management, including wage and employment systems, the focus to be directed by the end of the decade towards adjustments in macro-economic planning and control, prices and finance. Yet the pace of the process is still uncertain. Reforms will apparently be implemented with considerable caution and restraint in order to avoid organizational disruptions and aggravation of inflationary pressures.

groups are among the major obstacles because they may impede the implementation of measures that are agreed among policy makers. The measures taken to implement collective decisions must include public awareness campaigns. Leaders of the major industrial countries have to emulate the resolve of those of their counterparts in developing countries who have adopted bold, sometimes unpopular, reforms.

A more assertive stance on the part of the leading economies is indispensable to extricate the world economy from its present predicament. Unless these Governments are able, collectively, to remedy the imbalances and other disequilibria in the world economy, other measures will prove ineffectual.

## Policy issues requiring action within a multilateral framework

Trade is the first concern. The multilateral trading system has been eroded by bilateralism and managed trade. There has never been any lack of verbal commitment to improve the system and past experience shows that liberalization efforts can be successful if they are backed up by action. The commitments made at Punta del Este, Uruguay, marked an important step towards strengthening the system and preventing its further deterioration: it is necessary to ensure that these commitments are carried through.

The major difficulties confronting the trading system are already well known; they have been analysed and discussed in great detail over the years in numerous forums, including the various GATT committees, especially since the GATT Ministerial Declaration of 1982. Familiarity with the problems and the dangers they pose have not prevented their escalation. Protectionism seems set to embark on another world-wide rampage, as countries begin an acrimonious de-

bate and adopt forceful but short-sighted measures. The negotiating process that has already begun as a follow-up to the decisions at Punta del Este provides the opportunity to halt this process, but a much greater political will than has been evident in the recent past is necessary for the successful completion of these negotiations. Early implementation of the standstill and call-back provisions remain an important priority.

The recently announced intentions of the centrally planned economies to enhance their role in the process of world-wide economic change and to participate more actively in international trade, financial intermediation and technological development open the possibility of exploring ways by which this could be achieved in the existing or a modified multilateral framework. The more flexible option of engaging in international trade at the enterprise level should invigorate the trade of the centrally planned economies.

A major threat to the trading system stems partly from the persistently large trade imbalances of the large industrial countries. Multilateral surveillance could help prevent large disequilibria, lead to a more symmetrical adjustment process and be less costly in global terms than the present arrangements. Notwithstanding these potential benefits, progress in this field has been modest. The work of the International Monetary Fund and its members to strengthen multilateral surveillance through the use of objective economic indicators is a promising avenue. It would enable Governments to assess the interaction of domestic policies and the performance of major economic actors, and to examine the impact of their decisions on developing economies. More decisive support by all for the process of multilateral consultation and for the policy role of the Fund is fundamental if surveillance is to be effective in addressing major world economic problems.

Excessive instability in foreign exchange markets is adding to global uncertainties and hampering trade-related investment. There would seem to be a convergence of opinion in the views of the Group of Ten (of the developed countries) and the Group of Twenty-four (of the developing countries) that what is required is not a system of fixed exchange rates but one that permits flexibility with a degree of stability. Discussions on this issue continue in the Interim Committee and the Executive Board of IMF. Global needs clearly point to the importance of expediting the consideration of this issue. Progress could pave the way for an international monetary conference to decide on the global framework for exchange rate policies and also consider other outstanding issues included in the most recent reports of both the Group of Ten and the Group of Twenty-four.

The violent swings in oil prices, the large changes in the export earnings of energy-exporting countries and in the import bills of energy-importing countries, and the drop in energy investments in 1986, which might lead to disruptions in energy supplies in the years ahead, call for the close monitoring of the energy situation and for the exploration of ways in which oil markets could be made more stable. A promising dialogue between producers and consumers has begun; still, there is a clear need for better global monitoring and

analysis of oil market developments. The United Nations, especially the Economic and Social Council, could initiate such a process.

For developing countries, expeditious and flexible access to official compensatory financing remains a key factor in avoiding the adverse effects of excessive fluctuations in export earnings. The widening in users of the Compensatory Financing Facility (CFF) of the International Monetary Fund is an important step forward. Nevertheless, the resources of the Facility are too small in relation to recent fluctuations in export earnings and consideration should be given to the enlargement both of the Facility and of other similar schemes, such as the Stabex system of the European Economic Community. In the meantime, the effectiveness of such facilities should be further enhanced to cope with present problems. Use of CFF could be more automatic and drawing limits could reflect the medium-term financial needs and repurchase prospects of individual borrowers more closely, rather than being rigidly linked to Fund quotas.

There is a need for new approaches to solve the debt crisis of the majority of developing countries. In resolution 41/202, adopted by consensus, the General Assembly recognizes the wide dimensions of the problem, the need for common commitment and mutual co-operation and the importance of action in a number of areas. The recognition that growth-oriented adjustment is part of the solution implies that sustained efforts by developing countries to restructure their economies should be supported by a level of net transfers that allows them to increase their domestic capital investment. Apart from general policies leading to faster growth in international trade, which are likely to be accompanied by a movement of primary commodity prices towards their historical norms, three lines of action appear important.

First, there should be more comprehensive relief of the official debt of low-income countries, particularly countries in sub-Saharan Africa. This relief should be agreed upon in the context of the adjustment requirements and investment needs of individual countries, as contemplated in the new initiatives being considered by the Paris Club. It is also necessary to ensure that new arrangements lead ultimately to an additional net flow of official financial resources to low-income countries. Secondly, official and non-official creditors should contemplate ways to reduce interest costs in the context of debt restructuring exercises. The trend towards the elimination of fees and commissions and the reduction of spreads in the restructuring process, as well as the shift from the prime rate to LIBOR, are important steps, but, in most cases, progress towards achieving a rebate on interest — on either concessional or commercial debt — has been wanting. Thirdly, there has been increasing recognition that current levels of external liabilities are unsustainable for debtors and the market has discounted the value of their commercial debt accordingly. There is, therefore, a case for additional forms of debt relief for non-concessional loans: both lenders and borrowers have an interest in “clearing the books” of the developing countries’ debt in its present form. In the context of restructuring exercises, for example, it is in the interest of

both parties if banks provide some debt relief when the policy package presented by the debtor country will clearly enhance its financial position in the medium term and thereby improve its debt-servicing capacity.

A more comprehensive approach would be the establishment of a multilateral agency — preferably as part of an existing institution — to purchase the debt of developing countries from commercial banks at current market value and to convert it into new forms of liability that would allow debtor countries some relief and a different maturity structure. Under the auspices of the United Nations University, the World Institute for Development Economics Research is considering a proposed Debt Reconstruction Facility containing these elements. It would be funded primarily through recycling part of the external surplus of Japan and would receive financial support from other countries.

Enhanced support by the multilateral development institutions is critical at this time. Investment levels in developing countries have been declining, but there is a continuing need for infrastructural investment to ensure that the foundations for economic growth are not lost. Industrial countries should increase their support for the lending programmes of the World Bank and the regional development banks. The proposed general capital increases should be effected expeditiously; in the case of the World Bank, this is long overdue. The soft loan resources of all the multilateral financial institutions should also be increased, particularly in view of the decrease in the value of the dollar. The recently agreed eighth replenishment of the International Development Association at a level of \$12.4 billion may be considered a large increase when compared with the seventh replenishment, but it is no larger than the sixth replenishment in real terms. Despite recent efforts such as this, net resource flows to developing countries are not increasing adequately. In particular, much remains to be done to achieve the policy targets envisaged in the United Nations Programme of Action for African Recovery and Development 1986-1990 (General Assembly resolution S-13/2).

The Venice summit meeting of the Group of Seven major industrial economies in June 1987 and the seventh session of UNCTAD in July will provide the international community with the opportunity to progress on many of the questions identified above. An essential part of the process, however, is not only agreeing on principles, but deciding who should do what and ensuring — and monitoring — implementation. Firm political support for the multilateral system of economic co-operation should enhance the prospects of overcoming the problems of the industrialized countries and achieving the universally accepted goal of accelerated growth in the developing economies. Moreover, through their feedback effects, the two processes should be mutually reinforcing. The resulting international environment will serve as a framework for and be strengthened by a variety of policy measures adopted at the national level.

#### **Policy issues requiring concerted action among countries and measures at the domestic level**

As recognized by the policy makers of the major industrial

countries at the Louvre meeting in Paris in February 1987, a set of co-ordinated policies among the key developed economies is required to extend the life of the present economic recovery and to achieve a smooth reduction in the large trade imbalances. The elements of the policy package include a reduction in the budget deficit of the United States, an expansionary fiscal stance in the Federal Republic of Germany and Japan and a co-ordinated monetary policy to stabilize foreign exchange markets and avoid interest rate increases. There is considerable agreement on the direction of policies and some appropriate measures are already in place, but there is still hesitation regarding required magnitudes. Unless individual countries are able to compromise on some of their long-standing domestic commitments at the Venice summit meeting, growth is likely to remain sluggish. However, as shown in chapter II, a policy scenario in which the major actors jointly take appropriate decisive action is likely to lead to a rate of growth in industrial economies of close to 3 per cent in 1987, an even higher rate thereafter and only a negligible increase in inflation.

Despite an enhanced flow of information regarding economic co-operation among developing countries, such trade and financial activities have developed slowly. Nor has much progress been achieved in trade and financial schemes at the regional and subregional levels, even though the most dynamic economies are part of the developing world. More ambitious South-South co-operation schemes than those established to date need to be developed to spread growth and benefit from the fast-growing developing countries. A generalized system of preferences among developing countries and regional and subregional agreements, focusing on trade creation rather than trade diversion, could significantly enhance developing countries' prospects for faster and more efficient industrialization. The larger and more dynamic developing economies could play a key role by opening up their rapidly expanding domestic markets as a *quid pro quo* for more open markets for their exports in other developing countries.

The centrally planned economies are making concerted efforts to strengthen systemic changes in the institutional framework of intra-CMEA co-operation. One of the key aspects of these changes is the emphasis on a joint programme for scientific and technical progress. Supported by a reshaping of the external sector of CMEA members, promotion of cross-border ties at the enterprise level and encouragement of joint venture production in priority areas, this new policy should accelerate exports in the medium-term and relieve the current account pressures that some members now face. Simultaneously, closer interaction with developed market economies would facilitate the renovation and modernization of the capital stock in key branches, machine-building in particular. If the international political climate permits, imports of capital goods from developed market economies or collaboration in the area of science and technology could speed the process of technological transformation in the centrally planned economies.

Many developing economies, especially least developed countries heavily dependent on a few primary commodities for their export earnings, have fragmented economies and limited adjustment capabilities; they require substantial

changes in their production structures. The formulation and implementation of the necessary national development strategies are the responsibility of each country, but international financial support — particularly in the first stages — remains important. There is a clear need for more decisive, sustained multilateral and bilateral financial assistance for those developing countries making efforts to transform and diversify their economies.

The analysis of the few successful development experiences of the current decade suggest some common elements in the policy approaches of fast-growing developing countries. First, in countries with agricultural potential, sustained efforts to increase farm productivity and to reward farmers and peasants accordingly should lead to substantial gains in agricultural output in the long-term. Secondly, domestic disequilibria should not be allowed to accumulate, nor should economies resort primarily to external financing to postpone the adjustment called for by such disequilibria. Thirdly, increased reliance on domestic resources and a higher savings rate are likely to ensure a more steady expansion in productive investment. Fourthly, while a wide array of policies in several areas is usually necessary to accelerate

growth, it is critical that structural policies be carried out in a macro-economic policy framework that, while providing stability, does not work at cross-purposes with supply side measures. This requires consistency between development policies and fiscal, monetary and balance-of-payments policies.

The persistence of high unemployment in a large number of European market economies calls for renewed efforts to provide additional employment opportunities and to tackle those factors that impede the smooth functioning of labour markets. Measures in this area should be accompanied by actions to increase the demand for labour. There is a case for expansionary policies to reduce unemployment, especially in those countries where inflation is low, where the cyclically adjusted (or structural) budget deficit is close to zero and where there is no pressure on the balance of payments. If such countries move decisively, others with high unemployment but with pressure on their external accounts would be in a position to expand more freely. Under such conditions, a mutually reinforcing acceleration of growth would be accompanied by a marked reduction in unemployment.



## CHAPTER II

### WORLD ECONOMY IN PERSPECTIVE: KEY FEATURES, POLICIES AND PROSPECTS

#### Global Overview

In 1986, the world economy slowed down for the second year running. Global output grew by only 3 per cent, compared with 3.4 per cent in 1985 and 4.5 per cent in 1984. On average, economic conditions for the peoples of the world improved only marginally in 1986. World output per capita increased by about 1 per cent. This was half the average pace achieved in the 1970s and only a third of that of the 1960s.

The onset of economic depression in many energy-export-

ing developing countries and a significant deceleration in the pace of economic growth in China, Japan and North America were the major factors behind this decline (table II.1). Large swings in the terms of trade, brought about by unprecedented changes in key raw material prices and exchange rates, and policy responses to them were the major determinants of economic change in the world economy in 1986. The slow-down in global economic activity in 1986 exacerbated two serious problems facing the world economy.

Table II.1. Growth of world output<sup>a</sup> and trade, 1971-1988

	Level in 1980 <sup>b</sup> (billions of dollars)	Average						
		1971- 1981-						
		1980	1986	1984	1985	1986 <sup>c</sup>	1987 <sup>d</sup>	1988 <sup>d</sup>
		Percentage change						
<b>Output</b>								
World	..	3.9	2.7	4.5	3.4	3.0	3.2	3.7
Developing countries	2 085	5.6	1.5	2.2	2.0	2.5	2.7	3.8
Net energy importers	1 160	5.0	2.8	3.8	3.4	5.5	4.3	4.5
Net energy exporters	925	6.4	-0.3	0.0	0.0	-1.6	0.5	2.7
Developed market economies	7 640	3.1	2.2	4.7	2.9	2.4	2.6	3.0
North America	2 866	2.9	2.4	6.4	2.8	2.6	2.7	3.4
Western Europe	3 467	2.9	1.5	2.4	2.3	2.4	2.4	2.4
Japan	1 060	4.7	3.6	5.1	4.5	2.5	2.6	3.0
Centrally planned economies of Europe <sup>e</sup>	..	5.2	3.3	3.8	3.6	4.3	4.1	4.5
China <sup>e</sup>	..	5.7	8.8	12.0	12.3	7.0	7.0	7.0
<b>Trade</b>								
World trade volume <sup>f</sup>	1 990	5.0	2.7	8.9	3.2	3.5	3.0	4.0
<b>Memorandum items:</b>								
<b>Per capita output</b>								
Developing countries	900.0 <sup>g</sup>	3.4	-0.9	-0.1	-0.3	0.3	0.5	1.6
Developed market economies	10 296.2 <sup>g</sup>	2.3	1.6	4.1	2.2	1.7	1.9	2.3

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

a Real 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 GNP or GDP level in 1980 based on 1980 prices and dollar exchange rates.

c Preliminary estimates.

d Forecasts (based on Project LINK and other institutional forecasts). Projections for 1987-1988 are based on an average crude oil export price of \$17 a barrel.

e Net material product.

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

g In United States dollars; 1980 prices and exchange rates.

First, the international debt situation remains precarious. The total external debt of the developing countries has grown to almost \$1,000 billion and the ratio of debt-service payments to exports for the group as a whole reached a record level in 1986. Involuntary bank lending has become the main feature of private financial flows to many developing countries as net private financial flows to many of these countries have virtually halted (see chap. IV below). Interest payments on external debt by the developing countries — over \$65 billion in 1986 — continued to be a major drag on their capacity to import and weakened their ability to grow, while the net transfer of resources from developing to developed countries amounted to about \$24 billion for the second year in a row.

A second adverse effect of the sluggish pace of global economic activity was the continued very high unemployment rates, especially among the young, in many developed and developing countries. Employment surveys in developing countries indicate unusually high rates of urban unemployment, while in 10 out of 21 developed market economies, unemployment rates are currently in excess of 10 per cent, and in two countries nearly a fifth of the labour force is out of work.

During the period 1987-1988, the global economy is projected to grow by about 3.5 per cent a year. This modest gain over the mediocre performance in 1986 is chiefly the result of two uncertain and, to a large extent, transitory forces: a mild economic rebound in the energy-exporting countries (on the assumption that the price of oil will not fall below its level of early 1987) and an inventory-led cyclical upturn in the United States. If the macro-economic policy stance of the key industrial countries remains largely the same as in early 1987, projections for 1987-1988 indicate that world trade will remain sluggish, interest rates will not decline any further and will begin to increase, unemployment rates in industrial countries will remain high and the external imbalances of the major industrial countries will persist. However, two alternative policy scenarios presented later in this chapter suggest the possibility of a significant improvement in global economic performance.

The medium-term outlook does not point to any decisive improvement in global economic growth. The slow pace of capital formation, caused by sluggish growth of aggregate demand, lingering uncertainties and high real interest rates in a large number of countries, remains a major obstacle to faster output expansion, and to sustained improvement in the standards of living of all people throughout the world.

### **Developments in 1986 and early 1987**

Owing to the slow-down in Japan and North America, the developed market economies grew by only 2.4 per cent in 1986, compared with 2.9 per cent in 1985 and 4.7 per cent in 1984. The sharp decline in exports to the developing countries, especially to the energy exporters, and the continuation of relatively non-accommodating macro-economic policies in a few key industrial countries were the major factors behind the economic slow-down. Several Western

European economies, however, experienced a modest acceleration in their pace of economic activity in 1986. Indeed, most countries in the group entered their fourth or fifth year of continuous expansion, which by post-war standards is an atypically long period for a cyclical upswing; as at early 1987, there were no clear signs of an impending generalized slump. The industrial countries as a group continued to experience significant gains in per capita income in 1986. At the same time, greater convergence in their real output growth rates emerged, though at a lower rate than in 1985.

The aggregate gross domestic product of the developing regions grew by only 2.5 per cent in 1986, which implies that, for the group as a whole, there was virtually no gain in per capita output that year. More significantly, average per capita income fell by about 4 per cent during the year, largely as a result of a marked deterioration in their terms of trade.

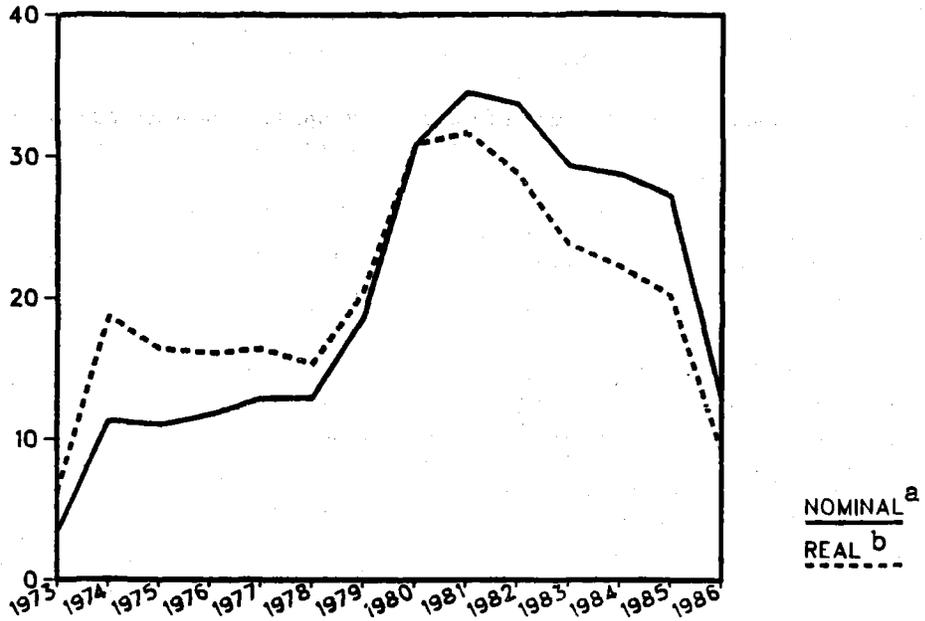
In most developing countries, agricultural and food production increased at the same rate as population, or faster. Industrial expansion, however, remained sluggish. Mining activities continued to face depressed export markets. On the whole, manufacturing expanded slowly as domestic demand remained weak and balance-of-payments constraints hindered imports of industrial inputs.

Diversity characterized the economic performance of individual developing countries in 1986 as it has in many years recently. More than half those countries had a growth rate of output equal to or less than that of population (see table II.2), although most energy-importing developing countries expanded output significantly faster than population. Per capita gross domestic product in the Republic of Korea increased by close to 10 per cent, while it increased at between 2.5 per cent and 6 per cent in Argentina, Brazil, Chile, Colombia, Cyprus, India, Pakistan, Turkey and Uruguay. In contrast, whole areas were affected by the decline in oil prices, in particular West Asia and North Africa, and the per capita gross domestic product of the large majority of energy-exporting developing countries fell considerably in 1986. It was the unprecedented deterioration in the terms of trade of this group of countries and, to a lesser extent, of other exporters of primary commodities that was the cause of the overall decline in per capita income in the developing countries during the year.

Taking a longer-term perspective, per capita output of the developing countries, on average, fell by about 1 per cent a year during the period 1981-1986, in contrast to the developed market economies, whose average per capita output rose by 1.6 per cent a year over the same period. An important reason for this difference has been the disparity in average rates of population growth: the average growth rate of 2.2 per cent a year for the developing countries was more than three times that of the industrial countries.

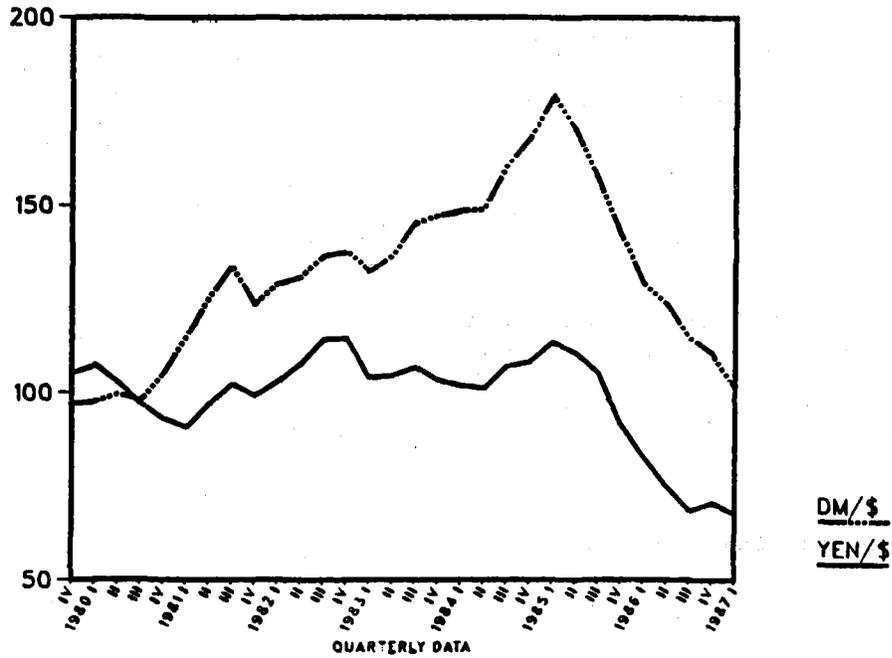
A major concern in the current period of sluggish and, for most developing countries, unstable growth is the protection of the most vulnerable groups of the population. The problem is compounded even further because large domestic adjustments are required to confront the changing international

Figure II.1. Nominal and real crude oil prices  
(Dollars per barrel)



a Spot price of Middle East light crude oil.  
b 1980 prices nominally adjusted by the GDP deflator of the developed market economies.

Figure II.2. Bilateral exchange rates  
(Index: 1980 = 100)



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

economic environment and this limits policy-makers' room for manoeuvre.

Developments in 1986 present a mixed picture regarding the poorest segments of the world's population. In one large economy, Indonesia, average per capita income declined in 1986 and the welfare of the lower strata of the population suffered accordingly. On the other hand, rapid economic growth in two other populous countries — Brazil and India — was an important factor in increasing consumption among the poor in 1986, although the gains achieved by low-income groups in Brazil were rapidly vanishing in early 1987. In much of sub-Saharan Africa and in medium-sized countries in Latin America, better harvests and lower energy prices tended to improve general economic conditions in 1986, to the benefit of the most vulnerable groups.

Government expenditures on health, nutrition and education are an important determinant of the welfare of the poorest groups. Although the situation varied considerably among countries, in most cases government revenues did not increase to the extent needed to allow any significant improvement in these expenditures. Particularly in the many countries that are encountering declining incomes, there is still a pressing need to prevent a further deterioration in the situation of the more vulnerable groups.

The planned economies have also been affected by the developments in international trade and world prices of en-

ergy, although less than the other country groups. The decline in oil prices reduced the hard-currency earnings of the two main energy exporters, namely China and the Soviet Union. China's growth rate of 7 per cent was still one of the highest in the world, despite a slow-down in comparison with recent years. The centrally planned economies of Europe grew by about 4 per cent. Most centrally planned economies continued to experience rising per capita net material product in 1986.

World trade grew by about 3.5 per cent in 1986. A significant part of this rise was due to a sharp increase in the volume of trade in crude oil, brought about by an unusual increase in stockpiling by several major net importers of oil. There was a significant deceleration in the volume of trade in other sectors, especially in manufactures (see chap. III below).

Key global prices continued to fluctuate during 1986, with important repercussions for the world economy. Oil prices moved erratically in both directions, but were on average about 50 per cent lower than their level in 1985. By early 1987, they were still \$10 to \$12 a barrel lower than in 1985 (see figure II.1). For the energy-importing countries, this meant that the oil price increase of 1979-1980 was entirely reversed. Adjusted for inflation in the industrial countries, the average price of oil was nearly 20 per cent below its 1974 level<sup>1</sup> (see figure II.1). Moreover, crude oil is priced and

Table II.2. Countries with growth rates of real GDP at or below the rate of growth of population<sup>a</sup>, 1970-1986

Country or regional groupings	Total sample size	Number of countries with real GDP growth rate at or below population growth rate						Affected countries in 1986	
		1970	1980	1982	1984	1985	1986 <sup>b</sup>	Population (millions)	Population percentage as group total
World total	112	21	38	66	45	49	47	850.0	17.6
Developing economies Excluding India	83 (82)	—	—	—	—	—	—	826.1 (826.1)	33.6 (48.5)
South and East Asia Excluding India	14 (13)	5	4	2	1	5	3	239.8 (239.8)	17.5 (39.3)
West Asia	10	3	4	7	8	7	7	81.6	85.9
Western hemisphere	23	3	7	21	12	15	12	147.1	37.8
Africa	32	9	14	24	23	19	22	357.6	67.2
Mediterranean	4	0	1	0	0	1	0	—	—
Developed market economies	22	1	6	10	1	1	2	13.3	1.8
Centrally planned economies of Europe <sup>c</sup>	7	0	2	2	0	1	1	10.6	2.7

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

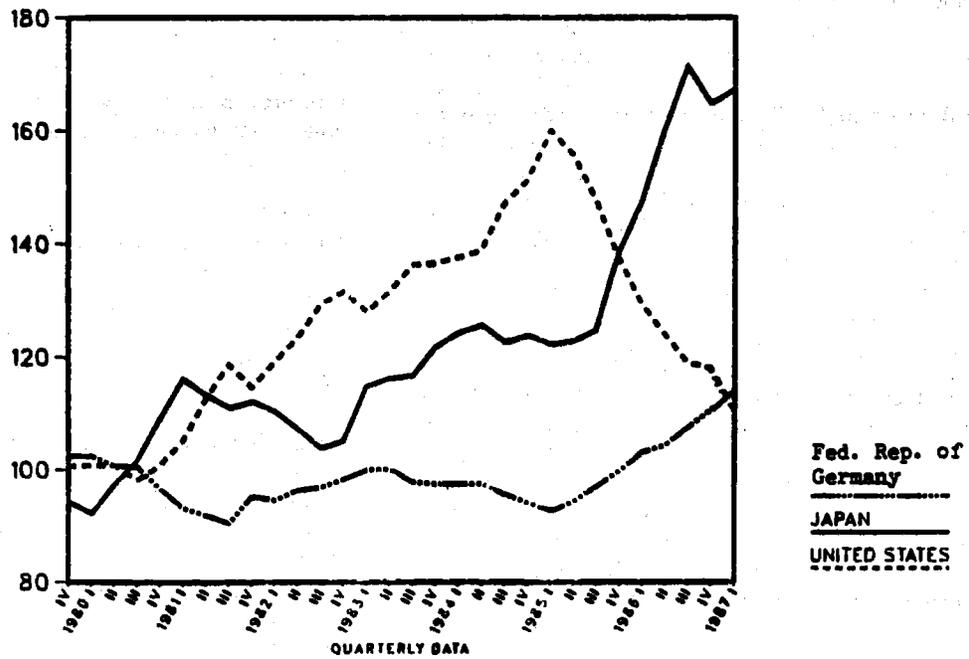
<sup>a</sup> Population growth rates are based on medium variant estimates reported in *World Population Prospects: Estimates and Projections as Assessed in 1984* (United Nations publication, Sales No. E.86.XIII.3).

<sup>b</sup> Based on preliminary data.

<sup>c</sup> The measured variable is per capita net material product of Eastern Europe and the USSR.

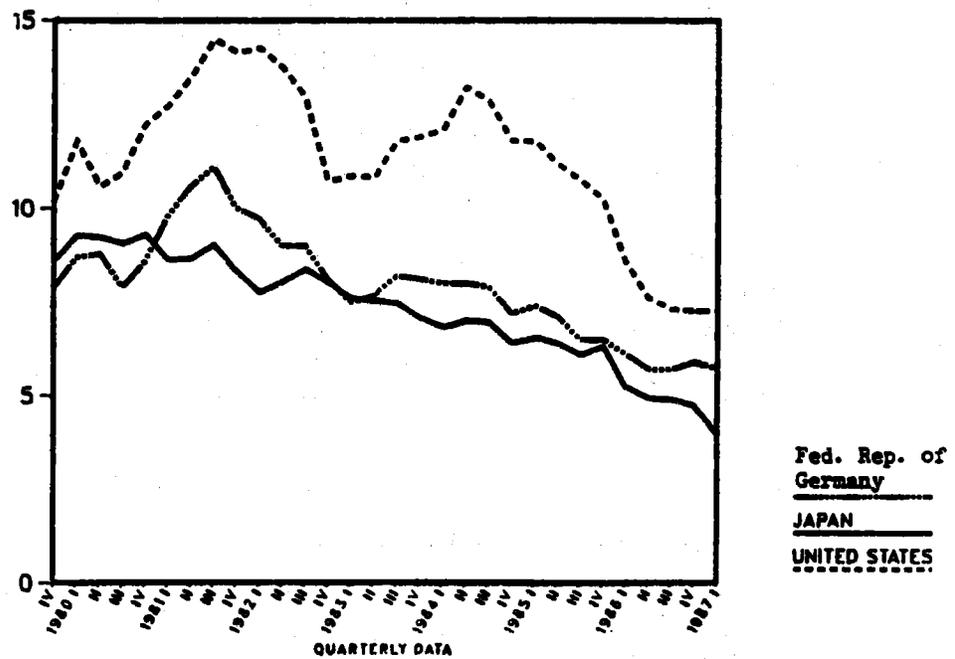
<sup>1</sup> Oil prices deflated by the GDP deflator of the developed market economies.

Figure II.3. Nominal effective exchange rate<sup>a</sup>  
(Index: 1980=100)



<sup>a</sup> MERM.

Figure II.4. Yield on long-term government bonds  
(Percentage)



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

traded in terms of United States dollars and this unit of pricing itself continued to fall substantially against most major currencies. By early 1987, it was up to 50 per cent lower against the yen and most European currencies relative to its peak in early 1985 (see figures II.2 and II.3).

The combination of the dollar decline and the oil price collapse has been extremely costly to energy-exporting countries, but beneficial for energy-importing countries. In dollar terms, the import costs of the energy-exporting developing countries increased considerably while the price of their oil fell by 50 per cent. For many of these countries, the purchasing power of their exports fell by two thirds. For Western Europe and Japan, the price of oil in terms of local currencies fell by 65-75 per cent between late 1985 and early 1987, nevertheless only a portion of the decline was actually passed on to the final users.

Prices of non-fuel commodities exported by the developing countries remained weak, in spite of the four years of economic recovery and expansion in the industrial countries. Prices of many commodities continued to decline and their combined index, in dollar terms, was about 20 per cent lower in 1986 than in 1980; and in real terms it reached its lowest level in more than four decades.<sup>2</sup>

Restraining inflation remains a main policy thrust in the largest industrial economies. This policy thrust, the weakness of non-fuel commodity prices, the fall in energy prices, and wage increases that were moderated by very high unemployment rates, made inflation rates in 1986 the lowest in more than two decades in a number of industrial countries. In a few countries, such as the Federal Republic of Germany, price levels fell. Inflation also decreased significantly in many developing countries; the median rate for the group was the lowest since the late 1960s.

Nominal interest rates declined significantly in most major industrial countries (see figure II.4) and in international credit markets. The six-month LIBOR on dollar deposits fell by more than 2 percentage points during the year. By early 1987, it had begun to increase somewhat as the fall of the dollar led to growing concern about the resurgence of inflation in the United States of America. However, real interest rates — the difference between nominal interest rates and inflation rates — remained high and, except in the United States, increased in the latter part of 1986 and early 1987 (see figures II.5 and II.6).

### Major policy developments

Despite the slow-down in the rate of growth of output, high unemployment rates and the elimination of high rates of inflation, the overall macro-economic policy posture of the developed market economies during 1986 remained cautious. Overall, fiscal policy stayed basically unchanged and monetary policy did not become accommodating, as indi-

cated by the very high real interest rates. Continued fear of rekindling inflationary pressures remained a major impediment to greater monetary accommodation, even in countries with appreciating currencies *vis-à-vis* the dollar.

Sharp divergences of views on macro-economic policies in individual countries continued to be a source of tension among the major industrial countries during 1986. By early 1987, the extent of these differences, particularly among the Federal Republic of Germany, Japan and United States, appeared to jeopardize the co-operative spirit that had developed since 1985. The major source of disagreement was the substantial divergence in fiscal policy stances. The differences in budgetary policy remained as wide as they had been since the beginning of the 1980s, despite frequent official pronouncements about the need to harmonize them.

In recent years, developing countries have been hurt by two repercussions of these policy differences, namely the persistence of high real interest rates and the continued growth of unprecedentedly large external imbalances among the major industrial countries. Because of the first repercussion, the cost for the developing countries of servicing their external debt has remained exceedingly high in real terms, even though the nominal costs have fallen. The second has been a major cause of the sluggishness of world trade and intensification of protectionist pressures in countries with large trade deficits.

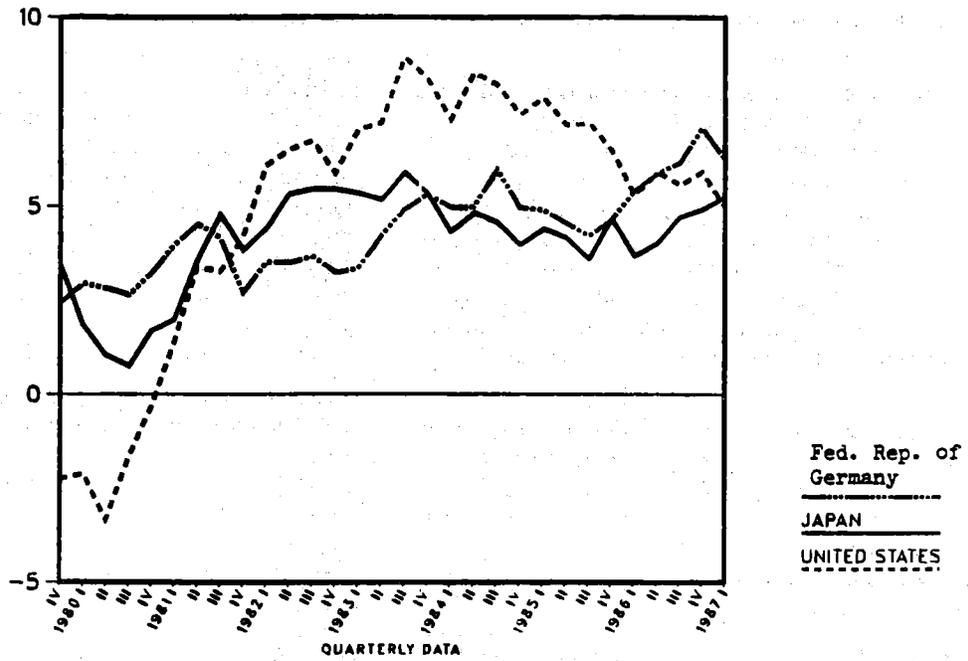
During 1986, the current account deficit of the United States was in excess of \$140 billion. The counterpart of this deficit was to a large extent the combined surplus of the Federal Republic of Germany and Japan, which amounted to about \$122 billion. Moreover, the federal budget deficit in the United States, which through its stimulating effect on aggregate demand had been a major cause of the country's large trade deficit, grew further to \$212 billion in 1986.

The external deficit of the United States was financed by foreign capital inflows, which grew by more than 20 per cent in 1986, making the wealthiest country in the world the largest recipient of foreign capital and the biggest international debtor. By contrast, the inflow of private capital into the developing countries remained almost unchanged and there continued to be a negative net transfer of resources from those countries as a group (see chap. IV below).

The continuing wide daily fluctuations in foreign exchange markets, the sharp decline of the dollar, and the worsening of international debt problems led the policy makers of the major industrial countries (the Group of Seven) to meet in Paris in late February 1987. Agreement was reached that further depreciation of the dollar should be prevented and joint efforts, including heavy intervention in currency markets, were to be made in order to stabilize the exchange rates of the key currencies at about the levels prevailing at that time. There was also a convergence of views among the participating policy makers that the massive current account imbalances of the three largest economies —

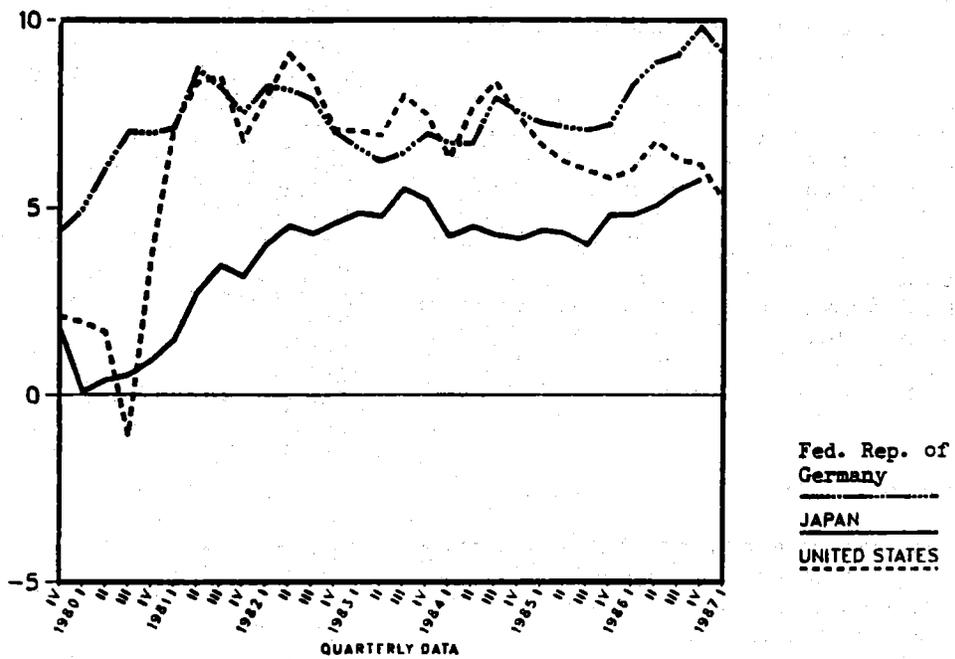
<sup>2</sup> Deflated by prices of manufactures exported by the industrial countries.

Figure II.5. Real yield on long-term government bonds<sup>a</sup>  
(Percentage)



<sup>a</sup> Nominal rates deflated by consumer price index.

Figure II.6. Real lending rates<sup>ab</sup>  
(Percentage)



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

<sup>a</sup> Lending rates of commercial banks to prime customers.  
<sup>b</sup> Nominal rate deflated by consumer price index.

the Federal Republic of Germany, Japan and the United States — were the main source of instability in currency markets. Pledges were made to co-ordinate policy in order to eliminate the root causes of the imbalances, which were

identified as the large fiscal deficit in the United States and the weak growth in Japan and the Federal Republic of Germany.

### Growth impulses and channels of transmission in 1986

The terms of trade swings in 1986 were without precedent. The impact of these shifts, together with the macro-economic policy responses to them and the internal adjustments of the major industrial countries, have significantly altered the dynamics of the international economy.

The dramatic price changes that have taken place since 1985 are not altogether isolated incidents. Wide fluctuations in either the price of oil, the value of the dollar or international interest rates are likely to have a measurable effect on the current level, as well as on the future time-path, of other

key parameters. The relationships among these variables are by no means tight, and a host of other pertinent economic and political variables are also important. Nevertheless, there are important linkages among these three key global prices. The macro-economic policies of the major industrial economies can play an important role in strengthening or weakening these linkages. The interrelationships among both the key parameters themselves and among policies directed towards them can play an important role in the transmission of growth across countries. Some key aspects of these linkages are highlighted in box II.1.

#### Box II.1. Oil price, the dollar, and international interest rates

The international price of oil, exchange rates among key currencies and international interest rates are mainly determined in their respective markets. Moreover, the variables that affect supply and demand in each market are well known. However, the main concern here is the less obvious impact of each of these parameters on the other. These influences were more detectable in 1986 than usual since the size of change in each of the parameters was very large.

The relationship between the dollar exchange rate and the oil price is complex. First, in the international market, crude petroleum is both priced and traded in dollars.<sup>3</sup> In 1984-1985, just before the fall in the oil price, the total value of such transactions averaged about \$300 billion a year, equivalent to about 15 per cent of world trade. The energy-exporting developing countries (which account for some 60 per cent of total world oil trade) receive most of their oil revenue in dollars, but it is spent mainly on goods and services produced in non-dollar markets. On average, between 60 and 65 per cent of the imports of the energy-exporting countries come from industrial countries whose exchange rates float against the dollar. Moreover, a significant portion of the nearly \$450 billion of international assets held by the oil exporters (which is concentrated among a few members of OPEC) is denominated in dollars.<sup>4</sup>

A large change in the value of the dollar has therefore major ramifications for the oil exporters' purchasing power abroad and for the value of their dollar-denominated assets. A sharp drop in the value of the dollar, for example, is likely to set in motion forces that may lead to an increase in the dollar price of oil within a relatively short period of time.<sup>5</sup> The lower local currency price of oil in importing countries with currencies that are appreciating against the dollar, if passed through to the users, may lead to a higher-level demand for oil, for consumption and stockpiling, and thereby to a higher dollar price of oil. Concerted restraint on the supply of oil by the energy-exporting countries would reinforce the rise in the dollar price of oil. Events since the latter half of 1986 seem to confirm this mechanism. Indeed, the sharp decline in the value of the dollar may have been a factor in the decision of OPEC to restrict output.

On the other hand, as indicated by the oil price and the exchange rate movements of the period 1982-1985, a sharp increase in the value of the dollar may have had the opposite effect on the oil prices. The demand for oil weakened in countries with depreciating currencies *vis-à-vis* the dollar, thus softening the dollar price of oil. It is also possible for a large change in the dollar oil price, through its impact on international transaction demand for the dollar, to affect the

*Box continued on adjacent page*

<sup>3</sup> For a theoretical treatment of the link between the value of the dollar and the price of oil, see Paul Krugman, "Oil and the Dollar", in J. Bhandari and B. Putnam (eds.), *Economic Interdependence and Flexible Exchange Rates* (Cambridge, Mass., The MIT Press, 1983), pp. 179-190. For a recently conducted empirical work relating the oil prices and the exchange value of the dollar, see B. Trehan, "Oil prices, exchange rates and the U.S. economy: an empirical investigation", in Federal Reserve Bank of San Francisco, *Economic Review*, No. 4 (Fall, 1986), pp. 25-43. The basic finding of the study is that changes in the value of the dollar have a substantial impact upon the dollar price of oil, but not vice versa.

<sup>4</sup> As at mid-1986, the combined identifiable foreign asset holdings of OPEC were estimated to be about \$449 billion, of which about \$77 billion were held in the United States and almost \$130 billion were held in Euro-currency banks and the off-shore centres. A substantial portion of the latter amount is believed to be denominated in dollars, though no precise estimate exists. For the breakdown of the "identified" oil exporters' fund, see Bank of England, *Quarterly Bulletin*, vol. 26, No. 4 (December 1986), p. 491.

<sup>5</sup> In general, for a given level of dollar price of oil, the oil-importing countries with appreciating currencies *vis-à-vis* the United States dollar would experience a terms-of-trade gain (and a rise in their real national income), which would result in a higher level of demand for oil. A fall in the dollar price of oil would reinforce such an effect.

## Trade prices and divergences in economic performance in 1986

Nowhere has the diversity in performance in 1986 been greater than between the oil exporters and the oil importers among the developing countries. While the real output of energy-exporting developing countries fell by 1.6 per cent in 1986, that of the energy importers rose by 5.5 per cent (see table II.1). The real national income of the energy importers, despite the terms of trade losses incurred on account of soft non-fuel commodity prices, grew by about 5 per cent in 1986. The energy exporters suffered larger deteriorations in their terms of trade — from 15 per cent to 60 per cent — which meant that they registered declines in real national

incomes ranging from 3 per cent to almost 30 per cent.<sup>9</sup> The fall in the combined real national income of the energy-exporting developing countries as a group was about 11 per cent. Within individual economies, the size of this decline depended on several variables, notably the degree of openness of the economy, the degree of dependence on oil exports, and the composition of imports. In general, the Middle Eastern oil exporters, whose dependence on oil exports is high, were the hardest hit.

The adverse effects of the oil price decline on the energy-exporting developed market and centrally planned economies group were milder and the set-backs to their economies limited largely to the energy sectors. Among the developed market economies, those losses were largely compensated

<sup>9</sup> Gross national product adjusted for terms of trade changes.

value of the dollar against other key currencies.<sup>6</sup> This channel of influence, however, seems to have become less important in recent years as the non-oil countries' demand for dollars and dollar-denominated assets has multiplied.<sup>7</sup>

The relationships between international interest rates and the value of the dollar, on the one hand, and the price of oil, on the other, have also played important roles in developments in the world economy in 1986 and in the first quarter of 1987. The link between these parameters is the anticipated rate of inflation in the industrial countries. The lower the anticipated rate of inflation, the lower the nominal rate of interest will be, especially yields on securities with longer-term maturity. Between the latter part of 1985 and mid-1986, the rate of inflation (which is a proxy for the expected inflation rate) in the United States fell by 1.9 percentage points, while the yield on long-term government bonds fell by about 3 percentage points. There were similar tendencies in several other industrial economies.<sup>8</sup> In the absence of a significant upward movement in labour costs, a key determinant of price levels in the industrial countries, the drop in oil prices (and other raw material prices) contributed to the lowering of nominal interest rates and raising of bond and stock prices in 1986.

The link between the changes in the value of the dollar and nominal interest rates is indirect: it operates primarily through the anticipated inflation rate in the United States and the perceptions of foreign investors in the United States securities markets. A sharp fall in the value of the dollar, if immediately and fully passed through via import prices, could lead to an increase in the inflation rate in the United States. Given the deregulation of the financial markets in recent years, a rise in the anticipated rate of inflation would rapidly be reflected in higher nominal interest rates, and yields on financial securities, such as stocks and bonds, would tend to rise as their prices declined in reaction to the higher interest rates. Such a rise in interest rates could be reinforced by a tightening of monetary policy in the United States in reaction to the acceleration in inflation rate. The rise in United States interest rates, however, need not spill over to other industrial economies if those countries follow an expansionary monetary policy to take advantage of the lower oil and commodity prices in terms of their currencies that result from the fall of the dollar. On the other hand, if the monetary conditions in these countries do not become more accommodative, as has been the case especially since the latter half of 1986, nominal interest rates may not fall sufficiently and may even rise in real terms.

<sup>6</sup> Usually even a small excess supply of oil, because of the price inelastic demand for oil, could lead to sharp drop in the price of oil. This in turn would lead to a sharp drop in the amount of dollars needed for international transactions of petroleum trade, which may have a depressing effect on the value of the dollar. In addition, if the oil exporters revert to selling some of their dollar-denominated assets in order to make up for the shortfall in revenues, the dollar may come under further pressure.

<sup>7</sup> In recent years, investors in the surplus countries of Western Europe and Japan have overtaken those in the oil-exporting developing countries in their purchases of dollar-denominated assets. The massive flows of capital from many industrial countries into the United States capital markets have dwarfed those from OPEC. For example, between 1983 and 1986 (September) while the total liabilities of banks in the United States to the oil-exporting countries in the Middle East rose by only \$0.7 billion, those to Western Europe and Japan rose by \$57.6 billion (see *Federal Reserve Bulletin*, vol. 73, No. 1 (January 1987), p. A59). Moreover, by 1985, the average daily international demand for dollars arising from fuel transactions was not more than \$1 billion, while the combined volume of the daily transactions in international foreign exchange centres involving the dollar may have reached \$200 billion.

<sup>8</sup> Between the latter half of 1985 and mid-1986 the inflation rates in the Federal Republic of Germany and Japan fell by 2.2 percentage points and 1.5 percentage points, respectively. However, in relation to the United States, the interest rate (yield on long-term government bonds) declines were less pronounced: the interest rate fell by only 95 basis points in the Federal Republic of Germany and by 198 basis points in Japan. This may indicate that besides the relatively less accommodating monetary stance of the Federal Republic of Germany and Japan, the inflationary expectations in these countries have been less affected by the decline in oil prices than those in the United States.

for by the gains in the manufacturing and other energy-using sectors. There was, however, a significant deterioration in the balance of payments of those countries.<sup>10</sup> Moreover, in the United States, the largest producer of petroleum among the industrial countries, there was a spill-over of losses beyond the petroleum and mining sectors as the fall of the oil prices affected a number of regional banks with concentrated loan portfolios in the energy sector.

The fall in the value of the dollar in 1986 had several important global effects. By making Japanese products more costly in the dollar zone, it led to a slow-down in economic activity in Japan, as the volume of exports fell by more than

2 per cent in 1986 after having increased by 30 per cent between 1983 and 1985. Secondly, it benefited the major exporters of manufactures among the developing countries. Those whose currencies were either pegged, or moved very little, *vis-à-vis* the dollar (e.g., Hong Kong, the Republic of Korea, Singapore and Taiwan, Province of China) gained competitiveness for their exports in non-dollar currency zones. In many cases also, the bilateral real exchange rates against the dollar had depreciated between 1980 and 1986.<sup>11</sup> As a result, a number of developing countries were able to increase their world market share significantly (see chap. III below).<sup>12</sup> The combined exports of East-Asian major ex-

Table II.3. World imports: geographical composition and volume changes, 1971-1986 (Percentage)

Country or country group	Share in world trade <sup>a</sup> 1985	Volume of imports (annual rate of change)			
		Trend 1971-1980	1984	1985	1986 <sup>b</sup>
World	100.0	5.0	9.0	3.5	3.6
Developed market economies <sup>c</sup>	68.8	4.8	11.1	5.5	8.0
United States	18.0	4.5	23.9	8.7	10.5
Western Europe	38.0	5.0	6.1	5.7	6.2
of which:					
Germany, Federal Republic of	(7.9)	(4.9)	(5.2)	(4.2)	(6.5)
Japan	6.0	5.0	10.8	-0.2	13.3
Developing economies	20.5	6.5	1.0	-5.0	-7.5
Capital-surplus countries	3.3	12.7	-10.6	-17.9	-21.0
Capital-importing countries	17.2	4.2	3.7	-2.3	-4.7
Centrally planned economies of Europe <sup>d</sup>	8.5	4.8	5.0	4.8	0.0
China	2.2	—	29.2	50.3	-20.0
Memorandum item:	Billions of dollars				
Value of world trade	2 000	20.3	5.5	1.0	12.0
of which:					
Developing country imports	410	22.3	-2.0	-5.0	1.8

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on GATT, *International Trade, 1985/86* (Geneva, 1986); IMF, *International Financial Statistics and Direction of Trade*, various issues; and other official national and international sources.

<sup>a</sup> Shares are based on merchandise imports valued in terms of United States dollars at current prices. Figures are rounded.

<sup>b</sup> Preliminary estimates.

<sup>c</sup> Including Australia, Canada, New Zealand and South Africa.

<sup>d</sup> Eastern Europe and the USSR.

<sup>10</sup> Among the developed market economies, the combined current account of the main oil exporters (i.e., Canada, Norway and United Kingdom) deteriorated by about \$22 billion in 1986, while the impact of the oil price fall on their output growth was relatively small. Nevertheless, all suffered significant terms of trade losses ranging from a 2 to 15 per cent decline in real national income. However, the high degree of economic diversification was the key factor limiting the amount of damage in those countries in comparison with the energy-exporting developing countries.

<sup>11</sup> The real exchange rate on a bilateral basis is equal to the nominal exchange rate corrected for the differences between the inflation rate in the home country (exporter) and that in the export market (importer). For example, between 1980 and early 1987 the won of the Republic of Korea depreciated by 28 per cent in real terms *vis-à-vis* the dollar, while the trade balance of that country rose from a deficit of \$4.5 billion in 1980 to an estimated surplus of \$4 billion in 1986.

<sup>12</sup> Combined exports of Hong Kong, the Republic of Korea, Singapore and Taiwan, Province of China, as a percentage of world trade increased from 3.8 per cent in 1980 to 6.6 per cent in 1986. Moreover, these countries' combined trade balance *vis-à-vis* the rest of the world increased from a deficit of \$12 billion in 1980 to a surplus of \$16 billion in 1986.

porters of manufactures in 1986 increased by 24 per cent to the United States, 15 per cent to Japan, and 40 per cent to the European Economic Community, despite the general sluggishness of world trade. Thirdly, depending on the currency denomination of the external debt and the foreign currency composition of export earnings, the decline in the value of the dollar has had a varying impact on the debt burden of the developing countries. The debt burden was reduced for countries whose total external debt was mainly dollar-denominated, and was increased for countries whose debt was mostly denominated in currencies that had appreciated against the dollar.<sup>13</sup>

### Trade impulses and the growth process in 1986

The substantial changes that emerged in the relative prices of key commodity and product categories in 1986 affected the level as well as the direction of trade flows. In turn, the changes in trade flows had a significant impact on the level of economic activity in the trading countries.

In terms of volume of trade flows, the developed market economies as a group were the only significant growth pole in the world economy in 1986.<sup>14</sup> This was reflected in the considerable margin that developed during the year between the rates of growth of imports and exports of those countries. In volume terms, their combined exports grew by less than 2 per cent while their imports rose by 8 per cent. The overall leakage of demand through trade channels to the rest of the world was equivalent to 1.5 per cent of the industrial countries' combined GDP.

The volume of merchandise imports fell by 7.5 per cent in the developing countries (see table II.3). Imports were stagnant in the centrally planned economies of Europe as a group and declined by more than 20 per cent in China. Among the developing countries, the sharpest decline in the volume of imports was among the major exporters of energy.

Two special aspects of the global transmission of the growth process in 1986 need to be highlighted. First, the growth impulses were highly uneven and benefited mainly a small number of the non-industrial countries, essentially the major exporters of manufactures in East Asia. The trade and output linkages among the major country and country groupings (see table II.4) show that, as recently as 1985, the most important market for the exports of developing countries was the United States. The developing countries' total exports to the United States as a proportion of their collective GDP has been slightly above 7 per cent, with nearly half

that amount accounted for by the major exporters of manufactures in East Asia. For developing countries of South and East Asia as a group, exports to the United States were more than twice their imports from that country and accounted for about 12 per cent of their combined GDP.

Japan and the United States were the most dynamic markets among the industrial countries in 1986, with the import volumes of each growing by more than 10 per cent (see table II.3). This, combined with existing trade links (see table II.4), meant that the East-Asian economies were the major beneficiaries among the developing countries from global trade developments.

A second major aspect of trade in 1986 was that, for the industrial countries as a group, the loss in trade volume was more than compensated for by a sharp improvement in their terms of trade, especially against the energy-exporting developing countries.<sup>15</sup> As a consequence of this offsetting price movement, the industrial countries' combined trade balance improved in nominal terms *vis-à-vis* the rest of the world, although it deteriorated in real terms.<sup>16</sup> The opposite took place for the developing countries as a group.

The terms of trade gains by the industrial countries in 1986 were brought about mainly by the sharp drop in oil prices and the rise in the prices of manufactures. The macro-economic transmission of the fall in oil prices operates through several channels. The most important macro-economic transmission channel of a fall in oil prices is the transfer of income from the energy exporters to the energy importers. In 1986, this transfer amounted to about \$90 billion, of which more than \$70 billion was from the energy-exporting developing countries. Within the developing regions, however, the revenue loss of the energy exporters was nearly four times the oil-related savings of the importers.

The ultimate impact of this transfer on the world economy depends on the relative size of the propensities to spend and to import in the income losing and gaining countries. The oil price increases of the 1970s have shown that an income transfer from comparatively low saving (industrial) countries to high saving (energy-exporting developing) countries, at least initially, may lead to a global slow-down as global aggregate demand weakens. An oil price decline should have the opposite result. But the overall impact of the fall in oil prices on the world economy in the short-run seems to have been negative. Several factors may explain this: by 1986 the savings rates of the two country groups may not have been much different and, as discussed below,

<sup>13</sup> For a useful summary of the effect of exchange rate adjustments on the external debt of the East-Asian developing countries, see *Economic and Social Survey of Asia and the Pacific 1986* (United Nations publication, Sales No. E.87.II.F.1), pp.26-27.

<sup>14</sup> It is important to note that the import volume of Eastern Europe as a group (i.e., the centrally planned economies of Europe excluding the Soviet Union) increased significantly in 1986. In fact, their combined export volume to the non-Socialist countries fell by 5 per cent, while their import volume from the same group rose by more than 6 per cent.

<sup>15</sup> For example, in 1984, another year of large changes in international trade flows, the margin between rates of growth of import and export volumes of imports), while in 1986 the same margin was more than 6.5 percentage points. In 1984, however, those countries faced a decline in their terms of trade (0.5 per cent), while in 1986 their terms of trade improved sharply by about 10 per cent. In sum, in 1986 the industrial countries' gain in terms of trade significantly exceeded their loss in trade volume.

<sup>16</sup> The industrial countries' combined current account balance in nominal terms improved by about \$50 billion in 1986. But in real terms, in constant dollars of 1985, it deteriorated by about \$70 billion.

Table II.4. World trade and output linkages: share of bilateral exports and imports in GDP, 1985<sup>a</sup>  
(Percentage)

Exports and imports of country or country group (1)	Trading partners (2)						Centrally planned economies
	United States	Japan	European Economic Community	Federal Republic of Germany	Developing countries		
					Total	Energy exporters	
<b>United States<sup>b</sup></b>							
Exports	—	0.6	1.1	0.2	1.8	0.7	0.2
Imports	—	1.9	1.8	0.6	3.2	1.0	0.2
<b>Japan<sup>b</sup></b>							
Exports	5.5	—	1.5	0.5	4.0	1.2	1.2
Imports	1.7	—	0.6	0.2	4.6	3.2	0.5
<b>European Economic Community<sup>c</sup></b>							
Exports	2.5	0.3	13.2	3.2	3.8	1.8	1.0
Imports	2.0	0.9	13.0	3.5	4.3	2.5	1.3
<b>Germany, Federal Republic of<sup>b</sup></b>							
Exports	3.2	0.4	14.8	—	5.4	1.7	—
Imports	1.7	1.1	13.0	—	5.0	1.6	—
<b>Developing countries<sup>d</sup></b>							
Exports	7.2	3.6	5.4	1.8	6.8	—	1.6
Imports	4.1	3.1	5.3	2.0	6.9	—	2.0
<b>South and East Asia</b>							
Exports	12.0	6.2	4.3	—	11.4	—	2.6
Imports	5.5	7.3	4.4	—	11.5	—	3.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Direction of Trade Statistics Yearbook 1986*, OECD, *Main Economic Indicators*; GATT, *International Trade, 1985/86* (Geneva, 1986); and other official international sources.

a Trade in services is not included. The figures in each row represent bilateral merchandise exports and imports of the country or country group (1) *vis-à-vis* the countries or groups in each column (2) divided by the GNP of the row country (1). All figures are calculated from output and trade figures in 1985 prices and dollar exchange rates.

b GNP data used.

c Including the Federal Republic of Germany.

d Including Asia but excluding China, which is included in the centrally planned economies group.

the slow-down may have been the result of the timing of responses of economic agents in both the energy-importing and energy-exporting countries.

In 1986, as a result of the lower energy prices, most international projections expected a somewhat faster growth of real output for the industrial countries than was actually experienced—3 per cent as opposed to 2.5 per cent. The shortfall was mainly due to timing. First, the import contraction of the energy-exporting developing countries was somewhat larger and took place in a shorter time span than had been expected; and secondly, the expected surge in consumer spending in the developed market economies did not take place because the pass-through of the declines in oil prices to

consumers was less than complete. Instead, the oil price declines resulted in increases in public sector revenues and profit margins in many industrial countries.<sup>17</sup> An additional factor that played a role in subduing overall economic activity in the developed market economies was the negative impact of the decline in the price of oil on the energy sectors of the energy producers among the group.

The sharp decline in import levels of the energy-exporting countries had an important negative effect on the level of economic activity of the industrial countries. The energy-exporting developing countries account for about 25 per cent of the industrial countries' total exports to the developing regions. Relative to each of the major industrial coun-

<sup>17</sup> *OECD Economic Outlook*, No. 40 (December 1986), pp. 36-43. For example, in Japan, while prices of imported energy fell by 55 per cent (between the second quarter of 1982 and the first quarter of 1986) after-tax gasoline prices fell by only 21 per cent; in Italy, while there was a decline in energy prices of about 30 per cent in the same period, after-tax gasoline prices actually rose by 18 per cent. For the industrial countries as a whole, prices of imported energy fell by 40 per cent, but the after-tax gasoline prices declined by only 15 per cent.

Table II.5. Developing countries' real rate of interest, and rate of change in terms of trade, export volume and external credit, 1961-1986  
(Percentage and annual percentage change)

	Average			1984	1985	1986 <sup>a</sup>
	1961-1970	1971-1980	1981-1986			
	<u>Percentage</u>					
Real rate of interest faced by <sup>b</sup>						
(1) All developing countries	4.2	-13.2	17.1	10.1	14.7	22.0
(2) Energy exporters	5.0	-15.2	23.7	11.7	13.8	53.3
(3) Energy importers	4.0	-4.0	15.6	9.0	15.1	7.0
	<u>Percentage change</u>					
Rate of change in terms of trade	-1.6	7.0	-4.6	2.3	-2.5	-25.0
Rate of growth in export volume	7.2	2.0	-0.4	3.3	-0.5	7.7
Rate of growth of total private external credit to the developing countries <sup>c</sup>						
Nominal	11.4	19.8	4.6	2.5	2.4	0.7

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

<sup>a</sup> Preliminary estimates.

<sup>b</sup> United States prime interest rate deflated by:

- (1) Rate of change in export unit value of the developing countries in dollars;
- (2) Rate of change in export unit value of the energy-exporting developing countries in dollars;
- (3) Rate of change in export unit value of the energy-importing developing countries in dollars.

<sup>c</sup> Figures for 1961-1975 are rough estimates; 1976-1986 figures for nominal changes are based on IMF, *World Economic Outlook* (Washington, D.C., October 1986). Credits are denominated in terms of United States dollars.

tries' GDP, the degree of dependence on the energy exporters' markets varies from about 0.7 per cent for the United States, to 1.2 per cent for Japan and 1.7 per cent for the Federal Republic of Germany (see table II.4). The collapse of the energy-exporting developing countries' imports in 1986 may have reduced the GDP growth rate of the industrial countries by about 1 percentage point.<sup>18</sup>

### Financial linkages and transmission of growth

Financial linkages among national economies have also played a critical role in the transmission of growth impulses across countries. In some instances, this has been even more important than the role of trade flows. The most important financial linkage between the developed market economies and the developing countries in recent years is the resource flow related to the rising stock of debt of the developing countries. The total external outstanding debt of those countries (excluding China) as a percentage of their aggregate gross domestic product rose from 28 per cent in 1980 to more than 50 per cent in 1985. Net interest payments on

external debt have also risen, from 1.5 per cent of GDP in 1980 to more than 3 per cent in 1985. Moreover, a large part of the developing countries' external debt is commercial bank debt with floating interest rates that are strongly linked to both LIBOR and short-term interest rates in the United States.

The evolution of the financial linkages between the developed and the developing countries in recent years has amplified the degree of economic interdependence between the two groups. While the financial linkage appears highly lopsided in favour of the developed countries, the ability of the developing countries to continue to service their external debt is important to the stability of the financial sector in the industrial countries. In addition, the financial resource flows from the developed to the developing countries play a critical role in the maintenance and expansion of the import markets in the developing areas, which in turn are important to the dynamism of world trade (see box II.3).

Reflecting this enhanced economic and financial interdependence, the cyclical fluctuations of output in developed and developing countries have become increasingly syn-

<sup>18</sup> Ignoring the implied price effects, the impact of a 20 per cent reduction in the volume of imports by the energy-exporting countries on the GNP of the developed market economies can be calculated (approximately) as follows:  $(-0.20) (0.25) (0.15) = -0.7$  per cent, where 0.25 is the share of exports to energy-exporting developing countries in the industrial countries' total merchandise exports and 0.15 is the share of merchandise exports in GNP of the industrial countries. Assuming an international multiplier of 1.5, which accounts for the secondary (or spill-over) effects, the total effect of the fall in exports to the oil producers in 1986 was about 1 percentage point of GNP.

chronized in recent years. The correlation co-efficient between the real output growth rates of these two groups of countries has risen from 0.25 in the period 1966-1974 to 0.5 in the period 1975-1984.

As shown in table II.5, the movements in some of the major transmission mechanisms, both real and financial, have been quite unfavourable to the developing countries in the 1980s: real interest rates faced by them have risen sharply, their terms of trade have deteriorated, their trade volume has moved sluggishly and the external financial inflows have slowed down dramatically.

While interest rates on concessional loans have remained low during the 1980s, in real terms they are also higher than

in the two previous decades. Moreover, several recent empirical studies have found that rising international interest rates, operating through financial channels, have had a significant negative effect on the growth of real GDP in developing countries.<sup>19</sup> As indicated in table II.5, in 1986 real interest rates on commercial loans faced by the developing economies remained very high by post-war standards, while the nominal growth of private external credit flows to these countries remained very low. Thus, even though nominal interest rates declined, in general the magnitude of the financial variables in 1986 were such that they continued to exert a dampening effect on the economic growth of many developing countries.

### Short-term outlook for the world economy

The heightened uncertainty in the world economy makes it unusually difficult to forecast even short-term developments. However, the potential negative consequences of a continuation of these uncertainties and the recognition of the need for correction of the major global imbalances discussed earlier has caused the major market economies to attempt to co-ordinate a number of remedial measures. Effective implementation of those arrangements should introduce an element of stability into international economic relations and contribute, both directly and indirectly, to an improvement in the world economic situation. On the other hand, continued disharmony in a number of other areas could readily multiply and have significant negative consequences. On balance, therefore, the world economy continues to be in a fragile state, its progress in the short to medium term being a matter of some conjecture.

The following subsection presents the results of a simula-

tion of the developments that seem likely to occur as at early April 1987. The results of this forecasting exercise, which is based on Project LINK, are shown in the tables in this section (and in the annex below) and represent an estimate of the likely course of the world economy over the next one to two years. The forecast is based on a pragmatic assessment of possibilities and is not to be interpreted as the most desirable outcome. The analysis in this *Survey* identifies a number of problem areas where a change in international economic policy would produce an improvement in the prospects for the world economy. In order to examine the benefits of remedial action in two of these key areas, this section also presents the results of alternative simulations that, first, assume a higher degree of policy co-ordination among the major developed market economies and, secondly, assume an element of debt relief for the indebted developing countries (see boxes II.2 and II.3).

<sup>19</sup> Preliminary results from regression studies attempting to isolate the impact of changes in trade flows, in terms of trade and in real interest rates on the rate of growth of output, indicate that the effect of real interest is quite large and dominates the effect of the trade variables (see the table below). An IMF study (Susan M. Schadler, "Effect of a slowdown in industrial economies on selected Asian countries", January 1986) finds that a decline (rise) in United States interest rates exerts a significant positive (negative) impact on the GNP growth rate in the Asian countries. See also David Goldsborough and Iqbal Zaidi, "The transmission of economic influences from industrial to developing countries", in *Staff Studies for the World Economic Outlook* (Washington, D.C., IMF, July 1986), pp. 173-187; R. Dornbusch, "Policy and performance links between LDC debtors and industrial nations", *Brookings Papers on Economic Activity*, No. 2 (1985), pp. 303-356.

Dependent variable: rate of growth of real GDP

	Constant	Export volume	Terms of trade	Real interest	Dummy (1974-1984)	R <sup>2</sup>
Total developing	6.4 (14.8)*	0.11 (2.8)*	0.10 (3.3)*	-0.46 (-8.3)*	-1.60 (-3.3)*	0.90
Net energy importers	5.5 (11.4)*	0.08 (1.5)	0.07 (1.5)	-0.34 (-5.6)*	-1.00 (-2.2)*	0.73
Net energy exporters	7.5 (9.2)*	0.17 (3.8)*	0.04 (2.9)*	-0.41 (-3.5)*	-2.9 (-2.8)*	0.91
Major borrowers	6.5 (10.3)*	0.02 (0.3)	0.19 (2.5)*	-0.47 (-4.2)*	-1.83 (-1.8)*	0.73

Note: Estimation method: ordinary least squares; period of estimation: 1965-1984. All variables are in percentage change (except real interest rate, which is in percentage terms). Figures in parentheses are t-statistics; (\*) indicates significant at 0.05 level. All regressions are corrected for serial correlation. United Nations Secretariat country groupings have been used. Dummy variable measures percentage point reduction in average annual output growth rates since 1973 independently of the variables listed in the table.

## Key policy assumptions

The major macro-economic policy assumption in the baseline projections, which constitutes a clear departure from recent experience, is the prospective gradual tightening of fiscal policy in the United States and a modest fiscal expansion in a few other major industrial countries (e.g., the Federal Republic of Germany and Japan), in line with their announced policies as at January/February 1987. Nevertheless, the overall fiscal stance of the seven major industrial countries is to move towards restriction in 1987-1988.

During the same period, the overall monetary policy stance of these countries is anticipated to become significantly less accommodating than in 1986, as the favourable impact of lower energy prices on general price levels begins to fade away. The tightening of monetary conditions results in a marked increase in interest rates in some of the major economies, beginning in 1987. According to the baseline solution, by 1988 the United States prime rate of interest will have risen by about 140 basis points from its low in 1986. The nominal effective dollar exchange rate will decline gradually throughout the simulation period and by the end of 1988 it will reach its average level of 1980. The oil price (the average export price of OPEC) is set exogenously in the baseline to average about \$17 a barrel in 1987-1988. This represents a rise of 6 per cent a year in real terms. The total inflow of capital (gross) into the developing countries is assumed to increase at an annual rate of 3.5 to 4 per cent in nominal terms. Major debtor developing countries are assumed to continue their macro-economic adjustment programmes by holding down real rates of increase in public spending, keeping real interest rates at positive levels, and at the same time allowing for real depreciation of their currencies.

Among the centrally planned economies, policies are based on the new socio-economic plan cycle for 1986-1990. In nearly all European planned economies, policies are aimed at accelerating the pace of output growth attained in 1986 through sharp increases in the pace of investment activity. These plans give high priority to machine-building branches and the production of electronic equipment and computers. The agricultural targets in these countries are more modest than those set for industry. Targets for the Soviet Union are on the whole in line with 1986 achievements. Although the overall investment activity is to moderate somewhat, some sectors with high priority are set to expand very rapidly. For example, production of machinery and equipment for machine-building and engineering is to grow by 40 per cent.

Given the persistent excess demand and emergence of imbalances in the budget and external account, China's economic plan for 1987 seeks to control and perhaps curb domestic demand, in particular, fixed capital investment. In agriculture, the priority is to raise grain output so as to match the record level achieved in 1984.

### Salient features of the baseline projections

Key features of the baseline projections for the world

economy in the next 18 months are summarized in tables II.6 and II.7. The projections indicate that, without a major policy change, the world economy will continue to grow at a much slower pace than in the 1970s. World trade will also grow at a sluggish pace, with a significant slow-down expected in 1987. The economic expansion of the developed market economies, which entered its fifth year in 1987, is expected to continue at a slow pace. The average rate of output growth for the industrial countries is expected to remain below 3 per cent in 1987 and improve only marginally in 1988. Among the major industrial countries, only the United Kingdom is projected to grow at a measurably higher pace than in the 1970s.

The process of adjustment in the Federal Republic of Germany, Japan and the United States, resulting from the continued pressures exerted by their external imbalances, and the tight fiscal and monetary policy assumed in the baseline are the key underlying factors for the slow pace of economic expansion in these countries. While the average inflation rate is projected to remain below 4 per cent — less than half the average rate in the 1970s — the high unemployment rates will not fall. Western Europe's unemployment rate is projected to remain around 11 per cent, which is nearly three times its average in the 1970s. The projections indicate that there will be a significant correction in trade imbalances of the Federal Republic of Germany, Japan and the United States in volume terms starting in 1987. In nominal terms the imbalances are more persistent and their correction seems to lie beyond the two-year horizon of the baseline simulation.

The developing countries as a group are also expected to grow at below 3 per cent in 1987. A moderate acceleration is anticipated in 1988 because of a partial recovery in the energy-exporting developing countries, reflected mainly in higher average growth rates in Africa and West Asia. On the other hand, the average growth rate of GDP in energy-importing countries as a group is expected to decelerate by about 1 percentage point below 1986 as the favourable effects of lower oil prices begin to fade away. In addition, a slower pace of output growth projected for Brazil has a dampening effect on the group's average. The great diversity of experience that has characterized the developing countries' performance in recent years is expected to continue in the next two years. The average GDP growth rate in Africa is expected to remain well below the rate of population growth, while the Asian economies will grow at rates in the range of 4.5 to 5 per cent. The performance of the Latin American region, with an expected average expansion of about 3.5 per cent, will continue to be dominated by the performance of the major debtor countries in the region. High real interest rates internationally and expected low levels of capital inflows will leave little room for manoeuvre in these countries.

In sum, baseline projections indicate that if there are no major initiatives to radically change policies in the industrial countries, the world economy will not grow at a sufficiently high pace to allow improvements in the standard of living of a large number of developing countries. Furthermore, unemployment rates in industrial countries will remain high, the international debt problem will not go away and the large

Table II.6. Short-term outlook for the world economy, 1986-1988  
(Annual percentage change)

	1986 <sup>a</sup>	Projections		Ratio Average of 1986-1988 divided by average of 1971-1980
		1987	1988	
World volume of trade	3.5	3.0	4.0	0.70
Real GDP				
World	3.1	3.2	3.7	0.85
Developing countries	2.5	2.7	3.8	0.53
Africa	-2.1	-0.2	2.4	0.01
South and East Asia	4.5	4.7	5.0	0.85
West Asia	0.3	-1.1	2.7	0.10
Western hemisphere	3.5	3.3	3.7	0.64
Mediterranean	4.4	2.9	2.9	0.64
Developed market economies	2.4	2.6	3.0	0.86
Western Europe	2.3	2.4	2.4	0.83
Japan	2.5	2.6	3.0	0.54
North America	2.6	2.7	3.4	1.00
Centrally planned economies of Europe <sup>b</sup>	4.3	4.1	4.5	0.83
China <sup>b</sup>	7.0	7.0	7.0	1.23
Memorandum item:				
Value of developing country exports <sup>c</sup>	-8.2	10.0	11.0	0.16

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on projections of Project LINK (9 March 1987) and other national and international sources. Forecasts are based on an average oil export price of \$17 a barrel.

<sup>a</sup> Preliminary figures.

<sup>b</sup> Output growth rates refer to net material product for 1986 as contained in plan fulfilment reports and to Secretariat estimates for other years.

<sup>c</sup> In terms of current dollars.

and persistent trade imbalances of the major industrial countries might exacerbate existing tensions.

The projected growth rates for 1987-1988 for the centrally planned economies are partly based on the annual plans for 1987 and the medium-term policy intentions expressed in the five-year plans, and these target rates still appear to be realistic under the prevailing socio-economic situations. Account has also been taken of plans that are consistently taut, and can therefore be attained only under the most favourable of domestic and external circumstances, including those in the area of agriculture, trade and international finance.

For the European centrally planned economies, the projected data for 1987-1988 show, by and large, stability in growth. Relative stability derives essentially from the legacies of the recent adjustment efforts in Eastern Europe and the fact that any acceleration of growth is being made contingent on a favourable external environment. Similarly, the growth efforts of the Soviet Union in the short run are predicated by and large on existing conditions. However, the ongoing economic reforms and other changes in economic institutions and mechanisms may help these countries to capitalize on the recent and near-term changes in economic structures towards the end of the decade and beyond.

The expected growth in China still exceeds that of the

1970s, but is below the performance in the early 1980s. This change is largely predicated on the need to regain domestic and external balance in order to make headway with urban economic reforms.

### Risks and uncertainties

The greatest risk facing the world economy within the next two years concerns the nature and the magnitude of automatic, as well as policy-induced, adjustments in the major global imbalances. Especially important is the policy response of Western Europe and Japan to a deceleration in the growth rate of United States imports. A combination of higher growth rates of exports and significantly lower growth rate of imports in the United States is expected to bring about a turn-around in the real foreign balance of the United States by 1988. This means that, on average, there would be less stimulus for the world economy, perhaps by as much as 1 per cent of the GNP of the United States. The slack left by the change in the economic situation of that country has to be eliminated through greater demand elsewhere in order to avoid a world-wide recession. But not all of the adjustment can or should fall upon the Federal Republic of Germany and Japan—the two countries with the largest trade surplus. A significantly higher level of financial

Table II.7. Developed market economies: short-term outlook for inflation and unemployment rates and current account balances, 1986-1988  
(Average annual or annual percentages)

	1986 <sup>a</sup>	Projections		Ratio Average of 1986-1988 divided by average of 1971-1980
		1987	1988	
<b>Inflation rate<sup>b</sup></b>				
All developed market economies	4.0	3.0	3.5	0.44
Western Europe	5.3	3.5	3.5	0.45
Japan	2.0	1.0	2.0	0.22
North America	2.6	2.8	4.0	0.43
<b>Unemployment rate</b>				
All developed market economies	8.1	8.1	8.0	2.00
Western Europe	11.0	11.1	11.2	3.00
Japan	2.8	3.2	3.4	2.00
North America	7.3	7.0	6.7	1.20
<b>Balance on current account<sup>c</sup></b> (billions of dollars)				
Germany, Federal Republic of	36	30	25	—
Japan	86	78	74	—
United States	-141	-150	-145	—

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on projections of Project LINK (9 March 1987) and other national and international sources.

a Preliminary estimates.

b GDP/GNP deflator.

c Including official transfers.

flows to the developing countries that would enable them to raise their import levels could go a long way towards easing some of the pressures being exerted on the world economy.

A related major risk to the world economy arises from the intensification of protectionist pressures in the developed market economies. There are already signs of domestic political pressure for trade barriers to stem the tide of imports into the United States. If these barriers materialize, a trade war could ensue, leading to significantly lower growth everywhere.

A sharp drop in the level of financial flows to the United States presents an important risk to the world economy. Such a decline in net capital inflows before United States fiscal and trade deficits are significantly reduced will bring about a further depreciation of the dollar *vis-à-vis* other major cur-

rencies and, at the same time, push up interest rates in the United States. Higher interest rates may induce a sharp recession domestically and thereby in the rest of the world. This eventuality would intensify the international debt problem and could spell disaster for many developing countries.

The debt problem of the developing countries is potentially a large risk to the world economy. The unravelling of the domestic economic reforms and re-emergence of the debt crisis in Brazil in early 1987 is most worrisome, although the possibility of a fully-fledged debt crisis is less imminent today than it was a year ago. This is because some favourable accords have been reached in recent months between the commercial banks, the official lending institutions and some of the largest debtor countries. Nevertheless, the overall situation is still precarious.

**Box II.2. Co-ordination of macro-economic policies  
in the industrial countries**

This scenario represents a set of feasible policy changes by the major developed market economies to reduce their large internal and external imbalances, create more employment and raise their output growth above those in the baseline with no measurable increase in inflation. To achieve these goals and, at the same time, to ensure that the foreign

exchange and assets markets will function in an orderly manner while the large adjustments are taking place, the policy shifts and the reconfiguration of the policy mixes in each country should be tightly co-ordinated with those of the other countries.

*Box continued on adjacent page*

**Impact of macro-economic policy co-ordination in the  
industrial countries on the world economy, 1987-1989<sup>a</sup>**

	Year 1	Year 2	Year 3
	<u>Percentage deviation from baseline level</u>		
Real GDP			
World	0.0	0.3	0.8
Developed market economies	-0.1	0.4	1.2
EEC	0.2	0.4	0.5
Japan	0.0	0.2	0.6
United States	-0.4	0.6	1.9
Developing countries	0.0	0.2	0.2
World trade volume	0.1	0.5	1.0
	<u>Percentage point difference from baseline</u>		
Inflation rate			
Developed market economies	0.0	0.1	0.2
EEC	0.0	0.2	0.3
United States	0.0	0.1	0.2
Unemployment rate			
Developed market economies	0.0	-0.1	-0.5
EEC	0.0	-0.1	-0.2
United States	0.1	-0.3	-0.8
	<u>Billions of dollars difference from baseline</u>		
Reduction in			
United States budget deficit	4	20	50
United States current account deficit	10	20	12

*Source:* Project LINK.

<sup>a</sup> Figures for output and trade represent a percentage change in the scenario level relative to the baseline level. The figures for year 1 may also be interpreted as additions to the baseline growth rates. For subsequent years, 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 on real world GDP in this scenario is 0.3 per cent above the baseline level. The addition to the growth rate in year 2 relative to the baseline is 0.3 percentage points, which is the difference between 0.3 and 0.0.

The baseline projections presented in this chapter assume a continuation of the cautious monetary policy and a gradual tightening of the overall fiscal policy, mainly on account of a deficit reduction programme in the United States, in the seven leading industrial countries in 1987-1988. This alternative scenario assumes a sharper tightening of fiscal policy in the United States, expansionary fiscal policy in the Federal Republic of Germany and Japan, and an accommodating monetary policy in all major industrial countries. The policy changes assumed in this scenario, are as follows (all policy changes are measured as sustained deviations from baseline level of the same variable): (a) a cut of \$20 billion a year in 1982 dollars (about 2.5 per cent) in real public spending in the United States; (b) a 1.5 per cent increase a year in real housing investment by the public sector in Japan; (c) a 10 per cent cut in the tax rates of households and businesses in the Federal Republic of Germany and Japan; and (d) monetary accommodation in all major economies (which results in a 1 percentage point reduction in interest rates in Canada, the United Kingdom and the United States, and a 0.5 percentage point reduction in all other major economies).

