WORLD ECONOMIC SURVEY 1988

CURRENT TRENDS AND POLICIES IN THE WORLD ECONOMY

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Department of International Economic and Social Affairs

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PREFACE

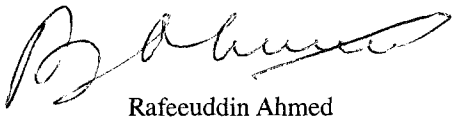
The *World Economic Survey 1988* reviews main international economic developments, analyses their implications and presents short-term forecasts for the different regions of the world.

A noteworthy feature of 1987 was that the dramatic financial shocks and instability in primary commodity markets, including oil, seemed to have had only minor repercussions on the growth of output. Economic expansion, though modest, has been maintained in the industrial world so far, despite the abrupt fall in stock markets (discussed in chapter IV of the *Survey*, as requested by the General Assembly in its resolution 42/195). Nor did developments during the year have any effect on the diversity in the performance of developing countries: chapter VIII analyses the growth differentials that have persisted since they emerged in the early 1980s.

The Economic and Social Council, in its decision 1987/187, requested the Secretary-General "to include in the *World Economic Survey 1988* a comprehensive analysis of the global effects of the indebtedness and persistent fiscal and external imbalances of developed countries on the international economic environment and in particular on the development process in developing countries". Chapter VII responds to that request, although other chapters also analyse how these imbalances relate to present macro-economic policies, to trends in international trade and to the changing pattern of international financial flows in the late 1980s.

Chapters II to IV discuss various elements of the analysis of the external debt of developing countries, including the link between the debt problem and the reverse transfer of financial resources affecting a large number of developing countries. Chapter V examines developments in oil markets and the changing structure of the oil industry. Chapter VI focuses on events likely to have far-reaching consequences both domestically and internationally, that is, the current economic reforms of China and the Union of Soviet Socialist Republics. As requested by the General Assembly in its resolution 42/178, annex I summarizes relevant economic indicators of the economic attainment of women throughout the world.

As in the past, the *World Economic Survey 1988* has benefited from analyses and studies of several institutions, including the regional commissions, the United Nations Conference on Trade and Development, the International Monetary Fund, the World Bank and the General Agreement on Tariffs and Trade. Our hope is that the *Survey*, in turn, will be of use to academic institutions, the public at large and, in particular, the Economic and Social Council in its efforts to improve the present performance of the world economy so that growth is of benefit to all. Chapter I contains policy conclusions to that end.



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Under-Secretary-General for
International Economic and Social Affairs

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EXPLANATORY NOTES

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

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

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

A hyphen (-) indicates that the item is not applicable.

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

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

A slash (/) indicates a crop year or financial year, for example, 1986/87.

Use of a hyphen (-) between dates representing years, for example, 1985-1987, 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 1988 and 1989 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:

ADB	Asian Development Bank
ADF	Asian Development Fund
AfDB	African Development Bank
CAP	Common Agricultural Policy of the European Economic Community
CFA	Communauté financière africaine
CFF	Compensatory Financing Facility of the International Monetary Fund
CMEA	Council for Mutual Economic Assistance
DAC	Development Assistance Committee of the Organization for Economic Co-operation and Development
EEC	European Economic Community
EIB	Export-Import Bank
EMS	European Monetary System
ESAF	Enhanced Structural Adjustment Facility of the International Monetary Fund
f.o.b.	free on board
FTO	foreign trade organization
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
IDA	International Development Association
IDB	Inter-American Development Bank
IEA	International Energy Agency
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
JSF	Japan Special Fund
LIBOR	London inter-Bank offered rate
MERM	Multilateral Exchange Rate Model of the International Monetary Fund
MFA	Multifibre Arrangement
MITI	Ministry of International Trade and Industry of the Government of Japan
NMP	net material product
ODA	Official development assistance
OECD	Organization for Economic Co-operation and Development
OECF	Overseas Economic Co-operation Fund
OPEC	Organization of the Petroleum Exporting Countries
Project LINK	International Research Group of Econometric Model Builders, with headquarters at the University of Pennsylvania at Philadelphia
SAEC	State Administration of Exchange Control of the Government of China

SDR	special drawing rights
SFA	Special Facility for Africa of the World Bank
UNCTAD	United Nations Conference on Trade and Development
UNICEF	United Nations Children's Fund

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 United Nations Secretariat 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:	Eastern Europe, Union of Soviet Socialist Republics
China	(In contrast with previous *World Economic Surveys*, China is not included in the group of centrally planned economies)
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, Africa (other than South Africa), Asia (excluding China, in certain cases, and Japan), Cyprus, Malta, Yugoslavia

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

Capital-surplus countries:	Brunei Darussalam, Iran (Islamic Republic of), 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 WORLD ECONOMY IN THE LATE 1980s

Output and income trends

The growth of gross world product in 1987 was slightly above 3 per cent — 1.8 per cent in per capita terms — which is somewhat higher than in 1986. Short-term trends indicate that the world economy will continue to expand during the next two years, but at a lower rate. There was wide diversity in the economic performance of regions and individual countries in 1987.

In much of Asia and North America, economic expansion accelerated. There was no change in the modest rate of increase in the combined gross domestic product of Western Europe, which, nevertheless, remained about two percentage points above population growth. Growth slowed in Latin America, the Mediterranean region, Eastern Europe and West Asia. In Africa, the rate of increase in gross domestic product was 1 per cent, less than half the rate of increase in population.

The instability of financial markets culminated in October 1987 in an abrupt drop of the stock markets in all major financial centres. It was the first global stock exchange crisis and evidence of the internationalization of financial relations. As central banks reacted swiftly to prevent a liquidity squeeze, the reverberations of the drastic reduction in wealth remained largely confined to the financial sphere. Stock prices have partly recovered in the past six months; yet the events of October 1987 continue to instil fears of similar turbulence to come, despite government action on domestic financial practice and more effective policy coordination among major actors. Key parameters of the international economy — exchange rates and interest rates — remain unstable. Their instability helped trigger the market crash and might again lead to major financial disruption. Other international parameters — prices of primary commodities, including oil — also remain volatile.

Large losses and gains from price fluctuations and changes in interest rates have been superimposed on movements in output, leading to erratic variations in per capita incomes. None the less, some regional trends can be discerned.

Per capita incomes in virtually all industrial countries have continued to grow steadily in the current decade. Moderate increases in gross domestic product, some improvement in the terms of trade — particularly for oil importers — and slow population growth have raised per capita incomes at an annual rate of between 1 to 3 per cent in most countries since 1982. This trend is likely to continue in the medium term.

The majority of countries in South and East Asia, including the most populous, have achieved consistent increases in per capita income in the current decade. Underlying economic trends and current policy stances indicate a consolidation of these gains in the short to medium term. In West Asia, armed conflicts and a large drop in oil prices at mid-decade have adversely affected incomes and output. While the considerable drop in per capita incomes came to a halt in 1987 — and per capita incomes in this region are still above those of most developing countries — prospects for a decisive improvement in the short term remain uncertain.

In most countries of Africa, per capita incomes have fallen without respite during the 1980s. A legacy of policy failures in agriculture, ineffective industrialization strategies and extremely low primary commodity prices largely explain the disappointing performance in sub-Saharan Africa. Since 1986, output growth has also slowed markedly in the economies of North Africa. At least in the short term, prospects for the whole continent remain highly uncertain: the room for manoeuvre on the domestic front appears limited, structural policies will take time to bear fruit, and export earnings and prices of primary commodities will probably remain weak.

The debt overhang and failed attempts to correct domestic disequilibria in the large economies in the recent past cast a long shadow over the economic prospects of Latin America and the Caribbean. For the majority of these countries, per capita incomes have fallen since 1981; for almost half of them, they fell again in 1987. There is little prospect of an early reversal. Inflation accelerated considerably in 1987, reaching three digits in the large countries by early 1988. The need to confront domestic disequilibria and a heavy debt burden (which may increase if interest rates rise) make it unlikely that investment ratios (which have fallen markedly since the onset of the debt crisis) will soon recover. Unprecedented adjustment has taken place in the trade balance of the region, which has shifted from deficit into surplus to the tune of $30 billion dollars. Largely as a result of this shift, which has absorbed savings and cut into investments, sustainable growth is not expected in the foreseeable future, if present policies continue.

The combined population of Africa, Latin America and the Caribbean and other developing countries with lagging economies exceeds 1 billion at the end of the 1980s. The revitalization of growth remains a major challenge for policy makers in these economies. Yet a more supportive international economic environment is also critical. Concerted action is required both for a smooth unwinding of the imbalances among key actors in the world economy and to pull these developing countries out of the vicious circle of stagnation and low investment. If this fails, there is the risk that social tensions and financial difficulties will intensify and disruptive courses of action will be taken. For many countries, it will become harder to reconcile legitimate aspirations of different social groups with dwindling or stagnant per capita incomes. The period ahead will be one in which multilateral institutions and traditional economic relations will be put to a major test.

International policy issues

Although the principal policy concerns relating to the functioning of the international economy are much the same as they were a year ago and the major issues are still unresolved, events in 1987 and early 1988 contributed to certain changes in the climate of international co-operation.

The immediate problems have not completely overshadowed long-term concerns, some of which received greater attention in 1987 than ever before. Environmental considerations and the need for sustainable development were more widely recognized. The status and participation of women continued to be given greater importance in the international agenda. The re-examination of economic structures with a view to raising productivity proceeded in all parts of the world, with deregulation of markets, notably financial ones, and extensive privatization of enterprise in market economies and far-reaching reforms in centrally planned economies. There was growing interest in the promotion of entrepreneurship and the improvement of public and private management.

In the short- and medium-term policy areas, which are the principal subject of this *Survey,* government positions have in some cases moved closer, and old and new proposals for tackling the serious imbalances in the world economy have received increasing attention from the general public. Important negotiations in international financial institutions were concluded successfully in 1987 and others are under way, notably in trade. In such areas as debt and adjustment, however, many Governments seem to be running out of options, having tried one approach after another, and a widespread sense of frustration and deadlock prevails.

The extreme fluctuations in the exchange rates among the major currencies of the world are but one manifestation of the instability of the international economic environment in recent years. In 1987, however, the steep decline in the value of the dollar continued with less disruption than many had feared. In spite of — or perhaps due to — the turbulence in international financial markets that marked the year, there was, early in 1988, greater determination and readiness on the part of the major industrial countries to co-ordinate their intervention in exchange markets. Whether or not further shifts occur in the near future in the relationship between the dollar and other principal currencies, they are likely to be significantly smaller than in the recent past. This represents an important step towards greater stability in international economic relations, although it will be put to a test when market pressures eventually begin to push the value of the dollar up again.

There was not much progress in 1987 in reducing the imbalances between the major industrial countries, but the problem was more widely recognized, and negotiations were oriented towards mitigating it. On the whole, however, the year brought into sharp relief the difficulties of co-ordinating macro-economic policies among even a small number of countries with divergent interests, different interpretations of how macro-economic policies work, and strong domestic political forces that constrain Governments in monetary and fiscal policy making, even were they to agree on desirable directions. Major Governments have become more aware of their interdependence and of the international implications of their own policies as well as those of their partners. None the less, if it is to serve as the foundation of the international monetary system, macro-economic policy co-ordination will have to evolve in the direction of agreed principles and rules: progress in that direction, however, has been very slow. The search for an international monetary system that meets the needs of today's world, in which financial markets have become global, must continue. What is needed is an anchor. In the view of an increasing number of experts, the system should be based on a standard, for instance a commodity standard. Such views, however farfetched they may seem today, deserve careful examination.

The debt crisis in developing countries did not move towards a solution in 1987 or early 1988. In some respects it deepened, as an increasing number of debtors took unilateral action and went into arrears not only to commercial creditors but to the International Monetary Fund (IMF) and the World Bank as well. The seriousness of this trend must not be underestimated. On the other hand, a number of important initiatives were taken. In the spring of 1987, the United States commercial banks, following the example of the largest one, decided to increase their provisions against debts of countries with debt-servicing problems and to take significant profit losses; these actions raised the market valuation of their stock and reduced the risk to the banking system. Schemes were floated to allow debtor countries to benefit from the discounts commercial banks were willing to accept in selling off their claims. With the help of bilateral donors, Bolivia was able to buy back a significant part of its debt at 11 per cent of the face value. A plan to convert part of Mexico's debt into long-term bonds at a discount was less successful than hoped for, but by no means a failure.

New proposals to engage the World Bank and/or IMF in the creation of some kind of debt reconstruction facility have been made; one such proposal was made in the spring of 1988 by the Chairman and Chief Executive Officer of the American Express Company. These proposals for debt reduction command increasing attention. The weightiest objection to them is that countries which admit they cannot service past debts might find it more difficult to persuade creditors that they will be able to service new ones. A practical problem is that of enlisting a large number of creditors, some of which would be more likely to be paid in full if others waived part of their claims. These problems are not insuperable, and approaches of this kind seem necessary to overcome the prevailing gridlock. Any one creditor is naturally reluctant to give up more than another does. Debtors will press for the relief given to the most favoured ones. Both creditors and debtors are torn between case-by-case approaches and general rules of fairness.

The United Nations system has provided political and technical support to the process of case-by-case experimentation in the search for solutions to the debt problem that promote future growth rather than compromise it. This is

helping to shape broad notions of the appropriate approach to different situations, which may include debt reduction in some cases and new financing in others.

Important guidelines for the approach to debt and adjustment have already been agreed upon by the international community in numerous resolutions and communiqués, all of which emphasize the mutual responsibility of all partners. The proposals for an international facility for the restructuring of international debt deserve careful study, possibly in the joint IMF/World Development Committee, which seems eminently suited to such a task.

In the area of international trade, one concern which spurred co-operation in exchange rate policy was the rising protectionist pressures induced by the high dollar. So far, the sharp correction of the dollar and its impact on United States trade has not led to any significant abatement of political pressure for measures to restrain trade. None the less, the proposed free-trade arrangements between the United States and Canada are important because they indicate that the benefits of free trade are recognized. The great ferment produced by the intention of the European Economic Community to achieve an integrated internal market by 1992 also testifies to the power of the concepts of liberalization and integration. For non-members of the Community, however, regional liberalization and integration pose the threat of greater exclusion.

From a global point of view, special importance attaches to the Uruguay Round of multilateral trade negotiations, the objective of which is to strengthen the open international trading system. The preparatory phase has been completed with great dispatch. It is now essential that progress be made with regard to the standstill and rollback commitments. As to agricultural trade and trade in services, the process will be difficult and prolonged. It is encouraging that developing countries are participating vigorously in these important negotiations.

Trade in petroleum is a big part of world trade and changes in oil prices have a large impact on both exporting and importing countries. In 1987, prices stabilized and tentative co-operation between OPEC and non-OPEC suppliers was initiated. The risk of sudden changes in response to minor disruptions remains high, however, and progress in the dialogue between producers and consumers has been disappointing. It is as essential as ever to enhance the multilateral capacity to monitor and analyse world oil markets.

The prices of other primary commodities have for many years been extremely low in real terms. The many developing countries depending on them for most of their export earnings have experienced extreme financial strains. Existing mechanisms to compensate for shortfalls in earnings are quite inadequate in the face of the amounts involved, and it is in any case uncertain whether prices will recover significantly in the future. The issues faced by most commodity-producing countries are how to raise productivity in order to remain competitive and, particularly, how to diversify into processing, production of food crops and industrialization in order to reach sustainable patterns of development, with less dependence on commodities which in the future seem to offer no secure livelihood.

As a result of multilateral negotiations, the United Nations Conference on Trade and Development (UNCTAD), at its seventh session in 1987, adopted a Final Act, which spelt out general obligations of different groups of countries in meeting the major problems facing the world economy and went into considerable detail on issues of money, finance and trade.

As for the international financial institutions, in December 1987, the World Bank secured agreement on a programme for extensive co-financing of projects for Africa's recovery and IMF negotiated the Enhanced Structural Adjustment Facility, which tripled its capacity to extend structural adjustment loans to low-income countries on concessional terms. In the spring of 1988, a General Capital Increase for the World Bank was ratified and an extended Compensatory Financing Facility in IMF, including a contingency credit line, began to emerge. These developments have gone a long way towards meeting the concern that the multilateral financial institutions are collecting from developing countries as much money as they are lending to them (or even more), thus in effect contributing to the negative transfer of resources from those countries. Another concern, however, is that, in spite of their privileged position as creditors, these institutions are becoming more deeply involved in the international debt crisis as more debtors incur arrears to them.

An agenda for international adjustment

The *World Economic Survey 1987*[1] concluded its discussion of the global economy by enumerating domestic and international policies that seemed called for in order to reduce the precariousness and lopsidedness of the international economic situation. While a collapse of the international financial system has been averted, it is a measure of the prevailing deadlock that virtually all of the conclusions reached in 1987 are just as valid today. At this stage, consideration needs to be given to a major global effort of co-operation with an agreed time horizon for the unwinding of the present imbalances and incongruities in financial flows.

There is as much need for domestic efforts as for international ones, but there will be little scope for improved co-operation unless there is a stronger perception all round that the commitments to undertake the necessary domestic efforts are credible and sustainable. Yet such domestic efforts to restore growth and stability are in many cases frustrated by the present international financial situation, notably by

1 United Nations publication, Sales No. E.87.II.C.1 and corrigendum.

the net outflow of resources from several large debtor countries.

Net financial flows are the mirror image of net flows of trade in goods and services. They cannot be adjusted without corresponding changes in trade, which in turn have implications for production, employment and living standards in the economies involved. To narrow the current account balance, spending has to be reduced and resources shifted into import-competing and export sectors. Corresponding shifts have to take place in trading partners.

If the United States is to reverse its deficit and run a trade surplus sufficient to meet the interest payments on its debt, that shift would be of the order of 5 per cent of its GNP. Such a shift could not take place within a short period of time, nor would that be desirable. Even if the deflationary effect on the world economy were offset by stimulative policies in other countries, there would be a need for extensive adjustments of capacity. Added to the structural transformation already imposed on the world economy by accelerated technological change, such adjustments would put further pressure on the trading system, on labour markets and on public policy.

In the case of developing countries, where a revival of investment is necessary, the required shift is in the opposite direction. Reducing the debt service obligation to bring it into line with the capacity to pay, which is a frequent recommendation, might contain the debt crisis, but that goes only half way towards restoring the transfer of resources into these countries rather than out of them. In the end, a renewed flow of capital is needed, not decades of merely paying off past debts.

In both cases much time will be required, and it is widely assumed that correction of these situations will continue into the 1990s. This is no more than a manner of saying that it will take substantially more than two years to correct such situations and present prospects and policies offer no assurance that the correction will not drag on until the end the century.

The political economy of the world in the late 1980s is not likely to let that happen, however. In the case of the imbalances among the main industrial countries, the financial markets may impose their solutions if government policies do not change. In the heavily indebted developing countries, political solutions may overrule market solutions. Governments straining to honour past debts will do so as long as the cost of unilateral refusal to pay seems greater. Their deep involvement in the dynamic world economy is a strong disincentive to measures that would disrupt their trade. But the limits are ultimately set by what political conditions will permit.

The present situation is highly precarious. It is universally recognized as unsustainable and the signs of strain are multiplying. It will be resolved one way or another, but an orderly resolution is preferable to one dictated by crises in the market place or unilateral rejection of obligations.

It would reduce the prevailing uncertainty and insecurity in the world economy if a co-operative framework were established, embodying at least three elements:

The objective of redirecting capital and trade flows in a manner consonant with the needs of stability and widespread growth in the world economy;

A timetable for the achievement of this;

Recognition of the need to sustain adequate financial flows throughout the adjustment process in order to avert the disruptive effect of sudden financial contraction.

Chapter II

WORLD ECONOMIC DEVELOPMENTS: MAIN FEATURES AND PROSPECTS

World economic growth in 1987

Structural adjustments of different kinds continued to preoccupy all countries in the world economy in 1987. Many of them, including both industrial and developing countries, suffer from deficits in their trade balances and current accounts which will require extensive reallocation of resources and restructuring of economic activity to take advantage of new technological and other opportunities. Many countries seek to restructure the framework of economic activity in order to make it more flexible and effective, and some are reconsidering the roles of the State and the private sector in the economy.

Notwithstanding these widespread structural adjustments, the world economy performed in 1987 broadly as anticipated because there were few unforeseen shocks to the system. In previous years, sudden changes in key international prices have had profound effects on groups of countries and on the world economy as a whole. In 1987, the major disruptions in national and international financial markets in the last quarter did little to disturb the prevailing trends and patterns in economic growth. Contrary to expectations at the beginning of the year, and particularly after the decline in equity prices in October, economic activity in the developed market economies picked up and even accelerated in the latter part of the year. International trade also regained momentum. Despite these developments, growth in the developing countries as a group slowed in 1987.

Preliminary estimates suggest that the gross world product continued to grow at over 3 per cent in 1987, as in the previous year (see table II.1). In the developed market economies, which account for some three fifths of world output, the rate of growth increased. In the centrally planned economies of Europe, the growth of net material product fell back by over 1 percentage point, while it rose as much in China. Among the developing countries, the pattern of growth was broadly as anticipated in the *World Economic Survey 1987*. In South-East Asia, particularly in the rapidly industrializing economies of that region, it was more rapid than estimated. South Asia, on the other hand, was afflicted by drought in some areas and floods in others and failed to live up to expectations. Growth in the Mediterranean region was

Table II.1. Growth of population and output by region, 1971-1989

	Population 1985 (millions)	Population growth rate 1985-1990 (annual percentage)	Gross domestic product 1985 (billions of 1980 dollars)	Rate of change of gross domestic product (annual percentage)					
				1971-1980	1981-1985	1986	1987[a]	1988[b]	1989[b]
World	4 837	1.6	..	3.9	2.7	3.3	3.3	3.2	2.8
Developed market economies	789	0.6	7 640	3.1	2.2	2.7	3.0	2.4	1.8
North America	264	0.9	2 866	2.9	2.4	2.9	3.0	2.4	1.4
Western Europe	353	0.2	3 467	2.9	1.5	2.6	2.5	1.9	2.0
Developed Asia	121	0.5	1 060	4.7	3.6	2.5	4.2	3.9	2.6
Centrally planned economies of Europe[c]	394	0.8	..	5.2	3.3	4.3	2.6	4.0	4.0
China[c]	1 060	1.2	..	5.7	9.4	7.4	9.3	8.0	7.5
Developing countries	2 595	2.3	2 217	5.6	1.5	2.9	2.7	3.0	3.1
Western hemisphere	405	2.2	822	5.5	1.0	3.6	2.5	1.5	1.6
West Asia	108	3.2	343	6.5	-0.9	0.1	-1.0	2.9	2.9
South and East Asia	1 486	1.9	606	5.6	4.8	5.5	5.6	5.5	5.2
Africa	523	3.1	305	4.9	-0.9	-2.1	1.0	2.0	2.5
Mediterranean	74	1.6	141	5.3	2.9	5.6	2.9	3.8	3.8

Source: Department of International Economic and Social Affairs of the United Nations Secretariat. Data on population and population growth rates are those published by the Department in *World Demographic Estimates and Projections, 1950-2025* (United Nations publication, Sales No. E.86.XIII.3).

[a] Preliminary estimates.

[b] Forecast, based on Project LINK and Secretariat estimates.

[c] Net material product.

Table II.2. Developing countries: rates of growth of gross domestic product by analytical country groupings, 1981-1989

(Annual percentage change)

	1981	1982	1983	1984	1985	1986	1987	1988	1989
All developing countries	1.1	0.2	0.8	2.2	2.0	2.9	2.7	3.2	3.5
Seven largest countries	3.0	1.2	-0.8	3.6	4.9	3.1	2.4	3.6	3.8
Bangladesh[c]	6.8	0.8	3.6	4.2	4.1	4.5	3.0	..	..
Brazil[c]	-2.0	1.4	-2.7	4.8	8.2	8.0	3.0	..	..
India[c]	..	2.9	5.4	4.9	4.5	4.8	2.5	..	..
Indonesia[d]	7.9	2.2	4.5	4.2	1.9	3.0	3.5	..	..
Mexico[d]	8.3	0.0	-5.2	3.5	2.7	-3.5	1.3	..	..
Nigeria[d]	-5.9	-1.9	-6.4	-5.5	2.4	-5.0	-2.0	..	..
Pakistan[c]	7.7	4.3	6.5	5.3	8.2	7.0	7.0	..	..
Other developing countries	0.2	-0.4	1.8	1.3	0.2	2.8	2.8	4.1	3.4
Net energy-exporting countries	-2.2	-0.4	-0.8	-1.1	-1.3	-0.7	-0.2	-2.4	1.8
Net energy-importing countries	1.5	-0.4	2.7	3.2	1.3	5.3	4.9	4.7	4.1
Memorandum items									
Fifteen heavily indebted countries	0.0	-0.8	-2.5	2.1	2.5	3.1	2.2	3.2	3.0
Sub-Saharan African countries[e]	2.1	-1.1	1.1	0.8	3.0	2.3	2.4	3.5	3.5
China[f]	4.9	8.3	9.8	12.0	12.3	7.4	9.3	8.0	7.5

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

[a] Preliminary estimates.

[b] Forecast.

[c] Net energy-importing country.

[d] Net energy-exporting country.

[e] Excluding Nigeria.

[f] Net material product. China is not included in the total for all developing countries.

also modest. Africa's situation improved somewhat, but the growth of output for the region as a whole remained below 1 per cent. In Latin America, the debt-related difficulties of some of the larger countries caused a greater than expected slow-down. Output in West Asia resumed the decline that was interrupted in 1986.

World trade and commodity prices

International trade grew more than anticipated in 1987, increasing by about 4 per cent in volume terms, compared to 3.5 per cent in 1986 (see chap. III below). That trade flows began to change in response to the realignments of exchange rates and to the differentials in growth rates among the developed market economies was as important as the growth of trade in influencing the global pattern of economic activity during the year. The appreciation of almost all major currencies *vis-à-vis* the dollar encouraged net imports into Japan and the Western European economies, while dampening those flowing to the United States. Countries in a position to exploit the former markets benefited, with those oriented towards Japan being in a particularly advantageous position because of that country's resumed rapid growth. Exporters competing with United States' producers found themselves in a more difficult position, although this was mitigated to some extent by that country's continued growth and still increasing demand for imports.

The developed market economies were the most affected by these changes, since the majority of trade flows are within that group of countries. However, developing countries were also affected to varying degrees. As indicated in table II.3, countries in Asia and Africa rely more heavily on exports to Japan and Western Europe than countries in Latin America and therefore stand to gain most from the changing pattern of trade flows.

This was illustrated in 1987 when a few countries in East Asia achieved increases in their volumes of exports of more than 20 per cent. These countries benefited from the depreciation of their currencies *vis-à-vis* most other major currencies, most notably the yen. The strength of the Japanese economy reinforced this price effect and boosted demand for these countries' exports, not only in Japan itself but also in third markets. The change in relative prices also encour-

Table II.3. Structure of imports and exports of developing country regions by region of origin and destination, 1985

(Percentage)

Region	Share of 1985 imports from			Share of 1985 exports to		
	United States	Western Europe	Japan	United States	Western Europe	Japan
Latin America and the Caribbean	30.0	17.5	7.9	37.5	20.6	4.3
Africa	8.6	54.4	5.5	11.7	65.1	1.5
West Asia	8.3	39.1	12.6	3.5	22.3	23.0
South and South-East Asia	13.8	14.9	20.0	13.1	28.6	16.4

Source: Handbook of International Trade and Development Statistics: 1987 Supplement (United Nations publication, Sales No. E/F.87.II.D.10), tables 3.2 and 3.3.

aged many Japanese corporations to establish or expand their own facilities in the subregion or to contract out part of their production process to firms there.[1] No other developing region matched the export performance of East Asia, but increased growth in trade was an important characteristic of the developing countries in 1987 (see chap. III).

There were few dramatic changes in the prices of traded goods in 1987. Oil prices did not suffer further declines and were generally higher than in 1986 (see table II.4 and chap. V below). As a result, and in contrast with the previous year, imports by the energy-exporting countries were not drawn down, but served as a positive rather than negative influence on their trading partners.

Trends in the prices of other primary commodities were mixed in 1987, but most indices suggest that, measured in real terms, these prices reached an all-time low in the first quarter of 1987 and have risen modestly since. As discussed in chapter III, measures of the average prices of commodities for the year as a whole hide important changes within the total. In some cases, notably beverages, prices continued their decline in 1987; in other instances, particularly metals, there was a sustained recovery throughout the year, while agricultural raw materials reversed their downward trend in the course of the year. Overall commodity prices did not have a major effect on the international balance of trade in 1987, although individual countries were affected more than average indices suggest. More importantly, however, the import prices of manufactures faced by developing countries increased steadily throughout the year when measured in dollars, with a negative effect on the terms of trade.

The higher rates of growth in the developed market economies and in international trade in 1987 were insufficient to increase the average rate of growth in the developing countries. There are several reasons why the developing countries benefit less than previously from growth elsewhere. The first is that the nature of many developing countries' trade linkages with the rest of the world has changed. Technical progress and other factors have resulted in both a shift in demand and a reduction in the income elasticity of demand for many commodities. The developing countries' dependence on exports of primary commodities has been reduced, even though it remains high in many countries or subregions.

A partial corollary to the decreased commodity-intensity of growth in the developed market economies has been the rapid expansion of services. Many services are non-tradable, and few developing countries have a comparative advantage in those that are tradable. The stimulatory effect of rising incomes in the developed market economies is reduced as the developing countries find themselves in the position of producing goods with a low income elasticity of demand and are unable to participate in the market for services where there is a high income elasticity of demand.

These changes in the pattern of demand help to explain the reduced interaction between developing and developed countries and the increased ties within the groups. Trade among developing countries increased from 23 per cent of their total exports in 1975 to 30 per cent in 1985; the corresponding figures for the developed market economies were 69 and 74 per cent. Conversely, the developed market economies accounted for only 62 per cent of developing countries' exports in 1985 compared to 69 per cent in 1975.[2]

Another consideration is that growth in the 1980s has tended to be concentrated in the larger economies, both de-

1 A similar process is occurring as Japanese firms and European firms establish themselves in the United States.

2 *Handbook of International Trade and Development Statistics: 1987 Supplement* (United Nations publication, Sales No. E/F.87.II.D.10), table 3.2.

Table II.4. Indicators of the international economic environment, 1980-1987

	1980	1981	1982	1983	1984	1985	1986	1987
	(Annual percentage change)							
World trade								
Value (in dollar terms)	22.0	-1.6	-6.5	-1.3	5.6	1.0	8.5	13.3[a]
Volume of world exports	0.0	1.0	-2.4	3.1	7.6	3.0	4.5	4.1[a]
World prices								
Oil	65.8	11.5	-4.3	-10.3	-4.3	-3.5	-45.6	16.4
Non-fuel primary commodities	13.4	-15.4	-16.1	6.4	1.2	-10.7	5.3	-3.8
Manufactured exports	11.1	-6.0	-2.1	-4.3	-2.3	0.0	19.8	18.4[a]
Dollar exchange rate[b]	0.1	12.7	11.7	5.8	7.9	4.5	-18.4	-11.9
Interest rate[c] (percentage)	14.0	16.7	13.6	9.9	11.3	8.6	6.8	7.6
	(Billions of dollars)							
World finance								
Total flow of resources to developing countries[d] of which:	128.4	139.1	117.8	97.7	86.1	82.3	84.0	..
Official development assistance	37.5	37.2	34.1	33.4	34.9	37.1	44.0	..
Net transfer of resources to developing countries[e]	40.3	41.8	11.8	0.1	-9.5	-22.7	-20.1	-22.5
Capital flows into the United States	-28.1	-27.9	-27.4	35.0	80.2	98.5	117.4	138.8

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*, various issues; OECD, *Development Co-operation: 1987 Report* (Paris, 1987); United States Department of Commerce, *Survey of Current Business*, various issues; United Nations, *Monthly Bulletin of Statistics*, various issues; and UNCTAD, *Commodity Price Bulletin*, various issues.

[a] Preliminary estimates.

[b] Based on the IMF Multilateral Exchange Rate Model, which is an index of the effective exchange rate.

[c] London Inter-Bank Offer Rate on six-month dollar deposits.

[d] OECD definition.

[e] For details, see table IV.2.

veloped and developing. These countries have proportionally weaker trading links than small and medium-sized countries and are likely to stimulate world trade less than if growth were concentrated in the latter group of countries.

Outside the area of trade, since the 1970s, financial flows and financial markets have come to play a more important role as a transmission mechanism between the developed market economies and the developing countries. However, net financial transfers to developing countries have diminished and become negative, while the effects of growth transmitted by financial markets may be inverse rather than positive. For example, faster growth in the developed market economies may be accompanied by an increase in interest rates; this would slow the growth of the developing countries as a group because of the higher debt-servicing costs of indebted countries, as appears to have been the case in 1987.

A further reason why growth in the developing countries is less correlated than previously with global trends is that external constraints have been joined by tighter domestic constraints in many developing countries. Many of the hard-pressed countries find themselves with less room for manoeuvre in economic policy than they had a few years ago, which makes it harder for them to respond to new opportunities.

International financial markets

Capital flows and the role of official finance

There was little change in the overall pattern of international capital flows in 1987. This was a reflection of the lack of progress in resolving the dual problems of external imbalances among the developed market economies and exter-

nal indebtedness on the part of many developing countries. The former meant that there were large capital flows into the United States and out of the Federal Republic of Germany and Japan as a counterpart to their current account imbalances; the latter remained an impediment to the revival of net private capital flows to developing countries and was the reason for the continued net transfer of resources from developing to developed countries (see table II.4 and chap. IV).

Concern about the sustainability of the United States' current account deficit increased. In previous years, private flows had been the main source of finance for this deficit, but official flows assumed this role on a large scale in 1987. The United States' external deficit was thus financed not by markets but by policy-induced decisions in partner countries.

The total debt of the developing countries increased by about 6 per cent in dollar terms in 1987, equivalent to an increase of about 2.5 per cent when changes in exchange rates are taken into account. This increase did not, however, reflect a revival of voluntary private capital flows to developing countries, but was largely official lending and concerted lending provided as a part of debt-rescheduling agreements. Some borrowers were able to reduce their indebtedness to commercial banks by devices such as debt-equity swaps and securitization. Such measures simultaneously enabled individual lenders to reduce their exposure; they also greatly increased their reserves to cover such debts and sold off debt in the secondary market.

Debt-servicing problems were aggravated by rising interest rates. This was not reflected in higher interest payments, which were almost unchanged from 1986 at $49 billion. One reason for this apparent inconsistency was that financial constraints prevented an increasing number of countries from remaining current on their debt payments, causing them to accumulate arrears. In other instances, payments could be maintained only through the provision of new loans. Like arrears, "new money" has the effect of increasing future liabilities but, under current circumstances, it maintains the standing of the borrower in international financial markets.

Overall, there was no breakthrough in the international debt strategy in 1987, despite the recognition of both the costs involved for all concerned and the fact that the problem is not going to disappear of its own accord. All forecasts point to a continuation of those problems until well into the 1990s unless there is a new approach to the debt problem. There was some progress in 1987 on the debts of sub-Saharan African countries which received some official debt relief from a few bilateral creditors and whose debts were being rescheduled on increasingly lenient terms. The most important new element, however, was the mobilization of additional concessional resources for sub-Saharan Africa by the multilateral financial institutions—the Enhanced Structural Adjustment Facility of IMF, the Special Programme for Africa of the World Bank and the increase in the resources of the African Development Bank.

The persistent instability in exchange rates and interest rates

The continued decline in the value of the United States dollar that started some two years earlier (see figure II.1) was the most important development in financial markets in 1987. This change in the value of the dollar affected trends in the world economy in 1987 and will continue to do so for the next several years.

The decline in the value of the dollar was from 160 yen to 128 yen and from 2.0 deutsche mark to 1.68 deutsche mark[3] between the last quarter of 1986 and the first quarter of 1988. Overall, the weighted average decline was some 12 per cent during 1987, making the cumulative fall about 35 per cent since the first quarter of 1985.

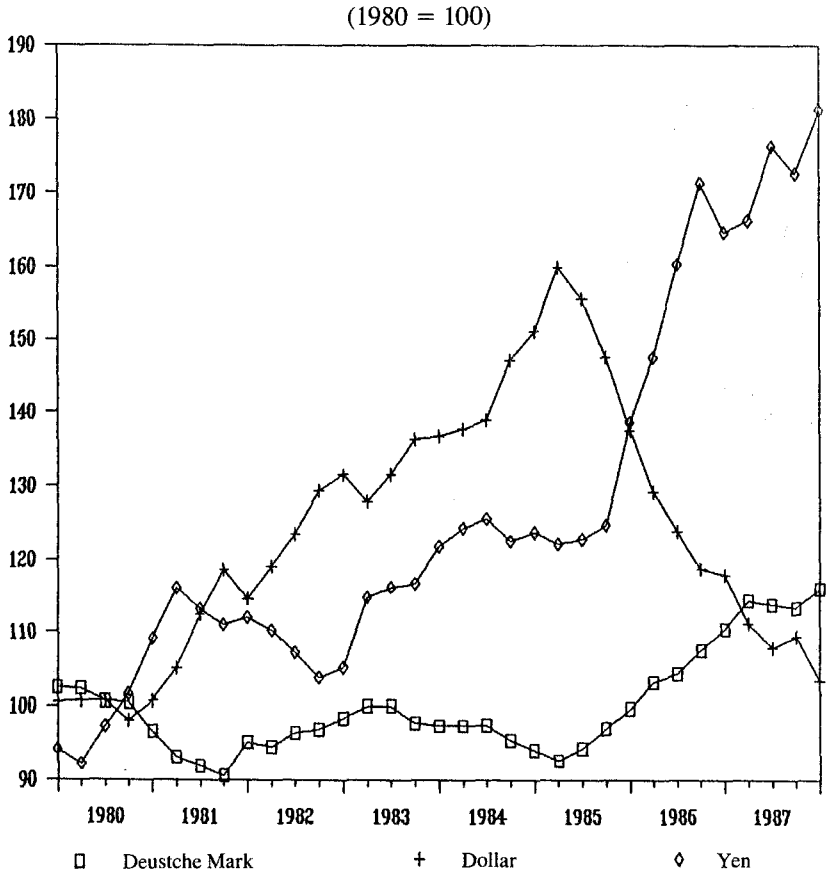
This transition to a new pattern of exchange rates has not been accomplished smoothly, but has been characterized by short-term fluctuations around the long-term trend. The gyrations in international currency markets in 1987 highlight the conflicting financial pressures on exchange rates in a globalized and deregulated market. In a market system, exchange rates influence the international allocation of resources and would be expected to tend towards equilibrium levels. However, they have to perform this function for two distinct markets—that for goods and services and that for finance. The equilibrium exchange rates in these two markets may not coincide in the short term. In addition, policy makers may have different views on the roles that they expect exchange rates to fulfil, most notably between the needs of domestic and international policy.

In the 1980s, halting inflation has been, and still is, a major objective, and monetary policy has been considered the most effective means of controlling inflation. However, changes in monetary policy also affect exchange rates. For example, a Government may counter perceived threats of impending inflation by raising domestic interest rates. In present financial markets, domestic interest rates are only one element in a spectrum of interrelated international rates. If other things remain unchanged, a rise in one country's interest rates is likely to prompt an inflow of funds and, in the absence of intervention to prevent it, an appreciation of the exchange rate. This will affect the relative profitability of importing and exporting activities and, in due course, is likely to reduce the trade balance. The use of monetary policy to control inflation may therefore conflict with the objective of maintaining stability in exchange rates. On the other hand, manipulation of interest rates to influence international capital flows (and thereby the exchange rate) may conflict with the objectives of domestic monetary policy.

The upward trend in interest rates that prevailed in most financial markets in the first half of 1987 (and that has emerged in the United States again early in 1988) reflected the

3 The existence of the European Monetary System makes the exchange rate with the deutsche mark broadly representative of that with most European currencies except the British pound.

Figure II.1. Nominal effective exchange rates of the Federal Republic of Germany, Japan and the United States, 1980-1987



Source: IMF, *International Financial Statistics*, various issues.

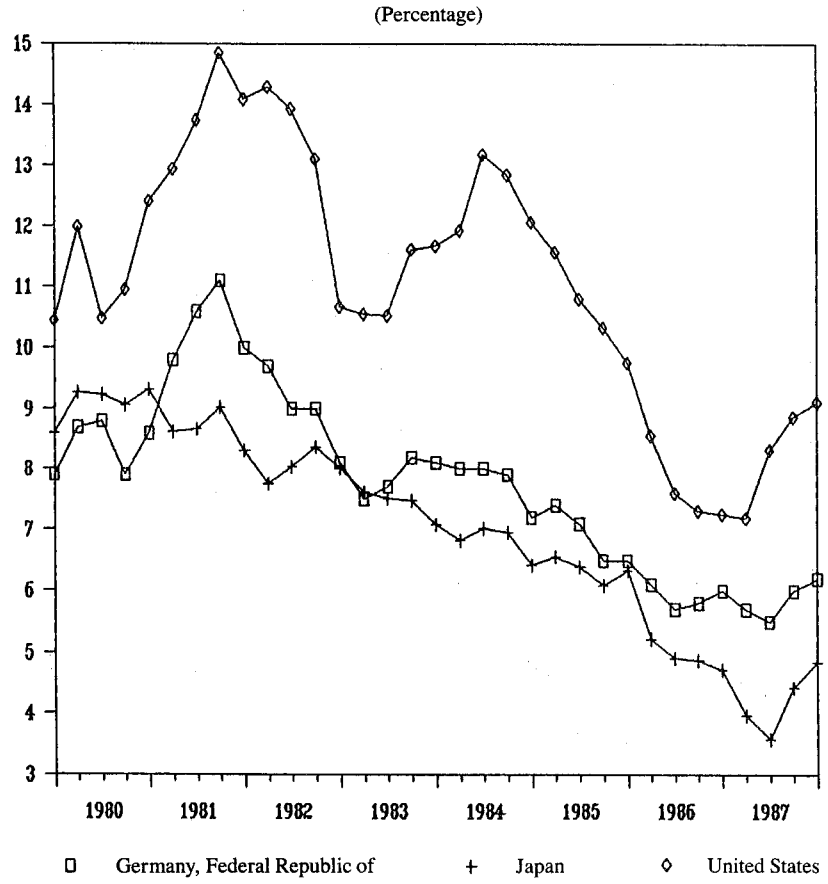
perception of both Governments and markets that inflation was about to increase. Prior to 1987, nominal interest rates had declined relatively steadily from their peaks around the beginning of 1982 (see figure II.2). During 1987, the trend became erratic. Early in the year, the downward trend continued and nominal long-term rates in the three largest market economies reached their lowest levels of the decade. This trend was reversed around the middle of the year as monetary authorities raised interest rates in an effort to fend off signs of accelerating inflation and to defuse inflationary expectations. Following the collapse of equity prices in October 1987 (see chap. IV below), Governments promptly relaxed monetary policy, *inter alia*, through a reduction in interest rates. This was reinforced early in 1988 by further reductions in interest rates in the Federal Republic of Germany, Japan and the United Kingdom. On these occasions, however, the adjustments were prompted by considerations other than inflation. In the first two instances, the interest rate cuts were part of an internationally agreed package of measures designed to reduce the imbalances among the developed market economies by stimulating the economies of the Federal Republic of Germany and Japan. In the last case, the United Kingdom Government reduced interest rates in an attempt to slow the appreciation of its currency *vis-à-vis* those of the European Monetary System, notably the deutsche mark.

The net result of these developments is that long-term interest rates in early 1988 are at broadly the same level as a year previously, although somewhat higher in the United States. Short-term interest rates are lower than a year ago. One reason for this is the large liquidity in the global financial system, due to a large extent to the apprehensions occasioned by the precipitous decline in equity values.

Real interest rates[4] remain high by historical standards and appear to be having a damaging effect on capital investment. Combined with the high degree of uncertainty among both consumers and investors, particularly the latter, they are disrupting the interaction between the real and financial sectors of the economy. With the prospects for the medium term unclear, there is a preference for financial instruments rather

4 In this context, real interest rates are measured *ex post* as the difference between nominal interest rates and the rate of inflation.

Figure II.2. Yields on long-term government bonds in the Federal Republic of Germany, Japan and the United States, 1980-1987



Source: IMF, *International Financial Statistics*, various issues.

than investments in physical capital. Even among financial instruments, the events of the past year have resulted in a preference for those of a short-term nature.

The low levels of investment in many countries are a matter of concern because they imply reduced growth in the future. To some extent, for example, the capacity constraints encountered in some of the developed market economies in 1988 are the result of inadequate investment earlier in the decade. Present trends suggest this bottle-neck is unlikely to be relieved in the immediate future.

The situation is more disturbing in many of the developing countries. Growth and adjustment both require investment, but in many countries the rate of investment has fallen (see table II.5). This is notably the case in some of the heavily indebted countries, where the rate of domestic savings has been maintained or even increased, but the rate of investment has nevertheless declined. This is largely attributable to the disequilibria prevailing in international financial markets—the transfer of financial resources from developing to developed countries, the high real rate of interest and, to a lesser extent, the instability of exchange rates.

The developed market economies: sustained growth, but slow adjustment

Since 1982, the great majority of the developed market economies have had annual rates of growth ranging between 1 and 4 per cent (see table A.III.1). None of the seven largest ones has suffered any year-to-year decline in its level of output, despite the persistence of some fundamental economic problems.

In 1987, these countries as a group grew faster than in the previous year, returning to the 3 per cent rate of growth achieved in 1985. Most of the rapid growth occurred during the latter half of the year, with an unexpectedly strong performance being displayed by Japan and the United States. In the United States, there was some fiscal tightening in 1987 as the federal budget was reduced by some $70 billion, equivalent to about 1.5 per cent of GNP. This was expected to have a contractionary effect on demand, but was offset by countervailing forces, most importantly, the lagged re-

Table II.5. Savings and investment rates in selected groups of developing countries

(Percentage of gross domestic product)

Country or country group	Gross domestic saving			Gross domestic investment		
	1980	1982	1985	1980	1982	1985
Low-income countries	22	21	24	25	24	29
China and India	26	27	28	28	27	33
Other low-income countries	7	5	6	14	13	15
Middle-income countries	25	21	23	27	24	21
Lower middle-income countries	..	17	19	..	23	20
Upper middle-income countries	..	23	26	..	24	22
Argentina	..	22	16	..	19	9
Bolivia	15	14	20	13	14	17
Brazil	20	19	22	22	19	16
Chile	16	8	16	18	10	14
Colombia	25	22	17	25	26	18
Côte d'Ivoire	23	24	26	28	24	13
Ecuador	23	24	24	25	25	18
Mexico	26	28	26	28	21	21
Morocco	11	8	12	21	23	22
Nigeria	28	16	14	24	25	10
Peru	19	14	25	16	17	20
Philippines	25	21	13	30	29	16
Uruguay	12	12	12	19	15	8
Venezuela	32	25	24	25	26	15
Yugoslavia	32	33	41	35	34	39

Source: World Bank, *World Development Report*, various issues.

sponse to the earlier depreciation of the dollar stimulated both import-substitution and exports.

The rise in the value of the yen was expected to have a deflationary effect on the Japanese economy and such effects began to appear in 1986 when the rate of growth of output in Japan fell to its lowest level of the decade. This trend was reversed in 1987 as an unexpectedly large increase in domestic demand took up the slack left by the decline in export demand. Overall, the growth of the Japanese economy accelerated to above 4 per cent, again making Japan one of the most rapidly growing of the developed market economies. Reinforced by the terms-of-trade gains resulting from the appreciation of its currency, this provided the slowly growing Japanese population with a sizeable increase in per capita income during the year.

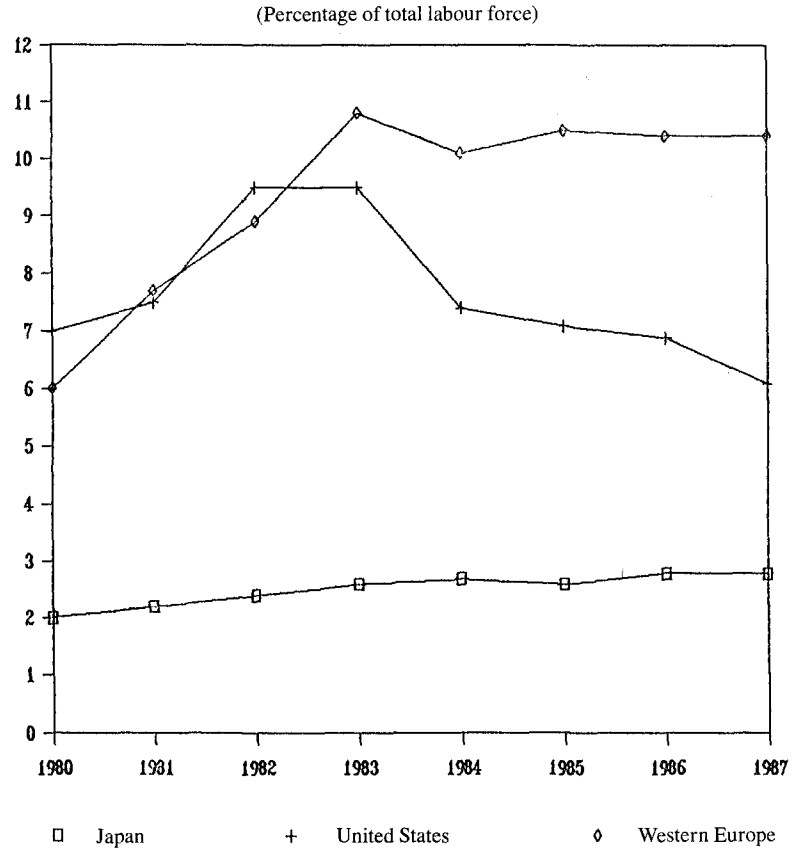
The remaining developed market economies accentuated the general reversal of the previous year's trend towards a convergence of growth rates in the range of 2.5 to 3 per cent. In addition to Japan, Canada and the United Kingdom accelerated their above-average performance of 1986. The depreciation of its currency in 1986 was one of the factors stimulating growth in the United Kingdom in 1987 and making it the fastest growing of the larger developed market economies. The Federal Republic of Germany had the opposite experience: the appreciation of the deutsche mark was one of the reasons its rate of growth fell by almost 1 percentage point in 1987.

The first signs of the lagged responses to the international policy changes and market adjustments that had been taking place since early 1985 began to appear in 1987. At the beginning of the year, the United States trade deficit was still growing because the depreciation-induced increases in import prices (combined with the maintenance, and even growth, of import volumes) were outweighing gains in the volume of exports. This deterioration in the visible trade balance was reinforced by a worsening invisible balance resulting from increased outflows of interest and similar payments on foreign capital. As the year progressed, there were signs of a shift away from imports and a continued growth of exports.

Unemployment and inflation

Unemployment in North America continued its steady decline in 1987, but in Japan, where it was expected to increase, it failed to do so. In Western Europe, it remained high (see figure II.3). The contrast in the employment situation in the three regions is striking. Although the United States and Western Europe have broadly similar populations, the number of unemployed in the United States is 7 million and the rate of unemployment fell to its lowest level in more than a decade early in 1988. Since 1980, the number of people employed in the United States has increased by over 13 million (see figure II.4). This increase in employment has three notable features: most of the gain has oc-

Figure II.3. Unemployment in Japan, the United States and Western Europe, 1980-1987



Source: OECD, *Main Economic Indicators* (Paris, March 1988); and OECD, *Employment Outlook* (Paris, September 1987).

curred in the service sector; more than half the new employees are women; and almost none of the increase has been accounted for by the large enterprises that play a dominant role in the economy as a whole.

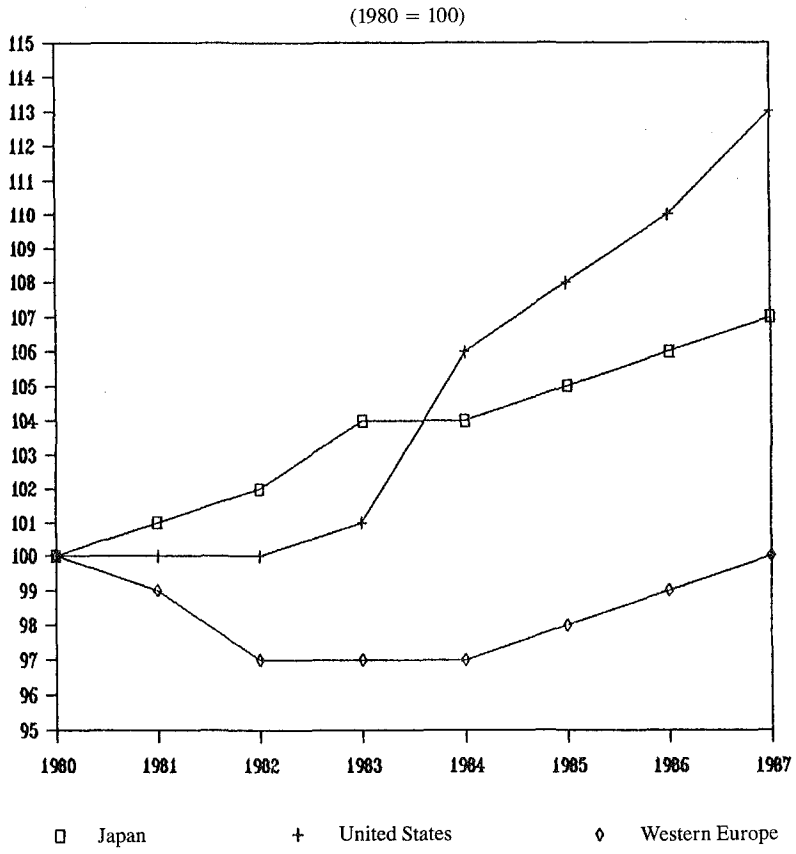
In 1986, the appreciation of the yen contributed to an increase in unemployment in Japan. Contrary to expectations, this trend was reversed in 1987, as the strong growth of domestic demand created sufficient additional employment opportunities to reduce the unemployment rate. As a result, unemployment in Japan remains atypically low by the standards of the other developed market economies at below 3 per cent.

In contrast, total unemployment in Western Europe is still more than 19 million people. No net new jobs have been created in the region this decade: the average rate of unemployment of approximately 11 per cent is about double what it was in 1980 and about four times the level prevailing in 1973. Within this average, there are some very high rates—about 20 per cent in Ireland and Spain.

Progress in reducing Western Europe's unemployment problem was muted in 1987. Unemployment fell in the United Kingdom, but rose in France, the Federal Republic of Germany and Italy. There were signs of progress in reducing unemployment in some of the chronically affected countries, but in Ireland the unemployment rate continued to grow. With regard to the most seriously affected segments of the population, there was a slight reduction in the number of unemployed youths in 1987. This was partly attributable to the decline in the proportion of youth in the work-force, but more importantly to a number of policy measures, such as the youth employment programmes in France and the United Kingdom. The number of long-term unemployed did not show any widespread improvement.

The continued high rates of unemployment in Western Europe have to be seen in the context of the region's steady growth over the past five years. This growth has failed to bring unemployment even close to the levels of a decade earlier, and a slow-down in economic activity would pose the threat of a further increase in the number of people out of work. As indicated above, economic growth—and therefore employment—in the United Kingdom benefited in 1987 from the earlier depreciation of its currency, while the opposite applied in the Federal Republic of Germany. The re-

Figure II.4. Total employment in Japan, the United States and Western Europe, 1980-1987



Source: OECD, *Employment Outlook* (Paris, September 1987); and OECD, *Main Economic Indicators* (Paris, March 1988).

sponses in future years to the changes in exchange rates that occurred in 1987 are likely to have an adverse effect on Western Europe's employment, unless accompanied by stimulatory policy measures. This possibility is investigated further in the last section of the chapter.

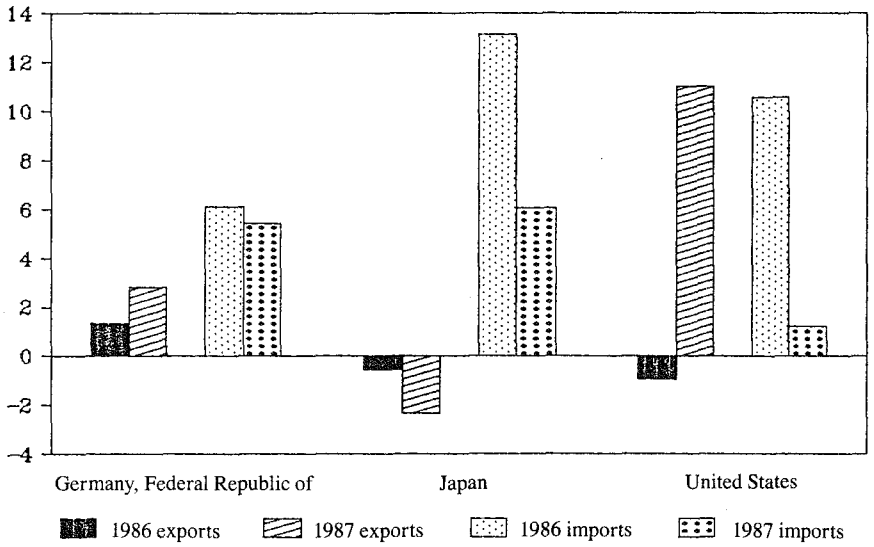
Inflation in the developed market economies remained below an average of 4 per cent in 1987. One measure of inflation—the rate of increase in consumer prices—showed a modest rise over its level in 1986 when it had been the lowest in more than two decades (see table A.III.2). Within this average, there was a decline in inflation in 1987 in some countries, particularly the smaller ones, that had had above-average inflation in 1986. Among the larger economies, there was almost no increase in consumer prices in the Federal Republic of Germany and Japan in 1987. Another measure of inflation, the deflator for gross domestic product, increased by the smallest amount this decade.

Inflationary pressures in Western European countries and Japan were eased in 1987 by the continuing appreciation of their currencies. The increase in the dollar price of oil, for example, was offset by the depreciation of the dollar. Within the United States, depreciation has not yet accelerated the rate of inflation, in part because of the relatively small role of imports in the economy, but also because some importers seem to have absorbed a large part of the implicit increase in domestic prices.

In the middle of 1987 and again early in 1988, inflation was expected by both Governments and other economic agents to accelerate. Analysts pointed to the apparent reversal of the downward trend in commodity prices (particularly those for industrial raw materials), and the pressure on wages in many countries. On the supply side, concern was expressed about the increasing rate of capacity utilization (perceived to be close to its non-inflationary maximum in some developed market economies, notably the United States). To date, however, increasing levels of capacity utilization have not been accompanied by any sizeable increase in inflation. The change in the composition of demand, particularly the shift towards service industries, may have reduced the relevance of industrial capacity utilization as a barometer for inflation. The concerted supply-side reforms that have taken place in many developed market economies in recent years may also have had the effect of reducing the rigidities of the market in responding to increases in demand. Finally, the high rates of unemployment in Western Europe suggest that there is scope for a non-inflationary expansion of output in that region.

Figure II.5. Volume of exports and imports of the Federal Republic of Germany, Japan and the United States, 1986 and 1987

(Annual percentage change)



Source: IMF, *International Financial Statistics*, various issues.

External imbalances and policy co-ordination

Most balance-of-payments deficits of developed market economies increased in 1987 and so did their surpluses (see table IV.1). Among the three major economies, there was a relative narrowing only in the case of Japan (see figure II.4).

The magnitude of the changes in the exchange rates of the major currencies since 1985 did not begin to be reflected in foreign trade flows until 1987.[5] Despite the depreciation of the dollar, the volume of United States' imports continued to grow in 1987, although at a much slower rate than in 1986 (see figure II.5). Imports of the Federal Republic of Germany and Japan grew at a slower rate in 1987 than in 1986, notwithstanding the appreciation of their currencies. The behaviour of exports corresponded more closely to the pattern that would be expected from the exchange rate changes: the volume of United States merchandise exports grew by over 10 per cent in 1987, while those of Japan fell for the second consecutive years; exports of the Federal Republic of Germany, on the other hand, increased faster in 1987 than in 1986. The year therefore marked a tentative beginning in the correction of the external imbalances among the developed market economies.

At the same time, the imbalances remained large in absolute terms and the enormity, complexity and dangers of the necessary task of narrowing them became more apparent.

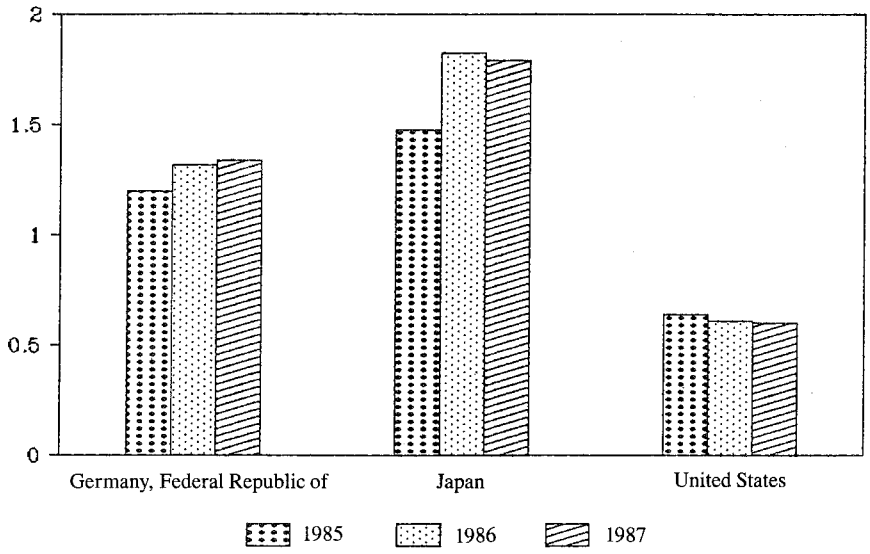
The absolute size of the imbalances is important in terms of the financial flows to which they give rise (see chap. IV), but it is their magnitude in relation to a number of other variables that explains the difficulty being encountered in overcoming them. In the case of the United States, for example, exports had fallen to about 60 per cent of the value of imports at the end of 1987, whereas in Japan the corresponding ratio was about 175 per cent (see figure II.6). This means that, on the unrealistic assumption that all the adjustment is on only one side of each country's account, United States' exports would have to increase by about 50 per cent or Japan's exports fall by an equivalent proportion in order to restore balance on their trade accounts.

The persistence of the imbalances, their apparent unsustainability and the threat that this was believed to pose to the stability of the global economy were the driving forces behind the international economic policy co-ordination that was initiated with the Plaza Accord of September 1985. This move towards economic co-operation among the leading industrial economies followed a period of benign non-intervention, during which inconsistent macro-economic policies within those countries contributed to the development of the imbalances (see chap. VII below). During the first phase of international economic co-operation among the leading industrialized countries, progress was halting and frequently prompted by the possibility of a crisis. The Louvre Accord of February 1987 marked a more determined effort by these countries to co-ordinate economic policy.

The Plaza Accord reflected official recognition that one of the measures necessary to remedy the imbalances was a de-

5 This is only what should be expected in view of past experience. Reorientation of long-standing customer-supplier relationships takes time.

Figure II.6. Ratio of exports to imports for the Federal Republic of Germany, Japan and the United States, 1985-1987



Source: IMF, *International Financial Statistics*, various issues.

preciation of the dollar. This joint effort to narrow the surpluses of the Federal Republic of Germany and Japan and the deficit of the United States through an adjustment of exchange rates recognized that there would be a delay before corrective changes in the volume of imports and exports would outweigh the negative price effects of currency realignments on the external financial balances. The duration of this delay has always been unknown, but the continued deterioration of the imbalances, even after the dollar began its prolonged depreciation, was initially tolerated by markets and accepted by Governments on the implicit understanding that a turnaround was imminent.

In 1987, it was not only the level of the imbalances that gave rise to concern in financial markets but also emerging doubts about the validity, in the prevailing situation, of this so-called J-curve effect. The failure of the current imbalances to respond in the anticipated way and in a timely fashion was seen as jeopardizing the holding strategy that had been adopted. As a result, markets often responded precipitously to fragments of economic or other information that suggested an inadequacy in either the strategy itself or the determination of Governments to adhere to it. One general consequence was that the value of the dollar continued to fall.

By February 1987, the consensus among policy makers was that the continuing depreciation of the dollar should be slowed and possibly halted. This understanding formed the basis of the Louvre Accord. A secondary objective of this agreement—and one that, it was hoped, might be achieved as a by-product of the first—was to reduce the prevailing erratic short-term movements in exchange rates. To these ends, the Governments of the leading developed market economies agreed to intervene in foreign exchange markets with a view to supporting the price of the dollar. The agreed target level for the dollar was not publicized. Recognizing the deflationary effects that depreciation of the dollar was likely to have on the world economy, surplus countries agreed to stimulate their economies.

The measures adopted to give effect to this agreement were a widening of the differential between interest rates in the United States and those of other key currency countries (in an effort to make the dollar more attractive to private investors) and official intervention in foreign exchange markets. In addition, the Governments of the Federal Republic of Germany and Japan announced some expansionary fiscal policies (see chap. VII).

These measures were initially successful in achieving greater stability in the value of the dollar, but the attention of policy makers then appeared to drift away from the fundamental problem of redressing the underlying imbalances that were the *raison d'être* of the Louvre Accord. In the United States, there was a feeling that the trade balance was about to improve; in Western Europe and Japan, there was a resurgence of concern about inflation and interest rates were raised accordingly. These *de facto* departures from the Louvre Accord resulted in a corresponding failure to achieve its short-term objective of more stable exchange rates among major currencies.

Financial markets became volatile because investors felt that international macro-economic co-ordination had weakened and that policy makers had abandoned efforts to address the underlying problems. On occasion, Governments acted in response to these concerns, but the actions some-

Table II.6. Developing countries:[a] frequency distribution of rates of growth of output, 1981-1987

(Number of countries)

	1981	1982	1983	1984	1985	1986	1987[b]	Population of countries in 1987 column: Number (millions)	Population of countries in 1987 column: Percentage of total
Zero or below	25	40	3	27	25	19	19	270	10.7
0.1 - 2.5 per cent	15	18	17	19	21	21	24	1 096	43.5
2.6 - 5.0 per cent	12	11	20	21	25	33	28	819	32.5
5.1 - 7.5 per cent	17	9	8	10	8	5	9	283	11.2
7.6 per cent and over	14	5	5	6	4	5	3	51	2.0
Total	83	83	83	83	83	83	83	2 520	100.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat. The data on population and population growth rates are those published by the Department in *World Demographic Estimates and Projections, 1950-2025* United Nations publication, Sales No. E.86.XIII.3).

a Based on data for 83 countries that account for 97 per cent of the population of developing countries.

b Based on preliminary data.

Table II.7. Developing countries:[a] geographical distribution of countries with negative rates of growth of per capita output, 1981-1987

(Number of countries)

	1981	1982	1983	1984	1985	1986	1987[b]	Population of countries in 1987 column: Number (millions)	Population of countries in 1987 column: Percentage of total
Western hemisphere	13	21	19	10	14	13	10	132.0	32.5
West Asia	4	7	7	8	6	6	6	77.8	76.8
South and East Asia	0	2	3	1	5	2	1	17.3	1.2
Africa	19	24	22	24	20	20	16	252.7	49.2
Mediterranean	0	0	2	0	1	0	1	23.5	30.9
Total	36	54	53	43	46	41	34	503.3	20.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat. The data on population and population growth rates are those published by the Department in *World Demographic Estimates and Projections, 1950-2025* (United Nations publication, Sales No. E.86.XIII.3).

a Based on data for 83 countries that account for 97 per cent of the population of developing countries.