The implementation of these policies produces several important results (see table). The reduction in the budget deficit is likely to have an immediate contractionary effect on the United States and other major industrial countries. However, global aggregate demand does not decline to any measurable extent because of the compensatory, though modest, fiscal expansion in the Federal Republic of Germany and Japan, and the monetary policy accommodation in all industrial countries. The latter policy change limits the decline of output in the United States, while preventing interest rates from rising in the Federal Republic of Germany and Japan despite their expansionary fiscal policy stance. The time-path of the nominal effective dollar exchange rate remains virtually unchanged from that in the baseline. Most benefits to the world economy come in the latter part of the simulation period. World output and trade each gain 1 percentage point or more over the baseline projections. Average growth rate of real output in the industrial countries reaches 3 per

cent, while the developing countries begin to receive some benefit in the form of higher real output in the latter part of the simulation period. Increases in inflation in the industrial countries are modest because of the significant under-utilization of productive capacity in most countries in the baseline and because of the gains in labour productivity resulting from increases in real output. The unemployment rate is significantly reduced in the United States. Gains in this area in Western Europe are modest but the decline in the unemployment rate in the Federal Republic of Germany (by about half a percentage point) is more significant than in other major European economies.

A key result of this scenario is that major reductions in the twin-deficits of the United States do not take place until the second year. Initially, the fiscal deficit declines only marginally because tax revenue drops as the economy slows down. As the economy begins to strengthen, tax revenue begins to rise while spending is curbed, and the deficit begins to shrink rapidly. On the other hand, the reduction in the United States current account deficit begins to slow down in the third year of the simulation, mainly because the increase in the level of economic activity in the United States strengthens import demand.

The results for the developing countries as a group are modest because of two critical assumptions. First, energy prices, and to a lesser extent other raw material prices, do not increase above their baseline level, which, because of the rise in industrial countries' prices, implies a terms of trade loss for the developing countries during the simulation period. Secondly, capital inflows into the developing countries remain unchanged from those in the baseline, where they were assumed to increase very little. In sum, the benefits of macro-economic policy co-ordination of the type described here accrues mainly to the industrial countries. This scenario suggests that the major industrial countries can achieve an increase in their output growth rate at a low rate of inflation, while correcting their macro-economic imbalances.

Box II.3. Debt relief for major debtor  
developing countries

The purpose of this scenario is to measure the impact of a reduction in the amount of interest the debtor developing countries pay to service their debt on their economic performance and on the world economy. The scenario is designed and implemented in such a way that the foreign exchange savings resulting from the reduced interest payments of each debtor country are used to increase that country's imports of capital goods.

The major policy assumptions embedded in this scenario are (a) for all debtor developing countries or areas except the Republic of Korea, Singapore, Turkey and Taiwan, Province of China, the centrally planned economies and all energy-exporting developing countries other than Indonesia, Mexico and Nigeria, interest payments are limited to 5 per cent of each country's total external debt outstanding at the end of the preceding year; (b) each debtor country uses the resulting foreign currency savings to increase imports of manufactures; (c) initially, interest rates in creditor countries rise by about 100 basis points in response to the financial difficulties of their commercial banks, one aspect of which would be a sharp decline in the stock prices and liquidity shortage of the affected banks in reaction to the fall

in their overseas earnings; and (d) central banks in the creditor countries increase the commercial banking system's reserves in order to curb the rise in interest rates.

The simulation results indicate that the size of the interest relief is about \$16 billion to \$17 billion a year. A higher level of real output in the debtor countries results from a rise in investment that, in turn, is facilitated by the higher level of imported capital goods. The impact on the debtor countries is quite large, as indicated by the gains accruing to selected countries listed in the table below. The increased imports of the developing countries also result in a rise in exports, and thereby a higher level of economic activity, in the industrial countries.

The critical policy assumption is the monetary expansion in the industrial countries. As indicated in the table below, without monetary accommodation interest rates could rise substantially in response to a liquidity shortage encountered by the commercial banks because of the decline in their revenues. A sharp rise in international interest rates, if allowed to take place, would defeat the purpose of the exercise and in fact lead to a global economic slow-down. This important

*Box continued on adjacent page*

Impact of debt relief for major debtor developing  
countries on the world economy, 1987-1989<sup>a</sup>

	Year 1	Year 2	Year 3
	Percentage deviation from baseline level		
Real GDP			
World	0.2	0.2	0.2
Developed market economies	0.2	0.2	0.2
Developing countries	0.4	0.4	0.4
Major debtors <sup>b</sup>			
Argentina	2.0	1.9	1.8
Brazil	0.7	0.7	0.8
Mexico	0.8	2.5	3.2
Nigeria	0.6	0.6	0.6
Republic of Korea <sup>c</sup>	0.2	0.2	0.2
World trade volume	0.7	0.7	0.7
Developing country imports <sup>d</sup>	2.5	2.5	2.5
Developed country exports <sup>d</sup>	0.7	0.7	0.9
	Basis points difference from baseline		
Interest rates			
With monetary accommodation	3	7	-5
(Without monetary accommodation)	79	78	76)

Source: Project LINK.

- a See note a to the table in box II.2 for an interpretation of the figures.  
b Only a partial list of the countries included in the debt relief exercise.  
c Not included in the debt relief scheme.  
d Values, deflated by export unit value of developed market economies, in terms of United States dollars.  
e Three-month treasury bill rate in the United States. One full percentage point is equivalent to 100 basis points.

conclusion applies equally to the discussion of alternative policies regarding the debt problem in chapter IV below.

It is important to note that some of the major debtor developing countries, particularly major exporters of manufactures (e.g., the Republic of Korea, Singapore and Taiwan, Province of China) benefit from the scenario, even though they are excluded from receiving debt relief, because of the higher level of world economic activity. The major shortcoming of the policy that forms the basis of this scenario is that it bypasses most of the smaller African debtor countries.

The 5 per cent cap on interest payments may not result in significant savings in relation to foreign currency earnings for these countries since their external obligations are mainly in the form of long-term official debt with average effective interest rates substantially below those paid by market borrowers. A separate relief mechanism is required to respond to the pressing needs of the large numbers of low-income official debtors, most notably those in sub-Saharan Africa. This issue is also addressed at greater length in chapter IV.

### Regional economic performances in 1986 and selected policy issues

The second half of the decade of the 1980s will be a critical period for the world economy. Important economic problems inherited from the first half of the decade remain unresolved: sluggish growth of output and trade continues in most parts of the world; protectionist pressures have heightened; the debt problem and the intensification of the development crisis threaten the social and political fabric in many developing countries; high rates of unemployment, particularly among young people, have led to social and political alienation of a large number of people in both the developed and the developing countries; and massive macro-economic and financial imbalances impair the orderly functioning of the world economy. More important, the pace of investments has slowed down and, given the present policies, it is doubtful that there will be a significant increase in capital formation in the near future.

It was the stagflation of the 1970s that prompted the change in the economic régime, from low to high real interest rates, in the industrial countries.<sup>20</sup> But after five years, instead of the sustained, non-inflationary high rate of output growth that they were seeking, the industrial countries have

achieved a sustained, non-inflationary low rate of output growth together with a high unemployment rate. It had been widely agreed by policy makers that private capital investment had to rise significantly to achieve a high rate of output growth. This, in turn, has as one of its requirements stable prices, which was the reason for the anti-inflationary policies of the early 1980s. However, investment rates have increased only moderately. Western European investment rates remain relatively low, and those in Japan and the United States have decelerated significantly since 1985. Gross fixed capital formation as a percentage of GDP for the developed market economies was lower in 1985-1986 than it was in 1980.<sup>21</sup> Low rates of growth of aggregate demand, uncertainty about its future level, particularly in Europe and Japan, and high real interest rates have been important factors inhibiting private investment. Moreover, intensified trade frictions and wide fluctuations in financial variables brought about by the large external imbalances have increased the uncertainty faced by private investors.

Similarly, in the majority of developing countries, wide domestic imbalances, rising interest rates, a heavy debt-

<sup>20</sup> Stagflation generally refers to relatively long periods of low output growth rate, high unemployment rate and high inflation rate. For a detailed analysis of this phenomenon during the 1970s see, Michael Bruno and Jeffrey Sachs, *Economics of Worldwide Stagflation* (Cambridge, Mass., Harvard University Press, 1985).

<sup>21</sup> Gross fixed capital formation as percentage of GDP for the developed market economies as a group was 22.1 per cent in 1980 and 20.2 per cent in 1985. In the European Economic Community, the ratio fell from 21.2 per cent in 1980 to 18.6 per cent in 1985 (see *OECD Economic Outlook*, No. 40 (December 1986), table R3).

service burden, stagnant or declining demand and sluggish trade performance have affected investment and output growth. However, the major problem in most developing countries is the inadequate level of savings. The total level of net domestic savings has been depressed by declining real per capita incomes and by greater public sector dissaving as a result of widening government budget deficits in the early 1980s. Both of these factors have themselves been influenced by external factors. For the major debtor countries, a portion of domestic savings has been transferred abroad to service their external debt, often resulting in a reverse net resource transfer. The low rate of economic growth in the industrial countries has adversely affected the terms of trade and the trade performance of many developing countries. In addition, inflows of foreign savings, in the form of net financial flows, have virtually halted. With low or declining investment rates, rates of growth of real income in many developing countries are barely equalling or exceeding population growth rates.

In several centrally planned economies, the new medium-term socio-economic plans for capital formation in the second half of the 1980s, in contrast to those in the previous plan cycle, express a deliberate policy change to accelerate capital formation. In Eastern Europe, a significant slowdown in investment occurred in the early 1980s. In the period 1981-1985, it fell by more than 6.5 per cent, while that of the Soviet Union rose by 18 per cent. The investment plans for the second half of the current decade envisage a 20 per cent rise in Eastern Europe and a nearly 24 per cent increase in the Soviet Union.

Investment rose by 130 per cent in China between 1980 and 1985. Policy makers in China, with the aim of slowing

down the growth of the economy, are planning for a significantly less rapid pace of investment increase in the second half of the 1980s. Even so, the new plan contemplates an increase in per capita income exceeding 5 per cent a year.

### Diversity of situations in developing regions

Economic performance has remained disappointing in many developing countries: in 1986, of a sample of 83 countries, 39 had real growth rates of GDP below 2.5 per cent, compared with only 19 countries in the 1970s (see table II.8). But there was also a considerable degree of diversity: in 1986, some 13 countries, with a combined population of 400 million people, had GDP growth rates in excess of 5 per cent. The increase in the net material product of China also exceeded this figure.

One of the distinguishing factors that separated the fast growers from others continued to be the size of economy. The larger countries have tended to perform better in recent years. Large domestic markets and the more diverse natural and human resource base have, in general, provided the policy makers in the larger developing countries with more room for manoeuvre. Among the very large economies, that is, countries with population well above 100 million people, Brazil and India again experienced in 1986 a rate of output growth significantly higher than that of their respective populations, and far higher than the average output growth for the developing countries (see table II.9). Domestic impulses in both these countries played a major role in their economic expansion as exports changed little—and declined in the case of Brazil—from the previous year. Agriculture and agro-industry maintained the robust performance observed since the mid-1970s in India. In Brazil, a rapid increase in the real

Table II.8. Frequency distribution of output growth rates and inflation in the developing countries, 1971-1986 (Number of countries)

	1971-1980	1981-1986	1982	1983	1984	1985	1986 <sup>a</sup>
Distribution of real output growth rates <sup>b</sup>							
Zero or below	4	22	40	33	29	25	20
0.1-2.5 per cent	15	31	18	17	17	20	19
2.6-5.0 per cent	31	20	11	19	20	26	31
5.1-7.5 per cent	18	9	9	9	10	8	9
7.6 per cent and over	15	1	5	5	7	4	4
Distribution of inflation rates <sup>c</sup>							
5 per cent or lower	0	12	6	14	18	23	25
5.01-10 per cent	26	22	24	19	15	13	14
10.01-20 per cent	41	20	26	22	16	15	12
20.01-50 per cent	7	13	13	12	15	15	13
50.01-100 per cent	2	4	4	2	7	4	8
Over 100 per cent	0	5	3	7	5	6	4

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

<sup>a</sup> Preliminary estimates.

<sup>b</sup> Based on rates of growth of real GDP in 83 developing countries.

<sup>c</sup> Based on inflation rates, measured by consumer price indexes of 76 developing countries.

Table II.9. Developing countries: real GDP growth rates, 1971-1986

	Population in 1984 <sup>a</sup> (millions)	Gross domestic product in 1984 <sup>b</sup> (billions of dollars)	GDP growth rate <sup>c</sup>		
			1971-1980	1981-1985	1986 <sup>d</sup>
Percentage change					
All developing countries	2 540.0	..	5.6	1.3	2.4
Seven largest developing countries <sup>e</sup>	1 406.2	790.1	6.3	2.4	2.7
Energy importers	1 073.8	472.3	5.9	3.3	6.3
Bangladesh	98.5	12.4	4.0	3.9	4.5
Brazil	132.6	227.3	8.6	1.9	8.0
India	745.0	197.2	3.3	4.7	4.0
Pakistan	97.7	35.4	4.7	6.4	7.0
Energy exporters	332.4	317.8	6.8	1.2	-2.6
Indonesia	163.4	85.4	8.0	4.1	1.0
Mexico	77.0	158.3	6.6	1.9	-3.5
Nigeria	92.0	74.1	6.3	-3.5	-5.0
Smaller developing countries <sup>f</sup>	1 133.8	1 200	5.7	0.9	2.2
Energy importers	704.2	..	5.1	2.7	4.8
Energy exporters	429.6	..	6.2	-0.8	-0.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *World Population Prospects: Estimates and Projections as Assessed in 1984* (United Nations, Sales No. E.86.XII.3); World Bank, *The World Bank Atlas 1986*, IMF, *International Financial Statistics*; and other official national and international sources.

a Annual mid-year population, medium variant.

b Based on estimates provided in *The World Bank Atlas 1986*.

c Annual average and annual rates of growth of real gross domestic product.

d Preliminary estimates.

e Developing countries (excluding China) with populations greater than 75 million persons in 1984.

f Seventy-six developing countries.

wage bill as a result of a stabilization plan stimulated industrial activities. The decline in oil prices and, particularly in the case of Brazil, the lower interest rates on external debt enabled these two countries to increase their imports to support the expansion of their industrial sectors. However, several other large economies such as Indonesia, Mexico and Nigeria, because of their dependence on oil exports, suffered considerable set-backs in 1986 as oil prices plummeted.

### Diversity of performance at the regional level

The interregional diversity in economic performance that had prevailed since the early 1980s in the developing areas did not change in 1986, so that Asia continued to fare better than other regions. But the intra-regional growth pattern changed markedly. In Africa, countries south of the Sahara—with the drought ending in most countries of the region—generally sustained the moderate recovery that had started in 1985. With the exception of the Congo, Gabon and Nigeria, where real GDP fell considerably, the rate of

growth of the sub-Saharan countries clustered in the range of 2.5 to 5 per cent in 1986. An improvement in agricultural production in most of these countries both on account of better weather conditions and because of an increase in producer prices and other recent redirections of policies lifted overall output. Notwithstanding improved food production in the subregion, such countries as Angola, Ethiopia, Mozambique, Somalia and the Sudan will still need a considerable amount of food aid in 1987.<sup>22</sup>

In North Africa, only Morocco achieved a considerable expansion of output in 1986. The drop in oil prices and a reduction in remittances from workers in the Persian Gulf area complicated the external payments position of several countries. Until 1984, oil exporters in North Africa had managed to maintain high import levels despite the softening of oil prices. But a significant decline in import levels was recorded in Algeria, Egypt, the Libyan Arab Jamahiriya and Tunisia in 1985. In 1986, these cut-backs intensified and severely affected industrial production. The problem was compounded by drastic cuts in public investment budgets. Consequently, not only did the real per capita GDP fall

<sup>22</sup> See Adebayo Adedeji, "Adedeji's Message", *West Africa*, 12 and 19 January 1987.

sharply but, because of the considerable deterioration in the terms of trade, all four countries experienced a drop in per capita real incomes of 8 to 10 per cent.

There was an acceleration in the rate of growth of Latin America and the Caribbean to 3.5 per cent in 1986. Real GDP growth rate in Argentina, Brazil, Chile and Colombia—all large or medium sized energy-importing countries—ranged from 5 to 8 per cent. The policy-induced deceleration of inflation in Argentina and Brazil led to considerable increases in the real wage bill and hence in the level of domestic demand, which in turn stimulated the level of manufacturing output. In Chile and Colombia, increases in agricultural output and exports provided impetus to overall output expansion. On the other hand, energy-exporters and the smaller economies of the Caribbean and Central America experienced a very sluggish expansion and, in some cases, a regression. Peru was an important exception. A rise in aggregate demand induced by consumer spending and the Government's decision to limit the service payments on external debt, allowing an increase in imports of close to 30 per cent, resulted in a rapid increase in industrial output. The rate of growth in the GDP of Peru exceeded 8 per cent in 1986. But in this case, as in the case of Brazil, the current account deteriorated markedly and it will be difficult to maintain the rapid pace of growth in 1987.<sup>23</sup>

The economic performance of the Asian developing countries continued to be more robust than that of other developing areas. The success of several major exporters of manufactures in substantially increasing their exports to the industrial countries has been a major factor behind the buoyant economic activity in Asia. Real GDP for the region as a whole grew by 4.5 per cent in 1986, an acceleration of 1.3 percentage points compared with the 1985 performance. The economy of the Republic of Korea, stimulated by a substantial depreciation of the won against the yen and a sharp increase in its volume of exports to the industrial countries, grew by about 12 per cent. Pakistan and, to a lesser extent, Burma maintained the growth momentum of the first half of the decade as agricultural production kept the rapid pace of expansion of previous years. Bangladesh, Nepal, Sri Lanka and Thailand grew at virtually the same rate—around 4 per cent—as in 1985, while Indonesia, Malaysia, the Philippines and Singapore virtually stagnated. Growth is likely to resume, though at a moderate pace, in the latter four countries in 1987. Some improvements in their balance of payments should take hold after a protracted adjustment process in 1985 and 1986.

The decision by some Middle Eastern OPEC members (mainly Saudi Arabia) in the second half of 1985 to raise crude oil output resulted in an increase in the petroleum production in West Asia. However, the contribution of this increased oil production to growth in GDP was largely offset by a rapid decline in real incomes brought about by the lower

oil prices and the decision of most Governments to cut budget expenditures. Overall output in the region barely increased in 1986. Average per capita real income fell by more than 10 per cent. Even though oil prices recovered somewhat in late 1986, the full impact of budget cuts is likely to be felt in 1987.

Countries in the Mediterranean region—Cyprus, Malta, Turkey and Yugoslavia—experienced a considerable acceleration in the rate of growth of their real GDP from an average of less than 3 per cent in 1985 to 4.4 per cent in 1986. Lower oil prices had a beneficial effect on the import bills of all four countries. None the less, these countries also have close economic links—exports of goods and services—with a large number of energy-exporters in the Middle East and the overall impact of oil price changes has been rather mixed. After a successful adjustment in the early 1980s, Turkey has maintained a rate of growth of above 5 per cent in the past three years. Real GDP of Yugoslavia, after a period of protracted recession since 1980, grew by 3 per cent in 1986.

### **The fight against inflation in 1986**

The sustained efforts of a number of developing countries to correct external and domestic imbalances, particularly by implementing policies to reduce government budget deficits, have had an important effect in reducing inflation. But a significant development in 1986 was the pervasive deceleration of inflation in some of the countries that followed unorthodox policies. Nearly all countries that had been experiencing hyperinflation or the threat of it in 1985 exhibited a remarkable slow-down in the pace of price increases by mid-1986.<sup>24</sup> Between 1985 and 1986, the annual average rate of inflation in consumer prices in Argentina declined from 385 per cent to about 80 per cent, in Bolivia from more than 8,000 per cent to less than 100 per cent, in Brazil from some 230 per cent to about 70 per cent, in Israel from more than 300 per cent to under 60 per cent, and in Peru from 150 per cent to 60 per cent.

The unorthodox policies adopted by these countries to fight inflation relied heavily on measures designed to lower inflationary expectations, including price controls, de-indexation and rules for wage-setting in the public and private sectors. Soon after the introduction of the stabilization plans, inflationary pressures eased considerably. However, after a year of application of the plans, serious problems persist and certain imbalances have emerged in some of these countries, particularly Brazil, as prices of a large number of goods, services and production factors have not adjusted adequately to reflect relative scarcities. Plans have entered a second phase in which attention has shifted to the fiscal imbalances, with the objective of achieving a better mix in the structure of relative prices in the context of a reduced inflation rate. The rapid decline in inflation,

<sup>23</sup> See Andres Bianchi, Robert Devlin and Joseph Ramos, "The adjustment process in Latin America 1981-1986", paper prepared for the Symposium on Growth-Oriented Adjustment Programs, convened by the World Bank and the International Monetary Fund, Washington, D.C., 25-27 February 1987.

<sup>24</sup> Only in the case of Mexico and Nicaragua was there a sharp acceleration in the rates of inflation.

through its effect on tax revenues, had already led to some automatic reductions in fiscal imbalances (as a share of GDP). However, as inflation rates began to stabilize in countries in which the thrust of the fiscal policy had not been changed, fiscal deficits widened again and inflation rates showed some acceleration in the latter part of 1986.

In the great majority of the developing countries, particularly those in South and East Asia, inflation rates have continued to subside and remain at comparatively low levels.

### Selected policy issues

Even though some developing countries have succeeded in growing at a fast pace despite external adversities, the economic progress of many developing countries during the 1980s has been particularly disappointing. The lack of flexibility that has characterized most of their economies, in part as a result of past policies but mainly because of internal structural factors, has proved to be a serious handicap in a period of a rapidly changing international environment. The erratic behaviour of international trade in the period 1980-1984 and its modest growth in 1985-1986, together with significant declines in primary commodity prices, has required substantial structural adjustments as well as major changes in the conduct of economic policy in commodity-exporting countries.

Moreover, the shift from a régime of low to one of high real interest rates in the industrial countries, accompanied by a retrenchment of international bank credit, has required a major redirection in the economic policies of a large number of the developing countries that earlier had borrowed heavily from international commercial banks. As protectionist pressures have become a reality in the developed countries, the major exporters of manufactures among the developing countries also have had to undertake adjustments to lessen their vulnerability to international trade. These adjustments have included less reliance on foreign commercial lending, lowering the level of external debt, accumulation of reserves, strengthening of the agricultural sector and reorientation of exports towards faster growing markets and new product lines.

The economic adjustments in the large majority of the developing countries have been mostly of a contractionary nature. In the process, most economic groups living in urban areas have been affected. While the need to protect the most vulnerable groups is being increasingly recognized, progress has been slow. Efforts have been hampered by tight fiscal conditions and by a lack of institutions and policy instruments to reach and assist the affected groups in an effective way. In only a few cases has adjustment been accompanied by an acceleration in the output growth rate.

### Savings and investment

A major factor in the slow-down of economic growth in developing countries has been the decline in investment. The rate of investment has continued to fall as the decline in the inflow of capital from abroad (foreign savings) has been accompanied by marked decreases in the level of domestic savings.<sup>25</sup> It is estimated that the gross capital formation as a share of gross domestic product for the capital-importing developing countries as a whole fell by more than 5 percentage points between the late 1970s and the mid-1980s. Yet about a quarter of those countries still managed to achieve a significant increase in that share. As analysed in chapter VIII, investment and savings ratios increased in several countries between the second half of the 1970s and the mid-1980s.

In Africa and Latin America—the regions hardest hit by the external debt problem—the investment ratio fell by more than 6 percentage points during the same period. For the developing countries as a group, central government fiscal deficits as a share of gross domestic product doubled in the same period, though much of the rise was concentrated among the energy exporters. The reduction in the level of net domestic savings in the developing countries reflects both a deterioration in the fiscal deficits of central Governments and a reduction in the level of private savings as real incomes declined.

An important structural factor that has affected the savings-investment balance in many developing countries, although to varying degrees, is the considerable dependence of public sector revenues on trade-related activities. As shown in table II.10, while the share of tax revenues derived from international trade for the developed market economies in 1983-1984 was, on average, about 3.9 per cent, for the developing countries it was more than 25 per cent. For a few developing countries, the trade-dependence ratio was as high as two thirds, while the maximum ratio for the developed countries was no more than 16 per cent.

Since import tariffs usually constitute an important share of the fiscal revenues, any shock that reduces the capacity to import—for example, a drop in capital inflows—leads to a significant decrease in fiscal revenues. More important, in many countries government revenues, development budgets and investment plans are often closely linked to export taxes or surpluses generated by publicly owned export-oriented firms. An adverse external demand shock for exportable products not only has a direct effect on the fiscal budget because of an abrupt reduction in public sector revenues, but also has indirect effects through the diminished capacity to import.

<sup>25</sup> For several studies concerning investment performance in the developing countries during the 1980s, see ECLAC, "Preliminary overview of the Latin American economy, 1986" (LC/G.1454); M. Watson, D. Mathieson, R. Kincaid, and E. Kalter, *International Capital Markets: Developments and Prospects*, Occasional Paper No. 43 (Washington, D.C., IMF, February 1986), pp. 77-81. Inter-American Development Bank, *World Economic Survey 1986* (Washington, D.C.), pp. 23-25; (United Nations publication, Sales No. E.86.II.C.1), pp. 108-121; IMF, *World Economic Outlook*, April 1986, pp. 58-60.

Table II.10 Sources of central government revenue in developed and developing countries, 1978-1984

	Taxes on net income and profit (percentage of total revenues)		Taxes on international trade (percentage of total revenues)	
	1978-1979 <sup>a</sup>	1983-1984	1978-1979 <sup>a</sup>	1983-1984
<b>Developing countries</b>				
Mean <sup>b</sup>	20.2	22.7	30.1	25.1
Co-efficient of variation <sup>c</sup>	0.5	0.6	0.5	0.6
Range	71.5-3.3	67.0-3.1	66.3-4.4	70.8-2.7
<b>Developed market economies</b>				
Mean <sup>b</sup>	33.3	31.6	4.3	3.0
Co-efficient of variation <sup>c</sup>	0.5	0.5	1.3	1.3
Range	64.7-9.8	60.9-9.2	21.6-0.0	15.9-0.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Government Finance Statistics Yearbook*, 1979 and 1986.

- a 1978-1979 was chosen to show the degree of dependency before the onset of the slow-down of world trade in the 1980s.  
b Unweighted arithmetic mean.  
c Ratio of standard deviation to mean. The smaller the ratio (i.e., the closer it is to zero), the less variation there is.

Increasing domestic taxes and issuing government bonds are not viable options for policy makers in most developing countries. Domestic capital markets are underdeveloped and new taxes, particularly income taxes, usually have administrative and legislative delays and are difficult to collect. Moreover, it is both economically and politically difficult to increase taxes at a time when personal incomes and profits are either stagnant or falling. There are other policy alternatives to increase investment levels, but they require either a reduction in government consumption, which could prove costly in political terms, or monetization of the public sector deficit which, because of the inflationary pressures that it usually induces, is likely to be counterproductive in the medium term.

Energy-importing developing countries have resorted to a mixture of policy responses to the trade-related fiscal shocks of the 1980s. One common feature was an abrupt fall in public investment, including funding for national development banks, which often constitute the major source for medium-term to long-term finance of the domestic private sector. In the second half of the 1980s, the reverberations of the external shocks have begun to subside and new policies have contributed to an improvement in the public sector financial position in a number of countries. However, the modest growth of international trade has limited these countries' room for policy manoeuvre and does not provide a large domestic stimulus to speed up growth.

The policy dilemmas faced in the energy-exporting developing countries have been formidable. The economic situation in these countries has deteriorated ever since the positive effects of oil price changes on trade-related public revenues peaked in 1981. Thereafter, because of slowly growing or declining export volumes, but particularly as the result of the oil price counter-shock that began in late 1985, there have been widespread and drastic cut-backs in the development budgets of these countries. A big problem facing some of the Middle Eastern oil exporters is the financial

crisis of their large private enterprises. Although the Governments of the countries of the region are still net creditors, the combination of private capital flight and a sharp drop in asset values has brought a large-scale financial crisis to some of the countries in the Persian Gulf area.

Exogenous factors have also played direct roles in reducing private savings in the developing countries in recent years. First, real per capita incomes have been adversely affected by the deterioration of the terms of trade in the 1980s, which in turn has inhibited private savings levels despite increases in domestic real interest rates. Secondly, countries with large external debts, or countries that had to rely heavily on short-term official or commercial credit, experienced sudden declines in profits as domestic firms faced a rapid rise in the outflow of resources to service their external debt. In sum, given the present constraints on domestic savings and the sharp decline in the net inflows of foreign financial capital into these countries, investment rates are likely to remain depressed in many developing countries. This in turn will restrain the rate of growth of output from accelerating far above the average of the 1980s.

Although the nominal interest rates in industrial countries have been on a downward trend since 1984, the burden of servicing external debt has been increased for developing countries because their export prices have declined more than the international interest rates. Many developing countries have been forced to redirect their investment policies towards smaller-scale, possibly more efficient, investments with shorter gestation periods. In some countries, where market incentives have been used aggressively to promote private initiative, the results thus far have been encouraging, particularly in the agricultural sector. Although it is still too early to generalize, it seems that the new policies of liberalization and deregulation of markets have led to a measurable acceleration in the growth of output in a number of countries in the mid-1980s. But it remains to be seen to what extent the new policies will lead to a sustained rise in per capita in-

comes in the absence of significant stimulus from either world trade or international financial capital.

### Economic interactions, policy debate and large external imbalances among the developed market economies

The main driving forces that affected prices, trade, output and employment in nearly every industrial country in 1986 were set in motion by the depreciation of the dollar and the fall in oil prices. The dollar decline, by affecting the relative competitiveness of each country internationally, redistributed demand away from the tradable goods and services produced in the yen and deutsche mark currency zones towards those produced in the dollar zone. The decline in oil prices benefited the energy-using sectors but hurt the energy industry, which suffered a significant decline in investment and employment in the major oil-producing countries. Externally, the industrial countries benefited from a terms of trade gain of some \$95 billion against the energy- and commodity-exporting developing countries, but their exports to the developing countries fell sharply.

Despite the terms of trade gain of about 1.5 per cent of their combined GDP, real output in the industrial countries increased by only 2.4 per cent in 1986 a deceleration of 0.5 per cent in comparison with 1985. Real domestic demand, however, grew by 3.5 per cent, 0.5 per cent higher than in 1985. The higher demand growth reflected the favourable impact of the lower oil prices on private consumption expenditures. On the other hand, private investment in several major economies weakened, particularly in the latter half of 1986.

The strengthening of domestic demand was more marked among the major European economies (France, the Federal Republic of Germany and the United Kingdom), while in

Japan and the United States demand grew at virtually the same rate as in 1985 (table II.11). There was, however, a significant weakening in the United States in the latter half of 1986 due to a decline in business investment rate and a slow-down in consumer demand. Uncertainty regarding the effect on business investment of the 1986 Tax Reform Bill was the major factor behind the 1.5 per cent drop in real non-residential investment in the United States in 1986.

Although real disposable income increased by 3 per cent for the year as a whole in the United States, it began to decline in the second half of 1986. The consumption level was maintained to a large extent because of a continued decline in the savings ratio, which fell to 2.7 per cent in the fourth quarter of 1986—the lowest rate since 1939. Moreover, the consumer debt rose sharply to a record level—about 17.5 per cent of GNP. However, increases in prices of equities and real estate in the United States in 1986 prevented the ratio of household assets to liabilities from changing significantly. In the Federal Republic of Germany and Japan, real domestic demand also began to weaken towards the end of 1986 as exports began to suffer from the sharp appreciation of their currencies against the dollar, and as energy-exporting developing countries reduced imports. In both of these countries, the fall in exports has begun to seriously affect the trade-related investment and employment.

Major differences in external and internal sources of output growth notwithstanding, there was considerable convergence in output performance in 1986. Real GNP grew by about 2.5 per cent in France, Italy, Japan and the United States. The Federal Republic of Germany's output grew by 2 per cent, and that of Canada and the United Kingdom by 3 per cent and 2.8 per cent, respectively. The smaller industrial countries grew by 2 per cent, which was a slightly

Table II.11. Contributions of domestic demand (DD) and net foreign demand (FD) to GDP growth, 1984-1986

	Developed market economies			Federal Republic of Germany			Japan			United States		
	GDP growth	DD <sup>a</sup> growth	FD <sup>b</sup> growth	GDP growth	DD <sup>a</sup> growth	FD <sup>b</sup> growth	GDP growth	DD <sup>a</sup> growth	FD <sup>b</sup> growth	GDP growth	DD <sup>a</sup> growth	FD <sup>b</sup> growth
	Percentage change											
1980-1985 <sup>c</sup>	2.0	1.9	0.1	1.2	0.3	0.9	3.9	2.5	1.4	1.9	2.5	-0.6
1984	4.4	4.8	-0.3	3.3	2.2	1.1	5.1	3.7	1.3	6.4	8.4	-1.9
1985	2.9	3.0	-0.1	2.5	1.5	1.0	4.7	3.7	1.0	2.7	3.4	-0.7
1986 <sup>d</sup>	2.4	3.5	-1.1	2.1	3.6	-1.5	2.5	3.8	-1.3	2.5	3.6	-1.1
1986 <sup>d e</sup>												
First quarter	2.5	3.5	-1.0	1.7	1.7	0.0	3.0	3.2	-0.2	3.1	4.4	-1.3
Second quarter	2.8	4.3	-1.5	3.3	5.0	-1.7	2.5	4.4	-1.9	2.7	3.9	-1.3
Third quarter	2.6	4.0	-1.4	2.3	3.2	-0.9	2.4	4.3	-1.6	2.2	3.6	-1.4
Fourth quarter	..	..	..	..	..	..	2.0	3.6	-1.6	2.0	2.5	-0.4

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *Quarterly National Accounting* and other official sources.

- a Rate of growth of real domestic demand, which is the sum of consumption expenditure and gross domestic investment.
- b Change in real foreign (trade) balance as a percentage of previous year's GDP/GNP.
- c Annual average growth rates.
- d Preliminary estimates.
- e Quarterly growth figures are annual rates calculated with respect to the corresponding quarter in the preceding year.

slower pace than in 1985. There was, however, a marked diversity of performance among those economies. The major exporters of food and other primary commodities, Australia and New Zealand, suffered terms of trade losses and their real output grew very little or fell. There was also a slow-down in the pace of economic activity in Belgium, Finland, Greece, Ireland and the Netherlands all of which grew at less than 2 per cent in 1986. In Denmark, Norway, Portugal and Switzerland, however, output grew by 3 per cent or more.

Inflation declined in nearly all industrial countries and the average rate fell to less than 3 per cent—the lowest in more than a quarter of a century. However, in four countries, Greece, Iceland, Portugal and New Zealand, the inflation rate was still in double digits, while in Japan and Switzerland inflation fell to less than 1 per cent, and in the Federal Republic of Germany it was slightly negative. Most of the decline in inflation rates in 1986 was due to the fall in raw material prices, but the rate of change in unit labour costs in manufacturing, also a major determinant of costs and prices, remained fairly moderate in most countries within the group.<sup>26</sup> The average rate of increase in hourly wages in manufacturing in 1986 was the lowest in more than two decades. The unemployment rate remained stubbornly high at about 8 per cent for the group as a whole. This persistent problem plaguing many industrial economies, particularly in Western Europe, is the subject of a more detailed analysis in chapter VII below.

The major developed market economies have reached an important juncture in their conduct of macro-economic policies. Although their overall budgetary and monetary policies have remained cautious, major inconsistencies among their policies have given rise to serious risks for the international economy. Despite efforts in 1985, 1986 and February 1987 to raise the level of economic co-operation, major economic problems not only remain, but have intensified. As at early 1987, the major macro-economic problems facing the industrial countries were massive trade imbalances; instability in foreign exchange markets, particularly the sharp decline of the dollar; very high rates of unemployment in the large majority of the countries; and the potential negative implications of the developing countries' external debt crisis for international financial stability and for the creditor countries themselves.

These policy issues are intimately related to one another. The key variable that links them together is the growth in the industrial countries of aggregate demand and its geographical distribution. The major policy debate has, therefore, centred on the desirability of a higher rate of growth of demand, its distribution among the major economies, and the policy changes needed to achieve the desired results. The United States Government, in order to avoid a recession and to stave off the intense political pressure for protectionist measures, wants to see the massive trade deficit narrow sig-

nificantly and quickly. It has urged the other major industrial economies to step up their demand growth in order to absorb more United States exports. It has been argued that if demand in the rest of the world does not grow at a sufficiently fast pace, the dollar will fall even more and protectionist legislation will have to be acted upon to narrow the trade deficit in the United States.

It should be pointed out, however, that more than a quarter of the \$100 billion increase in the United States trade deficit between 1982 and 1986 has been with the developing countries, which, because of the debt problem and the collapse of commodity prices, have had to cut back their imports.

### Fiscal and monetary policy

Data on structural, or cyclically corrected, budget balances show that the fiscal stances of the Federal Republic of Germany and Japan until 1986 were restrictive while that of the major industrial countries as a whole was expansionary (see table A.10). However, a major policy shift is taking shape among the major industrial countries in the area of fiscal policy, which, on balance, is moving towards restriction. The most important aspect of the shift is the gradual tightening of the fiscal stance in the United States. Other changes as at early 1987 involve a moderate expansion in the Federal Republic of Germany, Japan and the United Kingdom, and a movement towards restriction in Canada, France and Italy.

The main objective of monetary policy in all major economies has remained that of continual downward pressure on inflation and inflationary expectations, and the policy posture of the three major economies has been only cautiously accommodative (see table A.11). Even though monetary aggregates have been growing at the upper bound of officially set targets (or above, in the case of the Federal Republic of Germany), the declining income velocity of money has made policies less accommodative than had been anticipated by the monetary authorities. Falling nominal interest rates and deceleration of inflation were the key factors behind the decline in velocity in 1986. Financial innovations, deregulation of financial markets and, in general, greater substitutability between money and other financial instruments account for the unpredictability of money demand. The high degree of volatility of demand for money in most of the major industrial countries in recent years has put the usefulness of monetary targets in doubt. In early 1987 the monetary authorities in the United States stopped targeting the M1 (i.e., currency in circulation plus demand deposits), the most volatile monetary aggregate in that country.

Although the reductions in official discount rates caused significant declines in nominal interest rates in many countries, most of the reductions came in the latter half of 1985 and early 1986 when oil prices began to fall precipitously. The favourable effect of the oil price declines on inflation

<sup>26</sup> Unit labour cost (ULC) in manufacturing is defined as the nominal wage bill per unit of real output in the manufacturing sector. The percentage change in ULC is equal to the percentage change in the average nominal wage rate less the percentage change in average labour productivity (output per man-hours).

rates caused real interest rates to remain very high; indeed, they increased in both the Federal Republic of Germany and Japan.

### Attempts at policy co-ordination in industrial countries

The policy makers in the major industrial countries have recognized that the magnitude and nature of the problems facing their economies are such that their resolution requires frequent consultation, discipline and tight co-ordination in the conduct of macro-economic policy. Several major attempts have been made in that direction in the past two years. These were the Group of Five agreement (the Plaza Agreement) on exchange rate realignments and macro-economic policy adjustments (New York, September 1985); the policy declarations of the Tokyo summit meeting of the Group of Seven in May 1986; the bilateral agreements between the United States and Japan in mid-1986 on the yen-dollar exchange rate; and the Group of Six agreement (the Louvre Agreement) on policy realignments and joint intervention in foreign exchange markets to stabilize the exchange rate of the dollar (Paris, February 1987).

Despite these agreements, in the first quarter of 1987 the dollar fell sharply *vis-à-vis* all key currencies. The international currency markets were awaiting evidence supporting the declared policy pronouncements, particularly the intended reflation in the Federal Republic of Germany and Japan. Meanwhile, as the dollar declined, tensions began to develop over trade issues among the key countries.

Continued instability in the currency markets and further decline of the dollar have dangerous repercussions. They could induce a deep recession in Europe and Japan with adverse global repercussions. A recession would reduce those countries' imports from the United States. Moreover, a sharp and disorderly depreciation of the dollar would also be potentially troublesome for the United States since it would eventually lead to a higher rate of inflation and, most likely, to higher nominal rates of interest there.

The highly expansionary fiscal stance of the United States between 1982 and 1986 (see table A.10) has been a major cause of the deterioration in the trade position of the United States. The size of that country's fiscal deficit is expected to decline by \$30 billion in 1987, to about \$180 billion. This is a sizable reduction even though it fails to reach the target level of about \$150 billion set by the Balanced Budget and Emergency Deficit Control Act of 1985 (the Gramm-Rudman-Hollings bill). However, a more decisive policy shift in the United States has to be made and co-ordinated with the other major actors to avoid the possibility of a world-wide recession, with the major market economies in Europe and Japan accelerating their demand growth as pledged in the Louvre Agreement in February 1987. The policy makers in these countries fear that a significantly higher rate of growth

of demand will trigger inflationary pressures, particularly if the demand for raw materials expands too rapidly.<sup>27</sup> Moreover, Japan has argued that its central government budget deficit in relation to GNP is already quite large (see table A.10) and that the burden of public debt, measured as the ratio of debt to GNP, has increased from 28 per cent in 1980 to more than 40 per cent in 1985.

### Persistence of large external imbalances

The massive external payments imbalances that have emerged since 1983 in several major industrial countries have proved difficult to eliminate, and their persistence has had highly undesirable side effects on the world economy. They have already fundamentally altered global economic relations, and their prospective ramifications, both in real and financial terms, continue to be a major cause for concern. These imbalances are very large and still growing: the current account deficit of the United States rose from \$9 billion in 1982 to \$140 billion in 1986, or about 3.3 per cent of the country's GNP in 1986.<sup>28</sup>

To a large extent, the counterpart of the United States deficit has been the current account surpluses of the Federal Republic of Germany and Japan, which together rose from \$11 billion in 1982 to \$122 billion in 1986. Japan's surplus, in both absolute and relative terms, is unprecedented. At \$86 billion, Japan's surplus in 1986 was nearly twice as large as that of the previous record holder—Saudi Arabia in 1980. Relative to the size of its economy, Japan's current account surplus has also been growing very rapidly, from less than 1 per cent of GNP in 1982 to 4.2 per cent in 1986.

A major factor that distinguishes the present imbalances among the major industrial countries from those experienced in the 1970s is their persistence. The current account surplus of the countries members of OPEC emerged in 1974 and had disappeared by 1978, and OPEC's larger surplus of 1980 (\$106 billion) turned into a sizable deficit in just two years. Another important distinction between the 1970s and the 1980s is the source of the imbalances. The large current account deficits and surpluses of the 1970s emerged because of the sharp increases in the prices of oil and other raw materials, and were mainly between the industrial countries and the energy-exporting developing countries. The payments imbalances of the 1980s have been mainly among the major industrial countries and, to a large extent, are the result of inconsistencies in their macro-economic policies.

The magnitude and persistence of the present global imbalances have had three major repercussions. First, the massive international capital flows that have financed the current account deficits among the industrial economies have taken place at a time of near-stagnation in financial flows to the capital-importing developing countries and have lowered real interest rates in the receiving countries

<sup>27</sup> There is some empirical evidence that supports this hypothesis (see W. Beckerman and T. Jenkinson, "What Stopped the Inflation? Unemployment or Commodity Prices?", *The Economic Journal*, March 1986, pp. 39-54).

<sup>28</sup> Only Italy and the United Kingdom (in 1975) had current account deficits as a percentage of their GDP larger than that of the United States in 1986.

relative to those in the rest of the world. Secondly, the magnitude of the present and prospective external imbalances and their implied financing requirements have led to excessive volatility in foreign exchange and financial markets, as uncertainty about policy responses and their impact has infiltrated the markets. In such an environment, decision-making by economic agents investors in particular has become exceedingly difficult. Thirdly, the trade imbalances have heightened protectionist pressures in the deficit countries; in cases where threats have turned into action, the dynamism of world trade has been reduced.

The origin of the imbalances lies in part with the serious and prolonged misalignments among the exchange rates of key currencies in the period 1980-1985. However, the major cause of their emergence and their persistence has been the significant differences in the rates of growth of real domestic demand, mainly induced by policy, among the major industrial countries. Between 1980 and 1985, the annual rate of growth of real domestic demand was 3.6 per cent in the United States, 2.9 per cent in Japan, and only 0.5 per cent in the Federal Republic of Germany (see figures II.7 and II.8). In the same period, the dollar appreciated by 5 per cent against the yen and by 60 per cent against the deutsche mark. These two influences provided a strong external boost for the economies of the Federal Republic of Germany and Japan and a major drain on the United States economy. Several studies measuring the size of the effects of exchange rate movements and of the differential growth rates of domestic demand seem to indicate that the trade imbalances would have widened even in the absence of exchange rate movements, but that the latter played a key role in aggravating the situation.<sup>29</sup>

A persistent deterioration in the current account balance of a country is, in most instances, a reflection of an excess of aggregate demand over aggregate domestic production of goods and services; to eliminate such an imbalance, either domestic production has to be increased or domestic demand has to be reduced. The sharp deterioration in the United States current account balance between 1982 and 1986 is a direct result of such an internal imbalance. It is closely linked to the developments in the budget balance of the United States Government (see figure II.9) and to the changes in the balance between private savings and investment in that country over the same period. As shown in table II.12, the general government budget of the United States was consistently in deficit between 1982 and 1986 in the amount of about 3.5 per cent of GNP. In the same period, domestic sources of financing for this deficit dried up, as the excess of gross private savings over gross private domestic

investment fell from 3.5 per cent of GNP (17.6 less 14.1) in 1982 to zero (16.2 less 16.3) in 1986. Foreign savings (net inflow of capital into the United States) have become the main source of financing of the budget deficit. The major causes of the change in the savings and investment balance of the United States have been the sharp decline in the personal savings rate (from 6.8 per cent of disposable income in 1982 to 3.9 per cent in 1986), and a significant rise in gross private domestic investment during the period 1982-1985 as the economy, mainly fuelled by the government budget deficit, expanded. Although private investment has begun to slacken, excess domestic savings have not occurred as a result.

In the Federal Republic of Germany and Japan, the situation regarding the savings and investment balance has differed widely from that in the United States. In Japan, gross domestic investment has declined as a share of GNP, while private savings have remained steady and the government budget deficit has been sharply reduced. The combination of these elements has created an excess of domestic production over domestic demand, giving rise to a net outflow of resources that has risen continuously since 1983 and amounted to more than 4 per cent of the GNP of Japan in 1986. In the Federal Republic of Germany, on the other hand, gross domestic investment as a percentage of GNP has remained more or less steady, but private savings have increased, while the government budget deficit has declined significantly. Hence, in both the Federal Republic of Germany and Japan, the excess of the domestic supply of goods and services over domestic demand has resulted in a continuous increase in the outflow of capital from 0.4 per cent of their combined GNP in 1982 to 3.5 per cent in 1986. Such factors as exchange rates, personal saving rates, tax rates and trade elasticities, among others, have important roles in explaining the persistent imbalance in the current accounts of the three largest industrial economies, but the evidence indicates that the main cause lies in the divergence in fiscal developments among these countries.<sup>30</sup>

Since early 1985, the rates of growth of real domestic demand in the United States and Japan have become virtually the same (see figure II.10). In the European Economic Community, mainly because of the Federal Republic of Germany, there was an acceleration in the rate of increase in domestic demand in 1986. In addition, the value of the dollar has fallen precipitously since early 1985. Yet the imbalances have persisted; and although there are signs that they may stop growing, there are likely to be delays in the adjustment process. There is also the fear that, as long as the underlying policy causes are not corrected more decisively, the adjust-

<sup>29</sup> See Vincent Reinhart, "Macroeconomic influences on the U.S.-Japan trade imbalance", *Federal Reserve Bank of New York Quarterly Review*, Spring 1986, pp. 6-11. This study finds that the slower income growth in Japan than in the United States in 1980-1985 accounted for about 40 per cent of the deterioration in the bilateral trade balance. An earlier study by Stephen Marris (*Deficits and the Dollar: The World Economy at Risk* (Washington, D.C., Institute for International Studies, December 1985)), looking at the entire period 1980-1984, found that the growth gap between the United States and the rest of the world accounted for 25 per cent of the total deterioration in the United States current account deficit. However, in 1984 the growth gap effect had grown to 50 per cent.

<sup>30</sup> See Philip Turner, "Savings, investment and current account: an empirical study of seven major countries, 1965-1984", Bank of Japan, *Monetary and Economic Studies*, vol. 4, No. 2 (October 1986), pp. 1-58; Bank for International Settlements, *Annual Report* (Basle, June 1986), pp. 62-66; Council of Economic Advisers, *Economic Report of the President* (Washington, D.C., United States Government Printing Office, February 1987), pp. 107-113.

Figure II.7. United States: output and domestic demand  
(Index: 1980=100)

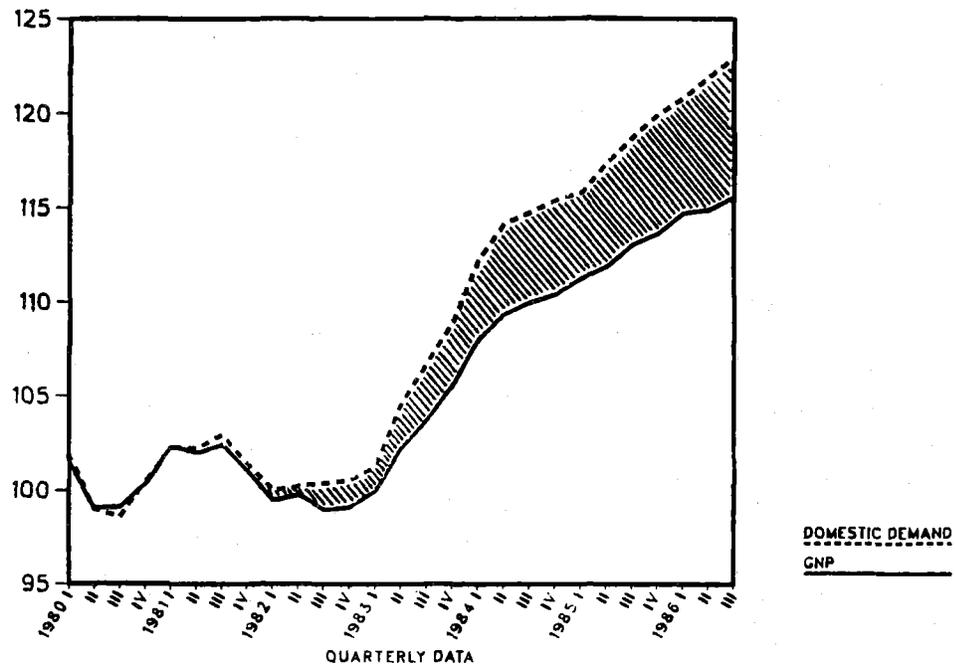
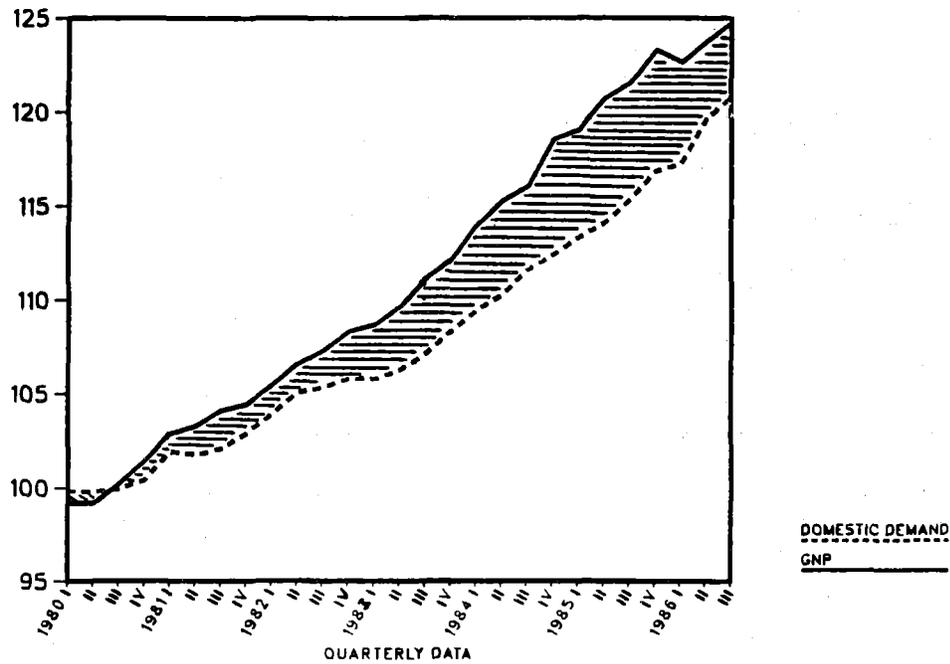
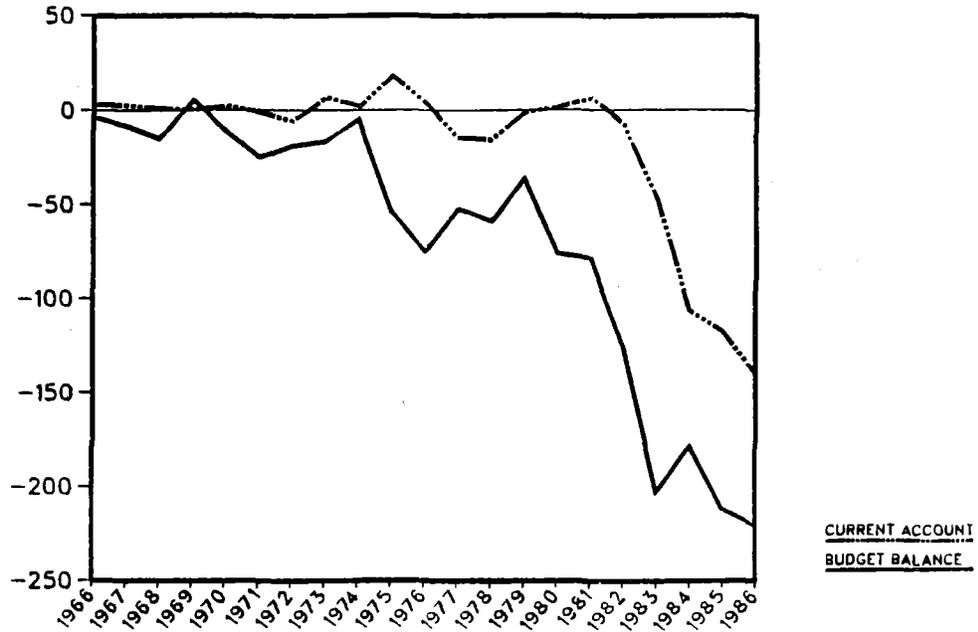


Figure II.8. Japan: output and domestic demand  
(Index: 1980=100)



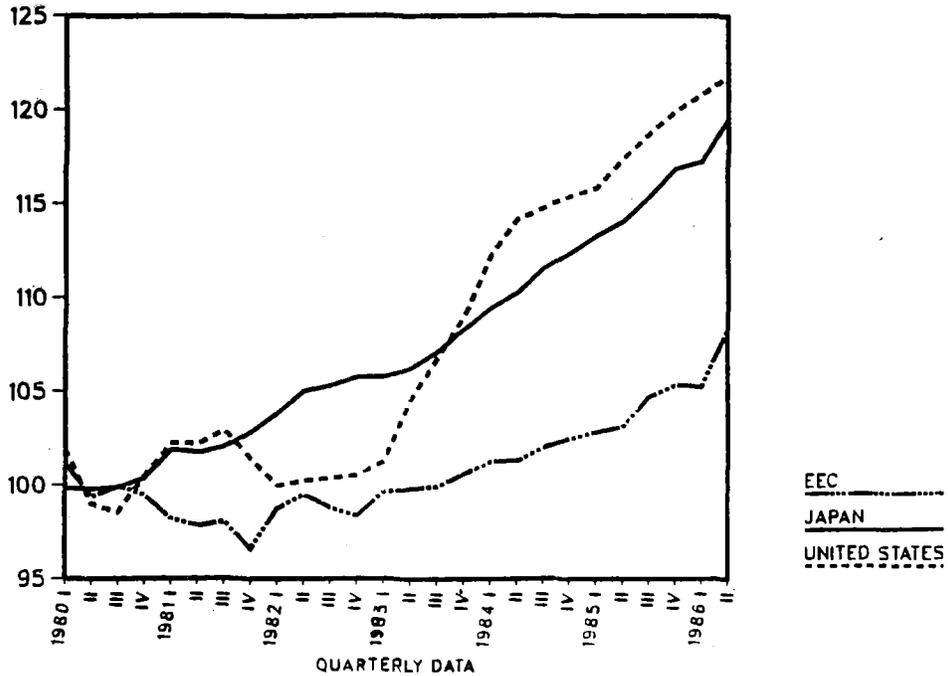
Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *Quarterly National Accounts*.

Figure II.9. Budget and current account balances of the United States (Billions of dollars)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Council of Economic Advisers, *Economic Report of the President* (Washington, D.C., United States Government Printing Office, February 1987).

Figure II.10. Domestic demand in EEC, Japan and the United States (Index: 1980=100)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *Quarterly National Accounts*.

Table II.12. Global payments imbalance and savings-investment balance of the United States, 1979-1986

	1979	1982	1983	1984	1985	1986 <sup>a</sup>
	Billions of United States dollars					
Current account balance <sup>b</sup>						
United States	-1	-9	-47	-106	-118	-141
Japan	-9	7	21	35	49	86
Germany, Federal Republic of	-6	4	4	7	13	36
	Percentage of GNP					
Net capital inflow <sup>c</sup> (foreign savings)						
United States	0.1	-0.0	1.1	2.4	2.7	3.5
Japan	0.9	0.7	-1.8	-2.8	-3.9	-4.2
Germany, Federal Republic of	0.8	-0.4	-0.5	-0.8	-2.0	-3.5
Government savings <sup>d</sup>						
United States	0.5	-3.5	-3.8	-2.7	-3.4	-3.4
Gross private savings						
United States	17.8	17.6	17.4	17.9	17.2	16.2
Gross private domestic investment <sup>e</sup>						
United States	18.2	14.1	14.7	17.6	16.5	16.3
Memorandum item:						
Inflow of capital to the United States <sup>f</sup>						
(billions of dollars)	64	127	101	128	150	240

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *OECD Economic Outlook*, No. 40 (December 1986), United States Federal Reserve Bank, *Federal Reserve Bulletin* (Washington, D.C.), various issues; Council of Economic Advisers, *Economic Report of the President* (Washington, D.C., United States Government Printing Office, 1986 and 1987); and Bank for International Settlements, *Fifty-Sixth Annual Report* (Basle, 1986).

<sup>a</sup> Preliminary estimates.

<sup>b</sup> Including official transfers.

<sup>c</sup> Including statistical discrepancy; minus sign indicates an outflow.

<sup>d</sup> General government budget balance, which is the sum of the budget balances of federal, state and local governments.

<sup>e</sup> By definition, gross private domestic investment is equal to the sum of government savings, gross private savings and net capital inflow.

<sup>f</sup> Sum of the net changes in foreign official and private assets in the United States plus the errors and omissions of the balance of payments of the United States.

ment pressure will fall upon exchange rates among key currencies and interest rates; these may easily overshoot their desirable levels, making the eventual correction process extremely costly.

While the legacy of the large United States budget deficit and its eventual correction weighs heavily in achieving a more sustainable trade deficit in that country, there are still other factors that might make the adjustment process unduly protracted. First, the dollar has not depreciated evenly against all currencies, as analysed in chapter III, and has appreciated against the currencies of main trading partners of the United States, namely Canada and Mexico, with whom the United States has a substantial bilateral trade deficit. Secondly, many exporters to the United States have not passed on to consumers the full impact of the dollar depreci-

ation, opting instead to protect their market shares and to let their profit margins be squeezed, at least in the short run.

A third factor, structural in nature, is that the ratio of United States merchandise imports to exports has become very high, rising from 1.10 in 1979 to 1.65 in 1986. The 65 per cent excess of United States imports over its exports currently means a difference of \$145 billion. The opposite is true for Japan: in 1986, its exports were 65 per cent larger than its imports. For the Federal Republic of Germany, the difference is less glaring: exports exceed imports by about 30 per cent. Given these initial conditions, it will take some time for the corrections to become visible, even though there have already been substantial price and income adjustments.

Fourthly, income elasticity of demand is relatively low for

United States exports, and quite high for its imports. The opposite is true for Japan.<sup>31</sup> Estimates made by the United Nations Secretariat of the income elasticities for exports are about 1.0 for both the United States and the Federal Republic of Germany and 1.75 for Japan. On the other hand, the income elasticity of imports is over 2 for the Federal Republic of Germany and the United States, and only 0.75 for Japan. These differences are closely linked to the commodity composition of each country's exports and imports.<sup>32</sup> An important policy implication of the differences in income elasticities is that stimulating domestic demand will be more effective in the Federal Republic of Germany than in Japan in reducing the trade surplus. Moreover, given the initial conditions and the income elasticities of exports and imports, real imports by the rest of the world must grow more than three times as fast as the rate of growth of real domestic demand in the United States in order for the United States to reduce its trade deficit quickly.<sup>33</sup>

A fifth factor affecting the adjustment of the trade balances is price elasticities of exports and imports. Economic

theory holds that, if price elasticities of demand for exports and imports add up to more than unity, exchange rate adjustments will lead to a correction of trade imbalances.<sup>34</sup> However, trade volumes may adjust only slowly to price changes induced by exchange rate realignments; initially trade imbalances may even worsen in nominal terms. This phenomenon, which is known as the J-curve effect, has been an additional factor in delaying the adjustments in the trade imbalances.<sup>35</sup>

A sixth set of factors that may have played a critical role in the emergence of global imbalances is the large, and sometimes destabilizing, changes in real exchange rates brought about by excessive capital mobility.<sup>36</sup> The attractiveness of United States assets to foreign investors, in part because of higher interest rates in the United States caused by the expansionary fiscal policy, has also been a factor in delaying the correction of the United States imbalance. Uncontrolled and excessive capital flows, together with relatively slow adjustments in product and labour markets, can lead to very large shifts in relative prices through exchange rate changes.

<sup>31</sup> For an analysis of the statistical estimates of income and price elasticities of export and import demand for the United States, the Federal Republic of Germany and Japan, see Yuzo Kumasaka, "Japan's trade surplus since the G-5 meeting of September 1985", Department of International Economic and Social Affairs of the United Nations Secretariat, Working Paper No. 3, May 1987.

Income elasticity of demand for imports is defined as the percentage change in the volume of imports demanded induced by a 1 per cent increase in the country's real income, holding all other variables, including prices, constant. Income elasticity of demand for exports is defined as the percentage change in the volume of exports demanded induced by a 1 per cent increase in the real income of the country's trading partners, holding all other variables, including prices, constant.

Price elasticity of export demand is defined as the percentage change in the volume of exports when the export price increases by 1 per cent, holding the real income of trading partners and all other prices fixed. Price elasticity of import demand is defined as the percentage change in the volume of imports when the import price increases by 1 per cent, holding the country's real income and all other prices constant.

Estimates of export and import demand equations are shown in the following table:

Trade volume by country	Income elasticity	Price elasticity <sup>a</sup>	
		Short-term <sup>b</sup>	Long-term <sup>b</sup>
Germany, Federal Republic of			
Exports	0.95	-0.04	-0.36
Imports	2.04	-0.21	-0.46
Japan			
Exports	1.75	-0.06	-1.35
Imports	0.75	-0.03	-0.49
United States			
Exports	1.00	-0.21	-0.93
Imports	2.19	-0.30	-1.20

Note: Estimation method: ordinary least squares; period of estimation: first quarter 1977 to first quarter 1986.

<sup>a</sup> Relative price of exports: unit value of exports in dollars divided by that of the rest of the world; relative price of imports: unit value of imports in domestic currency divided by the country's wholesale prices.

<sup>b</sup> Short-term: one quarter; long-term: eight quarters.

<sup>32</sup> In general, internationally traded manufactures have a higher income elasticity of demand than that of raw materials. In 1985-1986, manufactures trade as a percentage of total imports was 24 per cent in Japan, 58 per cent in the Federal Republic of Germany and 62 per cent in the United States. On the export side the same shares were 98 per cent in Japan, 90 per cent in the Federal Republic of Germany and 70 per cent in the United States.

<sup>33</sup> For the United States the naive calculation, other things being equal, is as follows:  $(2.2 \text{ income elasticity of imports} / 1.0 \text{ [income elasticity for exports]}) * 1.65 = 3.6$ , where 1.65 is the initial ratio of imports to exports. Thus world trade must grow by 3.6 times the rate of growth of domestic demand in the United States.

<sup>34</sup> This stability requirement is known as the Marshall-Lerner condition. Secretariat estimates indicate that the condition holds for the United States and Japan, but the results for the Federal Republic of Germany do not warrant a firm conclusion.

<sup>35</sup> The J-curve effect is observed because trade contracts are usually ratified long before the delivery date, but the transaction is recorded in trade statistics. So, for a given exchange rate change, trade volumes are not going to be affected for some time. Since, as is the usual practice in the industrial countries, exports are invoiced in the currency of the exporter, the trade balance may worsen initially as the result of exchange rate devaluation.

<sup>36</sup> See James Tobin, "A proposal for international monetary reform", *Eastern Economic Journal*, July/October 1978; and R. Dornbusch, "Exchange rate economics: 1986", *National Bureau of Economic Research Working Paper*, No. 2071, November 1986.

Large inflows of capital into the United States since 1980 raised the demand for dollars and dollar-denominated assets and contributed to the appreciation of the dollar over that period, thereby aggravating the trade deficit. As shown in table II.12, the net inflow of capital to the United States (i.e., excluding outflows from the United States) rose from \$64 billion in 1979 to \$240 billion in 1986. Such a massive movement of financial capital into a single country is unprecedented. Liberalization of financial markets, through the progressive removal of capital controls and the integration of national markets, particularly in Japan, the United Kingdom and the United States in recent years, has played an important role in this regard (see chap. IV below).

The overwhelming dominance of financial capital movements over the real flows in recent years may be illustrated by the fact that in 1986 the average daily transaction of internationally traded goods and commodities was about \$5.5 billion, while the dollar transactions, induced by capital flows, in foreign exchange markets reached \$200 billion a day. In 1979, the respective figures were \$5 billion and \$75 billion. As long as capital can move freely and in massive amounts, it is likely to influence exchange rate changes significantly and to affect adjustments in trade flows correspondingly.

On balance, it seems likely that the present large trade imbalances may persist. They will certainly do so if uncoordinated macro-economic policy shifts take place in key countries and if there are large swings in exchange rates brought about by capital movements rather than by changes in trade balances. During most of the post-war era, international capital flows were restricted while trade flows were relatively free of barriers. In the 1980s, the opposite seems to be the case and the global economy is having difficulty adjusting to the new situation.

### **The new policy setting and economic situation in the planned economies**

As the starting point of the medium-term socio-economic plans for the second half of the 1980s, 1986 was targeted as the year in which policy makers hoped to make headway with laying the foundations for the "economic intensification strategy" or with consolidating and strengthening the achievements of recent years. All-round economic intensification permeates the medium-term plan intentions. Two circumstances favoured this. First, the moderate to large external imbalances in a number of these countries, especially in Eastern Europe's trade with convertible currency partners, and the world-wide recession of the early 1980s had eased considerably by mid-decade. Secondly, policy makers in virtually all countries had decided to formulate and implement structural adjustment policies through concerted policy designs, which is a major departure from past practice.

#### **Policy setting**

Perhaps the most striking feature of this departure from past practice in the majority of the plans of the European centrally planned economies emerges from the policy

change as regards the choice between consumption and capital formation. Especially with respect to the latter, the new plans in several countries are in sharp contrast to those of the first half of the 1980s, when investment expansion was held to a minimum throughout Eastern Europe and in fact declined in several countries members of the group. Policy makers appeared to be prepared to ease the priority that had been placed earlier on safeguarding consumption levels, especially during the initial phase of the emerging adjustment measures taken in several Eastern European countries. In particular, the Union of Soviet Socialist Republics is embarking on a major acceleration of capital formation, even though the investment plan for 1981-1985 was well executed.

Though some of the Eastern European centrally planned economies appear to have returned to the policy of accelerating output growth through strong investment activity, which was typical of the 1970s, the underlying strategy differs sharply. Policy makers now intend to focus on highly selective branches, especially in high technology fields, and to implement various efficiency and capacity utilization measures. This stems from the need to strengthen the foundations for the modernization strategy envisaged through the late 1980s and early 1990s, and to improve domestic balances. This attitude is also very pronounced in the USSR.

In China, the key policy concern since late 1985 has been the further rounding off of the economic reforms and structural adjustments that have been major features of economic policies since the late 1970s, with urban reforms placed at centre-stage. With the political changes since the beginning of 1987, however, the pace of these reforms has been slowed. At the same time, in late 1985, policy makers in China, in contrast to the European countries, were hoping to cool off the economy, especially by holding the rate of increase in investment activity well below that observed during the period 1983-1985. This stance had several goals. Perhaps uppermost was relieving import pressure and domestic imbalances. The very rapid increase in consumer incomes, and hence demand, in the recent past could be met only partially because imports were not allowed to expand sufficiently. The major impetus to this policy stance was the prospect that a prolonged relaxation of import curbs to rectify consumer markets would lead to an undesirable, and at any rate unsustainable, deterioration in the external accounts. Because policy makers in China have restricted the inflow of capital from abroad to productive investments, a sharp and sustained deterioration in the payments balance in order to accommodate private consumption could not be permitted.

The other Asian planned economies are currently in a better position to experiment with economic reforms. Moreover, some have been aiming either at a moderation of growth, as in Mongolia, in view of the above-normal 1985 performance, or at very robust growth, as in Viet Nam, as a way of encouraging better capacity utilization, which had slackened earlier in the decade because of severe external payments difficulties. The Viet Nam plan aimed at 7.5 per cent growth for aggregate output, 8.8 per cent in industry and 8.9 per cent in agriculture.

Table II.13. Centrally planned economies: selected macro-economic indicators, 1981-1987

	1981-	1986-	1984	1985	1986		1987
	1985	1990			Planned	Actual <sup>a</sup>	
	Actual	Planned	Actual	Actual	Planned	Actual <sup>a</sup>	Planned
Total output							
Eastern Europe	2.2	4.0 <sup>b</sup>	5.3	3.7	5.1	4.7	4.7
Soviet Union	3.6	4.2 <sup>b</sup>	2.9 <sup>b</sup>	3.5	3.8 <sup>c</sup>	4.1	3.9
China	9.4	6.7	12.0	12.3	7.0	7.0 <sup>b</sup>	7.0
Industrial output							
Eastern Europe	2.8	4.4 <sup>b</sup>	4.8	4.1	4.4	4.7	4.1
Soviet Union	3.7	4.6	4.1	3.9	4.3	4.9	3.8
China	12.0	7.5	16.3	21.4	8.8	10.0 <sup>b</sup>	..
Agriculture							
Eastern Europe	1.1 <sup>d</sup>	2.7 <sup>b d</sup>	6.9	-1.3	3.0	5.1 <sup>b</sup>	3.2
Soviet Union	1.1 <sup>d</sup>	2.7 <sup>d</sup>	-0.1	0.1	4.4	5.1	2.4
China	8.1	4.0	12.3	3.0	3.0	4.0 <sup>b</sup>	..
Investment							
Eastern Europe	-1.3 <sup>d</sup>	3.4 <sup>b d</sup>	2.2	4.0	4.0	2.6 <sup>b</sup>	4.8
Soviet Union	3.7 <sup>d</sup>	4.3 <sup>d</sup>	1.9	3.0	7.6	8.0 <sup>e</sup>	5.0
China <sup>f</sup>	18.4	10.0 <sup>b</sup>	33.9	35.0	..	15.0	..

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

- a Preliminary.
- b Secretariat estimate.
- c NMP used.
- d Growth over the five-year period relative to the preceding five years on an annual basis.
- e State sector only.
- f Current prices.

Overall output targets for 1986 in the European planned economies ranged between 2.3 and 4.4 per cent, except for Romania, where planners had set growth at 10 to 12 per cent. This meant a slight acceleration on average over levels attained in 1984-1985. In China, aggregate output was set at 7 per cent, which was about half the pace registered in 1985 (table II.13). China's growth targets for 1986 were set within the context of the continuing need to seek moderation, adjustment, the elimination of flaws in the system of economic management, greater harmony in sectoral growth performances, and other aspects of the ongoing changes in organization, management and economic structures. A sharp downturn in aggregate, industrial and agricultural growth in comparison with the feverish expansion of 1983-1985 was, therefore, anticipated.

In the other Asian centrally planned economies, matters are less transparent. Policies announced by Viet Nam in late 1985 and early 1986 stressed as a priority the development of agriculture and the better utilization of capacity in part to support vigorous growth of consumer and export goods. Elsewhere among the Asian planned economies, fairly cautious policies appear to have been at the root of the plans, details of which were only partially available in official publications.

The aggregate output targets for the majority of the European countries were expected to be within reach by holding industrial output expansion to within the moderate range of 2

to 4.5 per cent—on average only a slight acceleration over growth in 1984-1985. Once again, Romania was the exception as it had slated industrial growth at more than 9 per cent. China was also an exception: in its efforts to cool down the swift growth of 1984-1985, it was aiming at compressing industrial growth from over 21 per cent in 1985 to about 9 per cent in 1986.

In agriculture, a diversity of objectives prevailed. The South-Eastern European countries and the USSR were hoping for a substantial recovery after the rather sluggish performance of 1985. The Central European countries, on the other hand, were anticipating little to moderate growth over the excellent crop gains obtained in 1985. Chinese authorities aimed at improving grain harvests and at moderating production of some other crops (e.g., cotton) in view of weak commodity prices.

Perhaps the single most important feature of some of the plans of the European countries was the stance on capital formation. This was particularly pronounced for the USSR, which planned a sharp acceleration in investment activity (7.6 per cent), and, to a lesser extent, for the Eastern European countries, particularly Romania, whose room for manoeuvre in recent years has been constrained. Chinese authorities, once again, had been hoping to bring investment activity under better control, through, for example, the central policy measures already put in place in mid-1985.

## Constraints versus goals and the performance in 1986

Several unanticipated developments or, at any rate, events that could not have been fully reflected in the plans have interfered with the smooth implementation of the planners' intentions in 1986, especially in the case of the European members of the group: the sharp decline of energy prices, weather variability, sluggish progress with economic reforms and country-specific problems with sustaining industrial growth.

Perhaps most serious has been the fall of energy prices, particularly for oil. But coal prices too, have declined, which has affected convertible currency revenues especially in the case of Poland. Although each of the planned economies, other than China and the USSR, in the aggregate is a net importer of liquid fuels, each has derived substantial convertible currency revenues from the sale of petroleum products to the market economies for about a decade. At the same time, the bulk of the crude oil imports of these countries continues to be procured from the USSR under the transferable rouble pricing régime. Romania is the only major exception to this generalization.

As a result of the slide in world oil prices, convertible currency revenues of the net fuel exporters (mainly China and the USSR) have been adversely affected, although there had been sizeable increases in export quantum of crude oil and oil products from the USSR. Most of the net fuel importers, however, have not been able to offset price losses by increasing volume for lack of availability. Moreover, these countries have not yet fully benefited from the downturn in world oil prices because the transferable rouble prices for 1986 were in principle based on the average of 1981-1985 world prices of oil and average annual exchange rates for the same period, most years of which were characterized by high prices and high dollar exchange rates. At prevailing official exchange rates, transferable rouble oil prices (roughly \$26 to \$28 per barrel) remained well above the average world price (about \$13.5 per barrel), even if allowance is made for the apparent overvaluation of the transferable rouble.

Regarding procurements from convertible currency countries, chiefly the fuel exporters in the Middle East and North Africa, most Eastern European countries obtain their crude oil through contractual arrangements. In some cases, these are heavily weighted in favour of long-term barter arrangements, so that the fuel importers in Eastern Europe were not able to take full advantage of the sharp decline in world oil prices on the import side, although the exports to market economies bore the full impact of the price slide.

The second important development was weather patterns and their effects, particularly on agriculture and primary electricity generation. With the exception of the German Democratic Republic and Poland, grain and several other summer crops in most of Eastern Europe and the USSR ear-

lier in the year appeared to suffer from prolonged drought and heat. This led to some cautious trade positions. However, rather favourable conditions in the latter part of the year helped to raise grain crops to well over the levels anticipated in mid-summer. This was especially true in the USSR, and in several other countries as well, so that the year as a whole was decisively good for agricultural products in general.

Whereas the adverse crop output situation was reversed as the crop season drew to a close, the weather conditions had serious consequences for other sectors in a number of countries of the group. Because of the severity and duration of the drought, electricity generation suffered considerably as planned hydropower could not be assured, owing to low water levels. Moreover, in the USSR, the drought in some parts of Central Asia affected water levels for hydropower generation. This was aggravated by the idling of the Chernobyl reactors. Together, these factors resulted in some drain on primary electricity generation. In addition, the comparatively poor crop expectations during most of the first half of the year in some of the Eastern European countries and the ban on imports of food from Eastern Europe imposed by the European Economic Community after the Chernobyl accident adversely affected their trade in agricultural products in the short run. Agricultural growth in China, Mongolia and Viet Nam appears to have proceeded quite satisfactorily.

Thirdly, it should be borne in mind that these countries are undergoing a period of serious assessment of the economic policies, policy instruments and supporting economic institutions that were enunciated at the Party Congresses of 1985-1986. This uneasy and at times arduous reform of the traditional economic mechanisms in many of these countries and the implications for the scope and range of economic cooperation, especially within the context of CMEA, continued to counsel caution sometimes excessive in the pursuit of short-term socio-economic objectives, without losing track of medium-term and long-term goals.<sup>37</sup>

Finally, the recovery in industrial output recorded by the European countries in the second half of 1985, after the very weak performance in the first half of the year, could not be sustained throughout 1986 in some of the countries of the European group because of the tightening foreign exchange constraint. In spite of the generally more favourable sentiment in world financial markets towards lending to the centrally planned economies and, on balance, some gain in reducing oil import costs from convertible currency countries, the pace of activity, especially in Romania, had to be reduced at times for want of industrial inputs.

Details regarding 1986 performances at this stage remain sketchy for some of the Asian centrally planned economies. The preliminary output figures for Eastern Europe indicate overall growth of about 4.7 per cent. Although this growth is below plan expectations, it surpassed the level attained in 1985 by a full percentage point (see table II.13). There was

<sup>37</sup> These systemic changes are discussed in detail in chapter VI below.

also a robust, if smaller, improvement for the USSR, from 3.5 per cent in 1985 to 4.1 per cent in 1986.<sup>38</sup> China's aggregate output growth of about 7 per cent was roughly on plan target. Mongolia is likely to surpass its 4.5 per cent growth target.<sup>39</sup> Growth in Viet Nam remained well below targets at 4.3 per cent (5.6 per cent in industry and 1.4 per cent in agriculture) and a number of constraints developed, for example in runaway investment activity, output quality, energy and other key industrial products. In addition, the Democratic People's Republic of Korea continues to encounter severe input supply problems for crucial products, oil in particular, because of foreign exchange constraints and below-plan domestic output growth.

Industrial growth in most Eastern European countries exceeded the pace observed in 1985 (see table II.13). It was better than planned in Czechoslovakia, the German Democratic Republic and Poland. In the USSR, it accelerated to 4.9 per cent or 1 percentage point above the 1985 level. China's industrial output slowed down dramatically from 20 per cent in the first half of 1985 to less than 5 per cent by the middle of 1986; it then rebounded sharply. For the year as a whole, growth was about 10 per cent—well above plan expectations. One positive feature of this rather expansive policy is that the rate of growth in light industry surpassed that of heavy industry by a significant margin. This is a favourable development both for the export supply of manufactures and for improving balance in domestic consumer markets two priorities of the current medium-term plan, as discussed in chapter VI below.

Product output levels or reported achievements relative to plan rates for industrial branches or ministries suggest that in most of the European countries of the group efforts to improve considerably the quality and range of output of the machine-building sector, especially electronics, automation and computer equipment, have been bearing fruit. In the case of the Soviet Union, growth in construction materials, metallurgy, including steel, and machine-building exceeded the pace for industry as a whole, but no dramatic achievement in changing the structure of industrial output in favour of high technology was registered. Production of primary and intermediate industrial products in China grew at a steady pace that was well above overall industrial growth, thereby improving market balance.

For agriculture as a whole, 1986 was a fairly good year in spite of poor grain harvests in some countries. In Eastern

Europe, overall growth in the sector may have exceeded 5 per cent well above the 3 per cent planned rate of expansion (see table II.13). But, as already noted, agricultural growth in 1986 was mixed, with record or near-record crops in the northern tier of Eastern Europe but another year of relatively poor and definitely below-plan crop growth in some Central European countries. The European group's total cereal output was about 310 million tons, which represents growth of about 5 per cent for Eastern Europe and about 10 per cent for the USSR. The latter's grain crop reached 210 million tons or roughly 20 million tons more than the preceding year. China's crops developed satisfactorily too, as the overall rate of growth of agricultural output exceeded both the plan and 1985 achievement.

The largest deviations from plans appear to have emerged for investment activity and foreign trade balances. Capital expenditures have been a critical determinant of the buoyancy of growth in virtually all European centrally planned economies. All except Hungary, Poland and Romania accelerated the pace of investment activity in 1985; but only some opted to replicate this effort in 1986. Only Bulgaria, Romania and the USSR aimed at a major boost in 1986. As it turned out, investments exceeded plans in Czechoslovakia, the German Democratic Republic and Hungary. Elsewhere the pace was modest at best.

Especially disappointing in countries, including the USSR, that had counted on a major breakthrough in modernization through the acceleration in investment activity, was the sharp increase in the volume of projects-in-progress, quite contrary to planners' intentions. Progress with restructuring the investment process and cutting gestation periods has been much more modest than policy makers had hoped for. In some Eastern European countries, especially Poland, the priority of foreign trade constraints was such that no more than a modest expansion in domestic demand could be accommodated and this was on the whole reserved for personal consumption.

Although the economic performance of China is deemed to be better balanced and progressing at a more normal pace in 1986 than in the preceding three years, investment expansion continued at a very high rate (in current prices, 15 per cent in the state sector and probably by as much in the industrial activities of the rural sector; this may translate into about 7 to 8 per cent in constant prices). This is still well above the planners' intentions, and authorities are aiming at reducing it further in the years ahead.

<sup>38</sup> The macro-economic data of the USSR for 1985-1986 seem to be in some cases statistically inconsistent. For instance, the data released in the statistical yearbook for 1985 are not internally consistent and are apparently based on revisions of data released in earlier editions of the yearbook or in the data reported by the CMEA secretariat. The same problems of comparability pertain to some of the preliminary data for 1986. One major reason may be a revision in methodology in computing aggregate output and use levels when there is a very sharp decline in the production and consumption of one important product category (alcoholic beverages in the case of consumer goods). Other modifications appear to have been introduced in some of the accounts but not in others.

<sup>39</sup> Details on other Asian centrally planned economies (the Democratic People's Republic of Korea and Viet Nam) are too preliminary to permit any reliable estimate to be made.

## Chapter III

### INTERNATIONAL TRADE

International trade patterns in 1986 were shaken by a sharp fall in oil prices, and continued to be affected by sudden changes in currency values and by the contraction of many debtor countries. This made for a significant redistribution of trade and for continued slow growth.

Prices of non-fuel primary commodities increased by about 5 per cent, and oil prices declined by about 45 per cent in dollar terms in the international markets, while the dollar prices of manufactures increased by 20 per cent. This change in relative prices of primary commodities produced an unprecedented movement in terms of trade.

The fall in oil prices and the resulting reduction in oil output in high-cost producers were a major factor behind the mild upturn in the growth of world trade in 1986: the volume of oil trade expanded by about 10 per cent. However, lower oil prices were devastating for many energy exporters, especially the heavily indebted ones.

World trade as a whole grew slowly, by about 3.5 per cent, but country experiences were extremely diverse. While the volume of imports of the developed market economies increased by about 8 per cent, imports of energy-exporting developing countries declined by about 20 per cent. Imports

of Japan and the United States of America increased sharply. Imports of China declined by about 20 per cent, while those of other centrally planned economies declined marginally.

The stresses and imbalances in the international economy discussed elsewhere in this *Survey* had a profound impact on the growth of world trade and on the flow of trade between countries. The heavily indebted developing countries are still impelled to expand their exports to service their debt and to restrict the growth of their imports as part of their adjustment efforts.

A favourable trade environment remains critical for the growth of the world economy and the smooth unravelling of some of its present imbalances. But the multilateral trading system itself is under serious stress, and the many national and international proclamations of intention to strengthen the system have not produced any significant result. Trade tensions increased during the year and there was no evidence of rollback of protectionism. By early 1987, new restrictive actions raised fears of a full-fledged trade war among some of the industrial countries. The recent international initiatives launching a new round of trade negotiations do, however, hold out some hope for improvement.

#### Growth of world trade

World exports in 1986 are estimated to have been about \$2.15 trillion, not much more than the \$2 trillion in 1980. Between 1980 and 1986, world trade in real terms probably increased by about 17 per cent (see table III.1). But, in a period of rapid changes in exchange rates, figures in real terms are only rough approximations, as it is difficult to measure with any precision what the changes in real flows really were.

Present indications are that growth in 1987 will be no better than 3 per cent, if the surge in the volume of trade in oil, which accounted for much of the increase in the total volume of world trade last year, returns to more normal levels. Indeed, the rate of growth of world trade has been declining. World exports grew at a rate of 2.5 per cent per year during the period 1981-1985, compared with 5 per cent during the 1970s. The elasticity of world trade with respect to world

income has itself also declined. A 1 per cent increase in world income during the 1960s was associated with a 1.8 per cent increase in trade (i.e., an elasticity of 1.8), but only with a 1.3 per cent increase in trade during the period 1980-1986. For 1986, the corresponding elasticity of about 1.2 per cent was the same as during the first half of the 1980s. Thus, trade remained a weaker engine of growth than in the past.

Moreover, a large part (about 2 percentage points) of the growth in the volume of trade in 1986 was accounted for by a significant but probably transitory increase in the export of oil. A good portion of the growth of world trade in 1986 was thus the result of a change in relative prices rather than the reflection of an expanding world economy. Excluding oil, the growth of world trade in 1986 was less than 2 per cent, which was below the rate of growth of world income.

Table III.1. World trade: 1980-1986

	1980	1982	1984	1985	1986
Total exports (billion dollars)	2 002	1 848	1 907	1 933	2 146
Total volume (1980=100)	100	98	110	113	117

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *Monthly Bulletin of Statistics*, June 1986, and GATT, *International Trade 1985-86*. Figures for 1986 are preliminary estimates of the Department of International Economic and Social Affairs.

The persistent weakness of world trade raises major questions of trade and development policy, in particular, whether countries should seek a greater degree of stimulant from the domestic economy than in the past. The question is not new.

### The trading system

The working of the multilateral trading system continues to be a cause for serious anxiety.<sup>1</sup>

Proclamations of commitments to the strengthening of the open multilateral trading system were often followed by national actions which have tended to undermine the system. Some of these actions were taken for the purpose of ensuring what has been termed as "fair" trade, while in other cases national-political or regional considerations have played an overriding role. Tension among trading partners rose sharply.

By the end of 1986, about 90 bilateral export restraint arrangements were reported by GATT, a large number of which were negotiated or renegotiated during the year. These were additional to bilateral agreements under the Multifibre Arrangement. Most of these were voluntary export restraints, involving the use of export quotas, but in a few cases unilateral quotas were also imposed.

The largest number of these export restraint arrangements pertain to trade in steel and steel products, followed by agricultural commodities, transport equipment, electronic products and textiles. The majority of such arrangements were among developed market economies but almost a quarter of them concerned exports from developing countries. A notable aspect of the developments in this area is that "voluntary" restraints, which used to be associated with traditional industries and agriculture, are now spreading to high-technology sectors, as in recent bilateral arrangements on trade in semiconductors.

High tension was manifested in the strong reaction in the United States to changes in Spain and Portugal's import policy on maize and sorghum, consequent to their entry into EEC. This exacerbated the conflict between the United States and EEC on agricultural policy. An agreement was, however, worked out in this area early in 1987 and the situation was diffused. Also in 1986, while talks were being held for an agreement on free trade between the United States and Canada, the two countries imposed large countervailing duties on each others' imports of lumber and corn, moves which have been termed, in some quarters, as a prelude to trade war. During 1986, threats of a trade war between Japan and the United States, whose imports have been growing fast in recent years, were averted by a series of arrangements between the two countries, some restraining exports or raising prices of exports from the former, some of the latest being semiconductors, textiles and machine tools, while others were aimed at increasing the access of United States exports (e.g., semiconductors, autoparts and aluminium) to the Japanese markets. Some broad understanding between the two countries on co-ordination of macro-economic

It has been asked especially in the context of "dependency" in international economic relationships, but the present slow growth of world trade has given the question added relevance.

omic policies was also worked out, which might have contributed to the easing of tension towards the end of the year, though the effectiveness of such policy co-ordination was being viewed with scepticism almost as soon as it was announced.

In March 1987, the United States announced a decision to impose a 100 per cent tax on imports of a variety of electronic products in retaliation against what the administration considered a breach, on the part of Japan, of an agreement on semiconductors concluded between the two countries in the summer of 1986. The agreement included improved access for United States manufacturers of semiconductors to Japanese markets and for monitoring of costs and prices of semiconductor exports from Japan both to the United States and to third country markets and was widely considered a significant step in the increasing bilateralism and "management" of international trade in recent years. This latest controversy between the two countries is additional evidence of the hazards of managed trade and the weakness of the present multilateral trading system.

A major development in 1986 was the extension of the Multifibre Arrangement by another five years, effective from August 1986. The Arrangement — formally, the Arrangement Regarding International Trade in Textiles — was first negotiated in 1973 and was intended to be a temporary measure for an orderly expansion of the trade in textiles. It now covers nearly half of the total world trade in textiles and clothing. It is one of the major arrangements in international trade which has remained outside normal GATT rules. Its principal beneficiaries tend to be established textile producers in countries with already large textile exports; the losers are the newcomers, particularly those from the developing countries. The Protocol extending the Arrangement declares, however, that the ultimate objective of the participants is the application of normal GATT rules to trade in textiles. It also reiterates that the principal aim of the Arrangement is to secure a substantial increase in the exports of textiles from the developing countries. The actual application of the Arrangement, which is usually effected through bilateral agreements between exporters and importers, has, however, become increasingly restrictive over the life of the Arrangement.

On the positive side, the most significant step taken during the year was the agreement reached at the special GATT session at Punta del Este, Uruguay, to launch a new round of multilateral trade negotiations. In a two-part Ministerial Declaration on trade in goods and trade in services, issued at the conclusion of the session, the participants agreed that the main objectives of the negotiations were further liberalization of world trade and the strengthening of the multilateral trading system and the role of GATT. It was also agreed, as

<sup>1</sup> *The World Economic Survey 1986* (United Nations publication, Sales No. E.86.II.C.1) dealt at some length with the systemic issues and problems of international trade.

one of the general principles governing the negotiations, that the principle of differential and more favourable treatment for the developing countries, as embodied in Part IV of the General Agreement and as decided in the Tokyo Round, would continue to apply to the forthcoming negotiations. A major aspect of the agreement was the commitment made by the participants that they would not take any trade restrictive measures which were inconsistent with GATT provisions and instruments and would phase out all such existing measures (the standstill and rollback commitments). The agreement envisaged that the multilateral trade negotiations would be completed within four years.

The Ministerial Declaration also contained a separate agreement on trade in services. The main objective of negotiations in this area was to establish a multilateral framework of principles and rules for trade in services for the purpose of expansion of such trade and as a means of promoting economic growth. Reflecting the reservation of many countries, especially developing countries, in this field, it was further agreed that the framework to be established would respect national policy objectives and laws relating to services, and take into account the work of relevant international organizations.

A major step in the Uruguay Round was taken in January 1987 when the GATT Group of Negotiations on Goods, established under the Ministerial Declaration, agreed on a negotiating structure and plans for negotiations on trade in goods. The Trade Negotiations Committee, set up to oversee the conduct of the Uruguay Round, arrived at an agreement on the mechanism for surveillance of the standstill and rollback commitments made in the Ministerial Declaration. At the same time, the Group of Negotiations on Services adopted a programme for the initial phase of negotiations on services.

### **Recent developments in trade flows by country groups**

#### **Changing sources of growth of imports and exports**

The volume of imports of the developed market economies in 1986 provided the main stimulus to the growth of world trade. Imports into these economies, which increased by about 5.6 per cent in 1985, after a peak of 11 per cent in 1984, are estimated to have grown by 8 per cent in 1986. The increase was especially large in the United States and Japan, but imports of the Federal Republic of Germany, France and the United Kingdom also increased substantially. The growth of import demand in the United States, which significantly contributed to the recovery of world trade in 1984, fell sharply in 1985 but is estimated to have been about 11 per cent in 1986. Japan's imports did not grow at all in 1985 but rose by an estimated 13 per cent in 1986. Imports of the Federal Republic of Germany increased by about 6.5 per cent, compared with a 4 per cent growth in 1985. The rate of growth of imports into France was 9 per cent, up from a 4 per cent growth in 1985. For the smaller developed market economies, imports increased at about 5 per cent.

A significant part of this increase in import demand in the developed market economies consisted of oil imports. Preliminary estimates suggest that the import of oil by these

The factors that have contributed to the weakening of the multilateral trading system - mercantilist sentiments and short-term national and sectoral interests - as well as the question of inequality of bargaining strength and the differences in the stages of development of the participants, will also come into play in the negotiating process. The task will require an equal measure of farsightedness and goodwill if it is to lead to a greater correspondence between proclamations of commitment to freer trade and actual trade policies than has been observed in recent years.

The recognition of interrelationships between the trading system and the monetary and financial system remains critical for the smooth functioning of both. Several hard-pressed debtor countries have continued to cut imports in order to generate a trade surplus and service unusually large interest payments on their debts. And, although the United States dollar has fallen by more than 40 per cent against the Japanese yen and the deutsche mark since the September 1985 meeting of the Group of Five, this has not, so far, corrected the huge deficit in the trade of the United States with its major trading partners, which has been the main source of trade tension among these countries.

The value of the dollar rose continually for almost five years and in 1985 was almost 50 per cent higher than in 1980. This prolonged period of rising exchange value is likely to have affected consumption patterns in favour of imported goods and, at the same time, eroded productive capacity in major lines of export and import-competing production through a persistent loss of competitiveness. These changes may not be easily reversible. From this point of view, some of the trade imbalances between the major developed countries appear to have been the result of the benign neglect of the exchange rate.

countries rose by about 10 per cent in 1986, after an actual decline in 1985. Since imports of oil account for about 20 per cent of their total imports, this raised the total volume of imports of these countries by at least 2 per cent.

Exports of the developed market economies grew only marginally, by 2 per cent during the year. This partly reflects Japan's efforts at slowing down the rapid increase in its exports to the United States, and stagnant United States exports. Japan's exports declined, for the first time in the 1980s, by about 0.5 per cent, and United States exports remained virtually stagnant in 1986. There was, however, a notable increase in trade between Japan and the European developed market economies. Europe's exports to Japan rose sharply during the year by almost 40 per cent in dollar terms. The flow of exports from Japan to Europe increased almost as fast.

A significant factor in the slow growth of total exports of the developed market economies was the decline in their exports to the developing countries. These exports probably declined by as much as 6 per cent in 1986, as developing countries faced a considerable decline in their capacity to import because of falling export revenues.

Imports of the developing countries as a group fell by

about 7 per cent in 1986 after a 5 per cent fall in 1985. Much of this was due to a sharp decline in imports of the oil-exporting developing countries, directly related to the falling

prices of oil. Imports of this group of countries had already declined significantly in 1985. Since developing countries account for about 20 per cent of exports from the developed

Table III.2. World trade: annual rates of change in volume and price, 1976-1987<sup>a</sup>  
(Percentage)

	1976- 1980	1981- 1986	1984	1985	1986	1987 (forecast)
<b>Volume of exports</b>						
World	5.2	2.1	7.6	3.0	3.5	3.0
Developed market economies	6.6	3.0	9.1	4.6	2.0	3.5
Developing countries	2.1	-0.4	3.3	-0.5	7.7	2.0
Capital-surplus countries	-1.6	-10.6	-9.3	-10.8	17.0	..
Other net energy exporters	2.8	-1.0	3.5	-4.1	4.5	..
Net energy importers	7.5	7.6	10.0	6.1	6.5	..
Centrally planned economies <sup>b</sup>	5.7	4.1	5.5	-0.6	2.8	1.0
China	..	11.3	17.6	6.8	12.0	8.0
<b>Volume of imports</b>						
World	5.5	2.8	9.0	3.5	3.9	3.0
Developed market economies	5.6	4.1	11.1	5.5	8.0	4.5
Developing countries	5.6	-0.6	0.8	-5.0	-7.2	0.0
Capital-surplus countries	11.4	-4.2	-10.6	-17.9	-21.0	..
Other net energy exporters	6.1	-4.1	-0.7	-6.2	-21.0	..
Net energy importers	3.9	1.8	6.0	-0.2	2.0	..
Centrally planned economies <sup>b</sup>	4.8	2.3	5.0	5.0	-1.6	2.0
China	..	11.9	29.2	50.3	-21.0	6.0
<b>Unit value of exports</b>						
World	12.2	-1.3	-2.2	-1.8	6.6	10.6
Developed market economies	9.8	-0.1	-2.8	-1.0	15.5	12.0
Developing countries	19.0	-5.6	0.4	-4.0	-18.3	9.0
Capital-surplus countries	23.5	-10.7	-2.3	-2.0	-45.3	..
Other net energy exporters	21.0	-7.5	0.3	-3.4	-32.1	..
Net energy importers	11.2	-3.1	2.8	-4.6	1.0	..
Centrally planned economies <sup>b</sup>	8.7	0.2	-3.7	-1.3	7.1	2.0
China	..	-4.8	0.1	-2.1	-10.0	0.0
<b>Unit value of imports</b>						
World	11.7	-1.7	-2.7	-2.0	6.9	9.8
Developed market economies	12.1	-2.1	-2.8	-2.0	6.1	10.0
Developing countries	12.5	-1.1	-1.9	-1.7	7.8	16.3
Capital-surplus countries	10.8	0.0	-1.9	-1.4	16.1	..
Other net energy exporters	11.1	-0.7	-2.1	-1.6	11.9	..
Net energy importers	13.4	-1.4	-1.9	-1.9	4.6	..
Centrally planned economies <sup>b</sup>	6.8	0.8	-3.6	-1.5	13.6	0.0
China	..	-3.9	-0.8	2.6	9.2	..
<b>Terms of trade</b>						
Developed market economies	-2.1	2.0	-0.1	1.0	9.0	0.5
Developing countries	5.8	-4.6	2.3	-2.4	-24.6	-6.3
Capital-surplus countries	11.5	-10.7	-0.3	-0.6	-52.9	..
Other net energy exporters	8.8	-6.8	2.5	-1.8	-39.3	..
Net energy importers	-2.0	-1.7	4.8	-2.7	-3.5	..
Centrally planned economies <sup>b</sup>	1.7	-0.6	-0.1	0.2	-5.8	1.0
China	..	-0.3	0.9	-4.6	-17.6	0.0

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

<sup>a</sup> Rates of change in unit values are based on indices expressed in dollars.

<sup>b</sup> Eastern European centrally planned economies and USSR.

market economies, this decline in their import demand made for a drop of some 1.5 per cent to those exports.

Imports of the energy-importing developing countries increased by about 2 per cent in 1986 following a slight decline in 1985. The growth of imports of Latin American countries was uneven, with a large increase in Brazil and Peru. African imports declined by about 10 per cent, largely because of declining foreign exchange earnings of the energy exporters. Imports of the energy exporters of the South and East Asian region declined, while those of the energy importers increased by over 6 per cent.

The volume of exports from the developing countries, on the other hand, increased by about 8 per cent during the year, after a decline of about 1 per cent in 1985. A part of this increase was due to the substantial expansion of oil exports, but exports from the energy-importing developing countries also increased by about 6 per cent. Exports from Latin America declined by about 2.5 per cent, owing to an 8 per cent fall in Brazil's exports and a 14 per cent decline in Mexico's. There was a substantial increase in exports from South and East Asia, notably from the energy exporters, which increased the volume of their exports by well above 5 per cent.

A number of developing countries managed to increase their exports remarkably. The combined exports of the nine major exporters of manufactures<sup>2</sup> to developed market economies increased, in dollar value, by about 13 per cent in 1986. A notable feature was that while exports of these countries to Europe and Japan had been stagnant over much of the 1980s, they increased fast in 1986. The value of their exports to Japan and Europe increased by 8 per cent and 24 per cent, respectively, and exports to the United States grew by some 8 per cent. This marked a significant diversion of exports of these countries from the United States, which has been absorbing an increasing share of this trade in recent years, to other developed market economies.

The volume of imports of the European centrally planned economies declined by 1.6 per cent during 1986. The volume of imports of Eastern Europe from developed market economies increased, but there was a sharp cutback in the Soviet Union's imports, partly as a result of a good harvest. The volume of exports of these economies, on the other hand, rose by about 3 per cent after a decline of 1 per cent during the previous year, partly as a result of an increase in oil exports. The growth of imports of China was drastically curtailed, from a rise of 50 per cent in 1985 to a decline of 20 per cent in 1986; yet China's exports continued to increase at a rapid pace of 12 per cent.

#### **Changes in balance of trade by country groups**

A dominant feature of the balance of trade of the developed market economies in 1986 was the continuing large trade deficit of the United States along with large surpluses of Japan and the Federal Republic of Germany.

Export earnings of the United States remained practically unchanged despite the fall of the dollar, and its imports increased significantly, leading to a larger trade gap. The trade surpluses of Japan and the Federal Republic of Germany registered a large increase, by about \$37 billion and \$27 billion, respectively, and signs of reduction in these surpluses were not yet evident by early 1987. The trade surplus of Canada remained significant, particularly its surplus with the United States.

The overall trade balance of the developed market economies turned from a deficit of \$40 billion in 1985 to a surplus of about \$3 billion in 1986, largely owing to the 45 per cent fall in the price of oil. The increase in the prices of manufactures, in dollar terms, relative to non-fuel primary commodities also contributed. The sharp reduction in the trade deficit of these countries thus reflected a very large improvement in their terms of trade.

The decline in the price of oil and the large adverse change in the terms of trade of developing countries worsened the trade balances of the developing countries despite a substantial increase in their volume of exports and a decline in their volume of imports. The balance of trade surplus of this group shrank to \$10 billion in 1986, a sharp decline from \$53 billion in 1985.

The largest change took place in the capital surplus energy-exporting countries, whose balance of trade surplus declined from \$34 billion to \$8 billion, the lowest since 1970. Other energy exporters suffered a deterioration only slightly less steep. There was a reduction in the energy-importing developing countries' trade deficit in 1986, reflecting continuing adjustments in some countries aimed at compressing imports, as well as substantial expansion of exports from some others. The trade deficits of these countries declined from \$58 billion to \$15 billion between 1980 and 1985 and shrank further to about \$8 billion in 1986.

During the first half of the 1980s, the centrally planned economies made significant adjustments in their external trade, including changes in the geographical direction and composition of their trade, aimed at generating convertible currency surpluses. Recently, however, nearly all these countries were led to scale down their plans for convertible currency surpluses to more modest levels or even to temporary deficits, owing in part to the slide in oil prices and to a drop in agricultural exports.

Two major factors determined developments in the trade of the European centrally planned economies in 1986: the drop in the dollar price of oil and the depreciation of the dollar against other major currencies. The price of oil, the Soviet Union's major export, declined by about a third. The export price of other commodities in convertible currency trade increased by about 6 per cent, while import prices increased by about 13 per cent. The terms of trade of these economies with developed market economies deteriorated as a result.

<sup>2</sup> Argentina, Brazil, Hong Kong, India, Malaysia, Philippines, Republic of Korea, Singapore and Thailand.

The overall trade balances of the Eastern European economies deteriorated considerably during 1986. Their surplus dwindled from about \$US5 billion in 1985 to a deficit of \$US400 million in 1986. However, they still maintained a small surplus with developed market economies. Their surplus with developing countries shrank to \$US800 million. The Soviet Union, despite the deterioration in its terms of trade, increased its overall trade surplus by some \$US3.3 billion over the surplus of 1985, by sharp cuts of imports, especially from non-socialist countries, and also a significant increase in the volume of exports. With its convertible currency partners, however, the USSR had only a slight surplus.

China's trade deficit was reduced considerably from the high level of 1985, despite a sharp fall in terms of trade. The volume of imports was heavily cut, by 21 per cent in com-

parison to 1985, while the volume of exports rose by 12 per cent.<sup>3</sup>

#### Exchange rate movements and trade balances

The changes in the values of major currencies during the 1980s, and especially since September 1985, have been large. The trade-weighted value of the United States dollar rose by 50 per cent in five years since 1980 reaching a peak in the first quarter of 1985 when it was 60 per cent above the base year value. By the end of 1986, it had fallen by 26 per cent from its peak level. The changes in the bilateral rates between the dollar and the major trading partners of the United States were even greater. Thus, the yen and the deutsche mark appreciated against the dollar by about 60 per cent (or the dollar depreciated by 40 per cent) between the first quarter of 1985 and the end of 1986.

Table III.3. Developed market economies: merchandise trade balance (f.o.b.), 1980-1986  
(Billions of United States dollars)

Country or country group	1980	1983	1984	1985 <sup>a</sup>	1986 <sup>b</sup>
All developed market economies	-69.4	-22.7	-47.6	-39.5	2.2
Excluding United States	-43.9	44.4	64.9	84.4	143.0
Major industrial countries	-33.1	-12.4	-46.1	-40.0	-4.7
Canada	8.0	15.0	16.6	13.3	7.2
France	-13.4	-8.8	-4.6	-4.5	-2.7
Germany, Federal Republic of	8.7	21.5	22.0	28.7	56.4
Italy	-16.4	-3.2	-6.0	-6.8	1.2
Japan	2.1	31.5	44.3	56.0	92.6
United Kingdom	3.4	-1.3	-5.9	-2.3	-11.7
United States	-25.5	-67.1	-112.5	-124.4	-147.7
Other countries	-36.3	-10.3	-1.5	0.5	7.5
Surplus countries <sup>c</sup>	0.5	8.6	10.1	10.0	7.5
Others	-35.8	-18.9	-11.6	-9.5	0.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*, and Project LINK.

- a Estimate.
- b Preliminary estimates.
- c Netherlands and Norway.

Table III.4. Trade balances of developing countries, 1980-1986  
(Billions of dollars)

	1980	1984	1985	1986
All developing countries	111	51	53	10
Energy-exporting countries	169	67	68	18
Capital surplus countries	136	31	34	8
Other energy exporters	33	36	34	10
Net energy importers	-58	-16	-15	-8

Source: IMF, *Balance of Payments Statistics*, 1986 Yearbook, and other national and international sources.

<sup>3</sup> For detailed trade balances by countries and regions for the period 1981-1985, see chapter VI.

Changes in exchange rates are expected and intended to produce changes in the value and volume of imports and exports. However, in the first place, it takes time for exchange rate changes to take effect. A deficit country which does not by itself set world prices will at first find that depreciation of its currency will raise both import and export prices in domestic currency in the same proportion, but since imports exceed exports, this will at first worsen the trade balance. It is only when these price changes take effect that the expected changes occur: when exporters take advantage of the opportunity to cut their prices in world markets and export more, and when domestic buyers respond to the increase in prices for imported goods by switching to domestic products. This produces the so-called "J" curve.

But that is only part of the overall picture. A trade deficit that is due to a persistent tendency to spend more than a country produces cannot be corrected by exchange rates adjustments alone, particularly when the savings gap is large in comparison to GNP or total exports. There have to be accompanying changes in the so-called fundamentals of the

situation. In the case of deficit countries, fiscal restraint is usually called for; surplus countries need to accompany the appreciation of their currency by a certain amount of fiscal stimulus to make it effective.

This is why present imbalances in the trade and current account situation cannot be resolved without the harmonization of the macro-economic policies of the major economies in the world system, discussed in chapter II.

It should also be noted that, in the present international monetary system, it is not self-evident how the changing values of currencies should be described and what effects one should expect from them. Much attention is given to the bilateral exchange rates between the major actors — the United States, Japan and the Federal Republic of Germany. But other countries have chosen different approaches in their exchange rate policies. Some have chosen to follow a key currency of special importance to them, others seek to stabilize the value of a basket of currencies, in which the weights given to other countries express their general trade concerns.

Table III.5. Trade balances of centrally planned economies, 1984-1986  
(Billions of dollars)

	1984	1985	1986
Total	16.7	-5.9	-2.2
Eastern Europe	6.9	5.0	-0.4
USSR	11.1	4.0	7.3
China	-1.3	-14.9	-9.0

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

Table III.6. Change in the values of currencies of major countries, 1985-1986

Country		Indexes of value (1980=100)										Rate of change (Percentage)	
		1985					1986					Average of 1986 over average of 1985	1986: IV over 1985: I
		I	II	III	IV	Average	I	II	III	IV	Average		
United States	(E)	160	156	148	137	150	129	124	119	118	123	-18.0	-26.3
Japan	(E)	122	123	125	139	127	148	160	171	166	161	26.8	36.1
	(A)	88	90	95	109	95	121	133	145	142	135	42.1	61.4
Federal Republic of Germany	(E)	93	95	97	100	96	103	104	108	110	106	10.4	18.3
	(A)	56	59	64	70	62	77	80	87	90	84	35.4	60.7
United Kingdom	(E)	75	82	86	83	82	78	79	75	71	76	-7.3	-5.3
	(A)	48	54	59	62	56	62	65	64	61	63	12.5	27.1
France	(E)	67	69	71	74	70	76	74	74	75	75	7.1	11.9
	(A)	42	45	49	54	47	59	59	62	64	61	29.8	52.4
Italy	(E)	68	67	66	67	67	68	69	70	71	70	4.5	4.4
	(A)	42	43	45	49	45	54	56	60	61	58	28.9	45.2
Canada	(E)	107	104	102	98	103	94	93	92	91	93	-9.7	-15.0
	(A)	86	85	86	85	86	83	85	84	84	84	-2.3	-2.3

Source: IMF, *International Financial Statistics*, January 1987.

E: Index of effective exchange rate, calculated by IMF using the Fund's Multilateral Exchange Rate Model (MERM).

A: Index of average rate in United States dollars per national currency.

Table III.6 shows some effective exchange rates. They illustrate the difference between bilateral rates and weighted ones. The dollar had fallen by about 40 per cent against the yen between the first quarter of 1985 and the fourth quarter of 1986 (i.e. the yen had risen by about 60 per cent). But its weighted average rate (weighted by the trade of the United States with 17 other industrial countries), shown in the table as (E), had declined by only 26 per cent.<sup>4</sup> The estimated change thus depends on the weights used.

The change is even smaller when the number of the trading partners included in the calculation is increased. A quar-

ter of industrial trade and about a third of total trade of the United States are with the developing countries. The currencies of some of the largest exporters among them actually depreciated against the dollar. Table III.7 shows the changes in the real exchange rates of major developing country trading partners of the United States. The real exchange rate of these countries *vis-à-vis* the dollar has continued to depreciate. All of these countries are actually running trade surpluses either to service a large debt or to replenish their reserves. Indeed, a trade-weighted dollar, taking into account all relevant trading partners of the United States, depreciated by only about 14 per cent in 1986.<sup>5</sup>

Table III.7. Real effective exchange rate of some major developing countries and territories<sup>a</sup>  
(1980-1982 = 100)

	1984	1985	1986	Change between 1985 and 1986 (Percentage)
Argentina	80	71	61	-14.1
Brazil	86	85	74	-12.9
Mexico	92	91	65	-28.6
Republic of Korea	96	89	74	-16.9
Hong Kong	100	104	94	-9.6
Singapore	102	96	80	-16.7
Taiwan, Province of China	97	95	88	-7.4
Average				-15.2

Source: Morgan Guaranty Trust Company, *World Financial Markets*, December 1986.

<sup>a</sup> The largest exporters to the United States.

### The changing commodity structure of international trade

The current problems of international trade partly reflect long-term structural changes in the world economy. These changes result from shifts that have been taking place in the

structure of production and demand and thus have major implications for trade and development policies at both the national and international levels.

Table III.8. Commodity composition of international trade

	Share in total merchandise exports (Percentage) <sup>a</sup>				Annual rates of growth in export volume (Percentage)		
	1960	1970	1980	1985	1960- 1970	1970- 1980	1980- 1985
Agricultural products	32	21	15	14	3.9	3.5	1.2
Minerals (including fuels)	17	17	29	23	7.2	1.7	-3.7
Manufacturing	51	62	56	63	10.5	7.1	4.8
Total	100	100	100	100	8.6	5.0	2.6

Source: Based on GATT, *International Trade 1985-86*, (Geneva, 1986).

<sup>a</sup> Derived from current dollar values.

<sup>4</sup> These changes are in nominal terms. For the purpose of examination of the impact of exchange rate changes on trade, the changes should ideally be measured in real terms, i.e. adjusted for the relative movements of rates of inflation in the trading countries. Since, however, the United States rate of inflation was not very different from the average rate for the other major economies, the real effective exchange rate of the United States should be close to the nominal.

<sup>5</sup> Morgan Guaranty Trust Company of New York, *World Financial Markets*, February/March 1987.

As table III.8 shows, the share of agricultural commodities in world trade has been halved since 1960, while that of manufactures has increased by one quarter. The increase in the proportion of trade in minerals is entirely due to the increase in oil prices during the 1970s, which also accounts for the fall in the share of manufactures between 1970 and 1980. The changing roles of the three groups of products are more vividly seen in the rates of growth of exports (real terms). The rate of growth of world trade in agricultural products declined by two thirds, while exports of minerals actually fell in absolute terms and trade in manufactures rose almost twice as fast as world trade as a whole.

### Trade in manufactures

Manufactures account for over 60 per cent of world merchandise trade. Since the long-term shift in the structure of production is away from primary production to manufactures, the growth of trade is becoming increasingly a matter of the growth of trade in manufactures. The shift from primary products to manufactures is very marked in exports of developing countries. The share of manufactures in their total exports increased from about 18 per cent in 1980 to 33 per cent in 1984 and 40 per cent in 1986.

Since the 1960s trade in manufactures has expanded much faster than trade in agricultural products and minerals, but the rate of growth has dropped in recent years. During the period 1981-1985, exports of manufactures grew at 4.8 per cent, compared with 7 per cent during the 1970s and over 10

per cent in the 1960s. Preliminary indications suggest that they increased only about 3 per cent in 1986.

One reason for the deceleration in the growth of trade in manufactures in recent years is that the growth of world manufacturing production slowed down during the 1970s and decelerated further in the first half of the 1980s, as table III.9 shows. The decline occurred in all three country groups but was much the sharpest in developed market economies.

The shifts in the sources of growth of manufactured exports have also been significant. Developing countries account for the bulk of the increase in manufactured exports during the period 1980-1985, as seen in the relative rates of growth (table III.10). Their exports of manufactures, after increasing at an annual rate of 24 per cent during the period 1970-1980, grew by 6 per cent during 1980-1985. As a result, developing countries increased their share of the world exports of manufactures from about 7 per cent in 1970 to 10 per cent in 1980, and to about 12 per cent in 1985. The share of the developed market economies declined from 85 per cent in 1970 to about 80 per cent in 1985. The centrally planned economies maintained their share at about 8 per cent.

Most of the increase in exports of manufactures from the developing countries has been directed towards developed market economies, not only because these economies account for about two thirds of developing country exports, but also because in recent years, exports to developed market economies have grown at a substantially higher rate than

Table III.9. Growth of manufacturing production  
(Annual rate)

	World	Developed market economies	Developing countries	Centrally planned economies
1963-1970	7.1	6.1	6.8	8.1
1971-1980	4.2	3.1	6.9	6.9
1980-1985	2.5	1.7	4.7	3.8

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, *Yearbook of Industrial Statistics, 1975* (United Nations publication, Sales No. E.77.XVII.8), *Industrial Statistics Yearbook, 1983* (United Nations publication, Sales No. EF.85.XVII.11) and *Monthly Bulletin of Statistics*, February 1987.

Table III.10. Growth of exports of manufactures by country groups<sup>a</sup>  
(Annual rates)

	1965-1970	1970-1980	1980-1985
Developed market economies	13.4	18.7	0.4
Developing countries	17.8	23.7	6.0
Centrally planned economies	8.2	16.4	1.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, *Yearbook of International Trade Statistics, 1982* (United Nations publication, Sales No. EF.84.XVII.6), and *Monthly Bulletin of Statistics*, May 1987.

<sup>a</sup> Growth of export values at current dollar prices.

exports to other developing countries. During the 1970s, exports from developing to developed market economies grew, in value terms, by about 22 per cent annually, while exports to other developing countries increased by 28 per cent, mainly as a result of growing markets of energy-exporting countries.

During the 1980s, this situation was reversed: in the period 1980-1985, manufactured exports of developing countries to developed market economies grew by 11 per cent, and those to other developing countries by only 4 per cent. Part of this change was due to the overall recession in the world economy, but the decline in trade in manufactures among developing countries was primarily the result of their new import constraints, especially those of the energy-exporting countries.

While the exports of manufactures from the developing countries have increased faster than world export of manufactures, this trade has been highly concentrated in a few developing countries. Ten countries and territories accounted for about 80 per cent of the total exports of manufactures from the developing countries in 1985.<sup>6</sup> The degree of concentration has increased. In 1973 the 10 accounted for 70 per cent of the total. In particular, four major Asian newly industrializing countries or areas — Hong Kong, the Republic of Korea, Taiwan, Province of China, and Singapore — managed to expand their exports very quickly. In 1986, aided partly by the depreciation of their currencies not only against the yen and other major non-dollar currencies, but also against the dollar, the combined exports of these countries increased by about 15 per cent.

### Commodities

Close to 40 per cent of world trade is accounted for by primary commodities. They constitute 70 per cent of the total exports of the developing countries and, if oil is excluded, the proportion is about 50 per cent. For the large majority of developing countries, the dependence on primary products is decisive for their economic conditions. As

table III.11 shows, over 70 per cent of the developing countries and territories depend on primary exports for more than 65 per cent of their export earnings. For a number of developed market economies, including Australia, Canada, and the United States, primary products account for a significant 30 per cent or more of their total exports. For the centrally planned economies, primary exports constitute about 45 per cent of the total, mostly because of rather large commodity exports by the Soviet Union.

Despite its declining share in world trade, trade in primary commodities thus remains of fundamental importance. Agricultural production and export policies of the developed market economies still constitute a major area of international trading relationships. Prices of primary commodities, especially in terms of prices of manufactures, remain critically important for those developing countries in which primary exports account for a high proportion of their total domestic production and their capacity to import.

One of the most important features of world trade in 1986 has been the fall in the price of oil. The weakness of oil prices already evident in 1985 turned into a sharp fall in 1986. As a result, the average export price of crude oil declined by about 45 per cent during the year. By the end of 1986, the combined index of non-fuel commodity prices measured in dollars had fallen slightly from the late 1985 levels (see figure III.1 and table III.12). But when measured in SDRs, the fall was more than 10 per cent.

Prices of most commodities declined. Among the prices of individual commodities in the UNCTAD indexes of primary commodity prices, 30 fell, 8 rose and 3 remained unchanged during the year. The prices of coffee and sugar were the only ones to rise significantly. On the other hand, the fall in the prices of a number of major products was large. Beverage prices rose, as coffee prices increased some 40 per cent over the 1985 level mostly as a result of a decline in production in Brazil caused by drought. But coffee prices soon declined again and by the end of the year were no higher than the average for 1985. Wheat prices declined by about 20 per cent in 1986 and were 30 per cent below their 1980 level.

Table III.11. The dependence of developing countries and territories on primary exports

Share of exports accounted for by primary products	Number of countries	Percentage	Cumulative percentage
Over 75 per cent	72	64.3	64.3
66-75 per cent	9	8.0	72.3
56-65 per cent	9	8.0	80.3
45-55 per cent	6	5.4	87.7
Less than 45 per cent	16	14.3	100.0
Total	112	100.0	

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on the *1984 International Trade Statistics Yearbook*, vol. I (United Nations publication, Sales No. E/F.86.XVII.7).

<sup>6</sup> Argentina, Brazil, Hong Kong, India, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan, Province of China and Thailand.

Sugar prices rose by about 50 per cent during the year but were still only about one third of their average for 1979-1981, as stocks remained high. Tea and cocoa prices declined for two consecutive years.

Prices of agricultural raw materials as a whole remained unchanged in 1986, after a decline of almost 10 per cent in

1985, and remained 20 per cent below their 1979-1981 average. Metal prices declined by about 7 per cent during the year and were almost 30 per cent below their average for 1979-1981. Tin prices in 1986 were half of what they were before the collapse of the London tin market in 1985. Among other major metals, prices of copper fell by almost 3

Table III.12. Indices of primary commodity prices, 1982-1986  
(1971-1981 = 100)

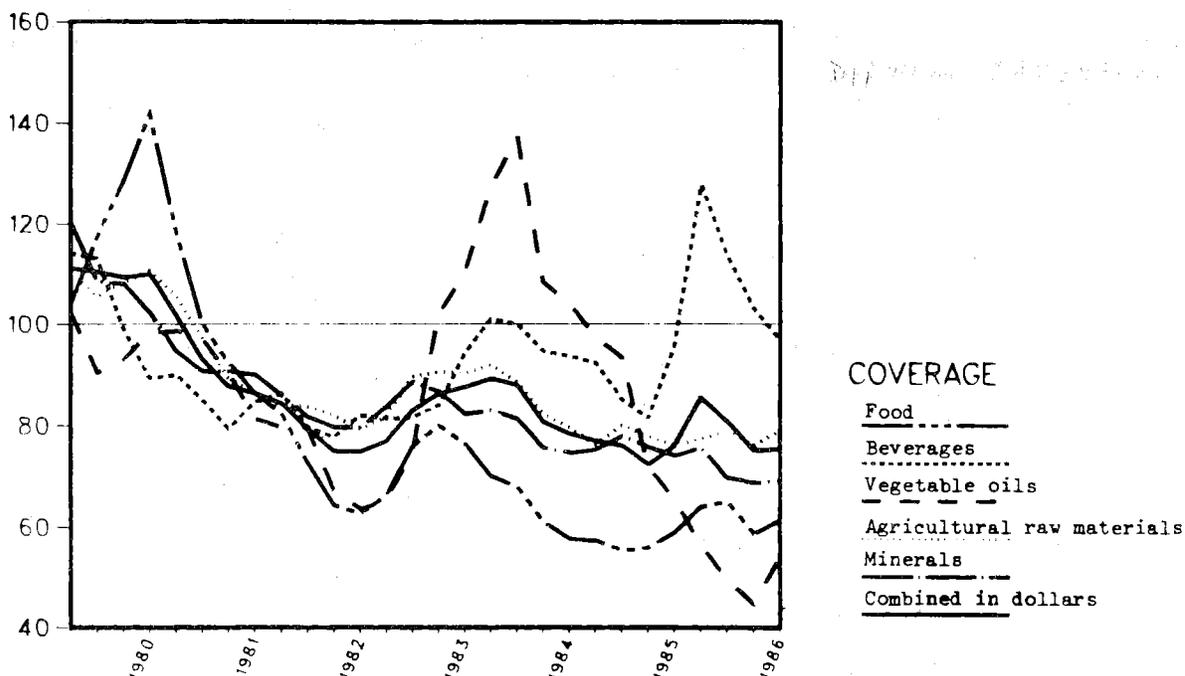
	Tropical Food beverages	Vegetable oil	Agricultural materials	Minerals & metals	Combined index		Prices of manufactures <sup>a</sup>	Real prices of commodities <sup>b</sup>
					Dollar	SDR		
1982	70	81	72	82	78	89	97	80
1983	75	85	88	88	83	98	93	89
1984	64	97	119	86	84	103	91	92
1985	57	89	82	78	75	93	91	82
I	57	92	97	76	77	100	84	92
II	55	85	93	80	76	96	89	86
III	56	81	72	78	72	88	93	77
IV	58	96	65	76	76	89	98	78
1986	62	110	51	78	79	85	109	74
I	64	128	56	77	85	96	105	81
II	65	114	50	79	81	87	108	75
III	59	103	45	76	75	78	113	66
IV	61	97	54	79	75	79	..	..

Source: UNCTAD, *Monthly Commodity Price Bulletin*, and United Nations, *Monthly Bulletin of Statistics*, December 1986.

<sup>a</sup> Dollar unit values of manufactured exports from developed market economies.

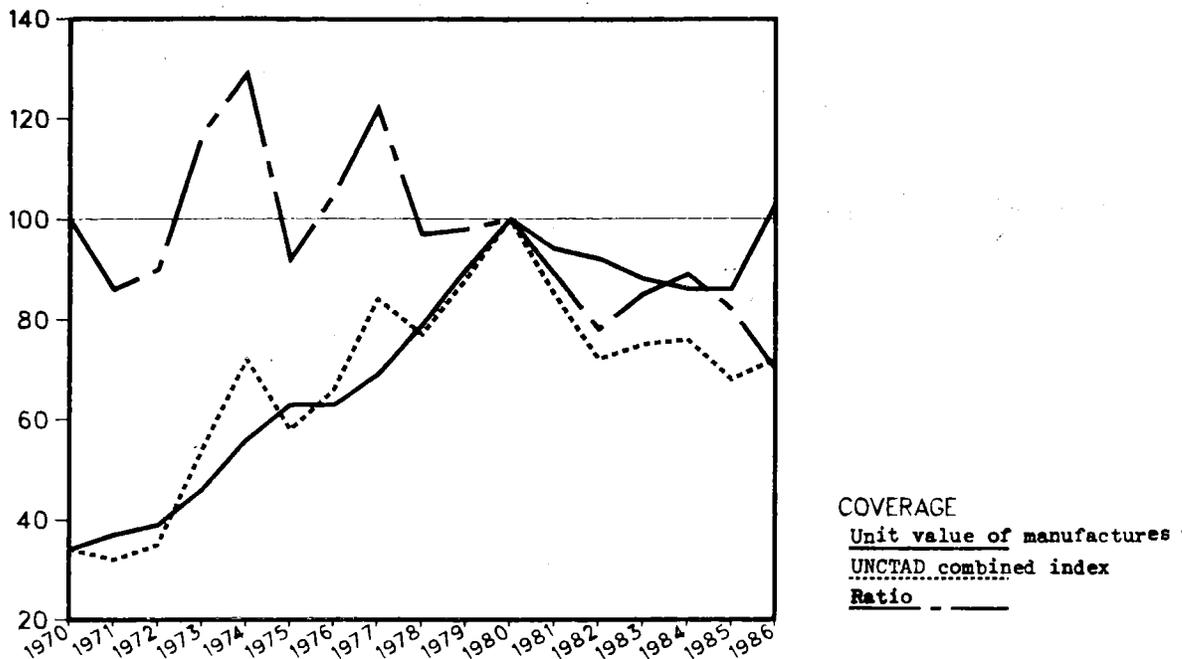
<sup>b</sup> Dollar index deflated by dollar unit value of exports from developed market economies.

Figure III.1 Prices of groups of commodities, 1980-1986  
(Indices of dollar prices: 1979-1981 = 100)



Source: UNCTAD, *Monthly Commodity Price Bulletin*.

Figure III.2. Commodity prices and export unit values of manufactures, 1970-1986  
(Indices of dollar prices: 1980=100)



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

per cent in 1986, after a small increase in 1985, but were about 30 per cent below their level of the early 1980s.

While export prices of primary commodities remained depressed, those of manufactures rose significantly. The dollar unit values of manufactured exports from the developed market economies increased by about 20 per cent. The real prices of non-fuel primary products, expressed in terms of prices of manufactures, declined by as much as 10 per cent during the year, following a decline of similar magnitude in 1985 (see figure III.2 and table III.12). The real prices of fuel oil, similarly measured, plunged by over 50 per cent in 1986.<sup>7</sup>

These price changes produced a decline of about 30 per cent in the terms of trade of the developing countries with the developed market economies in 1986 (see figure III.3). This is the sharpest adverse movement in their terms of trade in recent years. Declining commodity prices have benefited many developing countries too, particularly the major exporters of manufactures. Primary producing developed countries have suffered from depressed commodity prices.

But on balance, the terms of trade gain of the developed market economies has been very large. Apart from its indirect contribution to lowering the rate of inflation, the decline in the prices of imports from the developing countries in 1986 meant a gain of about \$56 billion for the developed market economies as a whole. Their gains from higher export prices was an additional \$38 billion. The total terms of trade gain of these economies for the year was thus of the order of \$94 billion.<sup>8</sup>

A first explanation of the present level of commodity prices is the low rate of growth of world demand for these products. This applies not only to industrial raw materials but also to basic food items. The capacity of a large number of developing countries to import food has been reduced by a falling level of real income, as their economies stagnated or declined and their terms of trade moved against them.

It must nevertheless be recognized that the sagging of prices of primary commodities in recent years reflect fundamental changes in the use of raw materials in developed countries.<sup>9</sup> There has been a continuing shift from produc-

<sup>7</sup> The dollar prices of oil declined by about 45 per cent, while the prices of manufactured exports rose by 20 per cent.

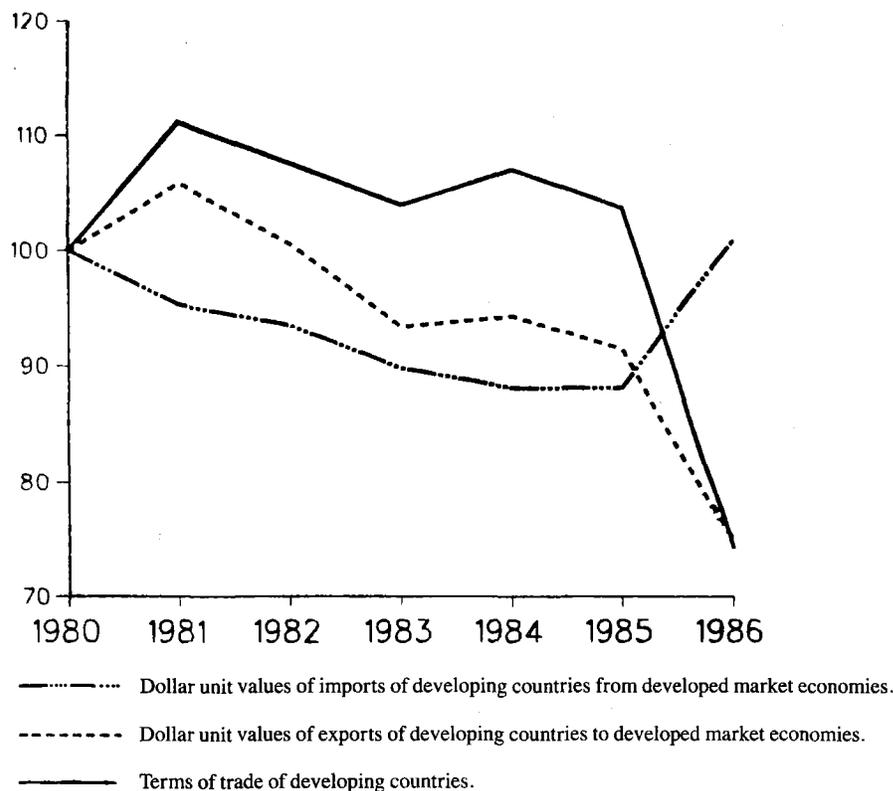
<sup>8</sup> Ignoring the indirect consequences of changes in prices, including changes in quantity, the terms of trade gain has been estimated as:

$$M(1 - p^m) - X(1 - p^x)$$

where M and X are 1985 import and export values, respectively, of the developed market economies from and to the developing countries, and  $p^m$  and  $p^x$  are, respectively, the 1986 index of import and export prices (with 1985 = 1.00). The actual values were: M = \$312 billion, X = \$250 billion,  $p^m$  = 0.82, and  $p^x$  = 1.15. The calculated value of \$94 billion is, of course, larger than — and conceptually different from — the actual change in the balance of trade, which takes into account changes in trade volume as well as changes in prices.

<sup>9</sup> Some of the factors underlying the decline in commodity prices were discussed in the *World Economic Survey, 1986*, chap. III.

Figure III.3. Unit values of trade of developing countries with developed market economies and terms of trade, 1980-1986 (1980=100)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on United Nations, *International Trade Statistics Yearbook 1984* and United Nations, *Monthly Bulletin of Statistics*.

tion of goods to production of services. Goods-producing sectors (agriculture and manufacturing) accounted for 35 per cent of the gross domestic product of the developed market economies during the 1960s but less than 30 per cent by the mid-1980s. The share of services increased from 56 to 62 per cent. Similar shifts are taking place in many developing economies. Services are less material-intensive than the production of goods.

The requirements of traditional raw materials per unit of physical output has also been declining. For example, the average weight of cars made in the United States declined from 1,700 kilograms in 1975 to 1,500 kilograms in 1985, and their average iron and steel content declined from 81 per cent to 69 per cent.<sup>10</sup> Technological innovation has led to substitution and saving of materials and created new products which require less materials per unit of output, as well as materials that are more accessible to industrial countries.

These two types of changes — shifts in the structure of

production and greater economy in the use of raw materials in the production of goods — have reduced the use of primary products per unit of gross domestic product. For a majority of the main agricultural and industrial raw materials, the rate of growth of consumption has been significantly slower during the 1970s and 1980s compared with the 1960s.<sup>11</sup> As economies move towards the post-industrial stage and output becomes less material-intensive, the total volume of industrial materials required will not grow unless there is a significant increase in the absolute level of industrial production.

The supply of food increased considerably faster than consumption during the 1980s. On the demand side, the capacity of a large number of developing countries to import food has been reduced by a falling level of real income as their economies stagnated or declined and their terms of trade moved against them. Thus, during the period 1981-1984, per capita consumption of food actually declined in sub-Saharan Africa and still today several countries in this area are confronted with acute shortages and famine. A falling or stag-

<sup>10</sup> Eric D. Larson, Marc H. Ross and Robert H. Williams, "Beyond the era of materials", *Scientific American*, vol. 254, No. 6, June 1986.

<sup>11</sup> See UNCTAD, "Impact of new and emerging technologies on trade and development" (TD/B/C.6/136, August 1986).

nant real income in other developing countries also depressed their food import demand.

On the supply side, the achievement of other developing countries in attaining food self-sufficiency had the same effect on trade in food. The farm support policies of many developed market economies, by restricting imports and increasing export surpluses, depress international prices of food. Overproduction of food grains as a result of these policies has led to a huge increase in stocks in recent years. The estimated world stock of cereals increased from 248 million tons in 1981 to 399 million tons in 1986, or by 60 per cent. In 1986, about 70 per cent of these stocks were held by the developed market economies, 45 per cent by the United States alone.<sup>12</sup>

It is unrealistic to expect trade in raw materials in general to grow in the foreseeable future at anything like their rates during the 1950s and 1960s. This has grave implications for many developing countries which have only a narrow industrial base and depend on one or two commodities for the bulk of their exports earnings.

### Trade in services

International trade in services only kept pace with the growth of trade in goods. Available information indicates that the share of non-factor services in the total merchandise trade of developed market economies and developing economies together was virtually constant during the past decade. In dollar terms, this share was approximately 21 per cent in 1975 and about the same percentage in 1985. However, services are a very heterogeneous group. During the 1980s, while traditional services such as shipping and other transportation have been declining, international markets have been expanding in the category "other services", which includes banking, insurance, consulting and other internationally traded business services undergoing technological changes related to the progress in telecommunications and the computer industry. The growth of trade in non-factor services during the past decade is shown in table III.13. Depending on which items are included, the estimate of the share of services may go beyond the often-mentioned figure of about 20 per cent of world trade. By the same token, a different assessment will be made of the growth of trade in services. Usually, those who identify strong expansion in the trade in services include in the definition the profit remittances of service companies abroad or even the dividends on all foreign direct investment, and sometimes all invisibles in the balance of payments, which are then vaguely treated as "trade in services".

One source of uncertainty in evaluating the changing importance of services in world trade is that there is no information about costs and prices in the trade in services. Therefore, it is impossible to ascertain to what extent

changes in services reflect changes in prices or real flows. For the services whose border exchanges can be more easily observed, such as shipping, passenger services, port services and other transportation, as well as travel, it is possible to gather some information on tonnage, number of passengers etc. But services do not physically cross borders and they do not pass through customs, where the volume of goods crossing borders is registered. No distinction between value and volume can be established for the category of services whose border exchanges are "non-visible", as royalties and license fees paid for patents, trademarks, copyrights and similar non-financial intangibles, nor for the gamut of transactions lumped together under "other private services".

It is believed that, in addition to the underreporting in world shipping owing to the treatment given to revenues of flags of convenience fleets, most of the underreporting in trade in services occurs in the category of business services. Thus, very uncertain magnitudes are reported for services which are the fastest growing component in the domestic market of services in developed countries and precisely those where most of the potential for growth in international trade in services is deemed to be.

For the developed market economies, exports of services appear to have grown at a somewhat slower pace than those of goods during the past decade. The service to goods ratio in exports has thus declined, though only slightly. But the category "other services" has grown faster than the other groups. In the United States, this category of exports has come to exceed the exports of royalties, fees and trademarks. The types of services in this fast-growing category vary in importance from country to country. The largest components of United States exports in this category are insurance, construction, health, education, and computer software. In the United Kingdom, by far the most important is financial services, followed by other business consultancy. In France, engineering in public works and technical co-operation projects constitute the most important type of service exports. There is, however, little information on the growth of these types of trade.

The lack of disaggregated trade data on private services and the limited information on the direction of this trade makes it so far impossible to examine in detail the possible trends of international trade in business services. In the post-war period, trade in goods has expanded fast as a result of specialization among firms within the same industry and highly differentiated consumer preferences. International trade in services may well develop along similar lines. Countries would then not only be exchanging services from different sectors, but also specializing within the same sectors. This is already happening among airlines, mainly as geographical specialization, but it could occur in other sectors, and not only geographically, but activity-wise.<sup>13</sup>

<sup>12</sup> FAO, *Food Outlook*, February 1987.

<sup>13</sup> See H. Schaumburg-Müller, "Europe's trade in services: comparative advantage of intra-industry trade", working paper 4/1985 (Copenhagen, Institute of International Economics and Management, Copenhagen School of Economics and Business Administration, 1985).

Table III.13. Trade in non-factor services  
(Billions of dollars)

		1975	1980	1982	1984	1985	Annual average rate of growth	
							1985/ 1875	1985/ 1980
Developed market economies								
Shipping	+	25.9	50.0	44.9	41.8	43.3	5.3	-2.8
	-	26.8	50.6	46.3	49.4	49.7	6.4	-0.4
	=	-0.9	-0.6	-1.4	-7.6	-6.4		
Passenger services	+	6.4	14.3	14.4	15.0	15.4	9.0	1.5
	-	6.5	13.3	14.1	15.8	16.6	9.8	4.5
	=	-0.1	+1.0	+0.3	-0.8	-1.2		
Other transportation	+	21.3	43.5	41.5	38.0	38.2	6.0	-2.6
	-	23.3	47.0	45.8	40.4	40.5	5.7	-2.9
	=	-2.0	-3.5	-4.3	-2.4	-2.3		
Travel	+	32.8	72.2	69.7	70.5	73.8	8.5	0.2
	-	35.5	76.7	71.5	71.6	75.3	7.8	-0.6
	=	-2.7	-4.5	-1.8	-1.1	-1.5		
Royalties and fees	+	6.3	11.5	9.5	10.2	10.8	5.5	-1.3
	-	5.0	9.3	9.3	10.2	10.8	7.7	3.0
	=	+1.3	+2.2	+0.2	0	0		
Other private services	+	41.6	88.9	89.6	86.5	91.3	8.2	0.5
	-	33.8	71.9	74.6	72.3	75.1	8.3	0.9
	=	+7.8	+17.0	+15.0	+14.2	+16.2		
Total non-factor services	+	134.3	280.4	269.6	262.0	272.8	7.3	-0.6
	-	130.9	268.8	261.6	259.7	268.0	7.4	-0.1
	=	+3.4	+11.6	+8.0	+2.3	+4.8		
Share in merchandise exports (per cent)		23.9	22.7	23.5	21.5	21.7		
Share in merchandise imports (per cent)		23.5	20.6	22.3	20.5	20.6		
Developing countries								
Shipping	+	3.5	7.1	8.1	7.8	7.4	7.8	0.8
	-	14.3	32.9	33.7	28.5	23.8	5.2	-6.3
	=	-10.8	-25.8	-25.6	-20.7	-16.4		
Passenger services	+	1.1	3.8	4.4	4.2	4.3	14.6	2.5
	-	1.3	4.1	4.1	3.4	2.9	8.4	-6.7
	=	-0.2	-0.3	+0.3	+0.8	+1.4		
Other transportation	+	4.9	12.4	11.6	10.3	9.3	6.6	-5.6
	-	4.0	11.7	11.8	10.5	8.9	-8.3	-5.3
	=	+0.9	+0.7	-0.2	-0.2	-0.4		
Travel	+	4.6	24.2	21.9	21.4	20.7	16.3	-3.1
	-	6.9	21.7	21.0	18.3	18.0	10.1	-3.7
	=	-2.3	+2.5	+0.9	+2.8	+2.7		
Royalties and fees	+	0.2	0.5	1.1	0.2	0.1	-6.7	-14.9
	-	0.5	1.0	1.3	1.0	1.0	7.2	0
	=	-0.3	-1.0	-1.2	-0.8	-0.9		
Other private services	+	6.7	17.1	26.4	22.1	20.0	11.6	3.2
	-	8.6	26.5	38.0	32.5	32.3	14.2	4.0
	=	-1.9	-9.4	-11.6	-10.4	-12.3		
Total non-factor services	+	20.8	64.6	72.4	65.5	61.7	11.5	-0.9
	-	35.6	97.9	109.9	94.2	86.9	9.3	-2.4
	=	-14.8	-33.3	-37.5	-28.7	-25.2		
Share in merchandise exports (per cent)		11.5	14.0	17.6	16.9	17.7		
Share in merchandise imports (per cent)		21.4	26.2	28.6	27.0	28.0		

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics* tapes, partial data for 24 developed and 100 developing countries.

Note: A plus sign (+) indicates export or receipt.  
A minus sign (-) indicates import or payment.

The relatively slow growth of the exports of services may seem at odds with the impression of fast growth that discussion on the subject often gives. There are a number of reasons for this. Apart from the lack of adequate data and widespread underreporting (see box III.1), there are conceptual and statistical difficulties of measurement. For example, there is no agreed way of measuring banking and other financial services. Data on international banking do not permit separation between fees for services (and therefore trade in services) and payments associated with foreign investment. There is probably underreporting of trade in services. A further reason is that many services cannot be transported across borders, despite the progress in data processing and storage and telecommunications. They either require the movement of the consumer to the country providing the services (as in tourism or some health services), or the movement abroad of firms and/or experts providing the services. Business services are often of the latter type. If international sales of services can occur only by transferring abroad the "production" of that service, they are obviously excluded from trade statistics.<sup>14</sup> The increasing importance of services in the domestic economy does not thus show up in a corresponding increase in trade. Perhaps equally important in this context, the comparison of the proportion of domestic output of goods traded internationally with that of services may be unwarranted because a large fraction of domestic services is already embodied in goods traded and this share is increasing over time.<sup>15</sup>

Finally, slow growth is often due to the numerous barriers to this trade from state supervision and regulation of service activities. These regulations are basically designed for implementing various domestic policy goals and might not be intended to keep out foreign suppliers, but they nevertheless can reduce the potential for international trade. Most countries consider that certain services cannot be left entirely to the market place. Banking, for instance, raises issues of fiduciary and monetary control; telecommunication raises issues of national security; some audio-visual works and entertainment may be considered inimical to national and

cultural identity and value systems; and social security, medical insurance and also other forms of insurance raise questions of consumer protection, equity and distribution.<sup>16</sup>

Such considerations seem to suggest that the growth of trade in services will remain modest in the near future, even if progress is made in multilateral trade negotiations on the subject, which will take a long time.

The growth of the developing countries' trade in services has been somewhat higher than that of the developed countries, though the data are uncertain, cloud the actual trend and make international comparisons tenuous. The growth has been highest for the category of "other private services", and imports in this group of services have grown faster than exports. Construction and engineering, mostly in the area of infrastructure projects, as well as related professional and technical services, are the most important items in the category of "other services" for the handful of developing countries exporting such services. The Republic of Korea has been by far the most successful in the field, well ahead of Turkey, Yugoslavia, Brazil and India. Developing country exports of construction and engineering services have been directed mostly to other developing countries, especially the oil-exporting countries.<sup>17</sup>

Developed countries have had a surplus in their trade in non-factor services, but, after growing during the 1970s, the surplus has recently declined from \$US12 billion in 1980 to \$US5 billion in 1985. The deficit of developing countries declined during the same period from \$US33 billion to \$US25 billion.

The developing countries' deficit in trade in services with developed countries is heaviest in the category of "other private services". In this category, developed market economies have consistently shown a positive balance of about \$US16 billion annually during the 1980s, while developing countries during the same period had a negative balance of nearly \$US10 billion per year.

<sup>14</sup> For the examination of foreign direct investment as a vehicle for delivering services abroad, see report of the Secretary-General on the role of transnational corporations in services, including transborder data flows (E/C.10/1987/11).

<sup>15</sup> Canadian research is under way to estimate the direct and indirect amount of services embodied in a unit of the country's exports and imports with the help of input-output tables. For Canada, using very rough approximations, H. G. Grubel estimates that one-third of the value added to gross goods output consists of intermediate services. If the same percentage can be assumed to exist in exported goods, it is easy to infer that a considerable share of merchandise exports are actually services. For Canada, for instance, it would mean that services exports (direct and embodied) could be more than three times higher than what is recorded in their balance of payments (see H. G. Grubel, "Direct and embodied trade in services", service project discussion paper 86-1 (Vancouver, Canada, The Fraser Institute, 1986), and A. M. Rugman, "A transaction cost approach to trade in services", paper presented to the annual meeting of the American Economic Association, New Orleans, December 1986.

<sup>16</sup> It has been argued that here "the analogy has to be partly with armaments negotiations: we would not expect nation states to leave the location of defence production to be determined by market forces" (J.N. Bhagwati, "GATT and trade in services: how we can resolve the North-South debate", *Financial Times*, 27 November 1985).

<sup>17</sup> See A. Sapir, "Trade in investment-related technological services", *World Development*, vol. 14, No. 5, May 1986.

### Box III.1. Technical note on the measurement of trade in services

Service exports can be categorized in three major groups. The first comprises those services whose border exchanges are more "visible": shipping, passenger services (basically transportation of persons) and "other transportation" (basically port services, but including also charters of carriers), as well as travel (mainly tourism). In short, the group represents transportation and travel.

The second group is royalties and license fees. In the standard balance of payments, it appears as "property income not included elsewhere", and its main component is income accruing to the owners of patents, copyrights, trademarks and similar non-financial intangible assets. The inclusion of royalties and license fees in trade in services is controversial. It can be debated whether they are payments for services — at least they are payments for intangibles — or factor payments. The discussion on the role of knowledge in production and trade cannot be settled here. In practice, most frequently royalties and license fees are included in service trade, as they are here. Depending on the level of detail that information on services will reach in the future, they could become an altogether separate grouping in the balance of payments, specifying diverse "intellectual property rights" payments or "disembodied technology" payments, containing disaggregate figures to show which industries are earning or generating royalties payments.

The third group is an extremely heterogeneous collection under the heading "other goods, services and incomes". In its guidelines for member countries in making their balance-of-payments reports, IMF does not yet require disaggregated data for the residual item "other goods, services and income". This heading basically comprises services and, moreover, it is under this residual heading that most of the services are reported. Goods are not recorded in this item, despite the title, except for goods that should probably be called "embodied services", such as periodicals coming from abroad under subscription arrangements. Broadcasting and television programmes embodied in tapes are probably recorded under this item, though there is no assurance that some of it does not appear also under "merchandise".

The only disaggregation broadly available in this item is between official and private transactions. "Official services" comprise those of general government and the central bank; the principal kinds are those performed by embassies and consulates, military units and agencies abroad, other official entities such as aid missions, government information, tourism and immigration offices abroad (but not state enterprises), receipts or contributions under military arrangements and military services obtained, and other goods and services provided to or obtained by Government.

"Official transactions" should be excluded from trade in services for certain purposes. The corresponding expenditures are determined mainly by political power and diplomatic goals and can hardly be regarded as subject to trade

policy or trade negotiations. It might be that in some cases, official and private transactions are difficult to disentangle in international statistical records, because what in one country is the export of a private engineering firm, and therefore included under "other private services", could be, in the reporting country, a government procurement for road building or airport construction, and recorded under official services.

"Other private services" is a miscellaneous item covering all the rest, namely, a very large number of different activities, provided not only to final consumers but also, in particular, to firms. The item would include:

(a) Communications (postal, cable, telephone and telecommunications);

(b) Insurance (other than international freight insurance recorded under shipping);

(c) Brokerage, as fees paid to agents other than those included in the value of merchandise, brokerage and commissions charged on other transactions;

(d) Financial services performed by banks, underwriters and finance houses, as measured by the amounts of their charges (but not interest payments, which are an altogether different item in the balance of payments);

(e) Merchandising, inclusive gains from transactions in commodity futures and commodity arbitrage where the parties are not residents of the same economy (although financial futures and operations and arbitrage gains on financial items are in the capital account of the balance of payments);

(f) Provision of management, accounting and kindred services (for instance, those provided to a subsidiary by its parent);

(g) Legal and other consulting;

(h) Processing and repair (except those under "port services");

(i) Franchises and similar rights;

(j) Software and data processing;

(k) Research, surveys, testing and chemical and physical analysis;

(l) Provision of instruction, training and technical know-how;

(m) Construction and building design;

(n) Engineering and industrial design;

(o) Leasing of structures, machinery and equipment (other than the leasing of transportation equipment registered under "other transportation"); these transactions appear in some national records as "equipment rental";

*Box continued on next page*

- (p) Leasing of films, tapes, records and other tangible assets;
- (q) Medical services and other care and cure services;
- (r) Entertainment and cultural services, as by orchestras, theatre, opera or ballet groups, circus, sports, individual performers;
- (s) Other professional and technical services.

The information on trade in "other services" disaggregated in its heterogeneous types that exists for a few developed countries goes down to only four or five very broad categories. Only the United States has information available down to some 20 categories. For developing countries, disaggregated data are non-existent, and a number of developing countries lack the item in their balance of payments even at the aggregate level.

Moreover, it might be that some of the payments for these services appear under other categories in the balance of payments such as labour income. Labour services provided by the crew of carriers in international transportation are classified under "labour income" in the IMF *Balance of Payments Manual*. Though such a recommendation is not spelt out for construction crews, it is likely that the foreign earnings of construction and engineering firms are partly reflected in remittances of their construction teams abroad and classified under "labour income" or "workers remittances".

Data on the direction of trade in "other services", which would allow the examination of the question "who is trading with whom", are in an even more shaky state than the sector-wise disaggregation.

Recorded under the heading "other private services" are, in principle, all the most technologically advanced intermediary services or business services. Concrete figures for this aggregate are sometimes puzzling,<sup>18</sup> and it could be that the weight of less sophisticated types of services in this aggregate is still important. The exact composition, even in the case of developed countries, is unknown and further data have to be awaited<sup>1</sup>

By their very nature, service transactions are more difficult to measure. In fact, the largest discrepancies between total world exports and total world imports appear in service items, namely, in transportation and in "other official and private services". A high discrepancy is shown in transpor-

tation, where world receipts recorded have been consistently lower than world expenditures. At the origin of most of the underreporting is the existence of open-registry fleets (also called "flags of convenience" fleets); these are fleets operating under flags of countries that do not require ownership or management to be located within their territories. As a rule, receipts and expenditures of open-registry fleets are not recorded in the balance of payments of countries of registry. Neither are they in the countries of residence of the shipowners, since they are operated by subsidiaries located in the country of registry.<sup>19</sup>

Other large discrepancies appear in the item "other official and private services". Uncertainties about measures in this item are of particular concern because proposals for the liberalization in services are focused on activities grouped in it. Measurement difficulties arise from the balance of services of centrally planned economies, from a seeming overestimation in the OPEC data for both expenditures and receipts in "other services" and, more importantly, from an underreporting of exports of business services of developed countries.

A special inquiry made in Sweden for the year 1977 revealed that actual receipts of royalties, patents and licenses were almost double the data recorded, and exports of technical services were almost four times the figure recorded in the balance of payments.<sup>20</sup> In the United States, according to a recent study, "as much as half of the nation's exports of services may escape the official statistics".<sup>21</sup> Defining trade in services as non-factor income and including fees and royalties, this study by the Office of Technology Assessment of the Congress of the United States concludes that the United States balance-of-payments data understate both imports and exports of services. The understatement for exports exceeds that for imports and in consequence, the United States surplus on services trade appears to be far greater than reflected in the official statistics. The mid-range estimate of the Office of Technology Assessment for exports is almost double the official figures.<sup>22</sup> The study has left out of the comparison the banking services, because in the United States balance-of-payments, there is no way of isolating what would be the fees earned by banks for services — that is, non-factor income and therefore part of trade in services — from the returns to United States holders of foreign portfolio investments — that is, factor income.<sup>23</sup> The special difficulty in measuring the services exported by the banking sector is not peculiar to the United States; co-mingling with interest

*Box continued on adjacent page*

<sup>18</sup> For instance, IMF balance of payment records show that developing countries, during the 1970s, have expanded their exports of "other private services" much more rapidly than developed market economies.

<sup>19</sup> For a more detailed discussion, see UNCTAD, *Economic Consequences of the Existence or Lack of a Genuine Link between Vessel and Flag of Registry*, Geneva, 1977 and OECD, "The world current account discrepancy", *Occasional Studies*, June 1982.

<sup>20</sup> See "The development of Sweden's balance of payments, Appendix: Omissions in reporting of exports of services", *Quarterly Review of the Sveriges Riksbank*, 1979: 2, cf. OECD, "The world current account discrepancy", *loc. cit.*

<sup>21</sup> United States Congress, Office of Technology Assessment, "Trade in services: exports and foreign revenues — special report" (OTA-ITE-316), (Washington, D.C., Government Printing Office, September 1986), p. 3.

<sup>22</sup> *Ibid.*, pp. 37-38.

<sup>23</sup> *Ibid.*, pp. 31, 38 and 54-58.

payments and other investment earnings is a general shortcoming.

Underestimation in service exports might arise also from the fact that in many cases services are sold bundled with goods — for instance, maintenance service for some equipment — and might be recorded under goods. This statistical problem is different from the larger issue of the growing “service content” in all industrial goods.

The uncertainty of the data on production of services and their trade across borders, and the possibility of the margin of errors that cannot be estimated, are likely to hamper for quite some time the assessment of trends and their impact in different economies or country groups. It might significantly slow the formulation of policy and negotiating positions in discussions on trade in services.



## Chapter IV

### INTERNATIONAL FINANCE, DEBT AND BALANCE-OF-PAYMENTS ADJUSTMENT

The primary concern of policy makers with regard to the International financial situation differ dramatically from those of a few years ago. At the beginning of the decade some developing countries were able to borrow large sums from international commercial banks. There were fears that credit was too easy, but the value of trade was growing strongly. The concern today is that many of those countries are excluded from new borrowing as a legacy of debt crises and the limited prospects for the growth of world trade. Instead, much of the world's international financial flows are directed towards the largest economy of the world, which used to be a major source of capital outflows.

At the beginning of the decade, the international community still looked to the large commercial banks to intermediate much of the recycling of financial resources from surplus to deficit countries. Today, more and more private international intermediation is carried out through securities markets in the major financial centres around the globe, which are themselves becoming ever more closely integrated. But many countries are excluded from these financial circuits.

The following analysis focuses on these dichotomies and draws policy implications from them. In line with the conclusion of chapter II, the analysis highlights the need for better co-ordination of adjustment policies among major developed market economies in order to maintain the confidence of the foreign creditors of the United States. Net capital flows to the United States need to be reduced in a gradual and orderly manner to avert a destabilizing and con-

tractionary fall of the dollar. At the same time, many developing countries need to rebuild their capacity to take in and service foreign commercial credits, a capacity that was lost in the debt crises of the 1980s.

One implication seen in the slow-growth trend of world trade and the depressed prospects for commodity prices is that partial debt relief in one form or another must be added to the options available in negotiations to restructure the debt of developing countries. The goal is to reach a sustainable debt-servicing burden through a combination of internationally supported domestic adjustment programmes and some relief from outstanding debt-service obligations. Consistent packages of domestic policy reforms, targeted adjustment credits and debt relief could be negotiated in the same complex of forums that has already been used to develop comparable packages that have had similar aims, but have not thus far granted permanent debt relief.

For the multilateral development institutions to play their proper role in this process, current and prospective negotiations to replenish and expand their resources need to be quickly completed. Increased official development assistance is as warranted as ever. Today, it would be especially timely.

In the long run, what is needed is a smooth redirection of international capital flows to developing countries instead of to the United States, in a context of sustained growth in industrial countries and recovery of international trade.

#### Intercountry flows of financial resources

Uneven and changing access to international finance has been a major determinant of import levels and the balance of payments on current account in the 1980s. Many developing countries and certain centrally planned economies that had relied on substantial foreign financing of imports in the 1970s and early 1980s found it necessary to reduce import levels and current account deficits quickly when new financing dried up and debt crises erupted. With diminishing optimism about the medium-term growth of world trade and financial inflows, other countries adopted more cautious attitudes to borrowing on foreign markets and sought to strengthen their current account balances. The Republic of Korea, with its economy growing rapidly, is beginning to use its new current account surpluses to reduce its outstanding foreign debt in order to lower its vulnerability to future financial disturbances. In a contrasting context of domestic austerity, Romania is reducing its indebtedness to foreign commercial banks. The energy-exporting developing countries that were capital exporters in the 1970s have also become more cautious, seeking to narrow recent current account deficits so as to slow the rate at which their net international asset positions are drawn down.

The recent experience of the United States of America illustrates the obverse case: being a reserve-currency country and seen as a safe and remunerative placement for funds,

the United States has encountered no limit thus far to its net financial inflows, much of which have originated in the Federal Republic of Germany and Japan. The resulting pattern in the balance of payments on current account of these three countries has stayed basically the same since 1984, but the aggregate balance of developed market economies swung from a \$40 billion deficit in 1984 to a \$28 billion surplus in 1986 (see table IV.1). The latter was due mainly to the shift in trade balances discussed in chapter III above, highlighting the fact that current account balances are simultaneously determined by net current and capital transactions. Indeed, trade factors also brought about the marked deterioration in the current account balances of energy-exporting developing countries, which was not, however, matched by the decrease in the current account deficit of energy-importing countries. Aside from a further deterioration forecast for the United States current account, some unwinding of these 1986 changes is expected this year.

#### Net transfer of financial resources from developing countries

The limitation of the overall flow of international finance to developing countries is highlighted by the trend in the net transfer of financial resources, that is the net flow of foreign

Table IV.1. World balance of payments on current account<sup>a</sup>, by country group,  
1980-1987  
(Billions of dollars)

	1980	1982	1984	1985	1986 <sup>b</sup>	1987 <sup>c</sup>
Developed market economies	-37.9	-7.4	-40.0	23.3	28.3	-3.0
Large industrial countries	-11.6	14.7	-40.0	-26.1	11.3	-17.0
Germany, Federal Republic of	-8.9	10.3	13.4	20.5	43.7	37.0
Japan	-9.4	8.3	36.5	50.1	87.8	80.0
United States	8.4	-1.7	-96.0	-104.1	-126.7	-140.0
Other industrial countries	-26.3	-22.1	0.1	2.8	17.0	14.0
Developing countries	40.2	-87.3	-39.1	-27.5	-61.5	-46.5
Capital-surplus countries	105.6	15.1	-2.3	8.3	-15.4	-8.0
Capital-importing countries	-65.4	-102.4	-36.8	-35.8	-46.1	-38.5
Energy exporters	2.5	-35.0	-0.5	-3.1	-24.1	-17.0
Energy importers	-67.9	-67.4	-36.3	-32.7	-22.0	-21.5
China	-3.2	5.9	2.4	-11.5	-7.5	-7.0
Centrally planned economies of Europe <sup>d</sup>	-5.0	3.3	10.0	2.3	-2.2	-0.5
Eastern Europe	-8.2	0.3	3.8	2.0	-1.8	-0.5
USSR	3.6	3.5	6.6	0.5	-0.2	0.5
Residual <sup>e</sup>	6.0	85.5	66.7	60.0	42.9	57.0

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

- a Balance on goods, services and private transfers.
- b Preliminary estimates.
- c Secretariat forecast, rounded to the nearest half-billion dollars, based on an average crude oil export price of \$17 a barrel.
- d Balance with market economies; total includes net interest payments of CMEA banks.
- e Reflects errors in reported data, balances of economies whose data are not included, and timing asymmetries in national inflows and outflows. Errors include under-reporting of services earnings, especially involving investment income channelled through offshore financial centres and non-factor services exported by the developed market economies to energy-exporting countries.

exchange resulting from net capital flows minus international payments of interest and profit.<sup>1</sup> For the capital-importing developing countries taken together, the net transfer was significantly negative in 1986 for the third year in a row (see table IV.2).

The contrast between the early and middle 1980s is stark. In the first period, capital-importing developing countries as a whole enjoyed net financial transfers that were applied both to the accumulation of official reserve assets and to payment for import levels that exceeded what could be purchased only with current proceeds, that is earnings from export of goods and services and the remittances from nationals working abroad. With the sharp fall beginning in 1982 in the net financial transfer and the heavy depletion of reserves, it became impossible for those countries in aggregate to spend more on imports than was earned in exports and remittance activity. Instead, the balance of payments on goods and non-capital services had to shift into surplus in order to effect a net transfer out of these countries, as well as to rebuild reserve levels. The latter had been accorded a high priority, which with hindsight was appropriate, as many

countries found it necessary again to draw down their reserves, especially the energy-exporting countries (see table A.12).

The negative transfers of \$24 billion for 1985 and 1986 shown in table IV.2 are each the result of adding together negative transfers for some countries, and positive transfers for others. It is nevertheless significant that 27 developing countries had negative transfers in 1985; with perhaps a slightly smaller number having negative transfers in 1986.

A negative transfer of financial resources is not always burdensome. For example, in the case of the Republic of Korea, the net transfer of resources was an outflow of over \$7 billion in 1986. In part this represented large net interest payments, but over \$4 billion of the net transfer was a net capital outflow, which took the form of both increases in foreign assets and net repayments of foreign debt. However, because of the Republic of Korea's strong export performance in 1986, and a favourable development of its terms of trade due especially to lower oil prices, import volume grew by 13 per cent and GDP by 12 per cent.

<sup>1</sup> For a formal derivation of the net financial transfer from standard macro-economic identities, see "Definition and measurement of the net transfer of resources", *World Economic Survey 1986* (United Nations publication, Sales No. E.86.II.C.1), annex III.

Table IV.2. Net transfer of financial resources to the capital-importing developing countries, 1980-1986<sup>a</sup>  
(Billions of dollars)

	1980	1982	1983	1984	1985	1986 <sup>b</sup>
Transfer on account of direct investment						
Net investment flow	9.2	11.4	8.4	7.9	8.8	8
Net investment income	-13.8	-13.2	-11.3	-10.6	-9.7	-9
Net transfer	-4.6	-1.8	-2.8	-2.7	-0.9	-1
Transfer on account of private credit flows <sup>c</sup>						
Net credit flow	34.2	25.8	9.8	8.7	-0.9	-6
Net interest paid	-18.0	-42.2	-38.6	-41.4	-38.3	-35
Net transfer	16.2	-16.3	-28.7	-32.7	-39.3	-41
Transfer on account of official financial flows <sup>d</sup>						
Net credit and grants	34.4	37.5	42.1	36.6	29.4	30
Net interest paid	-6.3	-8.9	-10.3	-11.9	-13.4	-12
Net transfer	28.0	28.6	31.8	24.7	15.9	18
Overall net transfer	39.6	10.5	0.1	-10.6	-24.2	-24
Memorandum items:						
Use of official reserves <sup>e</sup>	-15.8	23.4	-2.8	-17.1	-2.6	12
Balance of payments on goods and non-capital services	-23.8	-33.9	2.7	27.7	26.8	12

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics*; World Bank, Debtor Reporting System; and other national and international sources.

- a Sample of 98 countries for which adequate information was available.  
b Preliminary estimate (rounded to nearest billion dollars). Estimates of official and private credit flows for 1986 are especially subject to revision as full information is not yet available on banking flows and other factors.  
c Net flow on account of short-term and long-term liabilities and assets of developing countries *vis-à-vis* the foreign private sector.  
d Including use of IMF credit. A breakdown by source of official financing for a slightly larger sample of countries is given in Table IV.7.  
e Additions to reserves are shown as negative numbers.

The negative net transfer of resources has been causing difficulties in most developing countries, however, because it has been having an adverse effect on economic growth. Although most resources for investment in developing countries are derived from domestic savings, these countries normally also draw on foreign resources. Financial transfers that are not in the form of grants will require return flows to repay credits and to transfer interest and profits to the sources of the finance. It is understood that resources for those return flows should be generated from the investment of the initial inflows. Meanwhile, new inflows would help to finance further investment. In principle, the process can continue for a long period with total inflows exceeding total outflows, in other words with the net transfer of financial resources being positive, provided that returns from the investments are high enough and that the debt is serviced smoothly. Difficulties with the latter precipitated the premature drop in net transfers which, in turn, has been making the adjustment process difficult to carry out.