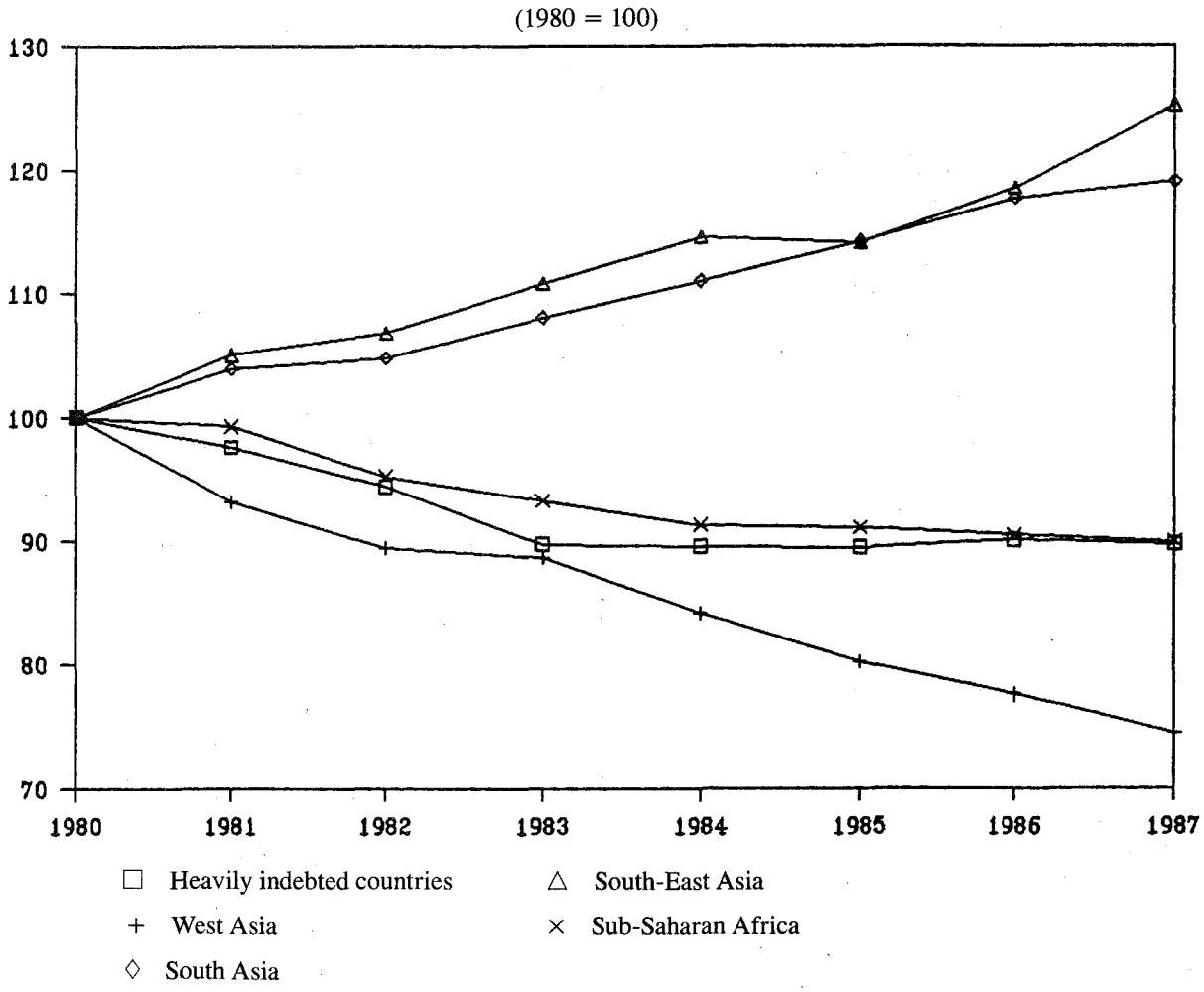
b Based on preliminary data.

times had an effect contrary to that intended and the enthusiasm of Governments for reassuring measures waned. As indicated in chapter IV, the consequential loss of confidence in international economic policy may have been one of the underlying causes of the global downward adjustment in equity markets in October 1987. This change in equity market sentiments was parallelled in currency markets, where it was reinforced by an apparent ambivalence on the part of the United States administration regarding the value of the dollar.

The turbulence in financial markets in October 1987 produced a prompt response on the part of policy makers. Fears of a global recession emerged, and monetary policy was rapidly relaxed accordingly. Governments also began to refocus their attention on the long-term underlying problem of the imbalances, with the United States Government announcing new measures to reduce its budget deficit.

A series of disappointing United States trade figures again raised doubts in the minds of financiers in December and there was another short period of rapid decline in the value of the dollar on international currency markets. The authorities again acted speedily, announcing their determination to maintain the dollar around its prevailing level. Nevertheless, the dollar's decline continued briefly until, in early Jan-

Figure II.7. Trends in per capita output in selected groups of developing countries, 1980-1987



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

uary 1988, the authorities co-operated in intervening on a large scale to reverse the downward trend.

The responses of Governments to the market's lack of confidence have become fewer in number but more decisive in nature as time has progressed. As a result, markets seem to have become convinced of the determination of Governments to adhere to their long-term policy goals and a higher degree of stability has prevailed in foreign exchange markets in early 1988. This should simplify the process of attaining sustainable balances among and within the leading developed market economies, but it is unlikely to be sufficient to do so. Further corrective actions appear necessary, some of which are likely to have a deflationary effect on the world economy. If this is to be avoided, some additional stimulatory fiscal measures in the surplus countries seem indispensable.

Developing countries: adjustment and development

Climatic conditions, which exercise a decisive influence on the economies of many developing countries, were, with the exception of South Asia and some countries in Africa, closer to normal in 1987 than in several of the earlier years of the decade. Some countries in these two regions suffered from inadequate or inappropriately timed rainfall, but there was no widespread regional drought. Wars and other forms of internal and external destabilization beset many developing countries. In some instances in Africa, poor harvests in 1987 were superimposed on, and partly attributable to, military conflicts, and the ensuing human suffering was increased as a result of obstacles to international efforts to relieve potential famines.

Table II.8. Developing countries:[a] annual rates of inflation, 1982-1987[b]

(Percentage)

	1982	1983	1984	1985	1986	1987
All countries	39.9	65.1	93.7	125.9	45.3	67.1
(Median)	(11.1)	(11.5)	(11.8)	(10.5)	(8.7)	(9.5)
Net energy exporters	22.6	36.2	34.8	97.0	27.8	39.8
Net energy importers	52.3	85.8	136.1	146.6	57.9	86.7
Western hemisphere	78.8	135.7	198.6	287.4	93.0	138.3
(Median)	(11.8)	(16.7)	(20.4)	(25.7)	(19.5)	(21.8)
West Asia	17.1	18.7	33.0	24.3	5.9	6.2
South and East Asia	8.0	8.8	10.1	5.7	5.2	6.5
Africa	11.7	23.2	23.4	11.2	12.4	25.8
Mediterranean	30.6	35.9	50.5	57.9	62.1	83.5
Frequency distribution						
5 per cent or lower	6	14	19	22	28	24
5.01-10 per cent	24	19	13	13	13	15
10.01-20 per cent	26	22	16	16	11	12
20.01-50 per cent	13	12	15	14	13	14
50.01-100 per cent	4	2	8	4	8	4
Over 100 per cent	3	7	5	7	3	7

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

[a] Based on a sample of 76 countries.

[b] Annual rate of change in consumer prices.

[c] Preliminary estimates.

The diversity that has characterized growth in the developing countries during the 1980s was not fundamentally altered in 1987 (see table II.6). The rate of growth of two of the largest economies, Brazil and India, slipped in 1987, with the result that more than half the population of the developing world (excluding China) lived in countries where the increase in output during the year was less than 2.5 per cent. One fifth of the developing world's population suffered a decline in per capita output in 1987 (see table II.7); for some groups of countries, this was the continuation of a trend that has existed since the beginning of the decade (see figure II.7).

Many developing countries continued to focus their attention during 1987 on adjusting to their economic predicament. Most of the countries that are heavily indebted to commercial lenders have been implementing policies designed to improve their external payments position for as long as five years. The failure of such measures to yield significant results, or even to offer the prospect of progress in the foreseeable future, is leading to frustration among both the Governments and the populations of the countries concerned. "Adjustment fatigue" manifested itself in 1987 in a debt moratorium by the largest debtor and various signs of intransigence on the part of others (see chap. IV).

Regional situations

Latin America: slow-down in output growth

Most of the economies in Latin America continue to be in a precarious situation. Noticeable increases in per capita income in 1987 occurred only in Chile, Colombia, Peru and Uruguay. For the region as a whole, the average increase in per capita output during the year was reduced to negligible proportions. This was so despite the structural improvements that have been made in the economies of the region since the debt crisis broke in 1982. The diversification of the region's export base has proceeded: primary commodities now account for less than one fifth of non-oil exports, compared to about a quarter in 1980. Even the energy-exporting countries have diversified considerably: more than half of Mexico's export revenue is from non-oil sales and Venezuela's non-oil exports are growing rapidly.

Despite this, the prospects for the Latin American region are for a continuation of a large net financial transfer abroad to service external debt obligations. This will entail negligible per capita income growth into the next decade. Even this prognosis is likely to prove optimistic if there are any unfavourable developments in the United States. Latin American countries would be seriously affected by an economic slow-down in the United States, particularly if it were accompanied, or induced, by an increase in interest rates. Such a slow-down would repeat the pincer effect of the early 1980s by reducing export earnings and increasing debt-servicing obligations.

A disturbing development in Latin America in 1987 was the resurgence of inflation. After a slow-down in 1986, several countries experienced a rapid escalation in prices the following year (see table II.8). In some countries, annual increases of over 100 per cent were recorded; early in 1988,

the average monthly rate was about 10 per cent in Argentina and Mexico and above 15 per cent in Brazil.

The high rates of inflation in Argentina and Brazil reflect the collapse in 1987 of the two countries' heterodox recovery strategies (the so-called "austral" and "cruzado" plans). In both cases, the failure to reduce fiscal disequilibria resulted in larger than expected government deficits and fuelled inflation. Mexico, the region's other large economy and major debtor, suffered a decline in gross domestic product as a result of the collapse in oil prices in 1986; its modest growth in 1987 was less than that of population and the country ended the year fighting the problems of inflation and a budget deficit.

Africa: insufficient recovery

For Africa as a whole, the modest gain in output in 1987 fell short of that in population and was insufficient to recoup the decline of more than 2 per cent in the previous year. This aggregate figure was heavily influenced by the performance of Nigeria, which suffered another year of declining output, brought about by the continuation of comparatively low oil prices and difficulties created by its external debt. The countries of North Africa also continued to be adversely affected by the earlier collapse in oil prices and export earnings. For sub-Saharan Africa excluding Nigeria, 1987 was a better year, with output increasing at roughly the same rate as population.

With the adoption in 1986 of the United Nations Programme of Action for African Recovery and Development 1986-1990, it was hoped that a turnaround in Africa's economic fortunes would become apparent in 1987. However, Africa's economic plight continued because of the persistence of two of its underlying economic difficulties—weak markets for its primary commodity exports and a precarious external debt situation. The lack of foreign exchange and the budgetary crises resulting from loss of trade-related government revenues continue to have a debilitating effect throughout the region.

The upturn in the prices of some commodities in 1987 did not extend to tropical beverages, on which sub-Saharan Africa is heavily dependent, and the exporters of copper could not fully exploit the upturn because of production bottlenecks, in part attributable to earlier retrenchment in the industry. There was, however, some improvement in the terms of trade for the region as a whole, and an accompanying increase in total export earnings. Despite this, the export earnings of the region in 1987 were probably no more than $65 billion—less, in dollar amount, than at the beginning of the decade, and far less in real terms.

The previous slow-down in capital inflows to sub-Saharan Africa was halted in 1987 as official flows increased. However, this improvement was offset by the inexorable increase in debt-service obligations. Many countries in Africa still have large outstanding amounts of non-concessional debt, primarily to official creditors. Some creditors have adjusted the terms of some of these debts, but many countries in the region were still unable to meet their debt-servicing commitments in 1987, leading to more reschedulings, the accumulation of additional external debt, and arrears in payments to the international financial institutions, which make the debtors ineligible for further assistance from those sources and jeopardizes their chances of obtaining external resources from other sources.

Yet there was progress in other key areas. Most importantly, there was a consolidation of domestic economic reform within the continent. There are programmes of economic reform in place in the majority of the countries in the continent, almost all of them drawn up in consultation with either the World Bank or IMF. Reforms are broadly aimed at improving economic efficiency, particularly in export-oriented and import-substituting industries. This usually involves a depreciation of the exchange rate and a reduction of trade barriers, the elimination of subsidies and other forms of government price intervention, the privatization or streamlining of state enterprises and measures to increase both public and private domestic savings, notably reducing public sector deficits. However, there is no assurance that the countries concerned will have the resources necessary to implement such programmes. Such difficulties caused some countries, notably Zambia, to discontinue their agreements with IMF during 1987.

A more encouraging note was the widespread recognition of the predicament of sub-Saharan Africa and of the continued deterioration of its external resource situation. There were many signs in 1987 of a positive international response to this crisis.

Asia: subregional diversity

Most of Asia was able to maintain the relatively steady growth of the past five years in 1987. Drought in India and some of its neighbouring countries disrupted a period of improvement in economic performance, reducing growth for the almost one billion people of the South Asia region to about 3 per cent, only 0.5 per cent more than the rate of growth of population. Despite this set-back—which might extend beyond the period of the drought itself—encouragement could be found in the fact that India was able to withstand such adverse climatic conditions without resort to large-scale external food aid. Such was far from the case one or two decades ago.

China's exports played an important role in facilitating its acceleration in growth in 1987 since foreign exchange constraints were threatening to disrupt the country's recent period of continuous high growth. Exports grew by about a quarter in 1987 while imports remained almost unchanged, with the result that the country's trade deficit fell from almost $16 billion to about $12 billion. Nevertheless, 1987 provided some support for the fear that China's present high rate of overall growth cannot be sustained. Industry again out-performed agriculture and imposed a strain on energy and transportation infrastructure. The result was an acceleration in inflation, with prices rising by more than 7 per cent during the year. The Government responded by tightening credit and this has already had the effect of slowing the rate of growth of the economy. Some further deceleration in China's high rate of growth seems unavoidable, whether in-

duced by policy, arising from imbalances between supply and demand within the economy or produced by an emerging foreign exchange constraint.

In South-East Asia, 1987 was another year of solid overall economic growth. Two economies in the region grew at a double-digit rate and others achieved increases in per capita income of more than 5 per cent. All the countries in the region benefited from expanded export opportunities in Japan, without appearing to have lost the momentum of their exports to the United States. Indonesia was constrained by the continued weakness in the international oil market, but still managed to grow at a rate in excess of 3 per cent.

Formerly, only a handful of countries in South-East Asia relied heavily on exports of manufactures to fuel their economic growth, but these have been joined by several others in recent years. Indonesia, Malaysia, the Philippines and Thailand have begun to compete in markets that were formerly dominated by exports from Hong Kong, Japan, the Republic of Korea and Taiwan, Province of China. Starting from a low base, their rates of growth of manufactured exports have been high and have stimulated economic growth. Meanwhile, the countries in the region that initially adopted this strategy have been so successful that their trade surpluses have become a matter of concern to the developed market economies and the economies themselves have advanced to the stage that there is discussion of a possible "Asian OECD".

Despite double-digit rates of growth of imports, Hong Kong, the Republic of Korea and Taiwan, Province of China, together amassed a current account surplus of some $27 billion during 1987 (see table IV.2), which made it possible for them to reduce their external debt. However, these examples of successful adjustment gave rise to bilateral pressure for a realignment of their exchange rates *vis-à-vis* the dollar and a liberalization of their import régimes. Some movements in this direction took place in 1987 and early 1988 and may be expected to continue. This would dampen the future growth prospects of these economies, but seems unlikely to dislodge them from their position among the world's most rapidly growing economies.

Developments in the economies of West Asia in 1987 were dominated by regional conflicts and the limited recovery of oil prices. For several countries in the region, economic progress takes second place to the widespread human suffering resulting from continued large-scale intraregional war and other hostilities. The region encompasses both countries in the upper echelons of the per capita income scale and a few countries classified as least developed. These characteristics give rise to a mixed economic performance, but oil continues to play a dominant role. In 1987, as for most of the decade, the decline in oil revenues had a negative impact on the region as a whole, but the commencement of large-scale oil production in two of the least developed countries in the region should boost those economies.

Centrally planned economies: reform amidst a mixed performance

Growth in the centrally planned economies of Eastern Europe and the USSR slowed from 4.2 per cent in 1986 to an estimated 2.6 per cent in 1987. The slow-down in these economies in 1987 was attributable in part to agricultural production, which fell by 0.1 per cent (after growth of 5.2 per cent in 1986), instead of increasing by 2.3 per cent as envisaged by the annual plans (see table II.9). In most countries of the group, 1987 was marked by an intensive reassessment of economic policies and the launching of initiatives aimed at economic reform (see chap. VI). Weak export demand, depreciation of the dollar and deteriorating terms of trade adversely affected foreign trade with market economies and the external indebtedness of countries in the region.

Reform and restructuring policy

In many countries, the drive to reinforce and advance reform encountered difficulties in 1987. Innovations in the regulatory and institutional framework, mostly unanticipated at the outset of the current five-year plan period and therefore not reflected in medium-term policies, had a disruptive short-term effect on sectoral performance. The attainment of growth targets might not be compatible with the restructuring called for by the economic reforms. As a result, intended increases in multisectoral investment sometimes gave way to the concentration of capital resources in sectors that offered the possibility of benefits from high technology.

A seminal event was the initiation of extensive economic reforms in the Soviet Union, analysed in detail in chapter VI. These had major repercussions for the Eastern European economic scene. The proposed reforms provided an opportunity for unconventional policies throughout the region and gave impetus to the elaboration of operational formulas. At the same time, the short-term need to remedy domestic imbalances and to achieve external equilibrium remained pressing.

The intended increases in total output in the European planned economies in 1987 ranged from 2 to 5 per cent, with the exceptions of Bulgaria and Romania where the targets were set at 8.5 and 5.7 per cent, respectively. These targets reflected the adjusted medium-term policy which emphasizes restructuring and institutional reorganization rather than rapid growth in the short run. The plans for 1987 assume that industrial output would increase by about the same proportion as overall output, and that agricultural production would increase by 1 to 2.5 per cent more than in 1986. The weather, however, interfered with these plans, causing agricultural production to grow by only 0.2 per cent in the USSR and to fall by 3 per cent in Poland and by 4.3 per cent in Bulgaria. The failure to meet crop targets adversely affected user industries and, coupled with the limited availability of imports of feedstock, inhibited production in the livestock sector. Compared to previous years with similar climatic conditions, the resilience of the agricultural sector in 1987 appears to have been enhanced by new managerial

Table II.9. Centrally planned economies: selected macro-economic indicators, 1981-1989

(Annual percentage rate of growth)

	1981-1985 Actual	1986-1990 Planned	1985 Actual	1986 Actual	1987 Planned	1987 Actual[a]	1988 Planned	1989 Planned[b]
Total output								
Eastern Europe	2.2	4.0[c]	3.7	4.7	4.7	3.2	4.8	6.1
Soviet Union	3.6	4.2[c]	3.5	4.1	3.9	2.3	5.9	4.9
Industrial output								
Eastern Europe	2.8	4.4[c]	4.1	4.7	4.1	3.5	4.1	4.4
Soviet Union	3.7	4.6	3.9	4.9	3.8	3.8	4.5	4.6
Agriculture								
Eastern Europe	1.1[c]	2.7[c,d]	-1.3	5.1[c]	2.4	-0.6	3.4	2.7
Soviet Union	1.1[c]	2.7[c]	0.1	5.3	2.2	0.2	5.5	2.7
Investment								
Eastern Europe	-1.3[c]	3.4[c,d]	4.0	2.6[c]	4.4	3.9	2.0	2.2
Soviet Union	3.7[c]	4.3[c]	3.0	8.4	5.4	4.7	4.3	1.4

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

a Preliminary estimates.

b Secretariat estimate of the rate of growth required to attain the five-year target for 1986-1990, adjusted for actual performance in 1986 and 1987 and the plan for 1988. Forecasts suggest that the rate of growth achieved will be lower than this estimate.

c Secretariat estimate.

d Growth over the five-year period relative to the preceding five years on an annual basis.

methods and policies which increased the autonomy and financial independence of farms.

Overall industrial production in the Eastern European economies in 1987 grew according to plan, although individual sectors deviated from planned levels. Some sectors of crucial importance, such as fuel and energy in Poland and the USSR, benefited from earlier investment and performed noticeably better than expected. Others—machine-building in the USSR in particular—were under stress, striving not only to meet stringent new quality criteria and technological standards but also to raise the volume of output. These goals were hard to achieve concurrently: in the Soviet Union, the output of machine-tools increased by 4.6 per cent instead of the planned 7.3 per cent. In contrast, the high technology sectors in most Eastern European countries, especially electronics and electrical engineering, had a strong performance and increased their export earnings. None the less, the overall industrial picture continued to be marred by the limited availability of energy, the sluggishness of construction and slow progress in the conservation of energy and material inputs.

Although shortages of energy and material inputs have become less of a constraint on growth, the energy situation remains tight in most countries of the area. The output of fuel and energy increased by about 3.5 per cent in 1987: production of oil and of gas in the Soviet Union grew faster than planned, by 2 and 6 per cent, respectively, and Polish coal production increased 3.1 per cent, rather than the planned 0.5 per cent. Nevertheless, the increases in supply were still not large enough to meet the demands imposed by the severe winter. Progress in reducing the energy and material intensity of production was uneven, apparently due to excessive reliance on administrative measures and mandatory quotas, as well as to the slow pace of structural change. The persistently high energy intensity of economic growth is believed to reflect insufficient progress in economic adjustment and restructuring; further measures intended to remedy this are envisaged.

Investment in 1987 was below that of the previous year and directed towards the medium-term objective of an in-depth modernization programme. The realization that industrial modernization cannot be achieved merely through increased investment resulted in a more modest approach to investment planning in 1987. The average planned rate of growth for 1987 ranged from 0.5 to 1.0 per cent in the German Democratic Republic and Hungary, to targets of 5.4 per cent in the USSR, 6.5 per cent in Romania and 8.9 per cent in Bulgaria. In some countries, the growth achieved was only 0.5 to 1 per cent because of an unanticipated curtailment of imports and a lag in the supplies of machinery and basic materials. In other countries, capital formation increased more than anticipated, either because reforms opened up additional sources of credit financing and gave enterprises more leeway in investment decisions or because a long-delayed drive to renovate and modernize fixed assets got under way. The former was the case in Hungary, where investment rose by 6 per cent instead of the 1 per cent planned, mainly because of an increase of 9 per cent in capi-

tal outlays by enterprises and local authorities. In the German Democratic Republic, renovation and modernization resulted in investment growth of 6 per cent in 1987, following a 5.3 per cent increase in 1986; the 1987 figure was the highest since the mid-1970s.

Consumption and changing price policies

Public and private consumption and the related question of streamlining the price system to reflect existing scarcities loom large in economic policy in the centrally planned economies. The desire for reform gave a new impetus to both debate and actions in these areas in 1987. Open popular discussions and the growing transparency of policy-making have led to the formulation of feasible and realistic compromises.

Pricing policy is aimed at balancing supply and demand in consumer markets. The instruments for dealing with this problem vary among countries, but three different approaches towards pricing can be identified.[6] countries which have targeted comparatively rapid reform implement retail price increases (usually in conjunction with monetary compensation to consumers) in order to reduce subsidies and to make price signals to producers and consumers more meaningful. Countries with a more reserved attitude towards the role of prices in economic management focus on adjustments in wholesale prices and usually prevent such changes from influencing retail prices. In a third group of countries, the emphasis is on price stability.

In addition to the need to rationalize prices and price setting, there is a need to make rational trade-offs between consumption and investment. Price policies are supported by measures aimed at containing inflationary pressure by imposing budgetary constraints on enterprises so that their future over the long term will depend on their efficiency. Industrial restructuring intended to increase competition and reduce monopolistic practices will assist in creating a price environment that will lead to increased efficiency.

Hungary and Poland provide examples of pronounced reliance on price policy at different macro-economic levels. In other countries, the focus is not directly on retail prices but on adjusting prices for material and energy inputs. When increases in retail prices are introduced, as in Hungary in 1987 and in Poland at the beginning of 1988, Governments try to mitigate the impact on consumers by providing direct subsidies to the most affected groups of the population to maintain their living standards. The adjustment and elimination of subsidies to retail prices is being discussed in the USSR, but the situation seems to be such that these ideas are unlikely to be translated into action in the near future.

The general objective of all price reforms is to widen the sphere of free contractual prices, but the extent to which this has occurred varies considerably among countries. In Hungary, the aim is to increase the proportion of free market prices at the retail level from 10 per cent of agricultural products in 1987 to 50 per cent in 1988. The same broad target applies in Poland. Another important objective is to gear wage increases to the growth in productivity.

In the Eastern European countries with a problem of external indebtedness (see chap. IV below), the need to maintain external balance has become a growing influence on pricing policy. In some cases, steps to limit the absolute level of consumption have been taken. In Hungary, for example, there was a drop of about 2 per cent in personal consumption in 1987.

Foreign trade and payments

As in previous years, the majority of the Eastern European countries are placing high priority on rectifying external imbalances, especially with developed market economies. None the less, the policies of export promotion, import restraint and limited domestic absorption that enabled these countries to start amortizing their external debt during the period 1982-1985 were not applied as forcefully in 1986 and 1987. The more relaxed approach to import control, which coincided with the depreciation of the United States dollar, resulted in more foreign borrowing and renewed growth in external indebtedness. However, the situation appears to be under control and the international credit-worthiness of the European planned economies has been maintained. Their external financial standing in the immediate future will depend on whether fears of an economic slowdown and rising protectionism in the market economies are realized. To prepare themselves for the possibility of such a change in the global environment, to improve their external economic position and to improve their bargaining strength, the European planned economies intend to invigorate their own regional market.

The foreign trade of the European planned economies in 1987 had some notable characteristics: demand for their exports weakened in developed market and developing economies; terms of trade deteriorated for the USSR[7] and improved slightly for Eastern Europe; energy imports increased due to a severe winter; and demand for agricultural imports fell. The cumulative effect was to undermine efforts to increase the trade surplus which, nevertheless, grew to $16.4 billion from $10.1 billion in 1986. Part of this improvement was accounted for by the depreciation of the United States dollar, but the biggest contribution to the overall increase was the estimated 17 per cent growth in the dollar value of USSR exports to the developed market and developing economies. Eastern Europe's surplus with these partners decreased.

After the increase in external indebtedness in 1986, European planned economies were more cautious in their international borrowing in 1987. However, the net indebtedness of the group grew in dollar terms, as the result of the bookkeeping translation of non-dollar liabilities into dollars.

6 A more extensive discussion of pricing policy is contained in chapter VI.

7 This decline was partially attributable to the fact that the increase, in dollars, in the world market price for oil, the major export of the USSR, was offset by the fall in the value of the dollar.

The early months of 1988 have passed uneventfully and economic indicators, particularly output, have shown more strength than expected. Forecasts must be treated with more than the usual degree of caution. Under present conditions, growth in the developed market economy countries is expected to slow in 1988 and to continue to do so in 1989. Improved policy co-ordination and appropriate domestic policy measures could smooth the downturn (see box II.1), but are unlikely to eliminate it. The centrally planned economies, on the other hand, are expected to follow the opposite pattern; China, while continuing its rapid growth, seems unlikely to be able to maintain its 1987 pace. The developing countries are expected to accelerate their growth slightly and to exert a moderating influence on the year-to-year fluctuations in world output.

Policy assumptions in the forecast

The forecasts for the growth of world output in table II.1 are based on the following assumptions. Among the developed market economies, it is assumed that there will be an *ex ante* reduction in the United States federal government deficit of $40 billion in 1989 and somewhat less in subsequent years. However, the forecast slow-down in growth in 1989 will reduce tax receipts, so that there will be little *ex post* reduction in the deficit. Monetary policy in the United States is expected to be tightened somewhat, leading to an increase in interest rates of half a percentage point in 1989. In the Federal Republic of Germany, it is assumed that the second phase of the reductions in income tax scheduled for 1990 will be implemented. For Japan, the assumption is that the 1987 decision to stimulate domestic demand will be continued and will include an income tax reduction in the second half of 1988. In the remaining developed market economies, no major changes in either fiscal or monetary policy have been assumed.

In the developing countries, it is assumed that those with external debt problems will continue to exercise budgetary and monetary restraint, sometimes accompanied by import restrictions, in order to contain import demand and, in some countries, reduce inflation. The few developing countries with current account surpluses are expected to liberalize their import régimes and allow their currencies to appreciate. The centrally planned economies of Eastern Europe are expected to increase investment and to proceed with their other announced economic reforms.

International trade and prices of primary commodities

It has been assumed that the OPEC average export price of oil will be $16.50 a barrel in 1988 and will increase in nominal terms by 3 to 4 per cent in 1989 in line with world inflation. Non-oil commodity prices are expected to be approxi-

Box II.1. *The consequences of more expansionary policies*

The most important characteristic of the baseline forecast presented in this chapter is the anticipated slow-down in demand, particularly of private consumers, in the developed market economies. The forecast assumes that there will be little change in present fiscal or monetary policies to offset this slowing of demand; to the contrary, it is assumed that the United States Government will make an *ex ante* cut in the federal deficit, thereby aggravating the overall decrease in demand.

The following alternative scenario is based on a package of monetary and fiscal measures intended to moderate the slow-down in world economic output projected for 1989 in the baseline forecast. The scenario assumes that the United States will relax monetary policy in 1989 in order to offset the deflationary impact of its restrictive fiscal measures. In the absence of policy co-ordination, this relaxation of monetary policy would tend to cause further dollar depreciation, to increase United States' net exports at the expense of its major trading partners, and thus to lower their GDP. To offset this impact, it has been assumed that the Federal Republic of Germany, Italy, Japan and the United Kingdom would introduce additional stimulatory measures.

The results of such policies would be a cumulative increase in world output over a three-year period of 0.6 per cent (see table). Two thirds of the increase would occur in the first year, raising the growth rate of global GDP by 0.4 per cent and eliminating the slow-down projected in the baseline forecast. The timing of the additional stimulus to coincide with the forecast weakening of economic activity would cause the rate of inflation to be only 0.2 per cent higher by 1991. Unemployment in the developed market economy countries would decline by 0.4 per cent but not until 1990, reflecting a lagged response to the 1989 stimulus. The impact would vary considerably among regions: the cumulative increases in output over the three-year period of the EEC countries and Japan would be more than twice that of the United States; the developing countries would gain only one tenth of a percentage point in GDP because of the assumed continuation of stringent adjustment policies.

The rate of growth in world trade would increase by 0.5 per cent in the first year and by 1.1 per cent over a three-year period; developing countries' exports would increase by seven tenths of a percentage point and their imports by only one tenth of a percentage point, with the resulting improvement in trade balances permitting a net addition to reserves and a reduction in net debt. A similar pattern would result for the centrally planned economies of Eastern Europe and China.

mately stable in 1988, but to decline in 1989. As in 1987, this general trend conceals considerable diversity in the outlook for individual commodity prices. A slowing in the demand for metals is expected and should prevent further large price increases in 1988. Exceptions are tin, the price of which is recovering from a cumulative fall of about 60 per cent during the past four years, and copper, where prices will probably increase as a result of the agreement reached among producers on export quotas. Although no large increases are anticipated, the average price of grains is expected to be higher in 1988 than in 1987. Cocoa prices are expected to continue to fall in nominal terms due to oversupply, and the price of sugar in 1988 will be higher because of poor growing conditions and correspondingly reduced output in Brazil and in South and East Asia in 1987.

On the basis of these assumptions, world trade is expected to grow at about the same rate in 1988 and 1989 as in 1987. Exports of manufactures are expected to increase at a faster pace than the average, while trade in industrial raw materials, especially minerals, is expected to increase at a slower pace.

The output growth forecast for 1988 and 1989

Growth of output in the developed market economies as a group is expected to fall from 3 per cent in 1987 to less than 2.5 per cent in 1988 and less than 2 per cent in 1989 (see table II.1). Among the major developed market economy countries, the slow-down is expected to be most pronounced in the United States where, partly as a consequence of the assumed fiscal tightening, GDP is expected to grow only about 1.3 per cent in 1989 (see table A.III.1).

The principal cause of the expected reduction in growth will be a slow-down in private consumption, especially in the United States but also in Canada, France, Italy, and a number of smaller developed market economy countries.

Impact of co-ordinated macro-economic expansionary measures in the industrial countries on the world economy, 1989-1991

(Differences from baseline)[a]

	1989	1990	1991
	Percentage deviation from baseline level		
Real GDP			
World	0.4	0.6	0.6
Developed market economies	0.6	1.0	0.9
EEC	0.7	1.0	1.2
Japan	0.7	1.1	1.4
United States	0.6	1.0	0.6
Developing countries	0.1	0.1	0.1
World trade volume	0.5	1.0	0.1
	Percentage point difference from baseline		
GNP/GDP deflator			
Developed market economies	0.0	0.0	0.2
EEC	0.0	0.2	0.3
United States	0.0	0.1	0.1
Unemployment rate			
Developed market economies	-0.2	-0.4	-0.2
EEC	-0.5	-0.4	-0.5
United States	-0.1	-0.4	-0.3
	Billions of dollars difference from baseline		
United States current account deficit	.25	-1.93	-2.76

Source: Project LINK.

[a] Figures for output and trade represent a percentage change in the scenario level relative to the baseline level. The figures for 1989 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 1989 the level on real world GDP in this scenario is 0.4 per cent above the baseline level. The addition to the growth rate in 1990 relative to the baseline is 0.2 percentage points, which is the difference between 0.6 and 0.4.

Any tightening of monetary policy in response to fears of resurgent inflation would only reinforce this trend. There is expected to be little, if any, growth of private residential construction; inventory accumulation is also likely to come to an end. Private investment in real terms is expected to fall somewhat in 1988 and more noticeably in 1989.

These trends in domestic demand are expected to be offset by a slight improvement in the net exports of the major developed market economies. A higher volume of exports and reduced demand for imports will contribute to growth in the United States in both 1988 and 1989, but will come mainly at the expense of other developed market economies, so that the contribution of the external sector to the growth of the group is expected to be slight.

The general slow-down in the developed market economies is expected to end the decline in unemployment rates of the past four years: the average unemployment rate is expected to remain at its 1987 level in 1988 and to increase slightly in 1989 (see table II.10). The rate of inflation is expected to increase by less than half a percentage point in both 1988 and 1989, and should remain below 5 per cent, thus providing scope for some relaxation of either monetary or fiscal policy.

Table II.10. Developed market economies: short-term outlook for inflation and unemployment rates, 1987-1989

	1987[a]	1988	1989
GDP/GNP deflator (annual percentage)			
All developed market economies	3.6	4.0	4.3
Western Europe	4.2	3.9	3.7
Japan	0.9	1.5	2.0
North America	3.0	4.1	4.6
Unemployment rate (percentage)			
All developed market economies	8.0	7.9	8.0
Western Europe	10.8	10.8	10.9
Japan	2.8	3.0	3.2
North America	6.2	6.0	6.5

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

[a] Preliminary estimates.

International capital markets will continue to be dominated by the large capital flows which are the counterpart of the current account imbalances among the developed market economy countries. These imbalances will persist, but are forecast to decline; the improved export performance of the United States and the effect of the slow-down in 1989 on its imports are expected to reduce that country's current account deficit by about $30 billion over the two-year period 1988-1989. This would be consistent with a further depreciation of the United States dollar against the currencies of its major trading partners of about 5 per cent by the end of 1988 and declines of 2 to 3 per cent per year thereafter.

The rise in interest rates anticipated in the United States in 1988 is expected to be accompanied by declines in other developed market economy countries. In 1989, however, interest rates are expected to increase throughout the developed market economies to a higher average level than in 1987. Widening the interest rate differential in favour of the United States should ensure the inflow of the external capital required to finance that country's expected current account deficits in 1988 and 1989 and should reduce currency fluctuations.

Little improvement is expected in international capital flows to developing countries. Net lending by the private sector is expected to be virtually zero, with gross borrowing approximately equal to debt repayments. Net borrowing by these countries from official lenders (including the International Monetary Fund) is expected to remain roughly at 1987 levels.

These unfavourable prospects for capital flows to developing countries are expected to be compounded by the weakening of world demand for their exports. With these predominant influences on the pattern of growth remaining fundamentally unchanged, the divergence in rates of growth among the developing countries is unlikely to be attenuated in the forecast period.

Growth in Africa in 1988 is expected to accelerate as a result of more normal weather conditions and improved agricultural production incentives. It will nevertheless continue to be below the rate of growth of population in the region. Growth in 1989 could approach a more acceptable level of 3 per cent if there are favourable weather conditions, stable exports of petroleum products and an increased donor response to the call for additional net capital inflows. This would halt the persistent decline in per capita incomes in the region.

The absence of a major advance in the present international debt strategy will severely restrict Latin America's prospects for the foreseeable future. In the near term, the expected slow-down in the United States economy, particularly its decreased import demand, will reduce Latin America's export opportunities and further aggravate its net transfer problem; the anticipated rise in interest rates in 1989 would worsen the position further. Expectations are for a decline in the rate of growth of the region to about 1.5 per cent annually over the next two years, resulting in a declining per capita income for the last two years of the decade.

Prospects are more favourable in South and East Asia. Slower growth of exports of manufactures is expected to dull the recent exceptional rates of growth, but they will still exceed 5 per cent annually. Contraction of oil output in 1987 and decreases in government expenditures in response to falling oil prices caused GDP in Western Asia to decline from 1984 until 1987. Amelioration of these factors in 1988 and 1989 is expected to result in growth averaging about 3 per cent annually in 1988 and 1989.

The Soviet Union annual plan for 1988 aims at a 4.1 per cent growth in net material product over the planned level for 1987. Since the result achieved in 1987 was lower than the planned target (2.3 per cent versus 3.9 per cent), the growth rate implicitly envisaged for 1988 is 5.9 per cent. However, official statements and other sources suggest that

4.1 per cent is considered a feasible growth target. This forecast may appear ambitious in the light of the low growth in 1987, but incorporates the expectation that economic reform will bring about improvements in efficiency and productivity and a better trade balance.

As for 1989, the tentative growth target in the five-year plan for 1986-1990 was set at 4.2 per cent for NMP utilized, or approximately 4.6 per cent growth in NMP produced. Under present circumstances, this target appears ambitious and growth in the neighbourhood of 4 per cent seems a more likely outcome.

For the centrally planned economies of Eastern Europe, official plans aim at an average of 4.8 per cent growth in 1988 and the five-year plans adopted in 1985 envisage an increase in NMP of about 5.2 per cent in 1989. However, planned growth rates have been higher than the rates achieved in recent years, and the possibility of increased external constraints suggest growth in the region of 3.8 per cent and 3.5 per cent in 1988 and 1989, respectively.

In China, moderation in economic expansion is the objective of economic policy and the Government is expected to restrain domestic demand, especially fixed capital investment, because of emerging pressure on both the government budget and on the current account of the balance of payments. As a result, growth is expected to moderate to 8 per cent in 1988 and 7.5 per cent in 1989.

This forecast for the world economy suggests that, with economic policies being maintained broadly as currently envisaged, growth will slow in the next two years, but its underlying pattern will not change. Moreover, the problems of the external imbalances among the developed market economies and the indebtedness of many developing countries will remain largely unresolved. The financial situation will remain fragile and this fragility will continue to be a source of downward risk in the forecast. On the other hand, despite the instability in the financial sphere in the past six months or so, production has maintained a significant momentum in developed market economies. If the confidence of consumers and investors remains unaffected in the near future, growth in 1988 and 1989 could exceed the forecast by half a percentage point in each of the major developed market economies. This should also require slight upward revision in the forecasts of developing countries and centrally planned economies. The question arises as to whether policy changes could improve on this performance.

A simulation scenario based on more stimulatory policies on the part of the three major developed market economies (see box II.1) suggests that it is possible to avert the slowdown in the world economy with only a modest increase in inflation, but that this would produce very limited progress in resolving the problems of the imbalances and external debt. These will therefore continue to pose a threat to the world economy. The imbalances among the developed market economies present potentially the larger problem. A decreased willingness to finance them could have adverse consequences for developed and developing countries alike. However, the imbalances may continue to be financed to the extent required and without serious disruption to international markets.

Such is not the case with the developing countries' problem of external indebtedness. Measures adopted by creditors and others have reduced the threat that this poses for the international financial system but have not yet reduced its constraining impact of debtor countries. Under such circumstances, even an acceleration of growth in the developed market economies would fail to elicit much of an improvement in growth in the developing countries.

Chapter III

INTERNATIONAL TRADE

Overview: an improvement in the growth of world trade in 1987-1988

World trade was somewhat more buoyant in 1987 than it has been so far in the 1980s, with the exception of 1984. It grew faster than expected[1] and, in comparison with the trend of the 1980s, substantially exceeded the growth of world income. The improvement, however, still leaves it below the growth rates attained in the 1960s and 1970s and does not appear to be the beginning of a significant alteration of the recent trend. The growth and pattern of world trade continued to be dominated by sharp changes in currency values, trade imbalances between the major developed market economies and the debt burden of the developing countries. The trading system remains under severe strain. Prices of primary commodities have shown some improvement, enhancing the import capacity of some commodity producers, but this has, on the average, been more than offset by a large increase in the prices of manufactures, and a significant improvement in their purchasing power is not in sight.

Yet there are indications that the rate of increase of world exports in 1988 will remain well above the average for the 1980s. International trade dynamics will continue to be fuelled by changes in comparative advantage, by the selective removal of restrictions in many developed and developing countries and by import-enhancing macro-economic measures in several economies that have large current-account surpluses.

The volume of world trade increased by just over 4 per cent in 1987 after a 4.5 per cent increase in 1986 (see table III.1). The increase was actually more robust than this figure suggests. The growth in world exports in 1986 was largely due to an increase in oil trade, which accounted for approximately a third of the increase in total world exports. The volume of imports of oil by the developed market economies increased by almost 11 per cent during the year, compared with a decline of about 3 per cent over the preceding five years. As the volume of trade in oil changed little in 1987, the 4 per cent growth was mostly accounted for by non-oil trade and was thus a noticeable improvement on its growth in 1986. Nevertheless, the growth of trade in 1987 was close to the average rate of growth in the 1980s and below the 5 per cent for the 1970s. Projections even for the short run have become more than usually difficult in the present unstable circumstances. A likely scenario is that in 1988 world trade will grow marginally faster than in 1987, but slip back to just under 4 per cent in 1989.

Trade in non-fuel commodities accelerated in 1987. Agricultural exports increased by an estimated 4 per cent, much higher than the average of 1.5 per cent for the 1980s. World exports of manufactures showed a marked recovery, growing by about 5 per cent after a 3.5 per cent increase in 1986.

The value of world trade rose by around 15 per cent in dollar terms, partly reflecting the further fall of the dollar in 1987. The value of world exports, which had reached $2.1 trillion in 1986, increased to around $2.4 trillion in 1987. The divergent rates of changes in trade volume and prices for the different country groups led to changes in their share of world trade, which continued the trend of the 1980s. The share of the developed market economies increased from 63 per cent in 1980 to 71 per cent in 1987, while that of the developing countries declined from 28 per cent to 19 per cent, mainly because of a sharp fall in commodity prices. The centrally planned economies accounted for 10 per cent of world exports in 1981 and the proportion remained practically constant throughout the 1980s (see table III.1).

An increase in the imports of developed market economies was the major factor behind the growth of world trade in 1987 (see table III.2). Total imports of these economies increased by over 5 per cent. Their exports also picked up after weak growth in 1986. The expansion of exports of the main deficit country, the United States, was stronger than expected in some of the more pessimistic scenarios and imports of Japan, the largest surplus country, also increased fast. Trade among developed market economies increased faster than world trade.

Despite the expansion of exports of the United States and imports of the main surplus countries, the trade imbalances between the major developed market economies remained very large. The apparent failure of the sharp depreciation of the dollar against all other major currencies to bring about the expected correction in these imbalances dominated the thinking on trade policy in 1987. It also further increased the threat of protectionism in international trade. By early 1988, however, there was clear evidence that trade imbalances had begun to shrink even in dollar terms, following the reduction in real terms that had started earlier.

The expansion of trade in 1987 also owed much to the increase in non-fuel exports of the developing countries. Much of this increase came from the exports of manufactures of the newly industrializing countries. On the other hand, the continuing decline in the imports of the energy-exporting developing countries remained a drag on the growth of world trade. A substantial increase in oil prices in 1987 was partly offset by an increase in the prices of manufactured imports of these countries. This, combined

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1 Major multilateral organizations revised their estimation of growth of the volume of world trade by at least 0.5 percentage points. The latest OECD estimate, for example, puts it at 3.75 compared with 2.25 projected earlier (OECD, *Economic Outlook*, June 1987 and December 1987). IMF raised its estimate from 3.3 to 4.7 per cent (IMF, *World Economic Outlook*, April 1987 and April 1988). The *World Economic Survey 1987* (United Nations publication, Sales No. E.87.II.C.1 and corrigendum) projected a growth rate of 3.0 per cent.

Table III.1. World trade, 1980-1987

	1980	1981	1982	1983	1984	1985	1986	1987[a]
Value of world exports (billions of dollars)	1 998	1 972	1 830	1 808	1 902	1 927	2 115	2 431
Developed market economies	1 252	1 228	1 151	1 148	1 221	1 266	1 468	1 727
	(0.63)	(0.62)	(0.63)	(0.63)	(0.64)	(0.66)	(0.69)	(0.71)
Developing countries	569	562	490	457	477	457	422	455
	(0.28)	(0.28)	(0.27)	(0.25)	(0.25)	(0.24)	(0.20)	(0.19)
Centrally planned economies	177	182	190	203	205	203	225	247
	(0.09)	(0.10)	(0.10)	(0.11)	(0.11)	(0.11)	(0.11)	(0.10)
Volume of world exports (annual percentage changes)	—	1.0	−2.4	3.1	7.6	3.0	4.5	4.1

Source: United Nations, *Monthly Bulletin of Statistics,* December 1986 and March 1988. Rates of growth of volume are estimates of the Department of International Economic and Social Affairs of the United Nations Secretariat.

Note: Figures in parentheses are shares of the country group in total trade.

[a] Preliminary estimates.

with the lagged effects of the precipitous decline in oil prices in 1986, led to a further decline in the imports of these countries in real terms.

The expansion of trade in 1987 also owed much to the increase in non-fuel exports of the developing countries. Much of this increase came from the exports of manufactures of the newly industrializing countries. On the other hand, the continuing decline in the imports of the energy-exporting developing countries remained a drag on the growth of world trade. A substantial increase in oil prices in 1987 was partly offset by an increase in the prices of manufactured imports of these countries. This, combined with the lagged effects of the precipitous decline in oil prices in 1986, led to a further decline in the imports of these countries in real terms.

A further factor constraining the growth of world trade was the unresolved problem of the external debt of the developing countries. The heavily indebted countries continued to restrict their imports in order to service their external debt. There is little reason to expect that the import capacity of these countries and of energy exporters will improve greatly in the immediate future, which will keep the growth of world trade well below its potential.

Many commodity prices increased in 1987, some significantly, but a decline in the prices of tropical beverages depressed the overall index of non-fuel commodity prices. The improvement in commodity prices was, moreover, more than offset by a substantial increase in the prices of manufactures. The real prices of commodities (in terms of prices of manufactures) declined on the average for the fourth year in a row.

The changes in the terms of trade in 1987, resulting from these price movements, were modest in comparison with those in 1986 (see table III.2). For the developing countries as a whole, the terms of trade improved somewhat, mainly because of a large improvement for energy exporters. For net energy-importing countries, the terms of trade declined further in 1987, continuing the unbroken downward trend of the 1980s. The large gain for the developed market economies in 1986 was followed by a further modest improvement in 1987, while the terms of trade of the centrally planned economies remained practically unchanged after a sharp deterioration in 1986.

The trading system: the need for action

The maintenance of the open trading system assumes special importance in a period of slow growth and large imbalances and uncertainties in the international economy because any weakening of the system is likely to make these problems worse. A highly restrictive trading system aggravated the depression of the 1930s. In an environment of slow world economic growth in the mid- and late 1980s, the multilateral trading system remained under severe strain. Although some steps were taken at the international level to strengthen the system, various national policies continued to undermine it. The trend towards bilateralism and quantitative restrictions, the two major threats to the system, continued unabated and international commitments to roll back protectionism, or at least stem its tide, were not followed up. Macro-economic imbalances in developed market economies and great instability of exchange rates have further contributed to the weakening of the trading system.

Table III.2. World trade: annual rates of change in volume and prices, 1976-1988

(Percentage)

	1976-1980	1981-1987	1985	1986	1987[a]	1988[b]
Volume of exports						
World	5.1	2.6	2.8	4.5	4.1	4.3
Developed market economies	6.6	3.2	4.5	2.6	4.0	4.5
Developing countries	1.9	1.0	-0.8	10.3	5.7	5.5
Capital-surplus countries	-1.6	-9.0	-10.0	16.0	-0.9	2.1
Other net energy-exporters	2.1	0.9	-4.8	11.0	-0.7	3.5
Net energy-importers	7.4	8.3	5.5	7.7	10.0	7.6
Centrally planned economies	5.7	3.5	-0.9	5.0	3.1	2.6
China	..	14.2	8.8	18.4	27.0	10.0
Volume of imports						
World	5.5	3.2	3.1	4.2	4.0	4.2
Developed market economies	5.6	4.3	5.3	8.0	5.1	4.2
Developing countries	5.5	-0.3	-4.7	-6.3	2.0	5.4
Capital-surplus countries	11.4	-6.3	-19.1	-23.8	-12.5	0.3
Other net energy-exporters	6.1	-4.4	-4.7	-20.5	-8.1	1.2
Net energy-importers	3.8	2.6	0.1	2.0	7.5	7.3
Centrally planned economies	4.8	1.8	5.3	-0.6	-0.8	2.8
China	..	9.3	58.2	-14.5	-8.4	4.1
Unit value of exports						
World	12.2	0.5	-1.8	6.6	11.4	7.0
Developed market economies	9.8	1.4	-1.0	14.8	12.0	8.0
Developing countries	19.0	-2.5	-4.2	-14.4	12.9	4.3
Capital-surplus countries	23.5	-3.6	-2.2	-32.4	21.9	3.9
Other net energy-exporters	20.9	-3.4	-3.6	-25.5	16.0	3.3
Net energy-importers	11.2	-1.7	-4.6	0.3	7.9	4.0
Centrally planned economies	8.7	1.0	-1.5	5.9	8.1	0.8
China	..	-2.9	-3.8	-4.6	0.6	4.1
Unit value of imports						
World	11.7	-0.3	-2.0	6.2	9.1	6.1
Developed market economies	12.1	-0.5	-2.0	5.9	9.6	8.3
Developing countries	12.5	0.5	-1.7	6.2	11.6	5.8
Capital-surplus countries	10.8	0.7	-1.7	11.0	10.5	7.2
Other net energy-exporters	11.1	0.7	-1.6	8.6	11.3	7.3
Net energy-importers	13.4	0.4	-1.8	4.3	12.0	5.2
Centrally planned economies	6.8	1.5	-1.4	11.5	8.4	0.6
China	..	0.7	-1.7	18.8	9.9	4.4
Terms of trade						
Developed market economies	-2.1	1.9	1.0	8.0	2.1	-0.3
Developing countries	5.8	-3.0	-2.5	-19.5	1.2	-1.7
Capital-surplus countries	11.5	-4.3	-0.5	-39.1	10.4	-3.1
Other net energy-exporters	8.8	-4.0	-2.0	-31.4	4.3	-3.6
Net energy-importers	-2.0	-2.1	-2.9	-3.9	-3.7	-1.1
Centrally planned economies	1.7	-0.6	-0.1	-5.0	-0.3	0.2
China	..	-3.6	-2.1	-19.7	-8.5	0.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.
Note: The large difference between world unit values of exports and imports in 1987 is partly due to incomplete information and different definitions among countries.

[a] Preliminary estimates.

[b] Forecast.

Non-tariff barriers to trade

After three decades of negotiated reduction of tariffs, international trade is now impeded mainly by quantitative restrictions. These restrictions have taken many forms,[2] ranging from bans on imports to surveillance and monitoring of prices and volumes of imports. Some of the restrictions are outright violations of the rules of the General Agreement on Tariffs and Trade (GATT), which prohibit quantitative restrictions in general, or are "grey area" measures, such as "voluntary" export restraints, which circumvent the rules. Many of the restrictions are in areas which have been kept outside the purview of GATT rules, such as the Multifibre Arrangement (MFA), while others are practised under exceptions to the rules, such as emergency import restriction measures necessitated by threats to domestic industry. Together, they constitute a formidable tangle of barriers to international trade.

Even excluding those quantitative restrictions which are permitted under exceptions to GATT rules, the use of non-tariff barriers to trade is extensive and appears to be on the increase. GATT was notified, or knew, of 135 major export restraint arrangements of various types in operation in 1987. Such restraints have become more numerous in recent years (see table III.3).

Table III.3. Number of export restraint arrangements in operation [a]

April-September 1986	October 1986-March 1987	April-September 1987
93	118	135

Source: GATT, "Developments in the trading system" (L/6087, L/6205 and L/6289)

a Excluding restrictions under MFA.

Of the 135 export restraint arrangements in operation in 1987, 64 were directed against developing countries, 51 against developed market economy countries and 20 against the centrally planned economies. Most of the restrictions on developing country exports were directed against the newly industrializing countries, of which the Republic of Korea faced by far the largest number (23). Japan faced the largest number (24) among the developed market economies.

Since the 1970s, quantitative restrictions have been spreading to sectors other than those traditionally associated with labour-intensive developing country exports. In 1987, known export restraints on steel and steel products (38), machine tools (7), motor vehicles (19) and electronics (11), accounted for more than half of the total. Almost half of the restrictions in steel and electronics were on developing country exports. Restrictions on the more traditional exports of the developing countries remain numerous, however, and have tended to intensify. There were about 70 bilateral agreements under MFA between developing countries and the European Economic Community (EEC) and the United States and about 25 outside it.[3]

The use of the various forms of non-tariff barriers to trade is more pervasive than suggested by the figures above. Examined at a disaggregated level of commodity classification, a large proportion of commodities traded internationally is found to be affected by non-tariff barriers of one kind or another. As table III.4 shows, over 30 per cent of all commodities traded were subject to quantitative restrictions in the 1980s.

The table also shows the distribution of the frequency of quantitative barriers by country and commodity groups. Developing countries make more extensive use of restrictions on trade than the developed market economy countries: about 40 per cent of the commodities traded are subject to restrictions by the developing countries, compared with around 20 per cent for the developed countries. The proportion of agricultural commodities facing barriers is much larger than that of manufactures in both groups of countries.

In terms of value, too, the proportion of trade affected by non-tariff measures is large. In 1986, around 20 per cent of the total value of imports of the developed market economies (23 per cent for non-fuel imports) was subject to such restrictions.[4] There is also evidence that the proportion of non-fuel trade affected by quantitative restrictions has been increasing during the 1980s.[5]

There were many different reasons behind the imposition of the various quantitative barriers to trade, as shown by the GATT provisions invoked to justify them. Many of the restrictive measures used by the developing countries have been taken under article XVIII of the Agreement, by which these countries are permitted to take such measures to protect their balance of payments. This provision was made in recognition of the special needs of the developing countries to increase imports for the purpose of economic development. Trade restrictions imposed by the developed countries for balance-of-payments purposes are now rare. Emergency measures to protect domestic industry from surges in imports have often been taken by the developed market economies under article XIX. Action under this article has often had a large impact on individual imports, but it has been used less frequently than other measures in recent years. Article XI prohibits quantitative restrictions, but many of the measures have been taken under exceptions to the article which permit, among others, measures to protect domestic agriculture. By far the largest number of restrictive actions have, however, been taken under the general exceptions to GATT rules allowed under article XX, many of which are based on non-economic considerations. For many other re-

2 GATT lists 33 types of quantitative restrictions in existence (see GATT, Group on Quantitative Restrictions and other Non-Tariff Measures, "Analysis of the Group's Documentation: note by the secretariat" (NTM/W/17)), 1 September 1986.

3 GATT, "Developments in the trading system, April 1987-September 1987" (L/6289), p. 24.

4 UNCTAD, "Problems of protectionism and structural adjustment" (TD/B/1126/Add.1), 22 January 1987.

5 *Ibid.* This refers to imports of developed market economies only.

Table III.4. Extent of quantitative restrictions in international trade in the 1980s

	Number of restrictions per country			Proportion of commodities affected by restrictions		
	Developed market economies	Developing countries	All countries	Developed market economies	Developing countries	All countries
All commodities [a]	170	355	290	0.19	0.38	0.32
Agricultural commodities	47	100	77	0.29	0.61	0.47
Manufactures	115	243	213	0.15	0.32	0.28

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data from GATT, Group of Quantitative Restrictions and Other Non-Tariff Measures, "Analysis of the Group's documentation: note by the secretariat" (NTM/W/17, 1 September 1986).

[a] Including minerals and precious stones.

strictions there is no clear justification under GATT rules.[6] Indeed, measures circumventing GATT rules include some of the major trade restrictions imposed by developed market economies and protect some of the largest industries (textiles, steel, transport equipment and electronics) in these countries.

The multiplicity of restrictions makes it likely that, at the national level, they sometimes work at cross purposes. There is rarely any examination of the consistency of the objectives that the various trade barriers are intended to serve. Even for specific measures, the rationale of trade barriers and the form they take only rarely come under close scrutiny. Examination of the grounds for protecting declining industries in terms of the costs and benefits for the national economy is not very common. Similarly, while there may be justification for national measures to protect the balance of payments, quantitative restrictions may not be the best way to do so, especially in a régime of flexible exchange rates.[7] The great variety of trade barriers erected by national authorities has tended to weaken the multilateral trading system.

Some recent developments

Although trade tension appears to have lessened compared with a year ago, frictions continue and there have been a number of disappointing developments and setbacks in recent months. Many of these frictions arise out of an increased concern with bilateral trade balances, while others have their origin in deep-seated issues of structural change.[8]

Expectations have been raised by the renewed interest in the major developed market economies in the liberalization of trade in agriculture. The large cost of protecting agriculture in industrial countries has been the subject of numerous studies. A major study conducted by the Organisation for Economic Co-operation and Development (OECD) in 1987 estimated these costs and emphasized the need for urgent action.[9] A number of proposals have been made to reform trade in agriculture, including proposals submitted in multilateral negotiating groups under the Uruguay Round. Little progress towards an agreement has, however, been made. The Common Agricultural Policy (CAP) of EEC is widely recognized as one of the prime examples of protection to agriculture and in need of major reform. The EEC Ministers of Agriculture have initiated a move for reforms, including cuts in milk output and reduction of support prices of beef, but little action has so far been taken. The EEC summit meeting in February 1988 agreed, however, on measures to limit production of cereals and oilseeds and set limits to agricultural spending as part of a package to control Community spending. The United States has initiated changes in its farm programme, under the Food Security Act 1985, which would cut government support to agriculture, but provide for subsidies to agricultural exports. In July 1987, the United States increased the funding of its Export Enhancement Program, which subsidizes United States exporters of agricultural products facing subsidized foreign competition. Australia decided to give direct producer subsidies to its farmers for the first time. An international understanding on agricultural subsidies remains out of reach. In December 1987, the United States decided, also under the Food Security Act, to cut its sugar imports in 1988 by 25 per cent in order to keep domestic sugar prices above world prices.

In other sectoral developments, a number of major suppliers of footwear agreed "voluntarily" to restrict their exports to some developed market economies. The Republic of Korea agreed to a "voluntary" restraint on its exports of electronics to the United States. Additional restrictive measures were taken by EEC and the United States on their steel im-

6 For information on the relative importance of the various types of measures described here, see GATT, Group on Quantitative Restrictions and other Non-Tariff Measures, "Analysis of the Group's Documentation: note by the secretariat" (NTM/W/17, annex 7), 1 September 1986.

7 See Jagdish N. Bhagwati, Anne O. Krueger and Richard H. Snape, Introduction, *The World Bank Economic Review*, vol. 1, No. 4 (September 1987), a symposium issue on the multilateral trade negotiations and developing country interests, p. 544.

8 Much of the information on recent developments in the field of trade is derived from GATT, "Developments in the trading system, October 1986-March 1987" (L/6205) and "Developments in the trading system, April 1987-September 1987" (L/6289).

9 See OECD, *National Policies and Agricultural Trade, (Paris, 1987).*

ports, as the problem of over-capacity in the steel industry persisted. Japan continued to restrain its exports of vehicles to EEC and the United States. On the positive side, the United States decided to remove the high tariff it had imposed on Japanese motor cycles, citing revived competitiveness of United States industry.

In textiles, the major development, with potentially serious consequences for developing country exports, is the set of textile bills currently before the United States Congress. Even a moderate version of the bills would severely limit imports of textiles into the country. The present Administration has, however, opposed the bills.

Trade tension between Japan and the United States continued in 1987, but there have been some important positive developments in recent months. Early in 1987, the United States imposed tariffs of 100 per cent on some Japanese electronic goods in retaliation for what it regarded the latter's breach of an agreement between the two countries on trade in semiconductors. Later in the year, the tariff on some of the items was reduced, but not entirely removed. Individual cases of trade friction between the two countries reflect heightened general tension produced by the very large United States trade deficit with Japan. In some cases, continuing United States pressure has yielded what is seen as an opening of the Japanese market to United States industries—for example, Japan's offer to facilitate access of foreign firms to Japanese government contracts for supercomputers. Japan also agreed to eliminate import quotas on a number of agricultural products, but a major dispute on the lifting of quotas on beef and citrus products continued. In a significant development, an agreement was reached early in 1988 allowing United States firms to bid for government-financed construction projects in Japan. The impact of these steps on the trade balance is, however, uncertain and probably minor, and some of these agreements have only helped to strengthen bilateralism in international trade. Such agreements have not always produced salutary results. The agreement between the United States and Japan on computer chips, by restricting total output, was widely held responsible for a sharp increase in chip prices early in 1988.

The trade legislation that has received the most attention because of its implications for international trade is the omnibus United States trade bill passed by Congress at the end of April 1988. Although some of the original extremely protectionist proposals were omitted from the final version, the bill is widely perceived as a major setback to free trade. It appears to further strengthen the trend towards reciprocity and bilateralism in trade relationships by requiring the Administration to retaliate against countries which are perceived to restrict United States exports. As at the end of April, the bill was under the threat of a presidential veto over certain of its provisions not strictly related to trade. Apart from creating an atmosphere of uncertainty about the evolution of United States trade policy, the delay in its passage might hinder negotiations in the Uruguay Round because the legislation contains provisions giving the United States Administration the authority needed to negotiate multilateral trade agreements. On the other hand, the bill in its present form, which the negotiating partners may perceive as overly protectionist, is unlikely to help the negotiating process.

One bilateral agreement in recent months does appear, however, to constitute a significant step towards freer trade. In December 1987, after a long series of negotiations, Canada and the United States signed an agreement to remove tariffs from a large proportion of trade between the two countries. For some products, tariffs are to be abolished immediately; for others, they are to be cut over a number of years. The agreement also lowers a wide range of non-tariff barriers and covers a number of aspects of trade in services. In another development, Mexico and the United States have moved close to an agreement to curb barriers to trade and investment. The two initiatives, especially the first, should significantly expand the area of freer trade and may mean a net creation of world trade rather than its diversion from the rest of the world. Genuine concerns have nevertheless been expressed on the implications of too many regional trading arrangements for the multilateral trading system.

An encouraging sign in recent months is that GATT member countries appear to be making greater use of GATT machinery for dispute settlement and reconciliation. While most trade disputes continue to be resolved through bilateral accords, including those under which supplying countries "voluntarily" agree to limit exports, a recent GATT report notes a rising trend towards the use of the multilateral forum of GATT.[10] A significant development in this area was the settling early in 1988 of the dispute between Japan and the United States on the former's use of quotas, covering 12 categories of agricultural products. The GATT Council upheld the finding of the GATT dispute settlement panel that these quotas violated the rules and Japan agreed to abide by the finding. The dispute settlement procedure of GATT has been invoked in a fairly large number of cases, including complaints by Japan and EEC regarding the discriminatory implications of the agreement between the United States and Japan on semiconductors and the action of the United States Government under it, and the GATT ruling on United States legislation which would tax imported petroleum at a higher rate than domestic production.

In the midst of these mixed developments, a further sign of support for the multilateral trading system is the number of countries joining GATT or wishing to join it. Among the five countries and territories which have joined in the past two years are Hong Kong, Mexico and Morocco, which together account for a large proportion of the trade of the developing countries. Tunisia has provisionally acceded to the Agreement and, as at the middle of 1987, 11 countries had taken initiatives to obtain GATT membership. China, with significant and rapidly growing external trade, has applied for the resumption of its membership in GATT and Bulgaria has applied to join. The Soviet Union is expected to resubmit its application for observer status at the GATT multilateral negotiations.

10 GATT, "Developments in the trading system, April 1987-September 1987" (L/6289), p. 5.

The Uruguay Round of multilateral trade negotiations

The year 1987 was the first full year of multilateral trade negotiations under the Uruguay Round, launched at Punta del Este in September 1986, which is seen by many as the main hope for strengthening the multilateral trading system. In scope and complexity, the Uruguay Round surpasses its predecessors and the negotiations are widely expected to be difficult and lengthy. The assessment of progress made by the end of the first year, however, appears on the whole to be favourable.[11] It is also possible that the process of negotiations itself helped some Governments to resist protectionist pressures.[12] Fourteen negotiating groups on goods were formed, negotiating plans were drawn up and a series of meetings of the groups were held. Before the end of the year, 168 proposals had been presented to the groups. The developing countries have participated actively, presenting about 40 proposals. Much of the progress made concerns technical matters of procedure. Many proposals on substantive matters also have been presented in the groups.

A major failure was the lack of progress in the implementation of commitments made at Punta del Este on standstill on new illegal trade measures and rollback of existing measures, although a mechanism for surveillance of these commitments was agreed on. Fresh violations of the commitments have been reported to the Surveillance Body.

Agriculture remained a crucial and difficult area of negotiation. In July 1987, the United States presented a comprehensive set of proposals to phase out all agricultural subsidies and import barriers by the year 2000. The Cairns Group of countries[13] and EEC also presented far-reaching proposals for reform of trade in agriculture. These proposals are still under discussion in the negotiating group on agriculture, but little substantive progress has been made. National action to subsidize agriculture has in fact paralelled multilateral discussion on liberalization of agricultural trade.