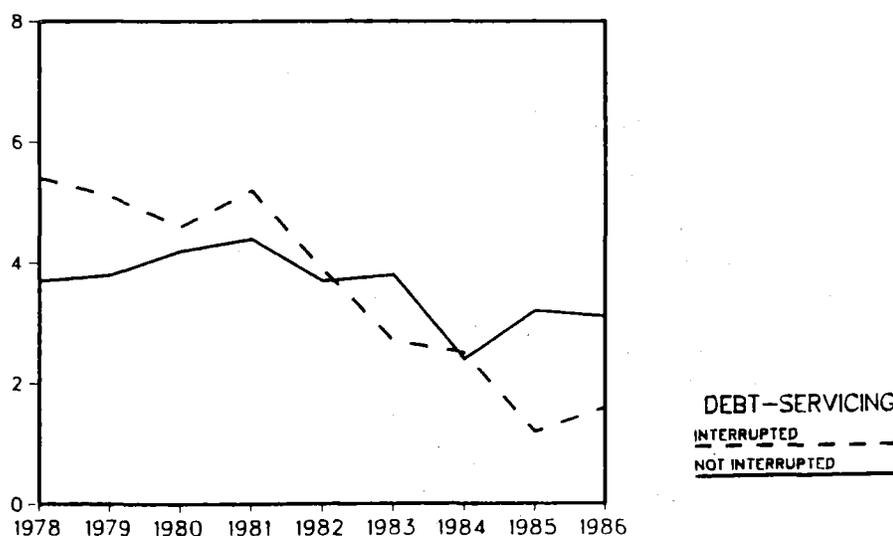
The sharp deterioration in the overall net transfer of financial resources to developing countries was basically caused

by the contraction and then the reversal in direction of net private credit flows (see table IV.2). As analysed below, substantial net private inflows are unlikely to return until developing country adjustments are in an advanced stage, domestic economic stability is increased, export prospects have improved, and sustainable economic growth has resumed.

This assessment applies to the wealth held abroad by the nationals of developing countries, often called capital flight,<sup>2</sup> as much as to the wealth originating in other countries. The high degree of communication among the affluent communities of the world, the extensive integration of international financial markets, and the policy preference for liberalization of capital markets all seem to have erased the distinction between the international movement of funds by enterprises and individuals from developing and developed market economies. Capital funds of developing countries are no longer restricted in their international movement by cultural barriers or a limited range of foreign investment opportunities.

<sup>2</sup> Some problems of definition and controversies related to capital flight were discussed in *World Economic Survey 1986*..., pp. 74-76.

Figure IV.1. Net capital flows to capital-importing countries, 1978-1986<sup>a</sup>  
(Percentage of GDP)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data and country classification of IMF, *World Economic Outlook*.

<sup>a</sup> Including official transfers, but excluding net changes in official reserves as a form of capital flow.

### Diversity of situations in capital-importing countries

One determinant of the ability of capital-importing countries to mobilize foreign financial resources is their recent debt-servicing history. Figure IV.1 summarizes the experience of two groupings of countries drawn from a larger grouping comprising the capital-importing developing countries, certain smaller developed market economies and member countries of IMF with centrally planned economies (see also box IV.1).<sup>3</sup>

On the whole, capital-importing countries that had no interruption in their debt-servicing did not suffer a shock to their net inflow of foreign capital. Since the late 1970s, as shown in figure IV.1, the range of fluctuation of the ratio of net capital inflows to the GDP of these countries as a whole has been less than 2 percentage points. Foreign capital has provided 10 per cent of the financing of domestic investment on average, a significant but not overriding contribution. The countries have also made substantial saving and investment efforts of their own, leading to a high overall ratio of

investment to GDP of 26 per cent or more from 1978 to 1986. As expected when investment is consistently high, it was accompanied by relatively rapid economic growth, averaging 5.5 per cent a year over the same period.

This experience is in marked contrast to that of the countries that had difficulties in servicing their foreign debt in the early 1980s, defined as the countries that incurred arrears during 1983 and 1984 or rescheduled their debt at least once from the end of 1982 to mid-1985. Capital inflows to those countries averaged 5 per cent of GDP from 1978 to 1981; but since the onset of the debt crisis, the ratio has dropped, ending in the neighbourhood of 1.5 per cent in 1985 and 1986. Net foreign capital in flows accounted for a relatively high share of investment in the first five years, averaging over 19 per cent, but that share was halved over the next few years. Investment also suffered, falling from a substantial annual average share of GDP of 25 per cent from 1978 to 1982, to an average of only 18 per cent since 1983. Not surprisingly, output growth suffered as well, averaging slightly over 2 per cent for the whole period, or zero growth in per capita terms.

<sup>3</sup> The sample includes all countries covered by IMF, *World Economic Outlook*, except the groups there denoted "industrial countries" and "capital exporting countries". Data pertaining to the groups of countries shown in figure IV.1 were derived from data of IMF. Sixty-one countries were in the subgroup whose debt servicing was interrupted and 63 countries were in the other subgroup.

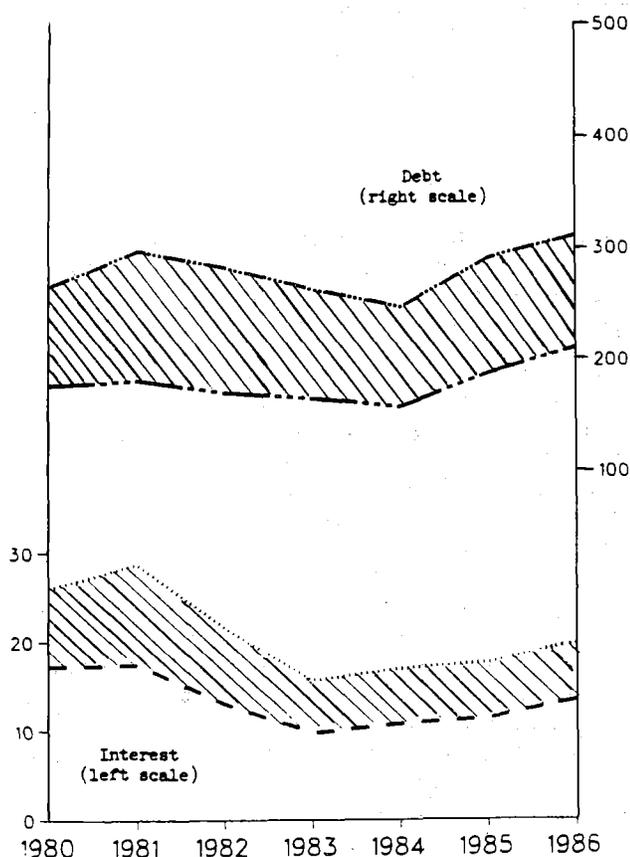
### Box IV.1. External debt and economic adjustment in Eastern Europe

Of the six centrally planned economies of Eastern Europe, Poland and Romania have required multiple reschedulings in the 1980s of international commercial bank debt and official debt owed to developed market economies. Both countries had confronted sudden limitations of credit from the market economies at the beginning of the decade and introduced sharp adjustment programmes in response. The other countries of the region, recognizing that adhering to plans for growth of output required net financial inflows whose availability was suddenly less assured, also introduced rig-

orous adjustment programmes. Today, after considerable progress in the intervening years, these countries remain vulnerable to debt difficulties.

The main policy goal of their early adjustment programmes had been to restrain absorption by holding down or even slashing investment and to a lesser degree consumption, containing imports and promoting exports. As a result, the group's trade balance with market economies shifted from a deficit of \$4.0 billion in 1980 to a surplus of \$7.0 billion by 1984. External debt indicators for convertible-currency debt consequently improved that year (see the figure).

Indicators of the convertible-currency debt of Eastern Europe<sup>a</sup> owed to market economies, 1980-1986  
(Percentage of convertible-currency exports<sup>b</sup>)



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

a Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland and Romania.

b As convertible-currency exports make up only part of exports to developing countries, it is difficult to give a precise estimate of total convertible-currency exports. The figure therefore shows debt and interest payments each relative to exports to developed market economies and to the latter plus developing countries, the actual ratios relative to convertible-currency exports lying in between (i.e., in the shaded areas)

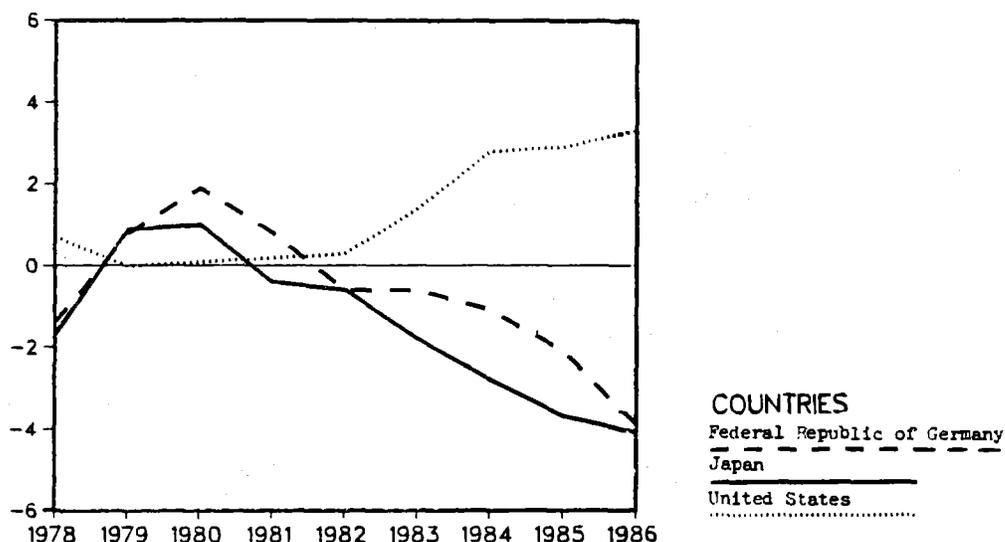
Trade balances with centrally planned economies improved at a slower rate, from a deficit equivalent to \$1.8 billion in 1980 to near balance by 1984. During that period, a continuing net capital inflow, especially from the Soviet Union, was obtained. That inflow, which helped to ease the transition to a trade surplus with the market economies, rose from \$1.9 billion in 1980 to \$3.4 billion in 1981, dropping back to \$1.8 billion in 1982. This was a major departure from earlier policy, in which trade balances within the group of the European centrally planned economies were kept within narrow bounds and not accumulated significantly over time. Indeed, special measures were taken to assist Poland in both its intra-regional and extra-regional payments relations.

After several years of austerity, Governments were able to ease restraints on imports and consumption, and investment slowly began to recover. But the dollar value of exports to the market economies fell in 1985; it essentially stagnated in 1986, when the terms of trade also deteriorated. In essence, the limit to export expansion on the basis of existing capacities and economic structures had been reached. The protracted slow growth in investment had taken its toll on the growth of overall production capacity, while the social and economic scope for switching expenditure from domestic use to exports had severely narrowed.

Once again, the region was confronted with a dilemma: cut absorption or increase external debt. Half the countries chose the latter, borrowing and building up foreign exchange reserves in 1985 and drawing on these and new facilities in 1986. As a result, the debt indicators worsened appreciably in 1986. The dilemma thus persists.

A lasting solution requires greater growth in production capacity — and thus in investment — than is foreseen. The 4.8 per cent growth in investment planned for Eastern Europe in 1987 is a sharp improvement over the 2.6 per cent realized in 1986. But more appears required to make up for the slow growth in 1979-1984. If 1987 targets are realized, the group's investment levels will return to what they were in 1980, but still remain well below the peak of 1978.

Figure IV.2. Net capital flow of the Federal Republic of Germany, Japan and the United States, 1978-1986<sup>a</sup>  
(Percentage of GDP)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of IMF and national authorities.

<sup>a</sup> Net inflow (positive) or outflow (negative) of all assets and claims, including official reserve assets.

### Changing capital flows of the United States

In marked contrast to many other capital-importing countries, net capital flows into the United States reached a new peak in 1986. So, too, did net outflows from the Federal Republic of Germany and Japan. The net inflow to the United States well exceeded 3 per cent of its GNP, capping a steady increase that began in 1983. The Federal Republic of Germany's net capital outflow almost doubled in 1986 as it approached 4 per cent of GNP, while that of Japan exceeded 4 per cent for the first time (see figure IV.2). The United States inflow is expected first to widen in 1987 and then to begin narrowing in 1988. The surpluses of Japan and the Federal Republic of Germany are expected to begin narrowing in 1987. In any event, all the net flows are forecast to remain substantial over the medium run and a primary source of the inflows to the United States would continue to be those outflows from the Federal Republic of Germany and Japan.<sup>4</sup>

The United States has been a favoured placement for international funds, especially since 1984. The attraction has ap-

plied both to United States funds that might otherwise have been lent overseas and to foreign funds that are placed in the United States market, as opposed to offshore dollar investments or investments in other currencies. Increasingly, the net flows have come from Japan, other Asian sources, especially in 1986, and from the European Economic Community, particularly the Federal Republic of Germany and the United Kingdom (see table IV.3).<sup>5</sup>

A new feature in 1986 was that net private sector flows to the United States were \$11 billion less than in 1985. Total net credit flows rose \$24 billion, however, to \$147 billion for the year. These extra funds came from foreign official inflows, virtually all of which were used to purchase United States Treasury securities. The flows were concentrated in the second and third quarter of the year when industrial countries attempted to slow the fall in the dollar exchange rate through intervention activities.<sup>6</sup> As a result, flows from Governments accounted for over one fifth of the net credit flows to the United States in 1986.

United States private lending abroad rebounded to \$66 bil-

<sup>4</sup> In particular, the baseline projection of Project LINK foresees net capital flows to the United States of \$120 billion in 1990, while net outflows from Japan would be \$55 billion, and the net outflow from the Federal Republic of Germany would fall to \$13 billion (forecast presented at a meeting of Project LINK, United Nations Headquarters, 9 March 1987).

<sup>5</sup> The integration of EEC financial markets makes it necessary to present data in table IV.3 for the Community as a whole rather than for individual countries. For example, substantial investments of the Federal Republic of Germany are routinely routed through Luxembourg and England. Even so, credit flows of EEC, Japan and others that are routed through offshore centres are not grouped with their original sources. Nationally identified flows in table IV.3 thus understate the actual flows.

<sup>6</sup> United States Department of Commerce, "U.S. international transactions, fourth quarter and year 1986", *Survey of Current Business*, March 1987.

Table IV.3. Net international credit flows to the United States, 1980-1986<sup>a</sup>  
(Billions of dollars)

Partner country or country group	1980	1982	1983	1984	1985	1986 <sup>b</sup>
Canada	-6.0	-1.0	0.5	3.0	7.2	7.5
Japan	8.3	13.9	19.3	33.1	45.0	53.4
European Economic Community	-8.4	-13.1	-2.0	10.2	25.1	26.0
Other developed market economies <sup>c</sup>	1.9	0.5	1.1	-0.2	2.1	1.8
USSR and Eastern Europe	-3.1	-3.0	-1.7	-2.1	-1.4	-0.3
OPEC countries	33.9	10.4	8.7	11.9	9.0	8.0
Offshore banking centres and other developing countries <sup>d</sup>	-19.3	-9.8	10.4	32.3	35.4	50.3
Total	7.4	-2.1	36.2	88.1	122.4	146.6
Memorandum items						
Private and public sector flows						
Foreign official	15.5	3.6	6.0	3.0	-1.3	33.4
United States Government <sup>e</sup>	-5.2	-6.1	-5.0	-5.5	-2.8	-2.0
Net private	-2.9	0.5	35.3	90.6	126.6	115.2

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 a 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.
- e Excluding reserves.

lion in 1986 from only \$7 billion in 1985. About 85 per cent of those credit outflows comprised bank lending, especially by Japanese banks that were funding international dollar loans in part with funds raised in the United States market by their branches in that country and United States-owned banks that were financing European securities operations from United States resources.<sup>7</sup> In 1985, foreign lending by banks in the United States was not even \$1 billion. In 1982 it had been \$111 billion. That decline in the outflow of funds had freed resources to pay for rapidly growing imports when the outflow of funds had freed resources to pay for rapidly growing imports when the United States current account deficit first swelled. The return to high levels of gross lending abroad in 1986 eliminated that source of financing and instead pushed up gross United States foreign borrowing requirements significantly beyond the net borrowing shown in table IV.3.

Measured total borrowing of \$188 billion was mainly supplied through three channels. First, foreign borrowing by banks provided over 40 per cent of the total. Secondly, foreign purchases of United States Treasury securities accounted for about another 20 per cent. Finally, almost 40 per cent of the gross measured foreign credit inflow was met through foreign purchases of other United States securities.

Out of a total inflow of \$71 billion to buy those latter securities, 25 per cent were for purchases of corporate stocks and the rest for bonds. In both cases, Western European buyers were dominant (54 per cent of foreign purchases of stocks and 74 per cent of bonds), although Japanese buyers were also important (19 per cent of foreign purchases of both types of security). Whereas European buyers have long been active in United States securities markets, as have Canadian buyers, substantial Japanese activity is a relatively new phenomenon, particularly in the equity markets.

The pattern shown by gross capital inflows to the United States in 1986 may typify the composition of inflows for the rest of the decade that is, heavily oriented towards portfolio investments. What is not yet known is whether such investments will be more or less volatile than traditional international banking flows or the interaffiliate financing of transnational corporations. Foreign investors, especially Japanese investors as discussed below, have apparently been interested in diversifying their portfolios into United States equity shares and bonds, despite exchange rate losses due to the fall of the dollar against the yen and several European currencies. For short-term placements, exchange-rate losses can be hedged on the forward or futures market. Funds placed in the market for a longer period, however, are

<sup>7</sup> *Ibid.* Data presented on United States financial inflows and outflows are as measured in United States balance-of-payments statistics. However, the large statistical discrepancy in United States payments data averaging \$24 billion in the 1980s is thought to significantly involve private financial flows and their earnings, which means that measured flows are incomplete.

exposed to exchange-rate loss, as was again the case in the first quarter of 1987.

The answer to what happens when the United States bull market ends probably depends heavily on what is happening at that time in other markets in the United States and elsewhere. At the present time, it can only be said that a certain vulnerability exists in the rapidly growing external financial claims on the United States economy. And although foreign claims of the United States are also growing, the net international investment position of that country including direct investment is becoming substantially negative; more than doubling in 1986 to the neighbourhood of \$250 billion.<sup>8</sup> In this sense, the United States has become the world's largest net debtor, although its gross debt the conventional measure of indebtedness usually cited in discussions of other debtor countries was far higher, on the order of \$920 billion at the end of 1986.

A large and rapidly growing pool of foreign-owned United States assets is thus being held by large numbers of investors in highly marketable and liquid form. Despite the large amount of outstanding foreign indebtedness, however,

the United States would not face a debt crisis in the same sense as already faced by the developing countries. Indeed, the debt is almost entirely denominated in domestic currency. The question at issue is the exchange value of the dollar payments and United States interest rates relative to those abroad. Reserve currency status as enjoyed by the United States is predicated on confidence in the purchasing power of the currency. Sharp and sudden movements of dollar exchange rates as in the first quarter of 1987 already seem to indicate substantial uncertainty on the part of holders of dollar assets. A loss of confidence of the foreign investors in the value of those assets measured in their home currencies could destabilize international foreign exchange trading and provoke a rapid further fall of the dollar exchange rate. In response, United States monetary policy might tighten to raise interest rates relative to those abroad, with contractionary effects on total demand, leading possibly to a recession. Confidence would be raised, however, by showing progress in correcting the full pattern of imbalances in international payments and fiscal positions, which emphasizes the importance of timely implementation of the coordinated adjustment measures derived in the analysis presented in chapter II.

### Composition of international financial flows

While it is expected that the international payments imbalances among major developed market economies will be reduced, though at a slow pace, it is uncertain whether adequate net financial flows will be redirected to the other capital-importing countries of the world. If not, the world economy may remain trapped in a path of undesirably slow growth of trade and output. It was argued in chapter II that significantly rising real income on a world-wide basis presupposes domestic macro-economic and structural adjustment in developed and developing countries and a reinvigorated growth of world trade. International financial flows are needed to support those developments. Yet it is doubtful that the institutional channels through which such flows were made in the past will again be open to the same degree to many capital-importing developing countries.

#### Portfolio investment: the emergence of Japan

Portfolio investment (equity shares, bonds and other securities) has recently served as a major form of balance-of-payments financing for the United States. On a smaller scale, net purchases of securities by the capital-surplus developing countries in the years of high petroleum prices and current account surpluses were followed by net reflows of portfolio funds since 1983, as foreign securities were sold and bond issues of the capital-surplus countries were floated

internationally. Capital-importing developing countries, however, have not generally received significant inflows of portfolio investment. The 15 countries on which the discussion of the debt crisis in middle-income countries has focused had some success in tapping such funds in the early 1980s, but there was a net reversal of those flows after their debt crises began (see table IV.4).

The growth of international flows of portfolio investment among developed market economies has well exceeded the increases expected solely on the basis of changing current account balances. Individuals and institutions are now relying more heavily on securities as a form in which to hold international wealth and borrow foreign resources. In 1986, for example, bonds accounted for over 60 per cent of net international bank and bond financing of the world, compared with under 40 per cent in 1982.<sup>9</sup> One reason is that the securities markets of the major developed market economies are increasingly being liberalized with respect to the instruments that can be floated, issuance procedures, interest rates and exchange controls.<sup>10</sup> In addition, innovations in securities financing have created a broader and more widely available selection of financial instruments.<sup>11</sup> The international investment-banking industry continues to generate a virtual flood of innovations in securities, many individually designed to meet the needs of one client or another. In 1986,

<sup>8</sup> Calculated as end-1985 net negative position of \$107 billion plus the net financing of the current account deficit of \$141 billion. More complete figures, including the effects of changes in exchange rates and the market prices of securities, are usually published by the United States Department of Commerce in the June issue of *Survey of Current Business*.

<sup>9</sup> These estimates are stated so as to take account of increases in coverage of banking data over time and estimates of double-counting of bank and bond financing, bond redemptions and repurchases. Data for 1986 pertain to first-half year (see Bank for International Settlements, *International Banking and Financial Market Developments*, October 1986, p. 21).

<sup>10</sup> See IMF, *International Capital Markets: Developments and Prospects* (Washington, D.C., December 1986), pp. 32-38.

<sup>11</sup> See "The changing institutional character of international financial markets in the 1980s", in *Supplement to World Economic Survey 1985-1986* (United Nations publication, Sales No. E.86.II.C.2).

Table IV.4. Net inflows from international portfolio investment, 1980-1986<sup>a</sup>  
(Billions of dollars)

	1980	1982	1983	1984	1985	1986 <sup>b</sup>
Developed market economies						
Europe	5.6	-15.7	-0.6	-0.4	-2.9	..
Japan	9.4	1.0	-3.0	-24.2	-41.4	-68.8
United States	10.5	9.5	1.8	25.6	67.5	88.4
Other	5.5	9.4	4.2	5.2	10.0	..
Developing countries						
Capital-surplus <sup>c</sup>	-24.0	-14.2	5.5	14.5	8.3	..
Capital-importing <sup>d</sup>	1.3	7.1	3.1	2.0	2.3	..
of which:						
15 heavily indebted <sup>e</sup>	1.7	4.4	0.4	--	-0.7	..
Unidentified <sup>f</sup>	-8.2	2.7	-11.0	-23.5	-43.8	..

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

- a Positive numbers indicate net sales of securities abroad (new foreign issues minus retirements, plus net sales to foreigners of existing securities held in domestic portfolios); negative numbers are net purchases of securities. Data are from balance-of-payments statistics which conventionally exclude placement of official foreign exchange assets but include as inflows liabilities constituting foreign authorities reserves).
- b Available information is insufficient to make estimates for country groups.
- c Excluding Brunei Darussalam.
- d Sample of 98 countries.
- e Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.
- f Excluding countries and errors and inconsistencies in national balance-of-payments data.

such innovations were heavily directed towards meeting the cash flow and risk profiles desired by Japanese institutional investors.<sup>12</sup>

Japanese holdings of international securities have only recently reached major proportions. Before 1985, the stock of long-term international securities owned by Japanese investors did not exceed the foreign holdings of long-term Japanese securities. But by the end of 1985, gross private holdings of foreign securities had grown to \$146 billion or 55 per cent of the Japanese private sector's total long-term foreign assets (including direct investment). At the end of 1980, comparable securities holdings had been only \$21 billion, accounting for 32 per cent of long-term foreign assets.<sup>13</sup>

The basic sources for these major changes in Japanese financial behaviour are found at the start of the 1980s. Substantial financial regulations had boosted economic growth in earlier decades by advantageously directing financial resources to the Government, banks and firms. As growth slowed, those regulations were seen to have become a disadvantage and deregulation of banking, money markets, and international capital flows began in the late 1970s. The Government of Japan then formally adopted a new policy, embodied in the Foreign Exchange and Foreign Trade Control Law of 1 December 1980, which, *inter alia*, liberalized cap-

ital movements in and out of Japan. For example, it eased restrictions on purchases of foreign bonds by Japanese investors and granted foreign exchange banks greater freedom to lend abroad.

At the same time, financial institutions, other institutional investors, non-financial corporations and individuals sought higher yields on financial investments. Money and capital markets attracted increasing funds, including excess liquidity of corporations that had reduced their rates of real capital formation. Funds were also shifted from banks into financial markets as inflation reduced the real return on bank deposits with fixed nominal interest rates.

Increased use of financial markets in Japan and more liberal access to foreign markets thus provided an environment conducive to the growth of foreign portfolio investment. The resulting surge in portfolio outflows was especially marked for private financial institutions and insurance companies. And further liberalization measures are being adopted that progressively increase the ceiling on holdings of foreign securities by different categories of financial institutions and broaden the range of allowed securities.

By late 1986, the share of foreign securities in total securities holdings of Japanese banks and also the share in trust accounts held by banks had each reached 15 per cent (com-

<sup>12</sup> See *Euromoney Special Survey: Innovations*, January 1987, pp. 2-8 and 41.

<sup>13</sup> Based on data of the Bank of Japan, *Economic Statistics Monthly*.

pared with 2.5 per cent in 1980). The comparable holdings of life insurance companies reached 25 per cent and those of other financial institutions almost 20 per cent. Indeed, an active market in United States Treasury bonds has arisen in Tokyo itself, and the yen-denominated Euro-bond market — with no exchange rate risk for Japanese buyers — grows apace.

The growth of international securities investing by Japan and analogous growth in the demand for international securities elsewhere are increasing the flexibility of world finance as they increase the diversity of financial instruments. In another sense, however, external portfolio investments are a relatively narrow mode of financing, as they channel resources almost completely to developed countries. To attract more of these funds into placements in developing countries, several developing country Governments and multilateral institutions have recently stepped up financial experimentation, seeking, for example, to deepen local capital markets and create mutual funds of developing country securities that could be sold internationally.<sup>14</sup>

For countries with a capacity to absorb additional debt, capitalizing on the securitization trend in international finance may be a key to channelling inflows of private financial resources over the medium term at least — provided the market finds those countries to be acceptable credit risks. For borrowers able to carry additional debt but lacking direct access to securities finance, new financial flows will be more dependent on the intermediation of the World Bank and other multilateral institutions. The latter borrow under their own name in the securities markets by issuing bonds, the proceeds of which are lent to member countries. These countries usually cannot float bond issues of their own and certainly not on the terms realized by the multilateral institutions. This emphasizes the importance of expanding the lending capacity of these institutions by increasing their own capital.

### The changing nature of international banking

Net international bank lending to the capital-importing developing countries totalled -\$4.5 billion in the first three quarters of 1986. Although a certain portion of this represented a writing-down on the books of banks of the value of debt to a few countries or sales of such debt to non-bank buyers, it also represented repayments of principal on bank loans in excess of new bank lending. During the same period, the capital-importing countries reduced their deposits in the same banks by \$10.9 billion, representing what might be termed a disengagement of the banks and the developing countries of \$15.4 billion.<sup>15</sup> On a comparable basis, lending

to Eastern Europe (excluding the Soviet Union) stagnated, while deposits were drawn down by \$1.4 billion. At the same time, total net international bank lending grew by \$110 billion.

These developments do not seem to have been an aberration but a continuation of recent trends. The partial exception was a temporary jump in lending to Eastern Europe of \$1.9 billion in 1985 (see box IV.1). In 1984, Eastern European bank debt had contracted by \$1.6 billion. For the capital-importing developing countries as a whole, bank lending (net of amortization) was of the order of \$40 billion a year before 1982, but it fell to \$9 billion in 1984, \$8 billion in 1985, and turned negative in 1986.

Global bank lending continued to grow throughout the period, which means that the lending has been increasingly concentrated on borrowers in the major financial markets and, in particular, United States borrowers. The flow of lending from international banks to the United States reached \$36 billion in 1984, \$58 billion in 1985, and \$47 billion in the first three quarters of 1986.<sup>16</sup>

These lending trends have persisted long enough to have changed the composition of the world stock of international bank debt. From the late 1970s until 1984, the developing countries accounted for about 20 per cent of total international indebtedness to banks. By September 1986, their share had fallen to 16 per cent. The decline was concentrated in 15 high-debt developing countries, but the share of other developing countries also fell. So, too, has the share of the centrally planned economies (see figure IV.3).

The changing distribution of international bank debt seems to reflect a sharply different emphasis in the business strategy of the banks compared with that of the early 1980s. At that time, banks were heavily engaged in directly recycling financial resources from capital-exporting countries to capital-importing countries. The standard instrument was a multi-bank arrangement financed out of Euro-currency deposits, although domestic currency loans to foreign borrowers also played a role. Together, these credit facilities accounted for over half of the total of international bank and bond financing arrangements. However, by 1984, this form of financing represented only one quarter of the total and in 1986 it was only 18 per cent.

Instead, banks have become ever more involved in the international securities markets discussed above. Almost half the gross international lending arrangements set up by banks in 1984 and 1985 were not even loans but back-up facilities for various international securities transactions, up from only 5 per cent in 1982.<sup>17</sup> Banks have also been major

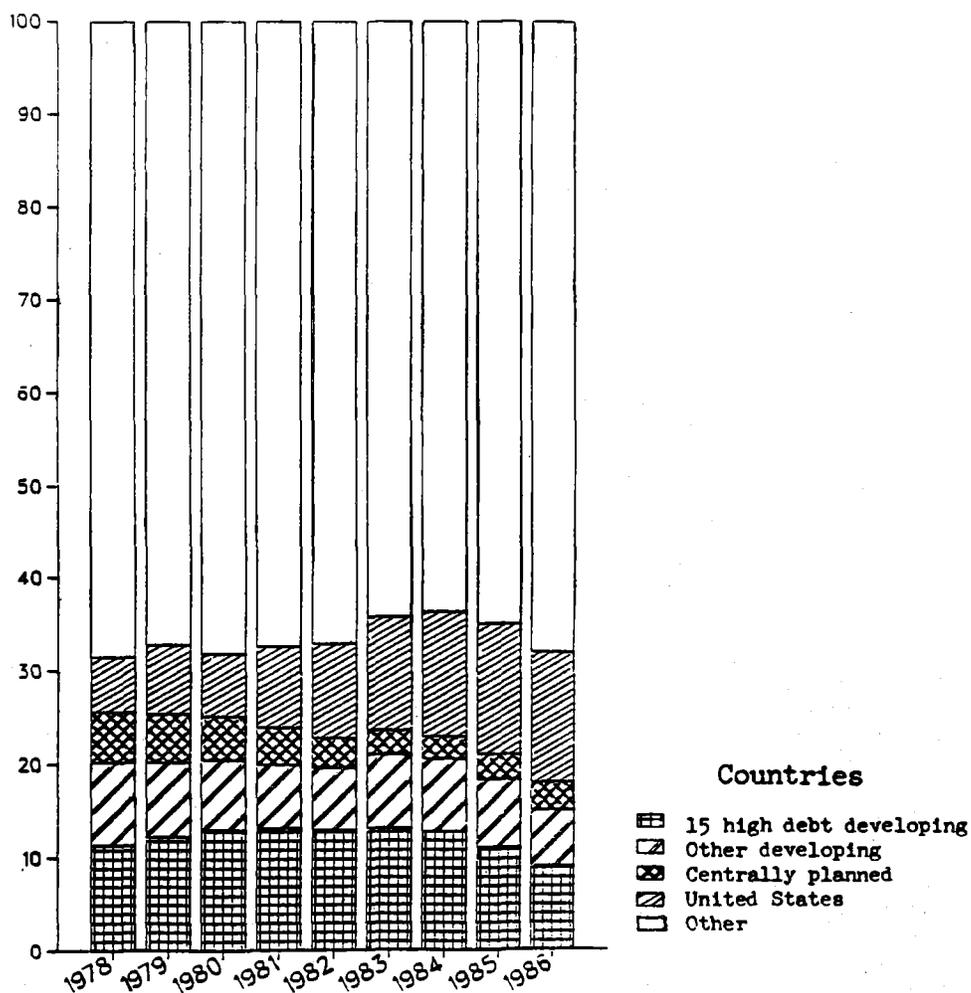
<sup>14</sup> See IMF, *International Capital Markets* . . . , pp. 72-73.

<sup>15</sup> Data are quarterly flows at constant exchange rates and pertain to all capital-importing developing countries, excluding offshore financial centres (derived from BIS, *International Banking Developments*, January 1987).

<sup>16</sup> The resurgence in 1986 of overseas lending by banks located in the United States appreciably slowed the growth of net international claims of banks on the United States economy. The latter fell from an increase of \$34 billion in 1984, to one of \$24 billion in 1985 and to one of only \$5 billion in the first three quarters of 1986.

<sup>17</sup> Arrangement of such facilities may have peaked in 1985 as the newly emergent Euro-commercial paper market, which does not require back-ups, has offered new competition. As a result, the facilities arranged by banks fell to 36 per cent of international bank lending arranged in 1986 (data of OECD, *Financial Statistics Monthly*, January 1987).

Figure IV.3. World distribution of indebtedness to international banks, 1978-1986  
(Percentage share at year-end<sup>a</sup>)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of the Bank for International Settlements.

<sup>a</sup> End of September 1986.

participants in the securities markets themselves, engaging heavily in swaps, options and forward rate agreements involving instruments with different currency and interest-rate characteristics.<sup>18</sup> As more and more of their income is earned in securities activities, international banks are becoming more like investment banks than pure commercial banks.

While this development has important implications for the effectiveness of monetary policy in the major international financial centres and for the prudent supervision of banks themselves,<sup>19</sup> it also has major implications for the interna-

tional flow of financial resources. In 1982, developing countries accounted for one quarter of the gross value of funds arranged on international banking and bond markets. In 1986, they accounted for only 6 per cent (see table IV.5). Developing countries were least active in the securities markets, where broad market familiarity and a high degree of investor confidence have been prerequisites for successful borrowing. Instead, developing countries were concentrated in syndicated bank borrowing, Table IV.5. Developing countries were least active in the securities markets, where broad market familiarity and a high degree of investor confidence have been prerequisites for successful borrowing. In-

<sup>18</sup> See BIS, *Recent Innovations in International Banking* (Basle, April 1986), prepared by a study group established by the central banks of the group of ten countries.

<sup>19</sup> See BIS, *Recent Innovations...* and OECD, "Prudential supervision in banking," *Financial Market Trends*, No. 35 (November 1986), pp. 13-23.

Table IV.5. Gross borrowing arrangements on international capital markets by the developing countries, 1980-1986  
(Billions of dollars)

	1980	1982	1983	1984	1985	1986
Bank credits arranged of which:	50.5	41.4	32.3	29.3	20.3	16.1
Involuntary lending <sup>a</sup>	--	--	13.9	11.1	7.1	--
Bonds	4.2	4.0	2.6	3.5	7.1	3.1
Total financing arranged	54.2	45.3	34.9	32.8	27.4	19.2
Memorandum items:						
Share of developing countries in world total (percentage)						
Bank credits	33.9	39.9	40.1	25.0	17.4	17.6
Total financing	27.0	25.3	22.1	14.3	9.6	6.1

Source: Data of OECD, *Financial Market Statistics*, re-aggregated according to *World Economic Survey* country grouping (forced lending, according to IMF enumeration of debt-restructuring agreements, as published to *International Capital Markets: Development and Prospects*, December 1986).

<sup>a</sup> "New money" arranged as part of agreements to restructure commercial bank debt. Although new money for Mexico (\$6 billion) and Nigeria (\$0.3 billion) was negotiated in 1986, arrangements were not completed and no commitments were announced before the end of the year.

stead, developing countries were concentrated in syndicated bank borrowing, where they have taken a declining share of a declining market. Indeed, a substantial portion of the credits arranged since 1983 were required of the banks in the form of "new money" components of debt-restructuring agreements in order to help service already outstanding debt. Even restricting attention to countries that have not had major debt-servicing difficulties and that have the capacity to carry additional foreign debt, the aggregate flow of loanable resources that might be intermediated directly by the international commercial banks does not seem set for a major expansion. Should those countries wish or need to substantially increase their rate of foreign borrowing, they might have to mobilize foreign resources through other channels. As noted previously, securities markets might be an option for some of the countries, but countries with low average income levels are unlikely to be able to tap such markets.

### The path of direct investment

Foreign direct investment has often significantly increased the capacity of host countries to produce tradable goods; but international capital movements to finance direct investment have not generally had a dominant impact on the balance of payments of major economies or on the conventional statistical aggregates of smaller economies. Net direct

investment flows have recently made a moderate contribution in aggregate to the net capital inflows of the capital-importing developing countries, averaging about \$8 billion a year after the onset of the debt crisis of 1982 (see table IV.6). The flows appear to have been deterred by overall economic slow-downs associated with balance-of-payments and domestic stabilization in host countries. In particular, net flows since 1983 to the 15 high-debt countries have averaged less than 60 per cent of the average flow from 1980 to 1982.

Major changes have also occurred in the flows of direct investment registered by developed market economies.<sup>20</sup> While there has been an increase in the measured net outflow from several countries, that of Japan has been especially marked and is likely to be sustained. Indeed, an influential report by a panel of advisers to the Prime Minister proposed a doubling over the next seven years of net direct investment as a share of Japan's gross domestic product.<sup>21</sup>

Japan's foreign direct investment outflows have been growing rapidly since approval requirements for direct investment were removed by the Foreign Exchange and Foreign Trade Control Law of 1980. Since then, Japanese direct investors only need to notify the Government of their investments. Meanwhile, foreign direct investment in Japan has remained marginal, generally staying below \$500 million a year.

<sup>20</sup> Differences in definition, coverage and valuation in national data on direct investment require that extreme caution be used in making cross-country comparisons from table IV.6. The extent of the inconsistency in reported data is indicated by the wide swings in unidentified flows shown in the table (see also the report of the Secretary-General on data on foreign direct investment, including capital inflows and outflows, and other aspects of the activities of transnational corporations (E/C.10/1986/3), submitted to the Commission on Transnational Corporations at its twelfth session.

<sup>21</sup> See "Report of the Advisory Group on Economic Structural Adjustment for International Harmony" (Maekawa Report), April 1986.

Table IV.6. Net direct investment flows, 1980-1986<sup>a</sup>  
(Billions of dollars)

	1980	1982	1983	1984	1985	1986 <sup>b</sup>
Developed market economies						
Japan	-2.1	-4.1	-3.2	-6.0	-5.8	-11.6
Major European sources						
Germany, Federal Republic of	-3.9	-2.0	-1.4	-2.2	-2.9	-3.5
Netherlands	-3.3	-1.6	-2.2	-3.4	-2.7	-2.0
United Kingdom	-1.2	-2.4	-2.7	-7.4	-4.7	-5.7
North America						
Canada	-3.2	-2.4	-3.5	-1.3	-6.0	-0.5
United States	-2.4	16.3	11.5	21.4	-0.3	-6.3
Other	3.7	2.9	3.3	-1.4	-2.2	..
Developing countries						
Capital-surplus <sup>c</sup>	-0.4	9.2	5.6	5.5	2.2	2.0
Capital-importing <sup>d</sup> of which:	9.2	11.4	8.4	7.9	8.8	8.0
15 heavily indebted	4.6	6.1	3.4	3.2	4.1	3.0
Unidentified <sup>e</sup>	3.5	-27.5	-15.7	-13.2	13.6	..

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

- a Net inflows are shown as positive numbers, net outflows as negative numbers. Significant differences among national reporting practices require extreme caution in making cross-country comparisons of the value of direct investment flows.
- b Data of developed market economies partly estimated; preliminary estimates for developing countries.
- c Excluding Brunei Darussalam.
- d Sample of 98 countries.
- e Excluding countries and errors and inconsistencies in national balance-of-payments data.

The outflow of Japanese direct investment has been strongly linked to Japan's trade performance, in particular, Japan's share of host country imports.<sup>22</sup> Much of Japanese investment has been for export substitution or the further manufacturing of Japanese intermediate goods for re-export. This notwithstanding, only 29 per cent of Japan's direct investment has been in manufacturing itself (measured in terms of the total value of investment notifications received since 1951, which excludes increases due to reinvestment of profits). The share of manufacturing is also declining, accounting for only 19 per cent of new investments in fiscal year 1985/86. The share of mining has declined even faster; although accounting for 14 per cent of accumulated investment since 1951, it was only 5 per cent of the total in 1985/86. The major growth has been in investment in services, especially financial services. Accounting for only 13 per cent of total investment since 1951, financial sector direct investment was 21 per cent of the total in 1984/85 and 31 per cent in 1985/86.

Having thus achieved a strong overseas presence—with increased lending from Tokyo itself—Japan has become the world's largest international banking nation. Its banks held over \$1 trillion in international assets in September 1986 or almost one third of the global total. By comparison, the second largest banking nation of the world, the United States, held less than 20 per cent and the third, the Federal Republic of Germany, held only 8 per cent. Two years earlier, Japan had been in second place, close behind the United States, whose banks then held more than one quarter of the world's international bank assets.<sup>23</sup> Similarly, Japanese investment banks have taken an increasing role in world securities markets; for example, four Japanese financial institutions were among the top 15 Eurobond investment houses in 1986, lead managing over 20 per cent of all issues, double their share in 1985.<sup>24</sup>

The recent growth of Japanese direct investment has been particularly concentrated in the United States, accounting for 44 per cent of the value of Japanese investment notifica-

<sup>22</sup> Econometrically estimated equations suggest that relative cost factors have also been important determinants, particularly the cost of raw material imports to Japan for investment in North America and relative wage rates, especially for investment in Asia (see Japan Economic Planning Agency, *Economic White Paper 1986*, pp. 200-201).

<sup>23</sup> BIS, *International Banking Developments*, January 1987, p. 15. Japanese banks became especially prominent in 1986 as underwriters of note issuance facilities, accounting for 7 of the top 15 banks in this field. Only 2 were in the top 15 in 1985, notwithstanding the fact that total activity in this market segment had been higher that year (based on data compiled by *Euromoney*).

<sup>24</sup> *Euromoney*, February 1987, p. 9.

tions during fiscal year 1985/86, compared with 33 per cent the year before. Market-related factors have in part determined the flows to the United States—for example, the attraction to financial sector investments or the effect of the rising yen in reducing the competitiveness of Japanese manufactured exports. However, policy-related factors have also played a role. As discussed in chapter III, there have been responses to pressures for protectionist limitations against imports from Japan and other major suppliers. Direct investments may be made in order to jump such barriers or prospective barriers. The most fully developed example is the automobiles industry, where Japanese companies have established co-operative ventures with every American manufacturer and have set up manufacturing facilities of their own in the United States. Japanese companies that produce automobile components are also undertaking direct investments in the United States.<sup>25</sup>

As the fastest growing source of direct investment, the Japanese share of the stock of total foreign direct investment in the United States rose from under 6 per cent in 1980 to over 10 per cent at mid-decade. The total inflows to the United States from all sources, however, after growing rapidly through the 1970s and up to 1981, when they reached \$25 billion, have since fluctuated in a range of \$12 billion to \$26 billion a year, the latter being the inflow in 1986.

Meanwhile, United States direct investment abroad, after an uncharacteristic period of very low or negative outflows from 1982 to 1984, rose to \$19 billion in 1985 and then to \$32 billion in 1986, fuelled especially by reinvested overseas earnings and loans from United States parents to overseas affiliates, the latter concentrated in the services sector. As a result, far from being a net source of financing for the United States balance-of-payments deficit on current account, net direct investment added \$6 billion to the United States net foreign borrowing needs in 1986 that were discussed above.

About one tenth of the 1986 outflow of United States direct investment went to developing countries, as did perhaps 15 per cent of Japanese direct investment in fiscal year 1985/86 (in both cases, excluding investments in tax-haven countries). Comparable figures apply to other sources of direct investment outflow. Policy makers believe that these flows can be increased through new multilateral efforts that would supplement existing schemes to promote direct investment in developing countries. Thus, to complement national facilities of developed market economies that insure direct investments against non-commercial risks (e.g., expropriation, convertibility and transfer abroad of profits

and capital, and breach of contract), the World Bank developed the Multilateral Investment Guarantee Agency (MIGA). When it becomes operational, MIGA will provide guarantees, insurance and reinsurance of direct investments along with technical and advisory services to host country Governments for promoting investment. The latter would supplement advisory services and research now provided by the United Nations through its Centre on Transnational Corporations. In addition, the International Finance Corporation (IFC) of the World Bank Group introduced a new service in 1986 designed to overcome investor hesitancy by transferring full investment risk from the investor to IFC until the investment matures.<sup>26</sup>

Aided by such new initiatives, developing countries will continue to arrange direct investments in particular projects or sectors, perhaps at a higher aggregate rate than in the recent past. Nevertheless, it will be difficult — as it has always been — to mobilize large volumes of direct investment when countries are in the midst of economic adjustment difficulties. For general balance-of-payments needs, other forms of financing must first be applied as catalysts for economic recovery.

#### **Official finance for adjustment and growth of developing countries**

In the entire post-war period, official financial flows have played a substantial role in financing balance-of-payments adjustment and economic growth in the developing countries. In the 1970s, parts of both of those roles were transferred to private sector financing, especially international banking. The preceding review of recent developments in international finance indicates that private resources have not recently made a major contribution to financing adjustment processes in developing countries.

Against those developments in private sector flows must be set the trend in official finance. Official grants virtually stagnated over the first half of the 1980s, although they rose at mid-decade in response to the food crisis in Africa. The performance of official lending, however, has been disappointing. The net transfer of resources associated with official lending has declined sharply in nominal dollar terms, as new lending did not keep pace with growing principal and interest payments. From over \$20 billion in 1983, these net resource transfers fell to \$2 billion in 1985, the last year for which reasonably complete data are available (see table IV.7). The sum of all bilateral transfers arising from official lending actually became negative in 1985, owing to the especially marked decline in new official export credits.<sup>27</sup> Bilat-

<sup>25</sup> See the report of the Secretary-General on recent developments related to transnational corporations and international economic relations (E/C.10/1987/2), paras. 13-25, submitted to the Commission on Transnational Corporations at its thirteenth session

<sup>26</sup> Denoted GRIP (Guaranteed Recovery of Investment Principal), the programme eliminates the risk of capital loss by having the investor lend its investment funds to IFC which itself makes the equity investment in the project. Later, the original investor either recovers his loan or takes over the equity stake of IFC if the project is a success. Capital gains and dividends would be split.

<sup>27</sup> The decline in imports caused by balance-of-payments restrictions was one reason for the decline in official export credit financing, which extends to export credit insurance as well as the direct lending included in table IV.7. Another reason for the decline is the standard cut-off of new credit as a result of debt-servicing difficulties and debt-restructuring agreements. For an analysis of issues in restoring official export credit cover, see "Trade financing for developing countries: some aspects of current difficulties and policy responses" (TD/B/C.3/212, 11 July 1986) study by the UNCTAD secretariat for the Committee on Invisibles and Financing Related to Trade.

Table IV.7. Net transfer of official financial resources to the capital-importing developing countries, 1980-1985<sup>a</sup>  
(Billions of dollars)

	1980	1981	1982	1983	1984	1985
Net transfers on lending						
Developed market economies	5.0	6.1	4.9	4.2	2.8	-1.4
Concessional	3.9	4.4	3.6	2.4	2.3	1.7
Non-concessional	1.1	1.8	1.2	1.8	0.6	-3.1
Centrally planned economies	0.9	0.5	0.6	0.7	0.2	0.5
Concessional	0.7	0.2	0.3	0.5	0.2	0.3
Non-concessional	0.2	0.3	0.2	0.2	--	0.2
Capital-surplus developing countries	1.4	1.7	0.5	0.6	0.3	-0.4
Concessional	1.2	1.5	0.7	0.3	0.3	0.2
Non-concessional	0.2	0.2	-0.3	0.3	--	-0.6
Multilateral development institutions <sup>b</sup>	6.1	5.9	7.4	5.8	7.0	5.2
Concessional	3.6	2.6	3.0	2.7	2.8	2.9
Non-concessional	2.5	3.4	4.4	3.1	4.2	2.3
IMF credit	1.1	4.7	4.2	9.0	1.8	-2.4
Total transfers on lending <sup>c</sup>	15.1	19.7	17.6	20.5	12.3	1.9
Concessional	9.4	8.6	7.8	5.9	5.7	5.5
Non-concessional	5.7	11.0	9.8	14.7	6.6	-3.7
Official grants <sup>d</sup>	13.4	13.6	11.3	11.5	12.6	14.5
Overall net official transfers	28.5	33.3	28.9	32.1	24.9	16.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on World Bank, Debtor Reporting System; IMF, *International Financial Statistics and Balance of Payments Statistics*; and other sources.

- a Disbursements minus principal and interest payments on medium-term and long-term credits to 104 capital-importing developing countries (*World Economic Survey* grouping) based on debtor data reported to the World Bank.  
b Excluding IMF, except for IMF Trust Fund.  
c Including other countries, multiple creditors and unallocated loans.  
d Aggregate of official transfers received from all sources for all purposes as reported in recipient countries' balance-of-payments statistics.

eral transfers related to concessional financing have not been spared from a weakening or stagnating trend; nor have the transfers from any of the groups of donor countries shown in table IV.7.

Lending by multilateral development finance institutions stands out strongly in comparison with these other lending flows. Although the transfer of financial resources through these institutions has fallen from its 1982 peak, it was the only source of significant positive net transfers associated with lending in 1985 among the groupings identified in table IV.7.

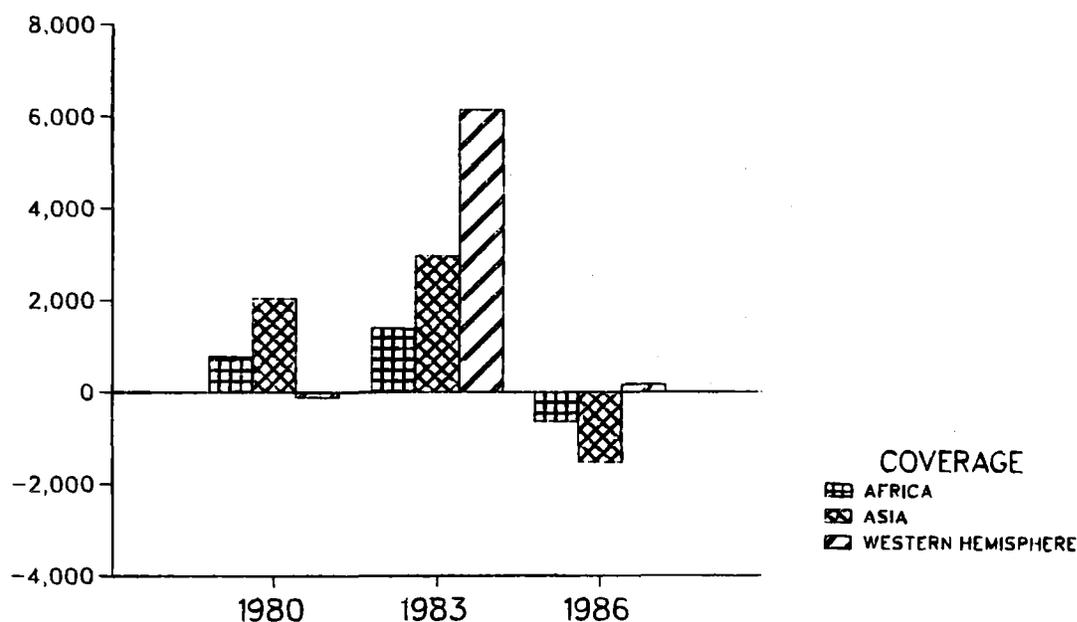
In comparison with the multilateral development institutions, flows from the International Monetary Fund showed greater swings. The Fund had boosted its net lending in support of adjustment of developing countries to \$11.1 billion in 1983 from half that amount in the two preceding years. Whether or not the 1983 flow was at a sufficient level, the net flow became -\$2.7 billion in 1986, having fallen to virtu-

ally zero in 1985 (see table A.13). Gross lending by the Fund in 1986 had fallen to little more than one quarter of its 1983 peak, while repayments on loans were more than four times the 1983 level. Net reflows came from the developing countries of Africa and Asia, while the net flow to western hemisphere countries was virtually nil (see figure IV.4). Lower-income and middle-income groups of developing countries accounted for almost the entire amount of net repayments (94 per cent).<sup>28</sup> The least developed countries made net repayments in 1986 for the third consecutive year.

These repayments of Fund loans did not indicate a general completion of adjustment processes. Indeed, the number and value of new IMF lending arrangements for developing countries increased in 1986 to 31, committing a total of \$4.0 billion in Fund resources (compared with 26 arrangements for \$3.4 billion in 1985). Nine of the new arrangements, committing \$0.2 billion, were under the new Structural Adjustment Facility (SAF), aimed specifically at the adjust-

<sup>28</sup> Countries classified into income groups in accordance with *Handbook of International Trade and Development Statistics, Supplement 1985* (United Nations publication, Sales No. E/F.85.II.D.12).

Figure IV.4. Net flow of IMF credit to the main regions of the developing countries, 1980, 1983 and 1986<sup>a</sup>  
(Millions of dollars)



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

<sup>a</sup> Net flows in SDRs, including Trust Fund, converted to dollars at yearly average exchange rates.

ment needs of low-income countries. The Facility — financed out of reflows from the IMF Trust Fund and providing resources on highly concessional terms under three-year adjustment programmes — became operational in 1986. It represented an explicit recognition that enhanced IMF financing of low-income developing countries was warranted. An important precedent was also set in 1986 for IMF financing of certain middle-income countries: for the first time, the Compensatory Financing Facility of the Fund was used to help meet the balance-of-payments needs of a country that is a substantial exporter of petroleum, namely, Ecuador.

Some additional official resources for adjustment assistance were also provided in 1986 by the World Bank through the \$1.6 billion Special Facility for Sub-Saharan Africa established in 1985 and designed to provide quick-disbursing assistance to low-income countries in the subregion that were undertaking medium-term policy reforms. In addition, World Bank Group programmes of structural and sectoral adjustment lending were expanded. Policy-based lending arrangements reached 22 per cent of total lending by the World Bank Group in 1986. However, total lending of the Group rose only 2 per cent in 1986, after a one third rise in 1985. Taking the last two years together, policy-based lending has thus been a rising share of a growing total.

Total commitments by multilateral development institutions grew only 4 per cent in 1986. This followed a 15 per cent growth in 1985, but the latter had largely been a recovery from a previous fall (see table A.14). These commitments have not grown commensurate with the need for multilateral co-operation, which must support adjustment as well as traditional long-run development programmes. The trend in total flows necessarily follows the trend in those of the World Bank Group, as the latter accounts for over two thirds of the total. But the trend of slow growth or decline in annual commitments has been almost universal among the institutions that provide financial and direct operational assistance. Indeed, most of the multilateral institutions committed less resources in 1986 than in their previous peak year and the commitments of several actually declined. Commitments of the World Bank Group in 1986 did exceed the previous peak (1983), generating an average growth since then of 4 per cent a year. Only the activities of the African Development Bank have expanded rapidly beyond their last peak year.<sup>29</sup>

One reason for the overall shortfall in recent years in multilateral financial activities lies in the nature of the bulk of the activities themselves, which are related to long-term development projects and programmes. A common consequence of adjustment programmes in response to

<sup>29</sup> Development finance commitments by Arab regional and national development institutions have also been on a declining or stagnant trend (see table A.15).

balance-of-payments difficulties has been a cut-back in investment spending. Countries under pressure to adjust their fiscal deficits tend first to reduce expenditures that can be postponed with minimal economic or social disruption for example, local counterpart financing of new public investment projects. In addition, some projects that were planned when expectations of international prices were different were reassessed, and in some cases new Governments that had replaced the originators of the project had different priorities. As a result, not only have projects been delayed, but a number of outright cancellations of multilateral loan agreements have occurred, as borrowing countries would otherwise have had to continue paying commitment fees on the undrawn balances of loan agreements.

While adjustment strategies had thus reduced the ability of many developing countries to absorb long-term multilateral finance, so, too, have the resources for lending been constrained on the supply side. Protracted negotiations for the seventh increase in the resources of the Inter-American Development Bank (IDB) not only slowed the Bank's lending activity in 1985 and 1986, but also curtailed the development of new types of operations that would have aimed at increasing the flexibility of its present operations. Similarly, the International Fund for Agricultural Development (IFAD), whose resources are exclusively devoted to projects for the rural poor, found its lending slowed by the long delay between the initiation of consultations on the second replenishment of the Fund in July 1983 and the coming into effect of the replenishment at a low level in November 1986 (the IFAD Special Programme for Sub-Saharan Africa had gone into effect in May). Commitments in 1986 were less than half the average for the period 1979-1983.

In the face of its resource constraints, IFAD has sought expanded co-financing from donor and beneficiary country Governments. Co-financing has also been a significant feature of the operations of the regional development banks and the World Bank. Regional banks have supplied funds to projects of IFAD and the World Bank, as have other development assistance and export credit agencies. In addition, the World Bank has pioneered in developing co-financing with private creditors, while both IDB and the Asian Development Bank have also experimented with private co-financing programmes of their own.

Most co-financing, however, has served to channel additional official financing into projects approved by the multilateral institutions. Although improved efficiency is embodied in having official financial institutions draw on the project evaluation expertise of the multilateral institutions, official co-financing does not in general raise net new resources for development financing and only modest amounts of new private resources have thus far been mobilized. In particular, between July 1983 and June 1986, the

World Bank arranged \$2.6 billion in commercial co-financing, one fifth of total co-financing with the World Bank. In fiscal year 1985/86, less than \$0.6 billion was arranged with private sources for four projects (out of 113 projects having \$3.5 billion in co-financed resources). This notwithstanding, World Bank co-financing with private sources of finance, especially commercial banks, may help facilitate the re-entry into private markets of countries that have been excluded from those markets since encountering debt-servicing crises.<sup>31</sup>

After more than half a decade of experience with official and private financial flows under the special conditions of the 1980s, an international consensus has been forming that multilateral finance for development should expand significantly over current levels. For example, the joint Development Committee of the World Bank and IMF strongly supported a growth path of World Bank lending that would raise total lending to \$21.5 billion in fiscal year 1989/90, although the existing capital stock could currently support a maximum continued annual lending level of about \$14.5 billion to \$15.0 billion. The Committee thus agreed that "a substantial general capital increase will be required if quality lending materializes as expected". Planning such a capital increase might be accorded high priority in 1987, especially as an important outstanding financing arrangement was completed in February 1987, namely that for the International Development Association (IDA), the soft-loan affiliate of the Bank. That agreement will provide \$12.4 billion in contributions for the eighth replenishment of IDA to be lent over three years, beginning 1 July 1987.

Major capital increases of the regional development banks are also under negotiation. The proposed capital increase of IDB would raise its lending authority by \$25 billion over four years, compared with total loan approvals since the Bank was created in 1959 of only \$35 billion. The capital of the African Development Bank would be increased by 200 per cent, to approximately \$18 billion, according to a proposal agreed upon in November 1986 by a special committee of 18 representatives of the Board of Governors of the Bank. Lending during 1987 to 1991 could rise more than 100 per cent over that of the period 1982-1986. Negotiations on the replenishment of the Bank's soft-loan affiliate, the African Development Fund, are scheduled to begin in 1987. Deliberations over a future capital increase of the Asian Development Bank are also under way, as the period covered by the present capital increase ends in 1987 (the Asian Development Fund was replenished in April 1986 for the period 1987-1990 at a slightly increased level in nominal terms over the previous replenishment).

At the same time, many efforts are also under way to improve the functioning of the multilateral institutions by streamlining and refocusing their activities. The United Na-

<sup>30</sup> Statement made by the President of the Inter-American Development Bank to the Joint Development Committee of IMF and the World Bank, Washington, D.C., 29 September 1986 (see *IDB News*, November 1986).

<sup>31</sup> See World Bank, *Annual Report 1986*, Washington, D.C., 1986), pp. 27-29.

<sup>32</sup> Communiqués of the Joint Ministerial Committee of the Board of Governors of the World Bank and IMF on the Transfer of Real Resources to Developing Countries (Development Committee), 11 April 1986, para. 10, and 29 September 1986, paras. 9 and 10 (see *IMF Survey*, 21 April 1986 and 20 October 1986).

Table IV.8. Gross foreign debt of the capital-importing developing countries, 1980-1986  
(Billions of dollars)

	1980	1982	1983	1984	1985	1986 <sup>a</sup>
Medium- and long-term debt	423.0	549.0	635.2	680.6	735.8	777
Official concessional <sup>b</sup>	105.4	120.0	125.5	129.4	146.4	290
Official non-concessional	58.5	78.8	95.7	108.2	122.3	
Use of IMF credit	8.9	18.7	28.6	31.0	35.3	37
Private	250.1	331.5	385.3	412.0	431.8	450
Short-term debt	124.1	159.2	128.6	119.1	116.8	112
Total	547.0	708.2	763.7	799.7	852.6	889
Total as a share of exports <sup>c</sup> (Percentage)	129.5	170.0	187.6	182.9	201.6	213
Memorandum item:						
Total debt of capital-importing countries (broader grouping) <sup>d</sup>	650	825	890	929	992	1 035

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on World Bank, Debtor Reporting System; IMF, *International Financial Statistics* and *Balance of Payments Statistics*; and other sources.

a Preliminary estimate.

b Including IMF Trust Fund.

c Total debt of a sample of 98 countries as a ratio to their exports of goods and services and private transfers received.

d Including in addition to the capital-importing developing countries, the member countries of the World Bank with centrally planned economies, Greece and Portugal (among the developed market economies), the Islamic Republic of Iran and Iraq (as published in World Bank, *World Debt Tables*, 1986-87 Edition (Washington, D.C., 1987), p. viii).

tions has been an active participant in these recent efforts, in particular with regard to the co-ordination of technical assistance and other operational activities of the various parts of the United Nations system (see General Assembly resolution 41/171). Strengthening management and eliminating duplication not only raise the effectiveness and efficiency of ongoing programmes, but they also raise the confidence of donors and recipients in the process of multilateral co-operation for development.

The argument for increasing multilateral efforts, however, is not that they should substitute for diminished bilateral efforts. All should increase. Indeed, total official development assistance (ODA) in the mid-1980s has not been significantly more than it was at the start of the decade in real terms (i.e., at constant prices and exchange rates) or even in nominal terms, estimated at roughly \$24 billion in 1986. A widely held expectation is that ODA is unlikely to grow by more than 2 per cent a year in real terms over the medium run. Although improved arrangements for donor co-ordination and better integration of ODA in adjustment and development planning will improve the productivity of ODA flows, many viable projects and programmes that would otherwise be supported with ODA financing will have to be postponed, abandoned, under-funded or not even designed. Meanwhile, evidence grows of increasing poverty and declining standards of living that have accompanied the

sharp economic adjustments of the 1980s. Expanded ODA, concentrated on improving the productivity and well-being of low-income groups, could make a unique contribution to ameliorating their situation.

If it is clear that additional official finance is needed and that ODA along with non-concessional flows from bilateral and multilateral sources should expand, it is less clear how large the overall increase in official financing needs to be. It is one thing to determine the total financing needs of the capital-importing countries based on their absorptive capacity and their ability to channel domestic savings into capital formation. It is another, however, to determine the capacity of these countries to carry more foreign debt. In recent years the growth of the overall indebtedness of the capital-importing countries has slowed markedly (see table IV.8), but their overall debt-servicing capacity does not seem to have grown stronger as a result. Indeed, one rough measure of debt-servicing capacity, the ratio of external debt to export earnings, worsened appreciably in 1986, reaching a level about 25 per cent above that in 1982 when the debt crisis began. The 1986 deterioration was due especially to the influence of lower petroleum prices on the exports of the highly indebted oil-exporting countries. In other words, the ability to carry more debt depends very much on the outlook for export earnings.

<sup>33</sup> See United Nations Children's Fund, *Adjustment with a Human Face* (forthcoming) and World Bank, "Protecting the poor during periods of adjustment," paper prepared for the Development Committee, 10 April 1987 (see *World Bank News*, 16 April 1987, pp. 8-10).

For some low-income countries that depend on a narrow range of commodity exports whose price trends have been weak, the requirements of servicing existing debt may already exceed their debt-servicing capacity over the medium run. For such countries only inflows of grant financing may be justified. Indeed, instead of new credits, some official flows might well take the form of subsidies or partial forgiveness of interest charges or write-offs of some past official loans. As will be argued below, several countries, particularly in sub-Saharan Africa, might be candidates for such considerations.

Another set of issues pertains to the countries that were substantial recipients of private bank lending, but have had credit lines virtually cut off since entering into debt-servicing crises. It appears, in particular, that outstanding bank loans to countries in this category are shrinking. Should that trend continue, new official lending would serve, in effect,

### The foreign debt crisis of developing countries

The debt crisis of developing countries is not being resolved, as the unilateral suspension of interest payments by Brazil and Ecuador in early 1987 has shown. It is now almost five years since August 1982, most commonly cited as the beginning of the crisis. It was in that month that Mexico was forced to abandon efforts to meet its foreign debt-servicing obligations and seek a negotiated restructuring of them along with a new programme for domestic economic adjustment. This had a symbolic as well as a real significance: Mexico was the second largest debtor country of the developing world, a country to which foreign commercial banks had lent over \$70 billion (including short-term and long-term credits), a major exporter of petroleum, and a country that had enjoyed a long period of economic and political stability. The confidence of international commercial banks had already been shaken by the deterioration of the economic situation of Poland in late 1980 and by the war in the South Atlantic in April 1982. But the August events dealt a blow to their willingness to lend to developing countries. Since then, the only debt-rescheduling country to fully re-enter the market has been Turkey, whose adjustment process differed significantly from that of other debtor countries (see box IV.2). A few special cases of voluntary bank lending to debt-rescheduling countries were arranged in 1986 (e.g., co-financing with the World Bank for Côte d'Ivoire and Uruguay and a self-liquidating trade financing facility for Ecuador). On the whole, however, the confidence of the banks has yet to recover.

Another debt crisis, affecting low-income countries without significant access to commercial bank credit, began even earlier. In 1981, seven countries of sub-Saharan Africa reached agreement with their major creditors to reschedule foreign debt. In those cases, the debt was largely owed to official creditors and the restructurings were multilateral of-

to help repay private credits. In that case, taxpayers in donor countries would indirectly help "bail out" the commercial banks. Larger budgetary allocations in donor countries would thus be needed to make a given net financial contribution to developing countries. Doing so would certainly further complicate an extremely difficult legislative process of increasing official resources for development assistance.

When banks withdraw from lending to such countries, it is because they have a negative assessment of the debt-carrying capacity of the countries, presumably derived from an outlook for trade, growth and interest rates comparable to that discussed in chapter II above. Economic adjustment of these countries might thus require some means for reducing the level of outstanding debt or interest costs, as well as measures to promote structural change and growth. They need to increase investment and this, in turn, warrants an increased transfer of resources to them.

Official exercises under the aegis of the Paris Club, in which the French Treasury serves as host for the negotiations. Repeated return trips by representatives of sub-Saharan countries to the meetings of the Paris Club have become almost routine.

### Adjustment efforts and the debt crisis

Despite many years of domestic adjustment efforts, generally at great cost to local populations, and after several rounds of debt renegotiating exercises, opinions still differ about the most effective strategy for regaining economic balance with sustained growth. It is increasingly accepted that there can be different paths of adjustment, although they all have certain broad features in common.<sup>34</sup> The political limits to prolonged austerity are recognized in most circles as is the need for a longer view of the adjustment problem. It is agreed that reforms should aim at relaxing structural impediments to economic change and stimulating entrepreneurship which is to say creativity and initiative in economic organizations, be they in the public or private sector.

But such reforms are not easily implemented when domestic economies are depressed, when slow growth of creditor countries makes it difficult for them to absorb an increased production of debtor country exports at prices remunerative for sellers, and when debtor countries have to operate with lower or negative resource transfers than in the past.

The economic adjustment difficulties of the high-debt, middle-income countries in particular were the focus of an international debt strategy put forward by the United States Secretary of the Treasury in his address to the 1985 Annual

<sup>34</sup> For a major synthesis of recent thinking and experience that found broad support among both developing and developed country delegations to a regional forum, see ECLAC, "Latin America and Caribbean development: obstacles, requirements and options", (LC/G.1440), paper presented to the Special Conference of ECLAC, Mexico City, 19-23 January 1987.

Box IV.2. Debt, net resource transfers and external adjustment in Turkey

Turkey has regained significant access to foreign private financing after a debt-servicing crisis forced it from the market in the late 1970s. The return to creditworthiness was signalled in 1985 when, rather than drawing fully on an IMF stand-by facility, Turkey arranged a substantial international commercial bank stand-by loan. The IMF stand-by was allowed to lapse without replacement. By 1986, official and private Turkish borrowers had begun to tap the market for revolving underwriting facilities, one of the new instruments for international securities finance.

Turkey's debt crisis arose after a rapid build-up of short-term debt in the mid-1970s. When a shortage of foreign exchange provoked a liquidity crisis in 1977, almost 60 per cent of total debt outstanding was scheduled for repayment within a year. A sequence of debt-reschedulings and economic adjustment measures followed, including a structural adjustment programme announced in January 1980 that was strongly oriented towards encouraging exports and enhancing productivity through greater reliance on market prices and stepped-up investment.

The results have been dramatic. The volume of exports,

which had grown by less than 4 per cent a year from 1973 to 1977, rose by 28 per cent a year in the first half of the 1980s (see the table). The spurt in demand from energy-exporting countries of the Middle East in 1981 and 1982 helped. The value of merchandise exports to that region tripled in 1981 and rose by another third in 1982. Exports to industrialized countries jumped by one third in 1981 and another 9 per cent in 1982. Thereafter, export growth was mainly accounted for by increased sales in industrial countries. In 1986, however, exports to the latter stagnated and sales to energy-exporting countries of the Middle East plummeted. However, the fall in export earnings in 1986 is expected to be more than made up in 1987.

An important shift in the composition of exports also occurred: the share of manufactures rose from 36 per cent in 1980 to 75 per cent in 1985. Service earnings improved substantially from construction contracting in the Middle East, tourism, and inflows of remittances from Turkish workers in other countries. All of these suffered in the special circumstances of 1986.

Gross national product grew by 4.6 per cent a year from

*Box continued on adjacent page*

Turkey in periods of economic crisis and adjustment: economic indicators of the 1970s and first half of the 1980s

	1973-1977	1978-1979	1980	1981	1982	1983	1984	1985
	<u>Annual rates of change</u>							
Gross national product	6.5	1.2	-1.1	4.1	4.6	3.3	5.9	5.1
Private consumption	6.6	-3.5	-5.2	0.6	4.2	5.0	4.9	3.7
Public consumption	9.5	5.7	8.8	0.9	2.0	1.7	3.2	3.3
Private fixed investment	9.8	-8.8	-17.3	-8.7	5.5	4.7	7.3	7.0
Public fixed investment	18.4	-5.0	-3.7	9.4	2.2	1.9	1.4	17.1
Export volume <sup>a</sup>	3.6	-0.5	7.4	62.2	36.9	7.8	20.6	11.8
Import volume <sup>a</sup>	7.6	-20.9	-2.8	11.1	4.9	12.5	13.5	6.0
Terms of trade <sup>b</sup>	-2.9	-6.2	-18.0	-8.4	-5.9	-1.2	12.1	..
Real effective exchange rate	2.1	3.3	-22.6	5.3	-8.3	-2.6	-2.6	0.4
Consumer prices <sup>c</sup>	21.5	64.4	116.7	45.8	27.2	30.2	53.0	45.5
	<u>Percentages</u>							
Unemployment <sup>d</sup>	12.3	12.7	14.4	14.8	15.1	15.7	16.0	16.2
Net financial transfer/GNP <sup>e</sup>	2.4	1.2	4.9	1.4	-0.2	1.7	0.5	-0.9
Debt/exports <sup>f</sup>	177	359	334	229	199	216	191	190

Source: OECD and Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of Turkish national authorities, IMF, World Bank and Morgan Guaranty Trust Company (real effective exchange rate index).

- a Goods and services (OECD national accounts basis).
- b Merchandise trade only.
- c Implicit private consumption deflator of GNP accounts.
- d Including disguised unemployment in agriculture.
- e Net capital flows and official transfers minus net interest and profit payments as a share of GNP in dollars.
- f Total debt as at year-end divided by earnings from exports of goods, services and private transfer.

1981 to 1985 (and by about 7 per cent in 1986). This supported a steady increase in consumption and a substantial expansion of investment, first in the public and then in the private sectors. Not all economic adjustment problems had been solved by the time Turkey returned to the private financial markets, as evidenced by the inflation and unemployment data shown in the accompanying table. Relatively heavy debt-servicing, resulting from deferment of principal payments under rescheduling, will have to be absorbed for the rest of the decade. It is clear, however, that substantial economic adjustment has been undertaken in Turkey in a context of economic growth and supported by a significantly expanding volume of trade.

A key condition for this performance is that along with domestic policy reforms to increase incentives for exports

(see, for example, real exchange rate adjustments shown in the table), substantial foreign financial resources were provided. Had these foreign resources not been mobilized, the sharp deterioration in the terms of trade would have severely reduced import capacity. Financing included IMF and World Bank lending, the OECD Special Action Programme for Turkey, and a sequence of debt reschedulings from the late 1970s to March 1982, including a plan by which arrears on non-guaranteed suppliers' credits could be settled in domestic currency, an option that was in fact taken by over half of those creditors. The financial arrangements for Turkey allowed the net transfer of financial resources to become strongly positive in the first year of the structural adjustment programme and to remain positive on the whole until 1985, thus adding significantly to domestic resources for investment.

Meetings of the Boards of Governors of IMF and the World Bank.<sup>35</sup> Since that speech, a group of 15 developing countries have become prominent in discussions of debt and development. Other middle-income countries have also endured debt crises in recent years, but a section of the following analysis highlights the 15 as a grouping of countries familiar to international discussions.

What stands out is the sharp contraction in the current account deficit of these countries, accompanied by poor economic growth. Table IV.9 shows that taken together they achieved no net increase in production from 1982 to 1984, during which time their aggregate current account deficit of over \$50 billion was virtually eliminated. They suffered a progressive deterioration in per capita output and a further decline in real income due to declining terms of trade and rising net foreign interest payments.

Their current account improvement was largely the result of import cut-backs, especially in 1982 and 1983. Domestic investment fell from around 25 per cent of GDP at the beginning of the decade to about 17 per cent in the mid-decade years. With stagnant GDP, investment in absolute terms declined by one third. Without investment, efforts to increase export volumes, especially in new lines, come up against a capacity constraint.

With weak foreign markets, the ratio of foreign debt to

export earnings has continued to rise despite the cut in new borrowing forced by the debt crisis. In aggregate, the net inflow of financial resources turned to a net outflow in 1982; it has remained negative since then. Instead of receiving over 3 per cent of GDP in net resource transfers, as in the late 1970s, the 15 countries together have transferred out an average of 3 per cent of GDP since 1983.

The second focus of the analysis of external debt is the developing countries in sub-Saharan Africa, which have also found it difficult to adjust. Significant arrears in international payments or formal debt reschedulings occurred in 31 out of 44 sub-Saharan countries in the first half of the 1980s. Import volumes were cut each year from 1982 to 1985 as current account deficits were reduced. The growth of output did not keep pace with population growth and the share of output devoted to investment fell.

The net transfer of financial resources remained positive in most countries, although it fell in almost all of them. In aggregate, for the countries included in table IV.10,<sup>36</sup> the net transfer fell from over 8 per cent of GDP on average in the years before 1982, to 4 per cent in 1984 and 1985. In the first half of the decade, export volume grew less than 2 per cent a year and the terms of trade fell 1 per cent a year on average. As a consequence, the ratio of debt to exports rose steadily.

The deterioration in some of these respects is estimated to

<sup>35</sup> See IMF, *Summary Proceedings of the Fortieth Annual Meeting of the Board of Governors, 8-11 October 1985* (Washington, D.C., 1985), pp. 50-58.

<sup>36</sup> Nigeria is excluded from table IV.10 because the large economy of Nigeria (accounting for roughly 45 per cent of the GDP of the sub-Saharan region) would statistically overwhelm the data for 41 other countries. Nigeria is included in the 15 larger countries shown in table IV.9. It has experienced a negative transfer of resources since 1984.

Table IV.9. Indicators of international financing and economic performance of 15 heavily indebted countries, 1978-1986<sup>a</sup>  
(Annual rate of change, unless otherwise specified)

	1978-1980	1981	1982	1983	1984	1985	1986 <sup>b</sup>
Gross domestic product	4.8	0.5	-0.4	-3.4	2.2	3.1	3.5
Investment (percentage of GDP)	25.5	24.5	22.3	18.2	17.4	16.5	16.8
Merchandise export volume	4.6	-2.2	-5.1	6.4	9.6	1.8	-6.5
Merchandise import volume	6.4	4.3	-16.7	-21.2	-2.4	1.1	-8.5
Terms of trade	4.5	-2.8	-4.1	-3.5	2.2	-1.9	-16.1
Current account <sup>c</sup> (billions of dollars)	-26.9	-51.2	-51.3	-16.0	-1.2	-1.1	-12.5
Net financial transfer/GDP (percentage)	3.5	1.8	-1.0	-2.3	-2.8	-3.7	-3.0
Total debt/export <sup>d</sup> (percentage)	186	203	273	298	281	299	342

Source: IMF, *World Economic Outlook*; and Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF data (financial transfers and debt).

<sup>a</sup> Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

<sup>b</sup> Estimate.

<sup>c</sup> Balance of payments on goods, services and private transfers.

<sup>d</sup> Including debt to IMF; exports of goods and services.

have stopped in 1986 for example, export volume increased 8 per cent and the transfer of resources rose to 6 per cent of GDP but a recuperation is not in sight. Indeed, the terms of trade fell 12 per cent. Certainly, there is no sign yet of a sustainable surge in economic growth that would once again place the region as a whole on a path of rising per capita output, which has not been seen since the early 1970s.

The economic trends of the 1980s, and the severe drought in 1984 and 1985, highlighted the crisis of African economic development. The seriousness of the situation led to the convening of a special session of the General Assembly in May/June 1986, at which African Governments committed themselves to implement the Organization of African Unity's priority programme for economic recovery 1986 to 1990<sup>37</sup> and the international community committed itself to support and complement those efforts (see General Assembly resolution S-13/2, annex). It was recognized that to carry out the programme, African countries needed additional external resources and that measures had to be taken to alleviate the severe burden of external debt in many of them (Assembly resolution S-13/2, annex, paras. 16 and 17).

### The argument for debt relief for Africa

One outcome in sub-Saharan Africa of the international strategy to address the debt crisis is that 22 countries resche-

duled their official or commercial bank debt 82 times from 1980 to 1986.<sup>38</sup> Aid flows were significantly increased in 1985 and 1986 (emergency food aid accounting for roughly half the 1985 increase), and domestic adjustment policies were being implemented in many countries in accordance with commitments made in the General Assembly.<sup>39</sup> Meanwhile, international economic conditions, in particular with regard to trade, have yet to improve as expected.

The servicing of external debt involves interest and amortization. The latter is generally offset by new capital inflows. For countries in debt crisis, however, the scheduled repayments of principal and sometimes interest are instead postponed in debt restructuring exercises. But payment of interest is thought to be a charge that should normally be kept current and not rescheduled. Indeed, over the long run, interest obligations must be met if the debt situation is to be sustainable that is, if the debtor is to be regarded as solvent. But for many countries in sub-Saharan Africa, doing so imposes a burden that is not likely to be ameliorated in the medium run under current trends for the growth of output and trade. Thus, even if continued application of the current debt renegotiation strategy serves to roll over amortization payments over the next several years, something more is needed in order to address the interest-servicing burden.

One way to measure the economic cost of interest payments is to compare them with the total value of domestic

<sup>37</sup> Africa's Priority Programme for Economic Recovery 1986-1990, adopted by the Assembly of Heads of State and Government of the Organization of African Unity at its twenty-first ordinary session, held at Addis Ababa from 18 to 20 July 1985 (see A/40/666, annex I, declaration AHG/Decl. 1 (XXI), annex).

<sup>38</sup> Based on enumeration in World Bank, *Developing Country Debt: Implementing the Consensus* (Washington, D.C., 1987).

<sup>39</sup> See end-of-year statement by the Executive Secretary of the Economic Commission for Africa (reprinted in *West Africa*, 12 and 19 January 1987).

Table IV.10. Indicators of international financing and economic performance of sub-Saharan Africa, 1978-1986<sup>a</sup>  
(Annual rate of change, unless otherwise specified)

	1978-1980	1981	1982	1983	1984	1985	1986 <sup>b</sup>
Gross domestic product	2.3	2.4	0.6	-0.7	2.0	3.0	4.0
Investment (percentage of GDP)	18.0	17.7	16.7	14.7	14.7	15.1	17.1
Merchandise export volume	1.8	-1.9	2.8	0.7	6.2	1.6	8.2
Merchandise import volume	4.3	0.1	-4.2	-8.0	-2.4	-0.3	3.0
Terms of trade	-4.5	-5.6	-4.0	1.6	4.5	-2.5	-12.0
Current account <sup>c</sup> (billions of dollars)	-9.2	-13.0	-11.8	-9.2	-6.8	-6.9	-9.8
Net financial transfer/GDP (percentage)	7.8	9.4	8.3	6.7	3.7	4.1	6.0
Total debt/export <sup>d</sup> (percentage)	155	194	230	247	243	280	306

Source: IMF, *World Economic Outlook*; and Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF data (financial transfers and debt).

a Excluding Nigeria.

b Estimate.

c Balance of payments on goods, services and private transfers.

d Including debt to IMF; exports of goods and services.

production. In this sense, the interest burden of sub-Saharan Africa rose from well under 2 per cent of GDP in the late 1970s to almost 4 per cent in the mid-1980s (see figure IV.5). Making foreign interest payments requires more than twice the share of domestic output that was required in the late 1970s. Had the interest burden not risen, it is not possible to say how the resources would have been used. But for the countries included in figure IV.6, the interest payments actually made since 1984 represent about 25 per cent of the value of investment spending and 19 per cent of imports compared with less than half that percentage for each variable in the late 1970s.