Some progress has been made in negotiations on trade in tropical products, which are mostly of interest to developing countries. EEC made an offer to reduce or eliminate tariffs and quantitative restrictions on a wide range of these products. The proposal is, however, conditional on a satisfactory level of reciprocity by the beneficiaries. A number of developing countries and the United States also submitted proposals for liberalization of trade in tropical products.

Negotiations on trade in services is a major new dimension of the Uruguay Round. The Group of Negotiations on Services, working in parallel with the Group of Negotiation on Goods, has, as its negotiating objective, the establishment of a multilateral framework of principles and rules for trade in services. In accordance with its mandate, during 1987 the Group dealt mainly with definitional, conceptual and statistical problems, the coverage of the multilateral framework for trade in services, existing international arrangements for trade in services and current practices limiting such trade. A number of proposals were made. The United States, for example, submitted a set of comprehensive proposals for the inclusion of the principles of transparency, non-discrimination and national treatment.

Little progress has so far been made on the important question of safeguards. Article XIX of the Agreement allows emergency action to protect domestic industry temporarily when it is threatened with "serious injury" as a result of increased imports. In practice, it has become a major vehicle of protection. There is a wide area of disagreement on the interpretation of "serious injury", the duration of the emergency measures, the treatment of the "grey area" measures (i.e., measures which do not technically violate GATT rules but circumvent them by such practices as voluntary export restraints) and the application of the principles of non-discrimination. It may be recalled that the inability to agree on safeguard measures was a major failure of the Tokyo Round. The negotiating group on safeguards in the Uruguay Round has only begun deliberations on these complex but well-known issues.

Issues of removal of quantitative restrictions and other non-tariff barriers to trade lie at the heart of the negotiations in the Uruguay Round. These issues not only concern the negotiating group on non-tariff measures, but pervade the examination of many of the questions raised in other groups as well. The very diversity of the types of trade restrictions in use raises complex issues of substance and makes their quantification for the purpose of negotiation difficult. In this regard, a recently submitted proposal, based on the well-known concept of effective rate of protection, to bring the various tariff and non-tariff barriers into a single measure of protection called the "effective rate of assistance", should facilitate the evaluation of existing protection in individual countries and thus help the negotiating process.[14]

In recent months, considerable emphasis has been placed, both in the negotiations under the Uruguay Round and in other forums, on the strengthening of the GATT system. There is a widespread perception that many of the GATT rules are porous and that GATT has been less effective in the maintenance of an open trading system than its founders expected. In the negotiating group on the functioning of the GATT system, there appears to be a convergence of views on the need for greater ministerial involvement in GATT meetings and for transparency and regular reviews of trade policies of member countries. Strong backing for efforts to strengthen the system was given in March 1988 at a meeting of trade ministers from 30 major trading countries.

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11 See "forty-third session of the GATT Contracting Parties: opening statement by the Chairman", GATT press release, (GATT/1424), 1 December 1987; and "TNC Chairman reviews first year of the Uruguay Round", GATT, *News of the Uruguay Round of Multilateral Trade Negotiations* (NUR 008), 2 October 1987.

12 GATT, *News of the Uruguay Round of Multilateral Trade Negotiations* (NUR 013), 21 December 1987.

13 Argentina, Australia, Brazil, Canada, Colombia, Hungary, Indonesia, Malaysia, New Zealand, Philippines, Thailand and Uruguay.

14 GATT, Uruguay Round of multilateral trade negotiations, Group of Negotiations on Goods, Negotiating Group on Tariffs and Negotiating Group on Non-Tariff Measures, "Communication from Australia" (MTN.GNG/NG1/W/14 and MTN.GNG/NG2/W/8, November 1987).

Trade, exchange rates and macro-economic imbalances

The proper functioning of the trading system and the success of current efforts to strengthen it will largely depend on the strength of the political commitment to freer trade and the micro-economic policies of structural adjustment that must accompany it. These efforts will also depend on the functioning of the international monetary system, especially the exchange rate régime. The events of the 1980s have cast serious doubts on the ability of a régime of freely floating exchange rates to restore and maintain equilibrium in external balances among countries. As a former Chairman of the United States Federal Reserve Board said recently, "the health and viability of an open international trading order will be importantly dependent over time upon the willingness of governments of large trading countries to reach some realistic collective judgement about the broadly appropriate level of exchange rates".[15]

The growth of trade is affected both by a prolonged misalignment of currencies, through their impact on the supply capacity of the domestic tradable sector, and by macro-economic policies aimed at reducing trade imbalances, through the total demand for tradables. The impact of these two factors on trade is examined briefly below.

Unstable exchange rates and supply capacity

It is widely recognized that in recent years exchange rates among major currencies have been influenced more by capital movements than by relative rates of inflation or productivity growth. The sensitivity of exchange rates to investor preferences among assets denominated in different currencies has weakened the traditional links between current accounts, purchasing power parity relationships and exchange rates. The floating rate régime has often experienced medium-term swings involving considerable misalignment of exchange rates, in the sense that actual rates deviated substantially and for a prolonged period from their long-run equilibrium level.[16] Such misalignments have been an impediment to free trade because of the protectionist tendencies they generate. More important, they may also have been a source of significant resource misallocation.

Exchange rates perform a crucial function in the international trading system as the relative price of tradables. An appropriate and predictable rate is thus essential for planning the optimal level of investment in export- and import-competing sectors. An overvalued exchange rate places a country at an across-the-board disadvantage in trade because its prices in both export- and import-competing industries will be above equilibrium levels. Domestic tradables output will be dearer than foreign products. Reducing prices to ensure competitive levels erodes profits. This may induce firms in the tradables sector to lay off workers and scrap capacity that could otherwise be productively employed at equilibrium prices. As and when the exchange rate swing reverses itself, however, new investment may be called for in these same industries as their initial viability is restored. Clearly, there are significant costs of adjustment associated with such shifts in resources, as is the case with any resource reallocation. However, when costs are incurred to effect a long-run improvement in the allocation of resources, there is a corresponding long-term gain that more than offsets it. This is not true when resource movements are imposed by inappropriate or misaligned exchange rates. The impact of the dollar's misalignment on resource movement bears testimony to that. There is evidence to suggest that an appreciation- induced decline in competitiveness over a long period may have led to disinvestment and thus to reduced capital, skills and organization in the United States tradables sector.

The nominal effective exchange rate of the United States dollar appreciated by around 55 per cent between 1980 and 1985.[17] The real exchange rate changed by similar magnitudes. This implied that there was a significant degree of misalignment.[18] As a result, the relative profitability of the tradables sector fell. However, expectations of a correction in exchange rates and, of course, the cost of shifting resources may have slowed down the actual process of resource reallocation. Not all industries producing tradables experienced similar reductions in profitability, however. Some avoided it, through offsetting increases in productivity. Others proved to be more vulnerable and may have suffered significant losses.[19] Industrial subsectors whose employment and installed capacity appear to have been most adversely affected by the dollar's appreciation are textile mill products, leather and leather goods, primary metal industries, non-electrical machinery and transportation equip-

15 Statement made on 30 November 1987 by Mr. Paul Volcker on the occasion of the fortieth anniversary of GATT (see *GATT Newsletter*, No. 51 (January, 1988)).

16 The long-run equilibrium level is that at which exchange rates, obtainable without trade or exchange restrictions, would generate a current-account balance consistent with some notion of normal or underlying capital flow. This rate has been called "fundamental equilibrium real effective exchange rate" (J. Williamson, *The Exchange Rate System*, 2nd ed. (Washington, D.C., Institute for International Economics, 1985), p. 27).

17 This is based on the MERM index of exchange rates, line am x (see IMF, International Financial Statistics (Washington, D.C.), various issues).

18 There is no estimate of actual misalignment in 1985. However, by end of 1983, when the dollar's nominal effective exchange rate had appreciated by 33 per cent over 1980, misalignment or overvaluation was estimated to be 18 per cent (Williamson, *op cit.*).

19 One simple indicator of such vulnerability is the price-cost margin of different industries. The average price-cost margin for United States manufacturing is around 0.5 with considerable dispersion around it: a high of 0.96 and a low of 0.30 for 20 two-digit industries; appreciation-induced price reductions could have generated losses for firms in industries with below average price-cost margins (R. G. Hubbard, "Comment on Hall's market structure and macro-economic fluctuations", *Brookings Papers on Economic Activity, No. 2* (1986)).

ment.[20] Surveys of workers displaced during this period confirm that the layoffs that occurred in these sectors were largely due to plant closings.[21]

The dollar has been depreciating since the middle of 1985. Its current real exchange rate is around the same level as it was in 1980. This depreciation has been accompanied by a great resurgence in demand for United States exports. Although the full demand effect of depreciation is still working itself out, capacity utilization rates of 95 per cent have already been reported in several industries. How rapidly these emerging supply bottle-necks are overcome will depend on investment in new capacity. The potential of the floating rate régime to reverse exchange rate swings, in directions not always consistent with the needs of the real sector, will no doubt affect the speed and volume of that investment and thus the supply capacity of the tradables sector.

Policies for reducing imbalances and emerging trade patterns

It is doubtful that the current level of the dollar's real exchange rate will be adequate to ensure major reductions in the external imbalance. The burden of further reductions in the current-account deficit of the United States is therefore likely to be borne by adjustments in the relative growth of domestic demand. Though estimates vary, some suggest that growth of demand of foreign industrialized countries will have to exceed that of the United States by 2.5 per cent over the next three years to ensure substantial reductions in the external imbalance of the United States at prevailing real exchange rates.[22] However, there appears to be considerable uncertainty about the nature of aggregate demand policies that countries will carry out for the purpose of achieving the necessary differential in relative growth of their domestic demand, as well as about the evolution of exchange rates. It is clear, however, that whatever mix of demand adjustment among countries is chosen, it will have a considerable impact on growth of world trade and of exports of developing countries.

An effective country mix of policies for reducing the current imbalances consists of a contraction in United States domestic demand offset by a commensurate rise in demand of Japan and Western Europe. This would be the least damaging to overall growth of world trade. To the extent that the income elasticity of demand for imports from developing countries is greater in the United States, the stimulus to export growth of developing countries as a whole will of course be lower, but not substantially. In addition, the geographical distribution of that stimulus will differ depending on commodity and market concentration of their exports. In view of the greater commodity- intensity of Japanese and European imports from the developing world, commodity exports may experience faster growth rates, relative to manufactured exports. Africa, with its greater dependence on commodity exports to Europe, will benefit more than either East Asia or Latin America which is more dependent on the United States market. Despite the attractiveness of this policy scenario, it seems unlikely to materialize. Western Europe, including the Federal Republic of Germany, appears reluctant to carry out such expansionary policies. Part of the reason is to be found in the fact that the prevailing output gap is low and the rate of growth of potential output appears to be slow,[23] both of which suggest that the spectre of early inflationary pressures may inhibit the necessary expansion of demand.

It is equally unlikely that the United States will make a very significant cut in the fiscal deficit and thus domestic demand if a good part of it is not expected to be offset by a rise in net export demand. The cut in the 1988 budget deficit of the United States is not large. The adverse impact of larger cuts on growth of world output and growth of world trade would be quite substantial.

What is more likely to emerge, therefore, is a reduction in the United States fiscal deficit accompanied only by a rise in growth of spending in Japan. This was evident in 1987, when growth of United States domestic demand fell from 3.9 per cent to 2.5 per cent under the impetus of Gramm-Rudman-Hollings cuts, while Japanese demand rose from 4 per cent to 5.1 per cent.[24] Western Europe, on the other hand, reduced its rate of growth of spending slightly that year, from 4.0 per cent to 3.4 per cent. Extrapolation of existing trends suggests a continuing decline in the rate of growth of demand of the United States and Europe and a rise only in that of Japan. Thus growth of output of the industrialized world is expected to be lower under such a scenario. This will no doubt affect world trade. More important, since a larger

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20 An econometric study of the determinants of employment in each two-digit industry category has been carried out, with trend, a proxy for aggregate demand, the relative price of energy and the real exchange rate as the determinants. The study indicates that a 60 per cent appreciation of the dollar from 1980 to 1985 may have reduced overall manufacturing employment by 8.4 per cent (i.e., a loss of 1.7 million jobs) (W. H. Branson and J. P. Love, "The real exchange rate and employment in U.S. manufacturing 1974-85", National Bureau of Economic Research, Working Paper No. 2435 (Cambridge, Mass., 1987, p. 175). Most of the reduction would occur in the durable goods sector, which was found to be more sensitive to the real exchange rate (i.e.,a 60 per cent appreciation would lead to a 12 per cent decline in employment in the durable goods sector). Movements in the book-value of fixed assets between 1980 and 1985 suggest declines in installed capacity (see United States Department of Commerce, *Annual Survey of Manufactures*, various issues).

21 P. O. Flaim and E. Sehgel, "Displaced workers of 1981-85", *Monthly Labor Review*, June 1987.

22 R. Dornbusch, "External balance correction: depreciation or protection?", *Brookings Papers on Economic Activity*, No. 1 (1987), p. 259, shows that the non-interest current account of the United States will be balanced by 1991 if such a differential in relative growth of demand can be sustained.

23 An output gap of around 3 per cent has been estimated for many countries in Europe; this is largely because growth in potential output is so slow, not exceeding 2.6 per cent a year (see C. Adams, P. R. Fenton and F.Larsen, "Potential output in major industrial countries", *Staff Studies for the World Economic Outlook*, August 1987, Washington, D.C., IMF, 1987) p. 24.

24 IMF, *World Economic Outlook, April 1988: A survey by the Staff of the International Monetary Fund* (Washington, D.C., April 1988), statistical appendix, table A.2.

Table III.5. Indices of prices of non-fuel primary commodities exported by developing countries, 1982-1987

(1979-1981 = 100)

	Food	Tropical beverages	Vegetable oilseeds and oils	Agricultural raw materials	Minerals and metals	Combined index		Prices of manufactures[a]	Real prices of commodities[b]
						Dollar	SDR		
1982	70	81	72	82	82	78	89	97	80
1983	75	85	88	88	85	83	98	93	89
1984	64	97	119	86	78	84	103	91	92
1985	57	89	82	77	76	75	93	92	82
1986	62	110	51	77	71	79	85	108	73
I	64	128	56	77	76	85	96	104	82
II	65	114	50	78	69	81	87	107	76
III	59	103	45	75	69	75	78	112	67
IV	61	97	54	79	69	75	79	114	66
1987	66	72	60	96	82	76	74	122	62
I	63	75	56	89	72	73	72	120	61
II	64	69	60	95	76	74	71	123	60
III	64	67	59	100	84	75	74	123	61
IV	71	74	65	102	97	84	78	127	66

Sources: UNCTAD, *Monthly Commodity Price Bulletin;* and United Nations, *Monthly Bulletin of Statistics,* December 1986 and March 1988.

[a] Unit values of exports of manufactures from developed market economies. The base of the original index was shifted to 1979-1981.

[b] Dollar index deflated by prices of manufactures.

share of growth of demand will come from Japan, the import-intensity of which is lower than that of other industrial countries, the adverse effect may be greater than is implied by lower output-growth alone. Export growth of developing countries will also suffer. With the share of the United States and Western Europe in total developing country exports exceeding 45 per cent, the slow-down will undermine their export growth. This adverse impact will also be unevenly distributed. The share of the United States and Western Europe, together, in the total exports of Africa and Latin America, exceeds the average for developing countries by a substantial margin. Nearly two thirds of their exports are marketed there. Asia is less vulnerable as its dependence on those markets is only around 35 per cent. While the magnitude of the potential impact is not easy to quantify, the unwinding of large payments imbalances cannot but continue to affect international trade over the next few years.

Commodity prices: some short-term improvement and continuing instability

Trends in commodity prices

The continuing weakness in commodity prices remains one of the critical issues of international trade of the 1980s. While the share of commodities in world trade has declined steadily, to around 35 per cent in 1986 from 47 per cent in 1960, for a large majority of the developing countries commodity prices still determine their capacity to import and to service their external debt. The low level of prices has greatly added to their difficulties of adjustment and growth in the 1980s. At the same time, their reduced import capacity has contributed to the slow growth of exports from the developed market economies. Some of these economies are themselves dependent on exports of primary commodities and have been suffering because of weak prices.

Prices of non-fuel primary commodities exported by the developing countries declined slightly, in dollar terms, in 1987. The UNCTAD index of commodity prices for the year as a whole was about 4 per cent lower than in 1986.[25] This represents the continuation of a trend which has taken these prices to record low levels (see figure III.1).

The average annual changes, however, conceal the variations in price movements during the year and the widely

25 Other indices of prices give a somewhat different picture. The IMF index for the developing countries shows an increase of 3 per cent. The discrepancy is largely due to the difference in weights of individual commodities in the two indices, especially in the weights used for tropical beverages. UNCTAD uses a higher weight for this category than IMF. Beverage prices declined steeply in 1987. *The Economist* dollar index of commodity prices shows an increase of 7.5 per cent in 1987 over the average for 1986 (*The Economist*, 12 March 1988).

divergent changes in the prices of individual commodities. Quarterly data show that prices in dollar terms moved up noticeably in the second half of 1987 (see table III.5). The price index for the last quarter of the year was about 10 per cent higher than for the corresponding quarter of 1986.

There was, in fact, a general upsurge in commodity prices during the second half of 1987 and the beginning of 1988. For the year as a whole, of the 40 commodities in the UNCTAD index, 24 increased in price and 15 declined. This contrasts with 30 declines and 8 increases in 1986 (see box III.1).

Box III.1. *The diversity behind the commodity price index*

In 1987, prices of beverages declined while prices of most other commodities increased. Yet the index of commodity prices showed a decline for the year. The weights used in the price indices of commodities exported by developing countries are the relative importance of individual commodities in the total value of exports of these countries. Construction of any index normally involves weighting of this nature, which serves the purposes of an index in most cases. The weight of a commodity in the total exports of the developing countries will, however, rarely correspond to its importance to an individual country. A commodity with a large trade weight in total trade may be of little importance to an individual country and a change in its price may not therefore mean much to that country. The diversity of changes in commodity prices and the inadequacy of any value-weighted index to reflect the distribution of the impact of price changes are illustrated in the table below.

The decline in the price of coffee (the item with the largest weight) in 1987, for example, indeed affected a large number of countries where it accounted for a significant proportion of their foreign exchange earnings. Nevertheless, there is an even larger number of countries which are dependent, some of them heavily, on, for example, sugar, oilseeds, copper or cotton, the prices of all of which rose during the year. Few of these countries are also coffee producers. The movement of commodity prices in general, which is largely influenced by coffee prices, does not capture the welfare implication of an increase in the prices of the exports of these, more numerous, countries. The same would be true if coffee prices were to rise and most other prices fall, a situation close to what prevailed in 1986.

Major commodities	Weight (Percentage)	Number of countries accounting for 0.50 per cent or more of total developing country exports[a]	Number of countries for which the commodity account for 20 per cent or more of their total exports[a]	Changes in prices 1986	Changes in prices 1987
Coffee	19.4	28	15	Increase	Decline
Cocoa	5.1	18	3	Decline	Decline
Tea	2.6	15	2	Decline	Decline
Total, beverages	27.1	61	20		
Sugar	8.7	18	6	Increase	Increase
Oilseeds and oil	6.8	26	3	Decline	Increase
Cotton	4.7	27	6	Decline	Increase
Wheat	0.7	7	—	Decline	Decline
Rice	1.5	9	1	Decline	Increase
Rubber	5.5	10	—	Increase	Increase
Copper	7.4	11	3	Decline	Increase
Aluminium	3.6	16	1	Decline	Increase
Tin	3.6	8	1	Decline	Increase
Total, other than beverages	42.5	132	21		
Number of prices which increased[b]				8	24
Number of prices which declined[b]				30	15
Change in price index[b]				Increase	Decline

a In 1982-1983.
b In the UNCTAD index.

Prices of tropical beverages declined sharply, which depressed the index. Coffee prices, which have the largest weight in developing country exports, rose through most of 1986, but started to fall in the latter part of the year, the decline continuing well into the second half of 1987. The movement of prices broadly reflected the state of the coffee crop in Brazil, where production was reduced by drought in 1986, but recovered in the next crop season. In mid-1987 prices of some varieties of coffee were 40 per cent lower than a year earlier. Later in the year prices started to recover, partly as a result of the International Coffee Council agreeing on the allocation of export quotas. Cocoa prices were depressed in 1986 and fell further in 1987. By the first quarter of 1988, prices were at a five-year low. Tea prices declined in 1987, for the third consecutive year.

But prices of most products rose, in dollar terms, during the year, from the historically low levels they had reached in 1986. Sugar prices which, by 1985, had reached their lowest level since 1970, recovered moderately in 1986 and again in 1987. Prices of agricultural raw materials on the average rose by around 25 per cent in 1987 and metal prices by 15 per cent over 1986 levels. There were large variations within these groups: prices of some varieties of cotton increased by almost 50 per cent, while rubber prices rose by around 20 per cent; copper prices were about 15 per cent higher than the average for 1986, but by the end of 1987 they were almost 70 per cent higher than a year earlier; aluminium and tin prices increased by around 20 per cent.

Persistent excess supply has been a major cause of the decline in commodity prices during the 1980s. The International Monetary Fund (IMF) index of commodity stocks increased by around 28 per cent during the period 1983-1986.[26] A reversal of this trend, brought about by a decline in excess capacity in some cases and a localized fall in production due to adverse weather conditions in others, contributed to the upsurge of prices in 1987. The world stock of foodgrains remained at high levels, but there was a production shortfall in 1987, partly because of weather on the Indian subcontinent, and a slow-down of the growth of output in China. World production of cereals declined by 4 per cent in 1987 and stocks fell by about 14 per cent.[27] Production of sugar in the 1987/88 season is estimated to remain at its level of the preceding year and to fall short of consumption for the first time since the 1970s. There has also been a decline in the production of oilseeds and cotton. The changes in the supply of metals have been particularly large. Copper stocks declined and were, at the end of 1987, much lower than at any time during the 1980s. Aluminium and tin stocks also fell.

The upsurge in commodity prices in 1987 and the beginning of 1988 has benefited the developing countries, in some cases substantially. However, the increase in dollar prices is not an adequate measure of the change and can even be misleading. Measured in terms of a basket of currencies represented by the special drawing right (SDR), average prices of non-fuel primary commodities exported by the developing countries declined significantly, even in indexes which show a slight increase in dollar terms. The UNCTAD SDR index declined by 13 per cent.[28]

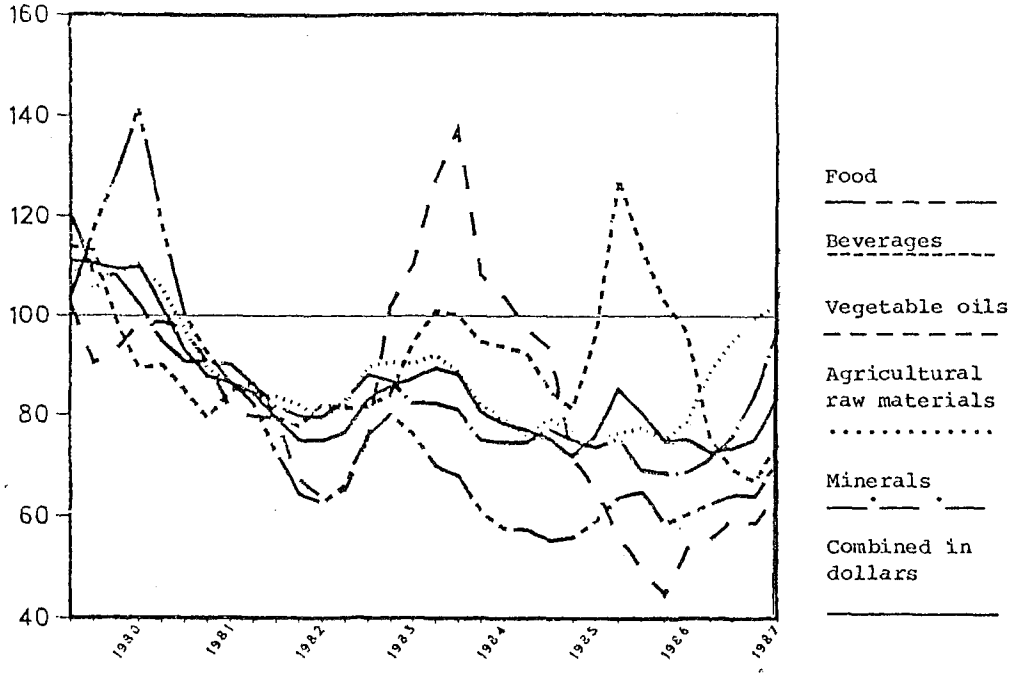
In real terms, the decline in commodity prices has been even more significant. When corrected for the changes in the prices of manufactures, which increased by around 13 per cent in dollar terms in 1987, commodity prices declined by almost 15 per cent, following an 11 per cent fall in 1986 (see table III.5 and figure III.2). During the period 1980-1987, commodity prices in real terms have declined by around 6 per cent annually. While a fall in these prices has been beneficial to those developing countries which are largely importers of commodities and exporters of manufactures, the majority of developing countries have suffered a loss of purchasing power of their exports during the 1980s and for many of them the recent increase in commodity prices was partly or wholly offset by an increase in the prices of their manufactured imports.

Furthermore, it does not appear that the recent upsurge in commodity prices is the beginning of a period of sustained improvement in prices. Some of the long-term and medium-term factors which have contributed to the depressed price levels of the 1980s remain at work. The long-term trend towards diminishing requirements of commodity inputs per unit of final output continues.[29] With unchanged policies, there is little evidence of a revival of high rates of growth in the industrial countries in the near future which might boost the demand for commodities. Moreover, though stocks of some commodities have declined in some cases, they remain large in others and excess capacity remains in a number of metal industries. The short-term response to an increase in prices of many agricultural commodities has often been an expansion of production which, in the absence of a sustained increase in demand, has led to a new round of decline in prices. These considerations suggest that price increases in recent months may, in general, be about to peak. Any further increase in 1988 and 1989 is expected to be only modest. In January and February 1988, there were already signs of a weakening of commodity prices. Agricultural raw materials and metal prices actually declined in February, leaving prospects for the near future in a state of uncertainty.

Oil prices increased by around 30 per cent in 1987 in dollar terms after a decline of 40 per cent in 1986. As a result, the terms of trade of the oil-exporting developing countries improved significantly, but not nearly enough to offset the sharp deterioration of the preceding year. Long-term demand and supply factors do not, however, suggest a sustainable further increase in oil prices for the near future. Early in 1988, there were already signs of weakness in prices as supply tended to outpace growth in demand. During the first

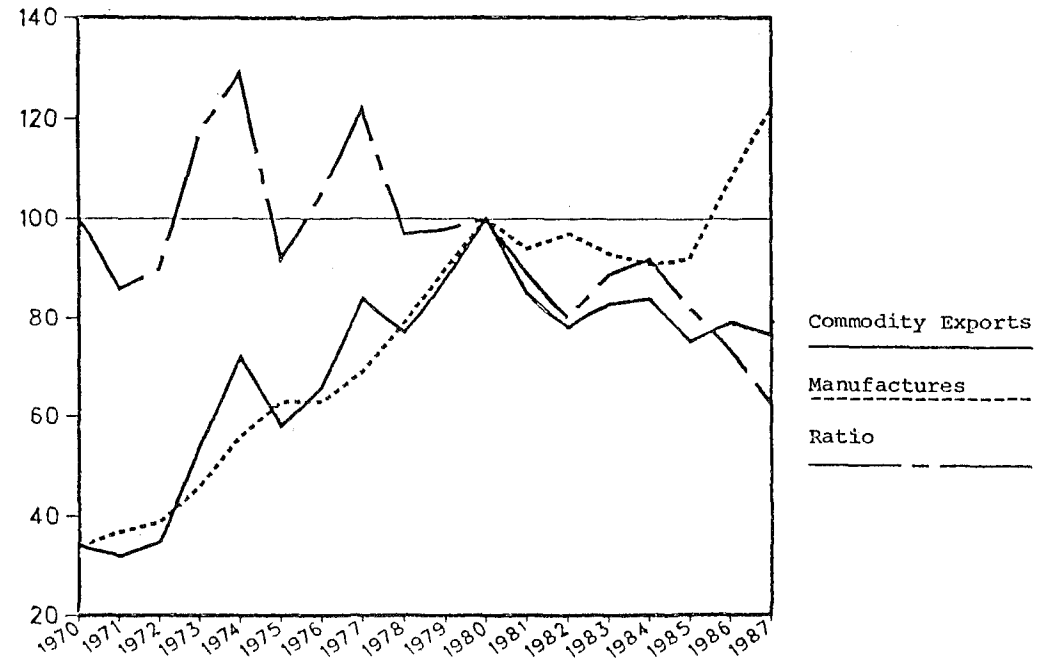
26 IMF, *Primary Commodities: Market Developments and Outlook* (Washington, D.C., May 1987), p. 8.
27 FAO, *Food Outlook*, No. 1/2 (February 1988).
28 The IMF index shows a decline of 7 per cent in SDR terms.
29 For a brief discussion of these factors, see *World Economic Survey 1987* (United Nations publication, Sales No. E.87.II.C.1 and corrigendum).

Figure III.1. Prices of groups of commodities, 1980-1987
(Indices of dollar prices: 1979-1981 = 100)



Source: UNCTAD, *Monthly Commodity Price Bulletin.*

Figure III.2. Prices of commodities and export unit values of manufactures, 1970-1987
(Indices of dollar prices: 1980 = 100)



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

quarter of the year, prices actually declined. The future course of oil prices is extremely difficult to predict. Most estimates for the year as a whole suggest little improvement over their 1987 level (for a fuller discussion of oil prices, see chap. V below).

Instability of commodity prices and commodity agreements

Prices of primary commodities not only are on a declining trend but also fluctuate widely. The magnitude of measured price instability differs depending on the method and period of measurement, but prices of primary commodities have been found to be considerably more variable than prices of manufactures. Not all commodity prices are equally variable. Subgroups such as food and agricultural raw materials experience greater instability than minerals and metals. Export volumes are much less unstable. Thus instability in value of commodity exports at the global level is attributable mostly to instability in prices.

At the country level, however, instability in the world price of commodities arising mainly from shifts in world demand is not always the dominant source of fluctuations in a country's export earnings. Variations in country supply are often greater than those in world supply of a commodity.[30] Thus variations in a developing country's export earnings are a function of both price instability and volume instability. Countries have sought to reduce domestic supply instability through marketing boards or loan facilities aimed at encouraging private stocking, with different degrees of success. World price instability has been addressed at the international level. Past policies have aimed either at reducing instability in world prices through commodity agreements between producers and consumers or at neutralizing the effect of unstable export earnings through compensatory financing schemes. Experience over the past 30 years suggests that single commodity agreements are less likely to be effective instruments for price stabilization than originally envisaged.

The recent collapse of the International Tin Agreement, long regarded as the most successful agreement, has emphasized the inadequacy of international commodity agreements as instruments of price stabilization. The experience of three decades has revealed the difficulty of negotiating such agreements and, once negotiated, the problem of sustaining their effective operation. The most fundamental weakness of the agreements stems from the fact that the basis of co-operation between producers and consumers implicit in them is extremely fragile. Generally, producers are reluctant to enter into a commodity agreement when prices are high and rising, while consumers are unwilling to join an agreement when prices are depressed and falling. Since markets have usually been in one state or the other, commodity agreements have been difficult to establish. The International Cocoa Agreement was signed after 10 years of negotiation, but not even a weaker agreement could be renewed in 1980 as its largest importer and exporter could not agree on a price-support range. Support for the Common Fund for Commodities of UNCTAD was hesitant in many consuming countries in a climate of depressed prices.[31] Only four new agreements could be negotiated in the post-war period despite considerable intergovernmental efforts. These agreements became possible when perceptions of producing countries about the future evolution of prices differed from those of consuming countries, so that both found it in their interest to agree. On some occasions, consuming countries joined even when that was not the case. For example, the largest importer is said to have joined the coffee agreement in 1956 because of its interest in supporting development in the exporting countries.[32] Similarly, many consuming countries supported new commodity agreements in the 1970s in the hope of maintaining some influence with producers. However, since the actual evolution of prices was not usually consistent with expectations of both groups, or if the initial non-economic motive was not sustained, tensions and disagreements emerged over the life of the agreement. This influenced the initial design of the agreements, the instruments chosen for price stabilization (e.g., export quotas versus buffer stocks), the level of the price-support range, the size of financing for buffer stocks and the allocation of export quotas, as well as the flexibility with which these choices were altered or updated when the situation warranted such action. The relative success or failure of international commodity agreements to maintain prices within the stated ceilings and floors can be traced to these choices.

Of the five commodity agreements that have existed in the post-war period, sugar and coffee used export controls while natural rubber and cocoa depended on buffer stocks only to stabilize prices; only tin used both export quotas and buffer stocks—this was prompted by the fact that the agreed size of buffer-stock financing was not large enough to prevent substantial price declines in situations of excess supply without the benefit of export quotas to restrain supply. Unfortunately, the joint use of export controls and buffer stocks tended to undermine the capacity of such agreements to stabilize prices, even when available finance was adequate. Stock accumulation could not be large since potential excess supply was reduced through export quotas rather than through purchases, and those stocks later proved insufficient to contain prices within the specified ceiling. Agreements that depended on export controls alone frequently failed to protect price ceilings. In many cases, the negotiated

30 Because shifts in supply in different countries partially offset each other, volume instability is more pronounced at the country level.

31 Econometric simulation for 10 core commodities of the Integrated Programme for Commodities of UNCTAD suggests substantial gains for producers and consumers, as well as considerable economy of resources through pooling (J. Behrman and P. K. Ramangkura, "Evaluating integrated schemes for commodity market-stabilization", *Econometric Modelling of World Commodity Policy*, C. Adams and J. Behrman, eds. (Lexington, Mass., Lexington Books, 1978), p. 170). Yet these gains were not perceived by consuming countries in the context of the depressed commodity prices of the 1980s.

32 C. P. Brown, *The Political and Social Economy of Commodity Control* (London, Macmillan, 1980).

price-support ranges were inconsistent with underlying market conditions; in others, there were no automatic mechanisms for updating the support prices. In large measure, both situations were due to the intrinsic difficulty of predicting price trends. As for protecting price floors, allocating and enforcing quotas were the main problems. The experience of the five agreements confirms these inherent difficulties.

The International Cocoa Agreement of 1972 repeatedly failed to maintain prices within the ceiling of the specified price-support range. In part, this was due to the inability of the agreement to identify and negotiate a range that reflected realistic market conditions. But it was also attributable to the low level of available stocks that could be deployed to restrain price increases. The lagged supply response to this period of high prices created downward pressure on cocoa prices, which breached the floors. Attempts to control this foundered against the backdrop of disagreements on the terms of renewal. As a result, the third cocoa agreement failed not only to agree on export quotas but also to obtain adequate financing for buffer stocks because of the absence of two of its largest producing and consuming members. Thus the objective of cocoa price stabilization has remained elusive.

The limitations of export quotas as a means of stabilizing prices is borne out by the International Coffee Agreement of 1962.[33] Even in the agreement's heyday, coffee prices were highly unstable.[34] The predominance of Brazil in world output permitted a sufficient degree of control over supply to keep coffee prices higher than the 1962 level for nearly a decade. However, supply responses to high prices from non-traditional producers in Africa reduced the dominance of traditional suppliers and generated downward pressure on world prices. The old quota allocations became unacceptable and thus difficult to enforce. Consuming countries, especially the largest among them, became less willing to sanction price-raising efforts, and the economic provisions of subsequent agreements remained suspended for most of the 1970s. Though revived in 1980 at considerable cost to Brazil,[35] the agreement proved difficult to sustain continuously.

The International Sugar Agreement was also based on export quotas. Considerable difficulty was experienced in renewing it during the period 1964-1969 and 1974-1977. When in operation, it failed not only to maintain prices within the agreement's ceiling, which was expected in the absence of buffer stocks, but also to defend the price floor. Identifying the appropriate trend-price was also a factor. More important, as EEC transformed itself from a large net importer to a large net exporter and the United States reduced its imports by half, the agreement was unable to control supply, which led to its collapse.

The buffer stock facility of the International Natural Rubber Agreement of 1979 did succeed in averting the recession-induced price collapse of the early 1980s. The agreement's provision for substantial financing of stocks,[36] as well as the explicitly articulated provisions for updating price-support ranges, imparted a degree of strength and flexibility that had not been available to other agreements. However, in the process of supporting prices over the 1980s, buffer-stock levels reached their limits, requiring review of support prices. It is likely that downward adjustments in support prices undertaken in line with automatic provisions of the agreement may have been inadequate. However, large sales of stock over the past nine months have helped restore the viability of the agreement.

Until recently, the International Tin Agreement appeared to have overcome most of these problems. Using both buffer stocks and export quotas, it was successful in maintaining prices within the agreed range, except for a few breaches in their price ceilings. These breaches were largely due to exhaustion of the agreement's buffer stock, a reflection of inadequate accumulation of stocks resulting from the use of export quotas.[37] The reason that this problem did not reveal itself in a much greater frequency of breaches in price ceilings is probably to be found in the activity of the United States tin stockpile.[38] Starting with stocks substantially larger than those of the tin agreement, the United States intervened in the upper price ranges; this compensated for the inadequacy of the agreement's buffer stocks. Export quotas under the agreement were, however, quite successful in defending the price floor. Jointly, they produced greater price stability than the tin agreement's intrinsic limitations would have permitted.[39] In the 1980s, activity of the United States tin stockpile was minimal and tin production by Brazil, a non-member, was substantial. China, another non-member, also emerged as an important producer. In addition, the sixth tin agreement in 1982 lacked the participation of the United States, the largest consumer, and Bolivia, the fourth largest producer. Given conditions of weak demand, members' pro-

33 An agreement among Latin American producers was converted to an international coffee agreement when it received official approval from consuming nations. United States support for it has been perceived as a charitable gesture for promoting development by some (Brown, *op. cit.)* and as a means of exerting some influence over producers by others.

34 A. D. Law, *International Commodity Agreements* (Lexington, Mass., Lexington Books, 1975), p. 76.

35 Brazil withheld 12 million tons of coffee at a cost of $1 billion to sustain the agreement.

36 Negotiated during a period of heightened interest in commodity arrangements and of high prices in 1976-1979, it proved easier to obtain agreement on a buffer-stock facility as large as 550,000 tons.

37 Export controls instituted at the end of 1957 were maintained for too long into 1959 and 1960, with the result that the buffer stock was run down so much that the ceiling could not be defended in 1961. The use of controls in January 1973 led to a breach of the ceiling in 1976 and 1975-1976 controls resulted in inactivity of the fifth agreement (see C. L. Gilbert, "International commodity agreements: design and performance", *World Development*, vol. 15, No. 5, (May 1987), p. 610).

38 At the start of the International Tin Agreement in 1956, the United States held a stock of 347,000 tons (18 months of non-socialist world consumption). An econometric model shows that the effect of the tin agreement's buffer-stock was minimal in comparison with the effect on price of releases by the United States tin stockpile (G. W. Smith and G. R. Schink, "The International Tin Agreement: a reassessment", *Economic Journal*, vol. 86 (1976).

39 Smith and Schink, *op. cit.*, p. 21.

duction was restricted to two thirds of the base level during the period 1982-1985. This became increasingly difficult to enforce. Brazil and Bolivia were unwilling to be regulated and Malaysia was unwilling to operate as swing producer. With resources for buffer stocking insufficient to mop up the excess supply, the agreement collapsed in November 1985.

In the light of this experience, the second window of the UNCTAD Common Fund for Commodities—support for diversification purposes—assumes particular relevance. Efforts to stabilize prices in the long run become ineffective when market pressures accumulate and fixed prices or prices fluctuating in a narrow band tend to exacerbate rather than ease those pressures. It can nevertheless be argued that an integrated programme to stabilize commodity prices should, under normal circumstances, be more effective than one involving an individual commodity as it is very unlikely that supply cycles—an important cause of instability for certain products—of the commodities under an integrated programme are going to coincide.

In any event, policies to reduce the deleterious effects of instability in prices and export earnings remain crucial. At the country level, they help to ensure that development programmes are not seriously affected by fluctuations that might be transitory. At the global level, they are important since they play an anticyclical role when there is a pervasive slow-down in world demand, as occurred in 1982. The compensatory financing facility (CFF) of IMF and the Stabex scheme of EEC have sought to fulfil such a role by preventing fluctuations in import capacity arising from fluctuations in export receipts, through compensating financial flows. However, only Stabex compensations are commodity-specific and on a grant basis, which makes them particularly suitable for low-income countries or highly indebted ones. CFF envisages no compensation if the shortfall in commodity exports is offset by a rise in manufactured exports. The cost of unstable commodity exports thus cannot be avoided. At present, the IMF facility is unlikely to cover commodity-specific shortfalls. A revamped facility is likely to emerge—one that will also include contingency financing. Theoretically, it could lead to increased compensatory financing. It is yet to be seen, however, what the modalities for access will be and what amounts countries will be able to draw when faced with abrupt shortfalls in export earnings.

Changes in trade flows among countries and balance of trade

The overall pattern of trade has been greatly affected by (a) macro- economic adjustments in the industrial economies and currency realignments, (b) changes in relative prices of primary commodities, (c) the burden of debt of the developing countries and (d) the successful export-oriented policies of the newly industrializing countries.

Developed market economies

The volume of imports of the developed market economies increased by over 5 per cent in 1987, compared with 8 per cent in 1986 (see table III.2). A large proportion of the increase in 1986 was accounted for by the import of energy, which did not change much in 1987. The volume of exports rose by over 4 per cent in 1987, compared with 2.5 per cent in 1986.

Behind these aggregates were much larger changes in imports and exports of individual countries. Exports of the United States increased by 8 per cent in 1986 and 12 per cent in 1987 and are expected to grow even faster in 1988. The growth of the United States economy in 1987 was in fact

Table III.6. Developed market economies: merchandise trade balance, 1980-1987

(Billions of dollars)

Country	1980	1984	1985	1986	1987[a]
All countries	-69.4	-47.6	-37.6	-1.9	-14.4
Excluding the United States	-43.9	64.9	82.9	142.4	144.8
Major industrial countries	-33.1	-46.1	-38.7	1.4	-8.2
Canada	8.0	16.6	13.2	8.1	8.8
France	-13.4	- 4.6	-5.4	- 2.4	- 9.0
Germany, Federal Republic of	8.7	22.0	28.3	55.3	69.8
Italy	-16.4	- 6.0	- 6.2	4.9	0.6
Japan	2.1	44.3	55.6	92.2	96.5
United Kingdom	3.4	- 5.9	- 2.6	-12.4	-15.5
United States	-25.5	-112.5	-121.6	-144.3	-159.2
Other countries	-36.3	- 1.5	1.1	- 3.3	- 6.2

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

[a] Preliminary estimates.

fuelled by foreign demand. Exports of the United Kingdom registered strong growth in 1987, while those of the Federal Republic of Germany increased only marginally and those of Japan declined by around 3 per cent.

The growth of import demand of the developed market economies in 1987 was more evenly distributed among major countries. Japan increased its imports by over 7 per cent, after a 13 per cent increase in 1986, as domestic demand expanded faster and somewhat more strongly than expected. The Federal Republic of Germany also increased its imports substantially, by 5 per cent. Both Italy and the United Kingdom increased their imports faster than in 1986. United States imports also increased by about 5 per cent. The growth of trade among developed market economies was the most important source of growth of their total imports and of world trade, but imports of those economies from the developing countries also increased.

The trade surplus of Japan and the Federal Republic of Germany and the deficit of the United States increased further (see table III.6). The trade surplus of Japan increased slightly from $92 billion in 1986 to around $97billion in 1987, having increased by $37 billion between 1985 and 1986. The trade surplus of the Federal Republic of Germany rose to around $70 billion, after doubling to $55 billion between 1985 and 1986. The United States trade deficit widened from $144 billion in 1986 to $159 billion in 1987, proportionally less than in the preceding year. There were, however, indications early in 1988 that the trade deficit of the country had begun to shrink. A strong economy and weak oil prices led to a deterioration of the trade balance of the United Kingdom. The trade deficit of France widened. Canada continued to have a large trade surplus, most of it with the United States.

Developing countries

Exports from the developing countries increased significantly in 1987. Exports of the net energy-exporting developing countries declined somewhat, but those of the energy-importing countries increased by 9 per cent in real terms, after an 8 per cent increase in 1986. Much of this increase was due to the growth of manufactured exports, but there was also a modest growth of exports of non-fuel commodities.

After two consecutive years of decline, imports of the developing countries increased by around 2.5 per cent in 1987, considerably above the average for the 1980s. However, the growth of imports varied widely between country groups, partly reflecting changes in their terms of trade and the commodity composition of their exports. Imports of energy-exporting developing countries declined for the sixth year in a row; after a 20 per cent decline in 1986, they fell by a further 12 per cent in 1987. Though there was a substantial recovery in energy prices during the year, the value of their exports remained below the 1985 level and the purchasing power of these exports remained even lower. The energy-importing developing countries, on the other hand, increased the volume of their imports in 1987 by about 7 per cent, which was high compared not only with the 2 per cent growth in 1986, but with the average for the 1980s as well.

The volume of imports of heavily indebted countries has been declining since the beginning of the debt crisis in 1982 as debt-servicing requirements eroded their import capacity. The general increase in commodity prices in 1987 benefitted some of the heavily indebted countries, but their imports, on the average, did not increase significantly in 1987.

The trade surplus of the energy exporters, which had shrunk from around $69 billion in 1985 to $16 billion in 1986, increased to an estimated $45billion in 1987 (see table III.7). The trade deficit of the net energy importers declined from $11 billion in 1986 to $8 billion in 1987. The continuing decline in their trade deficit in the 1980s is, of course, a reflection of the decline in the flow of resources to many of these countries over the years and the success of the newly industrializing countries in increasing their exports at a fast pace.

The trade performance of the newly industrializing countries has drawn considerable attention. These countries have been successful in increasing their exports, mostly manufactures, even in the 1980s when exports of other countries have been growing only slowly. Exports from the 10 leading exporters of manufactures[40] to the developed market economies continued to grow in 1987 (see table A.III.4). In current dollar terms, they increased by almost 23 per cent in 1987, compared with an 11 per cent increase in the preceding year, part of which is attributable to the depreciation of the dollar. The growth of exports of the Asian newly industrializing countries[41] was even higher. Still accounting for a small proportion of world trade, exports of these countries are the fastest growing component of world exports.

Table III.7. Developing countries: merchandise trade balance, 1980-1987

(Billions of dollars)

	1980	1985	1986	1987[a]
All developing countries	111.0	55.0	5.7	37.0
Energy-exporting countries	173.3	68.7	16.3	45.3
Capital surplus countries	140.3	35.0	7.0	24.8
Other energy exporters	33.0	33.7	9.3	20.5
Net energy-importers	-62.3	-13.2	-10.6	-8.3

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

[a] Preliminary estimates

The growth of the exports of the newly industrializing countries has sometimes been perceived as "disruptive" and has fuelled protectionist sentiments in some developed coun-

40 Argentina, Brazil, Hong Kong, India, Malaysia, Philippines, Republic of Korea, Singapore, Thailand and Yugoslavia

41 Hong Kong, India, Malaysia, Philippines, Republic of Korea, Singapore and Thailand.

Table III.8. European centrally planned economies and China: merchandise trade balance, 1980-1987

(Billions of dollars)

	1980	1984	1985	1986	1987[b]
European centrally planned economies					
World	2.2	17.9	8.8	9.0	16.5
Centrally planned economies	2.3	3.8	3.8	5.2	5.7
Developed market economies	-3.6	6.1	1.3	-3.4	0.9
Developing countries	3.5	8.0	3.6	7.2	9.8
Eastern Europe					
World	-5.8	6.9	4.9	0.8	4.7
Centrally planned economies	-1.8	-0.2	0.4	-1.6	2.0
Developed market economies	-3.8	4.0	2.2	0.5	0.3
Developing countries	-0.2	3.1	2.3	1.9	2.3
USSR					
World	8.0	11.0	3.9	8.2	11.8
Centrally planned economies	4.1	4.0	3.4	6.7	3.8
Developed market economies	0.2	2.1	-0.9	-3.9	0.5
Developing countries	3.7	4.9	1.3	5.3	7.5
China[a]					
World	-1.4	-1.1	-15.2	-12.1	-2.8
Centrally planned economies	-0.2	-0.4	-0.4	-0.9	-0.2
Developed market economies	-6.2	-7.5	-18.4	-16.6	-9.7
Developing countries	5.0	7.0	3.7	5.7	7.5

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

a The 1987 figures pertain to January to November.

b Preliminary estimates

tries. A less well recognized fact is that their imports have increased *pari passu* by around 20 per cent a year.

The main factor behind the trade tension resulting from the export performance of Asian newly industrializing countries is that their trade surpluses are unevenly distributed among the developed market economies (see table A.III.5). Most of the surplus arises in their trade with the United States (around $24 billion in 1987).[42] Their surplus with Europe is small ($4 billion) and they ran a substantial trade deficit ($12 billion) with Japan.

It is widely recognized that some of the newly industrializing countries with large trade surpluses should open their economies more fully by lowering trade barriers and letting their currencies appreciate when this is called for. This question, however, is often addressed in a bilateral rather than a multilateral context. It also often ignores a number of other considerations. First, the markets of some of the highly export-oriented newly industrializing countries are far less protected than is often supposed.[43] Secondly, these surpluses have emerged only recently for most countries after a long history of trade deficits, as in the case of Singapore and the Republic of Korea, and they may disappear rather quickly. Thirdly, the surpluses in some cases are being used to repay a large external debt which helped finance earlier deficits. These surpluses are thus largely a reverse financial flow from debtors to creditors and are not all designed for the accumulation of large foreign assets.

European centrally planned economies and China

The trade flows of the centrally planned economies of Europe in 1987 were largely characterized by slower than planned growth, adverse weather conditions, weak com-

42 Excluding exports of Taiwan, Province of China.

43 Empirical evidence is scanty but see, for example, World Bank, *World Development Report, 1987* (Washington, D.C., 1987), p. 89, which shows that the effective rate of protection of the Republic of Korea and Singapore are particularly low. Hong Kong is well known as a relatively unprotected economy.

modity prices, the depreciation of the dollar and a pressing need to increase earnings of convertible currencies. The restructuring and economic reform of these economies also played a role. The volume of their exports increased by around 3 per cent in 1987, less than in 1986. The slow-down was entirely due to a slower growth of exports of the Soviet Union. Nevertheless, growing at 4 per cent in 1987, the exports of that country were the main source of growth of the European centrally planned economies as a whole. Exports of the Soviet Union to the market economies increased by 10 per cent. Exports of the Eastern European economies increased only slightly above their 1986 rate of around 2 per cent. As in 1986, exports of the European centrally planned economies to the market economies grew faster than exports among centrally planned economies.

Imports of the European centrally planned economies continued to decline, falling by around 1 per cent in 1987 after a similar decline in 1986. Imports of the Soviet Union fell by about 2 per cent, following a 5 per cent fall in 1986. Lower fuel prices in dollar terms and the depreciation of the dollar against other convertible currencies largely explain the fall in imports of that country in 1986 and 1987. Imports of the Eastern European economies increased only marginally, owing chiefly to a deteriorating current-account position and in some cases worries about their external debt. Thus both Poland and Romania, two of the large debtors, significantly reduced imports in 1987.

The overall trade balance of the European centrally planned economies improved in 1987 (see table III.8). The Soviet Union, which had a large trade deficit with the developed market economies in 1986, had a small surplus the following year. The Eastern European economies maintained a small surplus with the developed market economies. The trade surplus of the European centrally planned economies with the developing countries remained substantial and increased in 1987.

Developments in China's foreign trade were very largely determined by the pace and pattern of growth of the domestic economy and the continuing policy of outward-orientation of the economy. The volume of exports increased by an estimated 27 per cent in 1987, after an 18 per cent growth in 1986. Much of the increase was in the export of manufactures, especially textiles and light industrial goods, domestic production of which rose sharply. The growth of exports is partly attributable to the effective depreciation of the yuan renminbi against the yen and the major European currencies. Imports had been growing very rapidly in the early and mid-1980s, almost 60 per cent in 1985 alone. This growth, however, had to be curtailed for the second year running, following a sharp deterioration of the trade balance in 1985. The volume of imports declined by over 8 per cent in 1987 after, an almost 20 per cent drop in 1986. The sharp increase in exports, an improvement in oil prices and the reduction in imports reduced the country's trade deficit from $12 billion in 1986 to around $3 billion in 1987.

Chapter IV

INTERNATIONAL FINANCE, DEBT AND INSTABILITY

Three sets of financial events captured the attention of policy makers around the world in 1987: severe strains in the international strategy for managing developing country debt, the need for central banks to finance increased amounts of the current-account deficit of the United States, and the October crash in all the major stock markets of the world. These developments highlighted the instability of international financial relations in the late 1980s. As it turned out, however, none of the events erupted into a full-blown international crisis, but the potential for crisis remained.

A brief review of the global international financial accounts shows that there were no sharp breaks with the recent past (see table IV.1). The aggregate current-account deficit of the developing countries shrank considerably in 1987, after climbing suddenly in 1986. But both the 1986 and 1987 changes were largely due to the sharp swing in petroleum prices, down in 1986 with a partial recovery in 1987. On the other hand, the accounts of the energy-importing developing countries seem to have improved considerably since mid-decade, registering a deficit of under $10 billion in 1986 and under $5 billion in 1987; under $10 billion is forecast for 1988. These figures are very much the result of the strong performance of three Asian economies—Hong Kong, the Republic of Korea and Taiwan, Province of China—whose total annual surpluses on current-account have been above $20 billion since 1986. The current-account deficit of the other energy-importing countries has been about $30 billion a year since 1985. Although they benefited from the fall in oil prices in 1986, they were hurt by the fall in the prices of their commodity exports. Their trade balance—a deficit—was virtually the same in 1987 as it was in 1985. In the same period the trade surplus of the three Asian economies more than doubled (see table A.III.6).

The international financial accounts of the developed economies remain highly differentiated, the United States being the most notable deficit country and the Federal Republic of Germany and Japan being the largest surplus countries. The imbalances grew again in 1987, to -$149 billion

Table IV.1. World balance of payments on current account,[a] by country group
1980-1988

(Billions of dollars)

	1980	1982	1984	1985	1986	1987[b]	1988[c]
Developed market economies	-36.9	-6.7	-39.0	-21.7	14.1	-12.7	-17.0
Large industrial countries	-10.5	15.2	-37.8	-24.5	13.4	-10.6	-11.0
of which:							
Germany, Federal Republic of	-6.8	11.3	16.0	22.9	46.1	55.2	52.0
Japan	-9.4	8.3	36.5	50.1	86.7	88.7	75.0
United States	8.4	-1.2	-96.6	-102.9	-127.2	-148.5	-128.0
Other industrial countries	-26.4	-21.9	-1.2	2.9	0.8	-2.1	-6.0
Developing countries	36.7	-77.5	-29.9	-29.5	-45.6	-9.3	-13.0
Capital-surplus countries	105.8	16.2	-2.2	8.0	-8.6	5.6	5.0
Capital-importing countries	-66.7	-99.6	-30.1	-26.0	-29.8	-14.5	-20.0
Energy exporters	2.1	-34.9	-0.2	-3.5	-20.9	-10.0	-12.0
Energy importers	-68.8	-64.7	-29.9	-22.5	-8.9	-4.5	-8.0
Recent surplus economies[d]	-7.4	-1.6	7.1	10.4	22.5	27.0	22.5
Other	-61.5	-63.1	-37.0	-32.9	-31.4	-31.5	-30.5
China	-2.4	5.9	2.4	-11.5	-7.2	-0.4	2.0
Centrally planned economies							
of Europe[e]	-5.2	3.3	10.0	2.3	-0.2	7.0	3.5
Eastern Europe	-8.3	0.4	3.8	2.0	-1.4	0.6	-1.0
Soviet Union	3.6	3.5	6.6	0.5	1.4	6.8	5.0
Residual[f]	5.5	80.9	58.9	48.9	31.7	15.0	26.5

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

a Balance of payments on goods, services and private transfers.
b Preliminary estimates.
c Forecast, rounded to the nearest half-billion dollars (see chap. II for assumptions and other forecast details).
d Hong Kong, Republic of Korea and Taiwan, Province of China.
e Balance with market economies; total includes estimated investment income deficits of CMEA banks.
f 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.

for the United States and $144 billion for Japan and the Federal Republic of Germany taken together (all measured as the balance of payments on goods, services and private transfers). The forecast for 1988 is that this imbalance will begin to narrow, although the improvement will not be large. In addition, the net current-account position of the developed market economies is forecast to remain unchanged, so that the reduction in the deficit of the United States is essentially matched by the reduction in the surpluses of the Federal Republic of Germany and Japan; the rest of the world will be largely unaffected.

In any event, the forecast assumes no sharp break in the trade or financial relationships of the major groups of countries: developed, developing and centrally planned economies. Given the unresolved international financial difficulties that are the focus of the present chapter, the forecast shows the likely outcome of another year of muddling through.

Debt and the negative transfer of financial resources of developing countries

The world debt crisis has been a central topic of international concern from at least 1982. Since then, many treatments have been recommended. Of those tried, some alleviated the situation in debtor countries. Yet, as at early 1988, few would argue that the problem is close to being solved. The word "crisis" seems inappropriate: it generally implies a decisive turning point, a crucial event, something of relatively short duration. In 1982, the debt crisis was thought of as a liquidity problem; today it is widely regarded as a question of insolvency.

The narrowed flow of resources to the capital-importing developing countries

The debt problem has mainly affected the developing world, although it is a problem neither of all developing countries nor exclusively of developing countries. But the debt crisis affected so many developing countries that financial indicators calculated for the aggregate of all the developing countries that are conventionally thought of as being net users of foreign capital began to show unusual results.

Table IV.2. Net transfer of financial resources of the capital-importing developing countries, 1980-1987

(Billions of dollars)

	1980	1982	1984	1985	1986	1987[a]
Transfer on account of direct investment[b]						
Net investment flow	6.4	7.9	6.2	7.5	5.7	7.5
Net investment income	-10.9	-10.0	-8.8	-8.1	-7.0	-8.5
Net transfer	-4.5	-2.1	-2.6	-0.6	-1.3	-1.0
Net transfer on account of private credit flows[c]						
Net credit flow	34.0	24.2	8.8	2.0	1.6	-1.0
Net interest paid	-18.5	-42.4	-41.4	-39.3	-33.6	-31.5
Net transfer	15.6	-18.2	-32.5	-37.2	-32.0	-32.5
Net transfer on account of official flows[d]						
Official transfers (grants)	13.5	11.3	12.5	14.4	14.4	15.0
Net credit flow	22.0	29.5	25.0	14.2	15.0	13.5
Net interest paid	-6.2	-8.8	-11.8	-13.5	-16.2	-17.5
Net transfer	29.2	32.0	25.7	15.2	13.1	11.0
Total transfer	40.3	11.8	-9.5	-22.7	-20.1	-22.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics;* World Bank, *World Debt Tables*; and other national and multilateral sources. Data are for a sample of 98 countries for which adequate information was available.

a Preliminary estimate, rounded to the nearest half-billion dollars.

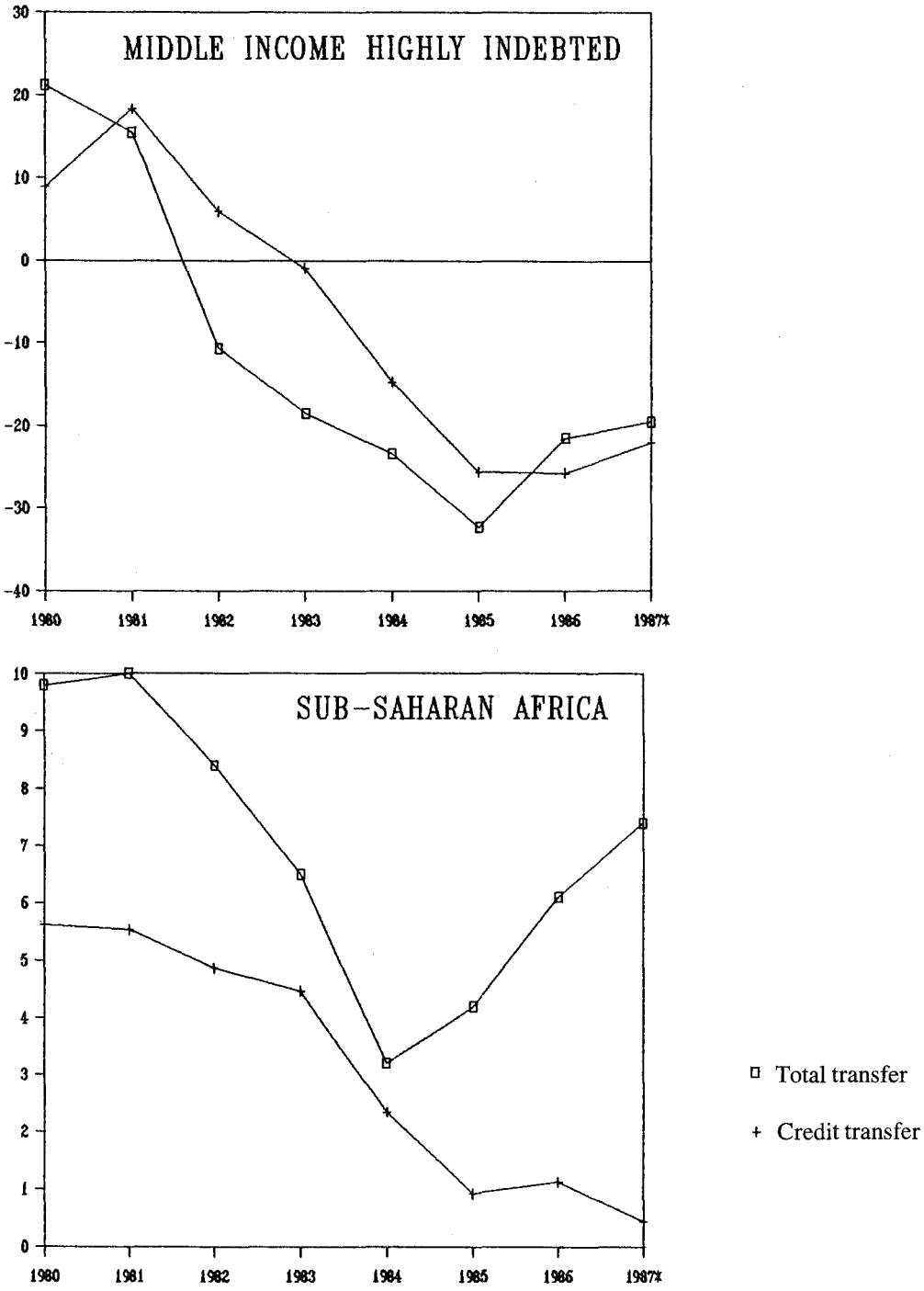
b Direct investment income excludes retained earnings and investment flow is shown net of reinvested earnings. In principle, retained earnings should be treated as paid out to foreign shareholders and returned as new investment flows. However, since reporting of these data is highly incomplete, and since the two items have completely offsetting effects on the net transfer, they are omitted here.

c Including long-term and short-term flows of foreign private liabilities and assets of the developing countries.

d Including use of IMF credit and other international monetary arrangements.

Figure IV.1. Net financial resource transfers from foreign creditors of middle-income and African country groups[a]

(Billions of dollars)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of IMF (for total transfer calculation) and the World Bank (for credit transfer calculation).

Note: The middle-income group comprises Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia. The African group comprises the developing countries of sub-Saharan Africa, excluding Nigeria.

* Preliminary estimate.

[a] Credit transfer relates to medium-term and long-term credit, including use of IMF credit and estimated flows of non-guaranteed private credit. Total transfer is defined in table IV.2.

In particular, the net transfer of financial resources—defined as the net capital or resource flow minus the net payment of interest and dividends—turned negative in 1984 and has remained negative, showing a net outflow of at least $20 billion in each of the past three years (see table IV.2). Although the total capital flow (i.e., the sum of credit, direct investment and grants in aid) to these countries has remained positive, the net payment of interest and dividends has become the larger amount. The relationship to the debt problem is clear: the part of the capital flow that has shrunk is the credit flow and the part of the investment income payment that has grown is the interest paid.

The relationship between the overall net transfer and the transfer related to foreign lending is most clearly seen in the group of countries that has been a focus of international discussions of debt and development, namely, the 15 middle-income countries associated with the 1985 debt-management proposal of the United States Secretary of the Treasury.[1] Indeed, the negative transfer of resources of the aggregate of developing countries, shown in table IV.2, is largely a reflection of the transfer from this group. As these countries are not, in general, recipients of large amounts of grant assistance and since direct investment flows have been relatively stagnant, changes in the overall net transfer have been closely related to changes in the net transfer arising from foreign credit activities: they were largely responsible for the substantial positive net transfers in the years leading up to 1982 and for the negative transfers thereafter.

Figure IV.1 shows for this group of countries the overall measure of the net transfer of financial resources and the net transfer arising from medium-term and long-term foreign credit flows.[2] The bulge in 1982-1983 in the difference between the overall net transfer measure and the net foreign credit transfer shown in the figure has proved temporary. To the degree that the bulge was due to what various authors have described as "capital flight", subsequent data suggest that capital flight is now, at least, a less serious problem.[3] Significantly improving the overall net transfer of resources to the middle-income highly indebted countries will thus require major adjustments in the financial relations of those countries with their foreign creditors. As almost 70 percent of their debt is with private creditors, predominantly foreign commercial banks, this will largely entail new relationships with the banks.

Figure IV.1 also shows the relationship of the net foreign credit transfer and the overall net financial transfer for a second group of countries, one that has been a special focus of policy attention in donor countries, namely, countries of sub-Saharan Africa. A group of those countries, excluding Nigeria, has been obtaining a small positive net transfer from medium-term to long-term foreign lending.[4] Reflecting the dominant share of official lenders to the region, accounting for 70 percent of the debt, all of the positive transfer has been from official sources, although individual official creditors have become net recipients of resources. In particular, IMF received almost $1.2 billion in net resource transfers from the region in 1987. It is also important that the net transfer from creditors is much reduced from the levels of the early years of the decade: $5 billion annually during the period 1980-1983 has been reduced to roughly $1 billion a year since 1985. During the first half of the decade, about the same drop took place in the overall net transfer, calculated by adding together all sources of flows. The contribution of foreign creditors has thus virtually disappeared, but, more recently, the overall transfer to the group has recovered part of its initial decline as official grant assistance has grown (and as repayment arrears, which are treated in part as short-term credit flows, have accumulated).

The economic meaning of the shift in resource transfers is most simply seen in the changes in the balance of trade in goods and non-financial services. This form of the trade balance is roughly the mirror image of the net financial transfer, the difference between the two being the net change in official reserves (see box IV.1). Usually, the trade balances of developing countries are negative and international finance helps to pay for imports, investment and consumption. As positive net resource transfers fell, the financial contribution fell and the trade deficit moved to zero. As the resource transfer became negative for some countries, their trade balances moved into surplus.

Since the net transfer for all the capital-importing countries combined turned negative, large amounts of domestically earned foreign exchange have had to be transferred abroad instead of being used at home. That is, the roughly $20 billion annual resource transfer out of the developing countries since 1985 should be seen against the approximately $40 billion annual inward transfer that took place around the beginning of the decade.

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1 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. The countries, which were not formally mentioned in the proposal but which have been associated with it, are Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

2 Information on the flow of short-term credit and interest paid is not sufficient to extend the estimates of net transfers from creditors to include those involving short-term transactions. For example, some data are available only on a basis that lumps together transactions of foreign and domestic entities, and other data are not directly recorded, such as changes in open-book credit of trading establishments.

3 The concept and issues in the measurement of capital flight were discussed in *World Economic Survey 1986* (United Nations publication, Sales No. E.86.II.C.1), pp.74-76 (see also Michael Deppler and Martin Williamson, "Capital flight: concepts, measurement and issues", *Staff Studies for the World Economic Outlook* (Washington, D.C., IMF, August 1987), pp.39-58).

4 Nigeria, which is included in the group of middle-income highly indebted countries, has itself had a substantial negative net transfer from its foreign creditors since 1984.

Box IV.1. Trade, the net transfer of resources and the official reserves buffer

The relationship between the net transfer of resources as shown in tableIV.2 and the trade balance is not exact because an important buffer exists between the two, namely, the change in official reserves.* For example, in 1986, the foreign exchange earnings of the sample of 98 capital-importing developing countries fell by $19 billion (see the table). No significant relief was accorded in the transfer of resources, but there was a major shift in the reserve accounts. Instead of $6 billion being added to reserves as had been done in 1985, $5 billion was expended, which meant that instead of import expenditure having to fall by roughly the amount of the drop in export earnings, it fell by only $5 billion.

One important aspect of the reserves buffer is that it must be replenished after use and this is what happened in 1987, at least at the aggregate level. With the rebound in oil prices, in particular, and with the continuing rapid growth of exports from some Asian countries, total export earnings of the sample of countries rose by $64 billion. Again, the overall net financial transfer from these countries was largely unchanged; but this time, instead of reserves being drawn down by $5 billion, they were built up by $7 billion.

Reserve accumulation—along with the increase in the value of the non-dollar portion of reserves arising from the fall in the dollar's exchange rate—has returned the capital-importing developing countries as a whole to the reserve levels of the early 1980s, both in terms of dollar value and in relation to total import expenditure (see table A.III.7). But the distribution of reserves among countries remains highly uneven, sub-Saharan Africa, for example, having not even two-months of import coverage. Moreover, when reserves cover less than three-months of total expenditure on imports, interest and other categories, as they do for most countries, there remains little room for manoeuvre when export earnings drop, as was seen in aggregate in 1986 and for many countries, particularly in Africa, in 1987 as well.

Trade, resource transfers and reserve changes of the capital-importing developing countries

(Billions of dollars)

	1980	1982	1984	1985	1986	1987[a]
Trade account[b]						
Exports	388.2	379.7	404.7	391.8	373.2	437.5
Imports	-412.3	-413.8	-376.5	-363.0	-357.9	-408.0
Balance	-24.1	-34.1	28.2	28.8	15.3	29.5
Net transfer of resources	40.3	11.8	-9.5	-22.7	-20.5	-22.5
Use of official reserves[c]	-16.3	22.4	-18.7	-6.1	4.8	-7.0

Source: Table IV.2 and the sources cited therein (sample of 98 countries).

a Preliminary estimates rounded to nearest half-billion dollars.

b Trade in goods and services other than investment income, and private transfers.

c Additions to reserves are shown as negative numbers.

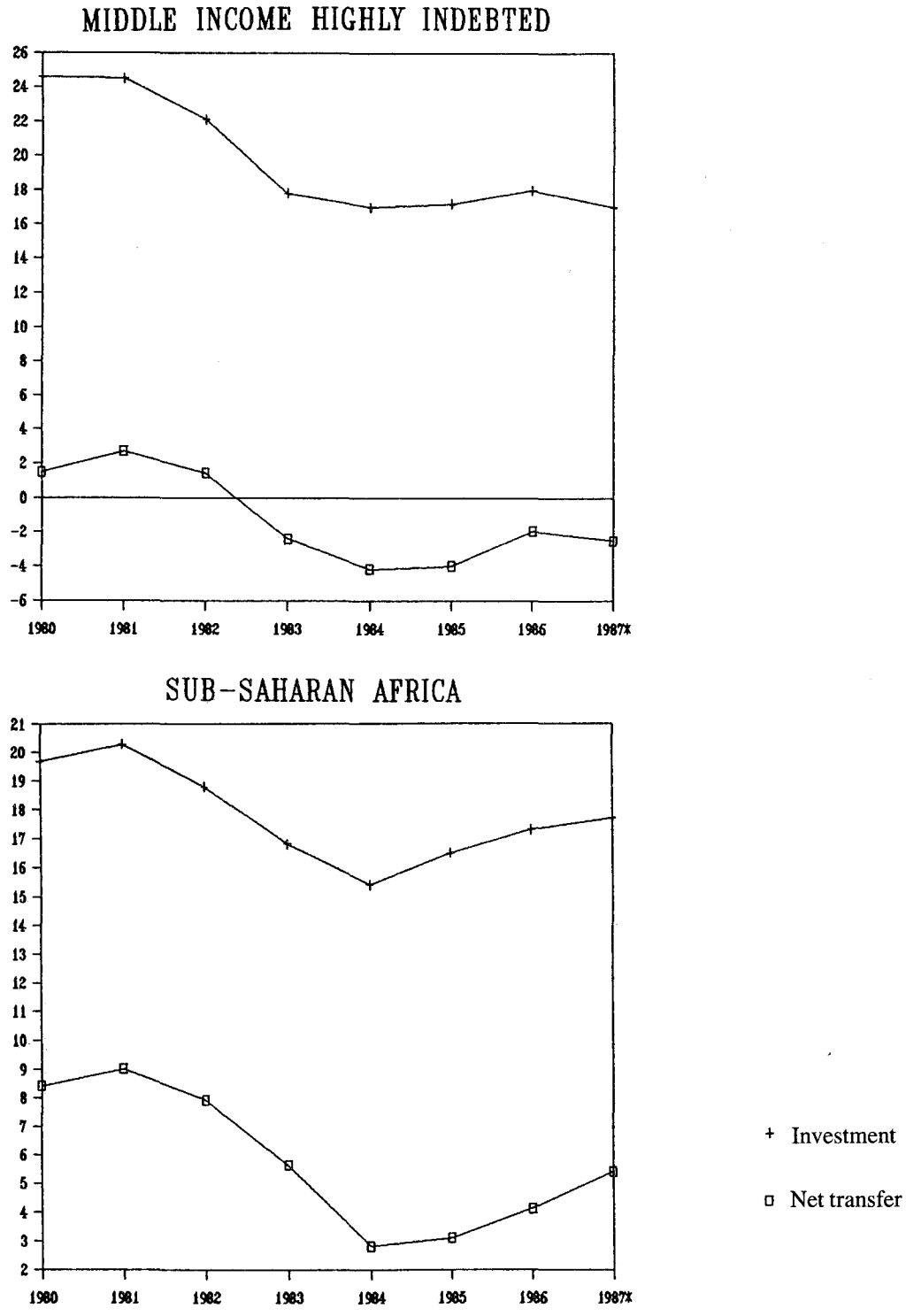
* For a formal derivation of the relationship between reserve changes and the net transfer, using national income accounting concepts, see *World Economic Survey 1986* (United Nations publication, Sales No. E.86.II.C.1), annex III, "Definition and measurement of the net transfer of resources".

Social costs of the transfer have been high.[5] Moreover, there is little controversy that economic recovery requires a stepped-up investment effort that is not feasible with the current trends in resource transfers. That investment shares have been very closely related to the net transfer is illustrated in figure IV.2 for the middle-income highly indebted countries and the countries of sub-Saharan Arica, excluding Nigeria. In the middle-income countries, pre-crisis rates of investment need to be restored. In sub-Saharan Africa, those rates were already woefully inadequate, not only in comparison with the rates that had become standard in other regions of the developing world, but also given the depth of the development problem facing those countries.

5 See Giovanni Andrea Cornia, Richard Jolly and Frances Stewart, *Adjustment with a Human Face: Protecting the Vulnerable and Promoting Growth* (Clarendon Press, Oxford, 1987); papers prepared for the International Conference on the Human Dimension of Africa's Economic Recovery and Development, Khartoum, 5-8 March 1988 (Economic Commission for Africa documents ECA/ICHD/88/1-50); and "Report of the Working Group on Human Resource Development", paper prepared for the United Nations Committee for Development Planning, twenty-fourth session, 12-15 April 1988.

Figure IV.2. Net resource transfers and investment in middle-income and African country groups

(Percentage of GDP)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of IMF (see the note to figure IV.1 for the composition of the country groups; net transfer includes changes in reserves, for consistency with national income accounting concepts).

*Preliminary estimate.

Components of the net financial transfer

As noted above, the largest source of the negative transfer has been private credits. These are primarily bank loans, but include private suppliers' credits, small amounts of bond finance and a large residual in balance-of-payments statistics that is thought to comprise mainly short-term commercial and bank credits to and from the developing countries. In 1987, there was a small net private credit outflow, according to preliminary estimates. On the positive side, however, a part of that result was due to the decision of the Republic of Korea to apply some of its recent balance-of-payments surpluses to reducing its outstanding debt.[6] Most other countries, in contrast, are in need of considerably more financial resources than are currently being made available to them.

In the early years of the decade, developing countries took up to 40 per cent of total international medium-term bank credits. Since 1985, they have taken about 17 percent, much of which is "forced lending" arranged as part of debt-rescheduling operations and used mainly to help pay debt-servicing on already outstanding debt. In 1987, forced lending made up almost half of the total of gross medium-term loans that the private markets extended to developing countries (see figure IV.3).

The net transfer provided through official channels is the one major financial category of flows that is still positive, albeit reduced by some 60 percent from the levels in the early years of the decade. Official assistance in the form of grants has not significantly exceeded the levels of the beginning of the decade although it has recovered, if slowly, from the trough of 1982.

In 1987, if not for the grants, the net transfer through official sources would also have been negative, according to preliminary estimates of the United Nations Secretariat. Data on the 1987 flow of official development assistance from member countries of the Development Assistance Committee (DAC) of OECD will not be available until June,

Table IV.3. Resource commitments of multilateral development institutions, 1980-1987[a]

(Millions of dollars)

	1980	1982	1984	1985	1986	1987
Financial institutions						
African Development Bank	571	766	879	1 154	1 639	2 140
Asian Development Bank	1 929	1 837	2 380	2 093	2 047	2 439
Caribbean Development Bank	45	45	65	48	59	46
Inter-American Development Bank	2 341	2 793	3 615	3 102	3 057	2 407
International Fund for Agricultural Development	394	338	211	131	147	233
World Bank group	13 434	13 098	13 528	17 896	18 294	20 580
World Bank	8 802	9 801	9 721	13 321	13 882	15 310
International Development Association	3 817	2 832	3 222	3 541	3 373	3 841
International Finance Corporation	815	465	585	1 034	1 039	1 429
Subtotal	18 714	18 877	20 678	24 424	25 243	27 845
Operational agencies of the United Nations						
United Nations Development Programme[b]	639	621	531	567	656	809
United Nations Population Fund	146	115	134	141	116	134
United Nations Children's Fund	279	405	204	452	248	330
World Food Programme	479	613	925	642	629	621
Subtotal	1 543	1 754	1 794	1 802	1 649	1 894
Total commitments	20 257	20 631	22 472	26 226	26 892	29 739
Memorandum item						
Commitments in units of 1980 purchasing power[c]	20 257	22 425	26 130	30 145	26 109	25 637

Source: Annual reports and information supplied by individual institutions.

a Loans, grants, technical assistance and equity participation, as appropriate; all data are on a calendar year basis.

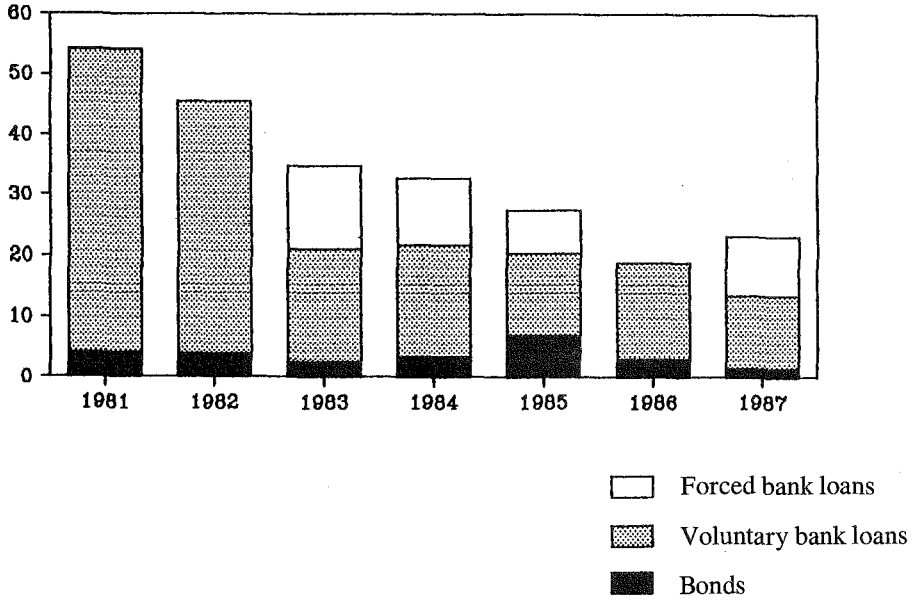
b Including UNDP-administered funds.

c Total commitments deflated by the United Nations index of manufactured export prices in dollars of developed market economies, 1980=100 (see United Nations, *Monthly Bulletin of Statistics*, March 1988 (ST/ESA/STAT/SER.Q/183)).

6 In the first three quarters of 1987, the Republic of Korea reduced its liabilities to international commercial banks by almost $6 billion at constant exchange rates, after an almost $2 billion reduction in the fourth quarter of 1986, according to data of the Bank for International Settlements (*International Banking Developments, Third Quarter 1987*, Basle, February 1988).

Figure IV.3. Gross capital market borrowing by developing countries

(Billions of dollars)



Source: Data from OECD, *Financial Statistics Monthly*, re-aggregated into *World Economic Survey* country grouping. Forced bank loans are arrangements for "new money" made as part of multilateral agreements to restructure commercial bank debt.

but if 1986 commitments are a guide, the net disbursements of DAC aid are poised to rise significantly, although only in nominal terms.[7] Partial year data on development finance commitments of Arab national and regional development institutions continue to suggest that the aid efforts made early in the decade by oil-exporting countries are no longer feasible (see table A.III.8).

Multilateral development financing activities are showing significant dollar increases, but they do not translate into "real" additions to assistance. Resource commitments by the multilateral financial institutions in 1987 rose by more than 10 percent in dollar terms (see table IV.3). Falling short of the nearly 17 percent increase in 1985, it nevertheless represents a recovery from the 2.5 percent rise in 1986. Total resource commitments have now reached an annual level of $30 billion. However, when deflated by the index of prices of manufactures, multilateral commitments were lower in 1987 than in 1986, and in 1986 they were below those of 1985, as the table indicates.

Preliminary data suggest that loan disbursements in nominal dollar terms increased in 1987 by around 5 percent, ending the previous year's decline. In real terms this is quite disappointing, especially in the light of increasing repayment obligations on outstanding loans.

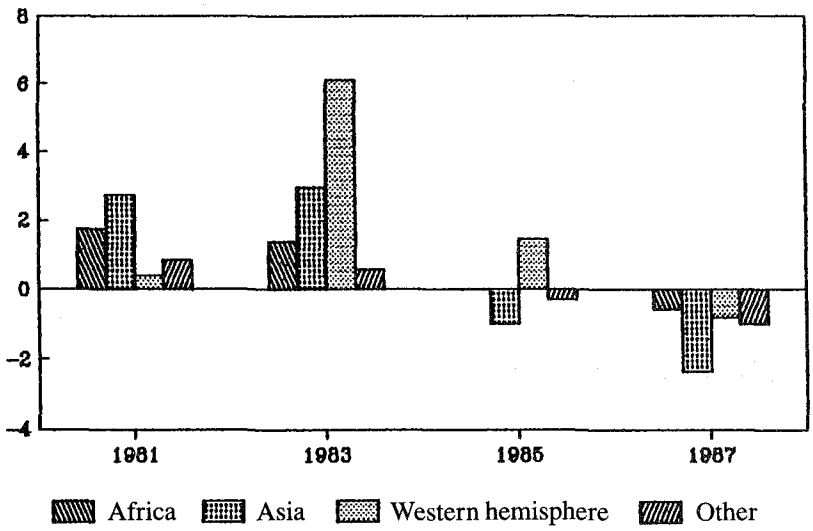
The lag between commitments and disbursements continues to be important. Indeed, for the World Bank group, which accounts for almost 70 percent of the multilateral total, the rise in resource commitments has been increasingly concentrated on lending that is intended to be quick-disbursing and in support of adjustment efforts. In fiscal year 1987, which ended in June that year, the share had already risen to 23 percent from 19 percent the year before. The agreement of March 1988 to increase the World Bank's capital base by $75 billion will significantly expand the Bank's lending ability.

At the regional development banks, important developments have also been taking place, while the dollar value of commitments by the operational agencies of the United Nations reversed their overall decline of 1986. Implementation of the international policy of strengthening the African Development Bank continues, and lending commitments there rose more than 30 percent in 1987, reaching almost four times the lending activity of 1980. Gross disbursements in 1987 also rose at about the same rate. Lending commitments at the Asian Development Bank also rose sharply, the result of its decision to expand programme lending in support of policy adjustment. The strong growth in lending was largely due to the sharp increase in the concessional loans of the Asian Development Fund (ADF), particularly to Bangla-

7 ODA commitments of DAC countries rose 21 percent in 1986 in dollar terms, after stagnating since 1983 (see OECD, *Development Co-operation, 1987 Report* (Paris, December 1987), p.256). However, the real value of those commitments when disbursed would be far less, owing especially to the devaluation of the dollar; if disbursed entirely in 1987, they would have represented an increase of 7.5 per cent measured in purchasing power over manufactured exports of DAC countries; if disbursed entirely in 1986, they would have represented an increase of 2 per cent.

Figure IV.4. Net flow of IMF credit to the main regions of the developing world

(Billions of dollars[a])



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

[a] Net flows in SDRs, including those of the IMF Trust Fund, converted to dollars at yearly average exchange rates.

desh. In addition, the Bank allowed Indonesia access to the Fund. Gross disbursements registered strong gains, as recent problems of limited absorptive capacity and lack of local currency counterpart financing in Asia have eased somewhat. At both regional development banks, the increase in commitments was concentrated in concessional lending, in recognition of the need to provide assistance to borrowing countries on terms that are more affordable.

In sharp contrast, resource commitments of the Inter-American Development Bank, even in nominal dollars, plunged from $3.1 billion in 1986 to $2.4 billion in 1987. This contraction in lending levels reflected the continuing economic recession that has affected the region since the early 1980s and, perhaps more important, the dispute on the voting power of members in taking key decisions. That dispute has stood in the way of agreement on the seventh general increase of the Bank's resources.

One large source of multilateral financial support of developing countries has instead become a net recipient of resources from those countries, namely, IMF. Even excluding Fund charges (i.e., interest payments), IMF has been a net recipient of funds from these countries since 1986; but the amount returned in 1987 rose to almost $5 billion (see table A.III.9). The reverse flow applied to almost every Fund "window" and to every geographical region (see figure IV.4).

It is sometimes argued that IMF is not a development finance institution but is more like a revolving fund. In this argument, it is presumed that the emergency ends within the prescribed period of Fund-supported adjustment programmes. In 1984, that period averaged 14 months. By 1987, it had risen to 26 months (see table A.III.9). This lengthening is encouraging, as is now the recognition by the Fund's Governors that the Fund needs to provide larger-scale, longer-term and concessional resources for the low-income countries seeking its assistance. The Fund is now providing such assistance through the Enhanced Structural Adjustment Facility, created at the end of 1987. It is nevertheless troublesome that adjustment is still a major problem and that the Fund has found itself agreeing to an average of 27 separate adjustment programmes a year since 1980. In that regard, 1987 was an average year. The time when the imperative to achieve adjustment in the balance of payments will be supplanted by a development imperative continued to recede.

Debt and the heavy debt-servicing burden

Several developing countries, the sum of whose population accounts for over half the population of the developing world, do not currently have serious debt problems as commonly understood.[8] Those countries may often be struggling with serious development problems, but they meet their debt-servicing obligations without disruption because those obligations are not overly large relative to their export earnings. In some cases, this is mainly the result of the earlier reluctance of policy makers to accumulate large amounts of the kinds of debt that entail heavy debt-servicing payments.

8 Including China among the developing countries raises the population proportion to about 70 percent.

Box IV.2. Debt management and integration of socialist countries into the international financial system

Centrally planned economies have traditionally had rather limited relations with the international financial system. However, this has been changing since the 1970s, marked by the increasing number of socialist country members of IMF and the World Bank, by institutional experimentation to enhance economic flexibility and openness in foreign trade, and by the growing use of foreign private credit flows and foreign direct investment in joint ventures.

By the early 1980s, three of the centrally planned economies of Europe had accumulated foreign debts that had become an especially heavy burden to service. These were Hungary, Poland and Romania, which together account for more than 80 percent of total Eastern European debt. By the end of 1987, according to national authorities, the gross debt in convertible currencies of Hungary had reached $18 billion, representing four times the value of merchandise exports to non-socialist countries; that of Poland exceeded $37 billion, representing almost six times the value of those exports; and that of Romania stood at $6 billion, which was equal to the value of those exports.

The international financial markets reacted early in the decade to the debt strains of Eastern Europe by reducing country risk ratings, which reached their lowest level in 1982-1983, at the bottom of the payments crisis. Adjustment measures and world economic recovery improved the trade situation and the ratings recovered, peaking in 1985, after which the trade of the Eastern European region again deteriorated.

Among the different approaches that countries have taken to cope with the debt burden, Romania's has been unique. Like other indebted countries, Romania has been undergoing debt restructuring through renegotiation, but it has also been reducing the level of foreign debt outstanding. It is seeking to repay all its hard-currency debt by 1990 and to refrain from resorting to any form of foreign credit.[a] Hungary has given high priority to avoiding debt renegotiations, although it is undertaking major economic restructuring and is seeking to sharply curtail the growth of its debt.[b]

In retrospect, some countries of Eastern Europe may be said to have overextended their use of international financial markets in the 1970s, based on expectations of interest rates and debt-servicing capacity that in the end were over-optimistic, as in the case of many developing countries. The Soviet Union, in contrast, whose economy is in any event less dependent on trade, has long taken a highly cautious approach to external borrowing. Soviet activity in private credit markets has traditionally been low-key, the bulk of it involving short-term finance. However, financial experimentation has grown recently, as in the floating of a small Swiss franc bond issue by the Bank for Foreign Economic Relations in January 1988, as a test for future Soviet issues.

The evolution of new Soviet approaches to external financing will be heavily influenced by the pace of domestic reform, including reform in the area of finance, which involves decentralization and creation of a potentially more competitive banking system. A new sign of this is that Soviet banks have begun to provide hedging against exchange rate risks to Soviet firms involved in foreign trade, which is quite a novelty in Soviet banking practice.[c] Traditionally, the hedging function has been carried out by the State Monopoly of Foreign Trade and Payments and absorbed by the central government budget. Soviet policy makers are also considering measures to enhance convertibility of the rouble (see chap. VI below).

China has been increasing its activity in international financial markets since 1978.[d] Foreign financing is to be used in development and modernization, although cautiously, subject to expected foreign exchange earnings. Over-indebtedness is to be avoided and official and preferably concessional loans are to be sought whenever feasible. A ceiling on the debt-service ratio of 15 per cent, used as a guide in the initial years of reform, has been retained.

Application of these principles, however, at first seemed to elude Chinese authorities—except adherence to a low debt-service ratio—as a consequence of the sequence and pacing of the domestic economic decentralization that was being undertaken. Decision-making on external trade, borrowing and domestic industry was decentralized without establishing institutions and indirect policy instruments to replace direct controls. The demand for foreign loans by local authorities and enterprises exceeded planned amounts and the current-account deficit soared in 1985. By 1987, gross foreign debt outstanding had more than tripled from the $8 billion level of 1980, reaching about $28 billion, although the increase in the past few years has been due in part to the rise in the exchange rate of the yen relative to the dollar, a problem that has affected many countries with relatively heavy shares of Japanese or European currency debt.

a Executive Political Committee of the Central Committee of the Romanian Communist Party, 28 December 1987 (see *Agerpres* (Bucharest), 28 December 1987; and *Scînteia* (Bucharest), 29 December 1987, p. 1).

b Parliamentary speech of the Prime Minister (see *Népszabadság* (Budapest), 19 September 1987, p. 2); and address by the Deputy Prime Minister (see *Magyar Hirlap* (Budapest), 20 February 1988, p. 5).

c B. Fedorov, "Novye funktsii bankov", *Ekonomicheskaya Gazeta*, No. 9 (February 1988), p. 20.

d The decision was promulgated at the Third Plenum of the Eleventh Central Committee, held in December 1978.

To regain control, some degree of recentralization of external borrowing was carried out by authorizing the State Administration of Exchange Control to monitor and approve new debt. In addition, efforts have been made to refinance some of the short-term commercial debt incurred in financing the current-account surge of 1985-1986. Although improvements have clearly been made, the system of debt management remains rudimentary and under strain because of inappropriate signals from the domestic price system and the insufficient degree of accountability of local authorities and enterprises.[e]

Finally, in China, Eastern Europe and the Soviet Union, a greater policy interest has emerged in increasing direct investment by transnational corporations in joint venture projects in their economies. Indeed, since 1986, all the centrally planned economies of Europe have passed or substantially modified legislation concerning direct investment, except the German Democratic Republic, which uses other forms of co-operation with foreign private corporations. The Soviet Union is in the process of negotiating framework agreements with consortiums of private companies in the United States and Europe (including banks in Europe). Some members of the consortium would generate foreign exchange earnings directly, while others would have a primarily domestic orientation. One important advantage of such arrangements, as distinct from individual joint ventures, is that they would facilitate the repatriation of profits in convertible currencies earned and establish limited convertibility within the consortium.

China reversed its policy towards joint ventures in 1979 after two decades of rejection of foreign direct investment as a means of importing technology and capital. Policy and its implementation have been evolving since then,[f] and will undoubtedly continue. Since late 1987, for example, some political leaders have been discussing ways of reducing foreign exchange and related restrictions on joint ventures—in particular, by giving virtually full management responsibility to the foreign investor.

Together, the international financial experiences of these countries, in particular with regard to foreign borrowing, seem to highlight a lesson that has also been learned by developing countries, namely, that while international financing provides a great opportunity to increase the resources for development, excessive use, especially of financing on commercial terms, can be dangerous.

[e] *China Daily*, 21 May 1987, p. 4; and *Business Weekly* of *China Daily*, 22 February 1988, p. 1.
[f] See *Foreign Direct Investment in the Peoples Republic of China* (United Nations publication, Sales No.E.88.II.A.3).

Some countries were never accorded significant access to credit because of the fragility of their economies and the poverty of their people, financial flows having instead been largely in the form of grants-in-aid. In yet other cases, large debts were accumulated, but export growth was very successfully promoted and the terms of trade did not deteriorate to any significant extent. For such countries, the debt problem is a potential one: only if their export earnings were cut back by an economic slow-down in their major markets or by protectionist exclusion of their exports, or if interest rates jumped appreciably, would their debt-servicing situation be likely to deteriorate seriously.

The reasons that some countries found themselves with excessive debt burdens and others did not are varied (see, for example, the different experiences of the socialist countries of Eastern Europe, the Union of Soviet Socialist Republics and China described in box IV.2). A key factor is that it takes time for an excessive debt burden to accumulate; three other factors are responsible: first, a readily expanded—highly elastic—supply of credits; secondly, a shared expectation by borrowers and lenders that capacity to pay will not deteriorate in the future, possibly accompanied by a political stalemate or lack of governmental mandate that makes decisive economic policy action difficult to take; and thirdly, a lack of national official accounting and control of the aggregate run-up of foreign obligations. Indeed, when the debt crisis erupted in some of the major indebted countries, there was no readily available record of how much debt was outstanding or even how large the Government's own obligations were. With the benefit of experience, national management of foreign debt has become a more salient policy issue and even an area of international co-operation, as shown by the technical assistance programmes in debt management offered by UNCTAD and the Commonwealth Secretariat.

Meanwhile, the developing countries that have accumulated excessive debt burdens have been unable to grow out of them or "adjust" out of them. Governments have changed and political mandates for decisive action have come and gone without a resolution of the problem. Increasingly, it is realized that the economic strains of adjustment under a heavy debt burden make it politically impossible to carry programmes of policy reform through to completion. The solution requires a reduction of the debt-servicing obligations immediately in the long run, which is to say that part of the answer for some countries is for creditors—both official and private—not to receive full, let alone timely, servicing of their loans.

The total amount of the loans outstanding to developing countries—not all of which need be candidates for debt relief—reached almost $1 trillion by the end of 1987 (see table

Table IV.4. Gross foreign debt of the capital-importing developing countries, 1980-1987

	1980	1982	1984	1985	1986	1987[a]
			Billions of dollars			
Medium-term and long-term debt	422.9	550.8	689.8	750.6	826.9	882
Official concessional	106.4	121.6	131.4	149.6	172.6	390
Official non-concessional[b]	67.1	97.8	139.1	159.8	185.8	
Private	249.4	331.4	419.3	441.2	468.6	492
Short-term debt	122.8	157.7	115.1	113.5	99.4	102
Total	545.7	708.5	804.9	864.1	926.3	984
			Percentage			
Total as a ratio to GNP[c]	33.6	42.4	50.2	52.8	53.8	53
Total as a ratio to exports[d]	136.8	182.6	201.7	221.1	247.6	226
Memorandum item						
Total debt of a broader grouping of capital-importing countries (billions of dollars)[e]	656	831	958	1 038	1 120	1 190

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of the World Bank, IMF and other sources (total sample of 113 countries).

a World Bank debt estimate, adjusted for differences in country coverage.

b Including use of IMF credit (excluding the IMF Trust Fund, which is included in concessional debt).

c Sample of 96 countries.

d Sample of 103 countries.

e Including member countries of the World Bank with centrally planned economies, Greece and Portugal among the developed market economies, but excluding the high-income oil-exporting countries (see World Bank, *World Debt Tables*, 1987-88 edition, vol. I (Washington, D.C., 1988), p.viii).

IV.4).[9] This represents roughly half of the aggregate GNP of these countries and more than twice their export earnings. At the beginning of the decade, in contrast, those ratios were one third and less than 150 percent.

The debt ratios indicate that the overall debt has become so large relative to economic size and relative to export earnings that no significant part it can be repaid in the short run because that would impose an impossible burden on the debtor countries. However, creditors neither expect nor necessarily want their loans repaid immediately, although they reasonably claim the contractual right to be paid according to schedules contained in loan agreements.

Creditors are usually flexible when major borrowers first have difficulty in meeting principal payments, one simple option being to refinance those payments with additional credits. The attraction of refinancing is that outstanding debt-servicing payments are made with the proceeds of the new loan and the debtor's accounts are kept current with his creditor. If difficulties persist, a more elaborate option is formal renegotiation of the repayment schedule, but in both cases the usual result of deferring debt-servicing payments is that they grow quickly, especially when the new loans or rescheduled amounts of old loans need to be repaid in only a few years. This has been the case for the heavily indebted developing countries and explains the simultaneous negative financial transfer, growing debt levels and continued debt-servicing problems.

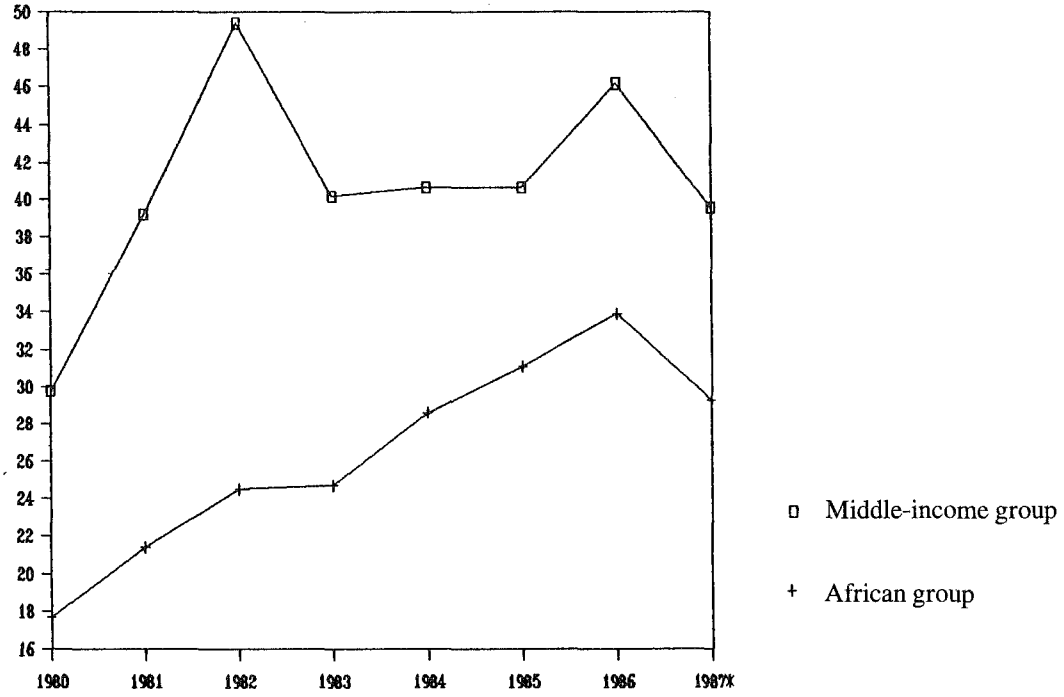
Over $150 billion of interest and amortization was scheduled to be paid on the medium-term and long-term debt of the capital-importing countries in 1987. Detailed data on payments made in 1987 will not be available until the end of 1988, but they will certainly show a significant underpayment, as has been the case in most of the 1980s. For the most part, interest payments are kept current and payments of principal lag. In 1986, for example, about 30 percent (or over $20 billion) of the total scheduled amortization was not paid; it was either rescheduled or arrears accumulated.

One highly unusual development in the present situation is that several developing countries have accumulated significant arrears to the multilateral institutions, which generally enjoy a privileged status with their borrowers and which on principle have not engaged in any rescheduling of their own loans. In particular, as at the end of October 1987, eight member countries of IMF had a total of approximately $2 billion of arrears to the Fund, 75 per cent of which had been outstanding for six months or more. Arrears to the World Bank were smaller but still significant: as at the end of June the amount overdue more than three months was almost

9 The 1987 increase in the dollar value of the debt shown in the table, about 6 percent, overstates the growth of new lending, which was less than 2.5 percent. The difference is mainly due to the fall in the exchange rate of the dollar, the *numéraire*, relative to the currencies of several major creditors (see World Bank, *World Debt Tables*, 1987-88 edition, vol.I (Washington, D.C., January 1988), p. viii).

Figure IV.5. Debt-servicing ratios of middle-income and African country groups

(Percentage of exports of goods and services)



Source: Based on data from IMF, *World Economic Outlook* (Washington, D.C., April 1988), adjusted. Debt-servicing includes interest paid on all debt plus principal payments on medium-term and long-term debt, including debt to IMF (see the note to figure IV.1 for the composition of the country groups).

* Preliminary estimate.

$200 million.[10] By March 1988, at least five countries were in arrears to the Bank.

Difficulties in timely debt-servicing have been concentrated in two regions: Africa and Latin America and the Caribbean. The problem is most readily analysed, however, in terms of groups of countries that do not follow geographical lines closely, such as the 15 middle-income, highly indebted countries, two thirds of which are Latin American, but which also include three major African economies, and the developing countries of sub-Saharan Africa, excluding Nigeria.

In the late 1960s and early 1970s, it was taken as a rule of thumb that a country's debt-servicing ratio should not exceed 15 percent of its export earnings. In 1981, the ratio for the middle-income highly indebted group of countries was more than twice that figure and the ratio for sub-Saharan Africa exceeded 20 percent (see figure IV.5). For the 1980s as a whole, the debt-servicing ratios of both groups of countries have been on an upward trend. The 1982 peak for the group of middle-income countries was one indication of the onset of the debt crisis. There was some improvement in 1983, as interest rates fell and the first major wave of debt renegotiations reduced amortization payments, but the aggregate debt-servicing ratio of these countries has been stuck at roughly 40 percent since 1983. Export earnings began to recover in 1984, but plummeted thereafter. Meanwhile, falling international interest rates and successive rounds of debt rescheduling have kept the debt-servicing ratio from again jumping, except in 1986 when the sharp drop in oil and some other commodity prices depressed export earnings. The improved debt-servicing ratio in 1987 was due to higher export earnings and lower amortization and interest payments. But reversals in the last two factors are expected in 1988, which may again raise the debt-servicing ratio.

In the case of the sub-Saharan Africa group, the debt-servicing ratio has risen almost without pause. Since over a quarter of that debt is on concessional terms and since much of the rest is at fixed interest rates, the upward trend in the aggregate debt-servicing ratio is less ascribable to debt-service trends than to disappointing export trends. Given the slow growth in export earnings, the rise in the debt-servicing ratio was almost inevitable.

10 See IMF "Financial statements of the General Department", quarter ended 31 October 1987, p. 13, and World Bank, *Annual Report*, 1987 (Washington, D.C., 1987), pp. 181-182.

Current management of the international debt problem

Despite the statements of spokesmen for creditor institutions and debtor countries and of international financial policy makers, the actual management of the international debt situation is less a comprehensive strategy being implemented than a tentative, piecemeal and thus far unfinished scheme. Much has been learned and participants have come to better appreciate the needs, constraints and abilities of others. A consensus on the broad outline of the problem and policy needs was reached at a political level in the United Nations General Assembly (resolution 41/202 of 8 December 1986) and reiterated in the Final Act adopted by the United Nations Conference on Trade and Development at its seventh session (July/August 1987) and in subsequent international meetings. The issue has been monitored closely by the Interim Committee of IMF, the joint IMF/World Bank Development Committee, and in numerous official and private forums. Yet, with action falling short of needs, collective government pleas for relief continue to be made, notably by the Organization of African Unity at a special summit meeting held at Addis Ababa at the end of 1987, and by eight Latin American presidents at a meeting at Acapulco, Mexico, also at the end of the year.

But progress, even if insufficient, has been made since 1982. A report on the debt situation prepared for the General Assembly at its forty-second session, in 1987, traced improvements through mid-year in the terms of debt rescheduling and discussed innovative features of debt restructuring.[11] Progress has continued to be made so that, for example, the average terms of commercial bank rescheduling in 1987 were a considerable improvement over those of 1986. The spread added to the LIBOR interest rate base, which had been 2 percent on average in the first round of negotiations, fell to 1.3 percent in 1986 and to 1.0 percent in 1987. The average grace period rose to five years, from four in 1986 and three in 1983 and 1984. The period over which the repayments had to be made was also lengthened, from 10 years on average in 1986 (6 in 1983) to 15 years in 1987.[12] The average terms should further improve in 1988, if the 20-year maturity with an 8-year grace period that Brazil and its creditors agreed to in March is a guide. By the same token, arrangements in the Paris Club for the rescheduling of inter-official debt have been eased, in particular for low-income countries, some of which have won 20-year reschedulings with 10-year grace periods.

But the atmosphere during much of 1987 was highly strained and may be characterized as one of fatigue and frustration among debtor countries and disillusionment among creditor institutions. Ecuador, which in late 1986 had begun to tap the private financial markets outside the context of debt-restructuring agreements, although in a limited way and under special circumstances, found it necessary in early 1987 to unilaterally suspend interest payments to its bank creditors. Brazil, soon after reaching an unprecedented agreement in the Paris Club to reschedule bilateral official debt without having secured an IMF stand-by agreement, found itself unilaterally suspending interest payments to its commercial bank creditors. In addition, Bolivia, Costa Rica, Cuba, the Dominican Republic, Honduras, Nicaragua and Peru were explicitly or implicitly in a state of moratorium with their bank creditors for most of the year.[13] In Africa, among the many countries that have fallen into arrears, two stood out. By the end of May, Côte d'Ivoire and Zambia had to suspend debt-servicing and, especially significant in the latter case, suspend a difficult and complicated internationally supported adjustment programme for lack of adequate financial resources.

In addition, the commercial banks, most prominently in the United States, took a new stance towards the debtor countries. Acknowledging to an unprecedented degree the financial weakness of their sovereign loans, banks added substantially to their loan-loss reserves. In some countries, this was an initiative of the banks; in others the regulatory authorities requested higher provisioning.[14] At the same time, banks continued to add to their equity, thereby reducing their relative exposure to problem debtors; European and Japanese banks were helped by the effect of the fall in the exchange rate of the dollar on the local currency value of dollar-denominated loans.

But although banks took major accounting losses in 1987 and debtor countries experimented with unilateral moratoriums, by early 1988 some major debtors and their creditors had returned to the negotiating table to seek more normal relationships. At the same time, several countries sought renewed adjustment programmes with IMF and the World Bank, and both institutions tried to improve their ability to address the adjustment needs of the developing countries—the Bank through a major reorganization and redirection of activities, and the Fund through an internal re-examination of its policies on the use of some of its facilities.

What has occurred is not a return to orthodoxy, but rather a recognition that so far no practical alternatives to "muddling through" have been offered. There is little expectation on any side that muddling through will achieve more than a little more time in which to find a solution to the debt problem. In the meantime, debtor countries continue to be hard pressed to increase exports in an international trading system under strain, while the political need grows in debtor countries to begin to derive benefits to incomes and growth, while making adjustments under a heavy debt burden.

Novel features of rescheduling

Various solutions to the debt problem, however, are being attempted through innovations in debt-restructuring that are being tested with increasing frequency. In recent years, sev-

11 See the report of the Secretary-General on the international debt situation in mid-1987 (A/42/523), 16 September 1987, sects. V and VI.

12 Data for 1987 cover the first nine months (see World Bank, *World Debt Tables*, ..., p. xxxiv).

13 See Economic Commission for Latin America and the Caribbean, "The evolution of the external debt problem in Latin America and the Caribbean" (LC/G.1497), 16 February 1988, p. 18.

14 For a summary of the action taken in 1987 in major creditor countries, see World Bank, *World Debt Tables*, ..., pp. xxiv-xxvii.

eral new features have been added to the menu of options from which debtors and creditors design their debt-restructuring packages.[15] To a degree, they are aimed at meeting the increasing reluctance of some creditors, especially smaller banks, to extend new loans to finance old ones. Many creditors have preferred to reduce their lending exposure to selected debtors, even at a loss. As more and more of the new rescheduling features have been designed, however, they have also pointed to new ways of addressing the need of the debtors to improve their net transfer of financial resources without increasing their debt burden.

Until recently, the major concessions to debtors in renegotiations did not entail significant losses to their creditors. Principal repayments were stretched out over longer and longer periods, but the extensions themselves were financed at market interest rates. In commercial bank restructurings, spreads over base interest rates and renegotiation fees were reduced, but they had risen to excessive levels at the onset of the debt crisis and the newer spreads still exceeded the spreads non-rescheduling countries obtained in the market for sovereign risk borrowing. Certainly, participating creditors were required to lend new money to help pay interest charges and were thereby forced to increase their exposure to troubled borrowers; but losses have not been realized on those loans either.

Other features of agreements gave banks the option of redenominating their loans into their home currency or another currency, which could spare them the exchange risk from devaluation of the original currency, usually the United States dollar. The banks also were allowed to change the base interest rate to which the spread was added in figuring interest charges. Whereas the former change shifted a new exchange risk to the debtor, the latter generally promised a lower interest payment. Another arrangement allowed longer periods between interest payments, from quarterly to semi-annually to annually, although the net benefit received by the debtor depends on the structure of the yield curve over time. The Philippines experimented with a scheme by which bank creditors could have the spread over the base interest rate paid to them in an instrument referred to as Philippine Investment Notes (PINs). Although the scheme has been discontinued, PINs were to be tradable and, in particular, could be swapped for local equity investments on favourable terms.

Additional features introduced largely for the benefit of creditors included putting up the forced "new" money in the form of a trade credit facility rather than straightforward balance-of-payments financing. The advantage of the former to creditors is the self-liquidating nature of trade finance and the association of the credits with actual shipments of goods; for the debtor, the new money is seen to be financing trade. Creditors have also been offered "on-lending" options, in which the new money is transferred to a new borrower who takes on the repayment obligation. This has advantages to banks that have other commercial interests in the debtor country and wish to give more emphasis to private sector banking relations than to sovereign risk lending. New money requirements have also been made more palatable to banks by arranging them as co-financing of World Bank loans—or "parallel financing" when no formal co-financing is arranged—which entails explicit guarantees or important cross-default clauses.

Other innovations in 1987 added a new dimension. Instead of trying to entice reluctant creditors to stay the course and put up new funds, the bank negotiating committees and the debtors devised measures that allowed creditors to withdraw from the process altogether. Indeed many banks, especially smaller ones, were already doing so through the secondary market in loan participations (in which loans are swapped or sold at a discount) or directly through debt/equity swap schemes in debtor countries. In the latter case, a loan is exchanged for equity in a domestically registered company, often a foreign firm or even a subsidiary of the bank's own holding company.

Argentina pioneered the new approach in 1987 through the introduction of "alternative participation instruments" and "new money instruments". The former offered creditor banks the option of exchanging up to $5 million of their loans (or $30 million if that was their entire exposure) for a bond paying lower interest and having a longer maturity than their existing holdings. For a creditor bank, one advantage of those bonds (known as "exit bonds") was that the amount of "new money" it would have to put up as its share of the restructuring package would be reduced or eliminated. In addition, throughout the debt crisis, developing countries have almost uniformly serviced their bonds without interruption and are widely expected to continue giving them priority servicing. In that sense, the bonds are—if only informally—priority debt.

That was one main advantage of the new money instruments, which were bonds with the same financial terms as the new money loan that was part of the debt package. The bonds were bearer bonds and thus more liquid than bank loans, and called for somewhat different accounting treatment. Each participating creditor bank was given the option of taking up to $1 million of its new money share in the form of these bonds instead of the standard new bank loan. This feature is important because it shows a growing recognition, however peripheral, that foreign bank debt can be subordinated to other privately held debt.

The Argentine package was made final in August 1987. In October, Ecuador reached agreement with its creditor banks on a package containing both exit bonds and a version of the new money instrument, called "A bonds". Brazil took these ideas several steps further by proposing large-scale refinancing of its bank debt using a form of exit bonds that would have paid interest rates significantly lower than market rates. But what was acceptable to the creditor banks at the margin was a "non-starter" when proposed as a means

15 For a review of the recent evolution of commercial bank debt-restructuring, see IMF, *International Capital Markets Developments and Prospects* (Washington, D.C., January 1988), pp. 50-63, and, for greater detail, World Bank, *Market-Based Menu Approach,* Debt Management and Financial Advisory Service Department, January 1988.

for handling the bulk of the debt of the most indebted developing country.

A further proposal, which improved upon that of Brazil in several respects, was made by Mexico at the end of the year. First, the arrangement was to be more fully voluntary in that it was designed outside the multilateral debt renegotiation process and the resulting loss for creditor participants was to be "market related"—the result of an auction—rather than negotiated.[16] Secondly, the subordination of the existing bank debt to the new bonds was to be made explicit. It was assisted by a special issue of zero coupon bonds by the United States Government, which was made available to Mexico. The bonds were scheduled to mature on the same day as the Mexican bonds. Thus, their purchase by Mexico would effectively guarantee full repayment of principal on the Mexican bonds on the date of maturity. Mexico would pay a competitive interest rate on its bonds, but would benefit from the discount in the original swap, which it was hoped would be up to 50 percent. The creditors still perceived themselves as subject to large risks as the interest payments were not guaranteed by any mechanism comparable to that for the principal; and for 20-year bonds, most of the cash flow is interest.

The Mexican arrangement thus did not work out as anticipated. Based on the prices of Mexican debt in the secondary market, it was hoped that $20 billion of bank debt could be exchanged for somewhat more than $10 billion in bonds. Instead, $3.7 billion of bank debt was retired and the Mexican debt was reduced by only $1.1 billion. The average discount was slightly above 30 percent and although almost $7 billion in debt had been offered in bid by 139 banks from 18 countries, much of it was considered to have been at an insufficient discount.

Specialists in the financial markets had felt for some time that the discounts on the Mexican debt and the debt of other major developing countries understated the "true" value of the loans based on economic fundamentals.[17] The market is thin and trades do not take place every day. In short, the secondary market tends to reflect the sentiment of a marginal share of the bank creditors.

Besides the size of the discount, in the Mexican deal the volume of debt being offered for bid was smaller than expected. Indeed, the same observation applies to the exit bond option in the Argentine programme. In both cases the reason appears to lie in an inherent shortcoming of voluntarist or market-oriented methods of seeking to address the debt problem.

Towards a solution to the problem of bank debt

If not for the debt overhang and unmet structural adjustment needs, the economies of the middle-income highly indebted countries could regain, if not surpass, their substantial economic dynamism of the previous two decades. Although institutional memories can be short and the political pressures that lead to unsustainable macro-economic policies may still be present in some countries, there is reason to be hopeful that sound and more equitable economic management will be widely popular in an environment of rising *per capita* incomes. The existing situation, in contrast, is not socially, politically or economically sustainable in the long run. How to unwind that situation is a political question, involving an apportioning of the adjustment costs between the debtor and its creditors and among the creditors.

For example, if several creditors were to take large losses in a given country now, it would relieve the country's debt burden, allow structural adjustment and broader development to resume and enhance the value of the loans held by the other creditors, some private, some offical and from many countries. Unless the banks are in dire need of additional liquidity in their portfolio, there is little incentive to take a loss now and subsidize their competitors. Instead, it may be a reasonable strategy for them to provide against the loans becoming non-performing and otherwise hold on to at least the bulk of them.

This is not to say that the banks would not quickly accept a swap of their debtor country loans for assets that would convincingly guarantee payment of interest and principal, even at lower interest rates,—for example, at rates paid on government paper in the major industrial countries. Banks might even absorb capital losses of 25 percent or more in a swap into such instruments if all the creditors agreed or were forced to participate (25 percent is mentioned because that represents the rough average of the provisioning already undertaken by United States banks). But this is not yet on the table; nor is implementation at hand of any of the large number of proposals for international facilities to restructure and reduce the debt burden of the developing countries.[18] The legislatures of the creditor countries have not yet reached the stage of being able to vote the resources required to underwrite such proposals, although if the United States Senate and House of Representatives are a guide, some are willing to encourage negotiations among Governments of creditor countries aimed at establishing a facility which would pass the discount on the debt to the debtor countries.[19] By the same token, prospective legislation to approve the $75 bil-

16 The loss was to be in the form of a discount on the bank debt as exchanged for bonds, rather than in the setting of an artificially low interest rate; but these formal differences are of less economic significance.

17 For exploratory econometric work in this area, see "The secondary market and the international debt problem", DIESA Working Paper Series, No.7, Department of International Economic and Social Affairs of the United Nations Secretariat, November 1987.

18 Two prominent additions to the many proposed facilities were made early in 1988: the proposal of Arjun K. Sengupta, an Executive Director of IMF, made before an Executive Board Seminar on 9 February 1988, and that of James D. Robinson, Chairman and Chief Excutive Officer of the American Express Company (see "A comprehensive agenda for LDC debt and world trade growth", *AMEX Bank Review Special Papers*, No. 13 (March 1988)).

19 This was a provision of the omnibus trade bill adopted by both Houses and sent to the President for signature in April 1988; the bill has since been vetoed.

lion capital increase of the World Bank is very much discussed in terms of whether or not the envisaged expansion in Bank lending for structural adjustment would serve indirectly to refinance private bank debt with multilateral official debt.

Governments of industrial countries have the capacity to act in the area of international debt and have done so. A number of significant advances were recorded in 1987 alone, largely with respect to the difficulties of low-income countries, as there is general agreement on the need of those countries for relief and on the pointlessness of a policy of inaction.

The arrangements recently completed for the Bolivian buy-back scheme are a case in point. The plan, which was elaborated during much of 1987, is part of a debt-restructuring and economic adjustment programme. Donor countries provided grant assistance to a facility especially created for that purpose in IMF, from which the Bolivian Government could draw to buy back some of its debt directly from its commercial bank creditors at a steep discount. The banks had formally agreed to the plan and had specified how the discounts would be allotted and the debt extinguished. The result, as at mid-March 1988, was that the banks agreed to sell over $300 million of the debt at 11 per cent of face value and waive the interest and charges in arrears, which brought the value of obligations extinguished to over $500 million. The remaining commercial bank debt of almost $700 million would be renegotiated.

The most important characteristic of the Bolivian arrangement was that all parties understood that Bolivia could not and would not service its debts in full. From that point, it was possible to design an arrangement in which the commercial banks took substantial losses in an orderly way (indeed, by 1985, most bank creditors had already heavily written down the value of those assets in their balance sheets), donors made a modest financial contribution that would not be interpreted as "bailing out the banks", a multilateral institution was involved in the role of honest broker, and an internationally supported reform and stabilization programme was instituted that would help underwrite economic adjustment efforts of a new Bolivian Government. An important issue is whether the experience gained by the creditor, donor and multilateral parties to the Bolivian case can be applied to other countries in comparable situations.

The difficult question pertains to the incomparable situations, namely, those of the major debtor countries. The three largest debtor countries alone—Argentina, Brazil and Mexico—owe well over $200 billion just to the commercial banks. A Bolivian type of operation could not be mounted for those countries. The scale of the necessary increase in official assistance would be prohibitive in terms of what legislators—and public opinion in donor countries—would seem to support at present. But other sources of the resources for retiring a significant part of the debt can be envisaged. The debtor countries might even borrow the money themselves on the private markets if such borrowing were convincingly guaranteed by donor country Governments or the multilateral institutions. Various methods might also be devised to share and spread the risk of such guarantees beyond the initial guarantor, but the time for such action is apparently still not ripe.

However, the time was ripe in 1987 for certain other actions by creditor Governments, which might also be built upon in 1988. The United States, for example, relaxed specific regulations to allow banks to purchase full ownership through debt-equity swaps of non-financial companies that were being privatized in debtor countries. Banks were also granted a deduction from taxable income for the face value of loans donated to environmental and humanitarian groups, including the United States Committee for UNICEF, which could then swap them into local currency or otherwise use them for programmes in the debtor country. Additional regulatory and tax measures can be envisaged which would further encourage the pass-through of discounts on outstanding obligations to the debtor countries and broaden the menu of options that banks from different countries could adopt in debt-restructuring negotiations.[20]

Indeed, one regulatory measure considered at the end of 1987 by the Group of Ten industrialized countries may set an effective time limit for an orderly, negotiated reduction of the developing country debt. This was the decision by the Committee on Banking Regulations and Supervisory Practices (the Cooke Committee) to recommend a common capital requirement for commercial banks in different countries.[21] Banks whose regulatory authorities have permitted lower capital backing would need to raise their reserves or equity by 1993. In the United States, where loan-loss reserves form part of the capital base, taking losses on developing country debt would become expensive if they had to be replaced immediately to meet the newly raised minimum capital standards. For these banks—and for banks in countries in which harmonization of capital requirements will require additions to capital, especially to back problematic loans to developing countries—there is good reason to seek to settle the debt overhang now.

But, as discussed above, competitive pressures and different business interests make it unlikely that banks will act individually to implement a market-based solution. What they need is political leadership from the Governments of creditor countries to decide upon a solution that is effective and equitable, and that the bank managements—not to mention debtor country Governments—would probably accept with a large sigh of relief. That solution could be to set broad guidelines for effective debt-reduction packages, within which there would still be scope for a case-by-case approach, as negotiations would have to proceed with individual countries.

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20 For a list of proposals, see Mary Williamson, "Banking regulation and debt: A policy of flexible response", *Policy Focus, 1988,* No.1 (Washington, D.C., Overseas Development Council, March 1988).

21 For a discussion of the proposal and its background, see "A proposal for an international bank capital standard," *Monthly Report of the Deutsche Bundesbank,* January 1988, pp. 34-39.

Relations with official creditors

It might appear paradoxical that the unusual Bolivian restructuring of bank debt was arranged for a country that has paid and is scheduled to pay more interest to official bilateral and multilateral agencies than to commercial banks on public and publicly guaranteed medium-term debt. Indeed, attention must also focus on the international treatment of debt to official creditors.

Several important strides were made in 1987 in the treatment of the debt of low-income countries owed to official creditors. Some of them were intended to alleviate the difficulties of African countries, but the facilities and precedents established are potentially applicable to all similarly situated countries.

International consciousness of the African development crisis had been building up since the beginning of the decade, debate having been galvanized by a series of reports and a special programme of the World Bank for low-income countries of the sub-Saharan region, by the United Nations emergency programme to counter the effects of Africa's drought, and by the special session of the General Assembly in May 1986, at which the Assembly adopted the United Nations Programme of Action for African Economic Recovery and Development 1986-1990 (resolution S-13/2).

This notwithstanding, both overall resource flows to the region and official development assistance fell in real terms in 1986.[22] But real commitments rose and the pass through to higher net flows should begin to appear. It nevertheless became clear during 1987 that the emergency adjustment needs of the continent were not being met, let alone the long-term development financing requirements. In country after country in 1987, foreign debts could not be serviced and imports had to be held down by excessive amounts. However, the need to do more was widely felt in the donor community and several initiatives were set in motion.

Some were directly addressed to debt problems, such as the lengthening of maturity and grace periods in Paris Club rescheduling of official bilateral debt, although no cash flow benefit would be felt by the debtor until after the expiration of the previous maximum grace period of five years for low-income countries. Others were directed towards a more general provision of financial resources that could be applied, *inter alia,* to debt refinancing. One such initiative was that of the Managing Director of IMF, which led to the creation at the end of 1987 of the Enhanced Structural Adjustment Facility (ESAF), marking a return of the Fund to concessional lending on a substantial scale. The predecessor of ESAF, the Structural Adjustment Facility, had itself been financed by the repayments of the last major concessional effort of IMF, the 1970s Trust Fund. ESAF will provide $8.4 billion in new resources to African and other low-income countries for commitment in 1988 and 1989. Loans will be provided for a period of 10 years at an interest rate of 0.5 percent and are intended to support medium-term balance-of-payments adjustment programmes. They should also help reverse the negative transfer of resources that Africa is currently experiencing *vis-à-vis* the Fund.

The World Bank also proposed a major enhancement of its special programme for debt-distressed developing countries, especially those in Africa. The Bank had established the Special Facility for Africa (SFA) in 1985 and mobilized almost $2 billion in additional resources for it, both direct support and bilateral co-financing. But SFA was due to end operations in June 1988. A series of meetings with major donors, which began in the summer of 1987, ended when the Bank won agreement (at a special meeting in Paris in December) for an increase of about $3 billion of co-financing of Bank-supported adjustment programmes, to be committed over three years.

The new concessional resources of the Bank and the Fund, along with other increased bilateral flows and an expanded African Development Fund at the African Development Bank, were seen as meeting a significant part of the emergency cash flow shortage of the target group of hard-pressed, low-income sub-Saharan countries. In the Bank's initial proposal, these flows were not expected to meet all the needs, as the Bank had also considered concessional debt relief as a legitimate source of enhanced resource transfers.

Indeed, the Governments of France, Sweden and the United Kingdom had informally circulated proposals in the first half of 1987 to introduce a concessional element to debt relief arranged through the Paris Club. The Nordic countries have also proposed establishing a fund at the World Bank to help reduce the servicing of non-concessional debt owed directly to the World Bank by the hard-pressed countries. In addition, the African Development Bank devised a comprehensive plan for concessional debt-restructuring that extends to official as well as private credit some of the ideas on securitization with guarantees at reduced interest rates discussed above.

Parallel with those efforts and with the implicit concern that the various proposals add up to an international package that is politically feasible and financially adequate, the Secretary-General of the United Nations convoked in April 1987 a group of high-level experts from the world of international finance and asked them to recommend concrete means, within agreed programmes, for alleviating the financial burden of the affected African countries. The Group, in its report to the Secretary-General of February 1988,[23] observed that the international community was acting in several ways to address emergency financing needs of the region, but that even under highly conservative assumptions not even the minimum necessary resources had yet been arranged. In the view of the Group, increasing the capacity of these countries to import was a critical precondition for recovery.

22 Real terms here refer to unchanged prices and exchange rates of OECD countries (see OECD, *Development Co-operation, 1987 Report* ..., pp. 214-219).

23 *Financing Africa's Recovery: Report and Recommendations of the Advisory Group on Financial Flows for Africa* (New York, United Nations, February 1988).

Adding together the new financial commitments as at early 1988, the Group saw a potential increase in flows of approximately $3 billion a year to 1990. But it concluded that an additional $2 billion annually was needed by the sub-Saharan countries, excluding Nigeria, "simply to restore the prospects for development and growth as of the early 1980s, which were already highly constrained in many countries of the region."[24] The Group suggested that about $1 billion of that amount might take the form of official debt relief and the rest increased official development assistance. Adding in the needs of Nigeria and North Africa, the requirements of Africa as a whole would be far larger and the amount needed would multiply again when the needs of lower-income countries throughout the world were considered.

The most significant conclusions of the Group, however, do not pertain to the quantitative estimates of the overall financial needs of one developing region, but to the modalities by which increased net resource transfers might be brought about. The resources accorded to any particular country would in any event be determined on a case-by-case basis.

Thus, one significant recommendation of the Group was that countries in especially difficult medium-term circumstances should receive from the Paris Club a rescheduling of all their debt service obligations to bilateral official creditors over the next three years, at virtually no interest (i.e., on terms comparable to those of IDA). For debtor countries whose debt-servicing capacity was less impaired and which could foresee a return to conventional financing at some future date, annual rescheduling was proposed, but at a moratorium interest rate, which, although somewhat higher than in the first case, would still be substantially below market rates. For a third group of countries, whose future credit rating was not in question, existing practices would continue. At the present time, Paris Club reschedulings embody no subsidy of interest rates on rescheduled loans. These recommendations of the Group, in particular, should be passed on to donor Governments and introduced into Paris Club deliberations as soon as possible.

United States foreign debt, related capital flows and the instability of major currency exchange rates

The United States has the world's largest net foreign debt. It is, however, a unique international debtor. As the supplier of the major currency for international transactions, the United States has been able to borrow almost entirely in its own currency. Thus, it is not susceptible to a foreign exchange crisis of the sort that afflicts developing countries when foreign lenders and purchasers of their financial instruments lose confidence in their economies and cease extending new credit.

A real danger exists, however, that a loss of confidence leads foreign holders of dollar assets to exchange them for assets in other currencies. In such a scenario, the ability and willingness of United States and foreign central banks to absorb the glut of dollars would be severely tested. To the degree that the inflows needed to finance the large United States payments deficits thereby became insufficient, the consequences for exchange rates and interest rates, and for economic growth, could be disruptive.

Such a turbulent scenario appears highly unlikely, although it cannot be dismissed as impossible, especially in the light of developments in financial and currency markets in 1987 and the continuing rapid growth of the United States foreign debt position. Even on optimistic assumptions, United States net external indebtedness would grow by more than $350 billion from 1988 to the second half of 1991.[25]

The size of the United States foreign debt

The external indebtedness of the United States can be measured in a number of ways.[26] The net international investment position, the most inclusive measure, is the difference between foreign assets held by residents of the United States and assets in the United States owned by foreign residents—where residents are individuals, corporations or official entitities. Gross debt, another measure, is simply the sum of a country's liabilities to foreign entities, which are held in the form of debt instruments. Finally, the term "net debt" is applied to various concepts. Sometimes it is the difference between all foreign credit, including foreign currency bank deposits, and gross foreign debt. Several analysts use the term to mean the difference between gross debt and liquid, or easily accessible, claims on foreigners. All other private and government claims on non-resident entit-

24 *Ibid.*, p. vi.

25 The key assumption in the exercise is that the United States trade deficit is largely eliminated by 1991 (but not the current-account deficit), in a scenario in which United States GNP grows 2.5 to 3.0 per cent a year (and demand grows by much less); the rest of the industrialized world grows at a rate of about 3 percent (demand at 3.5 percent); United States manufacturing grows at least 4 percent a year (which requires considerable investment); and the United States fiscal deficit is sharply curtailed (E.Gerald Corrigan, President of the Federal Reserve Bank of New York, in an address before the annual meeting of the New York State Bankers' Association, 28 January 1988 (see Federal Reserve Bank of New York, *Quarterly Review*, vol.12 (Winter 1987-88), pp. 1-5). This scenario is more optimistic than the baseline forecast presented in chapter II above. Mr. Corrigan also said that "sadly, and despite great effort, the details of a credible budget deficit reduction programme in the needed amount are not yet in place. In sum, the accretion of United States foreign debt is likely to have to be far larger than the $350 billion noted".

26 See Shafiqul Islam, "America's foreign debt: is the crisis moving north?", *Stanford Journal of International Law*, 1987, pp. 99-129, and "The United States as a debtor country: indicators of resource transfer and solvency", DIESA Working Paper Series, No.2, Department of International Economic and Social Affairs of the United Nations Secretariat, February 1987.

Table IV.5. Net international investment position of the United States

(Billions of dollars; end of year)

	1980	1982	1984	1985	1986	1987[a]
I. United States foreign assets	607	825	896	949	1 068	1 169
Official assets	91	109	120	131	138	136
Official reserves	27	34	35	43	49	46
Other Government assets	64	75	85	88	89	91
Private assets	517	716	776	819	930	1 032
Direct investment	215	208	212	230	260	298
Securities	63	75	89	113	131	156
Banking and other	239	433	476	476	539	578
II. Foreign assets in the United States	501	688	892	1 061	1 331	1 515
Foreign official assets	176	189	199	203	241	286
Private assets	325	499	693	859	1 091	1 229
Direct investment	83	125	165	185	209	250
Securities	90	119	186	290	405	408
Banking and other	151	256	343	384	476	571
III. Net international investment position (I-II)	106	137	4	-112	-264	-347
Memorandum item						
Indicators as a percentage of GNP						
Net position	3.9	4.3	0.1	-2.8	-6.2	-7.7
Gross foreign debt[b]	13.4	15.4	16.8	18.8	22.5	24.4

Source: United States Department of Commerce, *Survey of Current Business*, June 1987, for data to 1986; and estimates of the United Nations Secretariat for 1987, based on balance-of-payments data and roughly approximated valuation adjustments.

[a] Preliminary estimates.

[b] Foreign assets in the United States, excluding direct investment and corporate stocks.

ies held as debt instruments are excluded from that calculation because they cannot be readily mobilized.

The net investment position is the most commonly used measure of United States external indebtedness, although it is an inexact measure that variously overcounts or undercounts assets and liabilities. First, it includes some items that are not debt as such—in particular, foreign direct investment in the United States and foreign holdings of equity shares in United States corporations. Earnings paid on these assets are more variable and more directly related to earnings of the underlying investments than is interest on debt instruments. In addition, the net investment position misrepresents net indebtedness to the degree that certain United States assets included in the calculation are valued at an artificially low price. For example, gold held by the United States Government is valued at SDR 35 an ounce. Similarly, direct investments are carried at book value, which tends to undervalue the net direct investment position because United States investments abroad are on average much older than the foreign direct investments in the United States.