Although the burden of interest payments already made may thus be judged high, what matters most is the extent to which the situation is likely to be improved. Most of the foreign debt of the region (excluding that of Nigeria) is owed to official creditors, the share having risen continuously from 55 per cent of total debt in 1978 to 72 per cent of the total in 1986. Average interest rates paid on the stock of various types of debt owed by developing countries to official creditors have hardly fluctuated (see table IV.11).<sup>40</sup> Indeed, average interest rates paid by sub-Saharan Africa on its outstanding foreign debt have been about 6 per cent from the late 1970s to 1986. Most of the increases in total interest paid by these countries were therefore not due to the large jump in international market interest rates in the early 1980s; nor have these countries gained substantially from the subsequent fall in those rates. Moreover, further declines in market interest rates would bring little benefit.

The increase in total interest paid by these countries a rise from \$1 billion in 1978 to over \$4 billion in 1986 was largely due to the growth of the debt outstanding. That growth was substantial at the end of the 1970s (e.g., 22 per cent in 1979), but it has slowed in the 1980s. In all, the debt of the group reached about \$82 billion at the end of 1986.

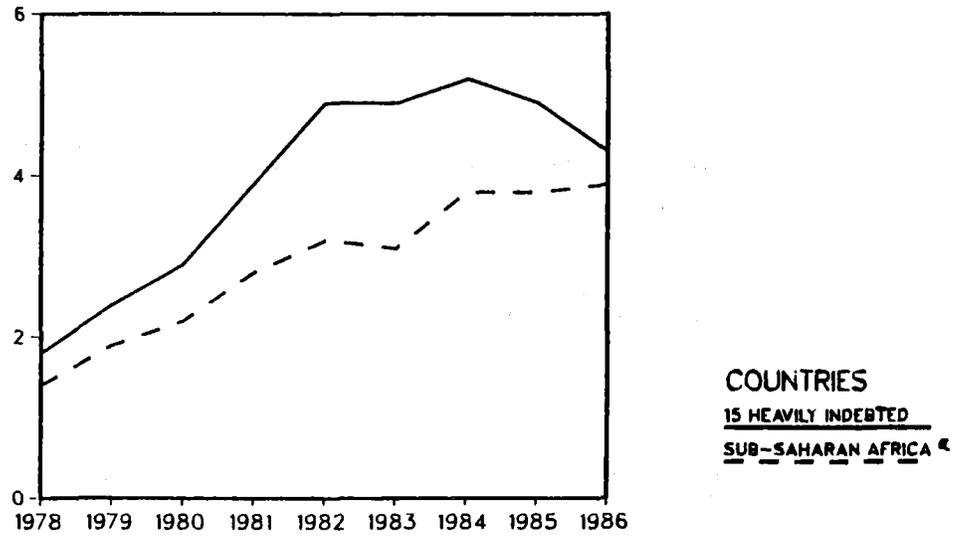
The countries of sub-Saharan Africa are caught in a bind: their interest burden is already high but it will rise even further if new capital inflows can be obtained and such new capital inflows are essential. The dilemma might be avoided if international commodity prices recover, improving the terms of trade, and if export markets become more buoyant than they have been for several years; but none of this is likely.

Given the overwhelming role of official financing in the region, Governments in their roles as bilateral creditors and governors of multilateral financial institutions could reduce the interest burden where it is excessive. Determining how much to reduce that burden in individual cases would be a process of adjustment planning and negotiation, but the object should be to ensure that adjustment is hastened instead of being hindered that is, that resources for essential programmes and projects are not siphoned off.

One way to implement such an approach is to agree in principle to consider full or partial forgiveness of interest due on certain classes of official debt as one option in Paris Club negotiations, linked to adjustment programmes adopted with and supported by the international community.

<sup>40</sup> This is the result of the smaller fluctuation in interest rates on new official credits compared with new private credits and of the fact that interest rates on most long-term official credits were fixed for the life of the loan while interest rates on most long-term private credits are adjusted periodically (usually every six months) in response to changes in short-term interest rates such as the London interbank offered rate (LIBOR).

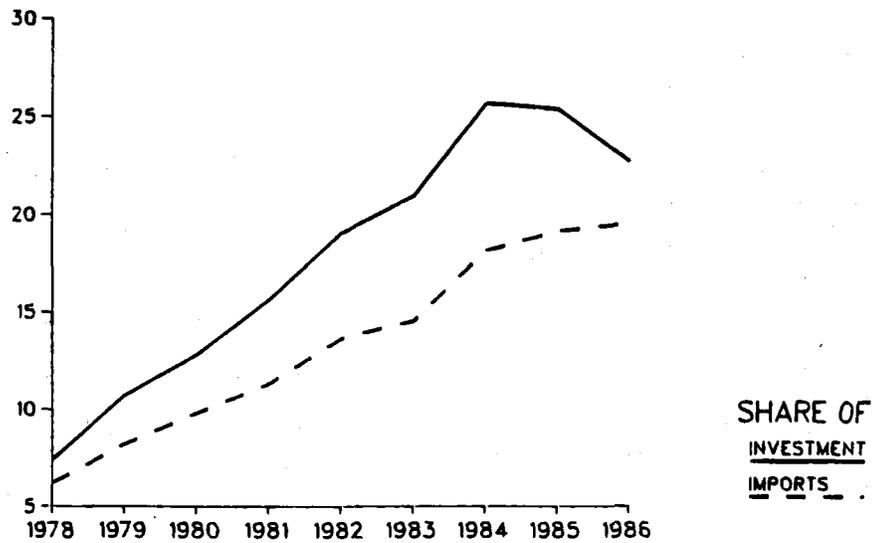
Figure IV.5. Interest burden of selected developing countries 1978-1986  
(Percentage of GDP)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of IMF.

a Excluding Nigeria.

Figure IV.6. Sub-Saharan Africa: interest payments in relation to investment and imports, 1978-1986<sup>a</sup>  
(Percentage)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of IMF.

a Excluding Nigeria, imports of merchandise, f.o.b.

Table IV.11. Average nominal interest rates paid by developing countries by type of debt and creditor, 1980-1986<sup>a</sup>

(Percentage)

	1980	1982	1983	1984	1985	1986 <sup>b</sup>
<b>Concessional debt</b>						
Bilateral official	2.3	2.1	2.0	1.9	2.1	2.7
Developed market economies	2.5	2.1	2.2	2.2	2.3	2.7
Centrally planned economies <sup>c</sup>	1.6	1.2	1.0	1.0	1.9	1.8
Developing country lenders	2.4	2.3	1.9	2.2	1.2	3.2
Multilateral loans	1.9	1.5	1.3	1.3	1.3	1.5
<b>Non-concessional debt</b>						
Bilateral official	6.8	8.1	7.3	7.0	7.4	9.0
Developed market economies	7.0	8.3	7.7	7.4	8.1	9.4
Centrally planned economies <sup>c</sup>	4.1	5.1	6.1	5.6	6.6	5.2
Developing country lenders	6.2	7.9	5.8	5.8	4.6	7.9
Multilateral loans <sup>d</sup>	9.6	8.3	8.4	8.4	8.4	10.0
<b>Private debt</b>						
Bonds	7.5	8.0	7.6	7.4	7.6	7.5
Floating rate bank debt	15.5	17.1	12.2	12.1	10.5	8.5
Short-term bank debt	12.0	12.5	10.0	10.5	8.2	6.9

Source: For private debt, OECD, *Financing and External Debt of Developing Countries, 1985 Survey* (Paris, 1986) and information supplied by OECD; for official debt, Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of the World Bank Debtor Reporting System.

- a Dollar value of annual interest payments and other charges (including spreads and fees on floating rate debt) as a percentage of disbursed and outstanding debt at the beginning of the year.
- b Estimated (official debt is based on scheduled interest payments as at end-December 1985 at end-1985 exchange rates).
- c Based only on loans to developing countries that report data to the World Bank.
- d Excluding use of IMF credit.

Interest payments on non-concessional loans of multilateral institutions might also be reduced under comparable conditions. In both cases, the cash flow of the creditor institutions would be disrupted, although the total amounts would not be large in most cases. One way to handle this in a multilateral context might be to establish a fund to subsidize interest payments, following the precedents of the two subsidy accounts set up in 1975 and 1980 at IMF to reduce the interest cost of drawings from the Oil Facility and the Supplementary Financing Facility.

While reduction of the interest burden is central to a long-run solution of the African debt problem, the short-run difficulty in meeting amortization payments must also be addressed. Interest plus principal payments absorbed little more than 15 per cent of export earnings of the group of sub-Saharan countries at the end of the 1970s. In 1986, they were estimated to rise to 36 per cent and to rise to 38 per cent in 1987 and 1988 according to the forecast of IMF. The prospect, in effect, is for more intensive use of debt rescheduling or a new accumulation of arrears.

Superior alternatives would reduce the long-run interest

burden at the same time as the short-run shortage of liquidity is alleviated. Creditors might thus agree to accept payment of interest and a portion of principal in local currency, the proceeds being placed in development funds for counterpart financing of internationally assisted projects. Another approach might entail conversion of certain classes of loans into grants, in other words, a write-off of such loans. This would extend a principle to new forms of credit that has already been accepted by the international community with respect to ODA loans. The adjustment of the terms of outstanding ODA loans to bring them into line with subsequently prevailing softer terms for ODA lending was agreed in principle in 1978<sup>42</sup> and implemented by many donor countries. In 1986, Canada and a number of European countries announced moratoria on debt servicing or acceptance of debt rescheduling on concessional terms or outright cancellation of particular debts to low-income African countries undergoing adjustment. And in early 1987, the official creditors in the Paris Club began actively considering proposals for more realistic rescheduling terms, including the possibility of below-market interest rates.

Such a process applied to multilateral loans, converting

<sup>41</sup> Including Fund charges and repurchases of Fund credit (based on IMF, *World Economic Outlook*, April 1987, statistical appendix).

<sup>42</sup> See *Official Records of the General Assembly, Thirty-third Session, Supplement No. 15 (A/33/15)*, Vol. I, part two, annex I, resolution 165 (S-IX).

some of them into grants or very long-term loans on highly concessional terms (e.g., those of IDA), would help to reduce the debt-servicing burden of low-income countries of Africa. Multilateral debt is usually not rescheduled, but three quarters of the debt-servicing during the period 1986-1988 of 13 of these countries is to be paid to multilateral institutions (including IMF). For such situations, at least, innovative debt relief of some sort is warranted.

### Debt relief for middle-income countries

The recent history of attempting to cope with debt crises in heavily indebted, middle-income countries is one of repeated frustration. The 21 middle-income or higher-income developing countries outside sub-Saharan Africa that have rescheduled their official or private debt since 1980 have done so 85 times up to the end of 1986. Substantial domestic adjustment needs have had to be addressed, as well as recovery needs from natural catastrophes, such as a series of severe earthquakes in Latin America. Many of these countries are heavily dependent on commodity exports and continue to suffer under the unprecedented weakness of the international prices of those commodities. What initially appeared to be a largely temporary shortage of foreign exchange—a liquidity problem—now seems to be a solvency problem.

The past and prospective cost of staying current on interest payments indicates the difficulty. The interest burden of the 15 highly indebted countries rose from less than 2 per cent of GDP in 1978 to 5 per cent in 1982 and was still over 4 per cent of GDP in 1986 (see figure IV.5). The 15 countries paid about \$38 billion in interest in 1986, compared with \$11 billion in 1978. Interest payments have averaged over 25 per cent of investment expenditures and over 50 per cent of merchandise imports since 1983, compared with less than 10 per cent and less than 20 per cent, respectively, in the late 1970s (see figure IV.7).

These countries have been especially vulnerable to swings in international interest rates since more than four fifths of the debt of the group was owed to private creditors. When their debt situation deteriorated, higher risk premiums and debt-rescheduling charges boosted the average rates on medium-term bank debt (see table IV.11). With the subsequent fall in market interest rates and a reduction in spreads in successive rounds of renegotiations of bank debt, the overall average interest rates paid have fallen. From 9 per cent in 1979, the average interest rate rose to 14 per cent in 1981 and 1982, before returning to 9 per cent in 1986.

The decline in market interest rates during 1986 is likely

to reduce annual interest payments further in 1987 for the group of 15 major debtors. Also, the spreads on floating rate debt to be renegotiated in 1987 are likely to fall, which will have a certain impact.<sup>43</sup> It is difficult to anticipate interest rate changes over the medium run, but only rather narrow movements of market rates are forecast, barring unforeseen economic shocks or a revival of inflationary expectations. Total interest payments should thus rise slowly from 1988.

The rapid rise in interest payments in the early 1980s and the slower subsequent rise were partly due to the changing composition of the debt. The share of official loans in the total debt of the 15 countries fell from 18 per cent in 1978 to 13 per cent in 1982 when the debt crisis erupted. The share has since risen to 25 per cent and will rise further only if lending from official sources continues to grow on a net basis.

Related to this is the currency composition of debt. Bank debt outstanding is overwhelmingly denominated in dollars, while official debt and suppliers' credits are generally in the currency of the creditor country. For many heavily indebted countries, especially in Latin America, the share of export earnings to non-dollar markets exceeded the non-dollar share of interest payments. For such countries, increased exports to pay debt-servicing were required in the period in which the dollar rose. By the same token, the decline in the exchange rate of the dollar since 1985 has helped these countries. In contrast, for developing countries whose debts are relatively more concentrated in yen or European currencies while their exports are directed more to dollar markets, the period of a falling dollar has been the more difficult one.<sup>44</sup>

The outlook for the interest-servicing ratio under current trends and policies is not encouraging. For the 15 high-debt countries, although the ratio is expected to fall, it will still likely be in the neighbourhood of 3.5 per cent of GDP in 1990.<sup>45</sup> Total debt is itself forecast to grow by less than 3 per cent a year in the period. This is in sharp contrast to the years before 1982 when the debt grew by more than 20 per cent annually; it is even less than the average rate from 1984 to 1986, which was about 4 per cent a year.

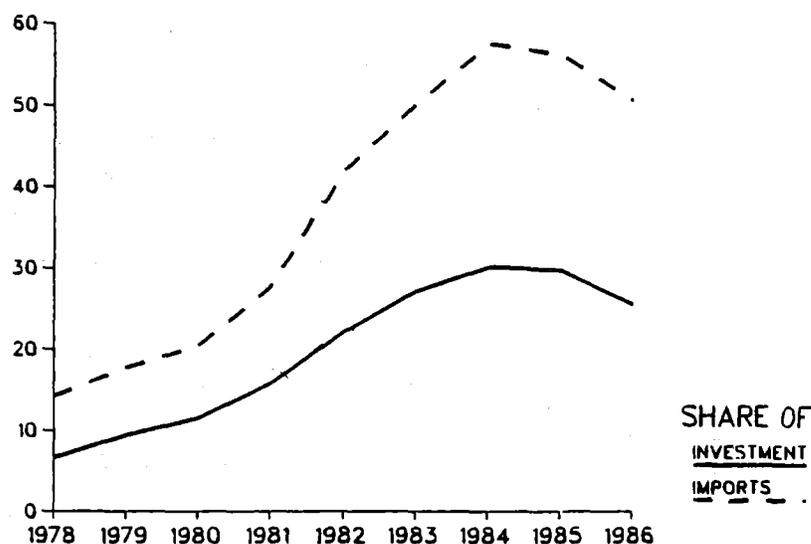
Growth of output is also expected to be low: for the group of 15 heavily indebted countries it is expected to average 3 per cent annually during the remainder of the decade. The terms of trade of many of these countries may worsen as commodity markets remain depressed while price levels creep upwards in the developed market economies, which will raise the prices of manufactured imports from those countries. The growth of export volume is expected to be slow, averaging 4 per cent a year for the 15 countries during the rest of the decade. Exports will be constrained partly by

<sup>43</sup> The most recent restructuring of Mexico's commercial bank debt dropped the spread over LIBOR from 1.13 percentage points to 0.81 percentage points. Argentina and Brazil, with spreads of 1.44 percentage point and 1.13 percentage points, respectively, have also been seeking significant reductions of spreads in their 1987 negotiations, as have other debtor countries (data of ECLAC, "Balance preliminar de la economía latinoamericana", *Notas sobre la economía y el desarrollo*, No. 438/439, December 1986).

<sup>44</sup> For the experience of several developing countries of Asia, see *Economic and Social Survey of Asia and the Pacific 1986* (United Nations publication, Sales No. E.87.II.F.1), pp. 26-27.

<sup>45</sup> Derived from the baseline scenario of Project LINK (prepared in March 1987). The LINK system includes models for 14 of these 15 countries, with all but two models of the smaller countries making explicit forecasts of foreign interest payments.

Figure IV.7. Fifteen heavily-indebted countries; interest payments in relation to investment and imports, 1978-1986<sup>a</sup>  
(Percentage)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of IMF.

<sup>a</sup> Merchandise imports f.o.b.

limited growth of foreign demand (assuming no roll-back of protectionist measures), and partly by capacity constraints resulting from inadequate investment levels. This is not an environment in which internationally supported domestic aspirations for development will be met.

The key question is how to raise the economic growth of these countries without worsening their interest-servicing burden. The danger in increasing the inflow of new credits if such could be mobilized lies in raising the debt and future interest payments. For middle-income countries it is not realistic to expect a significant increase in ODA grants, given the budget constraints on donor countries and the priority attached to channelling those funds to low-income countries. Non-debt-creating flows with greater long-run potential for significant expansion are increases in direct investment and a return flow of flight capital. But a major impediment to such higher flows is the uncertainty and instability in the debtor countries that derives from the very difficulties of economic adjustment under a severe external financial constraint.

Increasing attention has therefore been given to possibilities of reducing the level of debt outstanding. Debt to official creditors accounts for only a small share of the total debt of these countries \$112 billion out of a total debt of about \$454 billion for the 15 countries at the end of 1986. The discussion has thus focused on reduction of the debt or interest payments to private creditors, especially foreign commercial banks.

### Commercial banks and debt relief

A mechanism has already evolved whereby banks voluntarily write down loans to some debtor countries and offer the loans in a secondary market centred in New York. Most of the activity involves banks swapping loans or exchanging loans for other financial assets, but there have also been outright sales of loans. Turnover in this market has not been continuous, although the total value of transactions has grown rapidly. No systematic data on its size exist, but market participants have claimed that more than \$2 billion of debtor country debt was swapped or sold in 1986.

By themselves, such transactions do not benefit debtor countries as their liabilities are the same whether the loan is payable to the initial lender, another bank or some other institution. But an important factor is that the loan trades at a discount from face value, the size of the discount depending on the market's assessment of the difficulty the borrower will have in servicing the loan. Discounts have ranged beyond 40 per cent or even over 90 per cent in certain special cases, but for countries having debt-rescheduling agreements and adjustment programmes in effect, discounts on the order of 25 per cent to 35 per cent have been more common.

In the case of especially steep discounts, debtor country Governments might purchase some of their own loans and retire them. However, this option is limited by the lack of foreign exchange resources, which is the condition that cre-

ated the steep discount in the first place. What several debtor countries have done instead is to have another party purchase government or government-guaranteed foreign debt at a discount and in turn sell it back to the Government for local currency at an advantageous exchange rate and with various conditions set on the use of the local currency proceeds.

Most common are schemes to convert swapped foreign debt into equity, for example in the form of an increased stake of a transnational corporation in its subsidiary in the debtor country or investment by an international bank in a domestic financial institution in the country. It is estimated that in Latin America roughly \$1-2 billion out of \$3-4 billion of foreign direct investment has recently been financed with debt/equity swaps. This is not to say that direct investment has thereby been significantly increased, since many of the investments would probably have been undertaken anyway, though with a different financing arrangement. What the debtor country gains, however, is that the swapped debt is no longer a foreign exchange liability of the Government.

A variant of the debt/equity swap is to make it financially attractive for wealthy residents of debtor countries to purchase foreign debt at a discount (or swap for it) using assets that the residents had earlier moved offshore. The resident then converts the newly acquired debt into local currency at a value between the discounted price and the face value of the debt instrument and uses the proceeds to purchase domestic financial instruments. In such cases, although restrictions may be placed on the use of the proceeds to ensure that the funds are not again taken out of the country, the investor may seek to move other funds abroad to return his personal portfolio to what he originally thought appropriate. If he does so, that capital outflow will have to be financed. Whether or not the investor is able to do this depends on the extent of capital controls and the degree of openness of the financial and trading system of the country. Whether or not he wants to do it depends on his confidence in the domestic economic situation and the rate of return in his home market compared with overseas.

All in all, the amount of debt that can be retired through such swaps is limited by the amount of direct investment and net repatriation of flight capital that is feasible at any given time. As noted previously, such resources are likely to become more readily available after the debtor country's adjustment process has already advanced a certain distance.

If there are limits on the demand side to the reduction of developing country debt through sales and swaps, limits also exist on the supply side. As banks have carried the debt on their books at face value, they realize a loss when the debt is sold. In taking such actions, banks are usually withdrawing from medium-term lending to the debtor country. Thus far,

the practice seems to have been restricted to banks for which lending to the specific countries has not been a major part of their business.

In contrast, several of the world's largest banks are constrained in their participation in this market because they themselves hold much of the debt. That is, as at mid-1986, \$57 billion or over 20 per cent of the total bank debt of the 15 heavily indebted countries discussed previously was owed to the nine large money centre banks in the United States. These banks also dominate total United States bank lending to the 15 countries, accounting for two thirds of the \$87 billion total for United States banks.<sup>47</sup>

United States banks account for the largest share of the total bank debt of the 15 countries, but that share is less than one third. The share held by all Japanese banks together is roughly half the United States share, followed by that of British banks (13 per cent of the total). Banks from Canada and the Federal Republic of Germany each hold about 7 per cent.<sup>48</sup>

Attention thus necessarily focuses on treatment of the debt by the money centre banks of the United States. If a large United States bank sells part of its holdings of the debt of one country in such a way that the discount is readily identified, the bank might no longer be able to assert convincingly that it believes that the rest of its holdings of debt of the country has full face value. United States regulatory authorities could therefore insist that the remainder of the bank's holdings be written down by the amount of the discount. This would impose a major accounting loss on the banks, cutting deeply into reported profits when the losses are taken, but it would not reduce the debt-servicing obligations of the borrower country.

Indeed, a major motivation for the participation of the major banks in repeated reschedulings of developing country debt may have been precisely to avoid having to accept major losses. For the nine United States money centre banks, the value of the loans to the 15 high-debt countries in mid-1986 exceeded their own capital by 29 per cent. In contrast, the exposure of the next 14 middle-sized banks was 72 per cent of their capital and for the smaller banks, loans outstanding to the 15 countries were only 32 per cent of capital. These ratios were considerable improvements over the situation in 1982, especially for the nine largest banks when loans outstanding to the same countries exceeded their capital by 97 per cent.

Both small and large banks have built up their capital and reserves against problem loans in recent years, but smaller banks have been the most active in adjusting their portfolios of developing country loans through debt write-down and

<sup>46</sup> See the report of the Secretary-General entitled "Transnational banks: operations, strategies and their effects in developing countries" (E/C.10/1987/13), para. 59, submitted to the Commission on Transnational Corporations at its thirteenth session.

<sup>47</sup> Data of the United States Federal Financial Institutions Examination Council for June 1986.

<sup>48</sup> Based on data and estimates for roughly comparable dates and country coverage derived from consolidated data of banks and their foreign branches and affiliates, as contained in *Bank of England Quarterly Bulletin* for British banks, *Monthly Report of the Deutsche Bundesbank*, vol. 39, No. 1 (January 1987), p. 48, for banks of the Federal Republic of Germany; and *Canada: the International Financial Institutions and the Debt Problem of Developing Countries*, report of the Canadian Senate Committee on Foreign Affairs, to be published in May 1987, for Canadian banks; and data on exposure of Japanese banks as released by the Ministry of Finance of Japan.

discounting in the secondary market. The result is that the dollar value of the exposure of the nine large banks was the same in 1986 as in 1982, as concerted lending to some debtors was offset by some write-downs of loans to others, but the exposure of all other United States banks fell 15 per cent.

Writing down these loans had not been required by the regulatory authorities in the United States, except in circumscribed cases. Full valuation of the loans was concomitant with the international strategy for returning the high-debt countries to creditworthiness in the eyes of the market, which would thereby restore the full value of outstanding loans. A member of the Board of Governors of the Federal Reserve System of the United States recently observed that carrying debt at face value is warranted as long as the banks believe that the debt will be serviced and repaid and that participation in restructuring and new lending arrangements enhanced that likelihood, whereas refusal to partake in refinancing activities might signal the banks' own doubts about the collectability and thus the valuation of the loans.<sup>49</sup>

In any event, the economic condition of United States commercial banks has not been assessed highly by the financial markets. Indeed, the rate of bank profitability (measured relative to assets or as return to equity) has declined fairly consistently since the late 1970s, with 1986 having been one of the harshest years for the largest banks since the beginning of deregulation.<sup>50</sup> The riskiness perceived by the capital market in lending to the banks themselves also seems to have increased. One indicator is the widely followed ratings by Moody's Investors Service, which showed a decline in the average senior debt rating of bank holding companies from Aa3 in 1981 to just below the next lower rating, A1, in 1986. The fall was most marked for the money centre banks: before 1981 they averaged above Aa1, but by 1986 they had fallen by three ratings to about A1. In early 1987 the ratings fell further. The smaller regional banks, meanwhile, had raised their average rating from the relatively low A2 in 1981 to above A1 in 1986.<sup>51</sup>

However subjective the valuation of corporations by ratings services, there is a widespread feeling that the major United States banks are not as strong as their balance sheets indicate. Loans to developing countries are only part of the problem as the banks have also lent extensively in the agricultural and energy sectors of the United States economy, which have been buffeted in recent years. This notwithstanding, it might be time for the large United States banks to begin to recognize formally that a significant portion of their assets are overvalued and to accept some losses on them.

Indeed, banks from other countries have been taking losses on developing country loans through the discount market, as have the regional banks of the United States. In those countries, banks have been building up their capital

position and loan-loss reserves as United States banks have been doing, in all cases under the intense scrutiny of supervisory authorities. The banks have also increased special provisions or reserves against loss from loans to countries that experienced debt-servicing difficulties. Differences in accounting and legal treatment of banks make it difficult to compare the risk remaining to banks in various countries, but the apparently greater willingness of banks outside the United States to formally accept losses suggests that the provisioning by those banks had advanced beyond that of the large United States banks. In fact, besides the actual accumulation of open or hidden reserves, the position of banks in countries whose currencies have appreciated against the dollar has been strengthened recently, since the reserves are held in local currency while most of the debt is in dollars.

Japanese banks are even acting to facilitate the writing down of their loans to debtor countries to a greater extent than encouraged by Japanese tax law. In March 1987, 28 Japanese banks formed an offshore company to buy such debt at a discount with resources provided by the banks themselves. The banks, which as noted above have been growing rapidly, would thereby remove from their books assets against which they have already made certain provisions. The loss from the discounted sales of debt would be set against other earnings for tax purposes and the loan-loss reserve would be released. In addition, interest paid by the debtor to the offshore company and transferred to the original bank would be taxed at a lower rate than the same interest accrued directly. The offshore company is expected to absorb problem debt owed to Japanese banks in a systematic, loan-by-loan procedure and not all at once, and when a loan of a borrower is discounted to the company, other loans to the same borrower still on the books of the banks will not also have to be written down.

The shortcoming in the Japanese innovation is that it does not benefit the debtor country (unless the offshore company helps place the discounted debt in a debt/equity swap as discussed above). But the initiative implicitly recognizes that the existing international debt strategy is not working.

A new strengthening of the international debt strategy is therefore called for, one that would leave the banks less vulnerable and hasten the process of adjustment in the debtor countries. Indeed, the former requires the latter. Adjustment would be well served by a larger net transfer of resources to the debtor countries to be applied to structural adjustment and also by a lower interest burden than has yet been achieved under the existing strategy of debt management. Writing off an agreed percentage of the outstanding commercial bank loans would support both aims. It would also contribute to returning the actual value of the remaining debt held by the banks to face value by restoring debt servicing of the debtor to a sustainable level.

The write-offs could be negotiated in the same complex of

<sup>49</sup> H. Robert Heller, "The debt crisis and the future of international banking", paper prepared for the Annual Meeting of the American Economic Association, New Orleans, 29 December 1986.

<sup>50</sup> Federal Reserve Bank of New York, *Recent Trends in Commercial Bank Profitability: A Staff Study*, September 1986.

<sup>51</sup> *Moody's Money Centre Banks Industry Outlook*, January 1987.

linked forums that is already used for negotiating debt restructuring and policy adjustment, namely, commercial bank committees, IMF and World Bank executive boards, the Paris Club for loans of official creditors and various *ad hoc* bilateral official arrangements. The key difference is that bank committees, as well as the Paris Club, would be empowered and encouraged to consider a wider range of debt restructuring alternatives than is the current practice, that is by including a collective and selective debt write-off among the options.

Proposals to require banks to write off a portion of the debt or to waive some interest payments are increasingly being made.<sup>52</sup> Large banks and others involved in the current strategy have argued vigorously against such proposals.<sup>53</sup> Yet some version of partial debt forgiveness appears to be necessary, given the outlook for trade and non-debt creating financial flows.

From a global perspective, the partial debt relief option also has certain advantages. A partial debt write-off or a

reduction in interest payments below market rates (they can be made equivalent in actuarial terms) would not only raise the growth of developing countries and speed their adjustment, but would also raise the rate of growth of developed countries whose exports to the debtor countries would rise, as illustrated by the scenario discussed in chapter II above.

Implemented through case-by-case negotiations with each debtor and given the improved provisioning for bad debts and strengthened capital positions of the commercial banks, a partial debt write-off would not add a new threat to the stability of the world financial system. Indeed, it would probably be seen as strengthening the system. Appropriate phasing of the debt write-off by creditors (perhaps with central banks making contingent credit available to certain banks that might otherwise be placed in difficult circumstances) would serve to allay fears that major international banks and therefore the international financial system are at risk. Continuing along the current path would provide no such assurances.

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<sup>52</sup> In the United States alone, for example, proposals were made in 1986 by Senator Bill Bradley of New Jersey (originally in an address at Zurich, Switzerland, 29 June 1986) and by Congressman Charles E. Schumer of New York (*The New York Times*, 10 March 1986, and in more detail for the case of Mexico, jointly with Robert M. Lorenz and Jorge G. Castañeda in *Financial Times*, 22 October 1986), as well as by an increasing number of academic authorities. See, for example, Rudiger Dornbusch, "La economía mundial: tópicos de interés para América Latina", in *Más Allá de la Crisis de la Deuda*, Ricardo Ffrench-Davis and Richard Feinberg, eds. (Santiago de Chile, Corporación de Investigaciones Económicas para Latinoamérica and Inter-American Dialog, 1986), pp. 17-32; Stanley Fischer, "Sharing the burden of the international debt crisis", paper prepared for the Annual Meeting of the American Economic Association, New Orleans, 29 December 1986; and Jeffrey Sachs, "Managing the LDC debt crisis", *Brookings Papers on Economic Activity*, No. 2 (1986), pp. 397-431.

<sup>53</sup> See, for example, Morgan Guaranty Trust Co., *World Financial Markets*, September 1986.

## CHAPTER V

### THE INTERNATIONAL OIL MARKET

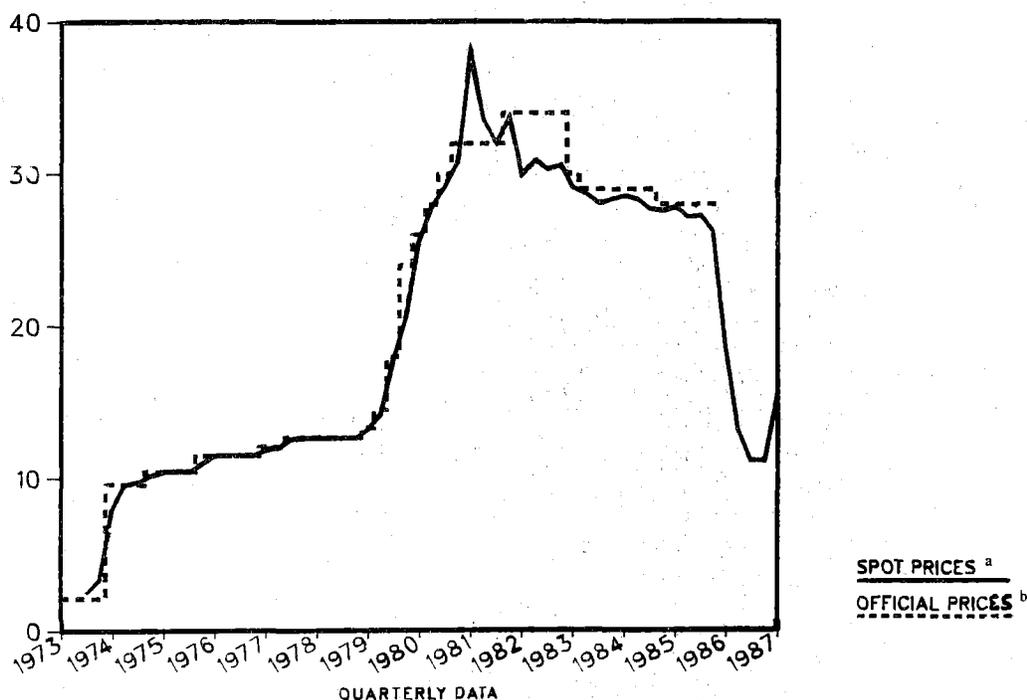
The year 1986 saw very sharp fluctuations in the price of oil. During the first seven months, oil prices plummeted about 64 per cent and recovered by about 36 per cent in the rest of the year. At year-end the price was roughly 51 per cent below its level one year earlier. The short-run effects of the price drop on oil demand and supply were considerable. On the demand side, the immediate effects on oil consumption surpassed expectations based on past estimates of the elasticity of oil demand with respect to oil prices. On the supply side, the situation was more complex as the expansion of oil production was cause as well as effect of the slide in prices. Another important implication was the pronounced shift in income from oil exporters to oil importers. The 1985-1986 oil shock largely reversed the income effects of the two oil shocks of the 1970s.

The longer-run implications of the fall in oil prices depend on how long prices will remain depressed. Energy investments, however, have already been affected. Expenditures on oil exploration and development, as well as on other sources of energy, declined substantially in 1986 and there are few indications that they will recover soon.

#### Energy consumption and output since the early 1970s

The sharp rise in the price of oil in 1973-1974 and 1979-1980 induced profound and far-reaching reactions. Much of the reaction to higher prices fell on consumption. Global energy consumption grew by an average 1.7 per cent per

Figure V.1. The price of Arabian Light crude oil, 1973-1986  
(Dollars per barrel)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *Petroleum Intelligence Weekly*, various issues.

<sup>a</sup> Spot market prices from the fourth quarter of 1984 to the latest figures in 1987 are estimated netback values.

<sup>b</sup> No official prices set for 1986.

year over the period 1973-1985. This contrasted sharply with the average 5.2 per cent per year sustained during the 1960s and early 1970s. Energy use decelerated progressively towards the end of the 1970s and into the 1980s as a result of investments in energy-efficient durable goods and shifts in consumption patterns. In the developed market

economies, energy consumption actually declined in absolute terms during the years 1979-1981, despite annual growth in aggregate income over the same period. This marked a historic shift in the relationship between income and energy use in these countries.

Energy production capacity, on the other hand, grew rapidly during the period 1973-1985. Its rate of growth rose as the period progressed. Investments made during the early 1970s began to pay off in terms of sizeable increments in production capacity in the late 1970s and early 1980s. These investments did not substantially change the broad geographic distribution of proven reserves, which remained preponderantly in the Middle East (see table A.16). But the production of fossil fuels and of nuclear power and hydro-power rose on a broad geographical base during the 1970s. Towards the end of the decade, however, there was some moderation in production growth under the influence of declining rates of growth of energy consumption.

By early 1981, the cumulative effects of falling energy consumption and rising energy supplies began to be felt in energy markets, especially in spot oil markets. As the excess supply situation gradually unfolded during the early 1980s, overt price competition developed in the oil market, which led to a rapid expansion in the amount of oil traded in spot markets. Spot transactions rose from 1 to 3 per cent of oil traded internationally in 1979 to perhaps one third of international sales by early 1985.<sup>1</sup>

Starting at nearly \$40 per barrel (pb) in 1981, or almost \$8 pb above the official price of \$32 pb, the spot market price for the "marker" crude oil (Arabian Light, 34o API, f.o.b. Ras Tanura) (see figure V.1) had fallen below the official price level by mid-summer. Until late 1982, the spot price fluctuated between \$30 pb and \$33 pb, basically in response to seasonal demand. By the autumn and winter of 1982/83 the spot price dropped below \$29 pb. It remained in the \$28-\$29 pb range during the first half of 1984, and slipped into the \$27-\$28 pb range during the second half. Official prices generally followed the course of spot prices with a lag (see figure V.1). Stocks played an important role in determining price movements over the entire period (see table A.17).

As price competition rose in the latter half of 1985 so-called "market-oriented" pricing instruments came into wide use. These included the discounting of official prices, barter exchanges at imputed prices below official prices and netback pricing arrangements. None of these practices were really new. The explosion in the number of transactions involving one or more of these devices was, however, unprecedented.<sup>2</sup> Netback pricing grew particularly fast. Under this arrangement, the price of crude oil sold depends on the (spot) market value of the products it yields, after allowing for transportation and refining costs. Such sales shift a considerable part of the refining risk from the refiner to the producer of crude oil.

The various marketing techniques adopted in the latter part of 1985 were symptoms of chronic over-supply. This was exacerbated by the decision of OPEC producers to limit

the application of its system of official prices supported by producer quotas in order "to secure and defend for OPEC a fair share in the world oil market consistent with the necessary income for Member Countries' development".<sup>3</sup> This decision had two consequences: a drop in oil prices and the collapse of the spot market. The value of the netbacks for Arabian Light was about \$25 pb in late 1985, a \$2 pb decline from the corresponding spot price at mid-year. Furthermore, the general resorting to incentive marketing devices, particularly for Middle Eastern crude oils or blends, cut sharply into spot markets.<sup>4</sup>

### Oil price developments in 1986

Although seasonal demand rose and seasonal supply dropped in the first quarter of 1986, the decline in prices picked up momentum as potential buyers withheld purchases in anticipation of still lower prices and in fact resorted to stock liquidation. This derived in part from the perception that netback and other incentive pricing arrangements would induce a sharp increase in liftings of crude oil later in the year. Netback prices for Arabian Light collapsed from \$21 pb in early January to \$15 pb in late March, and were below \$10 pb by mid-summer, as some of the earlier predictions of a crude oil glut materialized.

Despite the seasonal drop in consumption and non-OPEC production in the second and third quarters, OPEC output rose from 18.6 million barrels per day (mbd) in the first quarter to 19.2 mbd in the second and 20.7 mbd in the third. At the same time, exports of oil from centrally planned economies rose to about twice the level obtained during the first quarter. As a result, an enormous 5.3 mbd were added to stocks in developed market economies between 1 April and 1 October, and returns on Arabian Light plunged to an average \$9 pb in July. Some semblance of stability was restored to the market after August, when OPEC decided to reduce production quotas (see table A.18). Prices rose to about \$12.70 pb roughly half the price of one year earlier.

One result of the greater adherence to quota limitations was a drastic reduction in OPEC production - about 2.0 mbd - between the third and fourth quarters (see figure V.2 and table V.1). Together with the seasonal rise in oil consumption and seasonal decline in imports from centrally planned economies, approximate balance between physical demand and supply for oil was obtained. Although at the writing of this chapter it is too early to discern a clear trend in oil prices, the tone of the market in 1987 is firmer than in 1986.

The rise of netback sales in 1986 led to a change in the geographical direction of oil trade. Trade patterns reminis-

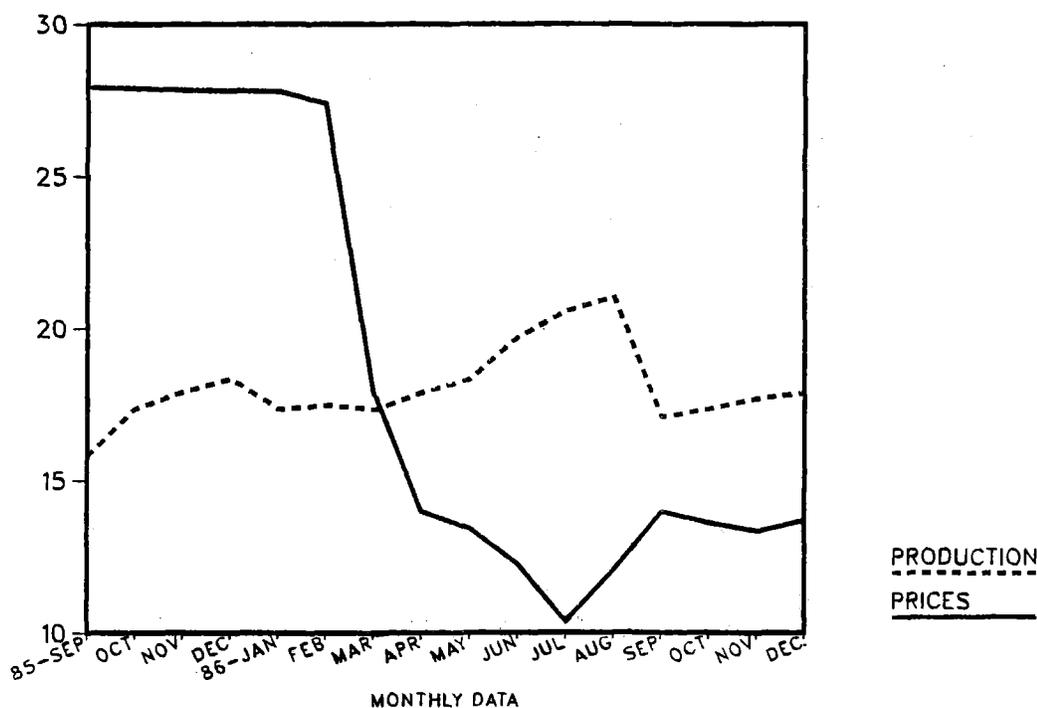
<sup>1</sup> *Petroleum Intelligence Weekly*, vol. XXIV, No. 1 (7 January 1985), p. 8.

<sup>2</sup> The prevalence of such practices in the summer of 1985 led the Ministerial Executive Council of OPEC to issue a report in September 1985 on "marketing malpractices", see *Petroleum Intelligence Weekly*, vol. XXIV, No. 42 (21 October 1985), special supplement.

<sup>3</sup> Quoted in *OPEC Bulletin*, vol. XVI, No. 10, (Vienna; December 1985-January 1986), p. 5.

<sup>4</sup> Some major price reporting services, for example, ceased to offer quotations of Arabian Light towards the end of the year, or qualified quotations as "notional". Thereafter, only estimated netback values for these crude oils have been published.

Figure V.2. OPEC oil production (millions of barrels per day) and oil prices (dollars per barrel)



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

1. Production: *Petroleum Economist*, March 1986 and March 1987.
2. Prices: United States Department of Energy, *Weekly Petroleum Status Report*, September 1985—December 1986. Average weekly prices (f.o.b.) weighted by estimated export volume.

Table V.1. Oil balances in selected years

(Millions of barrels per day)

<b>Developed market economies</b>				
Consumption	40.0	41.6	34.0	34.8
Production	13.8	15.7	18.8	17.9
Net imports	26.2	25.9	15.9	16.9
<b>Developing countries</b>				
Consumption	6.7	10.8	11.6	11.8
Production	34.0	36.9	25.7	27.8
Net exports	27.3	26.1	14.1	16.0
<b>Centrally planned economies</b>				
Consumption	9.4	11.1	10.7	10.8
Production	10.4	12.2	12.3	12.7
Net exports	1.0	1.1	1.6	1.9
<b>Memorandum:</b>				
Saudi Arabia production	7.6	9.5	3.2	5.0
Soviet Union production	8.6	11.8	11.9	12.3
United States production	9.1	8.4	9.8	9.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *Yearbook of World Energy Statistics* (United Nations publication, Sales No. EF.80.XVII.7); IEA, *Monthly Oil Report*, January 1987, *Petroleum Economist*, January 1987.

Note: For each group and year, consumption is production plus net imports (or minus net exports) minus stock additions.

cent of the 1970s were re-established. Middle Eastern oil began to reappear in North America in significant quantities and partially displaced Mexican and Venezuelan crude oils. Especially large flows of oil also reached Europe in 1986.

Financial innovations in the oil market intensified in early 1986. Netback arrangements were used by producers in the Middle East for sales to a broader array of customers, and other producers began to employ netback arrangements as well. Netbacks were also applied to spot sales of crude oil and even to the production share of foreign oil companies operating in developing countries. Other kinds of "formula pricing" of crude oil were adopted during the first half of 1986 in an effort to work out contractual terms that offered less risk to market participants. The proliferating contractual forms, though different in detail, all embodied a formula that linked the price of the oil purchased to published open-market spot quotations for baskets of oil on the date of

loading or delivery. By mid-year, crude oil supplies governed by netbacks or formulae represented 75-80 per cent of crude oil traded internationally.<sup>5</sup>

At the same time, oil markets further integrated. Oil futures contracts which appeared in 1985, began to assume a significant role in oil price formation in 1986.<sup>6</sup> The volume of contracts in both crude oil and products actually settled in kind is sufficient to have important effects on corresponding spot prices; indeed, prices in some spot transactions are based on near-term futures contracts. Furthermore, future oil prices in London and New York directly affect the spot prices of similar crude oil sold elsewhere and indirectly influence the pricing of the entire spectrum of refinery feedstocks throughout the world. The overall effect of these developments has been to link more closely the various markets for both crude oil and products across types of materials and geographic locations.

Table V.2. Change in petroleum product prices as of August 1986 relative to August 1985

(Percentage)

	Spot price <sup>a</sup>	End-user price excluding tax (Prices in United States dollars)	End-user price with tax	Change in dollar exchange rate <sup>b</sup>	End-user price with tax (Prices in national currency)
Gasoline					
Western Europe <sup>c</sup>	-31.4	-41.1	-11.1	-28.6	-29.8
Japan	n.a.	17.0	30.0	-35.0	-15.2
United States	-43.8	-38.0	-29.2	--	-29.2
Household heat oil					
Western Europe <sup>c</sup>	-48.0	-39.0	-23.5	-18.6	-41.6
Japan	-52.2	29.4	29.4	-35.0	-16.0
United States	-43.7	-28.0	-28.0	--	-28.0
Industrial heavy fuel oil					
Western Europe	-54.0	-53.2	-39.3	-18.6	-51.6
Japan	-54.6	6.2	-6.2	-35.0	-39.6
United States	-52.2	-50.0	-50.1	--	-50.1
Memorandum item:					
The 12 month percentage changes in crude oil prices <sup>d</sup> (as of June 1986 are: Western Europe -56.8; Japan -55.2; and United States -51.7.					

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IEA, *Energy Prices and Taxes*, second quarter 1986, 1986/No. 4, pp. 15-16.

<sup>a</sup> New York, Rotterdam and Singapore.

<sup>b</sup> In Japan, gasoline and household heating oil prices to end-users in yen fell relatively less than the amount of the yen's appreciation vis-à-vis the dollar, therefore, the signs of the relative change in the prices of these products in dollars are positive.

<sup>c</sup> Exchange rates for Western Europe are based on ECUs.

<sup>d</sup> All prices are for landed crude oil, c.i.f., in United States dollars.

<sup>5</sup> *Petroleum Intelligence Weekly*, vol. XXV, No. 26 (30 June 1986), p. 1.

<sup>6</sup> Futures contracts for gas oil and crude oil are currently traded in London, and those for gasoline, number 2 fuel oil, and crude oil in New York. Because of the similarity of materials traded in the cases of crude oil (Brent Blend and West Texas Intermediate) and light fuel oil (gas oil and number 2 fuel oil) and the similarity of contractual terms between London and New York, arbitrage minimizes price swings in both markets.

## The effects of lower oil prices on consumption

Relatively little crude oil is consumed as such. The demand for it is the result of the demand for oil products. Thus, the effect of a fall in crude oil prices on final oil usage depends on the extent to which crude oil price reductions are "passed through" to final consumers of oil products in the form of lower product prices, in addition to other factors such as the sensitivity of demand to price changes and the possibilities of substituting alternative sources of energy.

In 1986, petroleum product consumption in the OECD member countries grew at a rapid 2.3 per cent per year relative to the 1.2 per cent per year average decline over the period 1979-1985. Because this was about the same as the expansion of OECD gross domestic product (2.5 per cent), the energy intensity of output did not decline further. None the less, the timing of purchases and substitution during the year suggests that a considerable portion of the rise in oil product demand was motivated by price considerations.

Only partial information of the extent to which final consumers in OECD countries benefited from the fall in crude oil prices in 1986 is available (see table V.2). When expressed in terms of local currencies, petroleum product prices of final consumers fell quite remarkably over the year ending in August 1986. For each of the geographic areas shown in table V.2, the landed cost in dollar terms of crude oil delivered to local ports declined by over 50 per cent during the year ending in June 1986. However, only final consumers in the industrial sector of the United States experienced full "pass-through" in the decline of oil product prices. For consumers in all sectors of Western Europe and Japan and for consumers in the non-industrial sectors of

the United States, the declines in dollar prices fell far short of that registered for crude oil. Most of the discrepancies are accounted for by taxes. But with the exception of industrial fuel oil, product prices at the refinery level did not fall as much as crude oil. This means that windfall profits were taken by importers, refiners or both, which was especially pronounced in Japan.

Lower oil product prices last year expanded the demand for products through two mechanisms: the expansion of output of final goods and services utilizing oil products and substitution of oil products for other fuels. Table V.3 shows the changes in consumption of the principal groups of petroleum products in OECD countries.

Gasoline, diesel fuel and jet fuels all registered sizeable increases in consumption in 1986, mainly because of rises in the output of final services which use these products as inputs intensively, particularly for automotive and air travel, which are price elastic in the short run. Gasoline demand grew especially fast in the United States. But demand for heating oil also registered a large increase.<sup>7</sup>

The demand for the output of the industrial sector as a whole is not very price elastic in the short run and the costs of oil inputs amount to only a few percentage points of total costs of industrial products as a group. Therefore, the effect of lower heavy oil prices on heavy oil consumption by the industrial sector was slight. Use of heavy fuel oil rose only about one third as rapidly as that of middle distillates, mainly owing to substitution. But this positive growth in heavy oil demand ended a 10-year decline in the use of such fuels in the developed market economies, which increased in the United States but further declined, albeit at a slower rate, in Western Europe and the Pacific area.

Table V.3. Annual changes in petroleum product consumption, 1980-1986

(Percentage)

	North America		Western Europe		Pacific		Total OECD	
	Average 1980-1985	1986 <sup>a</sup>						
Naphtha	-10.1	-5.8	-7.6	1.9	-5.4	-6.8	-7.6	1.8
Motor gasoline	-1.4	2.2	-0.4	3.9	1.1	2.4	-0.8	2.6
Middle distillates	2.3	0.2	-0.6	5.0	1.2	4.9	0.9	2.9
Heavy fuel oil	-3.3	14.3	-2.8	-0.9	-2.9	-12.8	-3.0	1.0
Other products	-4.4	0.3	-1.9	6.3	-12.9	1.7	-5.1	2.0
Totals	-0.8	2.1	-1.4	3.6	-1.9	0.1	-1.2	2.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IEA, *Monthly Oil Report*, January 1987.

<sup>a</sup> Based on data of 10 months for January-October in both years.

<sup>7</sup> It rose dramatically in Western Europe, as middlemen and individual householders took advantage of lower prices to stock up on heating oil well before the normal autumn pick-up in demand.

Given the improved energy efficiency of the capital stock in the developed market economies that was built up over the past decade, there was little room in the short run for substitution of energy for capital services. However, the demand for industrial fuel oil was expanded by substitution for coal and natural gas in secondary electricity generation and industry. But the extent of fuel switching was much less than might have been expected, even in the United States where dual-fired capacity is much larger than elsewhere.<sup>8</sup>

The stability in market shares of competing fuels throughout the developed market economies apparently stemmed from the general emulation of marketing tactics originally adopted in the oil sector. Thus spot sales of coal and gas rose markedly.<sup>9</sup> The spot sale format provided a vehicle for the maintenance of vigorous price competition by substitute fuels with residual fuel oil. For example, by July 1986, when fuel oil prices were about \$8 pb, international coal prices had fallen 15-20 per cent from a year earlier and were also in the \$8-9 pb (BTU basis) range.<sup>10</sup>

### Production shifts

A decline in oil prices might be expected to lead to a shift in oil production in favour of oil-exporting developing countries, especially in the Persian Gulf, and against oil-producing developed market economies, particularly in North America. The size of the shift is especially a function of relative operating costs, which are significantly lower in most of the oil-exporting developing countries, and the degree to which current and expected prices cover operating costs in developed market economies. Other things remaining equal, a decline in oil prices will squeeze out the least efficient producers, especially the "small field" producers. But short-run price impacts need not be sustained into the future. Moreover, exogenous factors might be at work as well.

Among these exogenous factors, the decision of OPEC in December 1985 to seek a larger share of the international oil market was clearly significant. Oil production accelerated until August 1986 when OPEC in an effort to arrest the drastic decline in oil prices decided to reinstate a quota system (see figure V.2). In addition, repeated OPEC calls for the co-operation of North Sea and North American oil producers in restricting their output did not meet with any favourable response. On the contrary, in some cases authorities eased their taxation in order to maintain production.<sup>11</sup>

Oil output reductions in the developed market economies were largely limited to the United States owing to the high cost of production of marginal fields, especially stripper wells. The call of OPEC for oil production cut-backs, however, received more favourable consideration by a number of oil-exporting developing countries, such as Egypt, Malaysia, Mexico and Oman, which announced their own cut-backs.

By autumn 1986, it had become clear that the new OPEC policy of increasing its share of the oil market could not be achieved in the short term without a persistent reduction in oil prices to levels even lower than those experienced in the summer of 1986. But the sharp contraction in oil prices that did occur resulted in severe reductions in foreign exchange earnings for all OPEC countries (see table V.4) and other energy exporters.

Under these circumstances, a drastic reversion of policies was achieved at the OPEC conference which met at Geneva from 11 to 20 December 1986, and OPEC decided to return promptly to a fixed price system at a level of \$18 per barrel (the reference price of OPEC) as at January 1987. Moreover, OPEC came to the conclusion that it was necessary to undertake cuts in its production level as a means to support that price. An agreement was reached that the total production of OPEC for the first and second quarters of 1987 should not exceed 15.8 mbd. It was also agreed that production regulation should be pursued throughout the remaining period of the year to ensure enough support for the new OPEC price structure.

The decision of OPEC to cut output further and to revert to a system of reference rather than netback prices resulted in a firming up of oil prices to the target of \$18 per barrel at the beginning of 1987. The OPEC decision met with support once again from non-OPEC oil-exporting developing countries (e.g., Egypt, Malaysia, Mexico and Oman), which announced further cutbacks in their productions and, for the first time, Norway also announced a reduction of 7.5 per cent in its North Sea production. Further support was forthcoming from China and the Soviet Union, with announcements of cutbacks in oil exports to support the target oil price.

Whether voluntary restraints on production and/or export will succeed in giving greater stability to oil markets in 1987 depends on the increase in oil demand, which is expected to be lower than 2 per cent per annum, adherence to production cut-backs among OPEC and non-OPEC countries and oil production trends in other countries, including exports from the centrally planned economies.

<sup>8</sup> In the United States, switching from natural gas to residual fuel oil amounted to less than 200,000 barrels per day over the course of the year. By contrast, in 1979-1980 when heavy oil prices rose, nearly 500,000 barrels per day of residual fuel oil were displaced by natural gas, see *Petroleum Intelligence Weekly*, vol. XXV, No. 21 (26 May 1986), p. 4.

<sup>9</sup> Internationally traded spot sales of steam coal in mid-July constituted between 60 and 70 per cent of total market activity for coal, much higher than even one year earlier. Similarly, the spot market component of natural gas sales in the United States rose from about one third of the total in 1985 to over one half in 1986.

<sup>10</sup> *Petroleum Intelligence Weekly*, vols. XXV and XXVI, various issues. Substitution for heavy fuel oil was also hampered to some extent by regulatory rules, e.g., the Fuel Use Act in the United States.

<sup>11</sup> For instance, royalty payments in some states in Canada and the United States were eliminated or reduced.

Table V.4. Foreign exchange revenues from oil sales for OPEC countries<sup>a</sup>

(Billions of dollars)

Country	1985	1986	Projections	
			\$12 per barrel	\$18 per barrel
Saudi Arabia	27.5	21.7	15.4	23.8
Iran (Islamic Republic of)	12.9 <sup>a</sup>	5.5	6.7	10.3
Iraq	12.5 <sup>a</sup>	6.1	5.3	8.0
United Arab Emirates	12.5 <sup>a</sup>	6.2	3.7	5.6
Kuwait	9.7	6.6	3.5	5.5
Qatar	3.2 <sup>a</sup>	1.5	1.2	1.9
Nigeria	12.2 <sup>a</sup>	6.6	5.1	7.5
Venezuela	10.3	6.4	5.2	7.4
Libyan Arab Jamahiriya	10.9 <sup>a</sup>	4.6	4.0	5.9
Indonesia	8.6	4.2	3.1	4.7
Algeria	8.2	2.5	2.4	3.6
Gabon	1.3 <sup>a</sup>	0.7	0.6	0.9
Ecuador	1.7 <sup>a</sup>	1.0	0.6	0.9
<b>Total OPEC</b>	<b>131.5</b>	<b>73.6</b>	<b>57.0</b>	<b>86.1</b>

Source: *Petroleum Intelligence Weekly*, 26 January 1987.

<sup>a</sup> Crude only.

Table V.5. Production and operating costs in the United Kingdom sector of the North Sea in 1983

(Dollars per barrel)

	Production cost	Operating cost
Large fields	2.30- 4.90	1.10- 2.30
Medium fields	4.20- 5.80	1.60- 2.90
Small/marginal fields	8.70-20.70	1.80-14.50

Source: Tetsuya Iwasaki "International oil market", *Energy in Japan*, Bimonthly Report No. 82, November 1986.

In the short term, perhaps the most important oil production development was in the United States. During the period 1973-1982, oil production in that country was maintained as a result of massive investment. Because of disappointments in the magnitude of oil discoveries and a weakening oil market, expenditures for exploration slowed down even prior to the oil price collapse of 1986, but production was maintained at about 9.2 mbd at the beginning of 1986 as a result of investments in development drilling and a variety of high-cost enhanced oil recovery techniques. By December 1986, however, oil production had fallen to 8.3 mbd. Despite the increase in oil prices to about \$18 per barrel, estimates for oil production in the United States in 1987 indicate a further decline of about 0.5 mbd.

No such reduction in output is expected from the North Sea, where production may be maintained in the United Kingdom sector because of low operating costs and perhaps

increased somewhat in the Norwegian and other sectors (see table V.5).

Among the centrally planned economies, increased oil production was achieved in the Soviet Union. The drop from a high of 12.3 mbd in 1983 to 11.9 mbd in 1985 was reversed in 1986 when production expanded to 12.3 mbd. Similarly, in China, oil production increased by 4.6 per cent in 1986 to a level of 2.6 mbd. In both countries, output and investment plan targets indicate further expansion for 1987 and later years.

In some non-OPEC developing countries, such as Egypt, Malaysia, Mexico and Oman, oil production and exports were influenced in 1986 by oil price volatility and, after August, by agreed output cut-backs in co-operation with OPEC policy. These countries have announced further production cut-backs for 1987 in support of a target oil price of \$18 pb.

It is estimated that their combined reduction in output will amount to 0.5 mbd. However, oil production and exports are expected to increase by a similar amount in other oil-exporting developing countries such as Angola, Colombia and the Yemen Arab Republic. Moreover, significant oil output increases have been registered in some of the big oil-importing developing countries such as Brazil, India and Pakistan. Among these countries, Brazil has registered an impressive expansion of oil output which increased to 0.62 mbd in 1986 from 0.56 mbd in 1985 and only 0.19 mbd in 1980; in addition, new discoveries both offshore and onshore indicate additional output in 1987 and beyond.

The oil price collapse of 1986 has brought about a fundamental reorientation of energy investments which is likely to persist, at least in the short term, if oil prices can be stabilized at their current level of \$18 pb. The magnitude of the losses on past energy investments since 1985 in the high-cost producer countries has led to many bankruptcies, corporate restructurings and consolidations. These losses have not only affected the energy corporations themselves but also the support institutions that have traditionally provided technical services such as geophysical surveys, drilling and credit facilities. As a result, many oil corporations have cut back their investments considerably and further retrench-

ment appears to be in the offing (see table V.6). Capital expenditures in petroleum by majority-owned foreign affiliates of United States companies were \$20.8 billion in 1982, but are expected to decline to \$11.4 billion in 1987 (see table A.19).

Oil industry cash flows have been adversely affected by the oil price decline. This has been particularly pronounced for the independent oil corporations, which have been responsible for much of the exploration effort, especially in the United States and to some extent in the North Sea, and had, in recent years, been expanding their activities in the developing world. These companies have reduced their oil explorations. Because they have also cut back their participation in joint ventures, the financial stringency of these independent companies has also affected overall oil exploration and development of major transnational or national oil companies, which have had to postpone or cancel ongoing projects. About one third of the struggling independents are expected to go out of business before a solid recovery can be expected.<sup>12</sup>

In order to contain reductions in oil exploration and development investments since the 1980s, host countries have generally been willing to relax the terms and conditions of

Table V.6. United States oil companies—exploration and development investments, 1985–1986

(Millions of dollars)

Area	1985	1986	Percentage change
Canada	3 709	2 614	-30
United States	30 614	18 255	-40
Rest of the world	14 353	11 753	-18
Total	48 676	32 622	-33

Source: Tetsuya Iwasaki "International oil market", *Energy in Japan*, Bimonthly Report No. 82, table 6, p.35.

long-term contracts. As noted, some developed market economies have relaxed royalty payments and similar taxation measures to sustain production, particularly in marginal fields, retain existing exploration commitments or attract new capital. Similar measures have been taken in developing countries, although their implementation has been slower because of their political sensitivity, uncertainty with regard to the level of future prices and the long-term implications of such changes. None the less, by the end of 1986

more than 20 developing countries had announced revisions in their long-term contracts and several other developing countries were in the process of doing so.<sup>13</sup> Whether or not this process will be followed by increased capital flows in either absolute or relative terms in comparison with the developed market economies is as yet unclear. However, recent statements by exploration managers of major transnational oil corporations<sup>14</sup> and the interest shown in new exploration during 1986 indicate a shift of effort towards the

<sup>12</sup> *Petroleum Economist*, December 1986, p. 444.

<sup>13</sup> For example, in opening up to international bidders a huge tract of the Western Desert west of the Qattara Depression, Egypt offered new terms, including an increase to 50 per cent of production for cost recovery as compared to 40 per cent for previous contracts (see *Petroleum Economist*, December 1986, pp. 461 and 464).

<sup>14</sup> *Oil and Gas Journal*, 2 June 1986, p. 21.

developing countries, where exploration and production costs have been consistently lower than in the developed market economies.<sup>15</sup> At the same time, a shift away from offshore prospecting appears to have manifested itself in view of the cost of geophysical surveys, exploration and production drilling, and development of discoveries. Because profitability is greatly influenced by the level of oil prices and their volatility, host countries as well as transnational corporations may have to explore more flexible provisions of long-term contracts.

In contrast to the trends in developed market economies, some developing countries, including Angola, Brazil and India, have either maintained or even increased their plans for investment in oil exploration and development. Considerable increases have also been registered in recent years in natural gas, coal, nuclear power and new and renewable sources of energy.

### Policy implications of expected oil production

A variety of energy projections under different oil price scenarios have been prepared in the recent past. They indicate a reversal of recent consumption and production trends. Small annual increases in oil consumption in the developed market economies and bigger consumption increases in the developing world are expected.

In order to maintain or to increase oil output in the centrally planned economies, large investments are required. Some of the incremental output may be needed for domestic demand. In the Soviet Union, however, substitution of natural gas and nuclear power for oil may have a considerable effect on available export supplies. Medium-term oil production in the developed market economies is expected to be significantly lower than recent output levels because of the natural decline in productivity of existing fields and the continuation of lower levels of exploration and development efforts. High energy prices during the late 1970s and early 1980s not only permitted vast investments for new oil reserves but also the application of high-cost secondary and enhanced recovery techniques in existing fields.

In both the United Kingdom and the United States, output is expected to decline below current levels even if prices stabilize. The general consensus is that United States production cannot be maintained at existing levels unless oil prices rise considerably. In addition, since long lead times are required in exploration and development of new oil fields, particularly in difficult offshore or Arctic areas, considerable effort and time would be needed to rebuild oil industry capacity. Similarly, the United Kingdom sector of the North Sea was believed to be near its peak production capacity even before the oil price decline. Low oil prices will probably hinder exploration and development in that sector as well as in the Norwegian sector. But some additional out-

put may be expected from these North Sea areas in the medium term.

As a result of increasing consumption and the likely reduction in their indigenous oil production, the developed market economies are likely to become increasingly dependent on oil imports from the developing countries. Since most of the proven oil reserves of the world are in the Middle East, additional supplies will have to come largely from that area. Other oil-exporting developing countries, including Indonesia and Nigeria, although currently producing well below capacity, will need most of the incremental supplies for domestic consumption. A similar situation prevails in several oil-producing, oil-importing countries, because of the continuing slow-down in exploration effort, decreasing investment by transnational oil corporations and the overall scarcity of financial and technical capacities in many of these countries.

The world oil market can be expected to remain volatile because of its investment costs, lead times and market structure. The capital intensity of production makes the oil market inherently volatile. In periods of recession, oil prices tend to be eroded because of overcapacity and sizeable differences in marginal costs; in periods of growth, prices tend to rise owing to the same inflexibility of production and high marginal costs. Historically, production and exploration have been largely influenced either by a few transnational oil corporations or, more recently, by Governments. On the consumption side, excise taxes or import fees have been used either as important sources of government revenue or for the protection of domestic energy sources.

The overall result of these interventions is that at present two thirds of the oil market outside the centrally planned economies is supplied by the owners of limited and high cost oil reserves, which have been developed with massive investments. Owners of low-cost and abundant reserves supply the residual in the market, leaving at present at least 10 mbd of shut-in, low-cost capacity. This misallocation of scarce investment resources has taken place in periods of very high and low interest rates. It has concentrated resources in the developed market economies at a time when the developing world is starved of investment capital either from governmental or private sources. Furthermore, high-cost investments are not limited to oil, but also apply to other capital-intensive energy sources, such as nuclear power, whose economic feasibility is invariably justified on the expectation of high oil prices in the long run, and fears of import dependence, while often ignoring decommissioning, waste disposal and related costs as well as the possibility of catastrophic safety hazards.

Repeated calls by consumer countries for negotiations and stability during the period of high oil prices in the 1970s did not meet with a favourable response on the part of producer countries. Similar calls by producer countries during the period of lower oil prices in the 1980s continue to be ignored by the consumer countries. In these circumstances, the pro-

<sup>15</sup> See report of the Secretary-General on energy exploration and development trends in developing countries (A/41/383-E/1986/101).

posal of the Secretary-General at the second regular session of the Economic and Social Council in July 1986 remains important. The dangers of continuing uncertainty in the international energy situation need to be addressed. Investments in energy are long-term in nature and excessive

gyrations in the markets render price signals unreliable, resulting in periodic market upheavals. All parties would benefit if discussions were launched about ways and means to improve the monitoring and analysis of the international energy situation.

## CHAPTER VI

### ECONOMIC GROWTH AND TRADE IN CHINA, EASTERN EUROPE AND THE UNION OF SOVIET SOCIALIST REPUBLICS DURING THE PERIOD 1986-1990

During the first half of the 1980s, economic growth in most countries of Eastern Europe and the Union of Soviet Socialist Republics was, on average, less than during the preceding five years. The annual rate of expansion of aggregate output in Eastern Europe decelerated from 3.9 per cent in 1976-1980 to 2.2 per cent in 1981-1985 and in the USSR during the same period from 4.2 per cent to 2.2 per cent. In most Eastern European countries, performance remained well behind the plan targets for 1981-1985. This comparatively sluggish performance was widespread within countries. In every country for which data are available, the pace of expansion in agriculture, construction and industry lagged behind plan targets and, in many instances, trailed the achievements of the late 1970s. In addition, there were marked year-to-year variations in the recorded levels of economic activity. The fundamentals underlying the economic fluctuations and comparatively modest performance are complex. They range across the spectrum of key domestic and external constraints, some of which are chiefly exogenous and others the result of policy choices.

The mid-1980s provides an unusual, if convenient, watershed in the development policies of the European centrally planned economies. First, it is the period of the broad policy discussions on the formulation of the new medium-term plans, which in all these countries cover the years 1986-1990 and which are, in principle, synchronized through the co-ordination of intra-group trade intentions. As such, the medium-term planning framework offers the opportunity for a rounded assessment of recent economic performance and for a re-examination of the directions of current and prospective economic policies.

The introspection that accompanies the policy discussions on the successive drafts of the plans is invariably strongly influenced by the experiences of the plans just concluded. In the context of the unusual developments of the early 1980s, these plans exhibited unique characteristics as a result of various internal and in particular external economic imbalances, most of which could not have been foreseen at the time the plans were drafted and approved. This particular period in the medium-term planning cycle is also unusual because it coincides with shifts in economic institutions, management, and structural policies of several of those countries, including the USSR.

Secondly, the mid-1980s is characterized by experimentation with various new policy instruments and institutional and managerial features, and by the recasting of development strategies and growth objectives. The experimentation and recasting have been done for a variety of reasons, but

two stand out. The difficult economic policy choices that had to be made on an emergency basis in the early 1980s, primarily because of external payments imbalances, have led to calls for more flexible policies and institutions that can buttress more expansive growth ambitions. Systemic changes are also being sought in order to come to grips with the apparently long-term slow-down of growth in several of the industrially advanced members of the group. These efforts affect not only individual countries but also, directly as well as indirectly, regional economic co-operation within the context of the Council for Mutual Economic Assistance (CMEA).

The recent experiences, developmental priorities and policy concerns of China differ measurably from those of the majority of the European members of the group. During the early 1980s, China's economic performance was exceedingly buoyant. This stemmed especially from domestic policy changes and gradual shifts in institutions. Together they have moved the Chinese economy from being a strictly planned entity to one in which decentralized decision-making is gradually fostered. But the situation in the mid-1980s is lopsided and dualistic: the urban industrial sector is still overwhelmingly managed through central planning, in contrast to the rural, largely agricultural, sector.

In view of the major differences in economic performance, objectives, institutions and policy instruments, the first section of this chapter examines the framework of the medium-term plans of the European planned economies while the second deals with the Chinese economy. Special attention is devoted to the changes in economic mechanisms and policies and to the imbalances prevailing at mid-decade.

#### Centrally planned economies of Eastern Europe and the Union of Soviet Socialist Republics

#### Policy concerns and medium-term plans in the early 1980s

Two principal themes marked the medium-term socio-economic development plans for 1981-1985.<sup>1</sup> In most of Eastern Europe, these plans accorded the highest priority to rectifying the external imbalances incurred in the 1970s. Such imbalances had developed for a variety of reasons, including the serious deterioration in the terms of trade in both transferable rouble and convertible currency relations during the second half of the 1970s; constraints on the supply of key primary goods from within the CMEA region that had to be offset through other channels at different prices; and mis-

<sup>1</sup> For further details on these plans, 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", in *Supplement to World Economic Survey 1981-1982* (United Nations publication, Sales No. E.82.II.C.2), pp. 15-35.

calculations in external economic policies, including the assumption that the disturbances engendered by the first oil price shock in the mid-1970s would be a temporary aberration rather than the beginning of more fundamental shifts in global economic relations.

Some planners hoped to ease those external constraints by rapidly implementing the Long-term Target Programmes of Economic Co-operation that CMEA members had been elaborating since the mid-1970s. The Target Programmes were expected to help ease supply constraints in critical areas of production (especially fuels and raw materials) and services (in particular transportation). They were also intended to stimulate and accelerate the pace of broadly based specialization of production within CMEA. Forging more complex ties through specialization in a growing number of economic activities was thought to be an indispensable condition for regaining the trade pattern that had prevailed within CMEA during most of the post-war period: the exchange primarily of fuels and primary industrial products from the USSR for machinery and other manufactured products from Eastern Europe.

The correction of domestic imbalances took second place to the concern about improving the external sectors; even so, most countries hoped to improve control of both domestic investment and consumption demand by shifting resources into the export sectors and cutting down on domestic demand for imports. This was deemed necessary to accommodate external needs and also to create a more favourable environment for economic experimentation and for the growth of productivity. To the extent permitted by external constraints, there was to be an acceleration in the transition from the extensive type of economic development, relying chiefly on steadily expanding the supply of factor inputs, to the more intensive type of economic growth, in which increases in value added result principally from gains in factor productivity.

This order of priorities in policy concerns stemmed from the adverse experiences of the late 1970s and expectations about the prospective economic environment. These expectations included a long-term slow-down in the growth of the labour force; limited expansion of investment expenditures; limitations on the distribution of available capital funds among sectors, including distribution between the material and non-material spheres; a further deterioration of Eastern Europe's terms of trade; the policy objective of working off past debt; and export-marketing problems for manufactures, given the weak demand that was then besetting the global economy.

In view of those anticipated constraints on growth, output expansion for 1981-1985 was to be secured largely from productivity gains. Such gains were expected from a combination of organizational modifications, more intensive utilization of the available capital stock, including imported technology, changes in macro-economic planning tech-

niques, more flexible micro-economic management, better mobilization and motivation of the labour force, utilization of capital funds for reconstruction, modernization and automation rather than for the expansion of physical capacity, lowering the raw material and fuel intensities of output, improving the quality of domestic and export supply, and faster transmission of technological progress.

The external constraints for the Soviet Union were markedly different for at least two reasons. First, the USSR had been experiencing sharp gains in its terms of trade and had managed to expand its transferable rouble and convertible currency earnings, notably by increasing supplies of gas and oil. Secondly, the debt level of that country relative to its size, wealth and economic potential was far below that of the majority of Eastern European countries. However, the Soviet Union was also subject to certain external constraints. Successive harvest set-backs had to be offset through imports, especially of feed grains; the growing need to modernize plant and equipment through the importation of advanced technology; and emerging capacity constraints on feasible output levels for crude petroleum and hence on the primary external revenue earner. For those reasons, virtually all European planned economies adopted cautious economic policies.

#### Plan targets and achievements in the early 1980s

The evaluation of recent economic performance in the 1986-1990 plans and the intensive policy discussions prior to the finalization of the plans demonstrate that policy makers have become very concerned about the slow-down of growth in the early 1980s. The fact that, despite the rather "soft" plans adopted for 1981-1985, results fell short of intentions in several respects is being viewed as an opportunity to experiment further and make up lost ground, primarily through changes in policies, institutions and policy instruments.

As shown in table VI.1, only Bulgaria attained the planned pace of aggregate output growth between 1981 and 1985. Except for agriculture in the German Democratic Republic, neither the industrial nor the agricultural sectors in any of the countries for which final data are available exceeded the magnitudes planned. For the countries that adopted ranges (for example, Czechoslovakia), the pace of expansion at best approximated the lower bound. Though the below-plan performance in agriculture and industry was less pronounced in the USSR than in the Eastern European countries as a group, achievements remained well below the expectations of policy makers in the early 1980s (when the effect of the sizeable gains in terms of trade through 1984 could have been taken into account).

For most members of the group, 1981-1983 was characterized by a deceleration in growth rates compared with the 1970s.<sup>2</sup> For the group as a whole, the rate of growth declined

<sup>2</sup> The average growth rates for the period as a whole mask the considerable swings that were sustained on a year-to-year basis. For the period 1981-1984, the evolution of the main macro-economic aggregates and the adjustment efforts undertaken are traced in "Adjustment and investment policies in the centrally planned economies of Eastern Europe", in *World Economic Survey 1985* (United Nations publication, Sales No. E.85.II.C.1), pp. 89-101.

Table VI.1. Centrally planned economies of Eastern Europe and the USSR: selected actual and planned medium-term macro-economic growth rates, 1976-1990

	National income <sup>a</sup>				Gross industrial output <sup>b</sup>				Gross agricultural output <sup>c</sup>			
	1976-1980		1981-1985		1986-1990		1976-1980		1981-1985		1986-1990	
	Actual	Planned	Actual	Planned	Actual	Planned	Actual	Planned	Actual	Planned	Actual	Planned
Albania	4.6	6.2-6.5	3.0	6.2-6.5	6.0	6.3-6.6	4.9	5.2-5.5	3.9	5.4-5.7	2.5	6.2-6.5
Bulgaria	6.1	3.7	3.7	5.4	6.0	5.1	4.3	4.6-5.4	2.1	3.4	1.2	1.9
Czechoslovakia	3.7	2.0-2.6	1.8	3.4-3.5	4.7	2.7-3.4	2.7	2.8-3.4	1.7	1.8-2.2	1.8	1.2-1.4
German Democratic Republic	4.1	5.1	4.6	4.6	5.0	5.1 <sup>d</sup>	4.1	3.7-4.1 <sup>d</sup>	0.4	0.7-0.9 <sup>e</sup>	2.2	1.5 <sup>f</sup>
Hungary	3.2	2.7-3.2	1.3	2.8-3.2	3.4	3.5-4.1	2.2	2.7-3.0	2.9	2.3-2.8	2.2	1.4-1.9
Poland	1.2	· ·	-0.8	3.2	4.7	· ·	0.4	3.1	0.5	· ·	-0.5	2.0
Romania	7.3	7.1	4.4	9.9-10.6	9.5	7.6	4.0	7.5-8.3	4.8	4.5-5.0	2.0	6.1-6.7
Eastern Europe <sup>g</sup>	3.9	3.4-3.8	2.2	5.2	5.5	3.8-4.2	2.8	4.4	1.8	2.1-2.7	1.1	2.7
USSR	4.2	3.4	3.6 <sup>h</sup>	4.3 <sup>e</sup>	4.5	4.7	3.7	4.6	1.7	2.5	1.1	2.7
Total <sup>g</sup>	4.1	3.4-3.5	3.2	4.6	4.8	4.4-4.6	3.4	4.6	1.7	2.4-2.6	1.1	2.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national statistical publications, plans and plan fulfillment reports.

- a National income produced, except for the USSR, where the planned rates refer to national income domestically used.  
b Gross value of output at constant prices, except for the German Democratic Republic, where the plan data refer to the value of commodity production (i.e., gross output less work in progress).  
c Change in the five-year average output from the average of the preceding five years, expressed as annual compound rates.  
d Commodity production.  
e Estimate.  
f Estimated on the basis of projected individual or aggregate crop and livestock yields.  
g Excluding Albania and, for the period 1981-1985, assuming the following average annual growth rates for Poland: 0 to 1 per cent for national income, 0.5 to 1.5 per cent for industrial output and 1.5 to 2.5 per cent for agricultural output.  
h The actual rate for net material product used was 3.1 per cent. The data on total output and its components for the period 1981-1985 as a whole and for 1985 released in the 1985 statistical yearbook are not fully compatible with the annual data and the period averages for 1981-1984 disclosed in earlier yearbooks.

from about 5 per cent in 1978 to less than 3 per cent in 1982. This stemmed in part from the marked contraction in economic activity in Poland. But negative growth occurred in several other countries as well, at least for one of the years observed: 1982 yielded the lowest pace of growth recorded in the post-war period for nearly all of those countries. A rebound started in the USSR and Eastern Europe in the second half of 1983. This recovery solidified noticeably in 1984, aided partly by an exceptionally favourable agricultural performance,<sup>3</sup> but growth tapered off markedly in 1985.

The new plans and the related official policy discussions differentiate between domestic and external factors as reasons for the uneven developments of the early 1980s. The key external factors that help to explain the comparatively poor performance of most European planned economies are (a) the further marked deterioration in the terms of trade, particularly in transferable rouble relations; (b) the modest success in bolstering export performance, which appeared to have been geared largely to emergency measures to stem the drain on convertible currency reserves; (c) weak demand, especially in Western Europe, through 1983, which hampered efforts to expand convertible currency trade; (d)

for some countries, the limitations imposed on domestic macro-economic policies by high interest rates, the comparatively high level of convertible currency indebtedness in relation to export earnings and the small amount of fresh funds obtainable in the global financial circumstances of 1981-1983; (e) the unexpected deterioration in the political climate of East-West relations, which reduced the volume of reciprocal trade and capital flows; and (f) the virtual abandonment of the target programming approach when national economic policies began to focus on emergency adjustment measures rather than on structural changes.

Domestic constraints in a number of countries were no less pronounced. In spite of the planned moderation of growth in aggregate demand, the anticipated efficiency gains from better resource allocation and from modifying the composition of output were not realized in most countries. It proved difficult to reallocate investment resources, to maintain capital formation at planned levels and to realize the efficiency targets, with the result that the reduced, and even negative, rates of growth in investment entailed bottlenecks that the policy makers had hoped to resolve through growth moderation. This exacerbated bottle-necks in material supply; it also resulted in a slow-down in the renovation

<sup>3</sup> There were also two more working days in 1984 than in either 1983 or 1985. If growth performance had not changed, this by itself would have raised the aggregate numbers by perhaps 0.75 percentage points over the levels attained in 1983.

or replacement of fixed assets,<sup>4</sup> capital-output ratios generally remaining exceedingly high or even worsening; it hampered the intended cut-backs in ongoing capital projects,

whose volume in nearly all countries continued to rise;<sup>5</sup> and the more intensive and prolonged use of the rising obsolete capital stock caused expenditures for capital repair to soar.<sup>6</sup>

Table VI.2. Centrally planned economies of Eastern Europe and the USSR: net material product produced and domestically used  
(Average annual increase)

	NMP produced	NMP used	Consumption			Accumulation <sup>c</sup>
			Total	Personal <sup>a</sup>	Social <sup>b</sup>	
<b>Bulgaria</b>						
1976-1980	6.1	2.8	4.0	4.1	4.9	0.1
1981-1985	3.7	3.6	4.0	3.9	4.9	2.4
1986-1990 <sup>d</sup>	5.4	..	..	..	..	..
1981	5.0	7.7	5.3	5.0	5.5	14.8
1982	4.2	1.9	3.7	3.6	6.5	-3.3
1983	3.0	1.2	2.9	2.5	2.5	-3.6
1984	4.6	5.2	4.9	4.6	5.0	6.2
1985	1.8	2.3	3.3	2.6	..	-0.8
<b>Czechoslovakia</b>						
1976-1980	3.7	2.2	2.5	1.7	4.8	1.4
1981-1985	1.8	0.0	2.0	1.0	4.2	-7.3
1986-1990 <sup>d</sup>	3.4	3.0	2.9	2.3	4.1	..
1981	-0.1	-3.4	2.6	1.7	4.9	-21.7
1982	0.2	-1.6	-1.1	-2.3	1.8	-3.6
1983	2.3	0.6	2.8	2.1	4.2	-8.0
1984	3.5	1.2	3.0	1.7	5.7	-6.6
1985	3.0	3.2	2.7	1.9	4.4	5.8
<b>German Democratic Republic</b>						
1976-1980	4.1	3.6	3.8	4.0	3.1	3.1
1981-1985	4.6	1.2	2.5	2.8	1.4	4.4
1986-1990 <sup>d</sup>	4.6	..	..	..	..	..
1981	4.8	1.2	2.6	2.6	2.3	-3.7
1982	2.6	-3.3	1.2	1.9	0.6	-19.4
1983	4.6	0.5	0.6	0.6	-1.7	0.0
1984	5.5	3.4	3.7	4.3	1.7	0.0
1985	4.8	4.2	4.7	4.7	4.0	2.9
<b>Hungary</b>						
1976-1980	2.8	1.7	3.0	2.6	5.9	-2.9
1981-1985	1.3	-0.9	1.4	1.4	1.3	-13.6
1986-1990 <sup>d</sup>	3.0	2.7	..	1.7	..	..
1981	2.5	0.7	3.0	3.0	3.0	-8.6
1982	2.6	-1.1	1.4	1.4	1.3	-12.4
1983	0.3	-2.8	0.6	0.5	0.7	-20.4
1984	2.5	-0.6	0.9	0.9	1.2	-11.3
1985	-1.4	-0.6	1.2	0.7	4.5	-15.0
<b>Poland</b>						
1976-1980	1.2	-0.2	4.5	4.3	5.3	-11.8
1981-1985	-0.8	-1.6	-0.8	-1.6	4.1	-4.0
1986-1990 <sup>d</sup>	3.2	2.9	2.6	..	..	3.9 <sup>e</sup>
1981	-12.0	-10.5	-4.6	4.1	-8.1	-27.6
1982	-5.5	-10.5	-11.5	-14.6	11.5	-6.6
1983	6.0	5.6	5.8	6.2	3.1	4.9
1984	5.6	5.0	4.4	3.8	8.3	7.3
1985	3.4	3.8	2.9	2.2	6.6	7.2

<sup>4</sup> Thus, in the USSR, the ratio of amortized assets to the amount of fixed capital in industry declined by one third from 2.1 per cent in 1965 to 1.8 per cent in 1970, 1.6 per cent in 1975 and 1.4 per cent in 1985.