Measured by changes in the net investment position, the United States became a net debtor in 1985 (see table IV.5). Measured by gross debt, the United States debt has long exceeded that of all the developing countries combined; measured by net debt—that is, the net value of all interest-bearing or discounted securities and loans—the United States was a debtor through virtually all of the 1970s.

The net investment position of the United States appears to have dropped by more than $80 billion in 1987, bringing its net debtor position to almost $350 billion. The amount of net capital inflows were far larger—$161 billion, the size of the current-account deficit—but the combination of exchange rate changes and falling securities prices cut the deterioration of the net asset position in half. Because the outstanding amounts of foreign-held equity shares and bonds have grown so large, the reduction in the value of those amounts during the year almost matched the value of the new purchases. On the other side of the ledger, the 18 percent drop in the nominal effective exchange rate of the dollar from December 1986 until December 1987 gave a considerable boost to the dollar value of United States foreign assets (excluding direct investments which are carried at original book value). Nevertheless, even with these favourable valuation effects, the net debtor position deteriorated to almost 8 percent of GNP. In terms of the measure more conventionally applied to indebted developing countries, the gross indebtedness approached 25 percent of GNP.

It is not self-evident, however, that the growing net debtor position of the United States is a problem. Many analysts point to the fact that United States external debt is denominated in dollars. The United States thus runs no risk of insolvency since it always has the option of increasing the supply of dollars to service its debt. In addition, they argue that the external debt of the United States is small relative to the size

of its GNP. Assuming a 5 per cent real rate of return, the income needed to service these claims would amount to less than one half of one per cent of GNP.[27] Furthermore, reflecting the undervaluation of United States foreign assets, net earnings on United States investments abroad remain sizeable;[28] indeed, they exceeded foreign earnings on investment in the United States by $21 billion in 1986 and $14.5 billion in 1987, although this was in part due to the fact that profits, interest and dividends were received from abroad in currencies that strengthened relative to the dollar. It is notable, nevertheless, that in the third quarter of 1987, payments on foreign-owned assets exceeded income on United States assets abroad for the first time in recent history.

The concern expressed about the growing external indebtedness of the United States relates, rather, to the risks it poses for the stability of the world financial system. First, the heavy indebtedness holds the United States hostage to foreign capital inflows. Much of the increase in net debt of the United States has coincided with the accumulation of large budget deficits. This suggests that the capital inflows have been used largely to finance government and private consumption, rather than productive investment. To the degree that the debt pile-up feeds perceptions of economic mismanagement, it may weaken investor confidence.

A second concern stems from the rate of growth of the debt. In 1987, the ratio of net foreign claims to GNP grew by 1.5 percentage points (see table IV.5). If not for the valuation effects described above, it would have grown by about 3.5 percentage points. If the dollar and financial markets remain stable and this rate of increase is maintained, net foreign claims on the United States would reach 40 per cent of GNP by the end of the century. As the value of GNP grows, a current-account deficit that maintains a constant ratio to GNP would soon require very large net increments to the debt. The objective of current-account adjustment in the United States is to reduce the deficit as a share of GNP, if not necessarily to bring the deficit to zero. The annual deficit ratios since 1984 have thus far been 2.9 per cent in 1984 and 1985, 3.4 per cent in 1986 and about 3.5 per cent in 1987. It seems impossible to maintain the ratio at this level and the basic question is therefore not whether the deficit will be adjusted, since it cannot go on indefinitely, but whether the adjustment will be done smoothly.

Thirdly, although United States debt as a share of GNP may currently be modest, the absolute magnitude of the debt is already vast. Indeed, to the extent that the annual statistical discrepancy in the United States balance of payments reflects unreported capital inflows, United States net indebtedness is understated, not overstated as the debt optimists claim. The amount of understatement could be large as the statistical discrepancy is large—$24 billion in 1986 and $22 billion in 1987.

Finally, there is another concern about the large and growing United States indebtedness. Should the world's wealthiest country appropriate such a large portion of the surplus savings of the rest of the world as a way of sustaining levels of domestic expenditure that substantially exceed domestic output?

Capital movements: Federal Republic of Germany, Japan and the United States

The net external debt of the United States continues to grow and its current-account deficit persists because foreign firms, individuals and Governments are willing to continue lending to the United States. Two factors determine the increase of foreign holdings of dollar-denominated assets. On the one hand, as income and wealth grow outside the United States, the pool of financial resources grows and with, for example, a constant share of dollar assets in investor portfolios, the flow of new lending to the United States also grows. On the other hand, foreign investors may decide to change the dollar share of their portfolios, which would affect the demand for dollar-based financial instruments.

One implication of the pattern of current-account imbalances among the major industrialized countries (see table IV.1) is that the international ability to continue lending to the United States has grown *pari passu* with the need of the United States to borrow. The two single most important sources have been the Federal Republic of Germany and Japan, although their financial flows have followed somewhat different paths.

Japan's large current-account surpluses and its increasing role in global capital markets have transformed it into the largest international lender in recent years. Net long-term capital outflows more than doubled to a record $131 billion in 1986, rising to $137 billion in 1987 (see table A.III.11). Long-term capital movements have been dominated by Japanese investors' purchases of foreign securities; such purchases totalled nearly $88 billion in 1987—mainly in the form of dollar-denominated government bonds. Japanese purchases of foreign equities have been of far smaller magnitude; they rose sharply in 1986, however, and accelerated further in the first half of 1987 before falling off in the second half.

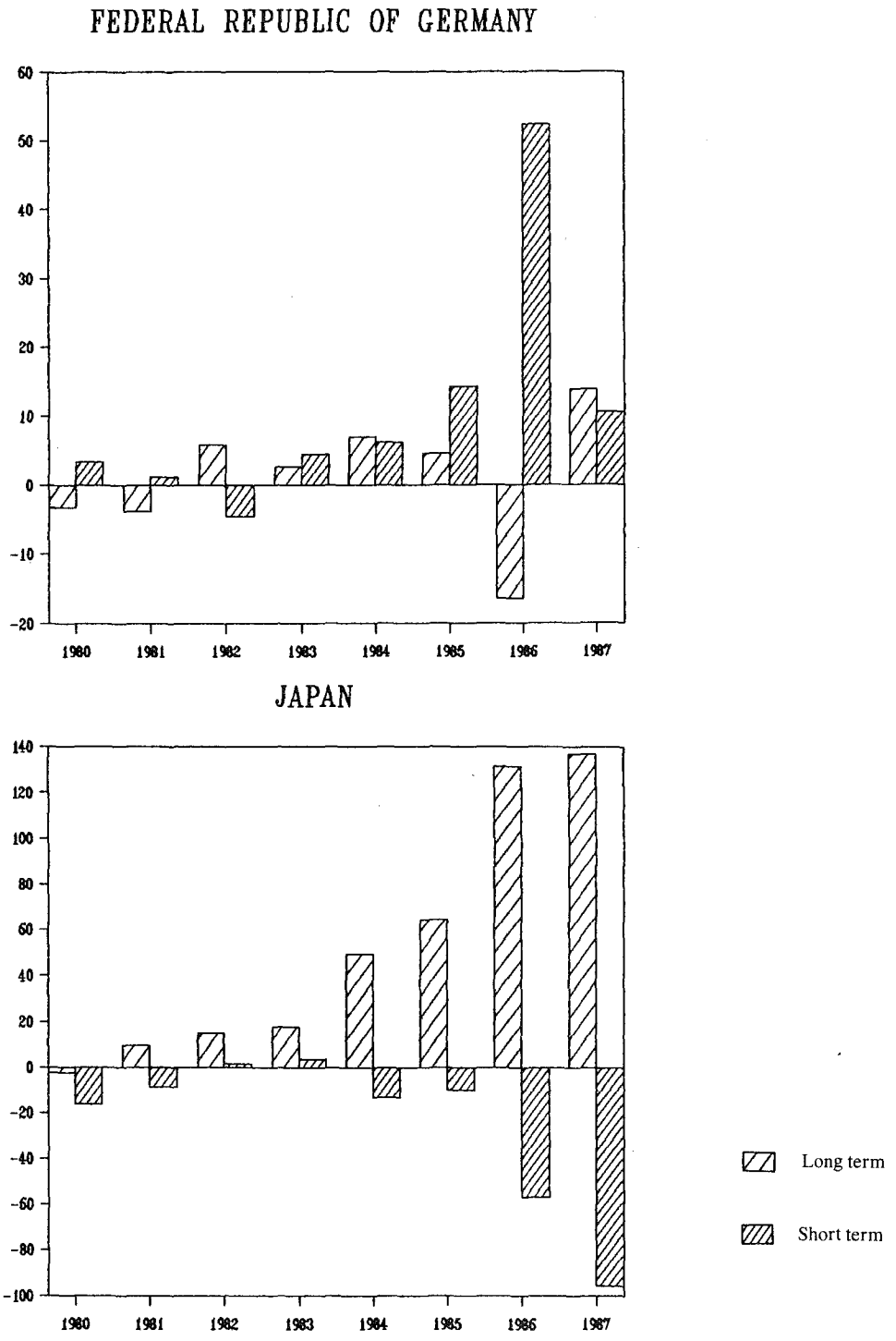
But Japan's overall net capital outflow is smaller than the outflow of long-term credit since the short-term capital account has shown large net inflows in recent years—reaching $96 billion in 1987 (see figure IV.6). The heavy net inflow that year can be attributed in large measure to net borrowing by foreign exchange banks, reflecting both the increasing international demand for yen deposits and Japan's growing role as a financial intermediary for the transfer of international capital. In addition, short-term foreign borrowing provides Japanese financial institutions with a hedge against dollar exchange rate losses on their investment in dollar assets.

The Federal Republic of Germany recorded a $30 billion increase in net long-term capital outflows in 1987; nevertheless, since there had been a net inflow in 1986, the outflow in 1987 amounted to only $14 billion (see table A.III.10). This

27 *Economic Report of the President* (Washington, D.C., United States Government Printing Office, February 1988), p. 99.
28 See John Makin, "The U.S. debtor status has been overblown", *International Economy*, January/February 1988.

Figure IV.6. Capital outflows of the Federal Republic of Germany and Japan

(Billions of dollars)



Source: Balance-of-payments data of the Deutsche Bundesbank and the Bank of Japan (excluding official reserve transactions).

swing nevertheless restored a pattern of financial flows that had been uncharacteristically reversed in 1986, when heavy foreign purchases of bonds of the Federal Republic of Germany caused a large net inflow of long-term capital. In 1987, net long-term outflows were mainly the result of substantial increases in purchases by the Federal Republic of Germany of foreign securities and in long-term credit outflows, combined with a sharp fall-back in foreign purchases of that country's securities. All together, long-term investment abroad by the Federal Republic of Germany reached $35 billion in 1987, compared with less than $25 billion in each of the previous two years. Coinciding with the long-term net inflows in 1986 were heavy net short-term outflows, driven by strong demand for deutsche mark in the Euromarkets; in 1987, however, they fell back to more usual levels.

The path by which surpluses of the Federal Republic of Germany help to finance the United States deficit appears to be largely indirect. In contrast to Japan, which was itself acting as a financial intermediary, European financial markets seem to be an important intermediary of the outflows of the Federal Republic of Germany, which helps to explain why that country persistently shows a substantial net outflow of short-term capital as well as, usually, an outflow on long-term account (see figure IV.6).

Thus, the international financial activities of Japan and the Federal Republic of Germany, along with other surplus economies, have provided large volumes of resources that, through various channels, help to finance the United States balance-of-payments deficit. In fact, the composition of the net flows coming into the United States has changed significantly in recent years, as longer-term financial instruments such as securities and direct investments have increasingly come to dominate net private inflows (see table A.III.12).

From 1983, when the deficit opened up, until 1985, net financing was entirely by private capital flows. The magnitude and composition of these flows were dictated largely by interest-rate and exchange-rate expectations, the desire of major surplus countries of Asia to accumulate United States assets, and the globalization of capital markets. Private flows took the form mainly of banking inflows, foreign purchases of United States Treasury securities and corporate Eurobonds, and a sizeable increase in foreign direct investment in the United States, spurred partly by increased fears of United States protectionism. Purchases of United States equities were modest, however, because of foreign concerns about the profitability of United States industry in the light of a strongly appreciating currency.

Beginning in 1986, mainly in response to the depreciation of the dollar, the mix of capital inflows into the United States changed dramatically. Coinciding with a further sharp widening in the United States current-account deficit was a $22 billion fall in net private inflows. This was due to a $70 billion rise in United States private outflows, almost all of it in the banking sector,[29] while foreign private inflows to the United States also increased, but by only $48 billion. In 1987, the private outflow slowed but so did the private inflow, so that the measured net private inflow was unchanged. Foreign private purchases of Treasury securities more than halved in 1986 and there was a $6 billion net sell-off in 1987, due to fears about the likely further fall of the dollar and about the ability of the United States Government to curb its large budget deficit. Foreign investors purchased almost $40 billion worth of United States corporate bonds in 1986, but only $22 billion worth in 1987, as investors outside the United States grew concerned about the direction of the dollar and the credit quality of many United States issuers. Banking inflows were about the same in 1987 as in 1986, but banking outflows fell back so that the net inflow from banks roughly doubled, to about $45 billion. The change reflected a widening of interest rate differentials on average for the year in favour of United States dollar investments.

Accompanying the decrease in foreign holdings of United States Treasury securities was a substantial increase in foreign purchases of United States corporate equities in the first three quarters of the year. The increased demand for United States equities reflected the potential they offered for relatively higher returns as United States industry was growing increasingly competitive after successive rounds of dollar depreciation.

For 1987 as a whole, Japanese buyers accounted for over 70 per cent of foreign purchases of United States stocks. The reason the share of Japan was so high was that Japanese investors continued to be net buyers of stocks in the fourth quarter of the year, when foreign shareholders as a whole sold off almost $8 billion in stocks in the aftermath of the stock market crash.

The shift to equities was accompanied by an increase in foreign direct investment in the United States in 1986 and 1987, exceeding $40 billion in the latter year. In fact, total direct investment was probably considerably higher since a large portion is financed through borrowing, mostly in the United States.[30] The net flow of direct investment in the United States as measured, however, has been small, as United States direct investment outflows have doubled over the past two years, in part reflecting exchange gains on overseas profits that are reinvested in the foreign affiliates.

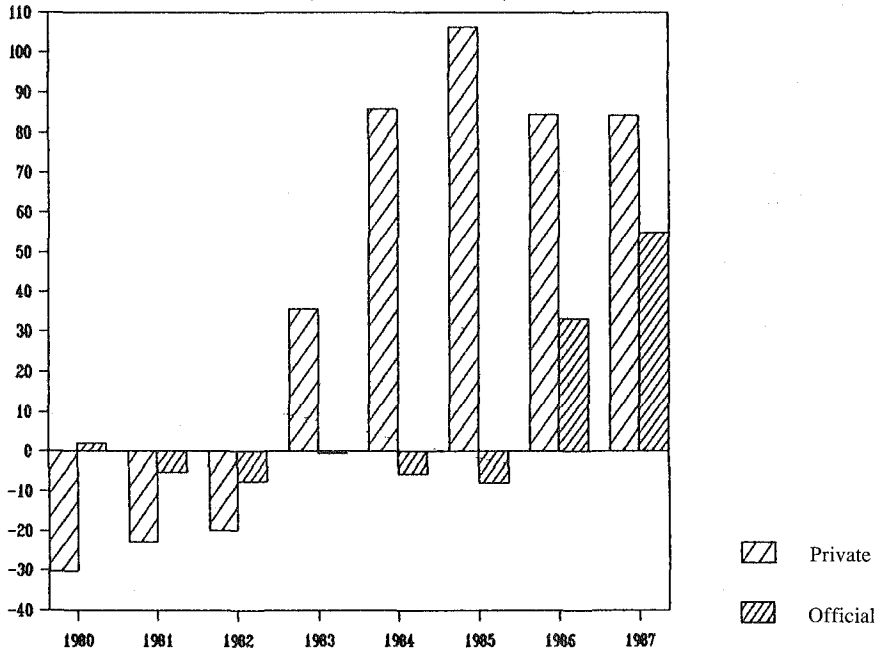
The above notwithstanding, the most striking of the recent changes in the financial flows to the United States is the growing importance of official capital inflows. Net inflows to United States residents from private sources have stagnated at around $85 billion since 1984 (see figure IV.7), while the current-account deficit has grown steadily. Inflows directly from foreign official sources have grown, reaching 34 percent of the total current-account financing in 1987.

29 An interesting asymmetry is that in some discussions of developing countries' international financial relations, sharp increases in private outflows such as those shown for the United States banking sector in 1986, are called "capital flight", while in the case of the United States, the discussion is usually in terms of the financial incentives of investing in different international capital markets.

30 See Morgan Guaranty Trust Company of New York, *World Financial Markets*, November/December 1987, p. 8.

Figure IV.7. Net foreign financial flows *vis-à-vis* United States residents

(Billions of dollars)



Source: United States Department of Commerce, *Survey of Current Business* (official flows understate total flows originating from foreign official sources, as discussed in box IV.3).

This, however, understates the total inflow that originates from official sources, which seems to have accounted for about two thirds of the total financing (see box IV.3).

Official finance and exchange rate management

Central banks of the major industrial countries intervened heavily, and in a co-ordinated manner, during 1987 in an effort to stabilize exchange rates. United States intervention, the first in the dollar's three-year decline, amounted to about $9.2 billion in dollar purchases. Intervention by the Group of Seven, excluding the United States, is estimated at over $60 billion in dollar purchases in 1987. The President of the Deutsche Bundesbank has stated that the dollar reserves of the bank rose by $15 billion over the full year. Japanese reserves grew by $38 billion, almost all of which were probably dollar purchases. Not all the intervention activity was aimed at stabilizing the dollar—indeed, significant intervention took place to support parities within the European Monetary System (see box IV.4). But much of it was dollar-related, particularly following the Louvre Accord of 22 February 1987, and, in any event, by building up central bank dollar holdings, it served to reduce the excess supply of dollars on the world's foreign exchange markets.

Box IV.3. How large was official financing of the United States balance of payments in 1987?

Measuring the magnitude of official financing of the United States current-account deficit entails considerable estimation. United States balance-of-payments data, in particular, tend to understate the magnitude. Balance-of-payments data show that in 1987 net private capital inflows—defined to include the statistical discrepancy—amounted to $106 billion, insufficient to finance the country's $161 billion current-account deficit. Official flows of about $55 billion covered the balance (34 per cent); these flows largely took the form of purchases of United States Treasury securities as central banks invested the proceeds of intervention operations in exchange markets.

While these data point to a larger role for foreign official financing of the United States payments deficit, they understate the magnitude of official financing. This is because foreign central banks may acquire dollar-denominated assets on the Euromarkets or from Japanese and other financial institutions outside the United States and, by however circu-

itous a route, they subsequently appear in United States balance-of-payments data as private inflows. Changes in the official reserves of key trading partners of the United States could thus be taken as a second indicator of the extent of official financing of the United States deficit.

Since the members of the Group of Seven industrial countries agreed to intervene in foreign exchange markets to support the dollar, they were expected to account for the bulk of the official dollar financing, as indeed they did (see the table), nevertheless, all foreign dollar accumulation has the same financial flow effect on the world dollar market, and so total reserve accumulation outside the United States is also of interest.

Official foreign exchange reserves of the Group of Seven, excluding the United States, expanded by $104 billion during 1987. The increase of $38 billion in Japanese reserves alone could account for the bulk of the official inflows, as suggested by the United States payments data cited above. If the increases in foreign exchange reserves of Taiwan, Province of China, are added, the total gain in reserves rises to $134 billion. Including the changes in reserves for all other countries, again excluding the United States, raises the total increase to over $200 billion. If the previous share of dollars in total world foreign exchange reserves—that is, a little over two thirds—is applied, the increase in reserves outside the United States implies central bank purchases of about $142 billion in dollars in 1987.

When exchange rates change, however, nominal changes in the level of reserves do not adequately reflect the official financing flow. Since central banks accumulate non-dollar reserve assets as well as dollar assets, there is a valuation adjustment problem. Because the depreciation of the dollar raises the dollar value of the non-dollar reserves, changes in the stock of total reserves overstate the flow of purchases of reserve assets.

Estimates by IMF of the currency composition of foreign exchange reserves (as published in aggregate in IMF *Annual Reports*) permit a direct estimation of reserve changes. This reveals a somewhat smaller gain in 1987 in the reserves of the Group of Seven, excluding the United States: $86 billion, compared with the $104 billion increase in unadjusted reserves, as shown in the table. The same exercise applied to the world as a whole implies total reserve accumulation outside the United States of $161 billion. The dollar component of that was approximately $108 billion, which was almost two thirds of the United States current-account deficit and may be taken as a gross estimate of the share being financed through official channels in 1987.

Changes in foreign exchange reserves
outside the United States in 1987

(Billions of dollars)

	Quarter			
	I	II	III	IV
Group of Seven countries excluding the United States	36.2	16.4	3.4	47.5
Germany, Federal Republic of	8.2	2.3	1.5	15.0
Japan	15.8	10.5	2.8	8.9
United Kingdom	3.1	7.4	0.5	12.7
Canada, France, Italy	9.2	-3.8	-1.4	10.8
Other industrial countries	6.7	14.5	10.7	13.3
Other economies	11.6	12.6	11.2	19.0
Taiwan, Province of China	8.2	6.2	4.2	11.8
Other	3.4	6.4	7.0	7.1
Total	54.5	43.4	25.2	79.7
Memorandum item				
Change in foreign exchange reserves at constant, start-of-quarter exchange rates				
Group of Seven, excluding the United States	30.7	16.8	3.1	35.5
World, excluding the United States	43.0	42.3	22.3	53.2

Source: IMF, *International Financial Statistics*, and estimates of the United Nations Secretariat, based on data supplied by IMF.

On balance, the trade-weighted value of the United States dollar—as measured using the IMF Multilateral Exchange Rate Model (MERM)—fell by 13 per cent between the time of the Louvre meeting and the end of 1987, most of the weakness following the global equity market decline of late October. During this period, the dollar depreciated the most against the yen and the pound sterling (16 percent each); it weakened by 10 per cent against the continental European currencies.

The magnitude and co-ordinated nature of central bank intervention may have slowed the pace of dollar depreciation, relative to previous bouts of weakness since the dollar's peak in February 1985 (see table IV.6). The massive intervention, however, was supported by co-ordinated interest rate adjustments and other efforts to redress underlying economic imbalances. Thus, in mid-March, less than a month after the Louvre Accord, downward pressure on the dollar mounted and the dollar fell despite heavy intervention by United States and European central banks. But United States long-term interest rates rose sharply and the Federal Reserve acted to tighten monetary conditions at the end of April. From early May to mid-August 1987, the dollar gained strength, bolstered by the release of favourable data on United States economic activity, by tensions in the Middle East, by the announcement of expansionary fiscal measures by Japan, and by the reaffirmation of the Louvre Accord at the Venice summit of industrial countries in June. Nevertheless, between mid-August and mid-October, the dollar came under renewed downward pressure, owing to

Box IV.4. Exchange rate management in the European Monetary System in 1987

Developments within the European Monetary System (EMS) in 1987 generally mirrored pressures on global foreign exchange markets. The year began with a realignment of EMS currencies that revalued the deutsche mark and the Netherlands guilder by 3 per cent and the Belgian franc by 2 per cent, relative to bilateral central rates against other currencies in the System. The realignment, the second in less than a year, occurred in the light of the massive capital movements associated with the weakness of the United States dollar. Indeed, both the April 1986 and the January 1987 realignments were associated with particular dollar weakness, which emphasizes the tendency for strains within EMS to be greatest during such episodes, owing to the position of the deutsche mark as the strongest EMS currency and thus the closest substitute for the dollar. Tensions within EMS were largely absent during the period of dollar strength from May to August; difficulties re-emerged in September, however, when the dollar came under added pressure as the weaker EMS currencies failed to keep pace with the strengthening deutsche mark. As a result, there was some expectation of a further realignment; when this did not occur and Italy announced a series of measures to dampen speculation on the lira, tensions subsided. The dollar's further weakness in the wake of the 19 October stock market decline, however, put EMS under renewed pressure at the end of the year.

The response to the tensions arising in the final months of 1987 partly reflected the Nyborg (Denmark) Agreement, adopted on 8 September by the governors of central banks of States members of the European Economic Community. The Agreement aims at strengthening the operating mechanisms of EMS to foster greater exchange rate cohesion, in particular by permitting joint financing of exchange market intervention to take place before a member currency reaches its floor or ceiling price. It also provides for stronger procedures for policy co-operation. Extension of the financing facilities for EMS intervention is another significant component of the package. The Agreement apparently guided the co-ordinated changes in official interest rates in early November—cuts in the Federal Republic of Germany, the Netherlands and the United Kingdom and an increase in France—and reductions in late November by Belgium, France, the Federal Republic of Germany, the Netherlands, the United Kingdom and other European countries.

Although the pound sterling has remained outside the exchange rate mechanism of EMS, the United Kingdom interest rate and intervention policies between early 1987 and early 1988 were directed partly at stabilizing the sterling exchange rate against the deutsche mark at around DM 3.00. In October, when the pound was pushing up against the unofficial DM 3.00 ceiling, the Bank of England intervened in the amount of $6.7 billion to restrain sterling. And in November, a period of dollar weakness, the pound was kept below the ceiling most days, showing up in a $31 million rise in reserves. However, the United Kingdom authorities finally capitulated to the relentless upward pressure on the pound in the early months of 1988, forsaking intervention and allowing the pound to rise above DM 3.10.

The strengthening of co-operation within EMS in 1987 meant that a larger share of exchange market intervention was aimed at supporting EMS parities. This suggests that a fair part of the 1987 reserve gains of the Group of Seven excluding the United States, was aimed in the first instance at supporting EMS parities rather than the dollar.

Part of the plans for a unified European market by 1992 includes complete liberalization of capital flows, as proposed by the Commission of the European Communities. Any further freeing of capital flows, however, may complicate the achievement of exchange rate stability within EMS and thus requires a simultaneous strengthening of the System. In this connection, the Nyborg Agreement contributes to the objective of enhanced exchange rate stability.

Table IV.6. Phases in the depreciation of the dollar, February 1985—January 1988

	Average monthly depreciation[a] (percentage)	Cumulative real depreciation to last month of period[b] (percentage)	Average monthly rise in reserves of Group of Seven, excluding the United States[c] (billions of dollars)	Intervention by United States authorities
Pre-Plaza Accord (Feb.-Sept. 1985)	1.3	9.0	0.5	$565 million purchases of foreign currency
Post-Plaza Accord (Sept. 1985-May 1986)	2.3	25.0	1.1	$3,301 million purchases of foreign currency
Pre-Louvre Accord (May 1986-Feb.) 1987)	1.1	34.0	4.3	$50 million sales of foreign currency
Post-Louvre Accord (Feb. 1987-Jan.) 1988)	0.9	41.0	6.1	$661 million purchases and $9,909 million sales of foreign currency

Source: Information supplied by the International Monetary Fund and estimates of the United Nations Secretariat.
a In terms of nominal effective exchange rate (MERM index), monthly averages.
b Real effective exchange rate of the United States dollar, defined in terms of normalized unit labour costs.
c Average change in foreign exchange reserves at constant, start-of-the-period exchange rates.

disappointing trade figures and rising concern about more rapid growth of the money supply in the Federal Republic of Germany and Japan—which was related to interest-rate movements in support of the dollar and central bank intervention. In the weeks immediately preceding the 19 October stock market drop, interest rates rose in a number of countries, including the United States and the Federal Republic of Germany.

Following the equity market drop, the dollar once again came under heavy downward pressure, partly because interest differentials in favour of the dollar narrowed when United States interest rates fell substantially. But this was followed by three rounds of concerted European interest rate reductions in November and December—including a 50-basis-point drop in the Bundesbank discount rate to 2.5 per cent—which restored the interest differentials to their levels prior to the equity market crash. Although the interest rate moves were accompanied by substantial intervention, the dollar fell sharply in the last two months of 1987 because of disappointment with measures to reduce the United States budget deficit, a fall in oil prices, poor United States trade figures and uncertainty about a prospective new agreement on policy co-ordination. The joint statement made on 22 December by the finance ministers of the Group of Seven countries reaffirming the objectives and policy directions of the Louvre Accord also failed to reverse the trend, the market apparently being disappointed at the statement's lack of new policy initiatives.

In sum, the record of exchange market intervention in 1987 suggests that it is most successful when combined with supporting interest rate moves—that is, when it is partially "unsterilized".[31] Indeed, perhaps the greatest success of intervention in 1987 was that it helped to alter the course of monetary policy in the Federal Republic of Germany and Japan in the direction of increased expansiveness. It should also be seen in conjunction with co-ordination of fiscal policies, such as the announcement during the year by Japanese authorities of fiscal stimulus measures.

But caveats about the limits of intervention are also in order. First, market nervousness is not something immediately allayed by policy. Exchange rate stability eluded the markets at the end of the year, although the markets stabilized in the first quarter of 1988. Secondly, the consequence of a period of extensive intervention is that it can have economic costs, including the losses borne by central banks when a depreciating dollar reduces the value of substantially enlarged dollar reserves. Even in 1987, for example, the Bundesbank

31 Intervention to support a falling dollar entails central bank purchases of dollars with, say, deutsche mark. This increases the supply of deutsche mark in world financial markets and reduces the amount of dollars somewhat, tending to reduce interest rates of the Federal Republic of Germany and raise those of the United States. When central banks counter the money supply effects of intervention by buying or selling their own Government's securities, they are said to sterilize the intervention, which is the usual practice.

reported a sharp fall in its profits due to exchange rate losses; this, in turn, led to a deterioration in the fiscal balance of the Federal Republic of Germany and made it more difficult for the authorities to adopt an expansionary fiscal stance.[32]

But even if losses not resulted from the dollar's fall in 1987, the exposure to losses would remain and the size of the potential losses would grow as continued intervention kept increasing the size of the dollar balances held. That possibility could strengthen the commitment of monetary authorities to support the dollar longer in order to prevent its decline, as long as it is part of a concerted programme for a smooth unwinding of current imbalances.

Causes and consequences of the stock market crash of October 1987

The crash on 19 October 1987 abruptly ended the unusually rapid run-up in world equity values that had begun in 1982 and accelerated in most markets in the last quarter of 1986 (see figure IV.8). Average stock prices rose more in markets outside the United States during most of the period 1982-1987, and in many they fell significantly further during the crash, with the notable exception of the Japanese marlet. The stock-price decline was unprecedented in magnitude—on the day of the crash alone, the Dow Jones Industrial Average of the United States lost 508 points or 22.6 percent. Subsequently, stock prices in world markets were highly volatile and average share prices stayed down for the remainder of the year. The drop in the monthly average industrial share indexes between September and December was 26 per cent for the United States; it ranged between 20 percent and 33 percent for Canada, France, the Federal Republic of Germany, Italy and the United Kingdom; and was 12 percent for Japan. Smaller markets showed similar variations in their decline during the period September-December, although considerably greater declines were registered in some economies, such as Australia (over 40 per cent) and Hong Kong (over 50 per cent). The decline of the Mexican market was particularly dramatic: from its all-time peak on 6 October to the end of December it fell 72 percent, but this occurred after a very large increase in prices earlier in the year.[33]

The crash highlighted the importance of the growing globalization of equity markets that has taken place in recent years and the strength of equity markets outside the United States. The current dollar value of equities listed on the Tokyo market, in particular, has recently comprised 44 percent of world-wide equity value outstanding, as compared with 30 percent in United States markets, according to industry sources. Linkages between stock markets are expanding as well. In 1986, cross-border trading volume reached $750 billion and increased in the first half of 1987 by an additional 50 percent.

The rising importance of cross-border equity trading can be attributed to several factors: sophisticated communications and trading technology, which make it profitable for traders and even issuers to move between markets when prices appear out of line; volatility of exchange rates, which has created both speculative and hedging incentives to hold securities whose prices are denominated in different currencies; and relaxation of both official restrictions and barriers to competition in equity markets, especially outside the United States. Part of international equity market activity can also be associated with the current-account deficits of the United States and the large capital flows it has pulled to that country, some of which took the form of equity purchases.

Globalization of equity markets is a natural extension of the internationalization that has already taken place in the interbank and securities markets, although the process carries with it some new implications and challenges. Share prices are driven much more by expectations than are bond prices. Depending on the expectations of investors in different parts of the world, stock prices in different markets can suddenly move in harmony or discord.

The crash of 19 October presents the most dramatic example to date of a sympathetic drop in equity values. Apparently driven by the New York market, foreshocks having appeared the previous week, the impulse spread to other markets in developed and developing countries, including Japan.[34] There followed a widespread repatriation of funds that had been invested in foreign equities. In the United States, for example, the third and fourth quarters of 1987 were marked by substantial declines in foreign stocks held by United States residents as well as even larger declines in United States stocks held by foreign residents (see table IV.7).

By the spring of 1988, stock indexes had recovered by sizeable amounts, but at highly divergent rates. By the first

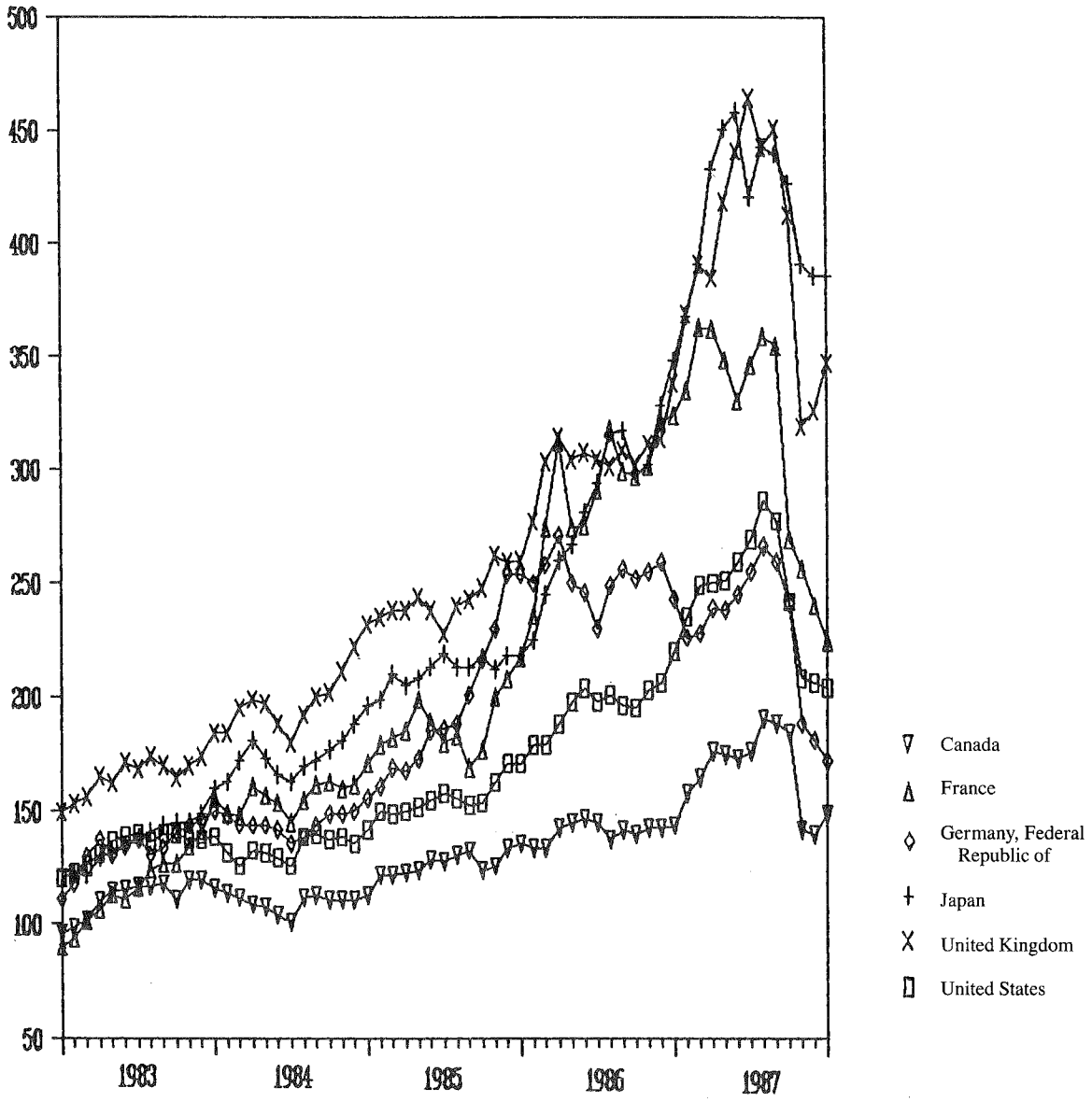
32 The Deutsche Bundesbank recently reported profits of DM 0.3 billion for 1987, down from DM 7.8 billion in 1986, and that DM 0.2 billion would be remitted to the Government, down from DM 7.3 billion the year before.

33 Although the Mexican decline began before the 19 October crash, one third of the total fall to the end of December took place on 19 and 20 October. The Mexican index finished the year 124 percent above the level of the previous year, which was less than the year's inflation rate (see El *Mercado de Valores* (Nacional Financiera), 1 February 1988, pp. 32-34).

34 Prior to 19 October, a few forecasters had predicted that a global crash would begin with a drop in the Tokyo market. Ratios of stock prices to dividends in Japan had become over five times those in the United States, which was thought to be part of the same phenomenon that led to soaring real estate prices. Among other factors, speculative investments by Japanese non-financial corporations were channelling surplus funds into equity markets.

Figure IV.8. Industrial share prices

(1980 = 100)



Source: OECD, Financial Market Statistics.

quarter of 1988, the Japanese Nikkei index had nearly returned to its pre-crash high, growing over the quarter by 19.7 percent, and with a net increase in foreign purchases. The indexes of some smaller markets such as those of Belgium and Sweden increased even more, while the Dow Jones Industrial Average of the United States grew by only 2.5 percent over the quarter, leaving the index 8.1 percent below its 13 October level.

Main factors behind the crash

The crash revealed strengths and weaknesses of the major—and some of the smaller[35]—stock markets around the

35 At one extreme, the Hong Kong stock exchange closed for four days (20-23 October), after a 9-day period in which the Hang Seng Share Price Index fell 41 percent. When the market reopened, prices fell by roughly another third as the sell orders accumulated during the closure were transacted. A major private and official rescue effort sought to restore liquidity to the stock market and the related futures market, and a process of reform was set in motion. In marked contrast, stock markets that were insulated from international stock trading largely escaped the crash, as, for example, in the Republic of Korea and Venezuela.

Table IV.7. Selected financial transactions between the United States and other countries, 1986-1987

(Billions of dollars)

	1986				1987			
	I	II	III	IV	I	II	III	IV[a]
Net purchases of foreign securities by United States residents	5.9	1.1	-0.6	-3.1	1.3	-0.4	0.9	1.8
of which:								
Foreign stocks	1.9	2.0	-1.2	-2.0	1.2	0.5	-0.4	-3.9
Foreign bonds	4.0	-0.8	0.6	-1.1	0.1	-0.9	1.3	5.7
Net private foreign purchases of United States private securities	18.6	22.9	17.1	12.3	18.5	15.9	12.7	-4.9
of which:								
United States stocks	5.9	6.8	4.2	0.1	9.8	8.4	5.0	-7.8
Corporate and other private bonds	12.7	16.1	12.8	12.2	8.7	7.5	7.7	2.9
Net foreign official purchases of marketable United States Treasury bonds	1.4	5.6	3.4	4.0	8.2	10.7	6.2	6.1

Source: United States Department of Commerce, *Survey of Current Business.*

[a] Provisional.

world. One concern was whether the markets had become victims of a generalized speculative bubble that had suddenly burst. As discussed in annex II below, the ratios of share prices to current dividends in most major markets were at levels substantially higher than would ordinarily be expected given long-term interest rates. Further, the amounts of the apparent "overvaluation" in share prices in late summer were roughly consistent with the subsequent declines in equity prices that occurred between late summer and the end of 1987.

Another concern was whether there were specific features of each market that were dominant determinants. The Japanese market showed itself to be particularly strong, the United States market relatively vulnerable. The superior performance of the Japanese market can be attributed to a number of factors. A high percentage of market capitalization is accounted for by domestic Japanese funds, and there was considerable Japanese repatriation of funds previously invested in foreign markets, especially New York. Macro-economic variables—strong real growth forecasts, low interest rates and a stable yen—continued to attract domestic funds and foreign investors into Japanese equities. In addition, Japanese regulations included daily limits of about 15 percent on the variation in stock prices, which may have forestalled panic selling in October. Moreover, investors perceived the market as receiving protection from the Government of Japan. As if to confirm that expectation, in January 1988 Japanese authorities postponed adopting a new accounting rule for tokkin investment funds that would have increased tax liabilities against these funds, and life insurance companies were allowed to increase from 3 percent to 5 percent the level of total assets that could be invested in such funds.

In the United States, where large paper losses shook the confidence of investors, policy makers and market professionals, explaining the crash became the subject of much study and controversy. As shown in annex II, there are indications that United States stocks were overvalued. In addition, the principal focus of studies by many of those most directly involved in financial markets has been possible weaknesses in market mechanisms. Recent innovations in trading techniques and instruments—in particular, "programme trading" involving stock index futures—were alleged to cause destabilizing trading behaviour, which in turn was said to have weakened overall confidence in the market. Another view pointed to economic fundamentals. It attributed the crash and subsequent volatility in stock prices to rising pessimism and uncertainty regarding economic policies, with major emphasis on the fiscal and current-account deficits of the United States, and how adjusting them would affect world financial and currency market stability, trade and growth. These two sets of views on the crash may be strongly related, since fragile markets are likely to be vulnerable to adverse information about macro-economic trends.

Faults in the stock market mechanism

The subject of most study and controversy has been the so-called programme trading involving stocks sold on the New York market and futures contracts tied to movements of indexes of stock prices that are sold on futures exchanges,

mainly in Chicago.[36] Buying or selling index futures contracts is significantly less expensive than buying and selling the corresponding set of stocks, and large investors have used index contracts as a means of speculating on movements in stock prices. In addition, large institutions such as pension funds have used the technique in hedging their portfolios—that is, protecting against a drop in the price of their stocks by selling futures contracts. If prices of the stocks represented in the index were to fall, the value of the index would also fall, resulting in a profit when the investor delivers the contract and is paid an amount related to the earlier, higher index. A popular type of hedging strategy which uses this approach has become known as "portfolio insurance". It was offered by investment advisory firms to pension fund clients on a large scale in 1987. Computer programmes would identify trigger points—usually after the Standard and Poor's index had taken a distinct downturn—at which sales of futures contracts in specified amounts should take place.

For the hedge or "insurance" to work efficiently, it was necessary that the value of the futures contract move closely in line with the Standard and Poor's index. Arbitrageurs in fact operated at low enough cost to keep the price of the futures contract and the Standard and Poor's index within rather close limits of each other. The combination of arbitrage and hedging capability appeared to reduce the risk of market fluctuations to large investors and permit large-volume trades without inducing serious price variability—that is, adding "liquidity" to the market—at low cost.

Some time before the crash, questions about the functioning of programme trading began to arise. As several post-crash studies revealed, many regulators and market participants came to believe that the futures market was linking stock and futures markets only too well. There was a suspicion that speculation in the futures market was at times driving the cash prices of the stocks included in the index, although this has been impossible to prove. Difficulties were seen in the way in which stocks and futures contracts could be purchased with borrowed funds. In both cases, the investors have to maintain a "margin" account, usually through a broker firm acting as an intermediary. Although margin requirements on stock purchases on the New York Stock Exchange are 50 percent for most investors, futures index contracts can be purchased with margins of only 15 percent or less, making them susceptible to greater speculative flows.

There were also complaints that, with the growth of institutional investors that deal rapidly and in large volume, too little attention was being paid to "company news" reflecting the true worth of firms and too much to speculating on broader macro-economic developments. Futures markets and related options markets, many believed, had provided the vehicles by which speculative tendencies and "herd instincts" could more easily drive stock market prices.

Another complaint was that the futures market was being misused or misunderstood. The system was designed to provide protection against modest, day-to-day fluctuations in price, not generalized and sustained drops. There is no means by which large drops in stock prices can be hedged; yet, it was argued, many firms were taking positions in stocks without regard to the possibility that a large number of firms would try to sell stocks or futures at the same time. This not only made the market vulnerable to declines, but may actually have produced excessive confidence on the part of institutional investors which encouraged the rapid, pre-crash run-up in equity prices.

Some believed that programme traders were culpable in deepening, if not causing, the crash. The Securities and Exchange Commission of the United States, in a study of the week of decline that culminated in the crash, reported that 30 per cent to 68 per cent of the sale of stocks at various times in the week from 14 to 20 October were accounted for by programme traders. According to the report of the Presidential Task Force on Market Mechanisms (the Brady Commission), portfolio insurance accounted for 20 per cent of futures selling and 10 percent of stock selling in the 19 October plunge. One institution did most of the selling on that day. The Securities and Exchange Commission reported that stock-index arbitrage accounted for more than one third of all stock transactions during two short, but critical, transaction periods on 19 October.[37]

Another argument is that imperfections in the links between the stock and index-futures markets produced or exacerbated the decline. For example, inadequacies in computer capability in the New York market and in financial resources of market-makers (also primarily in the New York market) led to frantic dumping of stocks at the New York Stock Exchange on 19 and 20 October. Sell orders overloaded the Exchange's Direct Order Turnaround (DOT) system, making it impossible to execute many sales. No such problem existed at the Chicago futures market, where traders could sell stock index contracts cheaply and quickly.[38] As a result, the spreads between the average prices of the actual shares in the New York market and the prices implied by the futures

36 The Kansas City Futures Exchange opened the first futures contract on a stock index (the Value Line index of stocks) in February 1982. This was followed in April 1982 by the contract on the Standard and Poor's 500 index at the Chicago Mercantile Exchange and on the New York Stock Exchange composite index in New York in May 1982. The Standard and Poor's 500 has dominated the market. This, like most of the other index contracts, involves "cash settlement"—that is, at maturity, the deliverer (the one who has sold the futures contract) must pay $500 for each point that the Standard and Poor's index has risen above the originally contracted price or, if the price falls below the contracted price, the deliverer will receive $500 for each point.

37 *Report of the Presidential Task Force on Market Mechanisms* (The Brady Commission Report), (Washington, D.C., United States Government Printing Office, 8 January 1988); *The October 1987 Market Break*, Securities and Exchange Commission Staff Report, (Washington, D.C., United States Government Printing Office, February 1988).

38 A different problem, however, did exist in Chicago, namely, the failure of floor traders on the Chicago Mercantile Exchange to absorb more of the large sales in index futures contracts that were coming in. Greater participation of these traders on the buying side of these contracts might have helped support the futures contract prices during critical periods, but traders were insufficiently capitalized and could not substantially increase their own holdings of the contracts.

contracts became the widest ever seen. This would have been prevented if arbitrageurs had sold stocks in the New York market and bought the lower-priced futures contracts in Chicago, but since sales could not be quickly executed in the New York market, the arbitrage broke down. The situation was aggravated by the many "specialist" firms on the New York exchange that are given trading control over specific stocks in exchange for a commitment to stabilize prices in those stocks. The firms were unable to function with their existing levels of capital when the volume of traded shares jumped. As stock prices fell, the resulting loss of capital made many specialist firms suspend trading in certain stocks, including some which make up the index underlying the Chicago futures contract. Thus, while traders could still conveniently buy futures contracts representing certain combinations of stocks, there was temporarily no means by which the corresponding New York Stock Exchange stocks could be traded.

Uncertainty about macro-policies

The second major interpretation of the reason for the crash and subsequent stock market volatility directly addressed the fact that the crash was not restricted to the United States market, but reflected investor concerns in Europe, Asia and some Latin American countries as well. In all these centres, there was a rising level of adverse expectations or uncertainty about the course of macro-economic policies of the major economies. As discussed previously, there had been some early signs of success in 1987 in policy co-ordination among the major industrialized market economies. Both the Federal Republic of Germany and Japan had pushed fiscal policies into moderately expansive directions in 1987, and massive official purchases of dollars in foreign exchange markets were partially unsterilized, leading to an easing of monetary conditions in both countries. The fiscal policies of the United States had become moderately contractionary and United States monetary conditions began to tighten.

Yet, several other developments, however, were disturbing to investors. First, the pace of United States adjustment was extremely slow and appeared to require a further build-up of the external debt of that country in the medium term. Although the United States federal deficit as a percentage of GNP had declined from 5.3 percent in 1985 to 3.4 percent in 1987, this was slow progress and Congressional budget negotiations did not seem to be accelerating the adjustment. Inability to correct the fiscal imbalance implied that at some time there would have to be a strong downward adjustment in dollar exchange rates, if only to reduce domestic private expenditure and thereby shift resources towards financing the fiscal deficit; or there could be a tightening of monetary policy by the United States Federal Reserve to prevent the exchange rate from falling, while also shifting expenditure. The dollar "free-fall" scenario entailed several distressing implications, including a cut-off in foreign purchase of dollar-denominated securities, renewal of United States inflation, high interest rates and domestic recession. But to monetarists in the financial markets, the threat of dollar-support by means of monetary policy was the more troublesome possibility. Noting that economic activity and stock price movements have been correlated with changes in the rate of growth of the money supply (the former lagging behind the latter), monetarists were already watching reduced rates of money growth in the United States with concern. Large-scale defence of the dollar through additional monetary tightening was, to them, tantamount to inducing a recession and a stock slump.[39]

A second development that was disturbing to financial market participants in 1987 was the rise of United States interest rates in the spring, associated with reduced willingness of private foreign investors to acquire United States Treasury obligations. The rise in interest rates was primarily at the long-term end (i.e., the yield curve "steepened" at a time of rising interest rates), a phenomenon often associated with expectations of inflation over the longer term. While the rise in United States interest rates could be perceived as due in part to monetary policy actions, it also seemed to imply serious scepticism about the willingness or ability of the United States to correct its fiscal and external imbalance.

Finally, questions were raised about the sustainability of the dollar-support programme as carried out after the Louvre Accord in February 1987. The major form of this support was intervention in foreign exchange markets in which Governments other than that of the United States purchased dollars and converted those balances into United States Treasury securities. The fact that some private flows had ceased moving towards the United States itself implied negative expectations in the private sector. How long the official flows would be maintained became an issue of some uncertainty.

Short-term consequences of the crash

First, although the crash caused an almost immediate downward revision of most forecasts of world growth, concern seemed to have dissipated by the spring of 1988. Real growth prospects have been revised to pre-October levels. The widely feared "wealth-effects" were to have induced a cut-back in expenditure by people who felt less well off, plunging the industrialized countries into a recession or at least slowing growth. But none of this occurred—in part, because stock ownership is a relatively small component of private wealth, and because of positive wealth effects from rising bond prices and falling interest rates. In addition, economic indicators did not point to fragility in the real side of the economy[40] and so expenditure cut-backs were not prompted on that score either. As pointed out by many financial analysts, the robustness of the real side distinguishes those instances in which an equity market crash does not precede a general financial collapse and real-side downswing, as in 1962, and those in which it does, as in 1929. The major symptoms of international imbalance—the developing country debt problem and the United States external def-

39 Many monetarists posit a more direct relation between money stock growth and stock prices. A slow-down in monetary growth, for example, would raise real interest rates and induce investors to shift from equity investment to bonds.

40 Most evidence has been favourable: leading indicators, low reported inflation rates and consumer confidence surveys.

icit—of course continued to be important issues, although apparently they were not sufficient to cause major downward shifts in private spending.

The major studies of the United States stock and futures market mechanisms produced proposals that were designed to (a) strengthen the technical efficiency of both the stock and stock-index markets in ways that would strengthen each market separately as well as improve the functioning of the arbitrage process; (b) increase surveillance and control over the individual markets, especially by means of price limits and other market "circuit breakers" that stop trading for short times during periods of extreme volatility; (c) create consolidated surveillance and control over the stock and index-futures markets; and (d) better balance the costs of operating in the futures and cash markets primarily by increasing margin requirements in the futures market.

Action taken thus far has been rather modest. Measures have been taken to increase market efficiency, such as requiring "specialist" firms to have more capital. Since most had already added to their capital, this appeared to be primarily for public relations purposes. Additional circuit breakers have included new price limits in futures markets and suspension of access to the Direct Order Turnaround system by programme traders on the New York Stock Exchange when the Dow Jones Industrial Average of stock prices rises or falls more than 50 points. No explicit coordination of the futures and cash markets was introduced and there has been almost no progress in consolidating control and surveillance.

At the private level, a number of firms have curtailed programme trading activities in the interest of investor relations and portfolio insurance is a much less heavily practiced investing strategy by large brokerage houses on behalf of their clients, although some brokerage houses have been engaged in more speculative use of programme trading on their own account. Although the issue is undecided, a movement has emerged in the financial community to ban programme trading entirely.

In the area of regulation of the banking and financial sectors, the shock to financial stability appears to have created momentum for a movement that seeks to re-examine the recent push towards deregulation of financial markets. In the United States, in recent years, pressures on commercial bank earnings have created a strong sentiment for repeal of the Glass-Steagall Act which separates securities underwriting activities from commercial banking. Although it is too early to say whether this repeal movement will be significantly diluted because of the crash and recent financial volatility, it is certain that the crash has extended the debate and provided arguments for the opponents of the deregulation of banking.

Chapter V

THE INTERNATIONAL OIL MARKET

For almost the whole of 1987, international oil prices remained within a narrow range of $17 to $18 a barrel, higher than the average price of approximately $14 a barrel in 1986 but well below the price of $28 a barrel which had prevailed in the previous three years. Oil demand continued to increase, although at a lower rate than in 1986.

Many oil-importing countries benefited from the low prices of crude oil, especially those with appreciating national currencies *vis-à-vis* the United States dollar. Several of the oil-exporting developing countries, however, experienced foreign exchange difficulties.

Throughout 1987, a lack of timely and accurate information caused serious uncertainties about the level of oil consumption, production, stocks and prices.

Accurate information about market conditions and the outlook for the world's most important commodity is obviously essential to the planning both of Governments and of companies. The information available, however, is unreliable. Traders swap billions of barrels of oil, speculators trade billions of dollars in futures contracts and oil companies make huge business expenditures based partly on statistics that are likely to be inaccurate.[1]

Some of the uncertainty is due to national policies in countries which regard information on petroleum reserves, production, stocks and even trade as secret; much of it, however, is due to weaknesses in national reporting capacities and the lack of an agreed international reporting system.[2] At present, apart from national sources, the main reporting systems are managed separately by the secretariats of the Organization of the Petroleum Exporting Countries (OPEC) at Vienna and the International Energy Agency (IEA) in Paris on behalf of their governing bodies and member countries.

Two recent examples—in addition to uncertainties about production levels in some member countries of OPEC, despite data reported from several sources—show the difficulty of making projections based on inadequate information. In January 1987, the Energy Information Administration of the United States Department of Energy revised its production estimates, showing actual output substantially lower than was reported throughout 1986: "The miscalculations through most of 1986 stemmed from the Energy Department's practice of projecting oil production using past trends. The system, which worked well when prices were fairly constant, was thrown awry by last year's (1986) sudden price drop."[3]

Similarly, IEA, in its *Oil Market Report* of end-December 1987, revised its estimates, particularly on oil consumption in developing countries since 1981: consumption in 1987 was 12.9 million barrels a day or 7.5 per cent higher than the figure of 12 million barrels a day originally published.[4] The lack of an adequate system for the collection and reporting of information deserves international attention.

Developments in oil markets in 1987

Oil price stability remains uncertain

After the great volatility of oil prices in 1986, member countries of OPEC, at their meeting in December that year, decided to implement production policies which aimed at stabilizing the market at $18 a barrel during 1987.

At the time of the OPEC meeting, oil prices were about $13 to $14 a barrel after recovering from their lows of less than $10 a barrel in July 1986 (see figure V.1). Because of low oil prices, the foreign exchange income of OPEC member countries dropped from $132 billion in 1985 to $77 billion in 1986. This loss of $55 billion in just one year caused serious financial difficulties in most of the countries concerned and individual pressures for persistent increases in production and exports were expected to continue.

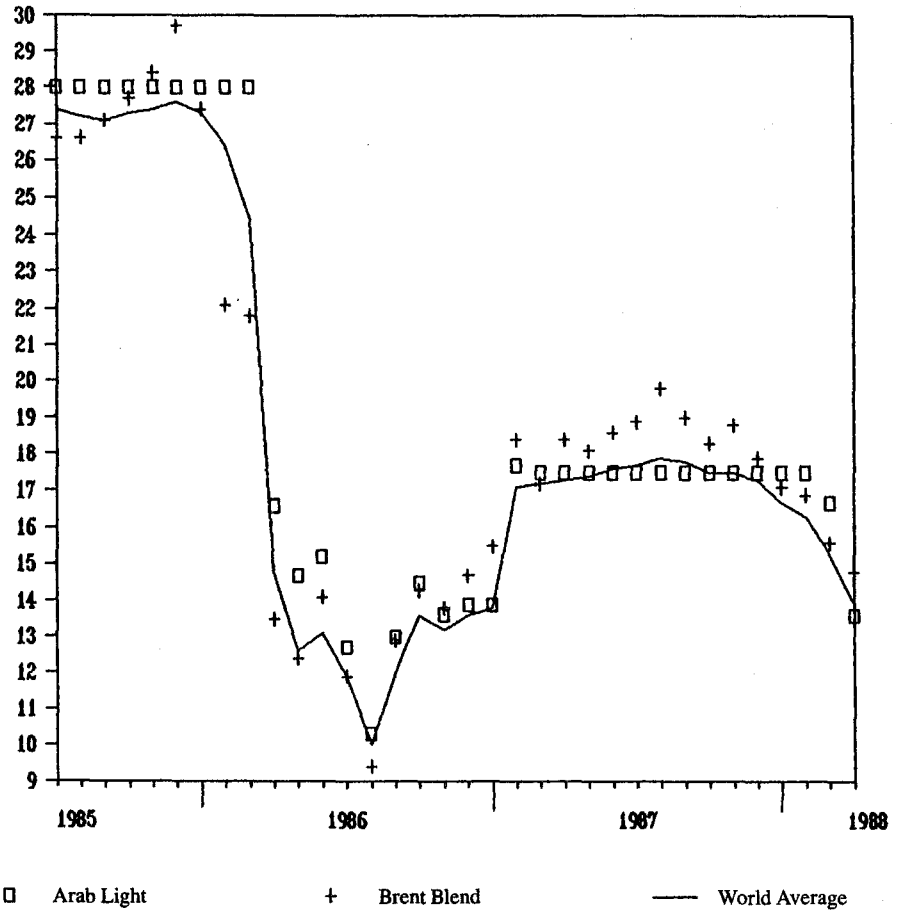
Despite these expectations, production restraint during the first half of 1987 resulted in the stabilization of the reference price which resulted in a 17 per cent improvement in oil export earnings for OPEC member countries (see table V.1).

Price stability was threatened during the summer of 1987 by increasing tensions in the Persian Gulf, which resulted in the protection of Kuwaiti tankers by the United States navy and the involvement of the navies of the Union of Soviet Socialist Republics and Western European countries with the stated aim of assuring oil shipments through the Strait of Hormuz. Prices on the spot market reached their highs in July and August ($20-$22.60 a barrel in the United States), but sizeable production above the agreed quotas by some of the OPEC member countries, particularly in the Persian Gulf, led to a decline in prices in the last two months of the year.

Questions about the stability of the international financial system and its possible effects on the world economy after the stock market crash of October 1987 added to the uncer-

1 James Tanner, "Vaporous oil", *The Wall Street Journal*, 24 November 1987.
2 The information on developments in world oil markets provided in this chapter necessarily reflects the inadequacies of the reported data.
3 Frederick Rose, "U.S. oil output falloff is worse than estimated, new data show", *The Wall Street Journal*, 21 January 1988, p. 6.
4 "IEA boosts estimates of oil use by third world", *Oil and Gas Journal*, 18 January 1988, p. 66.

Figure V.1. Crude oil prices, 1985-1988
(Dollars per barrel)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on United States Department of Energy, Energy Information Administration, *Weekly Petroleum Status Report*, 1985-1988 issues.

Table V.1. Value of oil exports of OPEC member countries[a]

(Millions of dollars)

Country	1970	1980	1985	1986	1987[b]
Algeria	681	12 647	9 170	3 760	3 300
Ecuador	1	1 563	1 927	983	600
Gabon	58	1 876	1 668	848	900
Indonesia	446	15 595	9 083	5 451	4 500
Iran (Islamic Republic of)	2 358	13 286	13 115	6 600	9 200
Iraq	788	26 296	11 380	6 980	11 300
Kuwait	1 596	17 678	9 729	6 200	6 550
Libyan Arab Jamahiriya	2 357	21 396	10 520	4 700	5 800
Nigeria	715	25 277	12 338	6 300	7 300
Qatar	228	5 428	3 355	1 460	1 900
Saudi Arabia	2 418	108 174	25 936	21 190	22 750
United Arab Emirates	485	19 496	13 395	5 890	8 800
Venezuela	2 371	18 248	10 352	6 713	7 400
Total	14 501	286 959	131 967	77 073	90 300

Source: OPEC, *Annual Statistical Bulletin, 1986* for 1970, 1980, 1985 and 1986; and Petroleum Intelligence Weekly, 7 December 1987, p. 3, for 1987 estimates.

[a] Including, where applicable, oil product exports. For some countries, exports of condensate may be included.

[b] Estimates.

tainties in the oil markets during this period. By mid-December, prices on the spot market had plunged to between $15 and $16 a barrel in view of fears of a major slow-down in the world economy and the difficulties of OPEC member countries in reaching an agreement during their meeting at Vienna from 9 to 14 December. Nevertheless, an agreement was reached to continue production with the same quotas as those set for the third quarter of 1987 (see table V.2); no quota was set for Iraq.

Table V.2. Planned and actual production of OPEC oil, 1987

(Thousands of barrels per day)

	First quarter	Second quarter	Third quarter	Fourth quarter
Planned	15 800[a]	15 800[a]	16 600[a]	16 600[a,b]
Actual	15 622	16 833	19 404	18 879
Difference	−178	1 033	2 804	2 279

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *Middle East Economic Survey*, 18 May 1987; and *Petroleum Intelligence Weekly*, 15 February 1988.

a Including a theoretical quota for Iraq of 1,466,000 barrels a day for the first and second quarters and 1,540,000 barrels a day for the third and fourth quarters.

b Revised in June 1987 from the original 18,300,000 barrels a day set in December 1986.

After a brief recovery, oil prices remained weak during the first three months of 1988, despite considerable restraint in OPEC output, because of reduced demand especially in Western Europe and Japan, increased supplies from non-OPEC sources and stock drawdowns. By the end of March spot market prices had reached their lowest levels since 1986 at about $14 to $15 a barrel.[5] Prices, however, can be expected to improve towards the $18 a barrel level for the rest of the year on the assumption that OPEC production will continue to be near the agreed level and that some non-OPEC oil-exporting countries will also support cut-backs.

Deceleration in consumption growth

After reaching a peak of almost 42 million barrels a day in 1979, oil consumption in the developed market economies declined to 34 million barrels a day in 1983 and remained virtually stagnant until 1986, when oil prices fell by about 50 per cent from $28 a barrel.

Taking into account inflation and the weakening of the United States dollar in 1986, the fall in crude oil prices in real terms was about 57 per cent. Because of excise and similar taxes, however, prices of petroleum products fell on average by only 28 per cent in the developed market economies, so that approximately half the crude price fall passed through to consumers.[6]

This fall in oil prices was accompanied by an increase in consumption of 2.7 per cent in 1986 or 1.0 million barrels a day (see table A.III.13). Increases in consumption were registered for all the four main energy petroleum products: 5.4 per cent for aviation fuels, 2.7 per cent for gasoline, 2.4 per cent for middle distillates and 1.8 per cent for heavy fuel oil.

This significant reversal of declining trends in oil consumption was somewhat marred by the poor performance of heavy fuel oil, which had previously caused most of the decline because of expanded use of coal, nuclear power and natural gas for electricity generation and industrial use. Apparently fuel oil prices became competitive enough to encourage switching in the United States, where consumption increased by 14.1 per cent. Fuel oil use, however, continued to decline in both Japan and Western Europe.

In 1987, oil consumption in the developed market economies increased by 1.5 per cent. Aviation fuels, motor gasoline and middle distillates increased by 3.0, 2.8 and 0.7 per cent, respectively, but heavy fuel oil consumption declined by 4.8 per cent because the increase in oil prices discouraged even limited switching with competing fuels, as in 1986.

In view of the expected slow-down in the rate of economic growth in the developed market economies, an increase in oil consumption of only 1.0 per cent is forecast for 1988.

Average annual increases in oil consumption have been consistently higher in the developing countries than in the developed market economies because of the greater dependence of the developing countries on oil and gas as their main sources of commercial primary energy (about 75 per cent in recent years), the lack of alternative sources of energy, higher rates of growth in population, rapid urbanization and, in some cases, good overall economic performance. Oil consumption increases were particularly high during the 1970s in OPEC member countries and other oil exporting developing countries because of generally rapid development based on high oil exports and oil prices and low or subsidized prices of petroleum products for national consumption. Even in the oil-importing developing countries, during the 1970s the average annual increase in demand was maintained at approximately 6 per cent, or more than four times the rate in the developed market economies. (see table V.3).

Table V.3. Consumption of energy petroleum products

(Percentage annual growth rates)

	1971-1980	1981-1986
Developed market economies	1.43	−1.30
Centrally planned economies	5.44	3.50
Developing countries	7.70	2.85
OPEC	11.68	4.65
Other oil-exporting countries	8.01	4.18
Oil-importing countries	6.09	0.70

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on United Nations, *Energy Statistics Yearbook*, various issues.

5 F.o.b. Middle East; in terms of constant dollars, these prices were very close to the lows of 1986.

6 Michael B. Morrison, "Will oil demand recover? A challenge to a consensus", *Petroleum Review*, July 1987, p. 47.

Higher oil prices in the early 1980s, as well as the impact of economic recession in many of the oil importing developing countries, caused a drastic deceleration in the rate of increase of oil consumption to about 0.7 per cent annually. About a third of these countries registered negative annual growth rates during the period 1980-1986.

In only 23 of 90 oil-importing developing countries was oil consumption more than 1 million tons annually (about 20,000 barrels a day): Argentina, Bangladesh, Brazil, Chile, Côte d'Ivoire, Cuba, Dominican Republic, Guatemala, India, Jamaica, Jordan, Lebanon, Morocco, Panama, Pakistan, Philippines, Republic of Korea, Singapore, Sri Lanka, Thailand, Turkey, Uruguay and Yugoslavia. During the period 1980-1986, annual increases in oil consumption comparable to those of the 1970s or better were registered by only 4 of the 23 countries (India, Jordan, Pakistan and Republic of Korea); eight of them registered negative annual rates.

Unlike the developed market economies, where heavy fuel oil use for electricity and industrial purposes dropped by about 49 per cent during the period 1970-1986, developing countries more than doubled fuel oil consumption during the same period (see table V.4).

Table V.4. World consumption of residual fuel oil

(Millions of barrels per day)

	1970	1980	1985	1986
Developed market economies	8.03	7.55	4.09	4.13
Centrally planned economies	2.09	3.81	3.84	4.02
Developing countries	1.33	2.67	2.77	2.84
World	11.45	14.03	10.70	10.99

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on United Nations, *Energy Statistics Yearbook*, various issues.

In 1987, oil consumption in all the developing countries increased by 2.4 per cent and is expected to increase by about 2.5 per cent in 1988.

Oil consumption in the centrally planned economies increased rapidly during the 1970s but decelerated somewhat in the 1980s. During the period 1981-1986, the average annual rate of growth of 3.5 per cent was higher than in both the developed market economies and the developing countries (see table V.3).

Growth of consumption was particularly strong in the Soviet Union. In Eastern European countries, however, oil consumption remained stagnant throughout the 1980s because of foreign exchange problems in obtaining supplies. Instead, consumption of energy focused on alternative sources, especially natural gas, mainly from the Soviet Union, and nuclear power.

Forecasts of world oil consumption in the medium term continue to be influenced by the experience gained by the developed market economies, during the past 10 years, in energy conservation and efficiency improvements, as well as in the development of substitutes, especially for producing electricity. However, an increasing perception that oil prices could remain lower in real terms than the high levels experienced in the early 1980s could result in the relaxation of government measures inhibiting oil consumption, reduce subsidies for high-cost energy substitutes and promote reverse substitution. A resumption of higher rates of economic growth, particularly in the developing countries, could lead to a rate of increase in consumption above the 1 to 2 per cent annual trend of recent years.

Production shift to developing countries

Once again the oil production policies of OPEC member countries dominated developments in the world oil markets in 1987. During the first half of the year, oil production levels were close to the quotas set for most of the OPEC countries, with the result that most trade transactions were carried out at the reference price of $18 a barrel.

In the summer of 1987, with fears of oil supply interruptions related to the conflict between the Islamic Republic of Iran and Iraq and intensified tensions in the Persian Gulf resulting in the damage of oil tankers and oil installations, oil production in a number of countries of the region increased well above quotas, apparently to meet increasing demand, particularly for stockpiling in consuming countries. The expanded output continued to be sold either at official prices or even at premium prices well into the autumn and considerable discounting was reported only during the last two months of 1987, particularly after the boycott of Iranian oil by France and the United States.

At the meeting of OPEC member countries in December 1986, production targets were set for each of the four quarters of 1987 (see table V.2). Since no quota was set for Iraq, it was expected that actual production in that country would continue at a higher rate than its previous quota and therefore some apparent over-production was built into the plan. However, over-production by the third quarter of 1987 had apparently reached 2.8 million barrels a day and by the fourth quarter, 2.3 million barrels a day. At the meeting of OPEC members in December 1987, it was agreed that the production levels of all members, with the exception of Iraq, would be 15.06 million barrels a day during the first half of 1988, with national production levels assigned in the same way as in the December 1986 agreement for the third quarter of 1987[7] (see table V.2 and table A.III.14).

For the first three months of 1988, OPEC production appeared to have been reduced substantially from its high levels of the second half of 1987 but it was still higher than the agreed quotas.

Because of consumption levels apparently lower than expected during the first few months of 1988, higher supplies from non-OPEC countries and stock drawdowns, various reports at the end of March indicated that consideration was being given to convening an extraordinary meeting of the

7 OPEC press release, 14 December 1987.

Conference of OPEC with a view to deciding on the necessary production level so as to restore the desired price stability as provided for in the agreement reached in December 1987.

It was also reported that non-OPEC oil-exporting countries (Angola, China, Colombia, Egypt, Malaysia, Mexico and Oman), at a meeting in London in March 1988,[8] were considering reducing their levels of oil production.[9]

Crude oil production in non-OPEC developing countries expanded substantially during the 1970s and accelerated further during the 1980s. As shown in table A.III.15, crude oil output increased from 1 billion barrels in 1970 to 2 billion barrels in 1980. By 1987, output had increased by a further billion barrels.

Much of this increase was due to expansion of output in non-OPEC oil exporting developing countries such as Angola, Egypt, Malaysia, Mexico, Oman as well as in Yemen, which began exporting oil in December 1987. Among this group of countries, however, output reductions due to lack of adequate reserves and maturity of oil fields were reported by Brunei Darussalam, Peru, Trinidad and Tobago and Tunisia.

China also achieved considerable increases in oil production, doubling output from 1.1 million barrels a day in 1973 to 2.1 million barrels a day in 1979. During 1980 and 1981, production declined to 2.0 million barrels a day but since then production has steadily improved, reaching a level of 2.7 million barrels a day in 1987. Targets for future production are 3.0 million barrels a day in 1990 and 4.0 million barrels a day by the year 2000.

Significant expansion of oil output was also registered in the oil-importing developing countries but it was limited especially to Brazil and India during the 1980s. Small new oil production was also reported in Bangladesh, Benin, Côte d'Ivoire, Ghana, Guatemala, Jordan, Pakistan, the Philippines and Suriname.

In the developed market economies, the most significant event was the continued decline of oil production in the United States. As indicated in the *World Economic Survey 1987*[10] the oil price decline of 1986 brought about a reduction of about 0.9 million barrels a day in oil production in that country between January and December 1986, mainly because of the closing of high cost, small output wells—the so-called stripper wells.

For 1987 as a whole, United States output was about 8.3 million barrels a day which was a 4.7 per cent decline from the average of 1986. Production in Alaska increased somewhat because of the start-up of new fields but in the contiguous United States production fell by 7.3 per cent to reach the lowest level since 1965. This declining trend was not expected to be reversed unless prices increased substantially.

Production of oil in the North Sea has been on the rise since the beginning of the 1970s, reaching a level of 3.5 million barrels a day in 1986. Production in the United Kingdom sector, however, was static at about 2.5 million barrels a day during the period 1984-1986, while increases were registered in the Norwegian and other sectors.

Crude oil production in the North Sea in 1987 remained virtually the same as in 1986. Although three oilfields started production in the United Kingdom sector during the year, output declined, averaging 2.45 million barrels a day; apparently, as a result of maturation of the biggest fields, the new production was not sufficient to reverse the slow decline. The drop in output in the United Kingdom sector was offset by substantially higher production in the Norwegian sector, up 12 per cent to an average of about 973,300 barrels a day despite production cuts of about 80,000 barrels a day across the board, made in support of OPEC. Output was also increased by Denmark and the Netherlands.[11]

Crude oil production in the Soviet Union, after a very impressive growth of 44.2 per cent, from 8.6 million barrels a day in 1973 to 12.4 million barrels a day in 1983, registered consecutive declines during 1984 and 1985. The decline was reversed in 1986 and 1987, production reaching a new high of 12.6 million barrels a day in 1987.

The improvement of the past two years was due to additional investments and managerial reorganization, particularly concerning the Western Siberian oil fields. For example, capital investment was to increase by 31 per cent in 1986 over 1985, particularly in development drilling.[12]

Small oil output in Bulgaria, Czechoslovakia and Poland remained static during the 1980s, while Hungary experienced a decline. Romania, the only other important oil producer in Eastern Europe, also registered a decline during 1985 and 1986.

Investment levels still depressed

Lower oil prices since the early 1980s have led to a downward trend in investments in petroleum exploration and production. The trend was particularly pronounced in 1986. Despite the relative stability of 1987, uncertainty and fears of yet another oil price collapse, coupled with the world financial crisis and its effect on oil corporations, have worked against a definite resumption of petroleum investments worl d wide.

Comprehensive statistics on investments in oil exploration and development are not available. However, information provided by the world-wide activities of seven major oil companies from the United States and Western Europe are an indication of the main trends (see tables A.III.16 and A.III.17). Oil exploration expenditures decreased from $9.2 billion in 1982 to $4.9 billion in 1986; investments in pro-

8 Norway and the USSR attended as observers.

9 Youssef M. Ibrahim, "5% output cut studied by OPEC", *The New York Times*, 10 March 1988, pp. D1 and D17.

10 United Nations publication, Sales No. E.87.II.C.1, p. 107.

11 For a comprehensive survey of the North Sea to end of 1986, see Clive Jones "A review of petroleum exploitation and production activities in North-West Europe", *Energy Exploration and Exploitation*, vol. 5 (1987).

12 *Oil and Gas Journal*, 5 August 1986, p. 20.

duction fell from $19.6 billion to $11.3 billion during the same period.

Capital expenditures of United States companies abroad have also been reduced substantially since 1982, as shown in table A.III.18. Although these estimates include both upstream (exploration and production) and downstream (refining and marketing) investments, by far the greatest proportion has been devoted to exploration and production. Investments fell from $11.4 billion in 1982 to $6.0 billion in 1987 in the developed market economies and from $8.3 billion to only $3.3 billion in the developing countries during the same period. Among the developing countries, the main recipients were such oil exporting countries as Colombia, Ecuador, Egypt, Indonesia, Malaysia, Nigeria, Peru, Trinidad and Tobago and United Arab Emirates.

The stabilization of oil prices in 1987 and expectations that any declines would be of short duration led to some increases in investment plans for 1988. According to a survey of 35 United States companies, investments in exploration and production in the United States were expected to increase by 14 per cent, from $15.6 billion in 1987 to $17.8 billion in 1988. This would follow a decline for six consecutive years since the peak of $57.8 billion in 1981.

Similar investments outside the United States by the same group of companies would increase by 23 per cent to $7.6 billion in 1988 from $6.2 billion in 1987.[13]

Because of lower prospects for oil and gas discoveries in the United States, as well as lower profit margins, a shift was developing in favour of investments abroad. As shown in table A.III.19, profit margins for each barrel of oil equivalent remained high even during the low price levels of 1986, mainly because of a drastic reduction in government take on crude oil and gas production.

Since oil and gas exploration and development costs have been reduced considerably in the past two years, the above increases in financial outlays indicate an improvement from the lows of 1986 and 1987, but their levels remain far below the peaks of the early 1980s. A definite resumption of investments will depend on higher cash flows to oil corporations and, because of the long lead times involved, their expectations of the condition of the oil market in the early 1990s.

The slow-down in investments is bound to affect future production levels and oil discoveries in the developed market economies and the developing countries. Consequently, increases in oil demand will be met by those oil-exporting countries which continue to have unused production capacities.

Developments in the oil market, particularly since the oil price collapse of 1986, have brought about some rapid changes in the structure of the petroleum industry in its efforts to adjust to the new circumstances. Changes related to oil company mergers and consolidations and the integration of major oil-exporting countries into downstream operations, often in the form of joint ventures, are briefly reviewed below.

Changes in the structure of the petroleum industry

Nationalization of oil reserves by a number of developing countries in the late 1960s and the 1970s had a profound effect on the position of the major oil companies. By 1986, their control of oil supplies had dropped to 33 per cent of the world total (excluding North America and the centrally planned economies), from 56 per cent in 1976. They continued, however, to show considerable strength in downstream operations, particularly in the marketing of petroleum products (see table V.5).

Since the energy crises of the 1970s, the major oil companies, as well as a large number of independent oil companies, have concentrated their exploration and development investments in the developed market economies (Australia and North American and North Sea producers), where despite relatively high costs returns were favourable until the mid-1980s, because of high oil prices. Their objectives were the diversification of crude oil supplies and an improvement in the proportion of equity oil which would remain under their control. In pursuit of similar objectives, investments had also been directed especially towards non-OPEC developing countries, mostly oil exporters, where costs were somewhat lower and prospects of discoveries greater than in the developed market economies.[14]

Despite these efforts, a recent survey of 30 big oil companies found that each dollar spent on exploration during the four years to 1986 yielded reserves worth 58 cents, with the result that, at current production levels the companies had less than 10 years of reserves left; consequently, the same survey indicated that the number of big integrated oil companies was likely to halve by the year 2000.[15]

Declining real oil prices since 1984, particularly the oil price collapse of 1986, resulted in a financial shake-up of many of the independent oil companies in the United States and the North Sea, which had been attracted into the oil play during the 1970s because of high prices and profitability. Their predicament was aggravated further by the stock market crash of October 1987, which made it even more difficult to attract additional financing. With many banks burdened by a multitude of non-performing energy loans to independent oil companies and with the persistent uncertainty about the level of oil prices in the short term, further bankruptcies can be expected, with consequent consolidation into the more financially secure oil companies.[16]

13 Robert J. Beck and Bob Williams, "U.S. industry's spending plans show first increase in seven years", *Oil and Gas Journal*, 22 February 1988, p. 17.

14 See the report of the Secretary-General on energy exploration and development trends in developing countries (A/41/383-E/1986/101), paras. 14-23.

15 "Drilling for oil on Wall Street", *The Economist*, 20 February 1988, p. 71.

16 According to a report in the newsletter section of the *Oil and Gas Journal*, 29 February 1988, oil company mergers and acquisitions numbered 244 in 1987, a 66 per cent increase over 1986.

Table V.5. Changes in operations of major oil companies, 1976 and 1986[a]

(Thousands of barrels per day)

	1976	Percentage of world total[b]	1986	Percentage of world total[b]
Crude oil supply[c]	25 362	56.1	13 625	33.4
Refining runs	19 194	43.2	13 426	30.1
Petroleum product sales	21 359	47.4	18 876	42.9

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *Petroleum Economist*, May 1978 and June 1987, and United Nations, *Energy Statistics Yearbook*, various issues.

a The 1976 operating statistics included two Europe-based groups: British Petroleum and Royal/Dutch Shell and five United States-based majors: Exxon, Gulf Oil, Mobil, SoCal and Texaco. Gulf Oil and SoCal merged to form Chevron in 1984.

b Excluding the centrally planned economies.

c In most cases, figures show net production of crude oil and natural gas liquids, plus purchases under special supply arrangements.

Table V.6. Ratios of crude oil reserves to production, 1987

	Estimated proved reserves[a] (millions of barrels)	Production (millions of barrels)	Reserves/production ratio (years)
Developed market economies	56 292	5 225	10.8
North America[b]	32 095	3 568	9.0
Western Europe	22 448	1 432	15.7
Centrally planned economies	60 800	4 712	12.9
USSR	59 000	4 558	12.9
OPEC	670 655	6 459	103.8
OPEC countries of the Persian Gulf[c]	558 215	4 270	130.7
Non-OPEC oil-exporting developing countries	70 808	2 332	30.4
Mexico	48 610	926	52.5
Oil-importing developing countries	10 394	644	16.1
China	18 400	966	19.0
World total	887 348	20 338	43.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on *Oil and Gas Journal*, 28 December 1987.

a As at 1 January 1988.

b Canada and the United States.

c Iran (Islamic Republic of), Iraq, Kuwait, Qatar, Saudi Arabia and United Arab Emirates.

The oil industry in some of the OPEC member countries and state-owned petroleum enterprises in both the developed market economies and the developing countries have also experienced significant restructuring.

The reversal of decision-making power in oil production and prices from the oil companies to host Governments since the early 1970s led to the strengthening of existing state-owned petroleum enterprises and the organization and establishment of new ones in both the developed market economies and the oil-exporting developing countries. However, the emergence of more abundant oil supplies and decreasing prices, particularly in the mid-1980s, have already led to a de-emphasis of the importance of these enterprises in the developed market economies. This trend has been strengthened further by an approach more generally oriented towards private markets in at least some of these countries. As a result, the state-owned petroleum enterprises of the United Kingdom—British Gas and the British National Oil Corporation—have been privatized and similar

objectives have been declared in other countries (e.g., Canada and New Zealand).[17]

Parallel trends have also been noted in non-OPEC developing countries where state-owned petroleum enterprises had been strengthened and new ones organized either for expanded exploration and production or for assuring imports through the oil companies or directly from the oil-exporting countries. In a few of the oil-importing developing countries, decisions have been made to privatize a large part of their oil industry. This process has been increasingly supported by at least some of the developed market economies through their aid agencies or through multilateral organizations. State-owned enterprises in oil-importing developing countries had serious problems to face. Oil import bills climbed so rapidly that many of these countries had to resort to borrowing foreign exchange; at the same time, additional borrowing was required for investments in exploration and development. As a result, a sizeable proportion of the debt problem of the developing countries was attributable to such loans, which could hardly be avoided in the absence of adequate interest by the foreign oil companies to invest in these countries and with the general expectation of even higher oil prices in the future.

Overall, it may be expected that the number of oil companies will be further reduced by further consolidations, including the privatization of some state-owned petroleum enterprises in both developed and developing countries.

Similarly, a reduction may occur in the number of significant oil-exporting countries given the concentration of oil reserves in the Persian Gulf and increasing depletion of reserves in non-OPEC countries, including in particular, North American and the North Sea producers and a number of oil-exporting developing countries (see table V.6).

In this connection, a recent study, after taking into account the totality of cumulative oil production, proved and inferred reserves and undiscovered resources, has projected declines beginning during the period 1987-1990 in Brazil, Colombia, Peru, the United Kingdom and United States; during 1991-1995 in Argentina, Canada, Egypt and the Soviet Union; and during 1996-2000 in Australia, Brunei Darussalam, India and Malaysia.[18]

The oil companies' loss of control over the reserves of several of the OPEC countries led to new trading conditions in the international market, especially after 1980 when fears of oil shortages were replaced by the prevalence of substantial production over-capacity in the OPEC countries. Long-term agreements between the oil companies and oil-exporting countries lost favour and, even when they continued to be made, their significance was minimized through the adoption of very flexible terms with regard to both quantity and price. At the same time, trade on spot markets or on the basis of prices established in those markets has been expanding rapidly.

In contrast to a pre-1970 oil market of relative stability because of the influence of the major integrated oil companies, the above-mentioned developments led to wide fluctuations in both oil supplies and prices and such instability can be expected in the future in the absence of further structural changes.

However, a variety of such changes as shown have already occurred and others are in the process of being made. For example, a number of OPEC member countries have embarked on programmes for downstream integration into refining and marketing operations in the developed market economies of Western Europe and the United States. Kuwait has established such operations in Western Europe on its own and Nigeria, the United Arab Emirates and Venezuela have entered into joint ventures in industrial countries. Other OPEC countries, including Saudi Arabia, have been reported to be planning similar moves.[19]

Whether the consolidation of the oil companies of the developed market economies and similar developments in the OPEC member countries, particularly in the Persian Gulf, will result in a reconciliation of interests remains to be seen. A new kind of integration in the oil industry might have a different impact on the world oil market in the future, particularly when the current abundance of oil supplies may once again turn into a scarcity.[20]

Medium-term outlook and conclusions

Since the dramatic drop in oil prices in 1986 and their stabilization during 1987 at around $18 a barrel, a likely scenario has developed, which may be summarized in expectations that (a) world demand for oil will continue to expand moderately at about 2 per cent annually; (b) if developing countries resume normal rates of output expansion, a somewhat higher growth rate of oil demand may occur; (c) despite new oil discoveries in a number of non-OPEC developing countries, the probability of large to giant discoveries remains small; (d) a few OPEC member countries will find it difficult to maintain their current export volumes (even with accelerated exploration and development investments) because of their limited geological resources and an increase in national demand due to population and economic growth; (e) in the developed market economies, oil production will decline because of limited reserves and resources and the relatively high cost of developing frontier areas such as the Arctic and offshore; (f) in the centrally planned economies, high investment requirements will hinder the fast development of resources (mostly in frontier areas of the Soviet Union and

17 "Gathering pace of energy privatisation in West Europe", *Petroleum Economist*, January 1987, p. 11.
18 Joseph P. Riva, Jr., "Oil distribution and production potential", *Oil and Gas Journal*, 18 January 1988, p. 58.
19 Youssef M. Ibrahim, "Going Downstream", The Wall Street Journal, 25 June 1987, p. 1; and "Oil producers reaching for the pump", *The Economist*, 19 September 1987, p. 78.
20 See Alessandro Roncaglia, *The International Oil Market: A Case of Trilateral Oligopoly*, (London, Macmillan, 1985).

China) that will be required to meet increases in national demand; and (g) OPEC countries will continue their current policies of increasing their share of world supplies with prospects for moderately higher prices in the medium term, but not high enough to encourage once again investments in energy conservation and alternative sources of energy, particularly in the developed market economies, which constitute by far the most important oil markets.

This scenario is not without challengers. On the demand side, they expect more intensive energy conservation measures, including improvements in the efficiency of transportation fuels. On the supply side, they envisage substantial cost-cutting through technological improvements and perhaps breakthroughs in the development of alternative energy sources, as well as in the oil industry itself, which is already experiencing considerable cost reductions through such technologies as three-dimensional seismic surveys, enhanced oil recovery techniques and horizontal drilling. Given these developments, they believe that future costs of frontier exploration and production are exaggerated, especially when the probabilities of discovering giant oil fields are considered. Under this scenario, requirements for OPEC oil will remain moderate, with possibilities for the continuation of the current level of oil prices for several years and an even lower level if cohesive policies among OPEC member countries cannot be sustained.

The lack of timely and accurate information and statistics on a variety of important parameters in the petroleum industry and the world oil market may have resulted in serious miscalculations, not only with regard to commercial transactions but, more important, with regard to massive and costly investments in both the energy and other sectors of the world economy.

Changes in the structure of the petroleum industry have had a considerable impact on energy prices and the necessity of analysing and monitoring developments is indicated for the future, particularly with regard to increasing corporate concentration and its possible impact on the international oil market.

A resumption of economic growth, especially in the developing countries, will be accompanied by increases in oil consumption, which may best be met through additional investments in exploration and development of indigenous resources. Particularly in oil-importing developing countries, such investments will require expanded co-operation with multilateral and bilateral sources of financial and technical assistance, as well as new strategies for co-operation with transnational oil corporations and among the developing countries themselves.

Chapter VI

ECONOMIC REFORMS IN THE CENTRALLY PLANNED ECONOMIES AND CHINA

Since about the middle of the 1980s, virtually all centrally planned economies have announced their intention of changing economic policies, policy instruments and associated institutions. Some have already embarked on far-reaching modifications. Others are in the process not only of formulating the purposes to be served by changes as yet incompletely defined but of designing the broad steps of the transition phase leading to a modified economic environment. Finally, some countries have not yet committed themselves to broad-based transformations. But even in these countries such shifts are bound to take place in time, if only because the mechanisms for reaching and implementing economic decisions in partner countries are being modified. This is also likely to require adjustments in the mechanisms and policies of regional economic integration established for the Council for Mutual Economic Assistance (CMEA). Because of the importance of CMEA relations, changes in the framework of CMEA will have repercussions on all members.

The principal features of the process of economic reform in the centrally planned economies are analysed in this chapter. The reforms in China and the Union of Soviet Socialist Republics in particular are discussed in detail owing to the size of these two countries, their role in the world economy, the far-ranging objectives of the ongoing reforms and the substantial degree of policy autonomy they enjoy.[1] The first section defines key concepts relating to economic reforms, models and mechanisms for the purposes of this chapter. Because the current cycle of broad-based economic restructuring is by no means without precedent, the second section summarizes reform experiences, particularly in Eastern Europe, during the two decades prior to the mid-1980s. The next two sections deal with the principal features of the current reforms in China and the Soviet Union. The final section describes the similarities and differences between the reforms in these two countries and discusses the potential impact on growth, economic organization and trade.

Because the societal organization of the centrally planned economies and the prevailing precepts that guide socio-economic policies are deeply rooted in Marxist-Leninist ideology and principles, economic reform in these countries is a complex social phenomenon that affects virtually all layers of society. Even its principal features are rarely confined to economics, if only because modifications sought in economic behaviour cannot but spill over into social attitudes and politics more generally.

Perhaps more important are the intricate interrelations of the social and economic policy dimensions of these countries, particularly in such areas as employment, the price system and provisions concerning wages and incomes. In fact, in all these countries reforms have been prompted to a greater or lesser extent by social concerns, including the need to accord a larger role to economic accounting as a technical instrument for improving resource allocations even when resource allocation has a direct impact on social issues. A number of planned economies are therefore consciously attempting to separate the social and economic spheres to a much greater degree than in earlier reforms in the hope of dealing sequentially with the myriad issues involved. Similarly, economic reforms have an important political dimension. They may even be sought as an inducement to political restructuring. Although the sociopolitical ramifications of economic reform are essential to an understanding of the dynamics of socialist society, this chapter does not specifically consider the sociopolitical aspects of the planned economy in evolution.

Key concepts of economic restructuring

Economic reform is essentially a process aimed at improving the way in which resources are mobilized and allocated with the goal of satisfying present and future, private and social needs better than before. Its features may range from the broad philosophy and objectives of development policies (i.e., the "strategy") to economic institutions and technical guidelines for economic behaviour (i.e., the "economic model"). The development strategy adopted by socialist policy makers at the outset of socialist construction aims, among other objectives, at full employment, rapid growth, broad industrialization as the foundation for steady economic development and substantial domestic policy autonomy. A pronounced priority is accorded to selected industrial sectors as policy makers mobilize resources chiefly for fast industrialization on a broad front. Macro-economic decisions on accumulation and investment pay at best marginal attention to domestic or external static scarcities.

Though rapid industrialization can be sought through alternative policy instruments and institutions, socialist policy makers deliberately opted for a particular economic model based on economies of scale, use of modern technologies and tight central control of large firms. This highly centralized model provides for central planning of nearly all eco-

1 The adjustments made in the early 1980s and the agenda ahead, particularly for Eastern Europe, were examined in earlier issues of the *World Economic Survey* (see "Adjustment, investment and structural change in centrally planned economies", *World Economic Survey 1986* (United Nations publication, Sales No. E.86.II.C.1), pp. 121-134; and "Changes in economic mechanisms", *World Economic Survey 1987* (United Nations publication, Sales No. E.87.II.C.1), pp. 127-129).

nomic decisions and strict regulation of the decision-making role of economic agents; nationalization of virtually all factors of production certainly capital and natural resources and in most cases land, but with some variations among countries; strong regulation of labour mobility; collectivization of agriculture in combination with state agricultural enterprises; a pronounced disregard of indirect co-ordination instruments and associated policies and institutions in favour of directive planning of resource allocation in physical detail; managerial autonomy strictly circumscribed by central planning and subordinated to the controls of local Party and, in most countries also, trade union interest groups; the channelling of most economic decisions through a complex administrative hierarchy, which tends to handle matters bureaucratically; and nearly complete insulation of domestic economic activity from foreign economic relations and influences.

Economic reforms include measures that modify one or more aspects of the highly centralized model. Because changes must necessarily start from the policy instruments and institutions already in place, gradualism is required, not only in formulating the reform laws and regulations and putting them in place, but also in changing the psychology of all actors in the economy. Thus, the transition from a situation characterized by pervasive quantitative planning to one relying on economic accounting through indirect co-ordination instruments requires adjustments in monetary and fiscal policies, in the financial sphere (including the role of the budget and the banks) and in managerial behaviour. Perhaps more important, these modifications depend on the maturation of new managerial styles and worker and consumer attitudes, a process that takes time. The speed and depth of the changes that can realistically be anticipated depend largely on the institution of appropriate incentive structures.

The traditional economic model of the centrally planned economy may be defined as the combination of institutions, behavioural rules and policy instruments that help to bring about mainly planned industrialization on a broad scale. Though there have been nearly continuous modifications of this model since about the mid-1950s, mainly because the bottle-necks that had earlier inhibited growth had been cleared,[2] three variations may suffice to set the stage for the discussion of the ongoing changes in the economic mechanisms of selected centrally planned economies: the selectively decentralized model, which was the aim of several countries in the 1960s, though there were palpable differences among reform blueprints; the modified centralized model that came about after the reform attempts of the 1960s were reversed or temporarily stalled; and the decentralized model currently envisaged in several countries.

The selectively decentralized model essentially aims at the administrative and organizational streamlining of the traditional model. It calls for some transformation in the policy instruments and some of the supporting institutions of the highly centralized economic model. But the basic precepts of the highly centralized model and the broad goals of development strategies are kept intact. The reform efforts of the 1960s came to an abrupt halt, except in Hungary, in the 1970s. Some of the reforms were derailed for sociopolitical reasons. Others faltered because the hoped-for stimulus to factor productivity growth did not materialize. To rectify the situation, most countries reverted to greater centralism in the allocation of resources, less enterprise autonomy, greater rigidity in decision-making instruments and other retreats from the reform intentions of the 1960s. This was followed by the third wave of reforms, which concerned partial recentralization of organization and management. The third model is, however, unstable in the sense that it is frequently altered in both major and minor respects, chiefly as a result of changes in the domestic and external economic environment.

Because in the end partial reforms can only bring partial, temporary results, comprehensive reforms will eventually be required to obtain steady growth primarily from factor productivity gains rather than physical inputs. Since the mid-1980s, the trend has been towards effective decentralization and co-ordination of decisions through indirect policy instruments and their supporting institutions under the guidance of macro-economic policies. To move well beyond the simple devolution of administrative authority typical of earlier reforms requires the support of a broad-based, fully developed economic mechanism. A properly functioning economic mechanism not only encompasses macro-economic planning but also seeks to allot a comparatively important role in resource allocation to monetary, financial, fiscal, trade, prices and incomes policies as a means of co-ordinating economic decisions and harmonizing them with the medium-term to long-term structural changes planned at central policy-making levels. This necessarily includes the creation of new institutions and policy instruments and activation of existing components of the model. Moreover, an economic mechanism as a rule incorporates active macro-economic policies. Although many such policies are incorporated in the traditional model, central planning in physical detail tends to neutralize them or render them superfluous.

Economic reforms in Eastern Europe to the mid-1980s

Since the late 1950s, as a central element of their overall strategy to modernize and improve allocative efficiency, the Eastern European planned economies have sought to modify their economic model. Until the mid-1980s, modifications included decentralization of decision-making in favour of firms, enhancement of the autonomy of economic agents, material incentives and value indicators as the key guidelines for resource allocation and more flexible macro-economic management. Such flexibility was apparent in the modification of sectoral output priorities and a shift in fiscal and monetary policy stances. Most of the measures were introduced in a cautious, incremental manner and without

2 Problems included an unstable regional or global economic environment, initial domestic strife over sociopolitical organization, inexperienced management, a labour force unaccustomed to the system of industrial production and burdensome rural over-population.

co-ordination among the economies concerned. Table VI.1 identifies the most important phases of the measures in the European planned economies.

Salient features of the reforms

Reforms are invariably directed towards some form of decentralization of production decision-making. By itself, this cannot ensure efficient production. At the very least, a direct link needs to be forged between the economic results of a firm and the material rewards to its managers and workers. Owing to the oligopolistic nature of the typical centrally planned economy, such guidance must initially proceed by some means other than competition. Firms therefore need to be transformed into separate accounting entities responsible for their own profit. Reform of the price mechanism, including pricing policies, and greater reliance on other instruments of indirect economic co-ordination are required to guide the decision-making of all economic agents. Efficient financial intermediation between savers and investors could

Table VI.1: Economic reforms in the European planned economies, 1957-1985

Year	Country	Details of reform
1957	Bulgaria and the Soviet Union	Substitution of regional planning for planning by ministries.
	Hungary	Introduction of agricultural contracts and procurement prices.
1959	Czechoslovakia	Introduction of enterprise associations.
1963	German Democratic Republic	New system of economic planning and management, with gradual changes in planning, management, pricing policies and wages tied to profit.
	Hungary	Partial decentralization of planning and management, mainly in agriculture.
	Poland	Some decentralization in industry.
1964	Poland	Greater role for material incentives in rewarding labour and for interest rates and profits in enterprise management.
1965	Hungary	Abolition of the centralized supply system.
	Soviet Union	Profit introduced as the main indicator of economic performance of firms that have obtained greater independence. Liberalization of individual plot farming.
1966	Poland	Reform of material incentives and factory prices. Extension of enterprise self-financing. Bonuses in export sectors based on net foreign exchange earnings.
1967	Bulgaria	Decentralization of planning and management. Greater role for material incentives and financial instruments.
	Czechoslovakia	Broad decentralization of planning and management. Strengthening of economic levers, especially prices.
1968	Bulgaria	Comprehensive price reform.
	German Democratic Republic and Romania	Greater flexibility in banking and credit.
	Hungary	Start of the New Economic Mechanism, with flexible prices, further decentralization of management, strengthening of material incentives in agriculture, and banking and credit reforms combined with stronger financial control.
1969	Romania	Extension of material incentives, some enterprise independence and decentralization of foreign trade.
1972	Poland	Reform around enterprise associations.
1973-1975	Soviet Union	Formation of enterprise associations.
1976	Hungary	Recentralization in industry, restriction of enterprise decision-making, stricter price regulation and a more egalitarian wage policy.
1978	Romania	Reform of the economic and financial mechanism.
1979	German Democratic Republic	Industrial reorganization around *Kombinate.*
	Hungary	Relaunching of managerial decentralization.
	Soviet Union	Improved planning around a strengthened economic mechanism.
1983	German Democratic Republic	Regulation on norms for economic agents, with stricter financial rules.
	Hungary	Administrative controls curtail some enterprise autonomy.
	Poland	Increased role for indirect regulators in management.
1985	Hungary	New forms of management of enterprises, including foreign trade enterprises.

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

be an essential element of reform of the production sector. Managerial and financial reforms have, in turn, major implications for the role of government in economic administration. As their involvement in micro-economic decisions wanes, central policy makers must regulate and guide decisions through macro-economic policies and institutional supports—relating to fiscal and monetary affairs, for example.

Decentralization of decision-making

During the first wave of economic reforms in Eastern Europe, chiefly during the 1960s, the administrative hierarchy of decision-making, especially in industry, was partly decentralized. The main aim was to dismantle the ministerial planning hierarchy, which was viewed as over-centralized, prone to autarky, impeding intersectoral links and inhibiting factor productivity growth. The newly formed agencies between the planning centre and firms were expected to be more flexible and efficient than central administration. These new bodies, however, merely reproduced and in some cases even aggravated the earlier problems of economic administration.

To counteract the new "localism", the power of the ultimate producers was steadily eroded as central management agencies, in some cases ministries, were gradually reinstated with even more authority than before. One important consequence was that there were frequent shifts of responsibility for specific firms among government agencies, which put the firms in a peculiar situation. Although managers of state enterprises or associations were given greater responsibility for the implementation of the plan, the division of authority between them and government organizations remained ambiguous, which aggravated the situation. In addition, economic instruments were still only incidental to plan formulation and implementation.

There have been various attempts to define the rights and obligations of state firms. In some cases, their role and place were spelt out in specific legal provisions, on the basis of which further decentralization measures were taken. In Hungary, such measures even included the abolition of intermediate organs of the management hierarchy. Elsewhere, however, sectoral ministries were reinstated at the centre of decision-making at first as a result of curtailing the authority and rights of the intermediate organs and later by repealing managerial decentralization.

Several attempts were made to introduce performance incentives and to hold firms and associations accountable for their own decisions. In most countries, increased micro-economic autonomy was instituted but the potential for central guidance and control remained. Yet the structure of the reform measures failed to provide for successful decentralization. For example, in the absence of proper economic signals, there is a fundamental conflict between setting output plans and prices at the central level and delegating decision-making power and responsibilities to lower levels of the planning hierarchy on the basis of indirect co-ordination instruments.

New performance indicators and planning

All reforms without exception seek to reduce the number of mandatory performance criteria and to substitute net or value magnitudes for gross or physical success indicators. Material incentives are linked to plan indicators including in some cases indicators on revenue, profit, sales or net output. Profitability becomes in principle an important criterion for evaluating a firm's performance and supporting its financial autonomy. However, because firms do not have discretion over the quantities and prices of their material and factor inputs or, for that matter, over the disposition of their outputs and at what prices, considerable obstacles to effective self-accounting remain. In some cases central authorities have intervened, as they did in the late 1960s and early 1970s, by resorting to material balances or norms on material inputs, primarily at the sectoral level.[3]

Pricing policies and price tiers

Proper pricing of labour and capital services and foreign exchange, for example is critical to enhancing the efficiency of resource use, particularly under decentralized decision-making. Thus profit can be a fair indicator of efficiency only if firms have some say over the prices they pay for their inputs and charge for their products. Because relative prices in the highly centralized model are as a rule heavily distorted, partly because of government preferences that are no longer relevant and because price changes are enacted only at long intervals, price reform becomes a crucial component of more general reform. But sociopolitical constraints on policy latitude permit only gradual price changes. Even these are influenced by *ad hoc* social and economic considerations. Furthermore, the price régime envisaged by the reform may fall far short of what is required to permit efficient enterprise decisions to be taken. Price policy is still set by the centre, which in addition directly declares a large number of prices. This applies more to consumer (retail) prices than to producer (wholesale) prices.

Traditionally, producer prices were set intermittently on the basis of average cost in the sector plus a profit mark-up. Profitable enterprises could not utilize earnings for expansion purposes as they were taxed away and partly redistributed to loss-making enterprises. Changes in input and output decisions were reached by means other than prices and related instruments. Retail prices were determined on the basis of the corresponding wholesale prices plus a retail mark-up and a complex network of other *fiat* adjustments, usually in the form of positive or negative excise taxes, to try to ensure equilibrium between supply and demand. Prices were intended to clear markets, but they often failed to do that, and so gave rise to endemic shortages in partial retail and wholesale markets and not infrequently also to macro-economic imbalances. Agricultural procurement prices remained low relative to the corresponding retail prices and to prices of industrial inputs.

[3] In several instances, norms on labour productivity, quality of output mix and fulfilment of delivery plans according to supply contracts were introduced in the late 1970s to replace gross output as the central plan performance indicator. But many other gross physical performance indicators did not lose their significance in planning practice and gradually, in the 1980s, the scope of central planning was once again increased.

Domestic price autonomy could be preserved thanks to the buffers against foreign competition—the State's monopoly of foreign trade and price equalization. The latter in particular ensured a nearly complete disjunction between the external sector and the domestic economy as transactions in traded goods were carried out domestically at prevailing *fiat* prices. Differences with actual trade prices converted at the official or commercial exchange rates were offset through a special budget account. As a result, prices and exchange rates remained incidental in allocative decisions. But the price stability attained in this way conflicted with the ambition of policy makers to improve aggregate efficiency, a dilemma that came to the fore in every single reform effort.

Although there have been many variants of price reform, its main features are described below. All economies sought to align, at least intermittently, producer prices with actual production costs and the real cost of imports, thus reducing state subsidies. Similarly, agricultural procurement prices were raised, also in relation to industrial prices, to encourage output and improve rural levels of living. Retail price changes, while frequent in some countries, were not sufficiently large to promote a better balance in retail markets.

In some countries (e.g., Hungary and Poland), changes in retail and wholesale trade prices were comparatively frequent. In others (e.g., Czechoslovakia and the German Democratic Republic), price changes, including the filtering through of foreign trade prices, were enacted only at discrete intervals of five years or more. As a result, prices were not rational instruments for efficient resource allocation.

In some planned economies, the pricing system encompassed both market-based and centrally administered mechanisms. The reforms were intended to improve the responsiveness of the price system to changing cost-price relationships in the world economy and to allow domestic market forces to affect prices. But these mechanisms were never really adhered to. As a result, firms willy-nilly adapted the composition of both inputs and outputs at times against policy makers' intentions. Firms requested, and were granted, various formal and informal subsidies and exemptions.

Monetary and fiscal policies

In the highly centralized model, micro-economic management rarely concerns itself with financial decisions. The siphoning off of profits by the government prevents any significant accumulation of reserves. Furthermore, enterprises holding temporary liquidity have virtually no access to interest-bearing financial assets. Firms have no flexibility to administer funds, either to finance investments or to augment profits through cash-flow management. Profit retention, greater managerial authority and autonomy, and greater availability and diversity of financial instruments were all envisaged in the reforms.

. The overall objective of monetary policy was to provide a financial base conducive to plan fulfilment and monetary equilibrium. Because money performed a passive function, the scope for monetary policy was limited. The mono-banking system provided the financial means to implement the plan but could not influence it. In place of direct or indirect allocation of budgetary funds, the reforms sought to introduce financial incentives and penalties administered flexibly by monetary authorities but the variants diverged widely. A lending policy with differentiated credit terms and maturities to facilitate self-financing and make it more meaningful was the most important financial instrument experimented with.

Banks were granted authority to lend according to the economic soundness of the purpose for which credit was sought. In some cases, new banks were established to service the specialized needs of industry, construction, agriculture, foreign trade and the co-operative sector, for example. Differentiated interest rates, although still fixed centrally to suit a variety of objectives, were actively used to promote the more efficient distribution of credits. But their intended impact on allocation was neutralized by the lack of financial accountability of borrowers and by the fact that the mono-banking system was kept essentially intact. The banking system thus remained exceedingly vulnerable to the pressures of government agencies for the financing of projects and the continuing expectation that banks automatically meet all capital requirements.

On the fiscal front, the budget in the highly centralized model performs three basic functions: control and co-ordination of physical economic processes through financial discipline, promotion of economic activities through fiscal incentives and penalties, and redistribution of national income among different layers of society. The scope of public finance is substantial as the budget includes not only the receipts and expenditures of the central Government but also of provincial and local authorities, other non-productive organizations and, in many cases, the balances of gross profit of state enterprises. The importance of the budget is further enhanced by the fact that it is integrated with other financial plans, including cash and credit plans, and the personal wage fund.

Reforms generally sought to bolster the economic role of the budget by replacing directives with more modern fiscal and financial instruments. The new emphasis attached to self-financing and bank credits as sources of investment outlays by firms tended to reduce the portion of funds passing directly through the state budget. None the less, the system of revenue collection remained complicated and poorly geared to the needs of economic agents. In nearly all countries of the group, turnover taxes and profit transfers continued to be the principal sources of revenue.

Sectoral impacts of the reforms

The reforms introduced in Eastern Europe since the early 1960s had different objectives and impacts. In most cases, changes were primarily intended to foster greater efficiency in resource use in manufacturing, to shift investments in favour of technology geared to saving energy and raw materials and to promote scientific and technological progress. The latter in particular became a critical concern once the global price shifts in energy began to be funnelled into CMEA pricing. Since the late 1970s, emphasis has been placed on domestic energy, raw material extraction and new types of entrepreneurship.

Agriculture passed through several changes. In Hungary, the sequence of economic reform measures started with a revamping of the rural economy. During the mid-1960s, investment constraints on state and co-operative farms were eased, agricultural management systems were revised and a more coherent relationship between the state and co-operative sectors was established. As a result, farming became more intensive and labour productivity rose substantially. There were side effects, however, that held the growth of net production below that of the use of materials, particularly in crop production, basically because profitability did not carry as much weight in measuring success as gross output. This was true also for the non-farming branches of the rural economy, though their net production expanded somewhat faster. The raising of income levels in agriculture, in some cases also in industry, proceeded along three lines: increases in state procurement prices in combination with some reduction in the prices of industrial inputs, easing of constraints on personal household plots and some reduction of the direct tax burden on collective farms. In almost all planned economies, plan indicators for agriculture were simplified, although here also temporary recentralization occurred to safeguard overall allocation priorities, to maintain the priority of exports and to curb domestic consumption by imposing strict rationing.

Foreign trade is also an area where some decentralization was introduced. Foreign trade organizations (FTOs) under the ministry of foreign trade were streamlined and more flexible export and import licensing was instituted. Associations of firms, selected firms producing for export and even some domestic trading enterprises were granted the right to engage directly in external trade. The overall tendency was to entrust the trade ministry with the co-ordination of trade with the overall economic plan, or with coming to grips with unforeseen developments. However, the pervasiveness of bilateralism in foreign trade complicated effective decentralization of decision-making.

Foreign trade and specialization acquired a critical role in the evolving structure, especially in manufacturing, of the planned economies and in buttressing factor productivity gains. The disjunction between trade and the domestic economy was partially lifted. The modalities for CMEA co-operation were changed too. All centrally planned economies entered into major co-operation agreements with market economy firms in the hope of acquiring equity capital, advanced technology and access to new convertible currency export markets. With the exception of the German Democratic Republic, all countries promulgated a legal framework for the creation and operation of domestic joint ventures that permit the acquisition of foreign know-how and technology. But the results have so far been modest, largely because it is difficult to harmonize the interests of partly foreign-owned economic agents with the central planning framework.

There was a significant reduction in payment restrictions with other countries. The number of clearing arrangements with developing market economy centrally planned economies countries shrank in favour of convertible currency settlements. Some of the countries joined the Bank for International Settlements, the World Bank, IMF and GATT. The role and use of exchange rates became more prominent, although these economies still administer multiple exchange rates in at least the rouble and convertible currency areas. The attitude of these economies towards regulating trade with the assistance of tariffs, among other instruments, changed as well. Some of them decided to activate or to introduce two-column tariffs to be able to reciprocate in tariff negotiations.

Lessons from the Eastern European experience

Though reforms in comparatively small developed economies, such as those of Eastern Europe, are by their very nature different from the reforms pursued in large countries that enjoy substantial policy autonomy, several lessons can be drawn from the former's experiences. Perhaps the most characteristic was that none of the reform blueprints was able to tackle the economy comprehensively, foresee many practical complications and avert resistance to the reforms. These factors proved formidable barriers to the consistent adjustment of the economic mechanism to evolving circumstances. Particularly deleterious was the inability of policy makers to weaken the deeply entrenched interests in the preservation of the *status quo ante* of important layers of the administrative hierarchy. Those opposing reform found support in three widely shared sociopolitical concerns: the conflict between greater income differentiation and the precepts of a socialist society, profit maximization, which could lead to unemployment and the reduction or elimination of price subsidies, which could fuel inflation.

Among the economic difficulties with partial reform, three stand out. First, the efficiency and output gains registered were well below expectations, in part owing to the absence of economic signals. Secondly, factor productivity, which was perhaps the central goal of reform, lagged far behind expectations. Finally, technological change was expected to alter economic structures in major ways and bolster productivity; it did neither, not even in countries that increased their imports of advanced technology. The failure of selective decentralization of the centralized model to bring about those shifts can be attributed in part to major weaknesses of directive planning. Such weaknesses include insufficient flexibility; unwillingness or inability of central authorities to deny resources to entrenched ministerial interest groups; lack of adequate incentives to promote quality, innovation and efficiency; and a chronic inclination of economic units to overspend.

The growing pressures to keep reform on track in spite of apparent resistance and initial set-backs in terms of below-plan performance tended to impart a cyclical element to the reform process. After the first phase of reform, unforeseen side effects or unexpected opposition slowed down, halted or reversed the follow-up process at unpredictable intervals. A few years later, policy makers sought to resume the reform process by different means, with mixed results. The contradiction between the new economic regulators and the customary planning and management carried out by central organs was perhaps the most pronounced in setting norms, for example, on gross output, material inputs, the wage

fund, the distribution of net and gross profit, various measures of productivity, capacity utilization, exports, product innovation, sales and the product mix in physical terms as substitutes for directive plan assignments, which became pervasive in the 1970s. Identifying all these elements was a huge and intricate task.[4] Under the circumstances, it is not surprising that many norms were set arbitrarily or were too imprecise to guide firms and hence resulted in unbalanced and inconsistent plans.

Such economic indicators as enumerated above undoubtedly helped to modify the behaviour of firms. In practice, however, directives issued tacitly or overtly by industrial ministries gained ascendency once again. Central agencies successfully re-established the power they lost when reforms were introduced. One principal reason was that the centre had not meaningfully changed the implicit success indicators for central agencies themselves. In such a situation, those agencies could not help but interfere in enterprise activities by formal and informal means. Requests for temporary exceptions and exemptions from the provisions of the reforms were common.

Until the mid-1980s, reforms in Eastern Europe were partial in both conception and results. This was perhaps most pronounced in the entrepreneurial sphere: opportunities for the macro-economic steering of economic activity through indirect co-ordination instruments were limited as a result of frequent and rather pervasive administrative and political intervention. Central authorities exercising ownership and control over state firms may intrinsically have conflicting objectives of efficiency and stability. It is therefore critical to lay down an unambiguous framework, including a framework for ownership and control, within which micro-economic units can seek to improve their performance and be held accountable for it. Experience has shown that it is not the consistency or ambitiousness of declared reform principles that determines their ultimate fate but rather the tenacity with which they are defended during the promulgation phase. This is required particularly because these economies lack a coherent macro-economic framework for co-ordinating decisions, even those of the various planning tiers themselves.

Economic reforms in China since 1978

Until 1978, management of the Chinese economy was essentially highly centralized. Certainly, since the early 1950s, there had been vacillations in strictness in adherence to the various components of this model. Such vacillations reflected temporary shifts in strategies, allocative priorities and methods of implementation of economic programmes. In 1976, however, the change in the political leadership placed the revitalization of the economy and the establishment of a solid basis for long-term economic growth as urgent tasks on the policy agenda. The blueprint for growth was the 10-year plan (1977-1986) formulated in 1977 fundamentally within the parameters of the traditional development model but with greatly expanded reliance on foreign technology.

After a year, the rapid growth attained under the plan, largely on the strength of domestic and foreign resource mobilization, had created serious domestic and external imbalances. At the end of 1978, a major change in development strategy was announced and the plan was effectively discarded. Although the goal of rapid economic growth was retained, this decision called for fundamental changes in the model of development. The next three years, however, were to be devoted primarily to "readjustment" of the economic structure so as to rectify existing imbalances and reshuffle resource allocation in a manner consistent with current development objectives.[5]

Ambitious reform centred on the rural economy

Every major aspect of the traditional model was to be modified. There was to be decentralization of decision-making to individual economic agents with greater reliance on efficiency indicators and on material incentives within the planning framework. Though the thrust behind economic growth was to continue to be rapid capital formation, the improvement of consumption was given the highest priority. The economy was to be more open to the international economic system through increased trade and capital flows, which would bolster modernization. The ramifications for the economic model as a whole were expected to be considerable.

Unlike earlier reforms in the European planned economies, China embarked on system-wide reforms by first tackling on a broad front a number of fundamental economic issues regarding decision-making and organization in the rural sector, particularly agriculture. Concurrently, more piecemeal changes in other sectors were also instituted. After the success of agricultural reforms, the decision to embark on extensive reform of the entire economic system was promulgated in 1984.[6] Implementation has proceeded slowly, however, as many economic consequences of reform have proved to be socially and politically unacceptable. Where implementation had not progressed far, various compromise solutions had to be resorted to. This has resulted in

4 To illustrate from recent Soviet experience, which will be important in examining ongoing reforms, the number of norms on the use of materials and fuels for metal products in industry increased from 120,000 in 1978 to 180,000 in 1980 and 200,000 in 1981 (see G. Pokarev, "Normativnaya baza planirovaniya: sostoyanie, problemy, zadachi", *Planovoe khozyaistvo* (Moscow), No. 8 (1981), pp. 31-32).

5 This decision was promulgated at the Central Committee Plenum of December 1978. The basis for the implementation of the strategy was the report on the work of the Government, presented at the second session of the fifth National People's Congress, in June 1979.

6 Decision of the Central Committee of the Communist Party of China on reform of the economic structure (adopted by the twelfth Central Committee of the Communist Party of China at its third plenary session, on 20 October 1984).

partial reform of major aspects of the system, including markets, prices, labour remuneration and the monetary and fiscal systems.

Increased use of markets and price signals

In China, isolated markets with flexible prices existed in the mid-1960s and, at times, flourished, notably in non-staple agricultural commodities, handicrafts and small self-employed businesses in urban and rural areas. These have been revived since 1979 as part of the process of decentralization. Markets have also been set up for industrial commodities whose allocation has been decontrolled. For broad segments of the economy, however, markets, if they exist at all, remain highly segmented, prices are not flexible and allocation is based primarily on administrative means.

As a result of the price reform, which does not seek to decontrol all prices, fewer commodities are subject to central price controls. Furthermore, even for prices that are regulated, the reform has led to price differentials for quality variations and has endeavoured to make the administration of state-determined prices more flexible and responsive to demand and supply conditions.

A series of price reform measures taken between 1977 and 1982 raised procurement prices paid by the central Government to farmers for the major agricultural commodities (grain, oilseeds and cotton). Prices of cash crops were raised relative to staples to promote the desired output level, reduce reliance on compulsory procurement and reflect factor production costs.[7] Since 1982, a series of smaller price changes have been implemented. At the same time, a private system of distribution known as "free markets" with fluctuating prices for quantities in excess of planned procurements has been revived.

Price reform has been constrained by the priority accorded to maintaining overall price stability and, in particular, the purchasing power of the urban population. As a result, either urban retail prices have not been raised or else price increases have been offset by income subsidies to urban workers. Both shifts have been financed from the central budget, which has created a conflict between price rationality, price stability and fiscal balance. In some cases, the reduction of compulsory purchases has resulted in government procurements falling short of planned goals because farmers tended to sell to free markets at prices higher than the procurement price or shift resources to more profitable agricultural and other activities.

At the outset of the reform, prices of manufactured goods had been frozen for many years at a level that well exceeded those of raw materials and energy and prevailing production costs. The rationale of this relationship involves history, ideology, *fiat* pricing and preferences of the Communist Party for the promotion of new industrial capacity during the 1950s. Consumer prices were uniform for broadly similar products without taking into account quality or demand differences. Prices of goods subject to mandatory procurement and distribution by the State were fixed by central planning in collaboration with the industrial ministries concerned. Prices of other goods were set by the Ministry of Commerce in consultation with central planning organs and the appropriate industrial ministries. With the ascendency of local self-sufficiency in production in the late 1960s, an additional system of pricing controlled by local governments for goods produced by locally funded, small-scale industries came into existence.[8]

The intent of price reform in China was originally to supplement but not replace the existing system. The reform of prices and distribution of industrial goods has so far been partial. It has freed a large number of commodities from centralized administration and control, but the result is a two-tiered system of pricing and supply. The distribution and pricing of products subject to output quota under the central plan are centralized. Above-plan output, however, is priced and distributed according to supply and demand and by individual economic units within a price range set by the State.[9] With persistent excess demand, the decontrolled price has consistently exceeded the controlled one. Some undesired effects of the system are unofficial secondary trading and incentives for investment in expansion of above-plan output at the expense of planned output.[10] The trend in reform has been a steadily increasing share of "market" transactions in the total distribution of industrial goods. At the same time, pricing authorities have raised administered prices of commodities for which the gap between *fiat* and market prices has been very large.

The insulation of domestic prices from trade prices was another characteristic of the price system. Given the overvaluation of the currency and the lack of a link between domestic and external prices, this system effectively favoured exports of agricultural goods, fuels and raw materials, and imports over exports of manufactured goods. As discussed below, the reforms since 1978 have improved the link between domestic and international prices by increasing the autonomy of the trading corporations and some producers in the direct handling of foreign currency and in price negotiations. More important, the national currency has been repeatedly devalued since 1983 to bring domestic prices more in line with international prices.

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7 The guideline for the initial price adjustment was to allow farmers to at least break even (see R. H. Myers, "Can Communist China's new price system work?", *Issues and Studies*, October 1983, p. 35).

8 Prices were fixed at the ex-factory, wholesale and retail levels. They included average costs, profit margins and the so-called industrial and commercial tax, which is essentially a turnover tax. Costs were based on the average for the whole sector with local variations; taxes and profits were determined centrally but could be adjusted to maintain prices at each level of distribution (for details, see K. Furusawa, "Pricing China's industrial products: difficulties in the reform of China's pricing system", *China Newsletter* (Tokyo), No. 52, p. 3; and C. Wong, "Between plan and market: the role of the local sector in post-Mao China", *Journal of Comparative Economics*, No. 3 (1987), pp. 385-398).

9 China Daily (Beijing), 13 April 1987, p. 4.

10 W. Byrd, "The impact of the two-tier plan/market system in Chinese industry", *Journal of Comparative Economics*, No. 3 (1987), pp. 295-308.

Towards wage differentiation and labour market flexibility

Before reform of the urban employment system and decollectivization of agriculture, wages and labour allocation were administratively determined by either the central Government or local authorities. Wages were set on the basis of need rather than productivity, with the result that only small differentials between individuals existed. Because labour mobility was virtually absent, serious distortions in the allocation of labour resulted. In rural areas, cultivation of private plots and private sales were abolished even though the collectivized sectors were unable to generate sufficient employment growth to improve productivity while absorbing the growing labour force. Restrictions in rural-to-urban migration severely limited the reallocation of labour from agriculture to industry. Self-employment in urban areas was prohibited and all employment of new workers was centrally assigned by the local branch of the state labour bureau. Employment tended to be viewed as an entitlement and dismissals and transfers were rare.

Since 1978, there has been more of a labour market in rural areas than urban areas, although migration is still highly restricted. Rural incomes are largely based on output and many of the underemployed have either moved into non-agricultural employment or become visibly unemployed. Self-employment has been reinstituted and individuals are free to seek employment in rural industries. The one area of labour allocation that has remained totally centralized is the assignment of newly trained skilled manpower, primarily university graduates. They are allocated by the Ministry of Labour and Personnel, in consultation with the Ministry of Education and the universities.

Labour reforms in urban areas initially focused on the decentralization of the system by which unskilled labour is allocated and the reinstitution of self-employment to improve job opportunities for new entrants to the labour force. There has been some improvement in the efficiency of job placement through the use of locally established labour service companies, which operate much like employment agencies. Bonuses have been reinstituted to foster productivity by linking rewards to performance. In practice, however, bonuses are still awarded across-the-board owing to strong resistance on the part of workers to large pay differentials. Wage differentials due to skill and education have been increased since 1978 but are still very small. Piece rate wages, floating wages based on performance and wages linked to enterprise profits have been experimented with. It is planned to extend them to the national level in 1988. In effect, a labour market in urban areas does not exist as most wages are centrally determined and mobility is greatly restricted.

More recently, reforms have been proposed that seek to allocate labour through economic mechanisms and remove institutions that obstruct such allocation. One of the reforms aims at gradually eliminating the "life-time employment" system by placing newly employed workers on renewable contracts of fixed duration, usually five years. These contracts are in principle negotiated between the two parties and include job requirements and performance criteria. An unemployment insurance scheme has been instituted to compensate workers who are laid off. So far, this employment system covers only a small proportion (4 per cent) of all workers in the state sector. Its flexibility depends on exercising the option of contract termination. There is evidence that some managers find it difficult to terminate employees owing to pressures from workers and Party cadres. At the same time, the most highly skilled workers are more likely not to renew their contracts because of better employment options. As a result, managers are not always favourably disposed toward this more flexible arrangement. The efficacy of the new employment system in improving labour allocation remains to be seen. There has been some experimentation with mechanisms for the transfer of skilled and professional workers as another means to improve mobility but their implementation on a more extensive scale has yet to begin. In the short term, reforms in wages and the labour market focus on the wider application of contract employment and a more effective linkage between productivity and labour rewards.

Even if markets existed for all economic resources there must be a structure of incentives to induce economic agents to respond in the expected manner. The most glaring deficiency is in urban, state-owned factories, which account for most of the urban industrial output. Managerial reforms implemented since 1979 have attempted to create incentives by allowing firms to retain profits. But other disincentives to profit-making have not been reduced substantially. Most notable are the lack of financial accountability of firms, the continued subjugation of the autonomy of managers to the Party and central Government and, on the whole, guaranteed employment and bonus and promotion systems, often irrespective of performance. In contrast, the self-employed and rural farm households have many fewer disincentives as their operational autonomy is relatively greater.

Banking reform in a rudimentary monetary system

The long-term goal of financial reform is the development of a financial market with commercial lending and a diversified asset structure regulated by a strong central banking institution through effective policy instruments. Reforms since 1978 have focused primarily on institutional change with the creation of a central bank and the delegation of lending functions to specialized banks each with its own network of local agencies. Banks are specialized by sector of lending, such as agriculture and industry, and by type of lending, whether for long-term investment, circulating capital or other current expenditures. Though loan decisions can be made by specialized and local banks, no effective indirect restraints on lending in the form of financial accountability of the banks have been instituted. As a result, loan decisions at the micro-economic level are primarily based on political rather than economic considerations.

Greater use has also been made of interest rates in reconciling credit demand and supply. Interest paid on savings accounts has been raised several times to bolster household

and enterprise savings.[11] Attempts have also been made to use interest rates to curb loan demand by firms. Owing to the absence of financial accountability of economic agents and the laxity of enforcement of loan repayments, these instruments have not achieved the results intended. In practice, direct rationing of credit and other controls remain the most effective measures available.

Continued reform of the financial system will focus on the development of a central banking institution, greater rationality in credit creation at the level of specialized banks and the development of a financial market to facilitate the flow of financial resources.

Reduced role of the central budget in financing the economy

As the monetary system in the highly centralized model is undeveloped, the fiscal system is one of the main channels through which the government influences the economy. This is still the case in China. The main outlays of the central budget are capital construction, enterprise expenditures (including expenditures on wages) and price subsidies to adjust the level of real consumption. The primary sources of revenue before the reforms were profits from state-owned firms, the indirect industrial and commercial tax and the agricultural tax. Through this centralized fiscal system the State had direct control of most investments, much of total savings and consumption. Prior to recent reforms, the mainstay of tax revenues was the industrial and commercial tax, which was incorporated into the price of products. The primary direct tax was the agricultural tax, which was based on standard yield per acre of land, with the rate, in principle, rising progressively with income yields.[12] In practice, however, it became a proportional flat rate tax. Payments were made in kind in grain-growing areas or in cash in cash-crop areas.

With reform of the fiscal system, part of the control of funds devolved upon local authorities, firms and, indirectly, individuals. There is more revenue-sharing with local governments; firms remit only part of their profits in the form of taxes and retain the rest, while individuals share in some of the retained profits through bonus payments. At the same time, there has been a shift in responsibility for investment expenditures from the centre to firms and local authorities. The share of out-of-plan (and budget) investment in total investment rose from 17 per cent in 1979 to 55 per cent in 1986. The disbursement mechanism for centrally planned investment was shifted to banks. Thus, a large proportion of investment, savings and consumption is beyond the direct control of the central Government.

In fixed investments, for example, expenditures are controlled by an investment plan and a credit plan. In principle, the two plans are co-ordinated so that only planned projects are funded. In practice, there appears to be a breakdown in the planning process at the lower levels of government so that unplanned projects get funded, leading to deficits in the budget. Indirect policy instruments to control out-of-plan investments by economic agents and local governments are quite ineffective, owing to the existing structure of incentives.

The reforms have resulted in only partial changes in the system of taxation. The primary modification has been the profit tax, which has become the major source of government revenue in lieu of profit remittance. The industrial and commercial tax remains an important source of revenue, although it has been differentiated into four distinct components. In addition to a turnover tax, there are now also a value-added tax, a differentiated product tax and several other indirect taxes, such as charges on fixed assets and circulating capital of firms, instituted experimentally. With greater decentralization of production and distribution in agriculture more use has been made of taxation of earnings in lieu of direct remittance of earnings or output. An individual income tax exists but its incidence is negligible as only very high personal incomes are affected.

Reforms in various production sectors

Reforms in the various aspects of the economic system have affected different sectors in varying degrees, depending on the organization and incentive structure targeted for change. To date, reform in the agricultural sector has been the most far-reaching although reform is continuing in all sectors.

The paramount role of agriculture

The agricultural sector was designated in 1978 as the first to undergo reform. Because its current output was nearly at subsistence level, growth in the sector was seen as critical to development of the overall economy. Reforms in the agricultural sector have been the most far-reaching. The focus of agricultural policy since 1978 has been on reducing inefficiencies by relying on material incentives to raise agricultural output and by diversifying production away from the overwhelming emphasis on grain and local self-sufficiency in grain production.[13]

The changes in agricultural policy announced in December 1978 were directed towards changing the structure of output in favour of cash crops such as cotton, oilseeds and livestock. The geographical distribution of output was modified to seek productivity gains through regional specialization. These goals were pursued by decentralizing decision-making with regard to cropping and structure of output through increased use of prices as a means of indirect control against the former direct control at the local level. Crop acreage targets at the local (commune) level were abolished in 1980, although broad, centrally determined production targets were retained. For price changes to be effective, it

11 B. Naughton, "Finance and planning reforms in industry", *China's Economy Looks Towards the Year 2000*, vol. 1, *The Four Modernizations*, selected papers submitted to the Joint Economic Committee, Congress of the United States (Washington, D.C., 21 May 1986), pp. 616-617.

12 A. Eckstein, *China's Economic Revolution* (New York, Cambridge University Press, 1977), p. 185.

13 N. Lardy, "Overview: agricultural reform and the rural economy", in *China's Economy Looks Towards the Year 2000*, vol. 1, *The Four Modernizations*, selected papers submitted to the Joint Economic Committee, Congress of the United States, (Washington, D.C., 21 May 1986), p. 327.

was felt that more direct linkages between effort and income payments to peasants were necessary. The so-called "agricultural production responsibility system" (*nongye shengchan zeren zhi*) replaced the collective system of production in the early 1980s. Subsequent reforms have reinforced this system of household production while retaining collective ownership.

Decentralization of pricing and distribution in the sector has been the biggest problem. Prior to 1979, centrally controlled distribution and pricing of major agricultural commodities were the primary means of ensuring an adequate domestic food supply at a low price. Within the framework of planned national output levels, the procurement and pricing systems were used to implement these targets at the micro-economic level by setting obligatory procurement quotas for local areas and production units or by manipulating prices and procurement quotas for three categories of products.[14] All category one products (grain, cotton and edible oilseeds) were subject to state procurement. Some category two products (including pork, eggs, silk, tea, tobacco, sugar cane and sugar beets) were subject to procurement. Category three products were minor commodities and native products not subject to procurement. To meet procurement targets handed down from the central to the provincial and then to the local governments, physical procurement quotas by product were set by the local authorities for each production unit.

Although prices for all procured commodities within the quota amount were centrally set, category one commodities were subject to a three-tier pricing system. For output up to the compulsory quota, there were two prices—the "quota" price and the "above-quota" price. In principle, quantities subject to the quota prices were fixed for three or five years, while those subject to above-quota price were adjusted annually according to anticipated changes in output. The proportion of output increments that could be sold at above-quota prices was usually 40 per cent. Quantities in excess of the obligatory quota sales were purchased at "negotiated" prices, which were usually above the other two prices.

Initial changes in agricultural policy emphasized price incentives to promote output growth. The virtual monopoly of the State in the distribution of major agricultural commodities remained basically intact, with the exception of the promotion of free markets where prices move in accordance with demand and supply. As grain procurements purchased at the lowest quota prices were reduced in 1979-1980 and production rose rapidly between 1982 and 1984, the share of procurement at above-quota and negotiated prices expanded markedly, resulting in steady increases in the overall procurement price of grain. None the less, the proportion of free market sales remained very low—4 per cent in 1984.

Since the mid-1980s, policy makers have sought to simplify centralized pricing, reduce the share of state procurement and increase market sales of cotton or grain.[15] This is consistent with the overall trend toward decentralization and represents a means of preventing continuing increases in procurement prices and the resultant fiscal burden. The timing of changes for cotton and grain was probably also influenced by several years of high production and, in the case of cotton, substantial excess supply.

The decentralization of decisions on cropping, price increases and the revival of private markets contributed to the unprecedented growth of output and yield of all the major crops in the early 1980s. However, the outcome did not coincide with planned physical goals. Using prices as an output incentive also conflicts with maintaining stable retail prices in urban areas unless the gap is closed through subsidies. The return to farmers from staples remains significantly below that of other commodities and, in consequence, the growth in output has lagged behind that of demand, contributing to rising grain prices in the free market. As a result, the central Government has had to resort to other incentives such as subsidies on input prices and prepayment for purchases. The decontrolling of prices of non-staples, such as vegetables and pork, has led to exorbitant price increases and a subsequent retreat to rationing and price control, suggesting that much remains to be done to streamline agricultural pricing.