<sup>5</sup> For example, the share of fixed assets put on stream with a vintage up to five years in the total year-end value of fixed assets in the USSR declined from 37 per cent in 1975 to 34 per cent in 1980 and 29 per cent in 1984; the corresponding figures for industry are 40 per cent, 37 per cent and 28 per cent. Comparable data for 1985 are not available, but a sharp reversal is unlikely to have occurred. The severe problems encountered with the accelerated replacement of fixed capital were no less pronounced for Eastern Europe. For countries that publish data (Bulgaria, Czechoslovakia, Hungary and Poland), the reported retirement rates of fixed assets were uniformly lower than in the USSR; in Czechoslovakia and Poland in recent years, they have amounted to around half the Soviet level. Furthermore, except for Bulgaria, retirement rates in all countries were steadily decreasing over time. This probably stemmed in part from the generally anaemic investment activity sustained in the first half of the 1980s.

<sup>6</sup> In Soviet ferrous metallurgy, for example, the expenditures equalled the amount of gross capital investment.

Table VI.2. (continued)

	NMP produced	NMP used	Consumption			Accumulation <sup>c</sup>
			Total	Personal <sup>a</sup>	Social <sup>b</sup>	
<b>Romania</b>						
1976-1980	7.3	6.9 <sup>e</sup>	7.1 <sup>e</sup>	6.9 <sup>e</sup>	8.4 <sup>e</sup>	6.6 <sup>e</sup>
1981-1985	4.4	0.3 <sup>e</sup>	2.3 <sup>e</sup>	2.4 <sup>e</sup>	1.5 <sup>e</sup>	-6.4 <sup>e</sup>
1986-1990 <sup>d</sup>	10.3	..	..	..	..	..
1981	2.2	-6.5 <sup>e</sup>	3.0 <sup>e</sup>	3.8 <sup>e</sup>	-2.5 <sup>e</sup>	-24.5 <sup>e</sup>
1982	2.7	-1.5 <sup>e</sup>	-1.3 <sup>e</sup>	-1.3 <sup>e</sup>	-1.4 <sup>e</sup>	-2.0 <sup>e</sup>
1983	3.7	2.2 <sup>e</sup>	0.7 <sup>e</sup>	-0.2 <sup>e</sup>	7.1 <sup>e</sup>	6.0 <sup>e</sup>
1984	7.7	2.8 <sup>e</sup>	5.9 <sup>e</sup>	6.1 <sup>e</sup>	4.0 <sup>e</sup>	-4.7 <sup>e</sup>
1985	5.9	4.8 <sup>f</sup>	7.4 <sup>f</sup>	..	..	-0.2 <sup>f</sup>
<b>USSR</b>						
1976-1980	4.3	3.8	4.7	..	..	2.2
1981-1985	3.6	3.1 <sup>g</sup>	3.9 <sup>f</sup>	..	..	6.7 <sup>f</sup>
1986-1990 <sup>d</sup>	4.3 <sup>e</sup>	4.1	..	..	4.6	..
1981	3.3	3.2 <sup>g</sup>	4.0	..	..	0.9
1982	3.9	3.5 <sup>g</sup>	1.2	..	..	11.0
1983	4.2	3.6 <sup>g</sup>	3.2	..	4.6	5.0
1984	3.2	2.6 <sup>g</sup>	3.9	..	3.5	-1.6
1985	3.5	3.1 <sup>g</sup>	3.2	..	..	2.4

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

- a Volume of consumer goods and services supplied to the population.  
b Consumption of material goods in institutions providing amenities and social welfare services.  
c Net capital formation plus changes in inventories.  
d Plan targets.  
e Secretariat estimates based on partial information.  
f Current prices.  
g The data released in the 1985 statistical yearbook for the period 1981-1985 as a whole and for 1985 are not fully compatible with the annual data and the period averages for 1981-1984 disclosed in earlier yearbooks.

The situation does not apply to all economies and all phases of the experience of 1981-1985. None the less, the few countries that succeeded in cutting back on the volume of investments in progress could sustain this activity only very temporarily and in just a few sectors.<sup>7</sup> By mid-decade, the potentially critical contribution to output of better resource allocation, of revised amortization strategies and of more efficient capital construction were in the forefront of policy discussions, just as they had been prior to the implementation of the plans for 1981-1985.

As a reflection of the priority accorded to generating external payments surpluses through trade, each of the uses to which aggregate income can be put tended to expand markedly less than aggregate output. In contrast to the differences between growth rates of aggregate output and uses of income observed during much of the early 1980s, there was some convergence in 1985 in all the countries concerned, regardless of the overall pace of growth. This change in the relationship between the growth rates of aggregate output and uses reflects above all the increasing need for resources for domestic utilization, if output growth is to be maintained even at a moderate 3 to 4 per cent a year, and set-backs in the trade sector. During most of this period the majority of coun-

tries sought to protect the consumer, with the result that the growth of consumption generally exceeded that of accumulation (that is, net capital formation including changes in inventories) (see table VI.2). Within the consumption component, the changes in personal and social consumption differed. Instead of the usual faster growth of the social consumption component, several countries (including the German Democratic Republic, Hungary and Romania) accorded at least equal, but mostly greater, priority to private consumption. This entailed a policy shift in some countries that may signal the start of a longer-lasting trend. In Poland, social consumption exhibited positive growth whereas private consumption contracted. In some countries, including Bulgaria and Czechoslovakia, social consumption grew faster. The experiences of the other countries either fall between the two patterns mentioned or lack a clear trend.

In the early 1980s, total consumption tended to grow faster, or contract less, than accumulation. When output growth accelerated in late 1983 and in 1984, this relationship changed: accumulation generally began to expand while consumption growth slackened. This reflected essentially the reassessment of the role of investment in propping up economic performance in the short to medium run and in

<sup>7</sup> For a more detailed examination of the investment process during the first half of the 1980s, see "Adjustment, investment and structural change in centrally planned economies", in *World Economic Survey 1986* (United Nations publication, Sales No. E.86.II.C.1), pp. 121-134.

ensuring genuine progress towards a more intensive, resource-efficient path of economic development. Judging by the strategies contained in the 1986-1990 plans, this trend may become even more pronounced in the years ahead.

The overall economic performance of the region in 1981-1985 provides few indications that the underlying deceleration in growth of the 1970s could be decisively reversed or that the foundations for such a shift in the future were even completed. In this connection, it is noteworthy that the favourable developments in 1983-1984 were achieved predominantly by cutting imports rather than exports, by imposing strict guidelines for saving energy and raw material and, in some cases, through partial modifications of institutional and organizational mechanisms. The marked improvement in the trading environment, especially in Western Europe, also played an important role. As developments have demonstrated, such measures by themselves are not likely to generate sustainable efficiency gains. The decisive long-term acceleration of economic growth can be achieved only by promoting structural changes through new investments, including the introduction of more efficient and productive technologies.

#### **Policy environment for the second half of the 1980s**

As a result of the uneven economic performance of the early 1980s, planners have come to recognize the need to address themselves to such issues as slowly expanding productive resources, deficiencies in management and planning systems, and slow factor productivity growth. These and related concerns have provided further impetus for policy makers to search more vigorously for ways and means of generating more buoyant economic activity, which is once again at the forefront of current medium-term economic policies. Such a path should be sustainable in the medium to long term, permit the correction of bottle-necks and imbalances, and raise the level of efficiency of production. The new five-year plans generally envisage an acceleration of growth throughout the second half of the decade as a result of consistent adjustment of economic structures and, in a number of instances, more vigorous investment policies.

The development strategies that emerge from the five-year plans aim at resource-efficient economic growth. Significant increments in national output at essentially current levels of energy, raw material and labour inputs, as well as a sharp reversal of the decline in capital productivity, are envisaged. These goals may be feasible if the policy commitments expressed in the plans - to foster more buoyant investment activity and promote technical progress, to enact consistent changes in the composition of investments by sector and technology, to increase efficiency in the utilization of energy and raw material inputs, and to undertake appropriate improvements in the overall character of policies, planning, management and organizational infrastructure - are kept firmly ahead of short-term economic disturbances and exigencies.

The rethinking of development strategies and especially the recasting of the concept of "intensification" on the basis of recent experiences appear to have led decision makers to the conclusion that a resource-efficient path of economic development does not of itself entail slower economic growth. It is deemed essential in some countries, including the USSR, to maintain the rate of growth of output at an average of about 4 to 5 per cent a year in order to provide for the modernization of the production apparatus and the acceleration of technological change. Accordingly, planned rates of growth of output for 1986-1990, except in the German Democratic Republic, have been set at levels that exceed those of 1981-1985 by between half a percentage point a year for the USSR and 6 percentage points for Romania (see table VI.1); Poland comes in at the upper end of the acceleration range, with an average increase of 4 percentage points. The German Democratic Republic has maintained comparatively buoyant growth in the first half of the 1980s and its current targets call for a continuation of its previous achievements.

These higher growth targets are the result of a two-pronged development strategy. They depend critically on generating much higher levels of factor productivity growth than could be attained in the past. At the same time, in order to foster greater efficiency, this relatively ambitious acceleration of output growth is expected to provide the capital resources to implement far-reaching structural change and modernization of fixed assets. Structural policies, a streamlining of economic mechanisms and the wider use of incentives for rational production decisions and work performance are expected to help achieve these goals.<sup>8</sup> To reinforce material incentives, plans provide for the growth of retail trade, especially services, to outpace that of remuneration, which is slated to expand only modestly. Better utilization of labour resources, therefore, is expected to emerge mainly through other than wage incentives.

The focal points of the efforts designed to adjust economic structures are the creation of an institutional environment that fosters steady innovation in the material sphere as an integral ingredient of the general overhaul of the planning and management systems. The institutional modifications envisaged range from the forms and methods of centralized economic control to new legal provisions that create more room for independent decision-making by enterprises. They are themselves considered a probe for still further fundamental adaptations of economic mechanisms. Such shifts are being undertaken, or are in the initial phases of policy discussions, in the majority of the European planned economies. In the longer term, they are bound to affect the environment for CMEA economic integration.

#### **Aggregate and sectoral output plans and policy orientation for 1986-1990**

Most of the plans emphasize special efforts to prevent output in the first phase of the five-year plan period from lagging behind the plan objectives, as happened in the first half

<sup>8</sup> The plans emphasize that further gains in personal incomes must be linked more closely to the contribution to output and efficiency.

of the 1980s. Except for Romania, the 1986-1987 aggregate output targets in all countries were set at the lower end of the range first adopted in the directives for the elaboration of the five-year plans;<sup>9</sup> that is, they are synchronized with the achievements of 1984-1985. The plan projections for the period 1986-1990 as a whole depend on gradual improvements in factor productivity, some of which should result from the ongoing changes in economic mechanisms in those countries. If kept on the present course, such changes in policies, institutions, policy instruments and behavioural rules may yield their first results in terms of level and quality of growth towards the end of the current five-year plan period.

Sectoral projections for 1986-1990 are, in some cases, at marked variance with average achievements earlier in the decade. The recent constraints on domestic and imported fuels and energy demonstrated that improved efficiency in resource use and faster adjustment to changing demand are essential to improve industrial performance. In recognition of this, the plans for 1986-1990 highlight policies for structural adjustments in the composition of output and the organization of enterprises, and for material and other incentives to boost technological achievements. The measures encompass the whole cycle from research to application and dissemination. This strategy is two-pronged. On the one hand, fast growth in output of branches promoting technological change (engineering, electronics, automation, new materials and biotechnology) is anticipated. On the other hand, policy makers expect to be able to reshape the existing economic mechanisms quickly and radically enough to speed up the transition to more efficient, less resource-intensive industrial growth. This in turn calls for an acceleration of modernization and a retooling of the economies.

Industry is generally expected to be the fastest growing sector in the coming quinquennium. Profound structural transformation is envisaged in order to reflect the recent shifts in domestic and external supply and demand. Such high-technology branches as informatics, telecommunications, complex and computer-controlled engineering, and robotics are to expand very rapidly. On average, the growth of capital funds appropriated for these sectors exceeds the average of that for industrial investments by a considerable margin. Output of energy- and material-intensive branches, including metallurgy and construction materials is slated to rise more moderately, in part to accommodate the high priority placed on compressing per unit material and factor inputs substantially below current levels. Some countries hope that savings in energy and material inputs alone will yield a gain in productivity equivalent to more than half the targeted industrial growth.

The 1986-1990 targets for agriculture and the food com-

plex as a whole are designed to ensure stable levels of supply well above desirable minimums. Another main aim is to raise the level of agricultural self-sufficiency and, in some countries, the volume of exports. The importance of improving the efficiency of agriculture through further modifications in the organization, management and incentive systems, in a number of cases by curtailing compulsory targets, is also emphasized in the plans. The role of indirect economic levers and incentives is bound to be more vigorous in the countries that have already introduced managerial changes. Agricultural units are expected to reduce production costs and waste of all kinds, and to utilize fixed assets, labour, energy and raw material inputs more effectively. To this end, measures will be enacted to raise deliveries of agrochemicals and technical equipment, to improve water and power supplies, and to expand food-processing capacity, including storage facilities. Improvements in pricing and procurement systems are intended to raise profitability levels in both crop and livestock production.

Measured against the levels achieved in the preceding quinquennium, average annual growth of gross agricultural output in 1986-1990 is targeted between 1.3 and 2.7 per cent (see table VI.1). An exceptionally high annual growth rate - between 6.1 and 6.7 per cent - has been adopted by Romania. Except for Czechoslovakia, Hungary and the USSR, these targets are generally above the average growth rates of 1981-1985.<sup>10</sup> Because the early 1980s was a comparatively good growth period for agriculture, the targets for the present quinquennium are predicated on rather favourable climatic conditions. The primary aim appears to be to eliminate the vulnerability to weather fluctuations, to overcome such chronic obstacles as the seasonal shortage of labour, to curtail losses and to ease bottle-necks in the agro-industrial infrastructure, rather than to accelerate output growth.

Construction activity in the early 1980s remained generally rather weak as a result of the priority accorded to appropriating investment funds in favour of raising technological levels, rather than starting up new structures. This policy continues to prevail. Most countries envisage expanding construction activity only modestly, although residential construction, the demand for which continues to be very intense, is an exception in several cases.<sup>11</sup> In financing residential construction, greater use will be made of household savings. Developments in the construction sector will be conditioned by efforts to focus resources, to readjust planning and management (with a view to shortening gestation periods and improving both the quality of output and labour productivity) and to introduce new materials and technology on a wide scale.

The transportation and communication sectors encountered severe bottle-necks during the earlier part of the dec-

<sup>9</sup> For further details, see the discussion of the current economic situation in chapter II above.

<sup>10</sup> Because of unusual year-to-year fluctuations in agriculture, all growth rates are measured over five years (i.e., total output over 1981-1985 relative to 1976-1980) and then annualized.

<sup>11</sup> In the first half of the 1980s, residential construction remained well below the achievements of the preceding quinquennium in all countries but the German Democratic Republic (see *Svět Hospodářství* (Prague), 1986: 121, p. 6), although a major increase in 1985 was reported by the USSR. In some countries, the new plans do not foresee any marked acceleration because of the priority of industrial modernization. On the whole, construction activity is to expand slowly at best.

ade in a number of countries. In order to avert a repetition, the broad improvement of infrastructure, the further electrification of railroads and the upgrading of the energy-efficiency of transportation stand at the forefront of developments in these sectors. Because of growing infrastructural interdependence within CMEA, modernization in electrification, transportation and communication is increasingly based on the needs of the group as a whole. Another important feature of the new plans is the importance attached to environmental policy and conservation of natural resources.

### Distribution of aggregate output

The new medium-term plans do not generally provide a detailed analysis of intentions regarding the expansion and distribution among uses of domestic income in the years ahead. From the available quantitative (see table VI.2) and qualitative information, all economies envisage somewhat higher growth for uses of income during this plan period than was attained in 1981-1985. Both the rate of expansion and the distribution between consumption and accumulation remain subject to potentially conflicting policy objectives. The plans are committed to far-reaching structural change, to the re-equipment of the productive apparatus (and hence to more rapid growth of investment than in the previous plan period), to working off external debt in both convertible currency and, except for Poland, transferable roubles, and to ensuring moderate growth in consumption for 1986-1990. Even with this acceleration, accumulation envisaged for several countries will remain below the 1980 level.<sup>12</sup>

The economic strategy outlined in the plans for 1986-1990 seeks important changes in the approach to planning the ratio between accumulation and consumption. At the beginning of the 1980s, it was widely asserted that a reduction in the level of accumulation without reducing output growth was an indicator of intensive development as well as an important source of steady growth in consumption. This is now widely considered to be unfounded.<sup>13</sup> A reduction in the share of accumulation, against the backdrop of a moderate or diminishing growth of aggregate output, inevitably compresses feasible consumption levels in the medium term. The strategic concept of development now asserts that the maximization of consumption in the long run must be achieved not through cuts in accumulation, but rather by expanding capital formation and through a vigorous investment policy.

In recent years, it has become increasingly clear that a low level of accumulation slows down the renovation of the capital stock. To improve the efficiency of fixed assets, it is necessary to enact rationalization measures, which may require comparatively low new capital investment at first. But

in the longer term, productivity can be improved at a steady pace only by raising capital formation, which may temporarily lift the share of accumulation in the uses of aggregate income. This short-run statistical effect should not necessarily be taken as evidence of a return to "extensive" development policies. On the contrary, intensification is being placed right at the centre of the current medium-term development efforts. Along with this rethinking of the role of capital formation in growth, a number of countries (including Bulgaria, Hungary, Poland and the USSR) also emphasize that the key to investment efficiency lies beyond purely quantitative adjustment of its volume.

Under the investment policy of the current five-year plans, the share of accumulation in aggregate income uses may temporarily rise, but the funds thus earmarked for capital formation will be released only in support of output decisions that yield marked productivity growth. "Intensive accumulation", which is resource-saving, presupposes a stepped-up pace of growth in high-technology sectors, an increase in the share of reconstruction and retooling, accelerated replacement of fixed assets and decisive cuts in gestation periods and construction costs. A reduction in excessive stocks of materials and equipment and an increase in the turnover of both working capital and commodity stocks in industry and in trade will also yield positive results.

The qualitative and quantitative growth path set for 1986-1990 thus depends heavily on more buoyant investment activity. The plans for 1986-1990 foresee a substantial reversal of the decline in investment ratios that characterized 1981-1985 for most CMEA countries. But the intentions are not uniform. The rise in gross investment in the Soviet Union will be slightly higher than output expansion; the same is true for Eastern Europe, except for Czechoslovakia, the German Democratic Republic and Romania (see table VI.3). Policy actions required to ensure structural change and raise efficiency, especially in Poland and the USSR, are being undertaken early in the current five-year planning period. In other countries, greater scope is seen for investments in the late 1980s. This increase in the volume of outlays, together with a stronger concentration and allocation by priority branches, are the principal features of the investment policy of the European centrally planned economies in 1986-1990.

The rationale for this approach may be illustrated by the industrial investment policy pursued in recent years in Eastern Europe. The decline in investment levels delayed the modernization of the sector's fixed assets and exacerbated capacity constraints in some branches. To overcome this legacy in the second half of the decade, the modernization of the engineering branches is to be fostered by a substantial infusion of capital funds. As a result, the share of the investment fund appropriated for this sector is set to rise. In the

<sup>12</sup> This is especially the case in Hungary (see J. Hos, "A VII. ötéves terv koncepcionális kérdései", *Gazdaság* (Budapest), No. 3 (1985), p. 16).

<sup>13</sup> During the industrialization phase between the two World Wars in the USSR and for the major part of post-war developments in nearly all countries, the share of accumulation in aggregate income uses steadily increased. The change in the proportion between accumulation and consumption in favour of consumption has become a new policy feature in the past 15 years or so. Thus, in the USSR, the share of accumulation in aggregate income uses declined from 28 per cent in 1966-1970 to 27.7 per cent in 1971-1975, 26.1 per cent in 1976-1980, and 25.1 per cent in 1981-1985.

Table VI.3. Centrally planned economies of Eastern Europe and the USSR:  
investment growth, 1981-1990  
(Percentage)

	1981-1985		1986-1990	1983	1984	1985	1986		1987
	Planned <sup>a</sup>	Actual <sup>a</sup>	Planned <sup>a</sup>				Planned	Actual	Planned
Bulgaria	3.6	4.5 <sup>b</sup>	5.8-7.0 <sup>b</sup>	0.7	0.3 <sup>b</sup>	8.6 <sup>b</sup>	5.8 <sup>c</sup>	2.0	12.1 <sup>d</sup>
Czechoslovakia	-2.1	-0.4	1.9-2.3	0.6	-4.2	5.4	0.8	2.8	2.6 <sup>d</sup>
German Democratic Republic	-0.6	0.1	1.5-1.9	0.0	-4.9	3.7	1.8	5.0	1.5 <sup>d</sup>
Hungary	0.0	-2.0	0.6-1.0 <sup>e</sup>	-3.4	-3.7	-3.0	0.0 <sup>c</sup>	5.1 <sup>b</sup>	1.0-2.0
Poland	..	-7.4	4.4	9.4	11.4	6.0	4.2	3.0	3.2-4.3
Romania	5.2	1.3	3.6	2.4	6.1 <sup>b</sup>	1.6 <sup>b</sup>	6.8	1.2	6.7
Eastern Europe	-0.1 <sup>f</sup>	-1.3	3.4	2.4	2.2	4.0	4.0	2.5 <sup>g</sup>	4.8 <sup>g</sup>
USSR	2.1	3.3	4.3	5.6	1.9	3.0	7.6	8.0 <sup>h</sup>	5.0 <sup>d</sup>
Total	1.8 <sup>f</sup>	1.9	4.1	4.7	2.0	3.2	6.6	6.5 <sup>g</sup>	4.9 <sup>g</sup>

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

- a Annualized on the basis of the ratio of investments in the current five-year plan to investments in the preceding five years.
- b Current prices.
- c Estimate of plan-over-plan; price basis unknown.
- d Estimate based on values; no details are available of whether the figures are evaluated in constant or current prices.
- e Based on year-end magnitudes.
- f Based on an estimated 5.9 per cent for Poland.
- g Secretariat estimate.
- h State investment only.

USSR, for example, investments earmarked for this purpose are planned to rise by 80 per cent over the average of the preceding five-year period, whereas they increased only by 18 per cent during the previous five years. In other countries the contrast is not so sharp, but the shift in policy is none the less very marked.

An investment policy targeted firmly at the steady modernization of economic structures and the acceleration of technological progress remains contingent in most countries on the easing of prevailing external and internal constraints and, secondarily, on the legacies of past capital formation. External payment commitments still take a heavy toll in some of these countries, and measures must be enacted to raise export earnings to a level sufficient for both debt repayment and the financing of imported investment goods. On the domestic side, the expeditious completion, and in some cases the scrapping, of the backlog of unfinished construction accumulated during the past five years, without jeopardizing the envisaged renewal of productive fixed assets, remains a critical task.

To work off the existing level of unfinished capital construction, regulations have been adopted to freeze some projects and to curb new ones. In addition, the share of investments earmarked for completion of projects in progress is to increase. In some cases, projects are being scrapped in mid-stream. Plans also emphasize a sharp expansion of the

share of machinery and equipment in total investments at the expense of new project start-ups or construction. The weeding-out of obsolete equipment is also to be accelerated. In the Soviet Union, for example, the rate of retirement of machinery and equipment is due to nearly double.

Given the priority accorded to investment, the plans emphasize that further gains in personal incomes are contingent on raising output and efficiency. Steady, if modest, increases in real incomes and levels of living remain high among the policy priorities. The patterns of consumers' incomes, consumer price formation and total consumption policy exhibit three main characteristics. First, incomes and consumption remain highly regulated by central fiat. Adverse developments that cannot be accommodated in the plan are generally offset either by general measures to adjust income distribution and consumption or by specific income or consumption allowances. Secondly, the socialist framework of these economies ensures that differences in the socio-economic position of different groups remain within rather narrow bounds. Finally, income policies continue to be implemented through the wage fund of enterprises, the level and distribution of social consumption funds and consumer price policies. All centrally planned economies emphasize the need to strengthen the incentive role of wages by linking them to productivity gains.<sup>14</sup> Most countries also stress that consumer price policies need to be more flexible. Policy in-

<sup>14</sup> This was attempted during the previous medium-term plan, but the ongoing policy discussions suggest the policy will be strengthened in the second half of the 1980s.

tentions regarding social consumption are less detailed. While no change seems to be envisaged on subsidies to the more vulnerable groups, in most countries, there appears to be a policy trend to limit social transfers to the bulk of the able-bodied population. This may ease the pace at which the share of the social consumption fund in total available resources rises, but it will not necessarily reverse it.<sup>15</sup>

### Consumer prices and price policies

The price and income policies of these countries are institutionally anchored to pervasive government controls. These policies are guided by both economic and overall social objectives that aim to ensure that all income groups of the population can procure basic necessities. The two main instruments to achieve this goal are the regulation of retail prices by planning the price level and its movements and the use of transfers to compensate partially different layers of society for changes in the price level. Though these precepts continue to prevail in the late 1980s, they do not inhibit a further widening of the more active consumer price policies pursued since the early 1980s in a number of countries.

Seen in the post-war perspective, movements in consumer prices in 1981-1985 were considerable, and were not neutralized by income or consumption increases in the majority of the countries concerned (see table VI.4). Official retail price indices showed a pronounced rise in all but the German Democratic Republic. The increase of between 0.9 and 2 per cent a year in Bulgaria, Czechoslovakia and the USSR stemmed largely from administrative price changes, as illustrated by the "blips" in the series shown in table VI.4. In Poland, for example, the price rise was unusually large and was achieved through deliberate policy measures. Hungary kept its price increases within the 6-7 per cent range attained in 1976-1980. In Romania, however, there was an acceleration from an annual average of 1.4 per cent in 1976-1980 to 5 per cent in 1981-1985. A common feature was that retail prices of foodstuffs increased faster than those of non-food products, except in Hungary, where the reverse prevailed.

Adjustments were even more pronounced for wholesale

prices, the linking of wholesale and retail prices, and the synchronization of foreign trade and wholesale prices. For lack of statistical data, these various interlinkages can be documented for a period of time for only Czechoslovakia, Hungary and Poland. The data suggest, first, that there has not been a uniform approach regarding the relationship among the three price layers. With respect to the link between import prices and industrial producer prices, the three countries followed quite different patterns. In Poland, the correlation is very high, except in 1982 when the central authorities implemented a general, autonomous price increase. Industrial producer and retail prices began to be aligned in Poland in 1983. The correlation is better for Hungary, largely because of its policy of letting prices reflect the market value of products, including trade prices, but with greater automaticity for producer than for consumer prices.<sup>16</sup> Nevertheless, other socio-economic precepts temporarily interfered with the smooth feeding through of price changes in the early 1980s.<sup>17</sup> In Czechoslovakia, no clear correlation exists between foreign trade and industrial prices or between the industrial prices and retail prices, basically because the country adheres to a substantial degree of domestic price autonomy, except during periodic (usually on a five to ten year basis) overhauls of fiat prices.<sup>18</sup>

Both the data for these countries and less systematic observations for others indicate that price policies have become more active since the early 1980s. More attention has been given to the import price level and to the structure of prices in comparison with prevailing domestic prices. Individual country price policies, however, continue to differ markedly. In the new five-year plans, modifications in price policies have been sketched even in some of the countries that have generally adhered to administratively fixed prices. All the plans emphasize the increasing role of consumer prices in balancing supply and demand for goods and services and in shaping real incomes. Consumer markets could become somewhat better balanced in these economies, especially if the planned growth of retail trade materializes.

In Hungary, Poland and Romania, and probably Czechoslovakia, future increases in consumer prices are determined largely by the policy objectives of balancing supply

<sup>15</sup> In 1981-1985, benefits from the social consumption fund played an important role in raising consumption and real incomes. In some countries, the share of social consumption in domestic resource use rose considerably over previous levels. This stemmed partly from the fact that the number of people whose incomes are derived from the social consumption fund, including pensioners, expanded more rapidly than the labour force. But it also arose because services provided from the social consumption fund grew faster than labour incomes in many countries. Nevertheless, in some countries (including Hungary, Poland and Romania) consumer price policies, especially for staple products, had an unusually large impact on the real value of such transfers.

<sup>16</sup> Briefly, an enterprise must adjust its domestic prices to export prices according to a special formula when its convertible currency exports amount to at least 5 per cent of its domestic sales. This is to ensure that the domestic price level, on average, should not move more than the export price in convertible currency relations. Furthermore, the producer price may not exceed the domestic price of a product that has the same utility characteristics and can be imported continuously in substantial quantities from convertible currency markets. Prices for energy, industrial basic materials and semifinished products have to be brought into line with their import prices.

<sup>17</sup> In 1981-1983, the priority of generating a convertible currency surplus necessitated some compromises on price policy principles. The policy principle was re-emphasized in 1985, however, and is strongly stressed too for the new five-year plan period (see B. Szikszay, "Árrendszertünk céljai és lehetőségei", *Népszabadság* (Budapest), 22 January 1985, p. 4; *Magyar Közlöny* (Budapest), 5 November 1984, pp. 866-871; and B. Csikós-Nagy, "Politika tsen v Vengrii", *Voprosy ekonomiki* (Moscow), No. 7 (1982), pp. 118-126).

<sup>18</sup> Wholesale prices were modified in 1982. Further rationalization measures in the price formation system were implemented on 1 January 1984, when there was again a one-time increase in the wholesale prices of fuel, energy and certain raw materials, including agricultural raw materials. In 1985, wholesale prices for other sectors were raised. Prices of fuel, energy and raw materials are based on actual acquisition, mostly import cost, but they are not uniformly incorporated into producer prices. However, wholesale prices are gradually being patterned on the basis of export effectiveness (see M. Sabolčik's commentary in *Finance a Úvěr* (Prague), No. 3 (1984), pp. 150-157).

Table VI.4. Centrally planned economies of Eastern Europe and the USSR:  
retail price increases, 1976-1985  
(Average annual percentage)

	Total	Food	Non-food <sup>a</sup>
<b>Bulgaria<sup>b</sup></b>			
1976-1980	4.0	6.2	2.4
1981-1985	0.9	1.6	0.4
1981	0.5	0.3	0.7
1982	0.3	0.6	0.0
1983	1.4	3.1	0.2
1984	0.7	1.0	0.1
1985	1.7	2.8	1.0
<b>Czechoslovakia<sup>b</sup></b>			
1976-1980	2.0	1.3	2.6
1981-1985	2.0	3.2	1.2
1981	0.9	0.0	1.7
1982	5.1	9.4	1.5
1983	0.9	0.6	1.1
1984	0.9	0.7	1.1
1985	2.3	2.6	0.8
<b>German Democratic Republic<sup>b</sup></b>			
1976-1980	0.1	0.0	0.2
1981-1985	0.1	0.0	0.1
1981	0.3	0.0	0.5
1982	0.0	0.0	0.0
1983	0.0	0.0	0.0
1984	0.0	0.0	0.0
1985	0.0	0.0	0.0
<b>Hungary</b>			
1976-1980	6.6	7.3	6.0
1981-1985	6.7	6.2	7.1
1981	5.0	3.1	6.5
1982	6.6	8.2	5.5
1983	7.2	5.6	8.4
1984	8.5	9.1	8.0
1985	6.3	5.0	7.2
<b>Poland</b>			
1976-1980	6.7	6.5	6.7
1981-1985	31.8	34.2	28.3
1981	21.2	22.5	13.1
1982	104.5	136.3	85.4
1983	21.4	11.9	22.5
1984	14.8	16.8	16.1
1985	15.0	14.9	16.7
<b>Romania<sup>b</sup></b>			
1976-1980	1.4	1.0	1.6
1981-1985	5.0	7.4	3.7
1981	2.2	1.7	2.5
1982	16.9	33.8	8.5
1983	5.2	3.7	6.1
1984	1.1	0.9	1.2
1985	0.4	0.3	0.4
<b>USSR<sup>c</sup></b>			
1976-1980	0.7	0.4	1.0
1981-1985	1.0	1.6	0.5
1981	1.4	1.9	1.6
1982	3.4	3.8	2.3
1983	0.7	0.6	0.8
1984	-1.3	0.0	-1.5
1985	0.7	1.8	-0.8

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

<sup>a</sup> The figures for Poland exclude services and alcoholic beverages. The figures for Romania are Secretariat estimates.

<sup>b</sup> Socialized sector only.

<sup>c</sup> State retail prices only.

and demand and of ensuring better synchronization between consumer prices and production costs. State subsidies for some consumer goods are expected to be curtailed or removed altogether, which is bound to entail painful adjustments, especially if trade results are passed on to domestic prices on a regular basis.<sup>19</sup> When indicated in the plans for 1986-1990, consumer price increases are to be less pronounced than those realized in the preceding medium-term plan period.<sup>20</sup>

The five-year plans for Bulgaria, the German Democratic Republic and the Soviet Union reaffirm the commitment to stable or only slowly increasing consumer price levels, but the plans of several other countries stress that the role of prices should be further increased. Producer prices in particular are slated to serve the intended structural change in the economies, to contribute to the phasing out of outdated production and to speed up the introduction and production of high-level technology. In the consumer sphere, more active retail price policies are to be pursued, in most cases subject to the social priority of maintaining positive real income gains. At the same time, the synchronization of retail prices with socially necessary outlays, economy-wide priorities and the user properties of goods and services are to be pursued.<sup>21</sup> In some cases, this may entail price reductions if the currently planned capital resources are appropriated and production efficiency raised.

### External trade and finance

During the period 1981-1985, the European planned economies made rapid and sharp adjustments in their external trade and finance: some of them had been adopted as targets in the medium-term plans; others were necessitated by unexpected developments. Most countries shifted from a large trade deficit, especially in convertible currency relations, to a sizeable surplus.

Pronounced fluctuations occurred not only in trade levels, but also in the geographical direction and commodity composition of trade. Some of these shifts stemmed from differential price movements in alternative currency markets and in the main product groups. There were also pronounced changes in export quantum, however, especially in 1982-1984; changes in import volumes were made conditional on export performance. This stance was eased in 1985 and the earlier gains were partly reversed - a trend that has continued in 1986-1987. The plans and, even more so, the accompanying policy discussions emphasize that, if the external adjustment efforts of the early 1980s are to bear fruit in the medium to long term, it is necessary to overcome these set-

backs, to promote exports of goods with a substantial value-added content and to consolidate the potential to participate more fully and fruitfully in global markets.

Three key characteristics of trade developments in the early 1980s were the efforts to generate convertible currency surpluses, largely through import cuts; the difficulty encountered by most countries in sustaining sizeable gains in export volumes; and unusual differences in price movements among commodity classes and partner groups. Cutting the convertible currency deficit and generating a surplus constituted the greatest success. From substantial convertible currency deficits, especially with the developed market economies (see table VI.5), all Eastern European countries went into surplus by 1982 and, except for Bulgaria and Hungary, sustained it, though at a lower level, through 1985. The quick and marked improvement in the current accounts was principally an outcome of recent highly restrictive policies that, at the same time, weakened the capacity of the countries concerned to regain a more expansionary economic policy. The improvement in the current account and related trade transformations allowed most of the Eastern European countries to service their external debt in an orderly manner and to ease the external payments constraint by mid-decade. That constraint continues to be quite confining, particularly in Poland and Romania.

Current account considerations were less acute for the USSR than for Eastern Europe. However, the sharp ups and downs in feed grain imports because of domestic harvest fluctuations, the buoyant demand for technology imports and the recent erosion of export revenues because of the oil price slide have caused the USSR to be more concerned about its external equilibrium. This is having an important impact on policy aims for the latter half of the 1980s.

Adjusting trade imbalances by cutting imports has been a feature of the response of the planned economies to external payments problems. Table VI.6 shows the movements in trade by source and destination. Unsynchronized changes in the prices of different commodities have constituted one of the most difficult problems confronting a large number of countries. In the case of the centrally planned economies, there were also differences in the price movements among major partner groupings, because of the institutional features of CMEA trade and payments mechanisms. Most important in this respect is that, since 1976, CMEA trade prices for many key products, especially fuels, foodstuffs and industrial raw materials, have been derived essentially from an average of reference world market prices for the five preceding years.

The regional price differentiation within CMEA has had

<sup>19</sup> This is mainly so for Czechoslovakia, Hungary and Poland where external prices have an impact on producer prices. For Hungary, see the interview with Rezső Nyers in *Figyelő* (Budapest), 22 May 1986, p. 3.

<sup>20</sup> The Hungarian plan, for example, specifically targets an anti-inflationary economic policy with emphasis on price and fiscal policy as well as on the further development of market relations. It is considered that inflationary pressures should be fought by economic policy and not by direct government interference. The plan aims at a substantial deceleration in the growth of consumer prices from 6-7 per cent a year in 1981-1985 to about 5 per cent (see *Népszabadság* (Budapest), 23 December 1985 (Supplement), p. 25 and T. Erdős, "Leszorítható-e az inflációs ráta?", *Társadalmi Szemle* (Budapest), No. 6 (1985), pp. 31-41).

<sup>21</sup> This was stressed especially in the Soviet draft plan (see (Moscow), 9 November 1985, pp. 1-6).

Table VI.5. Centrally planned economies of Eastern Europe and the USSR:  
trade balances, 1981-1985  
(Billions of United States dollars)

	1981-1985	1981	1982	1983	1984	1985
<b>Bulgaria</b>						
Total	-0.5	-0.1	-0.1	-0.2	0.1	-0.3
Centrally planned economies	-2.7	-0.8	-0.8	-0.5	-0.4	-0.2
Developed market economies	-3.3	-0.7	-0.6	-0.4	-0.6	-0.9
Developing economies	5.5	1.4	1.3	0.8	1.1	0.8
<b>Czechoslovakia</b>						
Total	0.6	0.2	0.2	0.1	0.1	-0.1
Centrally planned economies	-2.9	-0.1	-0.3	-0.7	-0.9	-0.8
Developed market economies	-0.2	-0.3	-0.1	-0.0	0.2	0.1
Developing economies	3.7	0.7	0.7	0.9	0.8	0.6
<b>German Democratic Republic</b>						
Total	7.2	-0.3	1.5	2.3	1.9	1.8
Centrally planned economies	2.2	-0.3	0.0	0.9	0.9	0.6
Developed market economies	3.1	-0.5	0.8	0.9	0.8	1.1
Developing economies	2.0	0.5	0.7	0.5	0.2	0.1
<b>Hungary</b>						
Total	0.5	-0.4	-0.0	0.2	0.5	0.3
Centrally planned economies	1.6	0.4	0.3	0.2	0.3	0.4
Developed market economies	-2.1	-1.1	-0.6	-0.0	0.2	-0.6
Developing economies	1.1	0.3	0.3	0.1	0.0	0.4
<b>Poland</b>						
Total	1.5	-2.2	1.0	1.0	1.1	0.7
Centrally planned economies	-3.9	-2.2	-0.5	-0.5	-0.4	-0.3
Developed market economies	2.0	-0.6	0.5	0.7	0.9	0.5
Developing economies	3.3	0.5	1.0	0.7	0.6	0.4
<b>Romania</b>						
Total	10.2	0.2	1.8	2.5	3.2	2.6
Centrally planned economies	1.1	-0.1	0.2	0.2	0.4	0.4
Developed market economies <sup>a</sup>	8.6	0.2	1.4	2.2	2.5	2.3
Developing economies <sup>a</sup>	-1.8	0.1	-0.1	-0.2	-0.7	-0.9
<b>USSR</b>						
Total	41.8	6.2	9.3	11.2	11.0	4.0
Centrally planned economies	21.9	6.0	4.4	4.0	4.0	3.6
Developed market economies	1.3	-1.2	-0.0	1.3	2.2	-0.8
Developing economies	18.5	1.5	4.9	5.9	4.9	1.3

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

<sup>a</sup> Because no subgroup totals are available, the data for developed market economies and developing economies are based on the sum of the reported bilateral trade flows.

both favourable and unfavourable repercussions. The delayed transmission of global price changes into the CMEA price formula undoubtedly eased the adjustment burden in the short run. Because CMEA countries provide more than three quarters of their energy imports, the Eastern European countries were initially shielded against the sharp price fluctuations in world markets, except on the margin. At the same time, the muted and delayed transmission of global price changes blunted the incentive to seek early and speedy adjustment to emerging imbalances. The structural transformations brought about to date have been slower and more confined than would have been desirable. This circumstance may exert a powerful influence on prospective changes in economic mechanisms.

Most of the five-year plans disclose only general intentions with respect to the planned growth in the level, commodity composition and geographical direction of trade. But the policy-related discussions, including those relating to re-charting long-term CMEA co-operation, contain sufficient information to deduce intended trade policies for the near future.

The ability of the European planned economies to intensify their trade dependence, as intended, is largely a function of demand, special CMEA co-operation arrangements, their productive potential and their success in boosting exports of manufactures. Such success depends on the institutional characteristics of the trade mechanisms of these countries,

Table VI.6. Centrally planned economies of Eastern Europe and the USSR:  
annual growth in the volume of exports and imports, 1981-1985  
(Percentage)

	Exports						Imports					
	1981-1985	1981	1982	1983	1984	1985	1981-1985	1981	1982	1983	1984	1985
<b>Bulgaria</b>												
Total	7.5	8.4	11.3	4.4	11.6	2.2	6.8	9.3	3.2	5.2	5.6	10.9
Socialist	8.4	5.0	15.0	9.9	9.7	2.8 <sup>a</sup>	4.0	0.3	4.0	5.9	5.9	4.0 <sup>a</sup>
Non-socialist <sup>b</sup>	5.2	16.6	3.1	-9.4	17.8	0.5 <sup>a</sup>	22.2	43.9	0.5	3.0	4.3	38.3 <sup>a</sup>
<b>Czechoslovakia</b>												
Total	4.3	2.1	4.3	6.2	6.8	2.4	1.4	-5.6	-0.1	4.0	5.9	3.1
Socialist <sup>b</sup>	5.1	3.9	5.7	4.4	8.2	3.1 <sup>a</sup>	2.6	-3.7	2.5	4.7	7.5	2.4 <sup>a</sup>
Non-socialist <sup>b</sup>	2.0	-2.5	0.6	11.0	3.0	-1.4 <sup>a</sup>	-1.7	-9.6	-5.8	2.2	1.8	3.7 <sup>a</sup>
<b>German Democratic Republic</b>												
Total	7.2	8.6	9.3	10.3	6.5	1.7	2.5	-1.5	-3.1	7.6	7.6	2.3
Socialist <sup>b</sup>	3.4	2.1	2.8	6.8	4.8	0.5 <sup>a</sup>	-0.6	-1.2	-4.9	-2.1	4.3	1.3 <sup>a</sup>
Non-socialist <sup>b</sup>	15.2	26.1	23.4	16.6	9.4	2.2 <sup>a</sup>	6.7	-2.0	-0.3	22.7	11.6	3.5 <sup>a</sup>
<b>Hungary</b>												
Total	4.9	2.6	7.3	9.4	5.8	-0.3	1.0	0.1	-0.1	3.9	0.1	1.2
Socialist	6.1	5.8	4.9	4.6	6.8	8.3	0.4	-2.5	0.0	2.9	2.3	-0.4
Non-socialist	4.2	-1.7	11.1	15.8	4.1	-6.6	1.8	3.3	0.0	5.1	-2.2	2.6
<b>Poland</b>												
Total	1.6	-19.0	8.7	10.3	9.5	1.6	-2.6	-16.9	-13.7	5.2	8.6	7.2
Socialist	4.4	-17.0	16.6	8.3	10.0	7.7 <sup>a</sup>	1.4	-6.3	-5.6	4.4	9.2	6.2 <sup>a</sup>
Non-socialist	-1.3	-22.1	0.9	12.4	9.0	-3.8 <sup>a</sup>	-8.4	-31.5	-24.2	6.6	7.4	8.6 <sup>a</sup>
<b>Romania</b>												
Total	4.4	13.6	-7.6	0.9	15.1	1.6	-3.8	-7.2	-22.8	-5.0	9.9	10.3
Socialist	-0.1	8.8	-8.4	-2.7	0.3	2.5 <sup>a</sup>	0.4	9.1	-11.3	0.5	0.9	3.8 <sup>a</sup>
Non-socialist	6.9	18.3	-6.8	4.0	21.8	-0.2 <sup>a</sup>	-8.5	-17.7	-32.6	-11.2	13.6	14.6 <sup>a</sup>
<b>USSR</b>												
Total	1.6	1.9	4.6	3.3	2.5	-4.3	5.7	6.4	9.8	4.0	4.4	4.0
Socialist	0.5	-1.0	-2.4	0.8	4.0	1.4 <sup>a</sup>	7.1	4.3	12.9	3.2	8.0	7.2 <sup>a</sup>
Non-socialist	2.8	3.7	18.5	6.5	0.0	-12.2 <sup>a</sup>	4.6	12.7	6.2	4.5	0.0	-0.1 <sup>a</sup>

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

a Preliminary.

b Secretariat estimates.

and virtually all of them, including the USSR, have recently placed priority on reshaping the trade sector and its links with domestic economies. It is also critically determined by the role that these countries seek in the global trade and financial framework in the years ahead.

For the countries that have specific plan targets for exports and imports (especially Czechoslovakia, Hungary and Romania), export volumes are slated to increase faster than import volumes and faster than aggregate output, but not by a very sizeable margin (implied elasticities are on the order of 1.1 to 1.3). Import intensities are, at best, to remain unchanged. Similar intentions appear to prevail for most of the other countries although there are no data. In other words, foreign trade targets are somewhat more ambitious than the achievements of the early 1980s, trade intensities are expected to increase and exports are to receive priority over imports, even in countries that do not have a substantial external debt.

Intentions regarding the commodity composition and geographical direction of trade are specified in less detail, if at all. But the priority attached by countries to working off the convertible currency and, except for Poland, the transferable rouble debts looms large over the policies to be pursued in the years ahead. Judging from the bilateral and multilateral co-operation programmes and agreements in place, there seems to be scope for intensifying intra-group economic relations, and the mutual trade of CMEA members is likely to be most expansionary. The comprehensive programme for co-operation in science and technology adopted by CMEA in December 1985 is expected to provide an impetus to accelerating economic co-operation and production specialization. Other programmes and agreements stress a qualitatively different approach to co-operation, and are henceforth to be fostered through direct relations among economic agents at different levels of the planning hierarchy. The main goal is to improve the quality and the composition of the goods placed on the regional market. At the same

time, jointly agreed output targets are to address shortages and make up for the non-availability of goods and services from market economies that arise because of foreign exchange shortages or because of economic and other impediments between East and West.

The quantitative goals for intra-group trade are ambitious. According to the recently concluded medium-term trade agreements, the targets for increasing reciprocal bilateral trade flows range between 3.5 and nearly 10 per cent a year, most being between 5.5 and 7 per cent. This suggests a further shift in the direction of trade in favour of CMEA partners. There appear to be similar intentions of high growth of reciprocal trade volumes with socialist countries that are not members of CMEA, particularly China and Yugoslavia.

Relations with the market economies in the years ahead will depend on East-West economic relations, the success with which convertible currency debts can be serviced and the ability of the developing countries to increase their trade with the centrally planned economies without gaining access to substantial new capital inflows. These constraints are likely to be more confining for trade with developed market economies than for economic relations with many developing countries. The experiences of the 1980s show that economic relations among the planned and developing country economies gain from having contractual and institutional mechanisms that reflect the special features of trade among countries having different socio-economic systems. In this respect, the conclusion of long-term intergovernmental agreements has generally been highly conducive to trade.

More attention has now to be given to flexibility in trade between planned economies and developing countries. Especially critical are provisions that permit faster adaptation to a changing environment, including prompt trade information and the dovetailing of plans by commodity groups and individual projects. The scope and forms of economic ties under long-term agreements could be made less rigid. Another set of problems, which became especially pronounced in the first half of the 1980s, derives from the payments system. Payment constraints for both the developing countries and the planned economies seriously impeded trade. Both groups need to look for forms of payment that support an expansion of their economic relations. Related to this is the need to leave room for exports of manufactures from the developing countries to the centrally planned economies.

In the long run, manufactures can find a stable market in the centrally planned economy countries only if those countries' policy decisions regarding economic structures create a demand for them. A mutually beneficial adjustment proc-

ess must necessarily be based on prevailing comparative advantages, industrial development ambitions and the extension of industrial co-operation. In their plans and guidelines for 1986-1990, the centrally planned economies see the extension of industrial co-operation as the basic means of strengthening their economic relations with the developing countries.

The impact of the expressed intentions regarding trade and international economic co-operation depends on two critical features. First, a proper political and strategic climate between East and West is a prerequisite for buoyant commercial and financial intercourse. Recently proffered initiatives to strengthen confidence in these relations are important. Similar interest expressed by several planned economies, including the USSR, in co-operating more closely with international organizations, such as the General Agreement on Tariffs and Trade (GATT), the World Bank and the International Monetary Fund,<sup>22</sup> may signal a major departure from the post-war attitude of these countries towards such organizations.<sup>23</sup> Likewise, the leaders of some planned economies have proposed a framework agreement between the European Economic Community and CMEA. It is important that the international community examine these and similar overtures in depth. Perceived obstacles should be fully explored before potentially important initiatives are summarily rebuffed.<sup>24</sup>

The second requirement for enhanced relations between planned and market economies is a continuation of the modifications in the organization and decision-making of the planned economies. Obstacles inhibiting more flexible and more extensive participation in the global economy could usefully be removed, subject to concordance with domestic socio-economic and political precepts. Modifications of the trade mechanism have been at the forefront of the ongoing changes in economic mechanisms and policies. It would certainly be helpful if the efforts of the centrally planned economies were to be complemented by measures in market economies to reduce and eventually eliminate hindrances to trade between East and West.

### CMEA integration and regional economic co-operation

The process of enhancing the dovetailing of the CMEA economies is regulated by a variety of bilateral and multilateral agreements. The national medium-term plans are synchronized at the CMEA level, *inter alia*, through the medium-term trade agreements and the specific protocols about joint projects included in the Concerted Plan of Multilateral Integration Measures.<sup>25</sup> The implications of the Plan

<sup>22</sup> The evolution of this attitude towards the international monetary system, as well as ways in which these countries could co-operate in that system, are explored in "International monetary reform and the socialist countries", in *Supplement to World Economic Survey 1985-1986* (United Nations publication, Sales No. E.86.II.C.2), pp. 1-27.

<sup>23</sup> Some of the countries — most recently Poland in late May 1986 — have already joined the Fund and the Bank. Others have explored ways in which they can co-operate more closely with these institutions.

<sup>24</sup> The request made by the USSR in August 1986 to accede to GATT as an observer may be mentioned as an example.

<sup>25</sup> This instrument of CMEA integration was first introduced for the medium-term period 1976-1980. It is now a standard part of the CMEA-wide negotiations concerning the co-ordination of plans. It is directly linked to longer-term integration documents, such as the programme on scientific and technological co-operation discussed below.

and of the trade agreements are integral components of the national five-year plans for each country. Seen within this framework, the new medium-term plans emphasize a continuation of past integration efforts, but with a shift in emphasis towards technological co-operation and economic intensification.

Fostering productivity growth through more intensive participation in global trade and finance was slated as a pivotal component of the five-year plans for 1981-1985. In view of the constraints on economic relations with the developed market economies, which had been rising since the mid-1970s, accelerated integration within CMEA became the prime focus of foreign economic policies. Target programming was to be the most important vehicle to facilitate economic integration, primarily among the European CMEA members. Five Target Programmes for enhancing regional economic co-operation (in fuels and primary raw materials, agriculture and foodstuffs, transportation, machine-building, and manufactured consumer goods) were elaborated in the second half of the 1970s. They comprised some 340 projects, the majority of which were to be initiated during the first half of the 1980s, in part through the Second Concerted Plan.

These Programmes were designed to be a common policy for structural adjustments and were intended to redress the prevailing domestic and external imbalances in some member countries, to support growth, to secure greater regional self-sufficiency in producer and consumer goods, and to expand and modernize the transportation sector. However, in view of the adverse developments in foreign trade and payments, particularly in 1981-1983, many of the measures envisaged in the Target Programmes had to be postponed and eventually their goals and *modus operandi* had to be re-examined in detail. The elaboration of a common policy for structural adjustment is, therefore, once again high on the agenda of national and regional policy measures associated with the current five-year plans.

At the forty-first (special) meeting of the Session of CMEA held on 17 and 18 December 1985, member countries adopted the comprehensive programme for co-operation in science and technology, which had first been enunciated at their economic summit meeting in June 1984.<sup>26</sup> The programme envisages the acceleration of technological progress through bilateral and multilateral agreements reflected in the annual and medium-term plans.<sup>27</sup> Specifically,

the programme aims at speeding up scientific and technological progress in the productive sphere in five broad areas: electronics, automation, nuclear energy, new materials and technologies, and biotechnology. In these sectors, CMEA members hope not only to catch up with existing scientific and technological know-how, but to surpass it and reach the frontier of research and industrial application, at the latest by the turn of the century. Such advances should permit acceleration of the pace of productivity growth in the CMEA region as a whole so that average labour productivity will be at least twice the present level by the year 2000 and the material content, especially energy and critical raw materials, of aggregate national output will be drastically reduced.

One of the fundamental aims of the programme is the creation of mutually compatible technologies throughout the CMEA area, and so the scope for production specialization and trade intensification is to be broadened significantly. The bases for generating technological progress and improving productivity could be radically altered during the implementation of the programme. A key provision is the emphasis on direct relations among enterprises, associations and scientific and technical institutes through concrete protocols and contracts. In addition, special bilateral or multilateral organizations may be set up to tackle particular issues pertaining to the acceleration of technological progress and productivity growth. Financing will be arranged through regular budgetary appropriations as well as through loans from the two CMEA banks. In addition, special funds may be set up for some of the concrete agreements yet to be worked out.

Since the adoption of the programme in late 1985, CMEA members have decided on a number of concrete steps towards carrying out the programme, and the modalities for its implementation have been discussed in depth. The programme comprises a total of 93 separate research projects to be finalized in the next three years; most of them are already regulated by concrete agreements concluded in the course of 1986. Each project includes a number of "topics" or sub-projects and, at a still more disaggregated level, several thousand "themes" or targets.<sup>28</sup> Unlike earlier forms of scientific and technological co-operation, each project is to be headed by a specialized Soviet entity that is invested with extensive executive powers in order to foster direct and permanent intra-group links in research, development and production.<sup>29</sup> The realization of these goals will require serious changes in the structure of CMEA, and in the style and

<sup>26</sup> The programme is entitled "Comprehensive Programme to Promote the Scientific and Technological Progress of the Member Countries of the Council for Mutual Economic Assistance up to the year 2000". It was published in all the main Communist Party newspapers of 19 December 1985.

<sup>27</sup> A number of elements were already in place at the end of 1985 because of the bilateral programmes of scientific and technical co-operation that had been negotiated earlier, in the first place between the majority of the Eastern European countries and the USSR.

<sup>28</sup> See Ondřej Lér, "Komplexní program vedeckotechnického pokroku zemí RVHP — význam organizací-koordinátorů", *Svět Hospodářství* (Prague), No. 42 (1986), p. 1.

<sup>29</sup> See *Izvestia* (Moscow), 22 March 1986, p. 1, *Nedelya* (Moscow), No. 27 (1986), pp. 6-7, Vyacheslav V. Sychev, "Novye rubezhi nauchno-tehnicheskogo sotrudnichestva", *Ekonomicheskoe sotrudnichestvo stran-chlenov SEV* (Moscow), No. 1 (1986), pp. 14-19; and Vyacheslav V. Sychev, "Novye rubezhi nauchno-tehnicheskogo progressa stran-chlenov SEV", *Planovoe khozyaistvo* (Moscow), No. 4 (1986), pp. 14-51.

methods of its activities.<sup>30</sup> These goals are to be pursued, as are the objectives of the programme, in conjunction with the ongoing changes in institutions, policies and instruments detailed in national plans and the related policy discussions.

### Changes in the economic mechanisms

Most of the policy discussions on the 1986-1990 plans, and some of the finalized plans themselves, emphasize the need for some type of economic reform in order to foster intensive development, focusing on efficiency, productivity and quality. Perhaps the largest change is envisaged in the character of traditional central planning. Major weaknesses of directive planning (such as insufficient flexibility, the unwillingness or inability of central authorities to deny resources to entrenched ministerial or local interests, the lack of adequate incentives to promote quality, innovation and efficiency, and the inclination of economic units to overspend) became major liabilities at the beginning of the 1980s and are to be mitigated by directing central planning increasingly towards strategic long-term development aims.

Changes in economic mechanisms have been under way in some countries for some time and announced in others. All countries have tried to improve management both below and above the enterprise level. Within enterprises, smaller and more compact organizational units, in most cases "brigades", have gradually taken responsibility for the fulfilment of plan targets. Labour remuneration is increasingly being linked to performance. Above the enterprise level, new associations are being created, including amalgamations of enterprises within branches or sectors.

A second feature of the early 1980s is the wider use of cost-accounting principles at all organizational levels. In some countries, this has been applied to whole ministries; in others, to selected institutions. A third common element is the use of indicators of economic performance that are closely connected with cost-accounting principles. In most of the countries, the number of obligatory norms for enterprise performance was lowered. This was accompanied by a shift from gross physical and value indicators to net value indicators, such as net normative output, income and profit.<sup>31</sup>

Fourthly, internal prices have been better aligned with world prices. This has been notably the case for energy and raw material inputs, in order to foster rationalization and greater cost consciousness. For wholesale prices and, to a smaller degree, for retail prices, reforms have taken place in all countries and the new plans leave no doubt that further changes are in the offing.<sup>32</sup>

Finally, the general requirements for improving plan discipline and more dynamic entrepreneurship have been re-examined. In Hungary, this has led to a deliberate acceleration of economic reform, while in other countries it has taken the form more of an adjustment to the existing systems.<sup>33</sup>

Much has been done to improve the economic mechanism in the USSR as a result of the economic experiments conducted since 1983: the rights of some industrial production associations in planning and day-to-day operations, including labour organization and remuneration have been expanded; at the same time, these organizations are held more fully responsible for the results of their work. In consequence, a higher degree of fulfilment of the assignments for product sales have emerged and labour incentives have been strengthened.<sup>34</sup> After an evaluation of the experiment, it was decided to move on towards the creation of an "intergrated system of management and control",<sup>35</sup> which has been under way since early 1986 for formal introduction mainly in 1987. As one of the important elements of this system, price formation has received special attention, although there is not as yet a clear consensus among experts on desirable price reforms and the management of prices.<sup>36</sup> More recently, the role of foreign trade in economic development, the decentralization of foreign trade operations in certain activities and the linking of trade and domestic economic sectors have been at the focus of policy attention.

Most countries are considering changes, or extensions of modifications recently enacted, in their management and planning systems. The scope of these intended changes varies from country to country. Almost all the five-year plans foresee a widening of the rights and responsibilities of enterprises in planning, production and investment decisions. In some cases, this implies the abolition of high-level management tiers and ministries; in others, it reinforces the role of

<sup>30</sup> Vyacheslav V. Sychev, *loc. cit.*, p. 19. The importance that these economies accord to this programme is shown by two further pieces of evidence. Soon after the programme was adopted, two new standing commissions (one for new and renewable materials and the other for biotechnology) were created. These are crucial CMEA organs for the examination of technical materials, organization and management of production co-operation and specialization, and are the nodal points for the preparation of feasible alternatives for decisions by higher-level CMEA organs. The other instance concerns the dovetailing of the modes of implementation of the programme with the ongoing transformations in the economic mechanisms of a number of CMEA members.

<sup>31</sup> G. Shilina, "Ekonomicheskie normativy v sisteme khozyaistvennogo mekhanizma", *Voprosy ekonomiki* (Moscow), No. 11 (1985), pp. 43-49.

<sup>32</sup> For a recent broad-ranging, yet succinct, recent review of Eastern European price policies, see N. Mitrofanova, "Sistema kontrolya tsen v stranakh SEV", *Voprosy ekonomiki* (Moscow), No. 7 (1986), pp. 109-118.

<sup>33</sup> A. Bachurin, "Khozaschet v sisteme upravleniya ekonomikoy", *Planovoe khozyaistvo* (Moscow), No. 12 (1985), pp. 31-42.

<sup>34</sup> For a summary of the results of the economic experiments, see A. Milyukov, "Novye formy upravleniya v deistvitelnosti", *Ekonomicheskaya gazeta* (Moscow), No. 33 (1985), pp. 9-10.

<sup>35</sup> From the resolution of the Central Committee as reproduced in *Kommunist* (Moscow), No. 4 (1986), p. 29.

<sup>36</sup> See N. Glushkov, "Planovoe tsenoobrazovanie: puti sovershenstvovaniya", *Kommunist* (Moscow), No. 3 (1985), pp. 38-48; I. Lipsits, "Sovershenstvovanie khozyaistvennogo mekhanizma tsenoobrazovaniya", *Ekonomicheskie nauki* (Moscow), No. 7 (1985), pp. 12-18; A. Komin, "Tekhnichesky progress i tseny", *Planovoe khozyaistvo* (Moscow), No. 10 (1985), pp. 13-20; and A. Gorodetski, "Khozaschet i optovye tseny", *Voprosy ekonomiki* (Moscow), No. 11 (1985), pp. 11-21.

medium-level associations of enterprises, such as the *Kombinate* in the German Democratic Republic.

The plans emphasize the need for a stricter link between the financial means of enterprises and their performance; for greater financial responsibility and hence less reliance on the state budget; and for increasing opportunities to mobilize retained earnings for expansion and modernization. More active use of credit in investment, including stricter credit conditions, is also being entertained. In nearly all countries, the number of mandatory enterprise indicators is being curtailed, in some cases quite sharply.<sup>37</sup> Contractual agreements among enterprises for their sales and purchases will be widened, and they will eventually become the dominant mode of inter-enterprise transactions in a number of economies.

All plans stress that scientific and technological excellence is indispensable to the development and large-scale application of key technologies. There are basically two approaches to this goal. One emphasizes even more vigorous adherence to centrally set research and development schedules. The other looks for more flexible co-operation between research and development institutions and production, and for further decentralization of research and development activities.<sup>38</sup>

Flexible price formation and sensitivity to changes in demand are called for. Price levels need to be linked not only to the cost of inputs, but also to the qualitative properties of goods and consumer demand. In other words, demand conditions are to play a more effective role in determining prices. Some countries plan to keep retail prices for basic goods and services stable throughout the plan period, although prices of new consumer products of high quality are to be modified as required.

In some countries, the regulations that apply to industry and agriculture differ. Most give top priority to encouraging

output and productivity in agriculture. The methods explored include delegating greater decision-making powers to agro-industrial complexes, collective farms and state farms; reducing waste by mechanizing storage, transportation and processing of farm output; and applying contract systems for groups and even families. In the USSR, farms are encouraged to use their own funds and raise bank loans to expand production. Cost-accounting principles are to be applied to agro-industrial complexes and farms, just as they are to industrial enterprises. This implies that the wages of farm workers will be contingent on the income earned by their unit.<sup>39</sup> It is not clear, however, whether retail prices in this sector are also to become more flexible than in the past. If so, procurement prices would have to be modified<sup>40</sup> and the state subsidy schemes would need to be re-examined.<sup>41</sup>

One of the most general objectives is to improve the economic determinants of accumulation, including investment decisions and their financing, especially in view of the difficulties in financing investment expenditures encountered in the early 1980s. In a number of countries, especially the USSR, the share of funds left at the discretion of enterprises in 1981-1985 remained well below the levels envisaged in administrative and legal provisions;<sup>42</sup> this made it impossible for enterprises to employ their financial resources effectively and profit margins shrank as a result.<sup>43</sup> Another consequence was the practice of using amortization funds to finance new investment projects instead of leaving them at the disposal of enterprises for maintenance and replacement.

In some countries, the plan calls for a steady decrease in costs not only in industry but also in agriculture and construction, although the target rates for the latter sectors are less clear than those for the economy as a whole or for industry.<sup>44</sup> This is expected to consolidate the financial base for increased accumulation. The economic mechanisms in the new policy guidelines aim at raising cost awareness, espe-

<sup>37</sup> In Czechoslovakia, for example, from 1986 on, there are only two compulsory plan indicators in agriculture: one each for grain and livestock production (see *Heti Világgazdaság* (Budapest), 22 March 1986, p. 13). In the German Democratic Republic, net production, profits, products and services for the consumer markets, and exports are to be used as the essential targets at all levels of management and planning.

<sup>38</sup> The USSR in particular is emphasizing the creation of interbranch associations for the purpose of accelerating scientific and technological development. Hungary specifically aims at increasing the role of enterprises in deciding upon the share of total outlays to be appropriated for research and development. The *Kombinate* in the German Democratic Republic already integrate basic research, development and application in production.

<sup>39</sup> Concrete regulations in the USSR include (a) a 50 per cent price bonus on the production of major commodities above the average 1981-1985 level, regardless of whether output actually reaches the new, and higher, 1986-1990 official targets; (b) both state and collective farms will be able to sell 30 per cent of the fruit and vegetables produced under the plan targets directly to local shops and restaurants or in private markets; (c) local regional authorities will have the power to fix retail prices for fruit and vegetables in local state shops; and (d) prices will vary from region to region. Most of these regulations are to be introduced in full in the course of 1987.

<sup>40</sup> In Czechoslovakia, state subsidies for capital goods are to be limited further, which will necessitate a price increase. Funds thus freed will remain at the disposal of agriculture, however. From 1 January 1986, the system of the mutual relationship between the growth of wages and adjusted producer costs, already in effect in other production sectors of the national economy, is extended to agriculture too (see *Rudé Právo* (Prague), 3 September 1985, pp. 1 and 2 and *Hospodářské Noviny* (Prague), No. 29 (1985), pp. 1 and 6).

<sup>41</sup> The German Democratic Republic is not planning any price increase for agricultural procurement prices, which necessitates a substantial rise in price subsidies, as noted in the plan. Retail price subsidies for foodstuffs rose from 7.8 billion marks in 1980 to 27.6 billion marks in 1985, when they constituted 31 per cent of total monetary allocations to the population from the state budget.

<sup>42</sup> In 1976-1980, the volume of profit in Soviet industry grew by 30 per cent (in comparable prices), instead of 70 per cent as envisaged in the five-year plan. In 1981-1984, the volume of profit increased by 28 per cent in the economy as a whole, instead of 31 per cent as envisaged (see B. Plyshevsky, "Teoriya i metodologiya planirovaniya: sovremennoe sotsialisticheskoe nakoplenie", *Planovoe khozyaistvo* (Moscow), No. 3 (1986), p. 24).

<sup>43</sup> During the first half of the 1980s in the USSR, for example, the reduction in the cost of production in industry practically halted and, in agriculture and construction, costs increased.

<sup>44</sup> For example, in the USSR the cost of industrial production is envisaged to decline by 4-5 per cent in 1986-1990, which means a quadrupling of the pace in the previous quinquennium.

cially in the investment sphere. The financing of capital investment will be more closely linked to sectoral and enterprise performance, with priority accorded to retooling and modernization. The transfer of profits to the budget will be set on the basis of long-term norms. The use of amortization deductions from enterprises for the financing of other industrial investment projects will cease, and depreciation allowances will be retained in the enterprise development fund. Higher rates of depreciation are to be introduced in 1986-1987. The resulting medium-term increase in the rate of accumulation should give greater impetus to technical change.

Important modifications in the economic mechanisms are being launched in external trade and finance. Many enterprises are being given greater autonomy in negotiating trade contracts with foreign trade enterprises, and some have been getting the authority to engage in trade directly. Some export revenues can be retained by these enterprises to finance imports, directly or indirectly, and thus their own expansion and modernization. Another part accrues in the form of bonuses to workers.

In recent years, the desirability of establishing joint ventures has come to the fore. This affects economic relations with both market economies and other planned economies. The European planned economies have become convinced that more active participation in the international division of labour, especially in the technology-intensive branches, requires closer domestic and foreign inter-company relations. The aim is to attain a higher level of technological sophistication, to use joint ventures to mobilize the benefits of co-operation with foreign partners and to foster investments in high-technology sectors without endangering the external balance. All European members of CMEA except Albania and the German Democratic Republic introduced new or modified existing legislation in late 1985 or early 1986.

The general characteristic of the changes is a gradual acceptance of certain kinds of foreign direct investment as a means of invigorating selected domestic economic sectors. The main target has been participation of foreign capital in equity joint ventures, mostly in sectors of high priority. Earlier joint venture laws in Bulgaria, Hungary, Poland and Romania yielded very modest results. This stemmed partly from insufficient guarantees and excessive restrictions, which have since been changed in successive modifications to provide additional incentives for foreign investors. Countries that passed such laws for the first time during 1986 (Czechoslovakia and the Soviet Union) formulated their legislation only after careful study of the results attained over the years by the first group of countries. Now that the Soviet Union has introduced joint venture legislation and is actively seeking modernization of foreign trade management, a new dimension may be added to this form of co-operation.

The results of the new legislation will depend on the mo-

dalities for its implementation. Ongoing managerial reforms, other changes in economic mechanisms, recent bilateral agreements concerning CMEA-wide inter-enterprise relations and the establishment of joint production entities appear to be mutually supportive. They may also foster joint ventures with third countries. Co-operation and specialization of production within CMEA and more realistic commodity and price relations could be promoted by successful joint enterprise ventures. Because the changes in CMEA co-operation mechanisms likely to come to the fore in the next few years are bound to be wider than those dealing with inter-enterprise relations and CMEA joint undertakings, the impact of CMEA integration on co-operation and specialization in production is bound to be still larger.

The forty-second meeting of the CMEA Session was held at Bucharest in November 1986, when the first year of the current medium-term plan period was coming to a close. At that time, economic performance in 1986 had been more modest than planned. The need to phase out obsolete products and processes, to raise efficiency and find the best ways to accelerate growth were apparently at the centre of the discussions. Most of the delegations shared the view that new forms of co-operation were required. It was stressed that accelerated growth could be attained in only two ways: by the adoption of more up-to-date methods of management, and by the faster introduction and application of the latest technology.

## China

Since 1978, when the agenda for rapid and balanced long-term economic growth until the end of the century was promulgated, China has attained very rapid expansion in both agriculture and industry. This was particularly so in the first half of the 1980s, when aggregate output growth averaged an annual 9.4 per cent (see table VI.7); the corresponding rates for agriculture and industry were 8.1 per cent and 12 per cent. Actual output exceeded plan targets by a considerable margin. At the same time, however, this impressive performance has given rise to serious bottle-necks and to domestic and external payments imbalances that need to be dealt with in order to sustain high-level growth and steady factor productivity gains.

The current five-year plan of China is the second medium-term development plan in the context of the economic adjustments and reforms promulgated since the late 1970s.<sup>45</sup> The approval of the plan in early 1986 came at a critical juncture in the path of China's transition to a middle-income, industrial country by the year 2000. The pivotal decisions on economic development and reform adopted in 1978, while maintaining the traditional goal of high growth, reflected fundamental changes in the approach to be taken.<sup>46</sup> Unlike the development policies of the previous three decades, which aimed at maintaining high levels of investment, even

<sup>45</sup> *Seventh Five-year Plan for Economic and Social Development of the People's Republic of China (1986-1990): Excerpts*, approved on 12 April 1986 at the fourth session of the Sixth National People's Congress.

<sup>46</sup> Decisions promulgated at the Third Plenum of the Eleventh Congress of the Central Committee of the Chinese Communist Party in December 1978.

Table VI.7. China: average annual growth rates of selected macro-economic indicators, 1979-1985 (percentage)

	1979-1980	1981-1985		1986-1990	1981	1982	1983	1984	1985
	Actual	Planned	Actual	Planned	Actual				
Net material product	6.7	4.0	9.4	6.7	4.9	8.3	9.8	12.0	12.3
Gross agricultural output <sup>a</sup>	4.4	4.0	8.1	4.0	6.5	11.3	7.8	12.3	3.0
Gross industrial output <sup>b</sup>	9.0	4.0	12.0	7.5	4.3	7.8	11.2	16.3	21.4
Gross fixed investment <sup>c</sup>	7.3	..	18.4	10.0 <sup>d</sup>	-3.7	17.3	14.1	33.9	35.0
Personal consumption <sup>e</sup>	8.2	4.8	9.0	5.0	7.3	5.3	7.6	10.9	14.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on State Statistical Bureau, *Statistical Yearbook of China*, various issues, and the World Bank.

- a Excluding output of village-run industrial enterprises.
- b Including output of village-run industrial enterprises.
- c In current prices.
- d Estimated volume over the entire period relative to the volume of the preceding period reset to an average annual rate of growth.
- e Per capita.

at the expense of consumption, the new policies have envisaged high growth with immediate improvements in the level of consumption. Efficiency gains in production through reforms in the economic system and changes in output structure, as well as through new capital formation, are to provide the backbone of sustained growth.

One key objective of current medium-term planning is to continue the drastic readjustment of economic structures. Current development priorities, like those in effect since 1978, emphasize the further shift from capital-intensive production toward labour-intensive production of consumption and light manufactured goods. Bottle-necks in energy infrastructure, transportation and the supply of non-fuel raw materials are to be eased by maintaining substantial growth of investment in those sectors. At the same time, the expansion of foreign trade is expected to continue at more moderate rates than in the late 1970s and early 1980s. The focus of import policies is on the acquisition of the technology and materials necessary for economic growth and, within the constraints of foreign exchange availability, for meeting domestic demand for consumer goods to a greater extent than has recently been the case.

These output goals are predicated in part on further reforms in enterprise management, finance, prices, wages and foreign trade. Reforms since 1978 have been aimed at raising economic efficiency through decentralization of decision-making. While contributing to rapid growth, they also

resulted in some macro-economic imbalances. The much larger than planned expansion of fixed investment and consumption aggravated commodity shortages and inflationary pressures. The imbalances in 1985 threatened the political viability of the objective of continued high growth and gave rise to concern that further decentralization would lead to loss of control over the economy.

The 1986-1990 plan is a compromise and emphasizes the need to slow the pace of reform. However, the commitment to continued reform of the economic system is stated without ambiguity in the plan. Towards the end of 1986, with the apparent success in moderating the pace of economic expansion that year, the schedule of some reforms, including those relating to prices and some financial mechanisms and institutions, appeared to have been moved forward relative to the policy tenor of the five-year plan.<sup>47</sup> Since then, however, the approach to reforms appears to have become more cautious again, price reforms in particular being slowed down for fear of aggravating inflationary pressures.

#### Economic development and the policy setting since 1978

By the time the new economic policy agenda was adopted in 1978, the economy had experienced several years of volatile but slow economic growth. The immediate cause was the

<sup>47</sup> Editorial in *Renmin ribao* (People's Daily)(Beijing), 23 November 1986, p. 1.

prolonged socio-political uncertainty associated with the cultural revolution and its aftermath. The debilitated policy-making framework threatened to destabilize the structure of the economy. The long-term causes were the cumulative effects of a continuation of negative factors, which included a chronically unproductive agricultural sector unable to meet domestic demand, inefficient use of capital resources and low labour productivity resulting from a lack of material and other incentives.<sup>48</sup> As a result, aggregate output growth declined. It averaged 5.5 per cent in 1971-1978 compared with 6.2 per cent in the period 1952-1970, but there were considerable year-to-year fluctuations. Furthermore, large trade imbalances began to accumulate in the early 1970s owing to deteriorating terms of trade, sharp increases in food imports and declining exports. Although the deficit was reversed in 1976 through the stringent cut-back of imports, poor harvests necessitated substantial increases in food grain imports in 1976 and 1977.

Following the shift in policy in 1978, aggregate output during 1979-1980 grew very rapidly. The growth rates of both agriculture and industry accelerated, surpassing historical rates and exceeding considerably the averages of the earlier 1970s (see table VI.7). Consumption grew substantially: the share of consumption in aggregate domestic uses of resources rose from 64 per cent in 1978 to 70 per cent in 1980, as rural and urban incomes were raised by large increases in agricultural prices, wages and bonuses. However, the budget deficit grew to 5 per cent of the total material product in 1980, on account of retail price subsidies and centrally financed investment expenditures. With the rapid expansion of demand, shortages of energy, transport and materials became very severe at times. Rapid domestic growth and more liberal trade policies accorded priority to the importation of machinery, equipment and foodstuffs, and the external trade account swung into substantial deficit in 1980.

The response to these imbalances was a number of measures in 1981 to stabilize the economy, primarily a reduction of the money supply (through the sale of government bonds and controls over credit creation).<sup>49</sup> The fiscal deficit was also drastically curtailed, primarily through cut-backs in budgeted investment expenditures in large infrastructural projects. Owing to the decentralization of investment financing, the central Government's efforts fell short of curbing the growth of aggregate investment expenditures in large infrastructural projects. However, it proved to be very difficult to impose effective limits on capital formation financed by the local governments, by industries outside the state sector and even by state-owned enterprises with large retained

profits. In the external sector, imports were drastically compressed through restrictions on the importation of machinery and manufactured consumer goods.

The stabilization measures resulted in slower growth in 1981. External and domestic deficits were reduced and shortages eased. The 1981-1985 plan adopted in 1982 set modest targets (see table VI.7), reflecting a recognition of the persistence of constraints on rapid growth and the fundamental lack of effective macro-economic management. The plan opted for balance at the cost of growth, while pressing forward with readjustment and reform.<sup>50</sup> By 1982, however, the economy resumed a rate of growth of over 8 per cent despite a target of 4 per cent. Planners were unsuccessful in restraining the expansion of gross fixed investment, a problem that has continued to plague economic management in recent years.

The more extensive economic and organizational reforms implemented in the 1980s modified — and in critical aspects diluted — direct governmental controls, without establishing alternative mechanisms for macro-economic management. This loss in the effectiveness of aggregate economic policies was particularly evident in the growth of fixed investment, personal incomes and imports that occurred after the easing of the administrative measures taken in 1981 to stabilize the economy. The growth of capital investment resumed in 1982, but control over investment was maintained until the end of 1983 through the political coaxing of local government leaders and the imposition of taxes on the use of retained funds and on investment by enterprises outside the plan.<sup>51</sup> Urban wages also grew modestly through 1983 as no major wage increases were mandated and much stricter rules on awarding bonuses were enforced. Rural incomes continued to rise as the decollectivization of agricultural production proceeded rapidly.

The reform of the financial system, which accorded the banking sector a more active role in the creation of credit for urban and rural enterprises and agriculture, further weakened central control over the supply of money. By early 1985, the economy had returned to a rapid rate of growth and domestic and external imbalances reminiscent of those of 1979-1980, but of much more serious magnitudes.

The outstanding development in the Chinese economy since 1978 has been the rapid growth of the agricultural sector. The growth of agricultural output accelerated from 4 per cent in the late 1970s to 8 per cent annually between 1981 and 1985 as a result of increased inputs and productivity growth (see table VI.7). Record levels of per capita output of

<sup>48</sup> N. Lardy, "Recent Chinese economic performance and prospects for the ten-year plan", in *Chinese Economy Post-Mao*, vol. 1, *Policy and Performance*, a compendium of papers submitted to the Joint Economic Committee, Congress of the United States, 9 November 1978, pp. 50-54.

<sup>49</sup> See World Bank, *China: Recent Economic Trends and Policy Development*, Report No. 4072-CMA, (Washington, D.C., 31 March 1983).

<sup>50</sup> *Sixth Five-year Plan for Economic and Social Development of the People's Republic of China (1981-1985)*, approved on 10 December 1981 at the fifth session of the Fifth National People's Congress.

<sup>51</sup> B. Naughton, "Finance and planning reforms in industry", in *China's Economy Looks Toward the Year 2000*, vol. 1, *The Four Modernizations*, selected papers submitted to the Joint Economic Committee, Congress of the United States of America, 21 May 1986, p. 610.

the major crops of grain, cotton and oil seeds were achieved. The increased productivity of the agricultural sector was a direct result of fundamental changes in agricultural policy, which emphasized material incentives and more decentralized decision-making. In addition, significant growth in capital construction — large-scale hydrological projects for example — and technological innovations in seeds and other inputs had occurred in earlier years.<sup>52</sup> Government procurement prices of the major agricultural commodities were raised by approximately 25 per cent between 1977 and 1982, concurrently with significant growth in private sales in trade markets. The earlier emphasis on grain production rather than cash crops and on local self-sufficiency in grain was reversed. Centrally mandated cropping patterns for local areas were abolished.<sup>53</sup> By 1983, the communal mode of production was completely transformed into a system of household production, under which land remains collectively owned, but is leased to farmers for up to 15 years; earnings are based on the output of the individual unit of production. Farmers are permitted to transfer their lease and to engage in other production locally or in small towns.<sup>54</sup> The increased mobility of labour and the encouragement of non-agricultural production in rural areas has resulted in the substantial mobilization and relocation of labour no longer required in agriculture.

The main themes underlying industrial policy for 1981-1985 were readjustment of the structures of output and intensified use of capital. Industrial growth targets were set at an annual level of 4 per cent, and two years of low to moderate performance elapsed before rapid growth resumed in 1983 (see table VI.7). After the buoyant growth of light industry in the late 1970s and early 1980s, the readjustment of output appeared to come to a halt and since 1982 light industry has grown more slowly than heavy industry. Between 1981 and 1985, the composition of heavy industry shifted towards the machine-building and construction materials sectors, where growth substantially exceeded that of the energy, coal and metallurgical sectors. With high growth in fixed investment, output of the construction industry also grew very rapidly, but not nearly quickly enough. Bottle-necks in supply, particularly of intermediate goods and infrastructural commodities and services, were not eased to any marked degree in the early 1980s and were aggravated in 1984-1985. Energy shortages persisted because industries were unable to improve their energy efficiency and because projects had had to be delayed or cancelled in 1981 in an attempt to stabilize the economy.