The changes in the incentive system since 1979 were partly a function of decollectivization. The break with the collective organization of production was complete by 1984, though social ownership of land and some capital was retained. The "agricultural production responsibility system" made the household the unit of production and based renumeration on output realized rather than on labour inputs. Although reforms were initiated in 1979, the pace was rather slow until 1981. By late 1981, less than 40 per cent of rural households were producing under the most rewarding form of the responsibility system—"household output delivery" (*baogan daohu*). By the end of 1983, however, 95 per cent of all peasant households were under this system.

The "household output delivery" system was based on a negotiated contract between the collective unit that had jurisdiction over the land and the peasant household. The contract stipulated the length of tenure, the area of land to be worked, the means of production to be made available to the household and the types and quantities of output to be delivered to the State and the collective. Excess output belonged to the household and could be sold or retained as desired. The contract also specified obligatory contributions to the collective for investment, maintenance of irrigation and water-management systems and the welfare fund. Tenure of the assigned area of land was initially for a season or a year; it was extended in 1984 to 15 years for most types of land. Since 1984, the transfer of land tenure among households, subject to the approval of the collective, has been permitted.

14 K. Walker, *Food Grain Procurement and Consumption in China* (New York, Cambridge University Press, 1984); and R. Hsu, "Grain procurement and distribution in China's rural areas", *Asian Survey,* vol. XXIV, No. 12 (1984), pp. 1229-1246.

15 Economic Daily (Beijing), 30 January 1985, p. 1; and Daily *Report: China* (Foreign Broadcast Information Service, 5 August 1986), pp. K12-K14.

A further stage of reform could be to increase the size of leased plots by allowing subleasing. This has been experimented with in local areas.[16]

Central control at the local level was greatly reduced by the elimination of the economic function of rural communes. The commune system as it had existed since 1958 was dismantled in 1983 and its economic functions reorganized under co-operatives. The major economic co-operative unit replaces the team, brigade and commune of the old commune system and is responsible only for economic functions, such as ownership of land and means of production, negotiating contracts with households and capital accumulation. The political and administrative functions were reorganized under local units of government renamed "township" and "village" corresponding to the "commune" and "brigade" of the old system.[17] Thus, decisions with regard to output, inputs, technology, marketing and investment have become much less subject to the direct control of the Government.

Rapid expansion of rural industries

An integral part of agricultural reform has been the promotion of rural industries using collective and individual resources. This was felt to be crucial particularly to facilitating the transfer of labour from agriculture to other sectors, which made it easier to raise agricultural productivity. Further, rural industrialization was expected to reduce the inequality of income distribution between urban and rural areas.[18]

Initial measures announced in 1978 emphasized the development of commune and brigade enterprises for processing agricultural products. Urban firms were encouraged to subcontract simple manufacturing processes to those enterprises, which were to be financed primarily by communes and brigades and through certain tax concessions and easier access to credit. Some state assistance was provided to poorer brigades. By 1980, there was a move towards consolidation and reform of commune and brigade enterprises. Their number declined as the small and inefficient among them were closed down or merged. The relative share of industrial firms shrank (but less so for light industry, in particular food processing, textiles and consumer goods), while that of construction and service firms rose. Measures were also taken to improve productivity of the enterprises by adopting a responsibility system in wage determination in lieu of the previous egalitarian system of distribution. These measures were reconfirmed along with the announcement of further rural reforms in 1984, thereby continuing the consolidation and readjustment of the enterprises.

The new policies announced in 1984 essentially extended previous measures to promote rural industrialization by further relaxing controls. They allowed more diverse forms of ownership and eased previous geographical restrictions on the flow of labour, capital and trade between rural and urban areas. Private (household) firms in industry and services were encouraged. Private ownership of small transport equipment, such as small motor boats, tractors and trucks, was allowed to stimulate the development of rural transport services. Joint private ownership was also encouraged to raise efficiency of production. The development of production units was to be directed towards joint ownership (between collectives across geographical boundaries, collectives and households and collectives and government) to take advantage of available physical and human resources. Migration by rural residents was officially permitted, but only to the smallest urban areas (towns) to establish small firms. Trade with urban areas in agricultural and light manufactured goods produced by households was also liberalized. The concentration of rural industries in towns was encouraged to make more efficient use of scarce infrastructure. Since 1984, large increases of capital for the development of rural industries have been financed through indirect government capital in the form of bank loans and use of the resources of local savings co-operatives.

One of the major consequences of rural reform has been a remarkable growth in rural net income per capita—16 per cent annually between 1978 and 1985. This stemmed from the rapid rise in agricultural income (at 12 per cent) and from the even faster gain in non-agricultural income (at 32 per cent), thanks to the development of rural industries.[19] But growth has been uneven, leading to increased income inequality within the rural population.[20] Although this runs counter to socialist principles of income distribution, it is viewed as a transitory price to be paid for the substantial improvement of rural incomes as a whole in the long run.

The rural non-agricultural sector has been absorbing the majority—over 60 per cent—of the total increase in the rural labour force. But underemployment in rural areas is still serious and continued restrictions on migration pose a barrier to the reallocation of labour to employment with higher productivity, even within agriculture itself. The limitation of relying solely on rural industries to absorb rural labour is further illustrated by the recent consolidation of these industries with a view to bolstering productivity.[21]

16 *Sing Tao Jih Pao* (Hong Kong), 30 November 1987, p. 16.

17 F. W. Crook, "The reform of the commune system and the rise of the township-collective-household system", *China's Economy Looks Towards the Year 2000*, vol. 1, *The Four Modernizations*, selected papers submitted to the Joint Economic Committee, Congress of the United States, (Washington, D.C., 21 May 1986), pp. 354-375.

18 H. Oshima, "The transition from an agricultural to an industrial economy in East Asia", *Economic Development and Cultural Change*, No. 4 (1986), pp. 783-810.

19 A recent survey of 30,000 rural households shows that, in 1984, households with per capita net income of below ¥RMB 200-500 received 90 per cent of their net income from agriculture, in contrast with 74 per cent for households with incomes of ¥RMB 200-500 and 44 per cent for households with incomes of over ¥RMB 1,000 (see *Renmin Ribao* (Beijing), 11 April 1986, p. 5).

20 While rural per capita income grew by a total of 66 per cent between 1978 and 1984 at the national level, per capita income in one of the poorest provinces in the north-west (Gansu) grew by only 25 per cent; in an affluent eastern province (Jiangsu) and in the Beijing municipality, it grew by 95 per cent and 195 per cent, respectively.

21 *China Daily* (Beijing), 12 January 1988, p. 3.

Gradual extension of reform to urban industry

The decision-making autonomy of state-owned enterprises continues to be limited, despite some attempted decentralization since 1980. Because these enterprises account for the bulk of industrial output, the entire system of industrial production remains centrally controlled. This involves a two-track system of control, one by the Party in the form of Party cadres in the firm hierarchy and the other by the central Government in the form of supervision by a lower unit of central ministries over the firm's budgets, expenditures and personnel.

The earlier reforms focused on creating material incentives to improve productivity from retained profits, with some decentralization of decision-making in pricing and marketing.[22] This could be sought either through bonus payments to induce workers to be more productive or through reinvestment to improve capital efficiency. This system evolved into one of profit taxation, which began on an experimental basis in the early 1980s. It was intended to improve efficiency incentives for the more profitable firms through differentiated taxation. Because it is very difficult to ascertain efficiency based on value magnitudes derived from seriously distorted prices, this system has yet to be fully implemented.

The outcome of these reforms in terms of gains in total productivity has not been as positive as desired. The root of the problem has been the lack of a comprehensive approach to a rational economic system or structure of incentives. Besides the distortion of prices of goods and services, the price of capital to producers remains artificially low. As a result, the demand for capital investment consistently exceeds that desired by planners. The general lack of autonomy and of financial accountability of economic agents inhibits the proper response of managers to the material incentives instituted and makes them more vulnerable to non-economic pressures by political leaders and workers.[23]

The most recent reforms in industry have been directed towards the problems of micro-economic management. The reforms were first implemented experimentally and then incorporated into new legislation, which has not yet been ratified because of resistance from government officials, party cadres and workers, for example. The legislation created a legal framework for state-owned firms to go into bankruptcy and be responsible for any debt. Provisions were made to hold management accountable for failure and for the redeployment of workers of the bankrupt firm. The legislation also conferred autonomy in operational decisions on managers and freed them from administrative and political intervention, including intervention in labour matters. These decisions covered personnel and production areas but managers continued to be subjected to largely centrally determined prices, wages and output and employment quotas.

The problems that have stymied the finalization of legislation on bankruptcy have not been overcome to date but some resolution is expected in 1988. Progress has been made since the thirteenth Party Congress (25 October to 1 November 1987) in the formulation of a draft law on the separation of ownership and management of state-owned firms.[24] Among other provisions, the function of the Party in micro-economic entities is curtailed and the rights of ownership and management are more clearly defined.

Increased managerial autonomy takes the form of the contract system of management. This is implemented in various ways and to different degrees at the micro-economic level.[25] The general principle is that firms enter into a contract with the government agencies administering them to decide on the proportion of profits to be remitted. If profits exceed the amount contracted, firms can retain a larger proportion. If profits are insufficient to meet the amount contracted, they are expected to make up the deficit. The implication is that managers will have greater autonomy in decision-making with regard to production, but details have not yet been released. Small firms have been using a leasing system that, for a fee, grants an individual the authority to manage and be financially responsible for a specified period of time. The potential for retaining any profit is expected to be an incentive for more efficient management.

Activation of foreign trade and exchange policy

The decentralization of the foreign trade system necessitated greater integration of domestic and foreign markets with an effective price system to guide decisions. But decentralization was first implemented with an essentially unreformed price system. Even subsequent attempts at price reform have been tentative and piecemeal. The objective was primarily to improve the capability of the system to handle a greatly expanding volume and diversity of trade. Such expansion was anticipated in view of the country's ambitious modernization, growth objectives and changing economic structure.

The initial reforms ended the trading monopoly of nine national FTOs, the centralization of foreign exchange holdings and centralized control of commodities traded. With the reforms, industrial ministries were allowed to establish their own FTOs to handle trade transactions directly. Provincial branches of the original national FTOs were increasingly freed from the operational supervision of the central corporations. Some coastal provinces and principalities were authorized to set up their own FTOs. This devolution greatly widened the segments of the Chinese economy coming into direct contact with international markets. Its effect was significant but small: by the end of 1984, prior to the most recent reforms, over 80 per cent of total exports and almost 70 per cent of imports were still handled by the national FTOs.

22 World Bank, *China: Recent Economic Trends and Policy Developments* (Washington, D.C., 31 March 1983), pp. 56-58.
23 Examples of this were the preferential hiring of the children of workers and the indiscriminate payment of bonuses across the board.
24 *China Daily* (Beijing), 12 January 1988, p. 1; and *Renmin Ribao* (Beijing), 12 January 1987, p. 2.
25 *China Daily* (Beijing), 30 December 1987, p. 4.

Besides decentralization of foreign trade activities, new incentives to export and increase the efficiency of foreign trade were implemented. FTOs became independent accounting units with an obligation to record profit and loss and the right to retain a proportion (up to 30 per cent) of their foreign exchange earnings to finance imports through the local branch of the Bank of China. Control of foreign exchange also devolved upon FTOs at the provincial level.[26]

An internal rate of settlement for the conversion to yuan renminbi of foreign exchange export earnings was established in 1981 to provide an incentive for exporters of manufactures,[27] pending more fundamental price reform. This measure was effective in increasing the number of FTOs that became profitable and boosted exports, but at a substantial cost to ministries and the central Government. But many FTOs remained unprofitable, and so were supported by the ministry or provincial government that had jurisdiction over them.

Although these initial reforms promoted trade, they also created unanticipated problems. Most publicized were the surge of imports without a commensurate rise in exports in 1980 and price competition among exporters, referred to as the sale of parallel goods. The first problem was the result of the internal price structure of China, aggravated by growing demand for over-valued currency and the newly instituted profit incentive of the decentralized FTOs. The second was the result of the larger number of exporters. Whereas export prices were centrally determined and trading monopolized by national FTOs before the reform, exporters of many commodities could set their own prices after the reform. Price competition was, in part, an expected response to the over-valued yuan renminbi and probably had the effect of boosting foreign exchange revenues from price-elastic exports. The prices of some commodities were reduced far below the state export price and threatened to compress foreign exchange revenues. But competition also resulted because of clamouring for very scarce rationed foreign exchange. The Government's response to the undesired results of the reforms was to recentralize somewhat by restricting imports and co-ordinating export prices through the reintroduction of import and export licences in 1980. But the general thrust of promoting trade through a more decentralized system was retained.

The reform announced in 1984 was regarded as the second phase of the reform of the foreign trade system begun in 1979. It represented an attempt at the total separation of government administration and micro-economic management in foreign trade activities.[28] The initial reforms had sought to entrust the management of foreign trade to provincial and municipal governments. The second phase shifted the management of foreign trade to firms and attempted to expose domestic prices to the world price structure. The number of independent corporations was increased several fold. At the same time, the reform adopted an agency system to mediate between FTOs and the firms they service. Under this system, FTOs provide handling services for a fee to the exporters of industrial and mineral products and to all importers who are ultimately responsible for the profitability of trade transactions. Firms are allowed to retain a larger share of foreign exchange earnings (30 to 70 per cent). The internal settlements rate was abolished in January 1985 as the official exchange rate of the yuan renminbi had depreciated to the internal rate. The official rate continued to depreciate in 1985 and was further devalued by over 15 per cent in July 1986.

With decentralization, macro-economic planning of exports and imports was to be reduced. The Ministry of Foreign Economic Relations and Trade, which incorporates the former Ministry of Foreign Trade, no longer drew up or imposed procurement and allocation plans for exports. Mandatory export plans were to be limited to a few commodities deemed to be "critical to national livelihood". They included oil, coal, agricultural commodities, handicrafts, textiles and garments, which together constitute over half the total export value. Central planning of imports was to be limited to whole plants, bilateral trade agreements and key commodities purchased from centralized foreign exchange earnings, including steel, grain, chemical fertilizers, rubber, tobacco and synthetic fibres. The latter account for about 40 per cent of imports. As part of the guidance plan, targets of gross export volume would continue to be issued for the roughly 100 commodities first selected in 1980. Imports were regulated through quotas by broad commodity categories and inputs essential to central investment projects. The volume and composition of imports were to be controlled through the allocation of foreign exchange.

With the shifting of financial accountability to the micro-economic sphere since 1984, the trading network was further widened. However, existing problems, such as the export of parallel goods, persisted while new ones emerged. The initial depreciation of the currency also proved to be insufficient to sustain the profitability of exports. Export growth decelerated and actually became negative during the first half of 1985. The disincentive effect of the existing discrepancy between domestic and world prices of manufactured goods was accentuated by the newly instituted profit incentive for FTOs, as they became less inclined to export than import manufactured goods in order to raise profits. Decentralization had little immediate impact on the dispersion or growth of exports as the top 10 FTOs in 1985 continued to handle approximately 80 per cent of total exports.

With the decontrol of some domestic prices in 1985 and the rapid growth of investment, domestic prices of some manufactured goods rose further, thus widening the gap between domestic and world prices. Combined with decentralized control over imports, this led to soaring import growth

26 Despite this, the allocation of foreign exchange before the 1984 reforms remained centralized at the provincial level, that is, under the control of provincial governments and ministries rather than FTOs.

27 The official exchange rate was YRMB 1.705 to the dollar in 1981 and the internal settlement rate was ¥RMB 2.8.

28 *Renmin Ribao* (Beijing), 20 September 1984, p. 1.

of 58 per cent for the year. The impact of decentralization on the dispersion and growth of imports was dramatic.[29]

In response, various recentralization measures were taken to stem import growth. Some local governments reverted to subsidization of exporters by paying a premium for their foreign exchange earnings in yuan renminbi in 1985,[30] which was subsequently sanctioned by the central Government. In addition, exporters were also permitted to import commodities that yielded very large profit margins to compensate for their losses. Import licensing was extended early in 1985 to slow the growth of imports and outright bans of certain consumer durables and automotive equipment were imposed. Measures were also taken to control access to foreign exchange by ordering firms to repatriate all their foreign exchange holdings to the Bank of China and by requiring prior approval to gain access to holdings.[31] Export licences to control parallel goods were issued for a larger number of commodities. At the same time, price adjustments were induced by currency depreciation, of 15 to 16 per cent annually in 1985 and 1986.

Thus, implementation of trade reforms has been slow and has involved a sequence of decentralization and recentralization measures. None the less, the system has become much more decentralized than it was in 1984. But the second phase of reforms has encountered considerable resistance from the organizations that would have had their influence reduced. There has also been resistance from firms that fear the consequences of competition and full financial accountability. Domestic prices remain highly insulated from world prices as a result of a trade pricing system that has essentially changed little.[32]

With decentralization of foreign trade, the exchange rate policy was modified and exchange controls were relaxed. The exchange rate was based on a basket of major convertible currencies from 1973 until 1986 with infrequent adjustments. Since then the objective has been to reset the rate more frequently to take account of balance-of-payments developments, the cost of earning foreign exchange and exchange rates of China's major trading partners.[33] In practice, however, adjustments are made infrequently. Major movements of the yuan renminbi, determined by the State Administration of Exchange Control (SAEC), have to be approved by the State Council. As mentioned above, a two-tier exchange rate system was in existence briefly from 1981 and 1984. The use of an internal settlements rate substantially below the official one was an attempt to correct the balance-of-payments deficit without an outright devaluation. From the end of 1983 until 1986, the exchange rate in terms of the SDR was adjusted downwards by an average of 26 per cent annually in response to imbalances in external accounts. Since then, substantial balance-of-payments improvements have obviated large exchange rate movements; the yuan renminbi has in fact remained fairly constant in terms of the United States dollar but has depreciated against other major currencies.

Prior to reform, exchange controls were strict and thoroughly enforced, as foreign exchange entered through two primary channels: bank transfers to national FTOs and remittances to residents. All access to possession and trade of foreign exchange was centralized in the State through the central banking system. With the decentralization of trade and foreign exchange holdings and the growth of tourism, the managed, over-valued exchange rate was undermined by secondary trading. As a result, since 1980, new regulations on foreign exchange possession, access and trading have been issued periodically in an attempt to maintain the official rate. Decentralization progressed until 1985, when recentralization measures were taken in response to a sharp deterioration in the balance of payments. Some further devolution is planned for 1988.

There were several major reforms in exchange control. The central handling of foreign exchange was delegated from the central bank to the Bank of China, which is a specialized bank. Trust and investment corporations were created and authorized to engage in foreign exchange trading in the context of foreign investment in China and transactions in the special economic zones. Much less restrictive exchange regulations were instituted for special economic zones and certain designated coastal cities. Firms involved in trade and subnational FTOs were allowed to retain a certain portion of their foreign exchange earnings for their own disposal but authority for access to these holdings was vested in SAEC. A limited, experimental system for foreign exchange trading was established in selected regions but within the Bank of China's purview. Participation was limited to the firms mentioned above and prices were determined by supply and demand. This created a two-tier price system, similar to that applied in the distribution of industrial goods. However, in this case, the system was not supported by the Government and the differential between the two prices increased. Individuals are allowed to hold foreign exchange but not to trade in it. For a while, foreign exchange coupons were issued to foreign tourists, in lieu of the domestic currency, at the official exchange rate. This attempt at restricting unsanctioned foreign exchange markets in tourist areas was unsuccessful, as secondary trading in these coupons flourished.

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29 In 1985, the share of total import value handled by the top 10 importers (9 of which were national FTOs) fell to 50 per cent from almost 70 per cent before the 1984 reform. The value of imports ($21.0 billion) handled by the smaller importers in 1985 was greater than the increase in total imports from 1984 to 1985 (about $15.6 billion).

30 Some localities were paying up to ¥RMB 4.0 to the dollar compared with the then official exchange rate of ¥RMB 2.95 to the dollar (T. Chan, Reform in China's Foreign Trade System, Paper No. 22 (Hong Kong, Centre of Asian Studies, University of Hong Kong, 1986).

31 This resulted in the control of an additional $3.5 billion or more by the Government (T. Chan, *op. cit.*).

32 Exports are still largely procured at domestic prices. Imports outside of the mandatory plan are priced at the import price plus the cost of transaction charged by the FTO. If this price is lower than the domestic price, the domestic price is charged.

33 IMF, *Exchange Arrangements and Exchange Restrictions: Annual Report 1987* (Washington, D.C., 1987), p. 154. Adjustments are probably against a basket of currencies but with weights that are much more malleable than in the past.

Foreign exchange allocations and transactions remain centralized and are generally not guided by adequate pricing or co-ordinated macro-economic policies. Rather, the foreign exchange plan in principle regulates all transactions including those in bilateral trade and involving locally retained foreign exchange.[34] The central bank is responsible for foreign exchange reserves and external borrowing; it recommends broad planning guidelines. The various components of the plan, including foreign trade and loans, governmental foreign exchange needs and remittances, are drawn up by the ministries concerned. The overall plan is co-ordinated and balanced by the State Planning Commission and submitted to the State Council for approval. SAEC supervises implementation of the plan by localities and ministries. In practice, there are breakdowns in the controls over implementation. This was manifested, for example, in the unplanned precipitous decline in China's exchange reserves in 1985. Further reform considered for 1988 focuses on the re-institution of a limited foreign exchange trading system as a first step toward increased market orientation of foreign exchange allocation.

Increased utilization of international loans and decentralization of borrowing have resulted from policy changes and reforms implemented since 1978. Previously, international borrowing was limited in accordance with the policy of self-reliance. Reforms included opening access to commercial financial markets and increasing the number of ministries and other institutions, including investment and trust corporations and certain local authorities, authorized to borrow. Control of the implementation of the plan for international borrowing, which is part of the foreign exchange plan, by lower level units is exercised through the issuance of loan guarantees usually demanded by foreign banks. Demand for foreign loans by local authorities and enterprises invariably exceed the planned amount, owing to the over-valued official exchange rate and lack of financial accountability of these units. When many foreign banks no longer demanded guarantees in 1985-1986, control broke down. As a result, there was greatly increased central borrowing to cover a soaring trade deficit, resulting in a rise in the ratio of debt to export earnings from 45 per cent in 1984 to 75 per cent in 1986. This raised the relative debt-to-national income level, which until then had hovered at most around 2 to 3 per cent.

Will reform continue?

Before the thirteenth Party Congress (October/November 1987), prospects for continued rapid reform were uncertain. This was not altogether new. Even the earliest reform of the agricultural sector, although implemented with great success, had not been without resistance, especially with respect to the institution of the "agricultural production responsibility system". Though overall implementation of the system was gradual, it met with resistance from local and national Party officials, whose authority was being undermined and who did not agree with the decentralization of decision-making and the essential dismantling of the entire collective system of production. This resistance, however, was overcome by first applying the system in poorer regions and justifying it as a means of letting the poorer peasants improve their incomes. The much heralded rise in agricultural productivity and incomes provided the momentum to push forward subsequent reforms in agriculture, the rural economy and the urban sector.

Concurrent with these attempts at more complex restructuring, some of the unanticipated negative consequences of earlier changes emerged. This resulted in greater opposition to the reforms. Even the success of agricultural reforms began to falter in 1985 as grain output fell below target, resulting in a call for a return to the traditional centralized model. The over-expansion of the economy, soaring prices and wages and a surge in the external deficit in 1985 further stalled the momentum of reform and favoured stabilization through recentralization.

Upheavals at the end of 1986 over reform of the political system and significant upward price pressure on prices convinced some of the leaders that there should be stricter adherence to the traditional economic model. Consequently, reforms slowed significantly in 1987, particularly in the more controversial areas of pricing, managerial autonomy and accountability. With renewed overheating of the economy in 1987 the focus of policy turned to "cooling off" economic growth and promoting grain output. However, since the middle of 1987 there have been growing signs of a revival of momentum towards continued reform with the reiteration of the importance to socialism of the development of productive forces. This was affirmed at the thirteenth Party Congress.

The Congress gave renewed impetus to further reform of the economic and political systems. The event that consolidated the political forces behind reform was the unanimous adoption of the report presented by Chairman Zhao Ziyang. This provides in-depth ideological reconciliation of past and future economic reforms with the principles of a socialist system. It also stresses the importance of continued devolution of decision-making. It calls for reform of the political system to separate the functions of Party and Government, which should mean greater autonomy for economic units. Thus, the official policy direction of the Party, supported by all members, is continued reform.[35] Though powerful critics of reform were replaced, the members of the top decision-making body, the Politburo Standing Committee, are by no means unanimous on the pace of reforms.[36] Obstacles to reforms that are difficult to surmount include their potentially negative economic consequences, such as price increases and supply shortages.

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34 IMF, Exchange Arrangements and Exchange Restrictions: Annual Report 1987 (Washington, D.C., 1987), and *Almanac of China's Foreign Economic Relations and Trade 1987* (Hong Kong, China Resources Advertising, 1987), p. 812.

35 *Renmin Ribao* (Beijing), 4 November 1987, pp. 1-4, and 2 November 1987, p. 1.

36 *Renmin Ribao* (Beijing), 3 November 1987, pp. 1-2.

Variants of the Eastern European reforms discussed earlier were tried out in the USSR from the late 1950s until the early 1980s, as shown in table VI.1.2. There were two major differences, however. First, decentralization of management in the USSR remained by and large confined to the administrative streamlining of planning and decision-making in firms. Even so, policy makers never progressed very far beyond the initial stages of the reforms. Secondly, external trade provided the major impetus to economic reform in Eastern Europe and up to the present has exhibited the more interesting features of reform. But such major reconsideration of the role of foreign trade in bringing about growth intensification never occurred in the Soviet Union. Earlier Soviet reforms relate in particular to the territorial restructuring of planning and administration introduced in 1957 and to the managerial decentralization attempted in 1965. Several experiments were also launched in the 1970s and in the early 1980s that modified the central model.

Broad backdrop to Soviet economic reform

In 1987, however, a major new thrust in reshaping the Soviet economic mechanism was launched. This was a logical evolution of the reform intentions announced since mid-1985, which were themselves based on the various managerial experiments of the early 1980s. These experiments were intended to give firms greater responsibility for their own performance. The measures announced in 1987, however, and even more so the policy intentions regarding follow-up in the years to come, amount to an important new phase in Soviet economic policies. Indeed, policy makers have made it clear that the measures announced constitute only the opening phase of a much broader-based reform, whose nature and scope is without precedent. The measures enacted thus far provide the very first steps in the direction of assimilating new micro-economic and macro-economic management methods throughout the economy.

Perhaps more important, the drift towards reform has been associated with protracted political, academic and societal discussions of economic and social issues for which there is no precedent in either the Soviet Union or any other planned economy, including China. In combination, they have set the stage for the creation of an overall sociopolitical environment that is more congenial and, indeed, conducive to launching new economic policies and establishing new institutions and policy instruments, even if only experimentally.

Of the measures introduced or discussed so far, the topics that have been elaborated fairly comprehensively concern individual and co-operative firms, foreign economic ties, income distribution and managerial autonomy. In March 1987, economic activity by individual and family firms was legalized for consumer goods and services and regulations were introduced to facilitate the establishment of co-operative businesses. A draft law promulgated in March 1988 signals further relaxation of these provisions with a view to bolstering employment opportunities, mobilizing capital and increasing the supply of consumer goods and services. New procurement rules in agriculture allow farms to sell more of their produce at market prices. Bold moves were made to introduce larger differentials in wages and labour-related benefits on the basis of productivity gains. Decrees in January and October 1987 authorized a number of industrial entities, in some cases individual firms, to engage directly in trading on their own account and to set up joint commercial ventures, including ventures with partners from market economies. Because the changes sought in the foreign trade sector since early 1987 were too minor to generate sufficient interest, the law on joint ventures was overhauled in October 1987. These examples illustrate the swift shifts in traditionally sensitive aspects of policy-making. They show the determination and pragmatism with which the Soviet leadership attempts to create a favourable setting for modernizing economic structures. This flexibility on the part of policy makers, including flexibility through the mobilization of resources, has been illustrated particularly well by the vigorous debate on the draft enterprise law in 1986 and 1987, which resulted in numerous amendments that in some cases significantly reinforced provisions for managerial independence.[37]

Ambitious scope of the reform

Perhaps the most outstanding feature of the perceived need for basic change in the economy is that Soviet policy makers now rule out the earlier piecemeal approaches to reforming the economy. The present reform strategy reaches well beyond such traditional remedies as shifts in investment policies, partial streamlining of organizational links and pressuring unprofitable firms to change by administrative means. Policy makers have committed themselves openly to comprehensive changes that will reverberate throughout society.

An important milestone was the adoption in June 1987 of two documents: "Basic provisions for fundamentally reshaping economic management" and the Law on State Enterprise (Association).[38] These represent the initial stage of the "radical reform aimed at constructing a new economic mechanism" publicly enunciated at the twenty-seventh Party Congress, in February 1986. However, by January 1988, when the law went into effect, only isolated components of a new system of economic management had been

37 For example, the draft law (art. 10, para. 4) stated that the firm "formulates" its annual plans, whereas the approved provision states that it "formulates and approves" its annual plans. Likewise, the provision that enables the firm to contest ministerial and similar regulations that it considers to be in violation of legislative requirements was added (as art. 9). The same attitude is reflected in the treatment of the structure of the wage fund. The draft law (art. 14, para. 4) called for norms on the maximum share of managerial and professional salaries, but the final text dropped this provision.

38 *Izvestia* (Moscow), 1 July 1987.

put in place. Administrative decision-making remained the backbone of macro-economic and micro-economic control. The substance of the new measures is the switch from what was primarily planning by injunction to cost-benefit control at every level of the economic hierarchy, to management of various interest groups, to effective human involvement and eventually to full participatory management.[39]

Economic reform measures enacted or formulated during the past two years have focused on two spheres: the reshaping of the organization of firms to overcome persistent bottle-necks and the revision of the economic environment affecting individual firms. Practical measures in the first area included the establishment of six "super-ministries" or high-level bodies that co-ordinate and oversee related groups of industries; the creation of a special state quality-certification agency; and the formation of some 20 intersectoral organizations to co-ordinate research, development and production of major industrial items in the forefront of technological innovation.

The new arrangements for the economy at large include reducing the number of centrally set plan targets; providing firms with greater latitude in determining employment, wages, prices and investment; linking managerial incentives to fulfilment of delivery contracts; and requiring firms to finance a greater share of their current and capital outlays from their own revenues. These measures allow organs of state control to concentrate on strategy and rates and proportions of development, they prevent central interference in the day-to-day matters of economic units at lower levels of the planning hierarchy and they foster the transition from an excessively centralized system of management to one actively encouraging self-management. At the same time, these measures are aimed at eventually demarcating unambiguously the functions of Party organs, local government and socio-economic organizations in economic decision-making. In the end, their success is predicated on fundamentally changing the working style of all sociopolitical and economic organs. Some of the measures are intended as levers to accelerate this attitudinal transformation.

Economic reform is considered to be the key factor in gearing the system of planning and management towards laying the foundations for obtaining sustainable growth at a rather high level from gains in factor productivity. It is conceived as a sequence of gradual transformations of economic sectors, rather than as an abrupt switch to a completely new, internally consistent, economic mechanism. The reform measures enacted thus far are the first steps in that direction. Continued progress must be ensured through detailed legislation on various aspects of reform implementation as well as its legal interpretation and administrative application.

A critical feature of the two documents adopted in June 1987 is the modification in the philosophy of social ownership. Earlier views advocated that only the State can fully represent the preferences emanating from the social ownership of the means of production, including those appropriated in the micro-economic sphere. With reform, strong support has emerged for the view that the firm as such represents the interests of public ownership. The firm is expected to utilize the means of production assigned to it for the benefit of society as a whole under the guidance of an appropriate economic mechanism. The practical ramifications of this doctrinal shift can be quite far-reaching, provided they are supported by simultaneous adjustment in planning procedures and management practices.

Towards autonomy, increased responsibility and self-financing of firms

Basic to the reform provisions to date is the creation of an economic environment conducive to self-financing and self-management of firms. To this end, each firm is to be authorized to adopt annual and five-year plans based on contractual obligations and government orders and to procure the necessary inputs primarily through wholesale trade. The volume of compulsory state orders is to remain well below the unit's productive capacity, so that direct relations among firms can be fostered. Because of the initial conditions in which the reform is being promulgated, the share of state orders will remain high for the near term. How state orders affect micro-ecoomic latitude for manoeuvre needs to be monitored closely to avoid state orders replacing central planning. Only thus can genuine wholesale trade be fostered.

Firms are expected to bear the full responsibility for their overall performance and the way in which they discharge their obligations. Financing of enterprise investments from the central budget is to be restricted to major investment projects only. In other words, because there is no effective capital market in place a new venture can be established or fundamentally restructured only through funds from the central budget. But even these relationships, unlike those in the traditional planning system, are to be regulated through long-term, stable parameters for payments for fixed assets and natural resources, which complement the norms on labour and profit taxes.

The changeover to cost-accounting and self-financing can be done in one of two ways. The newly formed workers' councils in each firm make the choice. The first option is based on retention of profit. It can be selected when the wage fund, essentially the total wage bill, is set according to agreed norms in relation to net output. Net profit after settlement with the central budget or superior body (ministry) and after repayment of bank loans is at the disposal of the firm. It can be appropriated for investment, social and cultural development, technological modernization and bonus payments. The second option is based on collective contract principles. In it the wage fund is a residual of net profit after settlement with the central budget and after transfers into funds for production development, technological promotion and social development constituted according to established norms.

Soviet policy makers emphasize that interfirm competition should be encouraged so as to cater to consumer demand

39 "Osnovnye polozhenia korennoy perestroiki upravlenia ekonomikoy", *Kommunist* (Moscow), No. 10 (1987), pp. 54-72.

and ease the effects of the monopolistic position of producers in a seller's market. On the other hand, there must be a transition to self-management with the help of workers' councils, which elect their own managers. Firms must have considerable leeway in selecting inputs, outputs and business partners. Fulfilment of contractual obligations is to be the main performance indicator. But the effectiveness of the new potential for competition and the matching of demand and supply depend to a considerable extent on the flexibility of the prices at which inter-firm transactions are effected. For the time being, as long as the sellers' market persists, the state quality-certification agency acts as a surrogate of competition. In the future, however, contractual freedom among state units should stimulate competition, but its impact is difficult to gauge at this juncture.

Centralized macro-economic control should guide individual agents by means of appropriate economic levers with the goal of optimizing the benefits to society as a whole. In addition to streamlined central planning, these levers include financial and credit relations, prices and exchange rates, material and technical supplies and foreign exchange controls. The central planning agency is entrusted with the elaboration of the concept and the guidelines for the economic and social development of the USSR for the next 15 years, the five-year plan being the principal instrument of economic control. But the main operative components of the plan should be indicative target figures rather than compulsory quotas; long-term stable economic "normatives", which are essentially approved standard ratios between indicators of performance and the distribution of revenue among the central budget, the ministry and the firm itself according to performance indicators; government orders for the most important products; and quotas for centralized investments and centrally distributed supplies.

The centrally set distribution parameters should prevent the firm from channelling an excessive share of income into labour remuneration. Where desirable, they should encourage decision makers to explore new avenues of improving performance. To that end, they should be predictable. The norms are therefore to remain stable in the medium run, perhaps within the context of the five-year plan. The selection of performance indicators and of norms with a view to rewarding improvement as fully as feasible is critical to the thrust of the reform and to steering a steady course towards a fully reconstructed economic mechanism. Organizational innovations include granting firms the right to establish joint production facilities on a co-operative basis or through complete merger. Industrial ministries are to be relieved of executive control over producers. They are to be transformed into centres for the co-ordination of research and development, the promotion of steady gains in the quality of output and quality control, technological policy-making and related tasks.

Emergence of negotiated wholesale trade

One salient feature of the new regulations is the gradual introduction of genuine wholesale trade in the means of production, including trade in capital goods, over the next several years. Negotiated intermediation of demand and supply will replace major components of the present administrative distribution of resources. This commercialization is to start first in the sphere of material inputs into the state production of consumer goods, machine-building, construction and agriculture. It also encompasses supplies for co-operatives and state firms. Government requests or state orders channelled through the state supply system are to be the only exception to the gradual dismantling of the state supply system in favour of direct inter-firm relations. But even they are intended to result from genuine economic bargaining between the centre and economic agents, rather than being imposed hierarchically upon micro-economic units.

The centralized material supply system should ultimately be confined to a comparatively small share of fuel and energy resources, raw materials and high-technology products. The agencies at present entrusted with material supply are expected to intermediate between demand and supply and to be remunerated primarily on a commission basis. Fulfilment of contractual obligations is to become the most important indicator of micro-economic performance once state orders are reduced to the role envisaged by policy makers. Violations of contractual obligations can result in fines of up to 8 per cent of the contract's value.

As a proportion of total inter-enterprise transactions, the role of wholesale trade in the means of production is still negligible less than 1.5 per cent of total industrial output in 1987; around 4 per cent is forecast for the end of 1988.[40] In spite of the limited scope for wholesale trade in capital goods, increased contractual responsibility and restraints applied to investment demand on account of self-financing are already bearing fruit. As an example, for the first time in the past 10 years inventories in 1987 increased more slowly than total output (see chap. II above).

The paramount role of scarcity-related pricing

The shifting of price determination away from the traditional average cost-plus basis is one central aspect of the reform. Increasingly, first for selected products and gradually for a growing number of products, prices are to be determined by supply and demand. Some modest changes have already been made in the system of price mark-ups and discounts for many products to encourage firms to improve product quality, expand their output mix and introduce new products. The highest placed policy makers have left no doubt that a radical reform of pricing must eventually become an integral part of restructuring.

Instead of price reform being partial and fragmentary, as in virtually all previous reform attempts in the European planned economies, it is now envisaged as comprehensive in the sense of involving a co-ordinated revision of wholesale, procurement and retail prices. Industrial and agricultural procurement prices need to reflect economic trade-offs and to provide appropriate guidance for managerial decisions on input-output mixes, including interregional and intertem-

40 *Ekonomicheskaya gazeta* (Moscow), No. 34 (1987), p. 6; and *Izvestia* (Moscow), 27 August 1987, p. 2.

poral ones, and for the proper assessment of factor productivity. Similarly, retail prices must become a lever for streamlining distribution and balancing consumer supply and demand. An important objective in reforming wholesale prices in particular is to bridge the gap between prices of manufacturing and extractive industries without raising the overall price level. Procurement prices for agricultural products and prices for construction services should increasingly result from contractual negotiations. Once such prices are set, current policy discussions emphasize, they should be kept stable for perhaps two to three years. In that respect, macro-economic policies regarding the overall price level and shifts in relative prices should become an important component of five-year plans with a view to reflecting more fully the tasks and conditions of the national economy. The consumer's role in the determination of prices is to rise sharply and price-setting procedures are to be simplified by drastically curtailing the share of centrally determined prices.

Policy makers are hoping to contain the upward pressure on prices by increasing domestic competition, eliminating shortages and curtailing all forms of monopolistic pressure. Regulations governing the foundation for negotiating contract prices are to be worked out as well.[41] Because retained profits are intended to become the major source of investment financing, firms are expected to become more interested in active price negotiations. The negotiated and approved contractual price for a specific product is to remain in effect for two years. Contractual pricing will initially be applied to products that have a direct and specific consumer, such as agricultural equipment or machinery for specific production processes. The share of prices determined centrally, once price reform and reforms are firmly in place well into the 1990s, should not exceed 10 per cent.[42]

Although policy makers have committed themselves to comprehensive price reform, the details of critical elements of such reform have still to be elaborated. It is as yet unclear which prices will be set by administrative fiat and which established as a result of direct agreements between producers and purchasers. From the ongoing policy discussions, the majority of prices will initially be constructed on a cost-plus basis.

Devolution in banking and monetary reform

The reform envisaged seeks to co-ordinate improvements in the price system with changes in the fiscal and monetary mechanisms. In reforming the monetary system, the priorities of gearing monetary circulation to the turnover of material resources, reducing gratuitous disbursements of financial funds for investment purposes and transferring budgetary receipts on a normative basis are stressed. Budgetary financing of investments is to be restricted to a narrow range of high-priority, goal-specific programmes of national importance and is to be kept separate from loans issued by special banks strictly on the basis of the economic viability of the loan request.

Policy makers are keen to consolidate the purchasing power of the rouble at home and to create the conditions necessary to utilize the rouble in foreign transactions. Given the dichotomy between domestic and external pricing systems, rouble convertibility is potentially a critical objective of change, a beacon for policy makers rather than a short-term policy goal. Convertibility of the rouble would require substantial institutional and policy transformations, in addition to those currently set in train. Judging from recent policy discussions, it is more likely that limited convertibility of the rouble and other national currencies of CMEA members within the context of selected regional transactions will first be promoted.

The reorganization of banking institutions involves giving them complete financial accountability and creating for them adequate incentives to improve the return on loans, making the financial performance of enterprises a basic criterion for loan disbursements and preventing intra-ministerial redistribution of circulating capital, depreciation funds and profits among subordinate firms. The first practical step in this direction was taken in July 1987 with the establishment of six specialized banks.

Wage reform, employment and consumption

The new provisions call for further strengthening of the links between labour remuneration and average productivity (i.e., output per worker). This endeavour is to be fostered by the introduction on a wide scale of the collective contract system (which governs the determination of wages and bonuses), by making profits the sole source of the social consumption fund set aside by firms and by lifting all restrictions on combining jobs. The wage reform introduced fully in January 1988 in essence grants enterprises nearly full rights, and imposes on them corresponding obligations, in setting payment scales according to merit and productivity. These differentiations can be undertaken within the provisions of the total wage fund. The reform sets growth in labour productivity as the upper limit for the expansion of nominal wages.

The wage increases envisaged are to be almost wholly financed from enterprise profits and are thus to be introduced in individual firms as resources are earned. The bonus system will undergo far-reaching changes. Bonuses are to be distributed at the discretion of the firm and limited only by its "labour stimulation fund". All central regulations on bonuses for different categories of employees are to be lifted. Within brigades and engineering and design bureaux, the size of individual bonuses is to be determined by the members. Basic salaries before bonuses remain regulated by centrally set payment scales, however. These are being raised by 20 to 30 per cent, but the increase is to come out of profits realized. The centrally set payment scales now serve as a reference, with the individual firm itself determining the rates for different categories of its employees, given the working conditions.

41 *Ekonomicheskaya gazeta*, (Moscow) No. 34 (1987), p. 7; and No. 48 (1987), p. 14.
42 *Izvestia* (Moscow), 30 August 1987, p. 2.

The changes envisaged in labour remuneration contrast sharply with the practice of previous reforms in at least two respects. First, implementation of a unified wage reform across all enterprises in an industry or region simultaneously is not envisaged at present. Secondly, most of the wage gains currently tabled will be financed from profits realized by enterprises, not from the central budget. Gradualism and pay-as-you-earn are the mottoes at this stage. By the middle of 1987, these new conditions covered 2,700 entities (around 6 per cent of the total), but more than 70 per cent of them did not noticeably change their bonus systems and failed to tie in wages to productivity.[43] It is hoped that this conservative attitude toward labour remuneration and inclination to link bonuses to gross output indicators rather than efficiency can be overcome by mid-1988, when the new wage regulations are to apply to over 65 per cent of the total non-agricultural labour force.

Another important component of the labour reform is that, instead of clinging to the *de facto* lifetime job guarantee, current employment policy emphasizes the urgency of utilizing labour more effectively. This may require temporary lay-offs, but their deleterious implications will be mitigated by providing, in effect, unemployment compensation. This is being introduced in conjunction with the creation of a network of job placement centres entrusted with the relocation and retraining of released and idle workers. These centres themselves are to be self-financing from placement commissions. Labour mobility is to be encouraged to staff private and co-operative enterprises under the provisions of the draft law of March 1988. This legislation may be enacted in anticipation of what, in a decade or so, may amount to a massive redeployment of labour (15-17 million people).

Fostering labour productivity through wage and related incentives places higher demands on the process of diversification of assets available to households and especially the supply of consumer goods with a high income elasticity. To meet these demands soon, the provisions adopted also established a practical framework for implementing the new economic policy with respect to the composition of output. Implementation is expected to be completed by 1990. An urgent task is to balance supply and demand in retail markets by promoting the output of consumer goods and services. Recently enacted provisions on private and co-operative ventures, which have been described as "market medics",[44] are aimed especially at improving the supply of foodstuffs, services and selected consumer durables.

Changing attitudes toward agricultural reform

The principal provisions of the new policy permit farms to sell a larger share of production at decontrolled prices and to market products more flexibly. Many of the arrangements introduced already in the industrial sector, such as normative planning, self-financing and the use of contracts, are to be extended to farms too. Emphasis on local decision-making, within the context of the contract brigades or similar production units within the farm, is evident. Such units are allocated land and livestock on a long-term contractual basis. Remuneration is based on output. These important features of the rural reform provide the basis for the functional decentralization of decision-making in agriculture, which may be a prerequisite for a breakthrough in the level and composition of farm output in the years to come. The question of further development of rural reform is to be addressed again at a meeting of the Central Committee in the first half of 1988.

The rural sector is increasingly encouraged to foster small-scale private or co-operative firms, including those engaged in manufacturing activities and services. Not only is this aimed at mobilizing available resources, it should also facilitate the redeployment of labour, enhance the allocation of capital in rural segments of the economy and indeed improve the supply of consumer goods and services.

Redesigning the role of foreign trade

In 19 August 1986, the Presidium of the Council of Ministers passed a decree which formally authorized the reorganization of Soviet organs involved in foreign economic relations and the restructuring of foreign trade practices and procedures. This permitted some 20 industrial ministries and 70 firms to engage in trade on their own account. One of the most significant changes was the possibility of entering into joint ventures both within and outside the territory of the USSR. At the end of October 1987, the joint venture regulations were amended by broadening the domestic base of the programme while an attempt was made to speed up approvals and decentralize responsibility.

The foreign trade reform introduced early in 1987 has proceeded rather fitfully, partly because it was drawn up without thorough preparation of either domestic or foreign partners, including CMEA members, and without a comprehensive assessment of how it would fit into the planning framework in 1987 and beyond. Domestic enterprises were unaccustomed to competing for markets and so were rather bewildered about how best to take advantage of their newly acquired latitude. Further, the financial and related infrastructure for direct trade relations was inadequate. Poor-to-fair results also stemmed from constraints on flexibility built into the five-year and annual trade agreements earlier concluded primarily with CMEA partners and the fact that the vast bulk of exports to market economies consists of fuels and industrial raw materials, which remain under central control. Finally, for several years, the Soviet trade environment has been under pressure from weak energy export earnings and rising prices for manufactures procured in market economies. Even considerable borrowing in financial markets did not suffice to permit policy makers to foster the modernization of engineering sectors that the current five-year plan (1986-1990) was to have vigorously encouraged from its inception.

Given the prevailing payments constraints, the lingering implications of the long years of separation between domes-

43 *Izvestia* (Moscow), 11 September 1987, p. 2.
44 *Pravda* (Moscow), 10 March 1988, p. 3.

tic and external economic processes and the fact that domestic changes will first have to proceed much further than they have to date before enterprises can engage effectively in trade, no major changes in the foreign trade situation can be expected in the short run. But if policy makers succeed in laying the foundations for co-ordinating decisions effectively by indirect means, the shifts in the medium to long run may be very palpable. The levels of productivity and material consumption of the Soviet economy still lag behind those of advanced industrial economies. Likewise, the dependence of the Soviet economy on imports of labour-intensive manufactures is likely to grow as it succeeds in strengthening its comparative advantage in medium-level technologies through structural and systemic change.

Changes in the foreign trade sector may in time also encompass services, including foreign direct investment, and perhaps labour mobility. They will affect trade with all partners, but mainly with other members of CMEA. Because of the importance of CMEA to the stability and growth of all its members, including the USSR, these issues are examined separately below in conjunction with the broader reforms contemplated elsewhere in the group and indeed in the organization itself.

Soviet reforms are likely to have major repercussions on trade and financial relations with the market economies too. Given the intention of policy makers to increase their exports of manufactures by a significant margin over the next decade or so, the Soviet Union will have to explore new markets. The developing countries might provide profitable outlets, particularly for products embodying medium-level technology. The tight foreign exchange constraints of those countries, however, limit their ability to engage in such absorption without finding a concurrent export market. If Soviet economic structures can be geared to sectors where the economy has a true comparative advantage, such a commercial *quid pro quo* is distinctly possible. Because of the existing labour shortage in the Soviet Union and pervasive self-reliance even in labour-intensive manufactures, there is ample room for the developing countries to capitalize on Soviet markets. Soviet policy makers have already indicated that market access will be facilitated for developing countries, including dynamic countries that, for a variety of economic, institutional and political reasons, have not yet tried to export to the USSR.

In relations between the Soviet economy and developed market economies, Soviet reforms are likely to have a number of distinct impacts. The joint venture provisions are probably better suited to these relations than to those with developing countries or even with other planned economies, especially if Soviet reforms progress substantially toward effective decentralization of commercial decision-making. Policy makers are bent on reducing the relative importance of raw materials in exports to developed market economies and on promoting manufactures. Capturing such markets is predicated on considerable "investments" in retooling, marketing, setting up servicing infrastructures and the like, which the Soviet Union may have to finance mainly through borrowing from global financial centres.

To realize those trade and external finance goals, the Soviet Union may also have to explore possibilities of establishing relationships with such trading organizations as GATT and with the international monetary system and work out structural arrangements, on its own behalf or in the context of its central role in CMEA, with such organized trading blocs as the European Communities.

Timetable for implementing reforms, the legal framework and emerging conflicts

An important part of the transition toward the coveted decision-making environment in the medium run consists of finalizing, streamlining and standardizing legal acts and regulations so that they will apply to all spheres of economic activity.[45] The aim is to minimize the room for arbitrary administrative intervention, which took place so frequently and pervasively in past reform attempts in virtually all planned economies.

The Law on State Enterprises (Association) emerged in response to the acutely felt shortcomings in the legal mechanism, which allowed arbitrary administrative interference by ministries and other supervisory organs in producers' affairs. The law defines legal norms for horizontal and vertical interaction of the firm with other economic agents. It also lays down material and disciplinary responsibilities of supervisory bodies for unlawful infringements and violations of the rights of subordinate agents.[46]

Following the letter and spirit of the basic provisions for fundamentally reshaping economic management (adopted in June 1987), the law enhances the autonomy of enterprises by stipulating that the enterprise will now receive control figures or targeted expansion and activity levels from central bodies once every five years along with state orders, long-term economic norms and ceilings on ranges of micro-economic policy manoeuvre. These indicators are not mandatory. The firm itself is responsible for conceptualizing its five-year and annual plans and such targets need not be approved by the ministries. The law also gives legal foundation to the right of enterprises to retain part of their export earnings.[47]

The law delineates the sphere of ministerial authority. Such authority is confined to issues of technical policy, to limiting the monopolistic reach of individual firms and to auditing production and financial performance, but not more than once a year. The law explicitly stipulates that if a

45 For example, during the introduction of the Law on State Enterprise (Association) and its application to all enterprises in 1988, the Ministry of Justice, in co-operation with the industrial ministries, has to review around 30,000 legal acts and regulations and invalidate those that conflict with the new law (*Sotsialisticheskaya industria* (Moscow), 10 September 1987, p. 2).

46 The draft law is set out in *Ekonomicheskaya gazeta* (Moscow), No. 8 (1987), pp. 4-8, and the approved text in *Pravda* (Moscow), 1 July 1987.

47 The share that can be kept fluctuates around an average of 30 per cent, depending on the type of economic activity. It is highest for finished manufactured products (possibly up to 80 per cent can be retained) and lowest for raw materials (where the retention quota may be as low as 5 per cent).

ministry, department or other agency superior to the firm issues a directive that is outside the jurisdiction of that agency or that violates legislative provisions, the economic agent has the right to contest it in a court of law with a view to having it rescinded in full or in part. Losses sustained by a firm as a result of compliance with instructions issued by a higher-level agency that violate the firm's rights, as well as those incurred because of the improper exercise of the higher-level agency's duties with respect to the firm, are subject to compensation by that agency. Though reform provisions allow economic agents to contest unrealistic state orders in a court of law, most firms are unwilling or hesitant to take such measures except as a last resort. They fear serious reprisals and arm-twisting by higher-level agencies or are simply unfamiliar with the proper procedures. So far, only one instance of such litigation has been reported and, apparently, the judicial authorities encountered serious difficulties in arranging a competent legal investigation of the problem.[48]

Transferring producers expeditiously to a system of full cost-accounting and reforming top management bodies in accordance with the new conditions remain the most important issues on the policy agenda for the next several years. By 1990, reforms of finances, prices, banking and the material-supply system are slated to be completed. Wholesale trade in the means of production should account for 60 per cent of total turnover by 1990 and around 90 per cent by 1992.[49]

Perhaps the most important problems to be tackled during the initial stage of the reform concern the definition of the substance and legal status of new economic levers such as state orders, control figures and the regulations on the distribution of gross profits. Serious problems have already arisen early in 1988 because of vague details, definitions and interpretation of reform regulations, which can seriously retard or blunt their desired impact. This feature is already particularly evident for state orders.

According to the spirit of the reform, contracts should be negotiated between central bodies and enterprises. Because of the inertia of traditional administrative practice, however, the planning centre and ministries have so far tended to resort to compulsory assignments through administrative pressure, even without the ministries ensuring the requisite resources. By these and other means the share of state orders in total enterprise output has remained very close to 100 per cent of capacity in many activities. Not only that, instead of concentrating on the most important products, state orders have been loaded with detailed regulations on the mix and volume of output.[50] Central control has therefore remained the order of the day.[51] Because this administrative pressure is supported by the ministries' hold over resource allocation, enterprises are nearly powerless to avoid or to alleviate it and in the end the whole attempt to foster their independence may be in jeopardy.[52] Because of this adverse situation, high priority is being given to enforcing the provisions on government orders. It is envisaged that in 1989 they are to be reduced to 70 per cent of total industrial output; and after 1991, to no more than 30 per cent.[53]

Similarly, the shape and scope of the emerging wholesale trade in the means of production are as yet unclear. The introduction of wholesale trade in earlier reform attempts, most notably that of 1965, was thwarted by persistent shortages and imbalances that encouraged hoarding. This in turn made it necessary to continue the *fiat* rationing of the means of production. Policy makers are at present attempting to combine a more balanced central plan with micro-economic autonomy based on genuine self-financing and adequate, built-in incentives to husband scarce inputs. Although the scale of the state supply system cannot be compressed noticeably in the short run, policy discussions stress that the supply system needs to ensure timeliness and an appropriate mix of supplies. Imbalances between financial and material resources that are bound to entail shortages and the lack of preparation of and familiarity with the material-supply system through which wholesale trade is to flourish may seriously impair the practical impact of these reform provisions.[54]

Control indicators are another important component of the reform provisions that have experienced a transformation similar to that of state orders. They were to replace mandatory quotas, volumes and levels for different characteristics of enterprise performance previously imposed by the centre. Although control indicators are intended to be non-binding and serve only as a reference for accounting purposes, the

48 For details, see "Isk ministerstvu", *Moskovskie novosti* (Moscow), 21 February 1988, p. 9. This is the first legal case in half a century of a Soviet enterprise contesting a ministry's order. This possibility was even recently considered only rhetorically (see "Mozhno li podat' v sud na ministerstvo?", *Sotsialisticheskaya industria* (Moscow), 22 November 1987, p. 2).

49 See the interview with A. Aganbegyan in *Izvestia* (Moscow), 25 August 1987, p. 2.

50 See, for example, "Vot priedet ministr", *Pravda* (Moscow), 9 February 1988, p. 2, and "Shtrafnoy udar", *Pravda* (Moscow), 17 February 1988, p. 2. On average, state orders accounted for 91.6 per cent of output in machine-building, 92.1 per cent in metallurgy and 97.2 per cent in fuel and energy, whereas for many other branches and enterprises they covered 100 per cent of production plans. In direct contradiction to the provision that state orders are to deal only with final products, they are more often than not issued for intermediate goods and services. State orders did not receive preferential treatment in the provision of inputs and the financial responsibility of the intended consumer was not secured (see E. Figurnov, "Zakazyvaet tot, kto platit", *Ekonomicheskaya gazeta* (Moscow), No. 6 (1988), p. 5, and "Otkazat'sya ot starykh metodov", *Ekonomicheskaya gazeta* (Moscow), No. 7 (1988), p. 5).

51 For an extensive discussion of this and related issues, see the interview with L. Abalkin, "Pobedit' byurokrata", *Izvestia* (Moscow), 1 March 1988, p. 2.

52 E. Yasin, "Sovetskaya ekonomika na perelome", *Kommunist* (Moscow), No. 12 (1987), p. 39.

53 See the interview with A. Aganbegyan in *Svenska dagbladet* (Stockholm), 2 February 1988, p. 2.

54 That this is a very real danger can be shown by the fact that requests for material supplies from enterprises included in the experiment on self-financing are 60 to 70 per cent satisfied. A survey of enterprise management showed that though 72 per cent of managers are in favour of wholesale trade, only 29 per cent believe that it can be properly handled by the existing material supply system (see E. Yasin, *loc. cit.*, p. 39, and *Pravda* (Moscow), 14 July 1987, p. 2).

ministerial bureaucracy is urging that they be made mandatory and that enterprises be required to report frequently on their fulfilment.[55] That would shift the emphasis in economic development from its qualitative aspects back to maximizing output growth, thus essentially nullifying the entire strategy of reform.

Although the set of regulations adopted in June 1987 (the "Basic provisions for fundamentally reshaping economic management") is regarded as the foundation of the reform process and is expected to be continuously amended, refined and supplemented, the drawbacks and inconsistencies cited point to some weaknesses in the legal foundation of reform at this stage of the restructuring effort.[56] Because of these inadequacies, work on preparing a number of new legal decrees has been intensified. The most important are "Regulations on state orders", "Regulations on branch ministries" and "Regulations on deliveries of material-technical and consumer supplies". These documents are soon to become major components of an economic code as the integral legal basis of the reform process.[57] This approach is reflected in recently adopted decisions, one of which aims at reinforcing the statute of the production association as the main component of the economic structure, thus encouraging the process of both vertical and horizontal economic integration. Instead of being enforced from the centre, integration should emerge from the mutual interests of firms entering into such an association. Another decision aims at bringing the economic environment of industrial research and development in line with the general principles of cost accounting. From 1987 onwards, research and development institutes are to be financed through a system of contracts for specific design and engineering projects, rather than, as heretofore, from the budget of industrial ministries.

Potentially the most serious issue in keeping the reform on track stems from the conflict between the goals of economic reorganization and accelerating aggregate growth.[58] High growth targets have usually meant "taut" planning. Full resource utilization normally generates tensions and shortages that could call for dysfunctional intervention by central authorities. This, in turn, could legitimize bargaining for temporary exceptions or exemptions from the reform measures for example, more favourable treatment, concessions, additional allocations and permission to hoard resources. None of these traits of economic behaviour in typical centrally planned economies accords with the intentions of the reform. The target for maximum growth may therefore have to be relaxed to accommodate steady reform of the economic mechanism.[59]

There are also serious contradictions between reform principles and short-term policy precepts that encourage the above-mentioned abuses. The major one is that while the Law on State Enterprise (Association) provides for micro-economic autonomy and self-reliance, current ordinances and government resolutions put the complete responsibility for ensuring planned volume and mix of manufactures on branch ministries. Plan fulfilment is perceived as the foremost political task of the ministries. This gives them powerful leverage over subordinate economic agents. The perception has been strong enough to permit the ministries to blatantly disregard legal curbs on their day-to-day intervention in the management of firms.[60] In 1988, drastic cut-backs in the number of civil servants attached to ministries (by 30 to 50 per cent on average), which noticeably disrupted the conventional vertical network of ministerial management. Although in the long-term this administrative measure will undoubtedly have a salutary effect on the reform process, for the time being it has seriously demoralized the ministerial bureaucracy and further slowed down the already protracted decision-making process.[61]

The gradual approach to reform may also emphasize the contradiction between short-term and long-term development goals. Short-term targets are conventionally represented by increases in output growth. An abrupt switch to a new economic mechanism is too risky. The gradual approach to reform therefore appears more attractive. However, in the long term, such gradualism may seriously weaken the impact of reform measures and undermine their effect on economic efficiency.[62]

Another crucial issue is the proper degree of co-ordination of the reform process among the different components of the economic mechanism. The promotion of micro-economic autonomy is at the heart of the reform. Its real extent depends not only on the amount of financial resources at the disposal of a firm but, more important, on gaining access to primary and intermediate inputs, which in turn depends on the flexibility of the distribution system. Results as at early 1988 are not particularly encouraging.[63]

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55 In extreme cases, technically illegal demands from the ministries to report monthly volume and structure of gross output are reported (see "Muskuly khozrascheta", *Sovetskaya rossia* (Moscow), 25 February 1988, pp. 1 and 2, and L. Abalkin, *loc. cit*).

56 B. Kurashvili, "Direktiva o direktore", *Moskovskie novosti* (Moscow), 28 February 1988, p. 9.

57 V. Laptev, "Pravovaya osnova samostoyatel'nosti predpriyatiy", *Ekonomicheskaya gazeta* (Moscow), No. 10 (March 1988), p. 16; and L. Abalkin, *loc. cit.*

58 Maintaining high growth is the main concern of the five-year plan and long-term targets to the year 2000.

59 According to one Soviet observer, "it is unreasonable to speed up the machine when the engine is under repair" (E. Yasin, *loc. cit.*, p. 37).

60 They demand detailed information and issue frequent instructions despite explicit legal proscription of these actions under the reform. Thus, the Ministry of Ferrous Metallurgy was demanding its enterprises on average to report daily on 220 indicators (with an upper limit of 4,100 indicators in the case of one major plant) instead of the 10 to 15 legally allowed (see "Informatsia k razmyshleniyu ... ili k soveshchaniyu", *Izvestia* (Moscow), 11 January 1988, p. 2). The non-binding status of control indicators is still conspicuously abused by the ministries that continue to increase the number of "additional" and "special" assignments (see "Ekonomicheskaya reforma i sily tormozhenia", *Ekonomicheskaya gazeta* (Moscow), No. 7 (1988), p. 14).

61 "Chemodannye nastroenia", *Sovetskaya rossia* (Moscow), 28 February 1988, p. 2.

62 For a discussion of this issue, see E. Gaidar, "Kratkosrochnye i dolgosrochnye tseli v ekonomike", *Kommunist* (Moscow), No. 10 (1987), p. 95.

63 "Prorvat' osadu nenuzhnykh predpisaniy", *Sovetskaya rossia* (Moscow), 6 January 1988, p. 2, and "Tot li eto khozraschet?", *Sotsialisticheskaya industria* (Moscow), 29 November 1987, p. 2.

Autonomy of firms is also a function of the soundness of price signals and the availability of bank credit. Because prevailing prices do not reflect scarcities and because current views on price reform continue to be expressed in terms of average sectoral costs plus some profit margin, the role of the price mechanism in the efficient allocation of resources will in effect remain secondary. A major change can occur only if central policy makers decide to proceed with comprehensive price reform and to infuse much greater flexibility into the price system than appears to be envisaged at this stage.

If provisions on self-financing are well ahead of effective economic reorganization and price reform, profits will necessarily reflect the lack of competition, administratively fixed prices and the prevailing conditions with regard to fixed assets, which firms themselves are unable to improve upon for lack of funds. At a more practical level, the impact of reform on the producer will depend heavily on such details as how and by whom the regulations on profit distribution are determined, how flexible prices are, who will have the final say in approving them and what criteria will govern the creation and distribution of credit.[64]

As the results of the experiment in self-financing indicate to date, the legacy of the traditional approach to management is still pervasive. The weight attached to indicators of the volume of performance, particularly gross output, is still considerable. Attempts to exert administrative pressure to coax agents into fulfilling unbalanced and unrealistic plans continue to encourage shortages and disrupt productive co-operation. Attempts to curb inefficient production are futile, more often than not.[65] Firms are still so heavily burdened with state orders that there is little or no room for managerial flexibility to mobilize resources to meet unexpected demand. Administrative sequestering of accumulated retained depreciation funds occurs, as do arbitrary changes in output quotas, supply allocations and surcharges for extra quality and export production. All this undermines investment capabilities and financial stability of *de jure* self-financing enterprises.[66] Deductions from profit for budget payments are as yet not governed by economic concerns. But managers continue to expect ministries to muster emergency financial aid in case of a liquidity crisis. Perhaps the only difference is that the volume of tradable (saleable) production is used as an indicator of performance instead of gross output. None the less, the increase in volume of production from the level achieved in the previous year—the so-called ratchet principle—is still considered by ministries as the central success criterion. In the same vein, norms lack uniformity because they are individualized for the different enterprises. Norms therefore put additional pressure on enterprises already working efficiently and provide unjustified benefits to those with concealed reserves for improvement. Instead of being stable, norms tend to fluctuate from year to year.[67]

All this strengthens the growing conviction that the main task ahead is to further improve the economic mechanism and make its introduction more ambitious, consistent and transparent. The end of the 1980s is generally viewed as a transitional period leading to comprehensive reform, during which managerial autonomy and a more solid legal framework for public scrutiny in economic activity should take firm hold, the pace and scale of reform in pricing and in the banking sphere are to be determined and contradictions between reform strategy and remnants of the command economy are to be resolved. It is recognized that the remaining years of the decade will be difficult, painful and perhaps tumultuous.

Soviet economic reform and CMEA economic co-operation

The reform intentions of the Soviet Union have already had measurable repercussions on policy stances of the majority of its partners in CMEA. All Asian and European CMEA members, except the German Democratic Republic and Romania, are currently engaged in some type of economic reform as defined in this chapter. The drift towards reform has created a new ambiance for changing the organization, policy instruments, institutions and policies of economic co-operation in the context of CMEA. This was especially manifest at the forty-third CMEA Council Session (Moscow, 13 and 14 October 1987), preparations for which were made in November 1986 by a "working summit" of key Party and government leaders from all member countries. Accordingly, CMEA as a regional organization and its underlying policies, instruments and institutions are to undergo radical restructuring too, as will the policies underlying economic co-operation among members.

As mandated by the forty-third Council Session, members are proceeding on several different fronts. First, it was agreed to reform the organizational structure of CMEA. This involves abolishing organs that have not performed well over the years, consolidating units that have in effect duplicated one another and generally gearing the work of the organization less to actual day-to-day planning of production and distribution than to the medium-term to long-term strategic planning of the key directions for structural change that members should fully explore. Thus, the staff of the organization is to be reduced by one third, 19 formal CMEA organs are planned to be abolished and 6 are to be created or recreated by combining existing institutions. In that respect, there is a close parallel with the intended planning reforms in individual CMEA members.

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64 For example, according to the regulations on bank self-financing, starting in 1988, part of revenue is expected to accrue from penalties on enterprises that utilize credits inefficiently. If not counter-balanced by other guidelines, this rule can motivate banks to be excessively harsh in assessing credit utilization. On the other hand, banks are allowed to give, at their discretion, 50 per cent discounts on rates for credits for technological innovation and modernization. But since wage funds and bonuses of banks depend on revenue, the banks may be reluctant to provide such discounts.

65 E. Gaidar, "Kursom ozdorovlenia", *Kommunist* (Moscow), No. 2 (1988), p. 41.

66 "Samostoyatel'nost' pod opekoy", *Sotsialisticheskaya industria* (Moscow), 19 December 1987, p. 1.