The lack of success in industrial restructuring in the early

1980s stemmed largely from the loss of control over capital investment in industry and, as a result, over the sectoral allocation of investment and growth. Attempts initiated in 1978 to intensify the use of capital met with little success as fixed assets grew faster than output between 1979 and 1985.

After administrative and financial controls were lifted, fixed investment resumed its rapid growth in 1984 (see table VI.7). Enterprises had larger retained funds than in the late 1970s as a result of the taxation of profits, extended to all enterprises in 1983-1984, in lieu of the earlier transfer of net enterprise receipts to the budget. Reform of the financial system shifted the control of credit supply for fixed investment and, in particular, for working capital to the banks away from budgetary allocations, and thereby greatly expanded the availability of funds for extrabudgetary investment.<sup>55</sup>

The enterprise reforms begun in 1978 were meant to create material incentives for enterprises to raise productivity. In the initial phase of reforms, this was done by allowing enterprises to retain part of their realized profit, which previously had to be transferred entirely to the State. This permitted enterprises to utilize a share of profits to raise worker remuneration and benefits, or investment. This was later replaced by a system of profit taxation which was structured to permit enterprises to retain the same proportion of profits as under the profit-retention system.<sup>56</sup> However, the implementation of this arrangement remains to be completed and the taxation system has not yet exploited the incentive effects of fiscal policy.<sup>57</sup>

Consumption grew rapidly in 1984 and 1985, after a period of moderation since 1981 (see table VI.7). Major determinants were the expansion of personal incomes, the increased supply of food and consumer goods from the rapidly growing agricultural sector and the easing of imports. Rural incomes expanded markedly owing to the development of non-agricultural production and the increase in procurement and market prices of agricultural commodities. In contrast, wages of urban workers rose little between 1980 and 1983, as government regulations limited bonuses to two months' wages. This control was necessary as enterprises with large amounts of funds had little incentive to maximize long-term profits and chose to improve the short-run remuneration and welfare of workers. The reported disincentive to productivity was a major consideration in the sharp modification in 1984, which imposed a progressive tax on bonuses exceeding two and a half months of total wages.<sup>58</sup> In the same year, bonuses per worker increased by more than

<sup>52</sup> N. Lardy, "Overview: agricultural reform and the rural economy", in *China's Economy Looks Toward the Year 2000...*, pp. 325-331.

<sup>53</sup> But production quotas of the major crops were retained until 1984-1985.

<sup>54</sup> Central Committee of the Chinese Communist Party, Document No. 1, 1984.

<sup>55</sup> See *Jingji ribao* (Economic Daily) (Beijing), 25 September 1985, p. 2, and *Jingji daobao* (Economic Report) (Hong Kong), No. 47 (25 November 1985), pp. 27-28.

<sup>56</sup> B. Naughton, *op. cit.*, pp. 607-609 and 611-613.

<sup>57</sup> The fact that the proposed capital use tax was not generally in force in 1985 contributed to the high level of demand for fixed investment by keeping the cost of capital to enterprises artificially low. Other unreformed aspects of enterprise management, particularly the weak financial accountability of enterprises and the lack of decision-making power of enterprises in most operational areas, also contributed to the continued high demand for investment in the expansion of production (see *Renmin ribao* (Beijing), 22 August 1986, p. 5).

<sup>58</sup> *Jingji ribao* (Beijing), 20 April 1984, p. 1.

Table VI.8. China: selected indicators of the external sector, 1978-1985<sup>a</sup>

	1979- 1980	1981-1985		1986- 1990	1981	1982	1983	1984	1985
	Actual	Planned	Actual	Planned	Actual				
	Average annual percentage change								
Export value <sup>b</sup>	38.7	..	8.6	..	21.6	1.5	-0.5	17.6	4.7
Import value <sup>b</sup>	40.6	..	16.2	..	10.4	-12.4	10.9	28.1	54.2
Export volume <sup>c</sup>	21.1	8.1	11.3	8.1	17.9	13.3	3.4	17.4	10.0 <sup>d</sup>
Import volume <sup>c</sup>	19.2	9.2	14.0	6.1	5.4	-0.7	9.4	29.1	50.4 <sup>d</sup>
	1978	1979	1980	1981	1982	1983	1984	1985	
	Billions of dollars								
Trade balance <sup>e</sup>	-1.1	-2.0	-2.8	1.7	4.3	2.0	0.0	-13.1	
Current account balance <sup>e</sup>	-0.7	-1.6	-2.4	2.0	5.8	4.5	2.5	-11.4	
Change in foreign exchange reserves <sup>e</sup>	7.1	-0.6	-0.5	-2.2	-6.3	-4.8	-1.8	4.6	

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on State Statistical Bureau, *Statistical Yearbook of China*, various issues, the World Bank and the International Monetary Fund.

- a Based on Ministry of Foreign Economic Relations and Trade data for 1979-1980 and on customs statistics for 1981-1985.
- b Exports are valued f.o.b. and imports c.i.f.
- c Estimates based on Ministry of Foreign Economic Relations and Trade import and export price indices for 1979-1980 and United Nations commodity and manufactured export price indices for 1981-1985.
- d Preliminary estimate.
- e World Bank and IMF statistics, based on Bank of China data.

50 per cent as many enterprises paid the equivalent of four to five months of wages. Much of the excess over normal bonus payments was ultimately financed by credit from the banking system, greatly increasing the amount of money in circulation.<sup>59</sup> This may have occurred in part because bonuses were paid under pressure from workers, regardless of profits, or because enterprises decided to hold their liquid retained profits so as to maintain flexibility in fixed investment decisions. A very accommodating lending policy on the part of banks facilitated the financing of large increases in bonuses.

After import restrictions were lifted and imports officially encouraged in 1983, the trade surplus that had existed since 1981 became a small deficit in 1984 and widened to almost \$13 billion by the end of 1985 (see table VI.8). Attempts by central decision makers to slow the growth of imports did not have any effect until import controls and a recentralization of the foreign trade system were implemented in late 1985.

The ineffectiveness of macro-economic policies in the trade sector, as in the case of investment, was a consequence of partial and incomplete reform. The decentralization of

the foreign trade mechanism and its institutional support was carried out without changing the fundamentals of the relationship between domestic and international prices. The devolution of authority to engage in trade, from centrally administered foreign trade corporations to corporations administered by local governments and to individual enterprises, multiplied the number of organizations that participated in trade but were not directly controlled by the central Government. These organizations and local governments were also given access to significant amounts of foreign exchange through profit retention.<sup>60</sup> Because they were also made financially accountable, they tended to emphasize transactions that were profitable. Domestic prices of manufactured goods relative to international prices were high because of high material and factor costs. This was accentuated by the overvalued exchange rate which made imports more profitable than exports. The strong domestic demand for consumer durables, intermediate goods and machinery and equipment, as a result of the rapid growth in output and income, reinforced the demand for imports.

The Chinese authorities became concerned about the overvalued exchange rate in the early 1980s. The relationship between domestic and international prices was first ad-

<sup>59</sup> *Financial Times*, 28 March 1985, p. 1.

<sup>60</sup> Y. Y. Kueh and C. Howe, "China's international trade: policy and organizational change and their place in the 'economic adjustment'", *China Quarterly*, December 1984, and *Renmin ribao* (Beijing), 20 September 1984, p. 1.

justed in 1981, when an "internal rate of settlement" was instituted. This rate, which was more favourable than the official one, applied to the conversion of foreign exchange into domestic currency (at ¥RMB 2.8 compared with ¥RMB 1.7 to the dollar in 1981) by enterprises or trading corporations. Significant official devaluation of the yuan renminbi against major currencies began in 1984 and continued through 1985, resulting in a depreciation of over 60 per cent between the end of 1983 and 1985. There was another major devaluation of 17 per cent against the dollar in mid-1986, but those depreciations were insufficient to rectify the external imbalance.

Other policy responses to the deficit included recentralization efforts and measures to adjust prices. Control over foreign exchange and access by trade corporations and enterprises were tightened.<sup>61</sup> Controls on the importation of machinery were put in place and a ban on importing consumer durables and motor vehicles was imposed in late 1985. As a result, import growth slowed to 1.6 per cent in 1986.

Along with the rapid expansion of international trade since 1978, there have been significant changes in the commodity composition of trade. During the early years of reform, between 1978 and 1980, the major changes in imports were in machinery, equipment and metals (to meet the demands of modernization) and in foodstuffs and consumer durables (to improve the level of consumption). With the stabilization policy of 1981, imports of machinery, equipment and metals were severely reduced while imports of foodstuffs and cereals continued to grow as agricultural reform had yet to yield major gains in production and the policy of improving consumption was retained.

Between 1983 and 1985, the structure of imports again shifted in favour of manufactured goods, particularly intermediate goods and machinery and equipment, owing to increased imports of those goods and substantially reduced imports of foodstuffs and agricultural raw materials. The share of primary and processed goods in total imports declined continuously from 40 per cent in 1982 to 12 per cent in 1985. The increase in imports of manufactured goods reflected a change in policy to promoting such imports after two years of severe trade restrictions, a rising trade surplus and excess domestic demand. The decline in imports of primary goods was the result of unprecedented growth in domestic grain and cotton output which enabled China to be a net exporter of these crops. The composition of China's exports has not changed significantly since 1978, except for a slight increase in the share of primary goods since 1983 because of the strong growth in exports of foodstuffs, live animals and crude oil.

The direction of trade changed significantly between 1978 and 1985, with a growing share of trade with developed market and developing economies and a corresponding decline in the share with centrally planned economies. This reflects a continuation of the trend that began in the early

1970s with China's renewed participation in the world economy. The shares of the planned economies in China's exports and imports in 1978 were 15 per cent and 13 per cent, respectively, but had declined to 10 per cent for both exports and imports by 1980. This decline continued through 1985, when the shares were 9 per cent for exports and 7 per cent for imports. The importance of imports from developed market economies in meeting domestic demand in China is emphasized by their share in total imports, which fluctuated around 70 per cent over the period 1978-1985.

### Medium-term plan for 1986-1990

The current plan emphasizes the importance of stabilizing the economy while continuing with the agenda of economic reform. Because of the priority placed on slowing down the growth of aggregate demand to mitigate rising inflation and shortages of materials and energy, growth targets were set at moderate levels compared with performance in the period 1981-1985. The current plan envisages a period of sustained annual growth of about 7 per cent and, by 1990, a reformed system of enterprise, pricing and finance that the central Government will be able to control effectively through both direct and indirect policies. In particular, the plan calls for the continuation of enterprise reform, while cautiously continuing further modifications of the economic system in the areas of pricing, finance and macro-economic planning and policies.<sup>62</sup>

Aggregate output growth targets have been set at 6.7 per cent, which is much lower than the almost 10 per cent annual growth for the period 1981-1985 (see table VI.7). This moderation was adopted in response to the immediate concern about easing domestic shortages in energy, transport, intermediate goods and consumer durables. The plan envisages a shift in the structure of production from the primary to the tertiary sector. By 1990, the proportion of output in the tertiary sector is to increase to 25 per cent, from 21 per cent in 1985, with a corresponding decline in the share of the primary sector to 27 per cent, from 32 per cent. The share of the secondary sector is expected to remain unchanged.

Among the main sectors, agriculture is planned to grow the slowest, at about 4 per cent a year. This is substantially less than that obtained since 1978, but comparable to the post-war trend. This plan target reflects the recognition that the immediate effect on productivity of the organizational reforms discussed above is wearing off and that future agricultural growth will require increasing investments and other inputs and improved organization of production and distribution. The plan also emphasizes the need to shift resources into the secondary and tertiary sectors, where productivity is higher. This will tend to compress the volume of incremental resources available to the traditional sectors.

Industrial output is planned to expand at an annual rate of 7.5 per cent, the rates for light and heavy industry being almost the same. Among light industries, consumer goods

<sup>61</sup> *The Asian Wall Street Journal Weekly*, 24 February 1986, p. 14.

<sup>62</sup> *Seventh Five-Year Plan for Economic and Social Development of the People's Republic of China (1986-1990): Excerpts*, chap. 1.

industries, in particular the processed foods, household appliances and textile and garment industries, are to be fostered to accommodate the increasing demand resulting from gains in personal income. The textile and garment industries are also expected to grow faster than average in order to promote these industries as one of the key sources of manufactured exports.

In heavy industry, policy discussions emphasize the need to bolster growth in basic sectors, such as energy and primary industrial inputs. Rapid growth in transportation is also stressed to ease bottle-necks. The expansion of production of raw and manufactured materials, such as timber, steel and chemical fertilizers, is also given particular attention. The policy discussions emphasize that, in order to meet the requirements of modernization, gross output of the machine-building and electronics industries needs to grow 8.5 per cent annually during the period 1986-1990. However, the level of technology that is scheduled to be attained by 1990 is expected to continue to be well below that of developed countries, in part because the increase in output and in imports of such goods is likely to continue to fall short of demand. Other sectors will be given less emphasis. In anticipation of a continued brisk pace of investment in productive capacity and housing, gross output of the construction industry is targeted to grow by 7 per cent a year in the same period.

Experience since 1978 suggests that the realization of these priorities will depend significantly on the ability of the central Government to control decentralized fixed investment and guide its sectoral allocation. The output of rural industries is planned to grow faster than the rest, as the policy of promoting rural industrialization remains in place. Service industries will grow most rapidly and priority will be given to the development of transport and communications, which remain bottle-necks in the economy. Commercial and personal service industries are also targeted to grow substantially, as they remain underdeveloped relative to the demands of the economy.

The distribution of output scheduled in the current medium-term plan does not differ significantly from the preceding plan. It is intended to raise consumption per capita by approximately 5 per cent, or total consumption by just over 6 per cent a year. This will mean a slower rate of improvement of levels of living than the growth of 8 to 9 per cent per capita since 1978. With rising incomes, there will be a shift in the pattern of consumption demand towards manufactured goods and it cannot be expected that this will be met by domestic production. However, owing to the need to regain balance in the external accounts, the excess domestic demand will probably not be met by imports in the short run. The growth in consumption will therefore be limited and, with continued efforts to curtail inflation, the excess demand will result in forced savings.

Investment is planned to account for an average of 30 per cent of domestic resource uses over the five-year period, about the same as that attained in 1981-1983, when invest-

ment growth was somewhat stabilized. The key to better control of investment will be the ability to control overall levels of extrabudgetary investment by enterprises and local government using retained funds, local taxes and bank credit. It is planned that about 60 per cent of total investment will be from the state budget, about two thirds of which is earmarked for priority industries. Because extrabudgetary investment tends to be made in heavy manufacturing, besides basic industries, its control is crucial to the achievement of overall sectoral investment priorities.

Control of fixed investment by indirect measures is being hampered by the incomplete reforms of the enterprise management system and of the overall financial system. The regulations issued in July 1986 to control fixed investment do not address the problems of the low cost of capital and the lack of financial accountability of enterprises,<sup>63</sup> but tend to rely on stricter administrative control over investment planning at local levels of government and on more rigorous requirements for obtaining working capital for new production units. An interest charge of 30 per cent on credit for unplanned investments was also instituted. More effective, flexible and permanent mechanisms for controlling investment are on the agenda for enterprise reform discussed below.

The planned annual growth in trade (8.1 per cent for exports and 6.1 per cent for imports) is below that of the 1981-1985 period and aims at reversing the foreign trade and payments deficits. The immediate focus of trade policy is to reduce the \$13 billion trade deficit of 1985. The ban on imports of consumer durables and automotive equipment appears likely to remain in effect through 1987. As yet, there are no indications that the recentralization measures taken with regard to the foreign trade system will be rescinded in the next five years. The 17 per cent devaluation declared in mid-1986 entails continued adjustment of domestic versus international prices. During the next five years, there will be selective imports in the areas of technology and production goods in short domestic supply, namely steel, chemical fertilizers, raw materials and fibres. The strategy to achieve the planned export growth includes the promotion of exports of manufactured goods, particularly textiles and other light manufactured goods. The collapse in world oil prices and continued weak markets for agricultural commodities have made it even more imperative for China to continue to place greater reliance on the growth of exports of manufactures.

Based on official policy discussions and recent developments, including trade agreements signed since 1985, a significant growth in trade with the USSR and the centrally planned economies of Eastern Europe can be expected during the period 1986-1990. Trade with developed market economies will likely grow steadily during that period in the absence of protectionist measures in these economies or a restriction of imports of machinery and equipment by China. With the decline in the value of oil exports from China to developed market economies and of grain imports by China from these countries, the composition of this dimension of China's trade can be expected to change further.

<sup>63</sup> *Renmin ribao* (Beijing), 24 July 1986, p. 1.

According to official statements, China expects to expand its utilization of international financial resources by promoting foreign direct investment and foreign credit. Barring dramatic changes in the environment for foreign investors, the bulk of growth is likely to be in loan capital rather than in foreign direct investment. Planned figures are not available but the amount of credit, including bonds, used in 1979-1985 was approximately \$20 billion. The amount for the current plan period will probably be significantly higher. In 1986, the utilization of foreign loans amounted to \$4.8 billion, an increase of 93 per cent over 1985.<sup>64</sup> This suggests that initially the Government was willing to raise its external debt — a major reversal of traditional policy — in order to finance imports needed for modernization and for the improvement of consumption, even if efforts to promote export growth fell short of target in the short run. However, recent policy modifications do not preclude a return to the traditional policy of balanced trade. If such a shift were to occur, China's demand for foreign loans could contract significantly.

### Continuation and extension of the economic reforms

The overall goal of reforms in 1986-1990 is the gradual transition from a centralized system to one that relies on a combination of direct controls and indirect economic instruments as guides for decision-making by individual economic agents. The plan emphasizes the gradual implementation of fundamental reforms of the system in the areas of prices, finance and macro-economic planning and policy co-ordination. These reforms will be instituted in the latter part of the plan period. In the first two years, continued reform of urban enterprise management and the urban wage and employment systems will be the focus. Based on the ongoing discussions on the annual plan for 1987,<sup>65</sup> the current pace of reform appears to be consistent with the medium-term plan and suggests some slowing down from the pace that was indicated in late 1986. Reports suggest that even the adoption as law of the centrepiece of enterprise reform — the "factory director responsibility system" — will be delayed.

As noted, urban enterprise reforms have yet to deal successfully with the lack of financial accountability and lack of autonomy of enterprises. These two factors remain major obstacles to the effective decentralization of decision-making in the urban sector. Reforms in the current plan will address these two issues, specifically by improving profit taxation, adopting legal procedures for bankruptcy, increasing the authority of enterprise directors and devolving control of the supply of inputs to the market and to individual enterprises.

The implementation of the new taxes proposed in 1983

remains to be completed. The new system has, thus far, been applied in a manner that does not link performance to after-tax profits effectively. Continuing reform will focus on strengthening the incentive effect of taxation. A law on bankruptcy of state-owned enterprises has been implemented on an experimental basis but has not yet been adopted as law.<sup>66</sup> It sets the conditions of bankruptcy and provides the legal framework for the disposal of state-owned assets for the settlement of debts, taxes and wages. It also provides for the possibility of legal action against leaders of a failed enterprise and their governmental supervisors.

The "factory director responsibility system", which has been phased in since 1985, provides the basis for granting factory managers more authority to enforce measures designed to improve productivity. Its success depends on the freeing of managers from extraneous interference. Resistance to the system has surfaced on two fronts: the centres of entrenched political and administrative control, whose powers are being eroded, and the workers, who object to the priority accorded to profits over wages and benefits. Supplementary regulations concerning this new system were issued in November 1986 in an attempt to separate the function and responsibilities of the factory director, party cadres and workers in an enterprise. According to these regulations, it appears that the authority of factory managers will be shared by party cadres and workers. This is expected to further the full-scale adoption of the system in the near future. However, ratification of proposed legislation to provide the legal framework for increased autonomy of factory directors has been stalled.<sup>67</sup>

Looser administrative allocation of materials will give enterprises greater control over the availability of needed inputs. More materials will be traded directly between enterprises, and prices will fluctuate according to supply and demand. Changes implemented in late 1986 include freeing above-quota output of rolled steel, chemicals and chemical fertilizers from controlled distribution.<sup>68</sup>

Modifications in the employment and wage systems in urban enterprises are an important component of central policy efforts to improve macro-economic control. They also have ramifications for enterprise autonomy. The objective of the reform of the employment system is to promote flexibility of labour markets, in some instances by permitting managers to dismiss workers. Under new regulations, all new employees of state-owned enterprises have been placed on fixed-term employment contracts, in most cases of a duration of up to five years,<sup>69</sup> effective from October 1986. They may be dismissed during the contract period if they do not fulfil performance requirements in the contract. At the end of the contract, the enterprise has the option to renew or to terminate the relationship. A recently instituted system of unem-

<sup>64</sup> *China Daily* (Beijing), 24 January 1987, p. 1.

<sup>65</sup> *Renmin ribao* (Beijing), 17 December 1986, p. 1, and *China Daily* (Beijing), 16 February 1987, p. 2.

<sup>66</sup> *Renmin ribao* (Beijing), 5 September 1986, p. 1, and *China Daily* (Beijing), 18 November 1986.

<sup>67</sup> *China Daily* (Beijing), 5 June 1986, p. 4, *ibid.*, 7 June 1986, p. 3, *Renmin ribao* (Beijing), 16 January 1987, p. 2, and *The New York Times*, 23 March 1987, p. 7.

<sup>68</sup> *China Daily* (Beijing), 21 October 1986, p. 2.

<sup>69</sup> *Renmin ribao* (Beijing), 9 October 1986, p. 2.

ployment insurance, with contributions from enterprises, will provide benefits for those workers who lose their jobs.<sup>70</sup> Improving linkages between performance and reward continues to be a key objective of wage reforms.<sup>71</sup> At present, wage scales remain centrally determined and total bonus payments by enterprises and job-promotion provisions are still subject to intervention at various levels of government. Despite these planned changes, the ability of enterprise directors to make rational decisions concerning employment, promotion and bonuses will hinge on the degree of autonomy that they eventually achieve.

One of the objectives of the ongoing reforms has been to improve the use of prices in the allocation of resources by shifting to a system that combines directive planning, guidance planning and market determination. This will entail reform of the pricing system to reflect supply and demand. It also calls for creating markets for commodities and services, such as technology, finance and labour. Prices of most consumer goods will be decontrolled over time and will be determined by supply and demand rather than by central fiat. The proportion of production goods subject to planned prices will be reduced, which is in line with the reforms implemented since 1978. These reforms have effectively decontrolled prices of some production goods, raw materials and agricultural commodities; but even planned prices will be adjusted to reflect market prices on an international basis.

The slow pace of progress with price changes reflects long-standing concern about the potential inflationary consequences. The 30 per cent increase in non-staple food prices and the sharp rise in the price of above-quota steel in 1985, after prices were decontrolled, have made that concern even more acute. In 1986, experimentation with further price reforms in the areas of consumer durables and textile materials continued. Enterprises have been allowed to raise or lower prices to widen the differential between goods of different quality and demand. In 1987, however, the priority appears to be price stability at the retail level.<sup>72</sup>

A critical component of measures to improve the effectiveness of indirect macro-economic policies is reform of the financial system. Financial reforms implemented since 1978 have given the banking system a much more active role in the creation of credit. However, the central bank still lacks the instruments necessary to control the money supply. Similarly, branches of specialized banks in industry, agriculture and foreign exchange have neither the autonomy nor the incentive to grant credit based on economic criteria; they are strongly influenced by local governments. The current medium-term plan envisages reforms that will place control over interest rates and reserve requirements at the disposal of central banks and that will reorganize specialized banks and other financial institutions into financially accountable enterprises carrying out their transactions in an economically rational manner.

## Conclusions

In comparison with previous medium-term and annual plans, the economic outlook for the second half of the 1980s that emerges from the new five-year plans is for a greater pace of growth of investment and output. All plans stress the need to have more expansion of capital formation than previously in order to accelerate modernization and foster gains in productivity. Emphasis in the preceding five-year plans was placed largely on rectifying external imbalances, moderating the growth of output in order to compress import demand and protecting attained levels of living. These objectives usually had to be modified in the light of developments during implementation.

Policy makers appear to have committed themselves to undertaking measurable structural changes by national efforts as well as, in the case of the CMEA members, at the level of intra-group institutions and policies. The new plans, particularly in Eastern Europe, still emphasize the priority of correcting the external sector, but do so largely through positive adjustment policies that envisage marked structural changes in the composition and quality of production, and the material and factor intensity of aggregate output. In addition, undertaking urgent changes in national and group-wide economic policies, institutions and policy instruments is an important component of most of the plans. Further decentralization of decision-making is to proceed by way of market-like instruments of indirect economic co-ordination and their supporting institutions. Greater enterprise autonomy and self-financing responsibilities may in time exert a positive effect on trade and other relations with market economies. Finally, more than before, the plans emphasize the importance of intensifying participation in international trade and finance. CMEA members may temporarily seek to enhance their group-wide ties more than their relations with developed and developing market economies in order to foster socialist economic integration. If successful, such efforts will in turn assist these countries in bolstering their export potential in global markets. Significant improvements in the environment for East-West economic relations and the wider participation of the centrally planned economies in international economic organizations are desirable components of the growing integration of these countries in global trading and financial networks.

As developments during the early phase of the current plan period have demonstrated already, more so than during any plan implementation phase prior to the 1980s, the five-year plans are being treated as policy blueprints that should be modified when circumstances require. The shifts in institutions and policies, as well as unforeseen developments in foreign markets, affected performance in 1986. On the whole, they have been weathered without losing sight of the key priorities in the development philosophy embedded in

<sup>70</sup> *Ibid.*

<sup>71</sup> See the interview with the Minister for Labour and Personnel in *Ban yue tan* (Beijing), No. 9, 10 May 1986, pp. 8-15, translated into English in Joint Publications Research Service, *China Report — Economic Affairs*, 16 July 1986, pp. 95-103.

<sup>72</sup> *Renmin ribao* (Beijing), 30 December 1986, p. 1.

the plans and, even more, in the ongoing policy discussions. Holding this course should permit these countries to modify their domestic economies, particularly if exogenous circumstances (including foreign trade and the weather) are at least average. Such measures are, in turn, bound to spill over into the foreign trade sphere, affecting also integration efforts within CMEA, later in the decade. There are also bound to be direct and indirect repercussions on trade with the market economies. Relations with these countries, however, remain

partly constrained by the fact that there continues to be a considerable mismatch between the products supplied by the planned economies and demand in third markets. A more growth-oriented combination of economic policies in key market economies and further relaxation of tension in East-West relations would provide the environment for the planned economies to have a more expansionary impact on the world economy.

## CHAPTER VII

### UNEMPLOYMENT IN DEVELOPED MARKET ECONOMIES: THE POLICY DILEMMAS

One of the major socio-economic problems of the developed market economies since the early 1970s has been the rising level of unemployment. There has been a steady upward drift in the number of unemployed and in their share in the total labour force. At the same time, marked differentials in unemployment levels by region, age group, sex and economic sector have emerged. Unemployment is a social and economic scourge at any time and, because of its sharp rise after a prolonged period of comparatively low unemployment, it might have been expected to become an acute policy concern in developed market economies. However, the high levels of unemployment in industrial countries in recent years have in most cases not dominated the political agenda

as much as lower unemployment did in the past: the reasons are not entirely clear. It may be widely believed that Governments cannot do much to reduce unemployment without touching off renewed inflation and balance-of-payments deficits. This chapter is largely addressed to precisely that issue.

Unemployment rates in all OECD countries combined<sup>1</sup> nearly tripled, from about 3 per cent in 1970 to about 8 per cent in 1986 (see table VII.1). Today the number of unemployed exceeds 29 million. The problem is particularly severe in Europe, where the unemployment rate rose from 2.5 per cent in 1970 to 11 per cent in 1986. The unemployed in

Table VII.1. Developed market economies: unemployment rates, 1970-1987<sup>a</sup>  
(Percentage of total labour force)

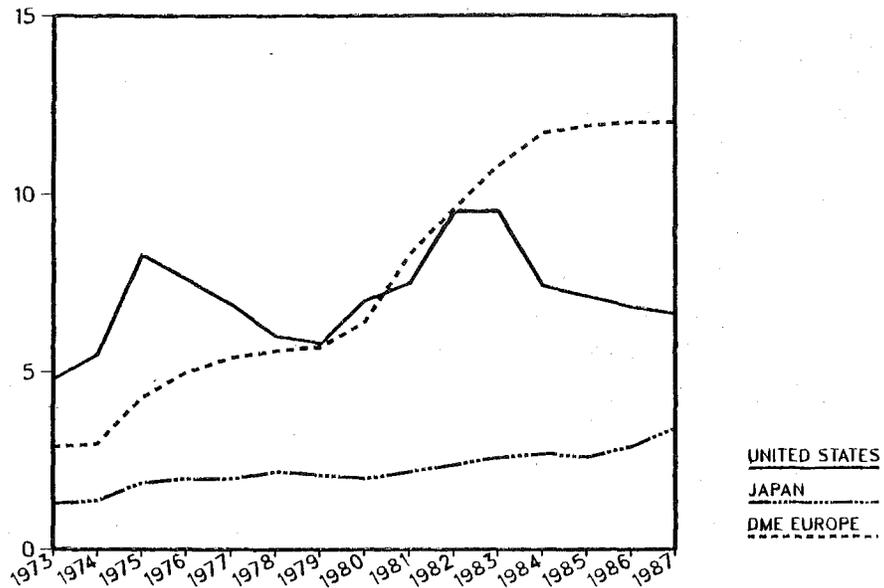
	1970	1975	1979	1982	1984	1985	1986 <sup>b</sup>	1987 <sup>c</sup>
Australia	1.6	4.8	6.2	7.1	8.9	8.2	7.6	7.6
Austria	1.4	1.7	2.1	3.5	3.8	3.5	3.4	3.6
Belgium	2.1	5.0	8.2	12.6	14.0	13.1	12.0	12.0
Canada	5.6	6.9	7.4	10.9	11.2	10.4	9.6	9.1
Denmark	0.7	4.9	6.0	11.0	8.5	7.6	7.2	7.9
Finland	1.9	2.2	5.9	5.8	6.1	6.2	7.2	7.5
France	2.4	4.0	5.9	8.1	9.7	10.1	10.4	11.1
Germany, Federal Republic of	0.8	3.6	3.2	6.1	8.5	8.6	8.2	7.9
Greece	4.2	2.3	1.9	5.8	8.1	8.4	8.7	9.4
Iceland	1.3	0.6	0.4	0.7	1.3	1.7	1.5	1.5
Ireland	5.8	7.3	7.1	11.4	15.5	16.8	17.3	17.3
Italy	5.3	5.8	7.6	9.0	10.2	10.5	10.7	10.9
Japan	1.1	1.9	2.1	2.4	2.7	2.6	2.9	3.4
Luxembourg	0.0	0.2	0.7	1.2	1.7	1.8	1.6	1.6
Netherlands	1.0	5.2	5.4	11.4	14.0	13.0	12.2	11.8
New Zealand	0.1	0.2	1.9	3.5	5.7	6.3	7.1	· ·
Norway	1.6	2.3	2.0	2.6	3.0	2.5	2.0	2.3
Portugal	2.5	4.4	8.0	7.3	8.9	8.6	8.6	8.6
Spain	2.4	3.6	8.5	15.8	20.0	21.4	21.0	20.8
Sweden	1.5	1.6	2.1	3.1	3.1	2.8	2.6	2.9
Switzerland	0.0	0.4	0.3	0.4	1.1	1.0	0.8	0.8
United Kingdom	3.0	4.3	5.1	11.4	13.0	13.2	13.3	13.0
United States	4.8	8.3	5.8	9.5	7.4	7.1	7.0	6.8
Western Europe <sup>d</sup>	2.5	4.1	5.4	8.9	10.8	11.0	11.0	11.0
Total <sup>d</sup>	3.0	5.1	4.9	7.9	8.1	8.0	8.0	8.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *Economic Outlook*, No. 40 (December 1986); and OECD, "Employment and unemployment: some issues and facts," paper prepared for the meeting of the Manpower and Social Affairs Committee, Paris, November, 1986.

- a Data for all countries except Denmark, Greece, Iceland, Ireland, Luxembourg, New Zealand and Portugal are standardized unemployment rates.
- b Estimates.
- c Extrapolations based on national definitions.
- d Based only on countries with standardized unemployment rates.

<sup>1</sup> Excluding Turkey, which is classified as a developing economy by the United Nations Secretariat.

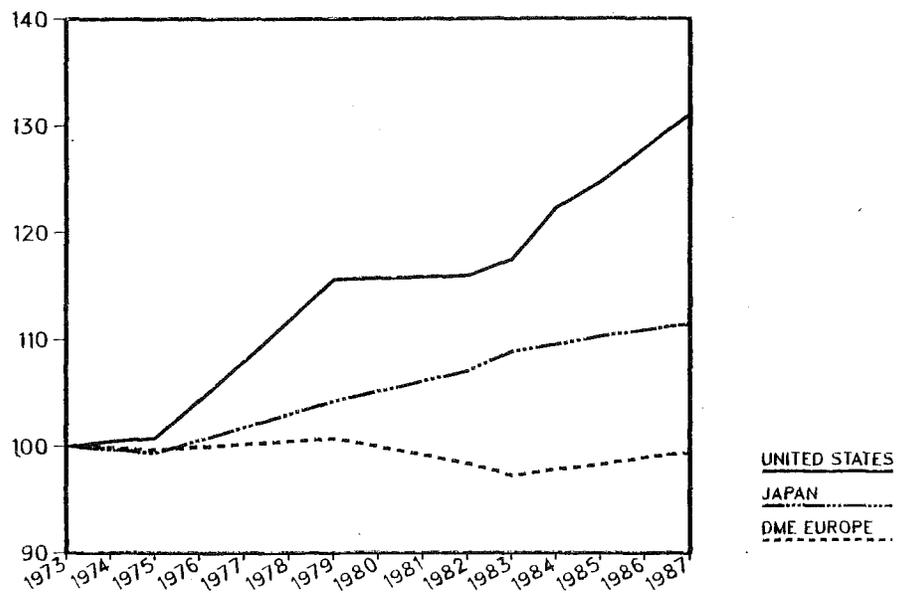
Figure VII.1. Selected developed market economies: standardized unemployment rates, 1973-1987  
(Percentage of total labour force)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on table VII.1 and OECD, *Economic Outlook*, No. 40 (December 1986).

Note: DME Europe refers to Belgium, France, the Federal Republic of Germany, Italy, the Netherlands, Spain and the United Kingdom of Great Britain and Northern Ireland.

Figure VII.2. Selected developed market economies: growth of employment, 1973-1987  
(1973 = 100)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *OECD Employment Outlook*, September 1986.

Note: DME Europe refers to all European countries members of OECD except Turkey.

Western Europe currently amount to some 17 million people. There are great variations among countries. Spain has the highest unemployment rate (21 per cent on a standardized basis) followed by Ireland. Japan, Luxembourg, Switzerland and some Scandinavian countries have held the unemployment rate below 3 per cent.

The United States of America lies between these extremes, although its unemployment rate too has fluctuated around a rising trend over the past decade and a half (see figure VII.1). In Western Europe, as the figure shows, there has been an upward ratcheting of unemployment, with joblessness rising in cyclical recessions (1974-1975 and 1980-1982) and cyclical recoveries (1976-1979 and 1983 to the present) too weak to improve the situation. This contrasts with the experience of the United States, where the cyclical recovery was sufficiently strong to bring unemployment rates down. From 1973 to 1987, net employment grew by 11 per cent in Japan and by 31 per cent in the United States (see figure VII.2). In Western Europe, few new jobs were created during that period. In the United States, there was a rapid expansion of part-time employment and lower paying jobs.

The unofficial or "underground" economy has grown in all developed market economies but more so in Western Europe than elsewhere. However, the share of the "second economy" on a value basis should not be exaggerated. Recent estimates put an upper bound of 4 per cent of GNP on that kind of activity in the more industrialized OECD countries, although the share for Southern European countries may be much higher.<sup>2</sup>

## Social and demographic aspects of unemployment

The unemployed are members of the labour force who want to work but cannot find a job. This group of people is in constant turnover, fed by new lay-offs or job seekers, but depleted by those who find jobs. The incidence and duration of unemployment in relation to specific social groups has also been changing in recent years. Two features stand out: the very high levels of unemployed young people and of the long-term unemployed, that is, those who are out of work for 12 months or more.

The combination of higher long-term and youth unemployment, especially in Western Europe, makes the social costs of labour market disequilibria particularly pervasive and debilitating. A large part of an entire Western European generation has been living with the prospect of not being able to obtain a full-time job with meaningful security. Without determined policy measures, the near-term prospects remain bleak. The persistence of high unemployment can only lead to further social unrest. The economic, psychological and social problems of the unemployed aged 50 or over are also prominent. Involuntary retirement and various incentive schemes favouring early retirement have, in many countries, reduced the reported number of unemployed people. But this group has to cope with unfilled personal and economic expectations at a time when longevity is on the increase and active life is prolonged.

Long-term unemployment, especially in Western Europe (see table VII.2), is in part due to structural adjustment,

Table VII.2. Selected developed market economies: long-term unemployment, 1982-1985  
(Percentage of total unemployment)

	1982		1983		1984		1985	
	Six months <sup>a</sup>	One year <sup>b</sup>	Six months	One year	Six months	One year	Six months	One year
Japan	33.1	14.9	33.8	15.5	37.6	15.2	..	..
United States	16.6	7.7	23.9	13.3	19.1	12.3	15.4	9.5
Selected Western European countries								
France	64.1	42.1	67.0	42.2	66.5	42.3	71.0	46.8
Germany, Federal Republic of	46.4	21.2	54.1	28.5	55.1	32.7	51.7	31.0
Italy	..	37.8	..	41.9	..	47.9	..	..
Spain	69.1	49.4	71.0	53.6	73.2	54.2	74.2	57.3
United Kingdom	54.7	33.6	58.1	36.5	60.2	39.8	60.4	41.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *OECD Employment Outlook*, September 1986, table K.

<sup>a</sup> Six months and over.

<sup>b</sup> Twelve months and over.

<sup>2</sup> The size of the Portuguese underground economy, for example, has been estimated at 11 per cent of GDP; see Bank of Portugal, *Quarterly Bulletin*, vol. 6, No.1, (March 1984), annex VII.

which is inevitably associated with some degree of mismatch between available labour skills and the changing pattern of demand and new technologies. In Belgium, France, Ireland, Italy, the Netherlands, Spain and the United Kingdom of Great Britain and Northern Ireland, over 40 per cent of the total are long-term unemployed. This is once again in contrast with the experience of the United States, where long-term unemployment has not exceeded 15 per cent of the total and the share fell by 4 percentage points from 1983 to 1985.

Two implications of long-term unemployment need to be highlighted. First, those who have been unemployed for a long time do not usually play any direct role in wage negotiations, unlike those out of a job for shorter periods.<sup>3</sup> In many cases, problems of the long-term unemployed do not even enter wage negotiations indirectly, through, for example, social contract or union negotiations. As a result, the employed, the "insiders", have a vested interest in seeking wage settlements that provide security for themselves. Since it has an important bearing on the nature of the trade-offs facing policy makers in combating unemployment, the potential policy implications of the "insider-outsider" problem are especially significant in Western Europe. Secondly, just as steady employment enhances the career prospects of job holders, so being out of work for a prolonged period of time diminishes the productivity, work opportunities and income-earning power of the workers affected.

Young adults have become victims of reduced entry-level recruitment opportunities. In such countries as Italy, where a high degree of job security is enjoyed by those in employment, the unemployment rate for youth is more than three times the country's overall average. The lack of training and work experience of unemployed young people makes many of them unsuitable even for low-paying and part-time jobs in the service sector in which some minimum skills are required, given the increased availability of married women, immigrants and others for such work.

Youth unemployment in Western Europe is nearly twice as high as in the United States and more than three times as high as in Japan (see table VII.3). For most European developed market economies youth unemployment exceeds 20 per cent. The comparatively low rate in the Federal Republic of Germany<sup>4</sup> is explained by the highly developed network of vocational training and apprenticeship programmes there.

High youth unemployment often engenders low motivation, poor achievement in schools, crime and the risk of riots, so that there is much interest in setting up training and job programmes for unemployed young people. With more job creation and training programmes in place, youth unemployment may slowly ease in Western Europe. Despite this, youth unemployment rates will probably remain above 20 per cent in Western Europe for the next few years.

There have been many attempts to explain the high rates of youth unemployment in industrial countries. Two factors have contributed significantly to it. One is demography: the large cohorts born in the immediate post-war period entered the labour force between the mid-1970s and late 1980s. This so-called "baby-boom" started later and lasted longer in some countries, notably the Federal Republic of Germany, Italy, Japan, Spain and the United Kingdom. The second factor is increased labour force participation of females, particularly those in the age group 20-24.

The drop in the cohorts entering the economically active population is likely to reduce youth unemployment in the next 10 to 15 years. Population growth will decline in the majority of the developed market economies, becoming virtually zero and possibly even negative in the Federal Republic of Germany, and growth in the age groups 15-19 and 20-24 will be lower than growth of total population in practically all these countries, in most cases even negative. The decline in the share of new cohorts in the active population in the next decade is especially marked in Western Europe.<sup>5</sup>

Except in Japan, labour force participation rates of females increased dramatically between 1970 and 1980. Since then, these rates have stabilized in most OECD countries. More than 50 per cent of the female population of working age now have a job outside the home, compared with about 30 per cent two decades ago. This demographic shift in the labour force is due in part to supply-side factors: efforts to supplement head-of-household incomes in the light of increasing expectations and declining purchasing power, anti-discrimination legislation, rising levels of education, the availability of appliances and conveniences that reduce household chores, and changing social norms (such as self-realization as a personal goal, later marriages, fewer children and higher divorce rates). On the demand side, in spite of equal-pay legislation, women can be hired more cheaply

<sup>3</sup> See O. Blanchard *et al.*, "Employment and growth in Europe: a two-handed approach", *Centre for European Policy Studies*, No. 21, May 1985; and R. Layard and S. Nickell, "The causes of British unemployment", *National Institute Economic Review*, February 1985.

<sup>4</sup> The Scandinavian countries for which data are available also have low youth unemployment (well below 10 per cent).

<sup>5</sup> Youth demographic pressure defined as age group 15-24 divided by 15-64 is as follows:

	1980	1985	1990
	(Percentage)		
France	24.8	23.3	22.3
Germany, Federal Republic of	24.2	23.5	19.5
Italy	23.6	23.6	22.5
Japan	20.5	20.8	21.9
Spain	25.7	25.9	25.2
United Kingdom	24.2	24.4	22.5
United States	28.4	25.1	21.8

Source: *World Population Prospects: Estimates and Projections as Assessed in 1984* (United Nations publication, Sales No. E.86.XIII.3). Thus, youth demographic pressure from the "baby-boomers" is expected to decline, except in Japan.

Table VII.3. Selected developed market economies: youth unemployment, 1984-1987<sup>a</sup>  
(Percentage of the total youth labour force)

	1984	1985	1986 <sup>b</sup>	1987 <sup>b</sup>
Japan	4.9	4.8	5.5	6.0
United States	13.3	13.0	12.5	12.0
Four major Western European countries <sup>c</sup>	21.6	21.7	21.5	21.3
France	24.4	25.6	25.8	26.5
Germany, Federal Republic of	9.9	9.5	8.3	7.0
Italy	33.4	33.7	35.5	37.0
Spain	44.5	43.6	43.8	42.3
United Kingdom	21.8	21.7	21.8	20.8

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *OECD Employment Outlook*, September 1986, table 10.

a The age group is 14-24 in Italy; 15-24 in France, the Federal Republic of Germany and Japan; and 16-24 in Spain, the United Kingdom and the United States.

b OECD estimates.

c France, the Federal Republic of Germany, Italy and the United Kingdom.

than men, in many countries. If working part-time, they qualify for fewer non-wage benefits. Thus, while more and more women are entering professions long dominated by men, including medicine and the law, and others continue to occupy jobs in the public sector, for example in teaching and nursing, most of them hold part-time, temporary or subcontracted jobs in the service sector.<sup>6</sup>

Many of these service sector enterprises have emerged in response to the needs of employed women and of an aging population. Lower pay, less job security and less social security protection mean that women carry a disproportionate share of the adjustment costs of structural change and increased labour market flexibility.

There has been a world-wide decline in the labour force participation rate of females and males in the 15-19 age group. This phenomenon chiefly reflects longer education, which delays entry into the labour force. Thereafter labour force participation rates increase, in particular for females in the age group 20-24.

Although female participation ratios may have stabilized in recent years, their impact on the unemployment situation and on the availability of new jobs is substantial. The share of women gaining access to new jobs is very high. For example, in the United States, where the employment situation has shown most progress, some 73 per cent of the extra jobs created since 1979 have been taken by women. In the other six largest OECD economies, employment of women has risen by 7 per cent, while that of men has fallen by 2 per cent.

The declining pressures from new cohorts and greater female participation point to less labour supply pressure.

However, these expected developments also give rise to a problem of a different nature: the aging of the labour force and an increasing old-age dependency ratio. An older labour force may exhibit less flexibility and obsolescence of skills. Rising old-age dependency burdens may cause new structural problems, such as increased regional immobility of an aging labour force. Company pension plans, for instance, are hard to transfer from one employer to another; older workers are therefore averse to changing jobs and thus the job market becomes less flexible.<sup>7</sup> Housing and unemployment benefits, however, are the two factors that most seriously constrain labour mobility.

### Income claims and unemployment

During the 1970s, real labour costs increased in most of the OECD countries. This was due not only to wage increases but to such benefits as improved severance conditions, social security, and locational and pension provisions. With regard to the labour incomes of those already employed, offsetting and even over-compensating for inflation took precedence over adjustment to slower productivity growth and deterioration in the terms of trade. Relatively high minimum wages, union pressures, high social security, unemployment compensation and severance pay, and wage indexation policies served to reduce real pay differentials. It also led to rising unemployment, particularly among young people and the active population aged 50 and above, and to the export of some manufacturing jobs to regions or countries with less expensive labour resources. Since 1982, however, this has changed somewhat.

<sup>6</sup> Many women are self-employed. In the United Kingdom, for example, the number of self-employed women has increased three times as fast as the number of self-employed men since 1980. They provide jobs for others. Forty per cent of the self-employed in the United Kingdom are employers themselves.

<sup>7</sup> While accounting for between a third and a half of old-age benefits in Australia, the United Kingdom and the United States, private pension schemes are negligible in some other countries, such as France and the Netherlands.

The pressures to keep real wages from rising come from various sources. Competitiveness is a key criterion. Faced with the choice of reducing costs or closing down, many firms adopted a firmer stance on wages.<sup>8</sup> Employers hoped that slower wage rises would improve corporate cash flows, profits and competitiveness. With real labour costs growing at or below the rate of labour productivity, competitiveness is likely to improve, thereby eliminating any tendency towards a net export of jobs from trade. Governments also viewed wage containment as essential to bring inflation under control and to keep employment and output up.<sup>9</sup> Labour unions have also had a role in keeping wages from growing at previous rates. In situations where the power of trade unions is on the decline,<sup>10</sup> many unions have opted for improved job security for their members in exchange for wage concessions. In a few cases, average wages have been reduced through the negotiation of two-tier agreements whereby new workers are hired at lower wages in return for improvements in pay and benefits for existing employees.

Although real unit wage costs have declined in many countries, employers have often preferred to economize on labour despite declining labour-to-capital factor costs. Whatever labour has been added has been part-time, temporary or subcontracted employment.<sup>11</sup> Employers have also sought to make more efficient use of their existing workers by introducing more elastic working hours that permit more intensive use of their plants and easier adjustment to shifts in demand.

Although precise, internationally comparable data through 1986 are not readily available, the evidence suggests that profit shares and rates of return on capital in major developed market economies, particularly in the Federal Republic of Germany and the United States, began to rise sharply after the second oil shock. Thus, the profit share in manufacturing in the United States and in four major Western European countries (France, the Federal Republic of Germany, Italy and the United Kingdom) hovered around 26-28 per cent in the period 1975-1978, and subsequently dropped to just over 20 per cent in the United States and to just over 25 per cent in Western Europe in 1980-1982. From then on, however, profit shares in manufacturing and the rate of return on capital have risen steadily. Profit shares are at present above the levels observed in the 1960s, particularly in the United States. In 1985, for example, profit shares were 31-32 per cent in those same Western European countries and the United States, compared with 31 per cent in Western Europe and 26 per cent in the United States in 1972. In the Federal Republic of Germany the share of net wages and salaries, including voluntary fringe benefits,

amounted to 38 per cent of national income in 1985, compared with 44 per cent in 1975 and 42 per cent in 1980.

Macro-economic policy makers expected this gain in corporate profits to stimulate investments and thereby expand demand for labour sufficiently to re-employ a significant share of workers laid off earlier and to absorb new entrants into the labour force. This has happened in only some countries, notably the United States. But even there, labour has not been able to reclaim its share in aggregate resources. Those laid off temporarily had to settle for lower paying new jobs and many of the new jobs were available only on a part-time, temporary or subcontracting basis. In most other developed market economies, there has been a continuing rise in the unemployment rate.

Although unemployment rates in Europe have apparently stabilized, the prospects of a large increase in employment levels are not very encouraging. There have now been 16 quarters of uninterrupted growth, yet no overall reduction in the unemployment rate is in sight. Certainly, jobs have been created in most developed market economies, but at a rate that has usually been slower than the rate of growth of the labour force. As a result, unemployment, particularly among young people, has remained very high. Recent experience shows that, on balance, slow growth does not create jobs.

The fact that employment was not boosted by real wage cuts lingers over some of the critical policy dilemmas in developed market economies. Policy makers in most European countries are still reluctant to engage in policies aimed at expanding demand. This reluctance is based on the expectation that stimulating aggregate demand would chiefly translate into higher, and possibly accelerating, rates of price inflation. Though there would also be a positive impact on output and employment from the demand stimulus, this is believed to be rather small. If demand does not drive up inflation, it is expected to spill over into imports and produce a current account deficit that may be difficult to finance at prevailing exchange and interest rates. Depreciation of the currency would again aggravate inflationary pressures and might lead to a reversal of the macro-economic policy stance, weakening the credibility of policy makers. These policy dilemmas play an important role in explaining the persistence of high unemployment in developed market economies.

The structure of labour markets, is therefore an important determinant of the policy stance on employment. Job prospects are in part a function of labour market regulations, mobility of the labour force, both among and within sectors

<sup>8</sup> In the United States, airlines, railroads, meatpackers, and steel are some of the industries that have renegotiated wages downwards or have resorted to a two-tier system to hold on to their markets.

<sup>9</sup> In France the indexation of wages was stopped in an effort to reduce inflation. In other countries, real minimum wages were allowed to be eroded by inflation; centralized bargaining was de-emphasized, as in Sweden, in the hope that more competitive wages could be obtained through decentralized negotiations; profit-sharing arrangements for workers have been encouraged.

<sup>10</sup> For example, trade union membership declined in the United States by nearly 14 per cent during 1980-1984, despite a 5.4 per cent increase in jobs.

<sup>11</sup> The net result is that big established firms and industries are no longer creating many jobs. In Canada, for example, employment in the 100 largest companies fell by 10 per cent between 1981 and 1984.

as well as within different regions or countries, and real wage rigidity. These factors can combine to price labour out of the market and raise unemployment. Rather than seeking to stimulate demand, economic policy could usefully be aimed first at curbing rigidities in the labour market. It should be remembered, however, that what may be rigidities from the policy point of view, may in fact represent much valued security for those affected. An appropriate balance must be sought between security for those employed and flexibility to help the unemployed.

As noted, labour market rigidities rose substantially in the 1970s, though there has been a marked increase in the degree of flexibility of labour markets in recent years. A critical policy question, therefore, is whether the functioning of labour markets has improved sufficiently to allow a reduction in unemployment without risking more inflation or external imbalances. An associated question is whether the risks at the national level might be mitigated by co-ordinating macro-economic policies among key actors in the international economy. These issues are explored in greater depth below for seven developed market economies (Japan, the United States and the five largest Western European economies, namely France, the Federal Republic of Germany, Italy, Spain and the United Kingdom).

In comparing these economies, perhaps the single most surprising contrast is that whereas employment growth has been stagnant in Western Europe and has risen strongly in the United States (see figure VII.2), average annual GNP growth rates from 1973 to 1987 have been approximately the same. The explanation is that the growth of output per person employed has been lower in the United States (0.5 per cent from 1973 to 1987) than in Western Europe (2 per cent) or Japan (3 per cent).

Though greater labour intensity of output helps to expand employment at a time of slow GNP growth, low productivity is not a solution. Higher labour productivity and, indeed, substitution away from labour in response to higher real wages stemming from productivity growth are at the heart of the economic development process. It is for this reason that the slow-down in productivity growth, which began two decades ago in most developed market economies, has been worrisome. The reason for this decline is not fully understood. The exhaustion of the shift of labourers from low productivity agriculture to high productivity manufacturing and the continuing movement towards the service sector, which has traditionally been viewed as having lower productivity growth than manufacturing activities may, in part, underlie the decline. It may also help to explain why labour productivity in the United States has been growing more slowly than in Japan or Western Europe. A general drop in total factor productivity since 1973, owing to slack demand and a rise in unused resources has also been suggested as a cause of the decline in labour productivity.<sup>12</sup>

Whatever the reason, the paradox is that the technological

potential for productivity increases and employment growth today is great. Labour productivity has certainly been increasing rapidly in the electronics industry, in particular in the fields of micro-electronics, computerization, robotics and communication technology, which have been leading the way in the "information revolution". Employment growth in these branches has been brisk to the extent that some firms have had difficulties in filling their vacancies. Unemployment is concentrated in the "sunset" industries, for example textiles, steel, ship-building and coal-mining. How to come to grips with the structural adjustments that are called for by these productivity differentials, with a minimum of unemployment and other dislocations, remains a major task of macro-economic policy.

Rapid technological change brings about severe dislocations and adjustment problems. Such change might therefore be considered a prime candidate for explaining persistent unemployment. However, this type of structural change does not lead to a direct macro-economic trade-off or policy dilemma. Instead, technological change conditions the very nature of the trade-off between price stability and employment because it affects the economic evaluation of labour and output itself. Trying to hold on to jobs that have become unproductive owing to technological change aggravates the misallocation of resources and results in losses for society as a whole.

### Macro-economic causes of unemployment

Although they can offer only partial insights, important policy implications can be derived from an assessment of the significance of competing theories that explain unemployment at specific points in time or in particular countries. With this aim in mind, three principal explanations of unemployment are reviewed below. The two traditional macro-economic explanations of unemployment focus on insufficient aggregate demand and rigid labour costs in aggregate supply. These are rather static rationalizations of the policy trade-offs involved. One dynamic explanation, the hysteresis hypothesis, has recently been offered: the past history of unemployment is an important conditioning factor of future unemployment and hence of future policy trade-offs.

### Classical unemployment

Neo-classical analysts maintain that unemployment stems from rigidities in labour markets. In other words, mass unemployment stems primarily from excessively high real wages and related non-wage labour costs.

The neo-classical approach suggests that expansionary ag-

<sup>12</sup> For a discussion of the productivity slow-down, see *Economic Survey of Europe in 1985-1986* (United Nations publication, Sales No. E.86.II.E.1), sects. 1.2 and 2.10.

gregate demand policies would not create employment, but would instead raise inflation. The appropriate policy response, according to this framework, is to foster greater wage flexibility and wage differentials and moderate non-wage labour costs, and reduce restrictions in labour markets. For a given capital stock and other non-labour factor inputs, unemployment would tend to decline because the real cost of labour relative to that of other factors of production shrinks. Together with other conditions for higher profit, such as low and stable inflation, this approach predicts faster capital stock accumulation in the medium term, therefore improving prospects for employment. This appears to have been a major consideration in recent policy stances in key developed market economies, as discussed above.

Putting it somewhat more technically, the neo-classical approach argues that a large part of the unemployment problem in developed market economies can be explained by unwarranted real wages that do not adjust when an adverse aggregate supply shock occurs, such as a jump in oil prices. At the prevailing real wage, the demand for labour would then fall. The difference between the actual real wage and the real wage warranted in order to clear the labour market (i.e., the real wage that would maintain full employment) is known as the real wage gap. The larger the wage gap, the more unemployment there is likely to be. A correlation between high unemployment and high real wage gaps, therefore, might be taken as evidence of the existence of classical unemployment.

Unfortunately, the warranted real wage level cannot be observed and different empirical specifications of the real wage gap yield different measurements. None the less, the majority of investigations support the view that real wage gaps are an important factor in explaining the rise of unemployment in Western Europe in the 1970s.<sup>13</sup> As an illustration of these findings, table VII.4 presents estimates of the real wage rate gap. This gap is here defined as the difference between the actual rate of growth of real wages and the rate of growth of labour productivity, which is taken as a proxy for the growth of warranted wages.<sup>14</sup> The estimates are presented in the form of a graph in figure VII.3, which clearly

shows that Western Europe did experience large real wage rate gaps in comparison with the United States in the 1970s. By the 1980s, however, the gap in Western Europe had turned negative, indicating a substantial easing of real wages relative to productivity growth.<sup>15</sup> This decline in the growth of real wages seems to have been followed by non-wage labour costs.<sup>16</sup>

The most striking feature about figure VII.3 is that Japan, which has not had a major unemployment problem until very recently, has the largest real wage rate gap. The reason has been the subject of much speculation. One explanation is that Japan has a high degree of real wage flexibility, meaning that for any given initial gap, Japan is well equipped to sustain adverse supply shocks without significant employment loss.<sup>17</sup> Table VII.4 lends support to this view since it shows that Japan has had the fastest deceleration of real wages among the major developed market economies. This finding can also be confirmed by recent measures of real wage rigidity, which are shown in table VII.5.

The measures of real wage rigidity in table VII.5 are derived from econometric estimations of the increase in unemployment that would be needed to offset a 1 per cent rise in real wages in the short or the long run (the Phillips curve). The long-run estimates measure the total rise in unemployment. The short-run measures ignore the lagged effects on unemployment of a rise in real wages. Therefore a lower coefficient, meaning that a 1 per cent change in real wages would bring forth a "low" percentage increase in unemployment, implies greater flexibility.

As shown in table VII.5, Japan has the highest degree of real wage flexibility in both the short and the long run.<sup>18</sup> The United States has a high degree of flexibility in the short run. This stems largely from nominal wage inertia. As nominal wage contracts are rewritten and as the total effect of a rise in prices makes itself felt, however, the United States economy loses much of its flexibility. Indeed, in approximately four years, both the United States and Western Europe appear to show a substantial amount of rigidity. The Federal Republic of Germany on the other hand seems to be an exception since, according to the estimates, it shows a high

<sup>13</sup> See OECD, *Flexibility in the Labour Market, 1986* (Paris, 1986), for a review of the empirical evidence on the role of real labour costs.

<sup>14</sup> A better proxy of the warranted real wage would leave unit labour costs unchanged and initially clear the labour market at full employment.

<sup>15</sup> The actual wage level gap in the manufacturing sector in Western Europe has fallen below that recorded in the United States as of 1984 (see R. Gordon, "Productivity, wages and prices inside and outside of manufacturing in the U.S., Japan and Europe", *National Bureau of Economic Research Working Paper Series*, No. 2070, November 1986).

<sup>16</sup> Since the late 1970s, non-wage labour costs as a proportion of total labour costs have stabilized or fallen in most Western European economies, though not in the Federal Republic of Germany; the average proportions in Western Europe, however, are substantially higher than those in either Japan or the United States (see *OECD Employment Outlook*, September 1986, table 29).

<sup>17</sup> See C. Adams *et al.*, "Differences in employment behaviour among industrial countries", *Staff Studies for the World Economic Outlook* (Washington, D.C., IMF, July 1986). However, other research contends that if the income share of labour is redefined to include household entrepreneurial income with employee compensation, it virtually erases major differences among real wage gaps in Western Europe, Japan and the United States at the aggregate level (see R. Gordon, *loc. cit.*, for details).

<sup>18</sup> These estimates of real wage rigidity should be viewed with caution since they are derived from Phillips curves, which are sensitive to specification and the period of estimation. The results shown here, however, do accord with the estimates presented in the third column of table VII.5 which are derived from a different methodology, using a simple structural macro-economic model of the labour market. In particular, the Federal Republic of Germany and Japan continue to display greater flexibility than the other selected Western European countries or the United States. The estimates in the third column of the table are reported as long-run wage elasticities in C. Bean, P. Layard and S. Nickell, "The rise in unemployment: a multi-country study", *Economica*, Supplement 1986, vol. 53, No. 210(s), and are inverted in the table.

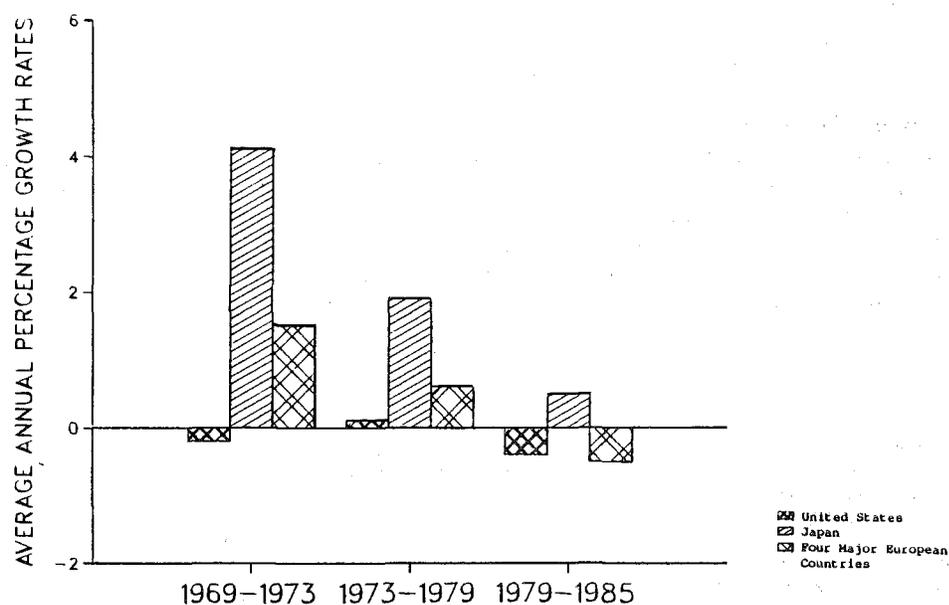
Table VII.4. Selected developed market economies: real wage rate gap,  
1969-1985  
(Average annual percentage growth rates)

	Real wages <sup>a</sup>	Labour productivity <sup>b</sup>	Gap <sup>c</sup>	Real wage acceleration <sup>d</sup>
<b>Japan</b>				
1969-1973	11.1	7.0	4.1	..
1973-1979	4.9	3.0	1.9	-6.2
1979-1985	3.6	3.1	0.5	-1.3
<b>United States</b>				
1969-1973	1.4	1.6	-0.2	..
1973-1979	0.3	0.2	0.1	-1.1
1979-1985	0.1	0.5	-0.4	-0.2
<b>Four major Western European countries</b>				
1969-1973	5.6	4.1	1.5	..
1973-1979	2.7	2.1	0.6	-2.9
1979-1985	1.0	1.5	-0.5	-1.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, "Employment and unemployment: some issues and facts," paper prepared for the meeting of the Manpower and Social Affairs Committee, Paris, November 1986.

- a Rate of growth of real wages per person employed.
- b Rate of growth of labour productivity per man.
- c Difference between the first and second columns.
- d Difference over time in the first column.

Figure VII.3. Selected developed market economies: real wage rate gap<sup>a</sup>,  
1969-1985



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data in table VII.4.

- a Real wages less labour productivity.

Table VII.5. Selected developed market economies: estimates of real wage rigidity, 1967-1983

	Short-run	Long-run	
	Coe and Gagliardi	Coe and Gagliardi	Bean, Layard and Nickell <sup>a</sup>
Japan	0.24	0.24	0.94
United States	0.67	3.06	2.08
Selected Western European countries			
France	1.52	3.03	1.61
Germany, Federal Republic of	0.58	0.61	1.15
Italy	0.80	1.62	2.63
Spain	2.18	..	..
United Kingdom	1.94	5.82	1.59

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on D. Coe and F. Gagliardi, "Nominal wage determination in ten OECD countries", *OECD Working Paper*, No. 19, March 1985, table 12; and C. R. Bean, P. R. G. Layard and S. J. Nickell, "The rise in unemployment: a multi-country study", *Economica*, Supplement 1986, vol. 53, No. 210(s), tables 3 and 5. The short-run indicator for Spain is from J. Viñals, "Fiscal policy and the current account", *Economic Policy*, No. 3, October 1986.

<sup>a</sup> Measuring the decrease in employment needed to lower the rate of growth of real wages by 1 percentage point.

degree of flexibility in both the short and the long run.<sup>19</sup>

These estimates suggest that real labour costs play a role in determining employment outcomes in developed market economies. The evidence is strongest for the 1970s, when real wage gaps (in terms of both levels and rates) were highest. Real wage flexibility also seems to matter in avoiding unemployment following adverse aggregate supply shocks. Japan and possibly the Federal Republic of Germany have a high degree of real wage flexibility in both the short and the long run.

### Keynesian unemployment

The analyses underlying table VII.5, which confirm the importance of real wages for unemployment, are unanimous in concluding that other factors are also at work.<sup>20</sup> Among these factors, aggregate demand is particularly important. This is the main message of Keynesian analysis, which holds that high unemployment is due to insufficient aggregate demand. Expansionary macro-economic demand policies would therefore increase output and employment.

Developed market economies have been buffeted by con-

tractionary aggregate demand shocks in the 1980s. Some were intended. For example, in a bid to lower inflation rates, most Western European countries and Japan matched the tight monetary policies of the United States in the early 1980s. Japan and Western European countries (especially the Federal Republic of Germany and the United Kingdom) also engaged in prolonged fiscal tightening. Since 1982, however, the United States has followed a strongly expansionary fiscal policy (see table VII.6). As shown in figure VII.1, the United States managed to lower its rate of unemployment after 1982. The fact that the United States was able to do this at a time when unemployment rates were rising modestly in Japan and increasing rapidly in Western Europe points to the significance of an expansionary aggregate demand policy in reducing high levels of unemployment.

Aggregate demand outside developed market economies has also been weak in the 1980s, imparting a further contractionary effect world-wide. In the main, this has been due to import compression in both developing and centrally planned economies. While the reasons for import compression vary greatly, the international debt overhang and the decline in primary commodity prices have been principal factors.

<sup>19</sup> Allowance has been made for the effect of productivity growth on German nominal wages; without this correction, the Federal Republic of Germany exhibits a high degree of real wage rigidity (see D. Coe and F. Gagliardi, "Nominal wage determination in ten OECD economies", *OECD Working Paper*, No. 19, March 1985).

<sup>20</sup> In addition to the references cited in table VII.5 see, for example, J. McCallum, "Unemployment in OECD countries in the 1980s", *The Economic Journal*, No. 96, December 1986; M. Bruno, "Aggregate supply and demand factors in OECD unemployment: an update", *Economica*, Supplement 1986, vol. 53, No. 210(s); J. J. Dolado *et al.*, "Spanish industrial unemployment: some explanatory factors", *Economica*, Supplement 1986, vol. 53, No. 210(s); and O. Blanchard *et al.*, *op. cit.*

## Hysteresis

While in theory it is easy to distinguish between unemployment stemming from insufficient demand or rigid labour supply régimes, in practice the highly complex relationships among economic variables blur the distinction. One type of unemployment régime might also give way to another. Thus, deflationary demand policies might turn classical into Keynesian unemployment. A prolonged period of Keynesian unemployment might, in turn, give rise to classical unemployment. This could happen if depressed investment spending led to a reduction in labour productivity and real wages did not fall, thereby generating unemployment. For most countries, therefore, neither demand nor supply policies will be likely to resolve the unemployment problem unless they are well co-ordinated. Moreover, the dynamic interaction between unemployment and inflation is not adequately captured by either explanation.

The trade-off between unemployment and inflation can change for many reasons. One explanation that has attracted much attention recently is the hysteresis hypothesis, which

draws attention to the importance of the past history of unemployment for the "natural" rate of unemployment. The presence of hysteresis may be ascertained by tracing the unemployment that results from the structural characteristics of an economy (the "natural" rate). At the natural rate, the labour market is said to be in equilibrium since it does not exert inflationary pressure. This definition has evolved into a doctrine of its own, known as the natural rate hypothesis, according to which there is no long-run trade-off between inflation and unemployment. Given a sufficiently long time horizon and the absence of money illusion, an economy is assumed to naturally tend to gravitate back to the full-employment or natural level. Consequently, disinflationary policies will lead to no additional unemployment in the long run. A lower rate of inflation and a temporary loss of output and employment would be the only outcomes.

Although the natural rate hypothesis appears to have been accepted in the formulation of policy in most developed market economies, unemployment rates in many of these countries, especially in Western Europe, are now much higher than was considered normal in the past. In addition,

Table VII.6. Selected developed market economies: change in the inflation-adjusted structural budget balance, 1984-1987<sup>a</sup>  
(Percentage of nominal GNP/GDP)

	1984	1985	1986 <sup>b</sup>	1987 <sup>b</sup>	
Japan	1.1	0.6	-0.1	0.2	
United States	-0.5	-0.8	-0.4	1.2	
Selected Western European countries					
France	0.3	0.5	-0.8	0.2	
Germany, Federal Republic of	0.1	0.5	-0.8	-0.1	
Italy	-3.5	-1.9	-1.3	-1.8	
Spain	0.4	-0.9	1.2	-0.4	
United Kingdom	-0.8	0.7	-1.2	-0.5	
Total, developed market economies	-0.2	-0.3	-0.4	0.4	
Memorandum item:					
Fiscal deficit (-) as a percentage of nominal GNP					
	1983	1984	1985	1986	1987
Germany, Federal Republic of	-2.5	-1.9	-1.1	-1.0	-0.9
Japan	-3.7	-2.2	-1.4	-1.5	-1.4
United States	-3.8	-2.7	-3.4	-3.4	-2.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *Economic Outlook*, No. 40 (December 1986), tables 4 and 5.

a General government financial balances. A minus sign indicates a demand impulse.

b OECD estimates

c Average of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, Spain, Sweden, the United Kingdom and the United States.

inflation rates in most of these countries seem to have stabilized at low levels and are projected to remain stable in the coming years (see chap. II above). These facts can be interpreted in two different ways.<sup>21</sup> They are consistent with the natural rate hypothesis if the adjustment mechanism is assumed to be weak and slow acting. Alternatively, there may be a tendency for the natural rate to follow the path of the actual unemployment rate, that is, there is hysteresis.

The natural rate of unemployment is unobservable. An analogous and measurable concept is the rate of unemployment at which wage inflation remains constant. This is the "non-accelerating inflation rate of unemployment" (NAIRU).<sup>22</sup> Table VII.7 reports some recent NAIRU estimates. These data show that the rate of unemployment at

which no wage inflation occurs has been moving up in France, the Federal Republic of Germany, Spain and the United Kingdom. In most cases, the actual rate of unemployment has also been well above the NAIRUs in the 1980s. Given the imprecise nature of such calculations, these observations should be viewed with caution. None the less, the alternative estimates that are available suggest that the NAIRUs have tended to increase over time and that they have been below actual unemployment rates especially in the 1980s. As a rough approximation, then, these estimates do lend support to the hypothesis that past unemployment affects the natural rate of unemployment, that is, there has been hysteresis during the 1980s.

There are several explanations of hysteresis effects. Three

Table VII.7. Selected developed market economies: NAIRU estimates<sup>a</sup>  
(Percentage growth rates)

	Time period	NAIRU	Actual unemployment rate
Japan	1971-1976	1.3	1.5
	1977-1982	2.5	2.2
	1983-1987	2.5	2.8
United States	1971-1976	5.4	6.3
	1977-1982	5.7	7.2
	1983-1987	6.0	7.6
Selected Western European countries			
France	1971-1976	0.0	2.5
	1977-1982	4.3	6.3
	1983-1987	6.0	10.1
Germany, Federal Republic of	1971-1976	1.1	2.1
	1977-1982	3.1	4.2
	1983-1987	6.0	8.0
Italy	1971-1976	7.6	5.9
	1977-1982	7.0	7.8
	1983-1987	7.3	10.7
Spain	1966-1972	0.9	0.9
	1973-1979	7.0	3.4
	1980-1984	11.3	11.4
United Kingdom	1976-1975	4.2	3.0
	1976-1980	7.6	5.4
	1981-1983	9.4	10.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *OECD Economic Outlook*, No. 40 (December 1986), table 16; for Spain, J. Dolado *et al.*, "Spanish industrial unemployment: some explanatory factors", *Economica*, Supplement 1986, vol. 53, No. 210(s); and for the United Kingdom, D. Coe and F. Gagliardi, "Nominal wage determination in ten OECD economies", *OECD Working Paper*, No. 19, March 1985, table 11, column 2.

<sup>a</sup> NAIRU estimates use the average rate of growth of import prices over the estimation period of the wage equation.

<sup>21</sup> See D. Coe, "Hysteresis effects in aggregate wage equations" (Paris, OECD, October 1986).

<sup>22</sup> The NAIRU is not strictly analogous to the natural rate in an open economy since changes in import prices may offset the full effect of wage inflation on the overall rate of inflation.

structural features that may be affected by a path of high unemployment are the stock of physical capital, the stock of human capital and the distinction between “insiders” and “outsiders” in the labour market.

First, entrepreneurial aversion to capital formation may result from high unemployment which depresses sales expectations. Lower potential capital formation, in turn, leads to lower output and therefore to a rise in the natural rate of unemployment.

Second, human skills are acquired through education and job experience. A prolonged bout of unemployment might then lead to the decay of human capital and to a worsening of the probability of finding a job. As a result, the natural rate tends to rise. Other things being equal, the more long-term unemployment there is, the more important this second channel is likely to be.

Third, hysteresis may arise from the wage-bargaining process.<sup>23</sup> In its simplest formulation, the argument is that those who take part in wage negotiations are principally concerned with their own real wages and job security. As adverse shocks occur and unemployment mounts in the economy, those that remain “inside” renegotiate their wages to preserve their employment, in effect excluding those that have become “outsiders”. In this case, real wages tend to be too high to allow employment for those who are outside the negotiating process. A rise in the natural rate is the outcome.

There may be other reasons why the natural rate of unemployment depends on the past rate. Indeed, the theoretical possibility of hysteresis is largely uncontroversial. But verifying its empirical significance and actual magnitude is a different matter, for which broad tests are only now being conducted. Preliminary studies indicate, however, that significant hysteresis effects “would have major implications for demand management and labour market policies”.<sup>24</sup> The implied policy dilemmas therefore must be faced for there appears to be a real risk that the trade-off between unemployment and inflation may worsen.

### Policy dilemmas

Recent reports on the unemployment problem have focused on the need to combine supply-side measures with demand expansion. How these measures might be co-ordinated, however, is not completely clear. In particular, the threat of accelerating prices lurks in the background. Table VII.7 embodies this central dilemma of policy makers. The

NAIRU has been moving up. Lowering inflation would therefore seem to require more unemployment.

The actual rate of unemployment in the 1980s has generally exceeded the NAIRU, however, which suggests that there is some scope for following expansionary aggregate demand policies without incurring more inflation. Moreover, if expansionary policies are not followed, the natural rate will tend to move up towards the actual rate of unemployment in accordance with the hysteresis hypothesis. If this effect is dominant, it will worsen the future trade-off between inflation and unemployment.

It might then appear that there is no policy dilemma if either the actual rate of unemployment is above the NAIRU or if hysteresis effects are dominant. Clearly, if only hysteresis effects are behind the rise in unemployment, then there is no unique long-run NAIRU. In such an environment, policy makers can bring down the unemployment rate to any level with stable inflation, at least in the long run. If deflationary policies are pursued instead, inflation rates would decrease and eventually stabilize at a higher permanent rate of unemployment.

As noted above, there is mounting evidence that the long-term unemployed do not play any significant role in the wage-determination process. The evidence is strongest for Western European economies, especially the United Kingdom.<sup>25</sup> This weakens the downward pressure on inflation that might be expected to arise from a given rate of unemployment, and is consistent with a rise in the natural rate of unemployment due to hysteresis effects operating through either the second (human capital) or third (insider-outsider) channels mentioned in the preceding section. An uncontroversial but important macro-economic policy implication that follows is that employment programmes should be aimed at reducing long-term unemployment. For any given level of unemployment, this will tend to lower inflationary wage pressure since the long-term unemployed are likely to be more receptive to flexible wage conditions than those who are only temporarily unemployed (i.e., for less than six months).

As the actual rate of unemployment has been far above the NAIRU in most developed market economies, there would appear to be scope for an aggregate demand expansion that would lower unemployment with a minimum of inflation. However, in the first place, NAIRU estimates must be viewed with caution because they are difficult to measure.<sup>26</sup> In order to determine the precise scope for a demand expansion, additional information is also required, particularly on country-specific aspects of aggregate supply.

<sup>23</sup> See O. Blanchard and L. Summers, “Hysteresis and the European unemployment problem”, *National Bureau of Economic Research Working Paper*, No. 1950, June 1986, in which an “insider-outsider” model has been constructed, which shows that employment, in the presence of shocks, follows a process similar to a random walk. In such a setting, employment and unemployment do not converge at the pre-shock equilibrium but are instead determined by the history of shocks.

<sup>24</sup> *OECD Economic Outlook*, No. 40 (December 1986), p. 35.

<sup>25</sup> See the references cited in note 3. In addition, the OECD’s most recent and preferred specification of the nominal wage equation for the United Kingdom incorporates hysteresis; as a result, no long-run relationship between the level of unemployment and wage inflation is detectable and a NAIRU cannot be calculated [see *OECD Economic Outlook*, No. 40 (December 1986)].

<sup>26</sup> They are based on price and wage equations that are sensitive to specification and to the period of estimation.

Secondly, even if the natural rate of unemployment is well below the actual rate, policy makers may still decide not to seek to close the gap for fear of encountering balance-of-payments difficulties. If such difficulties arise, depreciation may be required, which would exacerbate inflationary pressure. That this is a real possibility even for a large country seeking unilateral demand-led expansion was vividly illustrated in 1982 in the case of France. To combat unemployment, it is crucial that macro-economic policies be co-ordinated across countries.

### Scope for demand policies

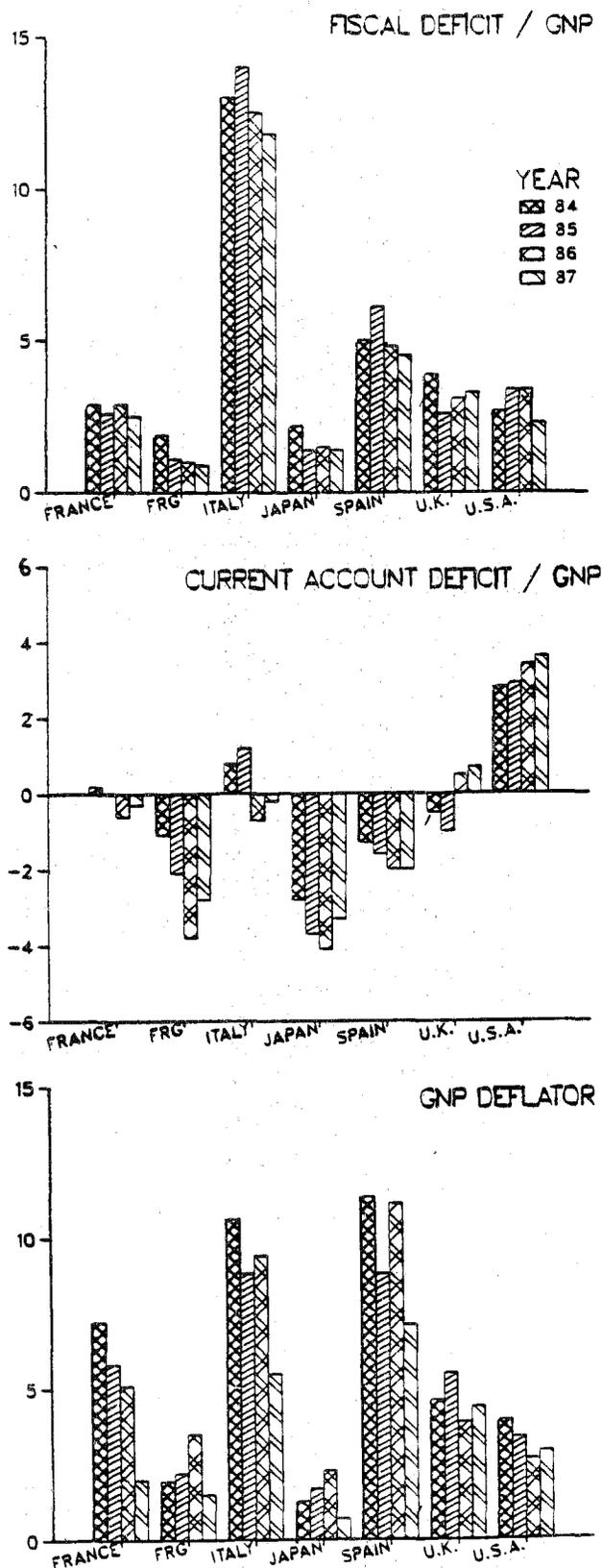
The growth of both real wages and non-wage labour costs in the 1980s has been slowing down in most developed market economies. In fact, the trend of real wages relative to average labour productivity has been downwards. If this declining trend in real labour costs continues, which would not rule out increases in real wages, it will eventually price labour back into jobs. The important questions, then, are whether current cost trends can continue and how long it will take before a significant dent in unemployment can be made.

A concept closely related to the cost of labour is the degree of flexibility of the labour market. The more flexible the market, the more likely that labour market disequilibria will not spillover into unemployment. The evidence on real wage rigidity reported above indicates that the degree of flexibility of the labour markets in the United States is about the same as that found in Western Europe. These economies have similar degrees of long-run real wage rigidity. In fact, the economies that appear to be most flexible in both the short and the long run are the Federal Republic of Germany and especially Japan. So long as these traits can be preserved, or possibly improved upon, both countries are well placed to engage in expansionary demand policies.

Broadly similar conclusions can be reached in a different way by considering progress in reaching principal objectives of macro-economic policy. For example, policy makers in most developed market economies have been pre-occupied with reducing inflation and fiscal deficits since the late 1970s; more recently, the need to lower current account imbalances has received a great deal of attention. While there is no unique way to measure progress towards these goals, and indeed other goals might be considered as well, one possible yardstick can be built upon the basis of these three target variables and their desired values. Thus, Governments might desire balanced budgets and current accounts and a zero rate of inflation. These targets would change over different phases of the business cycle and capacity utilization, and in the presence of shocks such as oil price jumps. There may even be asymmetrical evaluation of surpluses and deficits of equal normalized values. But progress towards attaining these objectives is surely in the purview of policy makers.

Figure VII.4 shows the magnitudes of the budget and current account deficits relative to gross national product as well as gross national product deflators. The higher the val-

Figure VII.4. Selected developed market economies: key macro-economic indicators, 1984-1987



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

ues of these magnitudes, other things remaining equal, the smaller the room for policy manoeuvre. Conversely, the closer to zero these magnitudes are the greater the degree of manoeuvrability. Whether large budget and current account surpluses are evaluated as offering more room for manoeuvre depends on the subjective preferences of policy makers. But it might be conjectured that progress in eliminating fiscal deficits in combination with current account surpluses should provide added room for expanding demand.

The indicators in figure VII.4 suggest, first, that Japan and especially the Federal Republic of Germany have relatively more room for pursuing expansionary aggregate demand policies. Secondly, France has recuperated greatly from the condition that forced it to reverse policy in 1983, and its present room for manoeuvre is higher. Thirdly, both the United Kingdom and the United States have less room for manoeuvre. In the case of the United Kingdom, the deterioration compared with the position in 1986 stems from an expected pick-up in inflation (by about 1 percentage point) and continued deterioration of the current account from virtual balance to a deficit equivalent to 0.8 per cent of gross domestic product. Fourthly, neither Italy nor Spain have much room for manoeuvre although, on current policies, a move towards fiscal consolidation and lower inflation is detected in both countries in 1987.

It should be clear that these indicators have nothing to say about aggregate supply conditions, which do matter in determining the scope for aggregate demand expansion. But the economies with the greatest degree of real wage flexibility also seem to have achieved significant progress towards stabilization.

### Role of international co-ordination

The data in figure VII.4 also show that the scope for demand expansion depends on factors that are not fully subject to national control. This is especially the case for current account imbalances, which in turn partly depend on exchange rates and the fiscal stances of large countries. Thus, until mid-1985, real depreciation of Western European currencies *vis-à-vis* the United States dollar added to inflationary pressure and contributed to a slower decline in inflation rates in Western Europe than in the United States. This may help to explain why most Western European Governments were reluctant to engage in expansionary demand policies at that time and instead followed contractionary macro-economic policies. These policies helped to slow down inflation, which was a major objective of policy, but at a considerable cost in terms of unemployment.

With the recent decline in the value of the dollar and in oil prices, Western European countries as a group will be able to engage in expansionary policies without as great an inflationary risk as before. Individual countries in Western Europe would face balance-of-payments difficulties if they attempted expansionary policies in isolation, but figure

VII.4 indicates that there is some potential for a fruitful collaborative effort. For example, France and the Federal Republic of Germany could engage in expansionary policies with little loss between them, whether in terms of departures from stabilization objectives or in terms of leakages outside their national boundaries, since they are each other's major trading partners.

This potential for co-ordination of expansionary demand policy among Western European countries has been explored recently by the European Economic Community,<sup>27</sup> as examined in chapter II above. This co-operative strategy aims at lowering the rate of unemployment of the group by 4 percentage points by 1990. The key ingredients of the strategy are faster growth through joint supply and demand actions under conditions of monetary stability. The supply-side measures include continued efforts at lowering real labour costs through a slowing of social security contributions. The demand-side actions incorporate reductions in direct taxation on households and increased levels of public investment. Fiscal policy, therefore, has a major responsibility in achieving the co-operative strategy of the Community.

This is a promising strategy in the medium term, but its success is by no means guaranteed. Among other factors, it is contingent on a sustained decline in the general government fiscal deficit of the United States and on annual growth in Japan of slightly under 4 per cent. A wider effort to co-ordinate policies should therefore be pursued.

### Conclusion

There is a need to combine aggregate supply measures with demand expansion to reduce unemployment in developed market economies. Improvements in aggregate supply conditions and notably in the functioning of labour markets are central to restoring full employment. Considerable progress has been made in this regard, but a continuation of the recent trend is still necessary.

An aggregate demand stimulus is also needed to lower high rates of unemployment. Because some countries have relatively greater room for manoeuvre, they are in a better position than others to lead in an expansion of demand. Given slow growth and high unemployment, it is very likely that expansion by these countries would be at least partly matched by a stimulus from other developed market economies. Such initiatives would help to provide a badly needed boost to a depressed world economy. Moreover, the likelihood that these countries might encounter serious balance-of-payments difficulties or rekindle rapid inflation is currently quite small.

Reluctance on the part of policy makers to engage in expansionary aggregate demand policies is acting as a drag not only on world economic growth but also on the employment prospects of the developed market economies.

<sup>27</sup> See Commission of the European Communities, *Annual Economic Report 1986-1987* (Brussels, October 1986).

## CHAPTER VIII

### THE FAST-GROWING DEVELOPING COUNTRIES OF THE 1980s

The rates of economic growth of the developing countries have diverged widely in recent years. Some countries have achieved high rates of growth while others have stagnated or have suffered an actual decline in income. The divergence of growth rates is, of course, not a new phenomenon. What has given the question added importance is the sharp deceleration of growth of the developing countries as a whole during the 1980s and the international environment in which it took place. At a time when a large number of these economies have been stagnating or declining, quite a few showed an impressive growth record. The present chapter examines the growth experience of 13 developing countries and territories and one planned economy with some major developing country characteristics (China) which had high rates of growth of GDP during the period 1981-1985, and seeks to identify factors that might have contributed to their relative success.

Why some countries do better than others has often been debated among economists and policy makers. The crucial role of various factors in long-term economic development has been much discussed and there is a certain amount of agreement on what some of these factors are.

The focus of attention in this chapter is, however, the rate of economic growth of selected countries over a relatively short period of time, namely, 1981-1985, and not on factors generally conducive to long-term economic growth. The idea is not to propound a theory of economic growth but to examine the circumstances under which some of the developing economies have recently done well compared with the rest. These circumstances were extremely varied and included domestic factors, as well as the external economic environment and, in some cases, even fortuitous developments.

The factors selected as possible explanations of growth of the fast-growing countries during the period are meant to reflect their structure of production and trade, initial conditions, domestic priorities and policies, as well as changes in the external economic environment. They are discussed under the following headings: share of agriculture in GDP and growth of agricultural production; export orientation of the economy; macro-economic performance; import capacity and growth of exports; and adverse external environment.

The approach used here for examination of the growth experience of the developing countries compares, for each of the above factors, the average experience of the fast-

growing countries with that of the other developing countries which have not fared well during the period 1981-1985. The methodology used is not meant to quantify the relative importance of the various factors in the explanation of growth differentials.<sup>1</sup> It nevertheless sheds light on the difference between the sample group of fast-growing and other developing countries in respect of each of the factors selected as explanatory variables.

The fast-growing countries are defined as those which had an average growth rate of GDP of 4.5 per cent or more and a per capita GDP growth of over 2.5 per cent during the period. The countries have been divided into net energy importers and net energy exporters and, for the purpose of comparison, other developing countries have been similarly grouped. The 14 fast-growing countries and territories so defined are, in alphabetic order: Burma, Cameroon, China, Congo, Hong Kong, India, Malaysia, Oman, Pakistan, Republic of Korea, Singapore, Sri Lanka, Thailand, and Turkey.<sup>2</sup>

It would, of course, be futile to look for explanations of high-growth performance that are valid for all countries. The importance of individual factors underlying the growth performance varies greatly from country to country. The growth of agricultural output does not have the same significance for Singapore as for China. Neither does external trade have the same importance for India as for the Republic of Korea. Nevertheless, a number of factors emerge from the analysis as significant in suggesting why these countries in general have fared better than other developing countries. At the same time, the experience of the high-growth countries themselves has been diverse. Such diversity should caution against any sweeping generalization or prescription for sustained growth which is applicable to all cases and circumstances.

It should also be pointed out that economic growth does not depend on economic factors alone. Social and political turmoil and armed conflict, perhaps perhaps more than anything else, have been responsible for poor economic performance in many countries in recent years. It should also be stressed that the choice of growth performance for investigation does not imply approbation of growth in preference to other policy objectives. Sometimes the record of social progress of individual countries has not matched their growth performance. To focus on growth is not to deny the importance of other national objectives such as equity and human rights.

<sup>1</sup> Such quantification would require the use of models, which would be much more complex than a decomposition exercise used, for example, in examining the effects of external shocks of balance of payments (see, for example, Edmar L. Bacha, "External shocks and growth prospects: the case of Brazil, 1973-89", *World Development*, vol. 14, No. 8, 1986). It also requires a separate examination for each country. Such tasks have been considered too ambitious for the present purpose.

<sup>2</sup> The rate of economic growth of the province of Taiwan has been one of the highest in the world but has not been considered here.

### The shrinking number of “success stories”

A striking fact about the countries which achieved high rates of growth during the 1980s is how few they are. Out of a sample of over 80 countries for which at least some of the relevant data are available only 14 could be classified as fast-growing during the first half of the 1980s. By contrast, 32 countries were fast-growers during the 1970s (table VIII.1).

For most developing countries, the rate of economic growth has fluctuated greatly. It has often come in a short burst of high growth followed by a period of stagnation or decline. As the table shows, “success stories” have often soured, and countries with poor economic performance in one period have achieved higher rates of growth in the next. Many of the success cases of the 1970s, including Brazil, Colombia, Cote d’Ivoire, Mexico, and the Philippines, have

experienced only slow growth or decline in income during the first half of the 1980s. Only rarely has a country achieved high and stable economic growth over a substantial period of time. For the majority of the developing countries, the basis of sustained economic growth thus remains fragile. Even among the fast-growing countries selected here, there was a sharp deceleration of growth in 1986 in a number of cases, namely, Burma, Congo, Malaysia, Oman and Singapore.

That all the countries in Latin America have disappeared from the list of fast-growing developing economies and only two from the African continent remain on it is due to the pervasive nature of the external shocks of the 1980s. At the same time, the geographic distribution of the high-growth countries points to important features of their economies which distinguish those economies from others.

Table VIII.1. The changing number of success stories

Countries considered high-growth in 1971–1980 but low-growth in 1981–1985 <sup>a</sup>	Countries considered high-growth in 1981–1985 but low-growth in 1971–1980 <sup>b</sup>	Countries considered high-growth in both periods
Algeria	Burma	China
Brazil	Cameroon	Hong Kong
Colombia	Congo	Malaysia
Costa Rica	India	Oman
Cote d’Ivoire	Sri Lanka	Pakistan
Dominican Republic	Turkey	Republic of Korea
Ecuador		Singapore
Egypt		Thailand
Guatemala		
Indonesia		
Jordan		
Kenya		
Libyan Arab Jamahiriya		
Malta		
Mexico		
Nigeria		
Paraguay		
Philippines		
Qatar		
Saudi Arabia		
Syrian Arab Republic		
Tunisia		
United Arab Emirates		
Yugoslavia		

<sup>a</sup> Countries with a GDP growth of 5.5 per cent or more during the period 1971–1980 but below 4.5 per cent during 1981–1985. (A lower growth rate was selected as a cut-off point for the 1980s because of the deceleration in the overall rate of growth in the world economy.)

<sup>b</sup> Countries with a GDP growth of 4.5 per cent or more during the period 1981–1985 but less than 5.5 per cent during 1971–1980.

### The share of agriculture in GDP and growth of agricultural output

Declining world prices of agricultural commodities during the first half of the 1980s certainly had an impact on real

agricultural income and GDP through changes in terms of trade. The influence of movements in terms of trade will be discussed later. It may be noted at the outset, however, that agricultural production for domestic consumption constitutes, on the average, about 65 per cent of total agricultural output of the developing countries.<sup>3</sup> For some of the largest

<sup>3</sup> Based on 1980 data for 50 developing countries (simple average). For the fast-growing countries, the proportion was much lower (about 17 per cent).

developing countries, the proportion is much higher. A large proportion of the agricultural sector of those economies is thus relatively unaffected by international price changes, although individual countries are vulnerable to them.

There is no indispensable relationship between the growth of agriculture and the growth of GDP. But, given the relative importance of agriculture in the gross domestic product of the developing economies, and the fact that agro-industry

constitutes a large share of manufacturing output, efforts to increase agricultural production naturally may be expected to have contributed to the overall performance of the fast-growing countries. However, the role of agriculture varies greatly.

On the average, the importance of agriculture in the fast-growing energy-importing countries is not very different from that in the other energy importers (table VIII.2).<sup>4</sup>

Table VIII.2. Growth of GDP, share of agriculture in GDP and growth of agricultural output

	Annual growth of GDP (Percentage)		Share of agriculture in GDP (Percentage)	Growth of agricultural output (Annual rates, percentage)	
	1981-1985	1986		1976-1980	1981-1985
Fast-growing countries					
Net energy importers:					
Republic of Korea	7.0	12.0	16	0.4	2.4
Pakistan	6.4	7.0	31	3.1	3.8
Singapore	6.1	1.5	1	..	..
Hong Kong	5.9	7.0	1	..	..
Burma	5.9	3.5	46	3.6	6.2
Thailand	5.3	4.0	25	2.9	3.8
Sri Lanka	5.0	3.5	28	4.8	4.0
India	4.6	4.0	37	1.5	4.0
Turkey	4.6	5.9	23	1.7	2.1
Mean	5.7	5.4	23	2.6	3.8
Net energy exporters:					
Oman	12.7	3.2	..	..	..
Cameroon	5.9	5.5	32	0.3	2.1
Congo	5.6	-8.0	12	1.8	1.2
Malaysia	5.0	0.5	24	2.8	3.3
Mean	7.3	0.3	23	1.6	2.2
China	9.5 <sup>a</sup>	7.0 <sup>a</sup>	31	7.4	8.1
Mean of other developing countries:					
Net energy importers	0.5	2.1	32	1.6	2.0
Net energy exporters	-0.9	-0.9	14	1.2	3.1

Source: For GDP growth, Department of International Economic and Social Affairs of the United Nations Secretariat. Agricultural data are from the Food and Agricultural Organization of the United Nations and national sources. Data on share of agriculture in GDP are from the World Bank, *World Development Report* 1982.

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

Countries with a large share of agriculture in GDP appeared to be as likely to grow as those with a small share. The average share of agriculture in GDP was 23 per cent among the former (29 per cent excluding Hong Kong and Singapore) and 32 per cent among the latter in 1980. Within the fast-growing countries, there is a large difference in the share of

agriculture: Singapore and Hong Kong have practically no agricultural base, while in Burma the sector accounted for 46 per cent of GDP. There was an inverse but rather weak correlation between those shares and the rates of growth of GDP among the fast-growing countries.

<sup>4</sup> Since the idea is to compare the individual experience of the fast-growing countries, and not the fast-growing countries as a whole, with the other developing countries, a simple rather than a weighted average has been used, except in table VIII.6.

Among the net energy-exporting countries other than Oman, which achieved high rates of growth, the importance of agriculture is about the same (23 per cent of GDP) as in the net energy importers but substantially higher than in the other energy-exporting countries. Both Cameroon and Malaysia have a large agricultural sector and were thus less dependent on oil than other oil-producing countries. They also did not neglect agriculture despite their oil abundance. In Oman and the Congo oil production overshadows other primary and secondary sectors. Oman had already experienced a sharp deceleration of growth and the Congo a decline in GDP in 1986 as a result of a very large drop in oil prices.

A much sharper contrast between the high-growth countries and other developing countries arises in the growth of agricultural production. Over the period 1981-1985, agricultural output among the fast-growing energy importers increased by about 4 per cent, compared to 2 per cent for the other developing countries in the group. Furthermore, the difference in growth rates was higher during this period than during 1976-1980.

A notable aspect of agricultural growth in the fast-growing energy-importing countries is that, apart from Hong Kong and Singapore, the growth was higher than the average for the other developing countries in practically all the countries in the group, including those where agriculture accounted for only a small proportion of GDP. Since agriculture constituted a large segment of the economy in the majority of the countries in the group, the growth of GDP was crucially dependent on increase in agricultural output. In Burma, India, Pakistan, Sri Lanka and Thailand the growth of agriculture played a large part in the overall performance. To a lesser extent, this is also true of Malaysia. In China, the growth of the economy depended very much on a phenomenal increase in agricultural production.

The basis of increase in agricultural output in these countries, especially in Asia, was the importance attached to agriculture in their long-term development policy, with its emphasis on the use of modern inputs and investment in infrastructure, especially irrigation.

A notable success of the agricultural policies of the South and South-East Asian countries has been the diffusion of new high-yielding varieties. By the late 1970s, modern rice varieties covered between 50 and 80 per cent of the cultivated land in China, Indonesia, Pakistan, the Philippines and Sri Lanka, and modern wheat varieties accounted for two thirds of the total wheat area in India. Such diffusion was made possible by a large extension of the area under irrigation, which increased by 40 per cent its share of the total agricultural land between 1966 and 1982, and by the use of modern fertilizers, the consumption of which in 1982 was four times the 1966 level in South Asia and six times in South-East Asia. Mainly as a result of such policies, the

level of self-sufficiency increased significantly in many countries of the region. China, which had been a food importer during the 1970s, became more than self-sufficient during the 1980s, Indonesia became self-sufficient in rice by 1984, and India had surplus wheat production in 1985.<sup>5</sup>

The success of the Green Revolution in Asia had led many to ask whether the same policies could be extended to other areas, in particular to Africa. Unfortunately, the moisture levels required for high-yielding varieties of cereals are not met in most of Africa. Most of the continent's water resources are not in areas where aridity limits production or, when they are, their development is too costly to be directed at the cultivation of staple food crops. According to an FAO evaluation,<sup>6</sup> for instance, the development of modern irrigation in Africa, with full water control, tends to cost two or three times as much as in India. Climatic considerations are, however, only part of the story.

A broad comparison of public investment in agriculture and price policies at a regional level between the developing countries of Africa, Asia and Latin America sheds light on the difference in performance. An FAO survey of public expenditure in agriculture in a sample of developing countries gives some comparative data for the period 1978-1982.<sup>7</sup>

The share of public expenditure devoted to agriculture can be taken as an indication of the priority given to agriculture. A significant point emerging from the FAO survey is the larger number of countries in Asia which have allocated a high share of public expenditure to agriculture. The analysis of the growth of public expenditure in agriculture also shows that African countries had often failed to increase planned agricultural expenditure. In 11 of the 21 African countries covered in the survey, planned agricultural expenditure declined over the period 1978-1982. In Latin America too, agricultural expenditure declined in real terms in many countries. In Asia and the Pacific, on the other hand, of the eight countries in the survey, only the Philippines showed a decline in real terms and five of the eight had growth rates of more than 10 per cent. Malaysia and Sri Lanka increased public expenditure in agriculture by more than 15 per cent a year.

Developing countries' agricultural price policies have been the subject of intense debate. However, there is general agreement that in many third world countries both the macro-economic and sectoral policies have often resulted in disincentives to agricultural production.

In particular, price policies have often made producer prices too low, resulting in underproduction. According to an FAO study,<sup>8</sup> there is clear evidence that price policies during the period from 1969-1971 to 1981-1983 were less favourable to farmers in Africa than in other developing regions. This was particularly true of export crops, and was attributable to government policy. As for producer prices of

<sup>5</sup> World Bank, *World Development Report*, 1986.

<sup>6</sup> FAO, *African Agriculture: The Next 25 Years*, Rome, 1986.

<sup>7</sup> FAO, *Public Expenditure on Agriculture in Developing Countries, 1978-88*, Rome, 1984.

<sup>8</sup> FAO, *African Agriculture: The Next 25 Years*

cereals between 1969-1971 and 1981-1983, they grew in real terms over the entire period by only 3 per cent in Africa compared with 18 per cent in Asia, 23 per cent in the Middle East and 30 per cent in Latin America. It should be pointed out, however, that agricultural pricing policies in Africa are already changing.

Sustained growth of production also depends on the success in reducing the vulnerability of agriculture to the vagaries of nature. The experience of the sub-Saharan African countries during the 1980s is a case in point. In the case of many South and South-East Asian countries, an essential achievement of the policy mix pursued in the agricultural sector has been the increased resilience of agricultural production to drought conditions. In India, agricultural development policies contributed to the relative stability of food grain production in the face of variable weather.<sup>9</sup> Similarly, the vulnerability of paddy production in Sri Lanka was significantly reduced by the increased use of modern inputs.

### Export orientation of the economy

The growth of an economy in a difficult international economic situation would depend both on the degree of its orientation to international trade and on its ability to adjust to the changing external environment. An economy which exports or imports little can pursue domestic policies with a high degree of independence of the external economic situation. The question is whether the fast-growing countries of the 1980s were relatively insulated from the international economy.

The high-growth energy-importing countries were, on the average, actually more export-oriented than other developing countries in this category. The share of exports in GDP in the fast-growing countries was about 41 per cent in 1980 compared to 20 per cent for the other energy-importing economies (table VIII.3). However, the degree of export

Table VIII.3. Export orientation of the economy

	Exports as percentage of GDP (1980)	Exports of manu- factures as percentage of total exports (1980)	Exports of manufactures as percentage of GDP (1980)
Fast-growing countries			
Net energy importers:			
Republic of Korea	30	90	27
Pakistan	9	48	4
Singapore	171 (115)	48	82
Hong Kong	98 ( 65)	92	90
Burma	8	—	—
Thailand	19	36	7
Sri Lanka	25	19	5
India	5	59	3
Turkey	5	27	1
Mean	41 ( 31)	47	24
Net energy exporters:			
Oman	67	3	2
Cameroon	16	5	1
Congo	56	7	4
Malaysia	54	29	16
Mean	49	11	6
China	6	47	3
Mean of other developing countries:			
Net energy importers	20	22	4
Net energy exporters	35	9	3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on the 1984 *International Trade Statistics Yearbook* (United Nations publications, Sales No. E/F.86.XVII.7). Data for Hong Kong were derived from *Commodity Trade Statistics, 1980* (ST/ESA/STAT/SER.D/87-3). Re-exports for Singapore were calculated from the *Yearbook of Statistics, Singapore, 1980/81*.

Note: Figures within parentheses exclude re-exports of Singapore and Hong Kong.

<sup>9</sup> World Bank, *World Development Report, 1986*.

orientation differed greatly within those countries: the export/GDP ratio was less than 10 per cent for Burma, India, Pakistan and Turkey, 30 per cent for the Republic of Korea and more than 90 per cent for Hong Kong and Singapore. Apparently, within the group, economies with the lowest export/GDP ratio were as likely to grow fast, as the most export-oriented ones. The figures for Hong Kong and Singapore are particularly high, partly because of the importance of re-exports in their total exports. However, even after correcting for re-exports, the figures remain much higher than for other countries.

More significant than the degree of export orientation is its nature. For countries relying mainly on export of primary commodities the world demand for which is stagnant and whose prices have been declining during the 1980s, export orientation implies a low or negative growth impulse from their exposure to the world economy, while for those countries exporting manufactures, in which trade has been increasing, it means a positive contribution to growth. Since world trade in commodities in general has weakened during the 1980s while trade in manufactures has been expanding, though at a slower rate than before, the distinction is crucial.

For the fast-growing energy-importing countries, the importance of manufactures in exports was much larger than for the other energy importers. On the average, 47 per cent of these countries' exports were manufactures compared with 22 per cent for the other countries in the category. Expressing exports of manufactures as a proportion of GDP, the difference between the fast-growing countries, on the average, and the other countries becomes even more pronounced. For the fast-growing energy importers, exports of manufactures constituted, on the average, 24 per cent of their GDP, as against 4 per cent for other energy-importing countries. This difference is a reflection of a difference in both the structure of the economies and degree of their outward-looking orientation. Again, there is a wide difference among the fast-growing economies themselves. But, apart from Burma, most of these countries have substantial exports of manufactures.

The energy-exporting countries' dependence on exports is of course much greater than for the energy importers. Since the world market for oil was depressed for much of the period and exports of the energy exporters as a whole declined, the fast growth of some of them calls for an explanation. None of the fast-growing countries is a member of OPEC and hence bound by the Organization's ceilings on total exports. Oman increased its production and export of crude petroleum by about 80 per cent between 1980 and 1985. Its exports earnings increased by 33 per cent between 1981, when the second large increase in oil prices had already taken place, and 1985. Being a relatively small producer of oil, it was able to increase output and export without producing an impact of its own on the international oil markets. Similar considerations apply to the Congo, which increased its volume of exports by over 50 per cent during the period

1981-1985. For both countries, oil accounted for 90 per cent of exports.

The importance of oil in the economy of Cameroon is smaller than in the Congo but it still accounts for 70 per cent of exports. Output increased by about 140 per cent over the period 1981-1985. The volume of the other exports of Cameroon, mainly cocoa beans, coffee and wood, was stagnant, but their prices increased. Malaysia has a much more diversified economy than any of the other three in the group. Though primary commodities constitute a large proportion of its total export, they are distributed over a number of major export items, namely, rubber, palm oil, tin, timber and oil. During the period 1981-1985, the country increased the volume of its total exports by 22 per cent, and exports of oil and palm oil by 50 per cent and 40 per cent, respectively, more than compensating for the falling international prices of some of its export products. Much of the strength of the economy thus lay in the relative diversity of its exports. Malaysia has also a small but rapidly growing industrial export sector. By 1985, however, sharply declining export prices led to a decline in GDP.

The above analysis suggests that it is not export orientation as such that is important in an examination of growth performance; it is the nature of the orientation and the opportunities of trade facing an open economy. It was possible for a number of countries to substantially increase their exports because their structure of production and export orientation enabled them to export goods for which world demand had been increasing. It was also possible for a few other countries to increase exports of a major primary commodity under depressed market conditions because their share of the world market was too small or when the larger producers were in no position to resist a reduction in their market share. There is also an example of a country (Malaysia) with a diversified export basket which consisted mostly of primary commodities but also a significant volume of manufactures.

Large countries are generally less export-oriented.<sup>10</sup> There is also some evidence to suggest that large countries had a better growth performance than small countries during the first half of the 1980s.<sup>11</sup> However, the three largest developing countries, namely, Brazil, India and Indonesia, and China had a very different growth experience during the 1980s. China grew very fast and India at a moderately high rate, and while the growth of Brazil and Indonesia was above the average for the developing countries, it was far below that of the other two countries. It may be useful to take a closer look at the contrasting experience of the four countries which account for a large proportion of the production and population in the developing world. They greatly add to the diversity of growth experience of the developing economies.

China, a country of continental size and with a population of close to a billion in 1980,<sup>12</sup> achieved a very high rate of growth of income during the 1980s. Its net material product

<sup>10</sup> The Spearman rank correlation between the size of population of 84 countries and their degree of openness in the 1980s was -0.63.

<sup>11</sup> See Note by the Secretariat on the world economy 1986-1988 (E/AC.54/1987/L.1).

<sup>12</sup> All comparisons between countries, except for growth rates, relate to the base year 1980.

(NMP) grew at an annual rate of 9.5 per cent during the period 1981-1985, a significant increase over the 7 per cent of the second half of the 1970s. Much of this acceleration was the result of a series of reforms initiated in 1978. Exports accounted for only about 6 per cent of total output making it one of the least open economies. Slightly less than half of its exports consisted of manufactures, a much higher ratio than for the other developing economies. The source of economic growth of China was overwhelmingly domestic, despite a significant opening up of the economy to foreign trade and investment in recent years. Much of it came from agriculture, which accounted for 31 per cent of the economy, and rural industries, which grew at a rate of over 20 per cent annually during the period. Industrial output as a whole increased by about 12 per cent per year. The country's terms of trade improved marginally over the period 1980-1984 and had a miniscule impact on the economy.

India, with a population of 700 million, is also of continental proportion. The share of exports in GDP was about 6 per cent, the same as for China, but the share of manufactures in exports was larger (57 per cent). The importance of agriculture in total output was somewhat larger (37 per cent) than in China and a diversified manufacturing sector accounted for 16 per cent of GDP. With exports accounting for only a small proportion of GDP, the sources of its growth were, as in China, very largely domestic. But the economy grew at only half the rate of growth of the Chinese economy during the 1980s. Between 1980 and 1984 its terms of trade improved by about 7 per cent.

Brazil, with a population of 120 million and an area comparable to that of China, is among the largest developing countries and the biggest in terms of the size of GDP. Its per capita income was more than six times higher than in India or China. The share of exports in GDP (9 per cent) was not much higher than for India or China but the proportion of exports of manufactures was significantly lower (39 per cent). The structure of its domestic economy is in many respects different from that of the other two countries. Agriculture accounted for only 13 per cent of GDP, while the contribution of manufacturing was about 26 per cent, more than in India and probably China too. Services accounted for as much as 53 per cent of GDP, compared with 37 per cent in India and 22 per cent in China. The economy grew at an annual rate of only 2 per cent during the period 1981-1985, after 8.5 per cent during the 1970s. Its terms of trade improved by 3 per cent over the period 1980-1984 but with a sharp deterioration in 1981.

The archipelago of Indonesia is smaller in total area than some of the other developing countries but, with a population of 145 million, it is one of the biggest. Its structure of production is markedly different from that of the other three. Primary-producing sectors constitute a much larger share of the economy than in the other three countries. Agriculture accounted for 26 per cent of GDP, and oil and gas for about 20 per cent in 1980; manufacturing accounted for only about 10 per cent. It is also a much more export-oriented economy, with exports accounting for 30 per cent of GDP. Almost 98 per cent of the country's exports were primary commodities, with oil making up 70 per cent. Over the period 1981-1985

the economy grew at an annual rate of 4 per cent. Unlike in the other three large countries, the terms of trade of Indonesia showed a sharp improvement in 1981, more than compensating for the declines in the following three years.

Export orientation and size by themselves explain very little of the striking difference in growth rates for China, India and Brazil. Much more important have been differences in the structure of production and trade and in the economic policies followed. Its economic system and the reforms of the late 1970s set the economy of China apart from that of India. For Brazil, with agriculture accounting for a small fraction of the economy, which is natural for a country at a higher level of development than the other three, even a large increase in agricultural output could not have made a significant difference in the rate of growth of GDP. Furthermore, both the tradable sector and the share of manufactured exports are relatively small, which make its policy of debt accumulation over the 1970s look imprudent in retrospect. The high degree of its orientation towards international finance was not adequately matched by export orientation of its production structure. The other large country, Indonesia, is much more export-oriented than the other three. Here again, it is the nature of its orientation rather than its degree which was critical. An almost total dependence on primary commodity exports exposed the Indonesian economy to the external environment to a much greater degree than the other large economies. However, it was much less affected than Brazil by the sharp increase in interest rates in the international financial markets during the early 1980s.

### Domestic macro-economic performance

The macro-economic performance of an economy is not independent of its external economic relations. For most developing countries, a sudden fall in exports and imports will affect important macro-economic magnitudes such as government receipts and expenditure. A decline in import capacity can hurt investment and lower the investment ratio, as has happened in some of the heavily indebted countries during the 1980s. On the other hand, macro-economic policies play a crucial role in adjustments to the changing external situation, as well as in long-term economic growth. Three related aspects of macro-economic performance of the fast-growing countries are briefly discussed here: the investment ratio, the savings ratio and the rate of inflation.

**The investment ratio.** On the average, the fast-growing energy-importing countries had a higher ratio of investment to GDP than the other countries of the group (table VIII.4). For the period 1981-1985, the average for the fast-growing countries was 26.1 per cent, compared with 19.5 per cent for the other countries. Most of these countries fall within a 20 to 28 per cent range, with the ratio of Singapore an exceptionally high 44.7 per cent. Within the high-growth countries, there is little correlation between the investment ratio and the growth of income during the period, reflecting differences in both the structure of the economies and efficiency of resource allocation.

Among the energy-exporting high-growth countries too, the investment ratio is higher (31 per cent) than in other developing countries in the group (24 per cent). It is also higher than the ratio for the fast-growing energy-importing countries, largely a result of the capital-intensive nature of investment in mining. The investment ratio of China (30 per cent) is among the highest in the developing regions.

**Domestic savings.** The difference between the fast-growing countries and other developing countries was particularly sharp in the rate of domestic savings. For the

high-growth energy-importing countries, the average ratio of savings to GDP during 1981-1983 was about 21 per cent, compared with an average of 11 per cent among the other countries of the group. All countries had a ratio of 10 per cent or above, in a majority of cases 15 per cent or above and in half the countries over 20 per cent. It should be noted that the fast-growing energy-importing countries had a smaller saving-investment gap than others and were able to finance a higher investment ratio with less reliance on foreign savings.

Table VIII.4. Domestic macro-economic performance

	Ratio of investment to GDP		Ratio of savings to GDP		Rate of inflation	
	Average 1976-1980	Average 1981-1985	Average 1976-1980	Average 1981-1983	Average 1976-1980	Average 1981-1985
Fast-growing countries						
Net energy importers:						
Republic of Korea	30.3	27.9	26.2	23.3	17.4	7.3
Pakistan	16.3	17.3	13.4	13.9	8.7	7.3
Singapore	40.8	44.7	31.4	36.5	3.7	3.3
Hong Kong	..	28.4	32.1	30.3	9.0	9.2
Burma	17.1	22.3	14.0	18.1	4.3	4.6
Thailand	26.8	22.4	20.9	18.5	9.8	5.0
Sri Lanka	22.0	27.5	15.4	11.0	10.3	12.2
India	23.0	24.0	22.1	21.4	4.2	9.3
Turkey	23.0	20.2	17.0	17.1	51.7	38.7
Mean	24.9	26.1	21.4	21.1	13.2	10.8
Net energy exporters:						
Oman	25.0	25.4	..	..	..	..
Cameroon	22.4	27.5	18.8	20.7	9.4	10.7
Congo	17.7	37.7	21.2	40.8	10.6	11.3
Malaysia	28.4	32.8	29.5	26.9	4.5	4.7
Mean	23.4	30.9	23.2	29.1	8.2	8.9
China	33.3	30.3	33.2	30.0	3.3	3.5
Mean of other developing countries:						
Net energy importers	22.8	19.5	11.3	11.2	23.6	34.8
Net energy exporters	27.3	23.7	31.6	31.4	15.4 <sup>a</sup>	21.7 <sup>a</sup>

Source: Department of International Economic and Social Affairs of the United Nations Secretariat; IMF, *International Financial Statistics, Supplement on Economic Indicators*, No. 10, 1985 and other issues; IMF, *Government Financial Statistics Yearbook 1986*, and other international and national sources.

<sup>a</sup> Excluding Bolivia.

The savings ratio of the fast-growing energy exporting countries was on the average considerably higher (29 per cent) than for the energy-importing high-growth countries. But it was not significantly different from that of the other energy-exporting countries. For China, the domestic savings ratio is practically the same (30 per cent) as the investment ratio as investment was financed almost entirely from domestic savings.

**The rate of inflation.** Perhaps the most remarkable difference in macro-economic performance between the fast-growing countries and others was in their rate of inflation. The average annual inflation rate in the high-growth energy-

importing countries during the period 1981-1985 was about 11 per cent compared with 35 per cent for the other energy importers. Apart from Turkey, which had a high rate of inflation, the rate of inflation in every fast-growing country for which there was data was lower than the average for the slow-growing countries. The inflation rate was also much lower among the high-growth energy-exporting countries than in the other countries of the group. Despite a sharp acceleration of the rate of inflation in China in 1985, the average for the country for the period 1981-1985 remained at 3.5 per cent.

It is worth noting that, in all three aspects of domestic

## Import capacity and growth of exports

macro-economic behaviour, the performance of the fast-growing energy-importing countries was better than that of the other energy importers not only during the first half of the 1980s but in the 1970s as well. The average investment ratio of these countries was only marginally higher than that of the slow-growing energy importers during the period 1976-1980 but their savings ratio (21 per cent) was much higher than that among the latter (11 per cent). Similarly, the rate of inflation among the fast-growing countries was half the rate among the other countries. Furthermore, during the first half of the 1980s, the macro-economic performance of the fast-growing countries remained unchanged or was even better than during the 1970s.

These facts suggest that the efforts of these countries during the 1970s to save and invest were important factors in the differential performance in the 1980s. At the same time, a greater price stability during the 1970s gave these countries more room for manoeuvre. Other energy-importing countries entered the 1980s with large domestic disequilibria.

The growth of the volume of imports of the developing countries as a whole decelerated sharply during the 1980s, reflecting the slow growth of the world economy during the 1980s, and contributing to the fall in the rate of growth of these countries. These imports were growing at about 5.5 per cent annually during the period 1976-1980 but only 1.5 per cent over the period 1981-1985.

Against this background of a general decline in import capacity, the experience of the fast-growing energy-importing countries stands in sharp contrast to that of the other developing countries. For the period 1981-1985, the dollar value of imports of these countries increased only marginally, on the average, by about 2.4 per cent per year. Since the unit value of imports declined by about 3 per cent, the increase in import volume was of the order of 5.5 per cent. The value of imports of the other energy-importing countries declined by over 6.7 per cent and their volume by about

Table VIII.5. Growth of imports and exports, 1981-1985  
(In current dollar values)

	(Annual rates)	
	Imports	Exports
Fast-growing countries		
Net energy importers:		
Republic of Korea	6.9	11.1
Pakistan	1.9	0.9
Singapore	1.8	3.3
Hong Kong	5.8	8.9
Burma	-1.0	-6.3
Thailand	0.1	1.8
Sri Lanka	-1.1	4.6
India	-0.1	2.0
Turkey	6.9	22.3
Mean	2.4	5.4
Net energy exporters:		
Oman	11.6	5.8
Cameroon	-2.6 <sup>a</sup>	1.6
Congo	3.0 <sup>b</sup>	8.7
Malaysia	2.7	3.6
Mean	3.7	4.9
China	16.4	8.6
Mean for other developing countries:		
Net energy importers	-6.7	-5.3
Net energy exporters	-2.1	-5.4
Memorandum items:		
Unit Values		
All net energy-importing developing countries	-3.1	-3.8
All net energy-exporting developing countries	-3.7	-1.2

Source: IMF, *International Financial Statistics*, December 1986.

<sup>a</sup> The Economist Intelligence Unit, *Country Profiles—Cameroon, Central African Republic, Chad, 1986-87*. The imports of Cameroon increased at a rapid pace during the 1970s, and their level in the 1980s remained considerably higher than in the mid-1970s.

<sup>b</sup> 1981-1984.

3.5 per cent. Imports of the fast growing energy-exporting countries increased at an annual rate of 3.7 per cent, while those of the other energy exporters declined by 2 per cent (table VIII.5). One of the major factors behind the poor growth record of many developing countries during the 1980s is, undoubtedly, declining imports.

The maintenance of a reasonable import capacity among the fast-growing countries was largely due to a spectacularly better export performance. The dollar value of exports from the high-growth energy-importing countries increased at an annual rate of over 5 per cent. Exports from the other energy importers, by contrast, declined at a rate of 5 per cent over the period, partly reflecting the fall in prices of primary commodities which have a large share of the total exports of these countries. The total export from this group of countries declined despite large increases of exports from some of the heavily indebted countries such as Brazil. Some of the largest declines took place among the African countries. In both the fast-growing and slow-growing energy-importing countries, imports did less well than exports, which reflects the tightening of the international financial situation and the contraction of net transfer of resources.

The fast-growing energy-exporting countries increased the value of their exports by about 5 per cent on the average, compared with a decline of over 5 per cent among the other energy exporters.

### An adverse external environment

The developing countries faced three sets of problems during the early 1980s: recession in the industrialized countries, and hence, a slow expansion of international trade, a substantial decline in primary commodity prices, and rising real interest rates and debt burdens. The differential impact of deterioration in terms of trade and increasing debt burden is discussed below.

**Terms of trade.** For the fast-growing energy-importing countries, the terms of trade showed an annual deterioration of 0.7 per cent over the period 1981-1984,<sup>13</sup> compared with a decline of 1.3 per cent for the other energy-importing countries. The impact of these changes on real income of the fast-growers varied greatly from country to country, ranging from 2.2 per cent of GDP (Hong Kong) to -1.1 per cent (Thailand). For only less than half the countries was the impact clearly favourable, while in the other cases the change was either negligible or adverse. On the whole, these countries had a favourable impact equivalent to 0.1 per cent of GDP, compared to an adverse impact among the other energy importers equal to 0.4 per cent of their GDP (table VIII.6). The gain in real income through terms of trade changes in the former category looks relatively small, particularly when compared with their rate of growth of income. As exporters of manufactures and importers of oil,

they benefited from changes in the relative prices of these products, but only marginally. The adverse impact on the slow-growing countries was larger (0.4 per cent per year), particularly when viewed in relation to the rate of growth of income of these countries during the period (0.5 per cent).

The impact of terms of trade changes among the fast-growing energy exporters was significantly adverse (-0.5 per cent), in contrast to a 0.1 per cent improvement among the other energy exporters. But the annual loss was fairly small when compared with their annual rate of growth of income.

**Debt-servicing costs.** The initial size of the debt burden does appear to have been much smaller among the fast-growing countries than among the others (table VIII.6). In the energy-importing group, the external debt/GNP ratio in 1980 was on the average lower (about 18 per cent) for the fast-growing countries than for other developing countries (about 28 per cent). A similar picture emerges when debt is compared with export earnings. For the fast-growing countries, external debt amounted to a lower proportion of their exports in 1980 (about 92 per cent) than for the other energy importers (111 per cent). There was a large variation in both ratios among the fast-growers. Among the major debtors, the debt/GNP ratio was only about 11 per cent in India and over 30 per cent for the Republic of Korea, Pakistan and Sri Lanka. The debt/export ratio varied from 80 per cent for the Republic of Korea to 428 per cent for Turkey.

A significant difference between the fast-growing and other energy-importing countries was that their exports were growing much faster than their debt, and this was reflected in the decline in the debt/export ratio, from 183 per cent to 92 per cent over the 1970s. For the slow-growing energy importers, debt was accumulating much faster than national income and the debt/GNP ratio increased from 19 per cent in 1970 to 28 per cent in 1980, and reached 50 per cent in 1984. Among the fast-growers, the ratio increased from 16 per cent to 18 per cent and to 22 per cent over the same period. An even more important sign of troubles ahead for the slow-growing countries was that debt was increasing faster than exports, and the debt/export ratio, unlike that of the fast-growing countries, was increasing. In other words, the capacity of these economies to transform domestic production into exports was already falling behind the rate of their absorption of foreign debt.

For the fast-growing net energy-importing countries, debt-service amounted to a significantly smaller proportion of their GNP (2.3 per cent) than for the other energy importers (6.5 per cent) over the period 1980-1984. Undoubtedly, the shock from this source was thus much larger for the slow-growing countries. The debt-service/export ratio was similarly much larger (22.6 per cent) for these countries than for the fast-growing countries of the group (11.4 per cent). Once again, there was a large variation among the

<sup>13</sup> Data for 1985 are not available for most countries. Commodity prices declined by about 11 per cent in dollar terms in 1985 and the terms of trade of the developing countries declined by about 1.3 per cent. However, data for the year should not materially alter the relative impact of terms of trade on the fast-growing and other countries estimated here.

Table VIII.6. Impact of changes in terms of trade and debt burdens

	Impact of terms of trade on GDP, 1981-1984 <sup>a</sup> (Annual rates, per cent)	Debt/GNP ratio			Debt/export ratio			Debt service/ GNP ratio (Average 1980-1984) (Per cent of GNP)	Debt service/ export ratio (Average 1980-1984) (Per cent of exports)
		1970	1980	1984	1970	1980	1984		
Fast-growing countries									
Net energy importers									
Republic of Korea	0.0	22.4	29.5	37.0	143.0	80.1	89.0	6.0	15.0
Pakistan	-0.4	30.6	34.4	29.7	380.7	266.5	258.7	2.4	21.0
Singapore <sup>b</sup>	0.3	7.9	12.1	10.6	7.6	5.3	6.0	2.0	1.0
Hong Kong <sup>b</sup>	2.2	0.1	1.8	0.9	0.1	1.8	0.8 <sup>c</sup>	0.3	0.3 <sup>d</sup>
Burma	-0.2	4.7	25.2	34.9	77.9	293.7	517.4	2.3	27.7
Thailand	-1.1	11.1	17.7	26.3	62.0	70.7	114.3	4.3	18.3
Sri Lanka	0.7	16.1	33.7	41.9	83.7	100.6	137.1	2.8	9.5
India	0.1	15.1	11.1	13.7	356.5	145.3	173.5	0.9	11.8
Turkey	-0.4	14.8	27.0	32.3	244.4	428.4	166.1	3.4	25.6
Mean	0.1	16.1	18.3	21.9	182.9	92.2	94.0 <sup>e</sup>	2.3	11.4 <sup>e</sup>
Net energy exporters									
Oman	—	—	8.2	17.2	—	11.7	26.6	2.4	3.6
Cameroon	-1.2	13.0	33.6	31.3	50.3	106.1	94.0	4.2	13.6
Congo	0.6	53.9	71.4	76.2	179.6	110.0	—	8.7	14.2 <sup>d</sup>
Malaysia	-1.0	10.0	16.8	39.4	21.3	26.1	62.1	3.0	5.0
Mean	-0.5	10.2	18.6	34.5	23.0	31.5	58.9	3.2	5.6 <sup>f</sup>
Mean of other developing countries									
Net energy importers	-0.4	18.6	27.5	50.3	102.7	110.8	169.6 <sup>c</sup>	6.5	22.6 <sup>c</sup>
Net energy exporters	0.1	18.9	24.7	41.6	130.3	93.4	176.7	6.3	25.8

Source: World Bank, *World Development Reports* and *World Debt Tables*, 1985-1986.

- a Defined as percentage change in terms of trade multiplied by the ratio of exports to GDP.  
b Debt ratios cover only public and publicly guaranteed debt.  
c 1983.  
d 1980-1983.  
e Excluding Hong Kong.  
f Excluding Congo.

Note: The means, except for terms of trade, are weighted averages.

fast-growers in the debt-service/GNP ratio, ranging, among the major countries, from 0.9 per cent for India to 6.0 per cent for the Republic of Korea, as well as in the debt-service/export ratio, which ranged from 10 per cent for Sri Lanka to 26 per cent for Turkey.

Among the energy-exporting countries too, both the debt/GNP and the debt/export ratios were lower in 1980 for the fast-growers than for the other countries. As with the net energy-importing countries, debt-service amounted to a much larger proportion of GNP of the slow-growing countries (6.3 per cent) in this category than among the fast-growing countries (3.2 per cent) during 1980-1984. The debt-service/export ratio is also much larger (22.6 per cent)

among the former than among the latter (5.6 per cent).

There is also evidence that the debt-shock arising from the increase in interest rates hurt the slow-growing developing countries more than it hurt the fast-growing countries. Not only was the difference in interest payments as a proportion of GNP large between the fast-growing countries and other countries but, among the energy importers, the difference was larger than in total debt-service liabilities as a proportion of GNP, as table VIII.7 shows. This is consistent with the fact that the proportion of commercial debt with variable interest was higher among the most heavily indebted countries than among others.

Table VIII.7. The relative interest payment burden of the fast-growing and other countries

	Ratio of debt-service to GNP (Average 1981-1984)	Ratio of interest payment to GNP (Average 1981-1984)
(a) Average for fast-growing energy importers	2.30	1.07
(b) Average for other energy importers	6.50	3.65
(b)/(a)	2.83	3.41
(c) Average for fast-growing energy exporters	3.15	1.83
(d) Average for other energy exporters	6.25	2.95
(d)/(c)	1.98	1.61

### Concluding remarks

A number of factors that lay behind the fast growth of 14 countries during the 1980s have been identified in the above analysis. Although a quantification of the relative importance of the individual factors has not been attempted, some broad conclusions emerge.

There is no doubt that external factors played a role in the poor economic performance of a large majority of the developing countries. The steep decline in the number of fast-growing countries during the period is in itself indicative of the impact of the changing external environment. A comparison of the impact of an adverse external environment on the different groups of countries does suggest that it was larger for the slow-growing developing countries than for the fast-growing ones. This is particularly true of the debt burden, which was smaller for the fast-growing countries. Changes in terms of trade also affected the slow-growing countries more adversely than the high-growth countries.

But this is only a part of a complex picture. The analysis also suggests that there were significant differences between the two groups of countries in the domestic policies followed, as well as in the structure of their production and trade, with differing degrees of ability to respond to the changing external situation.

The structure of production and trade among the fast-growing countries was more favourable for growth in an adverse international situation. They were more export-oriented but with a more important difference that this orientation was of the type that enabled them to expand exports - mostly manufactures - and increase imports even when total world trade was hardly growing.

The difference in the growth of agricultural production is one of the major factors underlying the difference in the growth of GDP between the two groups of countries. This was not fortuitous but was, for most countries, the result of the pursuit of a long-term policy of agricultural development. On the average, countries in which agricultural growth was higher during the 1980s also had a similarly high rate of growth during the 1970s.

It is worth noting that, among the fast-growing energy-

importing countries, the rate of growth of agricultural production was high in all cases where it mattered most for overall economic growth in the short and medium term, namely, in economies where agriculture accounted for a large proportion of GDP. The share was approximately the same, on the average, as that among the slow-growing economies. Although there are economies among the latter group where the importance of agriculture is smaller, and a high rate of growth of agricultural production would not have made much difference to the growth of GDP, there were many others where it made a crucial difference. A rate of growth of agriculture among the slow-growing countries comparable to that among the fast-growers would have significantly raised their average rate of growth of GDP during the first half of the 1980s.

A sharp contrast arises between the two groups of countries in their domestic macro-economic performance. Both the investment ratio and the savings ratio, especially the latter, were much higher among the fast-growing countries. The crucial importance of efforts at domestic resource mobilization comes through clearly. The rate of inflation was also much lower among the high-growth countries than among the other countries, which probably reflects their higher fiscal prudence and more sustained efforts to prevent domestic disequilibria to accumulate. Equally significant is the fact that their macro-economic performance was better during the 1970s as well, which perhaps points to a greater ability or commitment to pursue long-term development goals.

For many countries, the debt burden led, through compression of imports, to a sharp deceleration of GDP growth. The steep rise in interest rates and a virtual cessation of new commercial finance to the heavily indebted countries, most of which are among the slow-growing group, are certainly important immediate causes of their declining imports. But the evolution of the debt burden itself has important domestic policy implications.

The choice of financing economic development through debt accumulation is a national one, though the availability and cost of international finance influence the choice. Financing of development through a large inflow of capital has been a normal feature of economic development in not only the developing countries but in many developed economies

Table VIII.8. Profile of growth performance of fast-growing energy-importing developing countries and China

Countries	Factors underlying growth of GDP									
	GAGR (1)	XMFG (2)	GX (3)	GM (4)	INVR (5)	SAVR (6)	RINFL (7)	ITERM (8)	DSGNP (9)	DSX (10)
Republic of Korea	x	x	x	x	x	x	x	x	-	x
Pakistan	x	x	x	x	-	x	x	-	x	x
Singapore	..	x	x	x	x	x	x	x	x	x
Hong Kong	..	x	x	x	x	x	x	x	x	x
Burma	x	-	-	x	x	x	x	-	-	x
Thailand	x	x	x	x	x	x	x	-	x	-
Sri Lanka	x	-	x	x	x	-	x	x	x	x
India	x	x	x	x	x	x	x	x	x	x
Turkey	-	x	x	x	x	x	-	-	x	-
China	x	x	x	x	x	x	x	x	..	..

*Note:* The letter "x" indicates better or higher than the average of other energy-importing countries. A hyphen (-) indicates worse or lower than the average of other energy-importing countries.

*Factors:*

GAGR:	Growth of agricultural production.
XMFG:	Exports of manufactures as proportion of total exports.
GX:	Growth of exports.
GM:	Growth of imports.
INVR:	Investment ratio.
SAVR:	Savings ratio.
RINFL:	Rate of inflation.
ITERM:	Impact of changes in terms of trade.
DSGNP:	Debt-service GNP ratio.
DSX:	Debt-service export ratio.

in some phases of their growth. But the decision on how much to borrow and where to invest and, in particular, the choice between the tradable and non-tradable sectors, are matters of domestic policy. The rate of growth of debt relative to that of export is thus at least partly a reflection of past policy decisions. It is significant that the debt/export ratio for the fast-growing energy importers declined from 183 per cent to 92 per cent over the 1970s, while it increased, though only slightly, from 103 to 111 per cent for the slow-growing countries.<sup>14</sup>

The growth of exports itself has been much faster among the fast-growers during the 1980s, as pointed out earlier. But the better export performance during the period was not coincidental. These countries' exports had been growing much faster, on the average, than those of the slow-growing countries during the 1970s as well.<sup>15</sup> Of course, a number of the slow-growing countries of the 1980s increased their exports fast during the 1970s. But the difference in the average performance of the two groups is significant, and is a reflection

of the difference in their policy orientation, as well as in the structure of their production and trade.

Within the fast-growing countries, there are large differences in the values of most of the factors considered, attesting to the diversity of growth experience among the developing economies. Nevertheless, it is important to recognize that the relatively fast growth of these countries did not result from an accidental combination of favourable factors. As the profile of performance of the fast-growing energy-importing developing countries and China given in table VIII.8 shows, it was, in most cases, the result of a much better than average performance over a broad spectrum of factors. In a large majority of the cases, the record of these countries was better than the average for the slow-growers in all of the following factors: the growth of agricultural production, growth of exports, the investment ratio, the savings ratio, and the rate of inflation. Such performance is improbable in the absence of a consistent set of long-term development policies.

<sup>14</sup> A simple average (as against the weighted average used in table VIII.6) of a sample of 24 slow-growing energy-importing countries shows a much steeper increase, from 73 per cent in 1970 to 108 per cent in 1980, compared with an increase from 150 per cent to 155 per cent over the same period for the fast-growing countries.

<sup>15</sup> The volume of exports of the fast-growing energy exporters was increasing at an annual rate of 5.5 per cent during the 1970s compared to about 2.0 per cent for the slow-growers (simple average for 45 countries).



# STATISTICAL

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Table A.1. Developing countries: rates of growth of output, 1971-1987  
(Annual percentage change)

	1971- 1980	1981- 1986	1982	1983	1984	1985	1986 <sup>a</sup>	1987 <sup>b</sup>
Developing countries <sup>c</sup>	5.6	1.5	0.2	0.8	2.2	2.0	2.5	2.7
By analytical grouping								
Net energy exporters	6.4	-0.5	-0.2	-0.8	0.0	0.1	-1.6	0.4
Net energy importers	5.0	2.8	0.6	2.1	3.8	3.4	5.5	4.3
By region								
Western hemisphere	5.5	1.0	-1.3	-2.5	3.2	2.7	3.5	3.3
West Asia	6.5	-0.9	-0.8	2.6	-1.8	-1.8	0.3	-1.1
South and East Asia	5.6	4.8	3.5	5.6	5.1	3.2	4.5	4.7
Africa	4.9	-0.9	-1.0	-1.0	-1.6	1.7	-2.1	-0.2
Mediterranean	5.3	2.9	2.6	1.0	3.7	2.8	4.4	3.0
Distribution of growth rates				(Number of cases)				
Zero or below	4	22	40	33	29	25	20	-
0.1 - 2.5	15	31	18	17	17	20	19	-
2.6 - 5.0	31	20	11	19	20	26	31	-
5.1 - 7.5	18	9	9	9	10	8	9	-
7.6 and over	15	1	5	5	7	4	4	-

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

<sup>a</sup> Preliminary estimates.

<sup>b</sup> Forecasts.

<sup>c</sup> Country growth rates aggregated with 1980 output values in dollars.

Table A.2. Developing countries: annual rates of growth of real per capita gross domestic product, 1971-1986<sup>a</sup>  
(Annual percentage change)

	1971- 1980	1981- 1986	1983	1984	1985	1986 <sup>b</sup>
All developing countries	3.4	-0.9	-1.5	-0.1	-0.3	0.3
Western hemisphere	3.4	-1.3	-4.7	0.8	0.4	1.1
West Asia	3.6	-4.1	-0.8	-5.0	-5.0	-2.9
South and East Asia	3.3	2.6	3.4	2.9	1.1	2.5
Africa	1.8	-3.8	-3.9	-4.4	-1.3	-5.0
Mediterranean	3.6	1.2	-0.6	2.0	1.2	2.7
Memorandum item:						
All developed market economies	2.3	1.6	1.9	4.1	2.2	1.7

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

<sup>a</sup> Rate of growth of real gross domestic product adjusted for rate of growth of population. Population growth rate is based on medium variant estimates from annual data for 1970-1985 reported in *World Population Prospects: Estimates and Projections as Assessed in 1984* (United Nations publication, Sales No. E.86.XIII.3).

<sup>b</sup> Based on preliminary data.

Table A.3. Developed market economies: annual rates of growth of real gross national product, 1971-1988<sup>a</sup>  
(Annual percentage change)

	1971- 1980	1981- 1986	1983	1984	1985	1986 <sup>b</sup>	1987 <sup>c</sup>	1988 <sup>c</sup>
All developed market economies	3.1	2.2	2.6	4.7	2.9	2.4	2.6	3.0
Excluding United States	3.4	2.1	2.0	3.4	3.1	2.2	2.4	2.6
Major industrial countries	3.2	2.3	2.8	4.9	3.0	2.5	2.6	3.1
Canada	4.5	2.5	3.6	5.3	4.0	3.1	1.8	2.8
France	3.6	1.3	0.7	1.5	1.4	2.5	2.2	2.2
Germany, Federal Republic of	2.7	1.5	1.8	3.0	2.5	2.1	2.0	2.5
Italy	3.1	1.1	-0.4	2.6	2.3	2.5	2.7	3.0
Japan	4.7	3.6	3.2	5.1	4.5	2.5	2.6	3.0
United Kingdom	1.9	1.9	3.6	2.1	3.7	2.8	3.2	3.0
United States	2.8	2.4	3.5	6.5	2.7	2.5	2.8	3.5
Smaller industrial countries	3.1	1.8	1.3	3.4	2.5	2.0	2.2	2.0

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

<sup>a</sup> 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.

<sup>b</sup> Preliminary estimates.

<sup>c</sup> Secretariat forecasts, based on Project LINK country projections (March 1987) and other institutional forecasts.

Table A.4. Developing countries: rates of inflation, 1971-1986<sup>a</sup>  
(Annual percentage change)

	1971- 1980	1981- 1986	1982	1983	1984	1985	1986 <sup>b</sup>
Developing countries							
All countries	18.0	58.3	40.0	65.2	93.7	125.9	49.2
(Median)	(13.1)	(11.5)	(11.5)	(11.5)	(11.6)	(10.5)	(9.6)
Net energy exporters	13.5	28.4	22.8	36.4	34.9	97.1	34.4
Net energy importers	21.3	79.8	52.4	85.9	136.0	146.7	59.8
Western hemisphere	23.9	120.4	79.0	135.8	198.4	287.5	103.9
(Median)	(13.0)	(16.9)	(11.8)	(16.7)	(20.4)	(25.7)	(20.7)
West Asia	14.1	18.1	17.8	19.4	33.0	24.3	5.6
South and East Asia	11.4	8.4	8.0	8.8	10.1	5.7	5.2
Africa	14.0	16.1	11.7	23.2	23.5	10.9	9.8
Mediterranean	24.0	45.2	31.3	35.4	50.8	59.0	61.1
Frequency distribution <sup>c</sup>							
			(Number of cases)				
5 per cent or lower	0	12	6	14	18	23	25
5.01 - 10 per cent	26	22	24	19	15	13	14
10.01 - 20 per cent	41	20	26	22	16	15	12
20.01 - 50 per cent	7	13	13	12	15	15	13
50.01 - 100 per cent	2	4	4	2	7	4	8
Over 100 per cent	0	5	3	7	5	6	4

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

<sup>a</sup> Annual percentage change in consumer prices.

<sup>b</sup> Preliminary estimates.

<sup>c</sup> Number of cases from a sample of 76 countries.

Table A.5. Developed market economies: rates of change of GNP deflator and consumer prices, 1971-1987<sup>a</sup>  
(Annual percentage change)

Country or country group	1971-1980	1981-1986	1983	1984	1985	1986 <sup>b</sup>
<b>GNP deflators</b>						
All developed market economies	8.3	5.8	5.2	4.8	4.4	4.0
Excluding United States	8.9	6.4	6.2	5.3	5.0	4.9
Major industrial countries	8.1	5.3	4.7	4.2	3.8	3.6
Canada	8.8	5.7	4.9	3.6	3.4	2.8
France	9.5	8.6	9.5	7.2	5.8	5.3
Germany, Federal Republic of	5.3	3.2	3.3	1.9	2.2	3.3
Italy	14.7	13.1	15.1	10.6	8.8	9.1
Japan	7.6	1.8	0.8	1.3	1.4	2.0
United Kingdom	13.6	6.6	5.6	4.6	5.5	3.6
United States	7.4	5.0	3.8	3.9	3.4	2.6
Smaller industrial countries	9.7	8.4	8.1	7.6	7.0	8.0
North America	7.5	5.5	3.9	3.9	3.4	2.7
Western Europe	9.3	8.0	7.8	6.3	5.7	5.3
Others	8.2	3.5	2.7	3.1	3.5	5.1
<b>Consumer prices</b>						
All developed market economies	8.7	6.2	5.6	5.4	4.9	2.7
Major industrial countries	8.5	5.5	4.8	4.8	4.1	2.0
Canada	8.0	6.9	5.8	4.3	4.0	4.2
France	9.6	8.4	9.6	7.4	5.8	2.2
Germany, Federal Republic of	5.1	3.2	3.3	2.4	2.2	-0.3
Italy	13.8	12.7	14.7	10.8	9.2	6.0
Japan	9.0	2.4	1.8	2.3	2.1	0.5
United Kingdom	13.7	6.5	4.6	5.0	6.1	3.4
United States	7.8	4.9	3.2	4.3	3.5	1.9
Smaller industrial countries	9.6	9.3	9.4	8.4	8.0	7.5

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

<sup>a</sup> Country rates of change of prices are aggregated by using 1980 values in dollars as weights.

<sup>b</sup> Preliminary estimates.

Table A.6. Selected developed market economies: unemployment rates,  
1971-1986<sup>a</sup>  
(Percentage)

Country or country group	1971- 1980	1981- 1986	1982	1983	1984	1985	1986 <sup>b</sup>
All developed market economies	4.1	8.1	8.0	8.9	8.3	8.2	8.1
Major developed market economies	4.2	7.5	7.8	8.2	7.6	7.5	7.5
Canada	6.4	10.3	10.9	11.9	11.3	10.5	9.6
France	4.0	9.5	8.1	8.8	9.9	10.4	10.7
Germany, Federal Republic of	2.3	7.0	6.1	8.2	8.2	8.	8.0
Italy	6.4	10.0	9.0	9.8	10.3	10.6	11.2
Japan	1.6	2.5	2.4	2.7	2.7	2.6	2.8
United Kingdom	3.1	11.3	11.3	11.6	11.8	11.7	11.6
United States	5.8	8.5	9.5	9.6	7.5	7.2	7.0
Smaller developed market economies	4.0	10.0	9.5	10.8	11.5	11.6	11.3
North America	5.8	8.5	9.2	9.8	7.9	7.6	7.3
Western Europe	3.7	10.0	9.2	10.1	10.8	11.0	11.0
Memorandum item:							
Number of unemployed persons (millions)	15.0	31.0	..	31.8	30.6	30.8	31.0

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*.

<sup>a</sup> Number of unemployed persons as a percentage of the civilian labour force.

<sup>b</sup> Preliminary estimates.

Table A.7. China and centrally planned economies of Europe: basic economic growth indicators, 1971-1990  
(Annual percentage changes)

Country or country group	1971-1980	1981-1985 <sup>a</sup>	1986-1990 <sup>b</sup>	1981	1982	1983	1984	1985	1986 <sup>c</sup>	1987 <sup>b</sup>
<b>China</b>										
Net material product	5.8	9.1	6.7	4.9	8.3	9.8	12.0	12.3	7.0	7.0
Gross industrial output	8.8	11.6	7.5	4.3	7.8	11.2	16.3	21.4	10.0	..
Gross agricultural output	3.3	7.6	4.0	6.5	11.3	7.8	12.3	3.0	4.0	..
Gross fixed investment <sup>d</sup>	7.3	17.9	10.0	-10.5 <sup>e</sup>	26.6	12.6	33.9	35.0	15.0	..
Export volume	23.2 <sup>f</sup>	13.3	8.1	16.0	13.3	3.4	17.6	12.0	17.0	..
Import volume	23.7 <sup>f</sup>	9.6	6.1	-8.6	-0.7	9.2	29.2	50.3	-20.0	..
<b>Soviet Union</b>										
Net material product	5.0	3.7	4.3 <sup>e</sup>	3.3	3.9	4.2	2.9 <sup>e</sup>	3.5	4.1	3.9
Gross industrial output	6.0	3.9	4.6	3.4	2.9	4.2	4.1	3.9	4.9	3.8
Gross agricultural output	1.2	2.5	2.7 <sup>g</sup>	-1.0	5.5	6.2	-0.1	0.1	5.1	2.4
Gross fixed investment	5.1	4.2	4.3 <sup>g</sup>	3.7	3.5	5.6	1.9	3.0	8.0	5.0
Export volume	4.9	2.4	..	1.9	4.5	3.3	2.5	-4.3	7.1	..
Import volume	8.2	3.5	..	6.4	9.7	4.0	4.4	4.0	-8.0	..
<b>Eastern Europe<sup>h</sup></b>										
Net material product	5.8	2.4	4.0 <sup>e</sup>	-1.9	0.1	3.9	5.3	3.7	4.7	4.7
Gross industrial output	7.1	3.1	4.4	-0.5	1.2	4.4	4.8	4.1	4.8	4.1
Gross agricultural output	2.3	2.2	2.7 <sup>g</sup>	1.8	1.6	0.9	6.9	-1.3	5.1	3.2
Gross fixed investment	6.7	0.1	3.4 <sup>g</sup>	-7.1	-4.4	2.4	2.2	4.0	2.6	4.8
Export volume <sup>e</sup>	7.8	4.3	..	1.2	5.6	7.2	8.5	1.7	1.0	..
Import volume <sup>e</sup>	6.7	1.5	..	-5.3	-6.3	3.2	5.9	5.7	6.5	..

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national statistical publications, plans and plan fulfilment reports.

a Preliminary estimates based on plan fulfilment reports and other partial information.

b Medium-term and annual plan targets. In the case of planned ranges, the figure shown is the mid-point.

c Preliminary estimates.

d State sector only and in current prices.

e Estimate.

f In current dollars.

g Change in the five-year average output from the average of the preceding five years expressed as an annual compound rate.

h Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland and Romania.

Table A.8. Major developed market economies: *ex post* real short-term and long-term interest rates, 1975-1986<sup>a</sup>  
(Percentage)

Country	1975	1976	1981	1982	1983	1984	1985	1986 <sup>b</sup>
Canada								
Short-term	-3.1	-0.5	6.9	3.6	4.0	8.3	6.6	5.9
Long-term	-1.6	-0.3	4.2	3.7	6.2	9.7	8.0	6.3
France								
Short-term	-4.8	-1.1	3.0	1.8	2.6	4.1	3.8	2.5
Long-term	-2.6	-0.5	3.5	2.7	3.7	4.7	4.7	3.0
Germany, Federal Republic of								
Short-term	1.7	0.8	7.5	3.8	2.4	4.0	3.2	1.8
Long-term	3.9	4.3	5.8	5.6	4.5	5.8	4.7	2.7
Italy								
Short-term	-6.5	-1.0	1.6	1.9	2.6	5.8	5.6	2.0
Long-term	-5.2	-4.0	1.0	2.6	2.6	3.8	3.9	0.5
Japan								
Short-term	2.2	1.0	4.7	5.1	6.2	5.7	5.0	3.0
Long-term	1.2	1.5	6.0	6.4	7.3	6.7	4.8	2.8
United Kingdom								
Short-term	-13.7	-1.0	3.0	4.7	4.6	5.5	5.7	7.1
Long-term	-10.5	-0.5	2.5	5.3	5.2	6.2	4.2	5.5
United States								
Short-term	-3.2	-0.2	4.5	5.0	5.0	6.1	4.7	3.2
Long-term	-1.0	2.5	4.1	6.5	6.6	8.4	7.6	4.6
Memorandum item:								
Nominal rate of interest in the United States								
Short-term	5.8	5.0	16.4	12.3	9.1	10.2	8.1	6.6
Long-term	8.2	7.7	13.7	12.9	11.3	12.5	10.9	8.0

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*.

- <sup>a</sup> 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.
- <sup>b</sup> Preliminary estimates.

Table A.9. Nominal and real rates of interest, 1975-1986

	Nominal rate of interest		Price deflator		Real rate of interest <sup>e</sup>			
	LIBOR <sup>a</sup>	United States prime rate <sup>b</sup>	GDP of developed market economies <sup>c</sup>	Non-fuel commodities exported by developing countries <sup>d</sup>	LIBOR adjusted by		United States prime rate adjusted by	
			(1)	(2)	(1)	(2)	(1)	(2)
	Percentage		Percentage change		Percentage			
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	4.3	-10.7	4.1	21.7	5.6	23.1
1986 <sup>f</sup>	6.8	8.3	4.0	5.5	2.7	1.2	4.1	2.6

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 interbank offered rate on United States dollar deposits.  
b Interest rate that the largest United States 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.  
f Preliminary estimates.

Table A.10. Indicators of fiscal policy in the major developed market economies, 1978-1986 (Percentage of GNP/GDP)

	1978-1979	1982	1983	1984	1985	1986 <sup>a</sup>
Central government fiscal balance <sup>b</sup> (deficit (-), surplus (+))						
United States	-1.6	-4.1	-5.6	-4.9	-5.1	-5.0
Japan	-5.6	-5.9	-5.6	-4.9	-4.1	-4.3
Germany, Federal Republic of	-1.9	-2.1	-2.0	-1.8	-1.1	-0.7
All major industrial <sup>c</sup> economies	-3.0	-4.6	-5.4	-5.0	-4.9	-4.6
Change in structural <sup>d</sup> budget balance (a move towards more deficit or expansion (-), a move towards less deficit or restriction (+))						
United States	--	-1.0	-0.7	-0.5	-0.8	-0.1
Japan	--	+0.4	+0.5	+1.0	+0.5	+0.3
Germany, Federal Republic of	--	+1.4	+1.1	+0.2	+0.6	-0.3
All major industrial <sup>c</sup> economies	--	-0.2	-0.2	-0.1	-0.2	0.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat. Central government financial balance figures are based on IMF, *World Economic Outlook*, 1986 and 1987; changes in structural budget balance are based on OECD, *OECD Economic Outlook*, No. 40 (December 1986).

- a Preliminary estimates.  
b Excluding financial surplus or deficit of local (and state) governments.  
c Seven major developed market economies: Canada, France, the Federal Republic of Germany, Italy, Japan, the United Kingdom, and the United States.  
d Change in cyclically adjusted component of government financial balance over the previous year as percentage of GDP/GNP.

Table A.11. Indicators of monetary policy in the major developed market economies, 1978-1986

	<u>Average</u> 1978-1979	1982	1983	1984	1985	1986 <sup>a</sup>	Official target in 1986
	<u>Percentage change</u>						
<b>Money supply<sup>b</sup></b>							
United States	8.4	9.3	12.5	7.9	9.1	8.0	6-9
Japan	11.9	9.2	7.4	7.8	8.4	8.7	8-9
Germany, Federal Republic of	9.5	6.5	6.6	3.9	4.9	6.1	3.5-5.5
<b>Velocity<sup>c</sup></b>							
United States	4.0	-5.7	-4.9	2.5	-2.9	-2.6	-
Japan	-2.5	-4.2	-3.4	-1.4	-2.1	-4.0	-
Germany, Federal Republic of	-1.8	-6.5	-1.5	-1.6	-0.1	-0.3	-
							<u>Change in</u> 1984-1986
							<u>Percentage</u>
<b>Interest rates</b>							
<b>Nominal short term<sup>d</sup></b>							
United States	9.7	12.3	9.1	10.4	8.0	6.5	-3.9
Japan	5.5	7.1	6.7	6.3	6.7	5.1	-1.2
Germany, Federal Republic of	5.1	8.8	5.7	6.0	5.4	4.6	-1.4
<b>Nominal long-term<sup>e</sup></b>							
United States	9.0	13.0	11.1	12.4	10.7	7.8	-4.6
Japan	6.9	8.3	7.8	7.3	6.5	5.2	-2.1
Germany, Federal Republic of	6.5	9.0	8.0	7.8	7.0	5.9	-1.9

Source: Department of International Economic and Social Affairs of the United Nations Secretariat. IMF, *International Financial Statistics* and *World Economic Outlook*, 1986 and 1987.

a Preliminary estimates.

b The "broad money" concept is used. Broad money is defined as the sum of currency in circulation, private demand deposits and private time deposits (quasi-money). This definition is known as M2. The M2 definition is used for all countries except Japan (M2 plus certificates of deposits), the Federal Republic of Germany (Central Bank money) and the United Kingdom (sterling M3); end of period, year on year percentage changes.

c Annual percentage change in the ratio of nominal GNP to stock of broad money (see note b).

d Interest rate on 90-day financial instruments (e.g., financial bills and certificates of deposit).

e Yield on long-term government bonds.

Table A.12. Capital-importing developing countries: official reserves and ratios of reserves to current expenditures, 1980-1986

	1980	1982	1983	1984	1985	1986 <sup>a</sup>
	<u>Billions of dollars</u>					
Level of reserves <sup>b</sup>	108.6	80.3	81.7	93.8	102.9	96.2
of which:						
Energy exporters	44.5	28.8	31.3	36.4	38.9	31.9
Energy importers	64.1	51.5	50.4	57.6	64.0	64.3
Fifteen heavily-indebted countries <sup>c</sup>	50.0	26.3	27.5	39.6	40.7	32.4
Sub-Saharan Africa <sup>d</sup>	3.9	2.8	3.0	3.1	4.1	5.2
	<u>Number of months</u>					
Coverage of current expenditures <sup>e</sup>	2.7	1.8	2.1	2.4	2.7	2.5
of which:						
Energy exporters	3.2	1.8	2.4	2.7	3.0	2.7
Energy importers	2.4	1.9	2.0	2.3	2.6	2.5
Fifteen heavily-indebted countries <sup>c</sup>	3.1	1.6	2.1	3.1	3.2	2.7
Sub-Saharan Africa <sup>d</sup>	1.1	0.9	1.1	1.1	1.5	1.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF data and national and regional estimates.

a Partly estimated.

b Total reserves, end of period (with gold valued at SDR 35 per ounce).

c Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

d Excluding Nigeria.

e Expenditures on goods and services (including interest payments) for given year relative to total reserves at end of year, sample of 98 countries.

Table A.13. Net flow of IMF lending to the capital-importing developing countries, 1980-1986 (Billions of dollars<sup>a</sup>)

	1980	1982	1983	1984	1985	1986
Regular facilities	2.3	4.2	8.8	4.3	1.1	-0.6
Credit tranche drawings	1.5	1.9	4.0	1.2	1.1	0.3
Extended facility drawings	0.4	2.3	4.9	3.2	0.0	-0.9
Special facilities	1.2	1.4	2.2	-0.2	-0.8	-2.1
Buffer stock financing	--	0.1	0.3	--	-0.2	-0.2
Compensatory financing	0.3	1.7	2.1	--	-0.4	-1.4
Oil Facility	-0.7	-0.4	-0.1	--	--	--
Trust Fund	1.6	--	--	-0.2	-0.3	-0.6
Structural adjustment facility	--	--	--	--	--	0.1
Total flows	3.4	5.7	11.1	4.2	0.3	-2.7
Memorandum items:						
Selected characteristics of higher conditionality lending agreements						
Number initiated during year	28	19	33	20	26	31
Average length (months)	20	14	18	14	16	22
Total amount committed	7.5	2.6	15.7	4.0	3.4	4.0

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.

Table A.14. Multilateral development institutions: resource commitments,  
1980-1986<sup>a</sup>  
(Millions of dollars)

	1980	1982	1983	1984	1985	1986
<b>Financial institutions</b>						
African Development Bank	571	766	899	879	1 154	1 639
Asian Development Bank	1 929	1 837	2 089	2 380	2 093	2 047
Caribbean Development Bank	45	45	48	65	48	50
Inter-American Development Bank	2 341	2 793	3 099	3 615	3 102	3 370
International Fund for Agricultural Development	396	373	279	202	137	129
World Bank Group	13 434	13 098	16 131	13 528	17 896	18 294
World Bank	(8 802)	(9 801)	(12 066)	(9 721)	(13 321)	(13 882)
International Development Association	(3 817)	(2 832)	(3 112)	(3 222)	(3 541)	(3 373)
International Finance Corporation	(815)	(465)	(953)	(585)	(1 034)	(1 039)
Subtotal	18 716	18 912	22 545	20 669	24 430	25 529
<b>Operational agencies of the United Nations</b>						
United Nations Development Programme <sup>b</sup>	550	746	513	519	478	548
United Nations Fund for Population Activities	146	115	117	134	141	116
United Nations Children's Fund	242	241	263	261	281	285
World Food Programme	479	613	696	925	642	629
Subtotal	1 417	1 715	1 589	1 839	1 542	1 578
<b>Total commitments</b>	<b>20 133</b>	<b>20 627</b>	<b>24 134</b>	<b>22 508</b>	<b>25 972</b>	<b>27 107</b>

Source: Annual reports and information supplied by individual institutions.

<sup>a</sup> Loans, grants, technical assistance and equity participation, as appropriate; all data on a calendar year basis.

<sup>b</sup> Including UNDP-administered funds.

Table A.15. Arab national and regional development institutions: development finance commitments for developing countries, 1982-1986  
(Millions of dollars)

	1982	1983	1984	1985	1986 First eight months
<b>Functional composition</b>					
Project finance (loans or equity)	2 086	1 410	1 158	1 000	710
Technical assistance (grants and loans)	53	24	21	42	25
Import financing (grants, loans and leasing)	436	506	768	604	379
Balance of payments (OPEC Fund loans)	84	26	4	—	6
Other (grants) <sup>b</sup>	35	6	7	6	1
Total	2 694	1 972	1 959	1 652	1 120
<b>Geographical distribution</b>					
Africa	1 458	842	865	616	619
West Asia	426	424	544	486	245
Other Asia and Pacific <sup>c</sup>	655	507	393	394	158
Other <sup>d</sup>	155	199	157	156	99
Total	2 694	1 972	1 959	1 652	1 120

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 (i.e., data exclude contributions to most multilateral institutions and bilateral ODA outside the listed institutions and ODA by non-Arab donors).

b Including contributions to 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.16. World proven crude oil reserves

Region	End 1974		End 1985	
	Millions of barrels	Percentage of world	Millions of barrels	Percentage of world
North America	43 650	6.7	34 500	4.7
Latin America	30 548	4.7	84 683	11.4
Western Europe	17 711	2.7	19 315	2.6
Middle East	403 358	61.7	431 040	58.2
Africa	62 316	9.5	57 707	7.8
Asia and Far East	20 003	3.1	17 238	2.3
Oceania	2 375	0.4	1 625	0.2
Centrally planned economies	74 141	11.3	95 130	12.8
World totals	654 103	100.0	741 237	100.0
OPEC share	487 306	74.5	516 087	69.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OPEC, *Annual Statistical Bulletin*, 1984, p. 12; *ibid.*, 1985, p. 36.

Table A.17. Stocks of oil on land in OECD member countries<sup>a</sup>

	Companies		Governments		Total	
	Millions of barrels	Days <sup>b</sup>	Millions of barrels	Days <sup>b</sup>	Millions of barrels	Days <sup>b</sup>
1974	2 511	70	0	0	2 511	70
1975	2 913	81	0	0	2 913	81
1976	2 869	72	22	1	2 891	23
1977	2 921	70	29	1	2 950	71
1978	3 170	74	44	1	3 221	75
1979	2 950	68	161	4	3 111	71
1980	3 155	78	198	5	3 353	84
1981	3 287	89	242	6	3 528	95
1982	3 023	86	417	12	3 440	98
1983	2 818	87	476	15	3 287	101
1984	2 547	75	564	17	3 111	92
1985	2 540	77	651	20	3 192	96
1986	2 408	73	710	21	3 118	93
1987	2 474	74	747	22	3 221	96

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IEA, *Monthly Oil Report*, January 1987, p. 9.

<sup>a</sup> On the first day of the year.

<sup>b</sup> Days of consumption at then current rates.

Table A.18. OPEC oil production quotas  
(Thousands of barrels per day)

Country	March 1983	October 1984	September 1986	November 1986	First half 1987
Algeria	725	663	663	669	635
Ecuador	200	183	183	221	210
Gabon	150	137	137	160	152
Indonesia	1 300	1 189	1 189	1 193	1 133
Iran (Islamic Republic of)	2 400	2 300	2 300	2 317	2 255
Iraq	1 200	1 200	1 200 <sup>a</sup>	1 466 <sup>a</sup>	1 466 <sup>a</sup>
Kuwait	1 050	900	900 <sup>b</sup>	999	948
Libyan Arab Jamahiriya	1 100	990	990	999	948
Nigeria	1 300	1 300	1 300	1 304	1 238
Qatar	300	280	280	300	285
Saudi Arabia	5 000	4 353	4 353	4 353	4 133
United Arab Emirates	1 100	950	950	950	902
Venezuela	1 675	1 555	1 555	1 574	1 495
Total	17 500	16 000	16 000 <sup>a</sup>	16 505 <sup>a</sup>	15 800 <sup>a</sup>

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on various OPEC press releases.

<sup>a</sup> Deemed production; no quota set for Iraq.

<sup>b</sup> 921,000 barrels per day for November and 999,000 barrels per day for December 1986.

Table A.19. Capital expenditures in petroleum by majority-owned foreign affiliates of United States companies, 1982-1987  
(Millions of dollars)

Area	Actual expenditures				Latest plans	
	1982	1983	1984	1985	1986	1987
Developed countries	11 437	8 939	8 926	8 733	7 686	7 368
Australia	678	538	436	327	348	413
Canada	3 380	2 375	2 547	2 665	2 099	2 147
Western Europe	7 252	7 670	5 822	5 626	4 995	4 575
Developing countries	8 270	6 468	4 928	4 620	3 880	3 842
Latin America	1 915	996	822	950	807	668
Middle East	2 350	1 778	1 368	1 421	1 064	1 065
Asia and Pacific	638	661	571	437	382	396
All countries	3 368	3 032	2 166	1 813	1 627	1 712
	20 760	15 915	14 124	13 673	11 765	11 381

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Ellen M. Herr, "Capital expenditures by majority-owned foreign affiliates of U.S. companies, 1986 and 1987," *Survey of Current Business* (Washington, D.C., United States Department of Commerce, October 1986)



## WORLD ECONOMIC SURVEY 1987

CorrigendumPage 2, left-hand column, fourth complete paragraph

In the fourth sentence, "trade flows" should read "capital flows".

Page 9, left-hand column, first paragraph

In the last sentence, "call-back provisions" should read "rollback provisions".

Page 87, left-hand column, first complete paragraph

Footnote number 30 should be inserted at the end of the second sentence, i.e., after "operations".

Page 103, table V.1

The headings to the four columns should read "1973 1979 1985 1986".

Page 155, right-hand column, last paragraph

In the second sentence, one of the two words "perhaps" should be deleted.

Page 165, table VIII.6

In the penultimate row (Net energy importers), footnote c against the figure 22.6 in the last column should be deleted.

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