67 More than 170 types of fines, sanctions and penalties can be applied to an enterprise by the ministry and other central bodies for disobeying their directives (see *Ekonomicheskaya gazeta* (Moscow), No. 2 (1987), p. 6, and No. 31 (1987), p. 8 .

Secondly, there was apparently widespread agreement to rechart assistance policies to the non-European members of CMEA (Cuba, Mongolia and Viet Nam). Past development assistance efforts were deemed less effective than they could have been from both the recipient's and the donor's point of view. Donor countries agreed to work out a dovetailed multilateral approach within a medium-term to long-term coordinated programme targeted at providing economic assistance to the three non-European members so that their joint efforts would measurably improve the shared benefits of economic assistance.

In a similar vein, it was agreed to work out a new integration strategy for the period 1991-2005. Efforts to draw up such a programme have been on the table since the first calls for the CMEA economic summit meeting that took place in June 1984. The purpose then, as now, was to come to grips with the severe internal and domestic economic constraints faced by virtually all of Eastern Europe in the early 1980s. It is expected that the first draft of the programme will become available in time for consideration by the Council Session in July 1988. The Council Session is to re-examine the objectives, policies, instruments and basic institutional supports for regional economic integration.

The other major decisions adopted at the forty-third Council Session focused on the precise mechanism of economic integration to be elaborated by CMEA countries, given the ongoing reform process in key members. Although there was apparently broad agreement on the need to revise key elements of planning and monetary and financial co-operation, members were divided on a number of critical economic issues, including the introduction of a form of limited regional convertibility, the revision of the price-setting mechanism and the role of capital movements within CMEA. Some members continue to stress that a solution to these integration problems should be worked out primarily through the customary dovetailing of plans and the streamlined central command system that have been at the heart of past efforts directed towards advancing economic co-operation. In this connection, the Council Session also sought to reinvigorate the economics of inter-firm relations and the pivotal need to invest such relations with economic guidance rules and institutional instruments to facilitate management, including management in the sphere of settlement of accounts for selected transactions. This appears to apply in particular to the products emanating from selected scientific and technological co-operation efforts made within the framework of the 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, adopted in December 1985.

Some members are apparently hoping to provide selected direct enterprise relations with a limited type of convertibility: the relevant transactions would presumably be confined to the most important inter-firm relations established under the provisions of the Comprehensive Programme; convertibility would be restricted to intra-regional transactions (Hungarian forint against Bulgarian leva, but not leva against United States dollars) and the envisaged variant of convertibility would be introduced gradually, perhaps over a period of 10 years. The majority of CMEA members agreed to move ahead vigorously with establishing direct relations among firms from different countries and decided to put in place some critical indirect supports to facilitate such transactions. The first bilateral agreements on introducing regional convertibility for selected exchanges were signed early in 1988 by the Soviet Union with Czechoslovakia and apparently with Bulgaria also.[68]

Finally, the Council Session called for improvements in the traditional areas of co-ordination of economic plans and indeed to support direct business relations among firms at the regional level. This is a familiar statement, signalling that the policy debate on the prospective course of socialist economic integration is far from over at this juncture. Given the sheer size of the Soviet economy in CMEA relations, what happens to reforms in the Soviet Union is bound to exert considerable pressure for modifications in CMEA as a whole.

Conclusions

There are a number of similarities and differences between the multifaceted reform processes in China and the Soviet Union. Among the similarities, five stand out. Perhaps the overriding common element is the desire of policy makers to mobilize the resourcefulness, knowledge and initiative of economic agents through devolution of decision-making. These can be mobilized only if the proper incentives for both managers and labour are put in place. At the same time, the central planning agencies have to be reinforced in selected functions, including those related to structural change and medium-term to long-term development strategies. Responsibility for day-to-day activities devolves more and more upon individual firms, sometimes in combination with medium-level associations of businesses.

Secondly, it is now realized in virtually all reforming economies, particularly in the two selected for detailed discussion here, that such decentralization can succeed only in time, after putting in place a full-scale, comprehensive and integrated economic mechanism. Because key elements of the indirect policy instruments, the supporting institutions and particularly the macro-economic policies to guide decisions of household and firm in the desired direction are still rudimentary, gradualism and frequent adjustment of reform

68 *Rudé Právo* (Prague), 4 March 1988, p. 1. A useful backdrop to the convertibility debate is provided by G. Rybalko, "Konvertabelnost rublia povestke dnia", *Ekonomicheskaya gazeta* (Moscow), No. 9 (1988), p. 20, and V. Válek, "Hodnocení prvních zkuseností", *Svet Hospodářství* (Prague), No. 25 (1988), p. 1.

policies and intentions will be required during the transition phase.

Thirdly, both economies enjoy a substantial degree of policy autonomy, given their size and resource base. Yet both have undertaken reforms explicitly with a view to bolstering significantly their involvement in international economic relations. These efforts have not just been confined to the traditional trade and financial links. They also call for setting in motion the process of foreign direct investment, joint ventures and other forms of international economic co-operation, including co-operation with and in market economies.

Fourthly, policy makers in both economies have embarked on economic reforms that, within a short period of time, were stymied by the obstacles emanating from the weak environment inherited from their highly centralized or modified centralized models. The underdeveloped monetary and fiscal systems affected particularly the scope for dovetailing decentralized decision-making. Both economies are aware of the critical role of prices (including wage and bonus rates, interest and exchange rates and other scarcity indicators). However, transforming the pricing systems so that they can effectively support micro-economic decision-making without giving rise to substantial adjustments in relative prices and income inequalities that may be dysfunctional has been much more arduous. The greatest obstacles to economic reforms, from both economic and other sources, emanate particularly in connection with the completion of the economic mechanism that is anchored to indirect economic co-ordination. It is here that fundamental social and political precepts tend to come into play and they usually slow down or even inhibit reform.

Finally, features shared by virtually all reforms are the considerable degree of incompleteness of reform blueprints when put in place, marked underestimation of the difficulties bound to crop up during implementation and palpable wavering in complying with reform intentions, whatever the obstacle.

Some of the differences stem from the very different nature of the economies of the two countries, including level of development, geographical dimension, population pressure, support found abroad, managerial skills and disposition towards changing long-standing ideological commitments. As far as the reforms *per se* are concerned, the main differences are described below.

First, Soviet reforms (and virtually all earlier Eastern European experiments) have stressed the transformation of the managerial sphere, particularly in manufacturing, as the core of the initial reform movement. In China, the focus of initial reforms since 1978 was agriculture and rural activities generally; since 1984, it has shifted gradually to reform of the industrial sector, pricing and distribution.

Secondly, Chinese reforms have matured at a time of buoyant economic growth, after a decade of stagnation at a low level of economic development. In fact, the circumstances in which the reforms matured can only be described as chronically overheated. For the past several years, China has been one of the few countries in the world where policy makers have tried to curb the buoyancy of economic activity and yet ended up with a much faster pace of expansion than desired, largely on account of the inability of central policy makers to guide decisions. The result has been rapid growth, including growth in personal incomes, at the cost of serious imbalances that will have to be faced directly in the years to come. Soviet reforms and the ongoing experiments in Eastern Europe are in part attempts to come to grips with the fundamental conditions that have led to a long-term decline in the pace of growth and to chronic domestic and external imbalances. Reform requires technological innovation and modernization, which have been hampered in the Soviet Union by inadequate links between research and development, on the one hand, and production and distribution, on the other. In China, the resources for technological innovation and modernization were simply not available domestically.

Thirdly, from the very start it was estimated that modernization in China would have to depend extensively on the importation of foreign technology and capital and measures were put in place in two phases to facilitate foreign direct investment and boost export earnings. Export earnings boomed in the early 1980s on account of the felicitous gain in oil export revenues. But growth in exports and continued reform of the foreign trade and finance systems have continued to be pivotal concerns of ongoing reforms. In the Soviet Union, reform has had to proceed in the face of weak export earnings and the lingering effects of deep-rooted East-West tensions, which have only recently shown signs of abating. It has also suffered because of decades of neglect of links between domestic and foreign sectors and because enterprises lack experience in marketing their products abroad.

Fourthly, the Soviet Union committed itself to revising very thoroughly key instruments, policies and institutions of the economic mechanism, even though it has been encountering difficulties in turning these commitments into practical measures and implementing them. Although Chinese policy makers at times pay lip-service to the need to tackle all those elements also, their actions over the years to liberalize pricing in the broad sense and to complete the macroeconomic policy infrastructure have been piecemeal, based on trial and error. This is largely because of practical political difficulties, not ideological obstacles. Such obstacles appear to be more fundamental in the Soviet Union. This may in part be explained by the fact that the highly centralized economic system of the Soviet Union evolved as a homegrown response to the felt need to bring about the planned socialist economy; in China, as in all of Eastern Europe, the model was to a large extent imported; there is, therefore, perhaps less commitment to it in China than in the USSR.

Finally, in foreign economic relations the prospects and situations of China and the Soviet Union differ considerably. For example, China has found the East-West political and security climate much less antagonistic towards reform than the Soviet Union; it trades chiefly in convertible currencies, whereas about half of Soviet trade is with CMEA partners in transferable roubles and a substantial share of trade with developing countries continues to be on clearing account; and it has been very successful in conquering markets for labour-intensive manufactures, particularly textiles, in contrast

with Soviet reforms, which aim at bolstering the export of medium-level technology, for which the appropriate infrastructure is required.

The similarities and differences mentioned above show that, for both China and the Soviet Union, and for other planned economies committed to reform on a wide scale, measures to provide for an orderly transition from the old economic mechanism to a new one that is as yet incompletely defined will be at the centre of reform efforts during the final years of the decade. Concrete and unambiguous results of the ambitious economic reform in the Soviet Union, in particular, are not likely to become transparent until well into the 1990s, when the interrelated problems of price, finance and material and factor supply will have been tackled and, it is hoped, resolved. In the meantime, the gradual phasing in of the components of reform may impose short-term adjustment costs or even impede the full validation of new indicators of a firm's success. Similarly for China, continued reform is contingent on success in urban industries and on improving significantly the macro-economic policies to guide decisions of both firms and households.

The economic initiative at the core of the reform philosophy will not be the only way of improving the economy, but one of many which will include marked improvements in techniques of management and control. The most important factors in ensuring success with the reforms will be persistence and the political will of the leadership to remove ambiguities and outright distortions in the implementation of reform measures, to streamline and strengthen reform regulations and, at the same time, to guard against continuous changes in the rules of the game detracting from the main objective, which is to put economic decisions on a solid economic footing. The experiences of Eastern European countries may be sobering in this respect. In addition to the commitment of policy makers, a major effort is required to mobilize the active support of the population for economic reorganization, even in the wake of the initial uncertainties about availability of goods, job security, prices, labour incomes based on productivity and related factors and to overcome the resistance to reform of those whose social standing, privileges and influence the reform may jeopardize.

Chapter VII

THE EXTERNAL AND FISCAL IMBALANCES OF DEVELOPED COUNTRIES: CAUSES AND EFFECTS

The huge external payments imbalances of the leading developed market economies have become a dominant world economic concern. The conditions that gave rise to these imbalances have deeply affected the well-being of developing countries—to a greater extent than the developed countries—and the way in which these imbalances are resolved over the next few years will exercise a large influence on the economic growth of developing and developed countries alike.

Previous issues of the *World Economic Survey* have examined the development of these imbalances and some of their effects.[1] This chapter presents an overview of the subject, in part to identify the developmental implications of actions and measures that frequently have had primarily short-term objectives. The chapter traces the evolution of the imbalances, examines their effects on the development process, reviews measures to remedy them, and investigates the possible effects of these corrective measures on the world economy.

The imbalances in question are essentially the large balance-of-payments current account surpluses of the Federal Republic of Germany and Japan and the current account deficit of the United States. These imbalances present a problem because their absolute size means that they are an important element in world trade and global financial flows. There is less international concern about a number of other countries that have external imbalances of a similar magnitude in relation to their exports or gross national product. On the other hand, the three major imbalances have now reached sizeable proportions even in relation to these two comparators, despite the size of their economies (see table VII.1). Their size relative to their domestic economies makes the necessary correction that much more difficult from a domestic point of view.

It has to be recognized, however, that attainment of perfect balance in each country's current account is probably not possible and certainly not desirable as a policy objective, particularly in the short term. The present concern is therefore not with imbalance *per se*, but rather with the magnitude, nature and pattern of the imbalances. The current imbalances are considered to be too large and too long-lasting and to be inconsistent with the desirable long-term pattern of international capital flows, whereby surplus capital in richer countries should be used to finance investments in poorer countries. These difficulties with the present imbalances imply that the objective of policy makers should be to reduce their size and longevity and change their pattern, but not necessarily to eliminate them.

The need to reduce the imbalances is reinforced by the fact that both Governments and financial markets have come to doubt whether the large external deficit of the United States can be sustained. While there is no definition of a "sustainable" deficit, it would seem that, under present-day circumstances, at least three conditions must be met for a current account deficit to be sustainable: first, a large part of the source of financing of the deficit should be voluntary; secondly, that part financed by official credit should not involve major policy changes in the deficit country; and, thirdly, the deficit should not give rise to sharp fluctuations in currency markets, interest rates, trade policies and capital flows. These conditions are no longer met in the case of the present United States' deficit.

The large-scale deterioration in the external balance of the United States dates from 1983. In 1987, the current account deficit amounted to $161 billion (see table A.III.12). This has been mirrored in the rising surpluses among other developed market economies, particularly the Federal Republic of Germany and Japan (see tables A.III.10 and A.III.11); they have been joined in more recent years by Hong Kong, the Republic of Korea and Taiwan, Province of China (see table A.III.6).

Limited signs of reversal in some of these trends became apparent in 1987. However, the scale and pace of the needed adjustment are still very large and consequently the way in which the adjustment is managed is critical for the world at large. This is for two reasons. The first is the absolute size of the United States as an exporter and as a market for other countries. The United States accounts for about one eighth of world trade; an increase in exports or reduction in imports of the magnitude required to restore the United States' balance of trade would have a sizeable direct bearing on other countries' export opportunities. Such a reduction in the United States' imports in order to improve its external balance would, unless offset by expansionary policies elsewhere, reduce external demand and weaken economic activity in the rest of the world's market economy.

The second reason why the management of the United States' current account deficit has international significance is the large and growing volume of dollar-denominated debt held by foreign investors and central banks (see table IV.5). As the dollar is the principal reserve currency, the United States has been able to contract debt in its own currency to finance its external deficits. If, however, its large current account deficits continue, external debt will increase at a rapid rate, particularly since bulging interest payments will accelerate the process. Under such circumstances, foreigners are likely to become increasingly reluctant to add to their stock of dollar assets and, at some point, fear of further dollar depreciation could precipitate a large and sudden net outflow of financial assets from the United States. Such a loss of confidence would also be extremely damaging to

[1] See, in particular, *World Economic Survey 1987* (United Nations publication, Sales No. E.87.II.C.1 and corrigendum), pp. 41-47.

Table VII.1. Current account imbalances[a] in relation to gross national product and exports for the developed market economies and selected groups of developing countries, 1980-1987

(Percentage)

	1980	1982	1984	1985	1986	1987[b]
As a share of gross national product						
Developed market economies[c,d]	−0.8	−0.3	−0.7	−0.6	−0.2	−0.3
of which:						
Germany, Federal Republic of	−1.7	0.8	1.5	2.7	4.3	4.0
Japan	−1.0	0.6	2.8	3.7	4.4	3.7
United States	0.1	−0.3	−2.8	−2.9	−3.3	−3.5
As a share of exports of goods and services						
Developed market economies						
of which:	3.4	−1.3	−3.3	−2.8	−0.8	−1.6
Germany, Federal Republic of	−7.3	2.8	5.6	9.1	15.8	15.2
Japan	−8.2	5.0	20.6	27.8	40.7	..
United States	0.8	−4.1	−49.2	−54.6	−65.1	..
Fifteen heavily indebted developing countries	−18.3	−35.6	−1.0	0.1	−12.1	8.1
Sub-Saharan African developing countries (excluding Nigeria)	−28.2	−33.4	−12.8	−11.6	−17.8	−24.7
East Asian exporters of manufactures	−13.1	−2.5	8.4	12.0	20.8	19.4

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *Economic Outlook,* No. 42, December 1987; IMF, *World Economic Outlook,* October 1987; and other official national and international sources.

[a] Including official transfers.

[b] Preliminary estimates.

[c] Figures for developed market economies as a group are those of IMF (i.e., they exclude Greece, Portugal and South Africa).

[d] GDP (instead of GNP) is used for all countries other than the Federal Republic of Germany, Japan and the United States in the calculation for the developed market economies as a group.

trade financing and other, longer-term borrowing and lending for which the dollar is used extensively by third parties outside the United States. The subsequent turbulence in financial markets could bring about the often-mentioned "hard landing" for the dollar. A likely response by the United States' authorities would be to tighten the money supply. The heavily indebted developing countries would then be faced with an escalation in interest rates, even though the value of the dollar-denominated component of their debt would fall. More generally, the sharply shifting exchange rates and interest rates would adversely affect real economic activity world-wide.

Such turbulence may be avoided if the policies of the leading developed market economies are seen to be moving their external accounts into more sustainable balance with each other. There are serious doubts, however, whether the actions taken so far are sufficient for this purpose. Many question whether the dollar exchange rate has depreciated enough. Equally, it remains an open question whether the fiscal measures adopted to date in both surplus and deficit countries are sufficient to restore a better balance between domestic demand and output in each of those countries. Finally, there is not yet adequate recognition that the restoration of capital flows from the surplus developed market economies to the developing countries constitutes a necessary element of any comprehensive solution to the present imbalances. The remainder of the chapter elaborates on the events that caused this situation to arise, its effects and the crucial policy choices that it now poses for the world community.

Origins and course of the external imbalances

The external imbalances prevailing among the major developed market economies have their origins in the different macro-economic policies pursued by these countries from the early years of the decade. These gave rise to divergences among countries in the rates of growth of domestic demand and to a sweeping appreciation of the dollar exchange rate. Together these movements pushed external payments balances increasingly out of equilibrium. Though the external surpluses and deficit grew to huge magnitudes, the general thrust of fiscal and monetary policies in the different countries continued largely unaltered until early 1987; adjustment was mainly confined to the depreciation of the dollar that took place in financial markets after 1985.

At the outset of the 1980s, the major developed market economies largely shared the same broad economic ideas and aims. Their overriding immediate concern was to bring an end to the accelerating inflation of the late 1970s. Tight

control of the money supply was seen as the principal instrument for achieving this objective. For the longer run, their views were dominated by the wish to limit and reduce the role of the State in economic life: lower tax burdens and less regulated markets were seen as key conditions for more stable growth.

Despite these broadly shared views, the fiscal policies of the United States and the other major developed market economies diverged widely in practice. In the United States, first priority was given to the reduction of taxes and legislation introduced in 1981 authorized major tax cuts in three successive years beginning in 1982. However, these cuts were accompanied by an increase in government expenditure, including increases in defense expenditure, one argument in favour of the tax cuts was that the ensuing budget deficit would ease the political task of restraining the growth in government expenditure. Another argument was the much publicized supply-side contention that lower taxes would stimulate output and income to such an extent that lost tax revenue would soon be recouped. In the event, the United States did subsequently enter a period of recovery and sustained growth that has been exceptional in its length, but it was accompanied, until 1986, by ever-increasing budget deficits.

In Western Europe and Japan, a different approach to fiscal policy was adopted. Budget deficits in most of these countries had reached substantial proportions in the later 1970s and their Governments gave high priority to reducing them. This was viewed not only as an anti-inflationary measure, but also as a step towards containing the rise of public expenditure relative to gross national product and, eventually, towards lowering tax burdens. In Western Europe in particular, the reduction of the budget deficit was seen as an integral part of a broader medium-term strategy to restore growth in non-inflationary conditions. The dominant view was that the root cause of the accelerating inflation and rising unemployment of the 1970s lay in supply-side rigidities, particularly of wages. It was felt that, because of these rigidities, expansionary fiscal policies failed to elicit greater output but rather pushed up prices. Rising wage and other costs were viewed as lowering the profitability of investment, and inadequate investment gave rise to growing unemployment. Some observers argued that fiscal deficits were considered to aggravate the situation because they put upward pressure on interest rates and "crowded out" new investment. Since the initiation of policies designed to overcome these problems, budget deficits in Western Europe have been reduced significantly. Rates of economic growth, however, have generally remained lower than in the mid to late 1970s and the very high levels of unemployment have persisted.

The consequence of these differences in fiscal policies between the United States and the other developed market economies was divergent rates of growth in domestic demand. This was sharply higher in the United States than elsewhere, notably the Federal Republic of Germany and Japan, during the period of recovery in 1983 and 1984 (see figure VII.1) and led to a faster rate of increase in demand for imports by the United States than by other developed market economies (see table VII.2).

Table VII.2. Growth of real domestic demand, real gross national product, exports and imports in the Federal Republic of Germany, Japan and the United States, 1980-1986

(Annual average percentage rate of change)

	Real domestic demand	Real GNP	Export volume[a]	Import volume[a]
Federal Republic of Germany				
1974-1979	2.6	2.4	4.6	5.3
1980-1982	−1.2	0.2	5.5	0.8
1983-1986	2.3	2.4	3.9	3.5
Japan				
1974-1979	3.0	3.7	9.2	3.9
1980-1982	1.9	3.7	12.3	0.2
1983-1986	3.4	3.9	5.6	2.4
United States				
1974-1979	2.4	2.6	6.8	4.7
1980-1982	−0.5	−0.3	0.7	−1.6
1983-1986	5.3	4.1	1.2	12.0

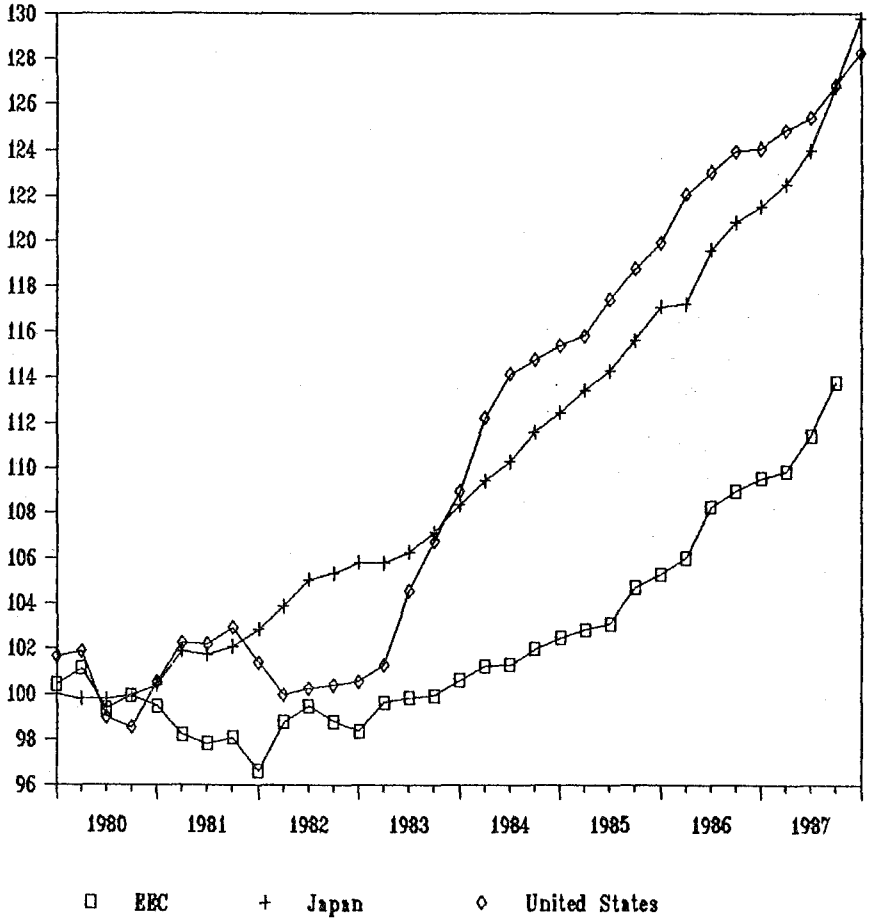
Source: OECD, *Economic Outlook,* No. 42 (Paris, December 1987), tables R1, R8, R9 and R10.

[a] Goods and services.

There was much less divergence among the developed market economies in their monetary policy. The late 1970s and early 1980s was a period when the more rigorous interpretations of monetarist theory were at their most influential among central banks. Stress was laid on the control of monetary aggregates as a determinant of the rate of increase in output or, if unemployment had fallen below its non-inflationary level, of prices. The avowed aim of policy was to break inflationary expectations in financial markets by control of these aggregates. In practice, however, the monetary targets of central banks were honoured more often in the breach than in the observance and the notion of automatic rules for the growth of monetary aggregates lost sway fairly quickly. Nevertheless, the credibility of monetary policy as an anti-inflationary measure has at no time been seriously questioned in any of the major countries.[2] As a result, monetary policy has tended to be non-accommodating, particularly in the first half of the 1980s. Moreover, judged by the behaviour of interest rates, the monetary policy pursued by the United States at the beginning of the 1980s was more restrictive than elsewhere. Interest rate differentials between the United States and the other major economies be-

2 See K. Clinton and J. Chanaqui, *Monetary Policy in the Second Half of the Nineteen Eighties: How Much Room for Manoeuvre?* OECD Working Papers, No. 39 (1987).

Figure VII.1. Domestic demand in EEC, Japan and the United States
(1980 = 100)



Source: OECD, *Economic Outlook,* various issues.

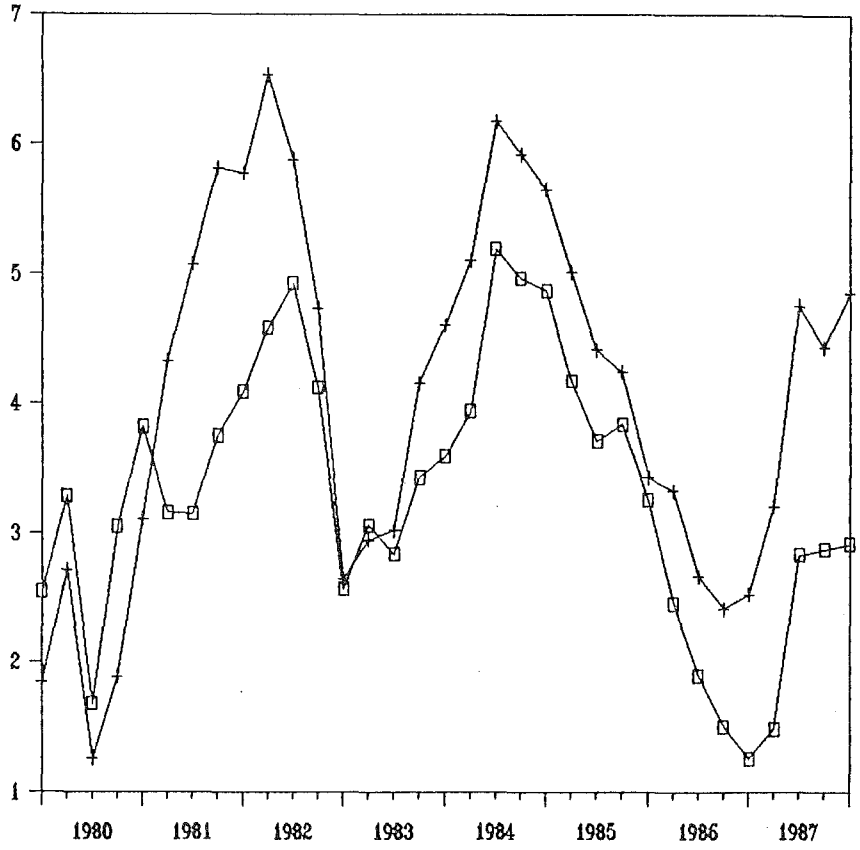
came very wide and remained strongly positive, even though they fluctuated in response to changing credit conditions as the United States economy swung upward (see figure VII.2).

The expanding demand for savings in the United States (in part to finance the fiscal deficit—see box VII.1), the higher interest rates in that country, the large and diversified nature of its financial market and the continuing international deregulation of capital flows combined to produce large capital flows from the Federal Republic of Germany and Japan to the United States, generating a strong demand for dollars in foreign exchange markets. This demand for dollars exceeded the supply made available by the surplus of United States imports over its exports, with the result that the dollar exchange rate appreciated (see figure II.1), cheapening imports and raising the price of exports. These changes in relative prices reinforced the effects of the divergences among countries in the rates of growth of domestic demand. In the first half of the 1980s, therefore, the system of floating exchange rates was one of the factors that appears to have contributed to the persistence of the external imbalances among the developed market economies.

From the last quarter of 1982 to mid-1984, there was a recovery and upsurge of domestic demand in the United States. In the three years that followed, macro-economic policies in Japan and Western Europe did little to reverse the divergence in the growth of demand. In line with their medium-term strategies, fiscal policies in the Western European economies remained restrictive. In addition, at least until early 1985, the inflationary effects of currency depreciation were quoted as a reason for monetary restraint. Inflation was aided initially by weak world commodity prices and subsequently by the positive effects of appreciating currencies, reinforced by lower oil prices. Consumer prices rose slowly in both the Federal Republic of Germany and Japan in 1984 and 1985 and recorded near zero or negative changes in 1986 (see table A.III.3). Despite low inflation, steady growth in the United States and the rising profitability of investment, the revival of investment in Western Europe that was expected by advocates of supply-side policies was not forthcoming. As a result, the growth of demand in these

Figure VII.2. Difference between interest rates[a] in the Federal Republic of Germany, Japan and the United States, 1980-1987

(Percentage points)



□ Difference between the United States and the Federal Republic of Germany

\+ Difference between the United States and Japan

Source: IMF, *International Financial Statistics*, various issues.
a Yield on long-term government bonds.

countries lagged behind output until 1986 (see table VII.2) when, partly in response to falling oil and other commodity prices, its relative growth accelerated.

The most significant change between 1984 and 1986 was not in fiscal or monetary policies but in the dollar exchange rate (see table IV.6). Having risen to 259 yen and 3.32 deutsche marks in February 1985, the dollar began a lengthy, downward readjustment. The leading developed market economies—motivated partly by concern about rising protectionist pressures—later gave official support to the downward shift in the Plaza Accord of September 1985. It was understood at the time that the depreciation would not have any early effects on the current account deficit, though no one then foresaw how delayed and muted the response would be. The United States' external deficit continued to grow but, despite a depreciating dollar, it was matched over most of the period by a continued and spontaneous inflow of private capital. Indeed, it was because of this continued capital flow into the United States that the descent of the dollar was comparatively slow and smooth.

In the realm of domestic policies, 1987 was notable as the year in which long-debated shifts in demand management policies began to be tentatively and partially translated into practice. The largest change was in the United States fiscal budget. Following adoption of the new rules for budgetary negotiations laid down in the Gramm-Rudman-Hollings Act, the projected budget deficit for fiscal year 1988 was reduced by $30 billion. At the same time, somewhat more stimulatory or less restrictive fiscal policies were adopted in the Federal Republic of Germany and Japan. For the first time in several years, the growth of output in the United States outpaced that of domestic demand. In the surplus countries, the pattern was the opposite; in Japan, domestic demand rose strongly.

The realization of more co-ordinated demand management policies was one of the points of agreement expressed in the Louvre Accord of February 1987. The Accord also set out the official view that the major external imbalances would begin to yield to correction within a framework of stable exchange rates. However, the confidence of financial markets in official policies ebbed when the will to make further adjustments in fiscal policies appeared weak and as trade imbalances continued to mount (despite some improvement in volume terms). To maintain stable exchange rates, large-scale intervention by central banks became necessary. Interest rates in the United States also crept up. As the rise in interest rates coincided with a speculative surge in stock prices, the yields on stocks and bonds increasingly diverged. This, in turn, was a factor behind the October convulsion in stock markets. Immediately afterwards, there was a breakdown of the exchange rate stability embodied in the Louvre Accord and a resumption of the adjustment process through a further realignment of exchange rates. The early months of 1988 saw some partial recovery and stabilization of the dollar exchange rate as a result of central bank intervention and evidence of progress in managing the United States trade deficit, but these gains in the value of the dollar proved to be temporary.

The result of these developments since early 1985, and particularly since early 1987, is that both the divergences in rates of growth in domestic demand and the shifts in exchange rates that were the main causes of the external imbalances among developed market economies have been reversed. However, the pattern of imbalances has been affected to some degree by other factors, such as shifts in the oil market,[3] the export drive of several East Asian countries and the debt crisis and its aftermath. In addition, there is the larger question of whether the current and prospective policy measures and present exchange rate alignments will assure a sufficient contraction in external imbalances.

Box VII.1. *The relationship between fiscal and external deficits*

The gyrations of domestic and international financial markets in 1987 caused increased attention (and a large amount of responsibility) to be assigned to the United States federal budget deficit. This continuing domestic deficit is widely perceived to be a direct cause of the United States' deficit on the current account of the balance of payments, itself the source of many of the wide fluctuations in financial variables.

The chain of causality between fiscal deficits and current account deficits is not as straightforward as is sometimes implied. Most developed market economies have had fiscal deficits more often than surpluses, but this has not manifested itself in a parallel series of trade deficits. Until 1985, for example, Japan tended to have a large fiscal deficit, but nevertheless managed to achieve consistent trade surpluses.

The missing link that explains this dichotomy is the level of total domestic savings (comprising savings by households, firms and the Government[a]) and its relationship to the prevailing levels of domestic investment and government expenditure. If savings by households and firms exceed private investment, the surplus can be mobilized by the Government to finance any excess of its expenditure over its receipts. If, however, there is no surplus of private savings over investment, a government deficit has to compete for resources, on either the home or the international market.

The result could be a decline in domestic investment, with no direct impact on the country's foreign transactions. Alternatively, domestic investment might remain unchanged and the increase in the budget deficit could be financed by an inflow of foreign capital, reflected in a deficit on the current account of the balance of payments. Neither theory nor empirical evidence provide a definitive answer as to which of these mechanisms has prevailed in practice in the United States in the 1980s: it would be reasonable to assume that both have been in operation to some degree.

A further complication is that some economists argue that an increased government deficit (public dissaving) will induce a correspondingly larger amount of savings by the private sector, so that a deficit will not create a net additional drain on the resources available for investment and other competing uses; others dispute this view. The empirical evidence on the cause and effect relationship between budget deficits and private savings is ambiguous. In the United States in the early 1980s, private savings decreased while the budget deficit increased, that is, the private sector did not increase savings to offset the public sector's dissaving, but this may have been attributable to any of a wide variety of factors other than the behaviour of the fiscal deficit.

The decline in private savings in the United States has been one factor contributing to the change that has taken place in the 1980s in the relationship between the saving-investment balances in the Federal Republic of Germany, Japan and the United States. In all three countries, domestic investment as a share of gross national product has tended to be lower than it was in the 1970s (see the table). The decline was most marked in Japan, where the booming investment activity of the 1970s—stimulated partly by the oil shocks—

[a] Government savings arise when tax and other revenues exceed expenditures.

3 The fall in oil prices has benefited the Japanese trade balance, while the rise in dependence on imported oil supplies has worsened the United States balance.

has faded. Domestic saving rates have also slipped in all three countries, but they have consistently been greater than domestic investment rates in the Federal Republic of Germany and Japan. In the United States, in contrast, the savings rate exceeded the investment rate in the 1970s, but has fallen below it in the 1980s.

One reason for the lower savings rate in the three countries between the 1970s and the 1980s has been a decline in the proportion of income saved by households. For social, institutional and economic reasons, household savings have long been relatively high in Japan. Contrary to the common impression, however, it is in Japan that the rate appears to have fallen most since the 1970s. In the United States, there has been a long-term downward trend—going back to the 1950s—in the proportion of income saved by households.[b] Even the increase in interest rates in the early 1980s had little effect on household savings and over the past four years, there has been a sharp downward shift: personal savings was some 7 per cent of personal disposable income in the first quarter of 1984 but had fallen below 3 per cent by the last quarter of 1987, aggravating the recent worsening of the saving-investment balance.

Saving, investment and the current account balance in the Federal Republic of Germany, Japan and the United States, 1974-1986

(Percentage of GNP[a])

	Gross domestic savings	Gross domestic investment	General government financial balance[b]	Current account balance
Federal Republic of Germany				
1974-1979	22.6	20.8	−3.0	1.0
1980-1982	21.2	20.9	−3.3	0.9
1983-1986	21.6	20.1	−1.7	2.1
Japan				
1974-1979	32.8	31.8	−3.3	0.3
1980-1982	30.8	29.3	−3.9	1.8
1983-1986	30.7	28.0	−1.9	3.2
United States				
1974-1979	19.8	18.7	−1.2	0.0
1980-1982	17.6	18.1	−1.9	−1.5
1983-1986	16.6	18.0	−3.4	−2.6

Source: OECD, *Historical Statistics 1960-1985* (Paris, 1987), tables 6.8 and 6.17 and OECD, *Economic Outlook*, vol. 42 (Paris, December 1987), tables R13 and R20.

[a] Data are arithmetic averages of the annual ratios.

[b] There is an element of double-counting in these figures, especially for the Federal Republic of Germany and Japan, because the general government balance includes public investment. This does not, however, distort the change over time in the overall relationship between savings and investment for each country.

Notwithstanding these changes in private savings, a more important reason for the weakening of total savings relative to investment in the United States and the opposite in the Federal Republic of Germany and Japan lies in the behaviour of public saving. The dissaving of Government rose sharply in the United States from the 1970s to the 1980s, but it moved strongly the other way in the Federal Republic of Germany and Japan. As noted above, in all three countries, the Governments that held power at the onset of the 1980s shared a common intent in wishing to reverse the upward trend in the share of public revenue and expenditure in national income. In the Federal Republic of Germany and Japan, this took the form of strenuous efforts to reduce the sizeable budget deficits that had been inherited from the 1970s. In the United States, first priority was given to cuts in taxes rather than to the containment of expenditure.

Set on these divergent tracks, the saving-investment balances of the three countries have evolved in different ways. The Federal Republic of Germany and Japan have tended to generate more savings than have been absorbed by domestic investment, and the United States has done the opposite. The latter generated a demand for savings which the former were well placed to meet.

[b] See L. Summers and C. Carroll, "Why is US national savings so low?" *Brookings Papers on Economic Activity*, 1987.

Effects of the external imbalances on the international economic environment

Any assessment of the performance of developed market economies during the 1980s has to give pride of place to their success in moderating the pace of inflation within their own countries. At the turn of the decade, rates of inflation that were high by the standards of the previous three decades were impeding the growth of these economies, most notably because of the various negative effects they were having on fixed investment. To the extent that the imbalances within and among the developed market economies are a result of efforts to reduce inflation and to the extent that these efforts are considered to have had salutory effects, it can be said that the imbalances have contributed to the development process in those countries. It also has to be recognized that the development of the external imbalances has been accompanied by an exceptionally long and sustained period of expansion in these countries which, although slow by the standards of the previous two decades, has been the most important component of the growth of the world's market economies for the past five years.

It is also difficult to demonstrate that an imbalance, in and of itself, has negative consequences for the development process in either developed or developing countries. Indeed, a fiscal deficit can be beneficial to growth within an economy, while an external deficit stimulates growth in the country's trading partners. Both of these effects have been apparent in the development of these two deficits in the United States.

Nevertheless, the combination of policies which won the gains achieved in the 1980s and which produced the imbalances was also instrumental in creating an international trading and financial environment that has been damaging to the economic performance of most developing countries. For these countries, the three consequences of these policies that have had the most immediate and general effects have been the weakness in world import demand (and therefore the slower growth of the developing countries' export volumes), the decline in primary commodity prices and high interest rates.

Other consequences can be traced directly to the imbalances themselves, but their precise impact is more difficult to specify. First and foremost among these repercussions are the large fluctuations in financial variables that have been experienced, particularly in the second half of the decade. Exchange rates have displayed the greatest volatility in this period, but interest rates and the prices of financial assets have also fluctuated more than in previous years. In part, these developments can be attributed to the deregulation of international capital markets. The overall impact of the increased variability that has occurred is difficult to quantify,[4] but it seems clear that economic dynamism has been stifled by the increased uncertainty that has developed. More tangibly, the hardening of protectionist attitudes can be ascribed to the difficulties of some of the deficit countries and, now that adjustment is beginning to take place, to some of the changes that will have to take place in the surplus countries.

Effects on trade in primary commodities

Exports of primary commodities have been affected in two main ways by the economic conditions that surround the external imbalances of the major developed market economies. The first effect has been on the prices of primary commodities and the volume demanded; the second has been on the distribution of world demand for primary commodities among regions. Exchange rate realignments and, to a lesser extent, high interest rates have also affected primary commodity exports.

The weakness of primary commodity prices has been a salient feature of the 1980s. Their downward trend since 1980 has been interrupted only by a temporary recovery in 1983-1984, a brief upturn in early 1986 and the signs of another possible recovery at the end of 1987 (see figures III.1 and III.2). While the weakness in prices has several sources, a significant reason, especially affecting industrial raw materials, has been the slow growth of domestic demand in the developed market economies as a group.[5] The weakness in the prices of industrial raw materials during the 1980s was largely attributable to the fact that the industrial output of the developed market economies as a whole persistently fell short of potential. The industrial production of these countries rose at an annual rate of only 2.3 per cent between 1980 and the third quarter of 1987; for the Western European countries, the rate of increase was only 1.1 per cent annually.

Apart from the effect of the weakness in global demand on prices of primary commodities, it has been significant for developing countries that the main sources of the demand deficiency during most of the 1980s were Western European countries and Japan. These countries are much more dependent than the United States on imported supplies and account for more than 80 per cent of the exports of primary commodities from the developing regions. The slow growth of Western Europe during the 1980s has had particularly adverse implications for sub-Saharan Africa, because it is not only highly dependent on exports of primary commodities but also closely linked to Western European markets.

From the point of view of supply, efforts by debtor countries to increase export earnings in order to meet increased

4 For an examination of the effects of increased variability of exchange rates on international trade, see *World Economic Survey 1986* (United Nations publication, Sales No. E.86.II.C.1), p. 99 and P. De Grauwe, "Exchange rate volatility and the slowdown in growth of international trade", IMF Working Paper 87/38, 22 May 1987.

5 For a fuller analysis of the recent factors affecting primary commodity prices in recent years, see chapter III above and previous issues of the *World Economic Survey*, in particular *World Economic Survey 1985* (United Nations publication, Sales No. E.85.II.C.1), chap. III.

interest payments were often counter-productive. Since demand for primary commodities is usually inelastic with respect to price, increased production by several countries simultaneously added to the downward pressure on prices and resulted in lower revenues than initially envisaged.

Exporters of primary commodities have also been affected by the major currency realignments that have taken place in the 1980s. The large shifts in exchange rates among the major currencies have provoked adjustments in demand and supply in individual commodity markets and have brought losses or gains for individual countries according to the different currencies in which their exports, imports and external liabilities are priced. Since prices of primary commodities are set mostly in dollar or sterling markets, a change in the exchange rates among the major currencies alters the local currency price of primary commodities in those countries whose currencies are not tied to the dollar or sterling. For developing countries whose exports are sold predominantly in dollars but whose imports are drawn mainly from other countries, the appreciation of the dollar in the first half of the 1980s meant an element of improvement in their terms of trade, partially offsetting any deterioration resulting from a decline in the dollar price of the commodity itself. For these countries the subsequent depreciation of the dollar has amounted to a deterioration in their terms of trade and has compounded the decline in the price of primary commodities that continued until 1986.

The oil-exporting countries provide an example of the way in which exporters of primary commodities have been affected by the interactions between demand, price and the exchange rate. The price of oil is quoted in dollars. Oil became more expensive, and has subsequently become cheaper, for importing countries whose currencies followed the general pattern of first depreciating and then appreciating against the dollar as the 1980s progressed. The initial price increase helped to curtail demand and the more recent lower price, if passed through to consumers, should stimulate consumption.[6] However, the depreciation of the dollar has coincided with a decline in the dollar price of oil, adding to the severity of the contraction in export revenue which these countries have been experiencing since 1986. The decline in export earnings resulted in a commensurate cut in the import demand of the energy-exporting countries. This was a major reason why the stimulus to real domestic demand and output expected in the developed market economies during 1986 from the fall in oil prices failed to materialize.

These various effects on commodity prices are difficult to trace since they will vary from commodity to commodity depending on their price elasticities, the market shares of different countries and the importance of imports and exports within countries. Moreover, substantial adjustments in demand and supply are likely to take place only if the currency realignment is expected to be relatively permanent. There is little empirical evidence to permit assessment of the effects of recent changes in exchange rates on the revenue derived from primary commodity exports.

A final effect of the policies of the developed market economies on commodity markets was through interest rates. The higher interest rates of the early 1980s increased the costs of inventories, held for either strategic or strictly economic reasons; this had a once-and-for-all effect of dampening demand.

Effects on trade in manufactures

The effects of the conditions giving rise to the huge external imbalances on exports of manufactures have been twofold. First, as with trade in primary commodities, the divergences among the developed market economies in the rates of growth of their domestic demand have provided some developing countries with more buoyant export markets than others. Secondly, trade has been threatened by a hardening of protectionist attitudes.

The strong upsurge of domestic demand in the United States between late 1982 and mid-1984 and its continued expansion thereafter presented a buoyant market for those countries which were exporters of manufactures, notably those of Latin America and East Asia. Among the Latin American countries, the need to generate large trade surpluses to meet debt service payments added urgency to the expansion of exports, and successive real devaluations of their exchange rates against the dollar were employed throughout the period to stimulate exports.

Among East Asian countries, the strong performance of exports of manufactures was not reinforced by exchange rate depreciation until 1986; real effective exchange rates for these countries remained stable in most of the prior years. The main reasons for the growth of their exports have been their relatively advanced and diversified industrial structure, their ability to absorb new technologies and their strongly export-oriented policies. Of particular importance have been the extensive links forged with corporations in the United States and elsewhere which have been eager to take advantage of these countries' capabilities as reliable and cheap sources of supply. These relationships have taken the form of affiliates established by transnational corporations in the countries concerned and large-scale sub-contracting of the production of final products and their component parts to independent companies in those countries. The nature of these relationships means that the resulting trade has been affected relatively little by the modest changes in real exchange rates that have taken place between the dollar and the currencies of East Asian countries recently.

As a result of their export performance, the East Asian countries have acquired large and growing surpluses in their balance of payments on current account (see table A.III.6). These have become a significant component of the global surpluses which are the counterpart to the United States deficit. The recent accumulation of surpluses has enabled the Republic of Korea—which was among the most heavily indebted developing countries in 1982—to begin repaying the principal on its outstanding debt. The largest surplus in this group is that of Taiwan, Province of China, which has regis-

6 For a more complete analysis, see *World Economic Survey 1987* (United Nations publication, Sales No. E.87.II.C.1 and corrigendum), box II.1.

tered a huge increase in its foreign exchange reserves; these now stand second only to Japan's in size.

For the exporters of manufactures as a group, the most general concern arising out of events in the 1980s has been the strengthening of protectionist sentiment in the developed market economies. Governments in these latter countries have resisted many of the demands for more protection, but the list of protective measures has nevertheless grown (see chap. III above). Developing countries have usually lacked the bargaining strength needed to defend themselves against threatened protectionist steps. Particularly vulnerable have been the marginal, new suppliers of the products—such as textiles—with which most countries begin their career as exporters of manufactures.

The reasons for the strength of protectionist sentiment in the developed market economies in the 1980s are high levels of unemployment in Western Europe, the socially painful contraction of "sunset" industries, the existence of excess industrial capacity in the face of deficient demand, and the struggle for technological leadership in new industries. In the United States, however, these tensions have been exacerbated by that country's growing external trade deficit. The stagnation of the United States' export industries during the first half of the decade and the intensified foreign competition faced by its import-competing industries have given rise to pressures that are an important part of the political dialogue today.

Effects on the transfer of resources to developing countries

The circumstances that gave rise to the external imbalances among developed market economies profoundly altered the external financial environment for developing countries, particularly those that are heavily indebted. Interest rates soared in the early 1980s and thereafter declined only slowly from their high level (see figure VII.3); at the same time, the rate of growth of export earnings fell sharply and generally recovered only weakly. It was this transformation of the external environment that largely triggered the debt crisis.[7]

Despite some easing of these difficult external conditions, the debt problem remains unresolved. Moreover, it is clear that the process of accumulating the imbalances and that of unwinding them are not symmetrical. The costs that some countries, particularly the indebted developing countries, incurred (and are continuing to incur) as a result of the circumstances surrounding the build-up of the imbalances will not be offset by equivalent gains when the process is reversed. For example, the lower nominal interest rates that now prevail in world markets have reduced the present burden of debt service. However, this cannot compensate for the losses of income and output, or for the dramatic slowdown in investment, that were occasioned by the high level of external payments made earlier in the decade. Nor does it eliminate the additional debt that was accumulated when such payments could not be made or the long-term negative consequences of the decline in investment.

During the 1970s, accelerating inflation virtually put an end to long-term loans at fixed rates of interest; in their place, the banks devised the instrument of revolving, medium-term, variable interest loans. This allowed the extensive re-lending of current account surpluses of the energy-exporting countries to the energy-importing developing countries. However, it also shifted onto the shoulders of borrowers the whole of the risk arising from any change in monetary conditions. When, in the early 1980s, the developed market economies adopted the control of inflation as their first priority and rigorously tightened their monetary policies, the indebted developing countries were faced with steeply increased nominal interest rates. At the same time, the global recession, induced by the anti-inflationary policies, sharply reduced their export earnings (see table III.1). Thereafter, nominal interest rates declined only slowly and the recovery in export earnings was weak, with the result that the debt situation has shown little improvement.

There are several possible explanations for the high, though declining, nominal interest rates in the developed market economies over most years since 1980. For example, it has been argued that there was a "crowding-out" effect, that is, that, in competing with private investment for available private saving, the budget deficits in the developed market economies, particularly in the United States, were one cause of the upward pressure on interest rates.[8] As a demand component, the rising budget deficits were an influential factor, but it seems apparent that monetary policy and the inflationary expectations of lenders played the leading role. When monetary policy was rigorously tightened at the turn of the decade to arrest inflation, interest rates rose to high levels. The important role of monetary policy and expectations cannot, however, completely dismiss the role of the fiscal deficits in raising interest rates and thereby having an impact on indebted developing countries. Even if the deficit-induced component of the increase in interest rates has been small, it will have had a sizeable short-term impact on the debt-servicing obligations of indebted countries[9] and, through this, on their development process.

Recently, fear of a reactivation of inflation and inflationary expectations has dominated monetary policy. This fear has been fed, among other things, by concern that the high levels of public and private indebtedness might, at some point, cause central banks to increase the liquidity of the

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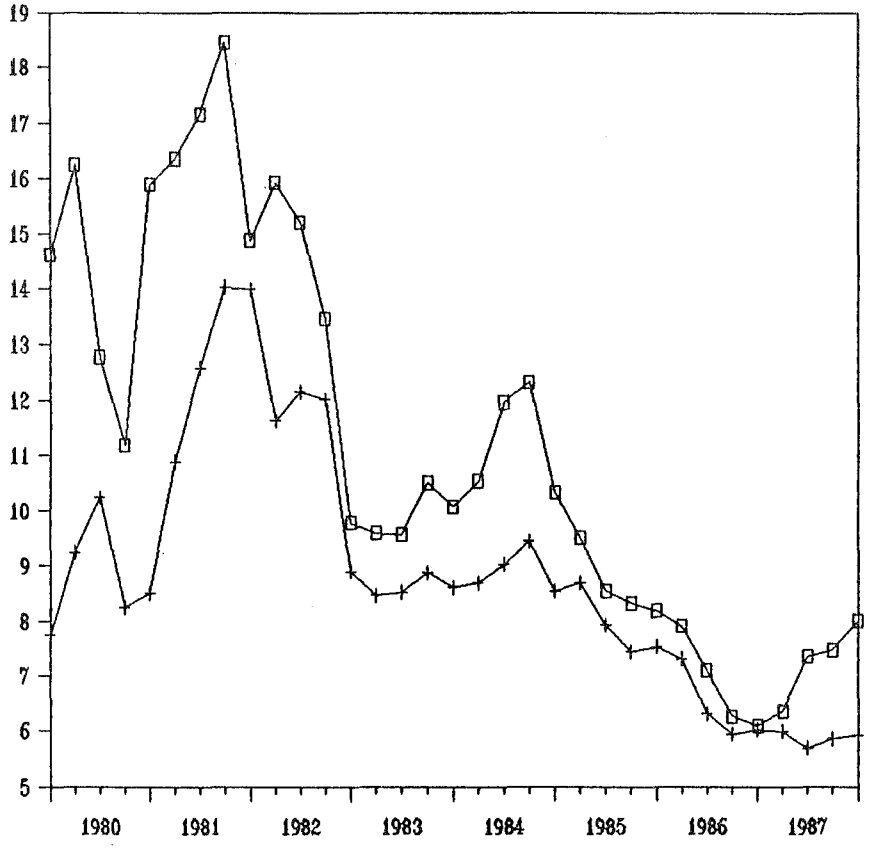
7 In 1983, IMF reported that, "for the oil importing developing countries, the entire deterioration of their combined current account balance from 1978 to 1981 can be ascribed to three adverse factors [reduced export volumes and prices, increased import prices and higher interest rates]". IMF stated that the "key consideration here is the generally unfavorable nature of the external economic and financial environment faced by these countries in recent years and the importance of certain major adverse influences almost wholly beyond their own control" (IMF, *Annual Report* (Washington, D.C., 1983), p. 34). See also *World Economic Survey 1983* (United Nations publication, Sales No. E.83.II.C.1), chap. I.

8 Deepak Lal and Sweder van Wijnbergen, "Government deficits, the real interest rate and LDC debt", *European Economic Review*, vol. 29, No. 2 (November 1985).

9 It is estimated that a 1 per cent rise in the interest rate on their debt costs the developing countries at least $5 billion annually in debt service.

Figure VII.3. International interest rates, 1980-1987
(Percentage)



□ London Inter-bank Offered Rate (LIBOR) on six-month dollar deposits

\+ Rate on special drawing rights. This is a weighted average of short-term interest rates in France, the Federal Republic of Germany, Japan, the United Kingdom and the United States

Source: IMF, *International Financial Statistics*, various issues.

system. In addition, private investors have appeared unconvinced that the decline in the rate of inflation would last and have adjusted their interest rate expectations only slowly. Conditioned by the experience of the late 1970s, any movement towards relaxation of monetary policy has been cautious. As a result, real interest rates have remained high.

The high nominal interest rates in the developed market economies in the early 1980s were an integral part of the process that gave rise to the imbalances, but it is significant that these rates have remained high in real terms (see table VII.3). The declining trend in nominal rates has not been matched by falling real rates because nominal rates have lagged behind the declining rate of inflation. These high interest rates tend to discourage investment in physical capital in both developed and developing countries, thereby slowing the development process around the world. Low levels of investment reduce the current level of economic activity, make the global adjustment process more difficult and impose a constraint on growth in the future.

Investment in developing countries has also been slowed by the lethargic nature of resource transfers to developing countries. The macro-economic policies of the developed market economies have also had a direct and adverse effect on official flows to developing countries, because efforts to reduce the growth of fiscal outlays have influenced the volume of development assistance provided by some countries. In addition, the increase in interest rates gradually affected bilateral official loans to developing countries, as well as those of the multilateral financial institutions, so that the cost of official borrowings increased along with that of commercial credit.

It was not until 1987 that there was a perceptible decline in the ratio of interest payments to export earnings for the

Table VII.3. Long-term real interest rates[a] in the Federal Republic of Germany, Japan and the United States, 1973-1987

(Percentage)

	Federal Republic of Germany	Japan	United States
1973-1979	2.8	−0.7	−0.5
1980-1982	4.7	5.5	3.9
1983-1987	4.2	4.8	6.7

Source: OECD, *Historical Statistics, 1960-1985*, *OECD, Main Economic Indicators*, January 1988; and IMF, *International Financial Statistics*, March 1988.

[a] Yield on long-term government bonds less percentage change in gross national product deflator.

countries that are heavily indebted to private lenders (see chap. IV).[10] (It did not take place in sub-Saharan Africa where debt is mostly official debt at fixed rates of interest.) However, other debt indicators—such as the ratio of outstanding debt to exports—have failed to improve and the improvement in the servicing ratio has done little to relax the strains imposed on the domestic economies of these countries by the inescapable need for tight import compression.

These developments partly explain the rapid reversal during the 1980s of the previous net transfer of resources from developed to developing countries.[11] As indicated in table IV.2, there was a transfer of some $40 billion annually from the developed to the developing countries at the beginning of the 1980s. In 1987, there was a net transfer of financial resources from the developing to the developed countries of more than $21 billion. Nor was this a temporary phenomenon: the reverse flow of resources has continued uninterrupted since it emerged in 1984 and, in the absence of a fundamental breakthrough regarding developing country debt or some other major advance in international economic relations, it will continue on a large scale until well into the next decade. During the 1980s as a whole, the positive flows of more than $90 billion during the early years will be substantially outweighed by the negative flows from 1984 to 1990.

This period of negative net transfers to developing countries has coincided with the burgeoning capital inflows into the United States that have been the counterpart of that country's trade deficit. The United States has, in effect, been drawing on world savings, particularly those of the Federal Republic of Germany and Japan. Such a situation—whereby one of the more affluent countries absorbs a large volume of resources for an extended period of time—not only contradicts economic logic and economic history, but would also be viewed by many as inequitable. Even if there has been no direct "crowding-out" of financial flows to developing countries by the budget deficits in the developed market economies, the outcome has been similar: the fiscal deficits have been financed, while net financial flows to developing countries have been negative for the past four years.

The correction process

There has been some, albeit slow, progress towards reduction of the United States trade deficit since the dollar began to depreciate in February 1985. Despite the depreciating exchange rate, importers into the United States have been hesitant in raising their dollar prices, evidently preferring to reduce their profit margins and to cut costs than to see their share of the market contract. Similarly, exporters from the United States have not used the opportunity of the depreciation to increase their dollar prices, apparently preferring to reduce their prices in foreign markets in order to restore their sales position abroad. These reactions have accentuated the familiar lags in the adjustment of the amounts of traded goods demanded and supplied to changes in local currency prices.

The effects of the depreciating dollar on trade balances began to appear around the end of 1986. During 1986 as a whole, the volume of United States' exports was about 7 per cent higher than in 1985, while the volume of its imports was some 14 per cent higher. In 1987, however, export volume rose by more than 10 per cent, while imports increased by less than 5 per cent. Export prices in dollars changed little during the year, but import prices increased by more than 6 per cent. The value of exports and imports accordingly grew at a roughly similar pace, but the trade balance widened to $161 billion (from $142 billion in 1986) because imports are much larger than exports.

In the area of fiscal policy, the United States federal deficit fell from its record of $221 billion in fiscal year 1986 (which ended in September of that year) to $148 billion in fiscal year 1987, bringing it down to 3.3 per cent of gross national product. This reduction was partly under the impetus of the Gramm-Rudman-Hollings Act but it also owed a good deal to other, more transitory factors.[12] The cuts agreed upon for the fiscal years 1988 and 1989 are much more modest. Leaving aside asset sales (whose receipts are not saving out of current income), the deficit in fiscal year 1988 is to be reduced by $30 billion (which is not much more than the mandatory minimum of $23 billion specified in the Gramm-Rudman-Hollings Act). In fiscal year 1989, the reduction will be $42 billion. These cuts will reduce the structural deficit of

10 Besides interest rates and export earnings, the ratio is also affected by depreciation of the dollar since interest payments are mostly in dollars while some export earnings are in currencies appreciating against the dollar.

11 A major reason for the reversal is the retrenchment in commercial bank lending to developing countries; the slow-down in net credit flows from the multilateral financial institutions has also contributed (see chap. IV above).

12 There were temporary gains in revenue occasioned by the transition to the new rules and rates applicable under the Tax Reform Act of 1986; there were sales of assets, a non-recurring source of revenue; and the economy grew more strongly than expected.

the Federal Government by only 0.4 per cent of gross national product over two years.

For its fiscal year 1987 (which ends in March 1988), Japan adopted a supplementary budget involving additional public spending amounting to about 0.5 per cent of gross national product. It has also been stated that public enterprises, which are excluded from the general government budget, will be extensively utilized to stimulate domestic activity. For fiscal year 1988, policy is again expected to be expansionary. The guidelines issued to ministries for preparation of the budget indicated a shift away from a restrictive approach and a tax reform bill approved in September 1987 contains cuts in direct taxes. The effects of the tax reform package are expected to raise gross national product in 1988 by 1 to 1.5 per cent.[13]

The Federal Republic of Germany has laid particular stress on the reduction of budget deficits during the 1980s. Fiscal policy, however, was mildly expansionary in 1987 as a consequence of tax cuts, and it is expected to be so again in 1988. Nevertheless, the effect on total domestic demand to date has been small. Real domestic demand grew by about 2.5 per cent in 1987 and real output by 1.5 per cent. The main source of the weakness in real domestic demand has been the low rate of growth in fixed investment, which rose by only 1 per cent in 1987 and is not expected to increase by more than 1.5 per cent in 1988. Investment is sluggish in large measure because of the stagnation of the export sector (which accounts for one third of gross national product). The fiscal stimulus (about 0.3 per cent of gross national product in 1987) was too small to offset the deflationary effect of currency appreciation. In 1988, the growth of demand is forecast to be somewhat lower. Further, on the basis of recent policy pronouncements, fiscal policy is expected to be neutral in 1989. In view of the weak performance of the economy, many have argued for an advancement of the tax cuts scheduled to be introduced in 1990.

Trends and policies in the Federal Republic of Germany are influential in setting limits to the policies which can be pursued in other countries of Western Europe. This is both because of its importance as the largest trading nation within Western Europe and because its financial policies directly affect several other countries through their common links in the European Monetary System. Experience has shown that expansionary policies in other countries are likely to encounter difficulties if they are inconsistent with the policy stance of the Federal Republic of Germany. For the Western European countries as a group, fiscal policy was, on average, slightly contractionary in 1987 and is expected to remain broadly so in 1988. Both France and the United Kingdom, two of the other large economies in the region, have been experiencing increasing deficits on their current accounts; this would normally be expected to discourage a further expansion of fiscal policy.

Are further measures necessary?

Discussions about the sufficiency of the adjustments made so far generally focus on exchange rates and the rates of growth in demand relative to output in the leading developed market economies. The exchange rate and import policies of East Asian countries have also been questioned recently. A third range of issues concerns the pattern of international capital flows and the role of developing countries as recipients and as markets for United States exports.

Exchange rate realignment

Despite the evidence that there has been a reversal in the past trends in United States' exports and imports, it is unclear whether—within the framework of current policies and exchange rates—the change has been sufficient to improve the United States current account balance adequately within an acceptable period of time. The question arises because of the scale and the speed of the improvement that is called for. Since imports were more than 60 per cent larger than exports in 1986, exports have to grow at a considerably faster rate than imports if the deficit in the trade balance is to be reduced at any significant speed. The task is made more difficult by the fact that external indebtedness grows and debt servicing increases with each year of deficit. Consequently, the trade balance has to improve by more than the increase in debt service payments if there is to be a reduction in the current account deficit. Of greater concern is the fact that, in the absence of a speedy narrowing of the current account deficit, foreign investors could become increasingly reluctant to accumulate more dollar assets.

By the end of March 1988, the real effective exchange rate of the dollar had depreciated by more than a third from its peak in February 1985 and was slightly below its level of 1980. The official view expressed in the first four months of 1988 was that the dollar had fallen far enough; the relative competitiveness of United States tradable goods was seen as sufficient to restore reasonable balance in foreign trade. Some econometric exercises support this point of view but others suggest that some further depreciation may be needed if balance is to be restored by the early 1990s.[14]

A simple way of presenting the problem and of illustrating the uncertainties that surround judgements about the exchange rate starts from the fact that the current account of the United States was more or less in balance in 1980.[15] This was consistent at the time with a deficit in the trade balance equivalent to about 1 per cent of gross national product (since net investment income sufficed to offset the trade deficit). However, if the current account is to be restored to balance in the future, a surplus will have to be recorded in the trade balance in order to cover net investment payments; it has been estimated that these could amount to 0.5 per cent

13 IMF, *World Economic Outlook* (Washington, D.C., September 1987).

14 See, for example, Stephen Marris, *Deficits and the Dollar: The World Economy at Risk* (Washington, D.C., Institute for International Economics, 1987); Martin Feldstein, "At the mercy of investors: economic forecasts 1988", *Financial Times*, 4 January 1988; and R. Dornbusch, in a paper presented to a conference organized by Business International (see *The Economist*, 23 January 1988, p. 66).

15 See William Branson, "Discussion on Reaganomics", in *Economic Policy: The Conservative Revolution: A Special Report* (Cambridge, Cambridge University Press, 1987).

of gross national product. Thus, the real effective exchange rate would have to fall below its 1980 level sufficiently to improve the trade balance by about 1.5 per cent of gross national product. One estimate shows that a 13.5 per cent real depreciation improves the trade balance by about 1 per cent of gross national product,[16] implying that a further depreciation of 15 to 20 per cent might be required before the early 1990s in order to restore balance.

Several qualifications to this reasoning suggest that this estimate of the required depreciation may be an understatement. Income in the United States has grown more than in other developed market economies, so that its relative income level has risen since 1980. Some economists also maintain that consumer preferences in the United States have shifted in ways that favour imported goods. On the production side, there is evidence of a secular decline in the United States trading position because other countries have been catching up technologically and relative productivities have changed.[17]

On the other hand, the above line of reasoning, as well as most econometric models, estimate the depreciation necessary to restore complete balance in the current account by the early 1990s. However, the depreciation called for becomes more modest if only a narrowing of the deficit is required. The condition in this case is that foreign investors remain willing, at the prevailing exchange rate, to purchase dollar assets so that the deficit continues to be financed. Whether this condition is likely to be fulfilled depends heavily on private investors' perception of risks.

Fiscal policies and the saving-investment balance

In addition to the adjustment of exchange rates, it is essential that the leading deficit and surplus countries adjust their rates of increase in domestic demand relative to output. This is primarily a matter of adjustments in fiscal policies to alter domestic saving relative to domestic investment. The short-term effects on external balances of feasible changes in demand may be minor by comparison with changes in exchange rates. Simulations by OECD indicate that, over a period of one or two years, a 10 per cent devaluation of the dollar would have substantially larger effects on the trade balance than any likely accompanying changes in demand.[18] Nevertheless, failure to make the needed adjustments in demand will diminish the effectiveness of exchange rate changes. If the United States economy is to release the output needed to increase net exports, a relative contraction in domestic demand has to occur, particularly since the economy is currently operating at comparatively high levels of capacity utilization and employment.[19] Further, since the United States plays such a large part in world trade, the contraction in its external demand emanating from a depreciation of the dollar transmits a significant deflationary impulse to its trading partners. Offsetting action has to be taken by the surplus countries if aggregate demand in the world economy is not to suffer.

The fiscal measures taken so far have gone some way towards meeting these short-term concerns. However, the correction of the external imbalances demands the progressive adjustment of saving-investment imbalances over the next several years. Changes that can modify the saving behaviour of households are slow acting and necessarily have to be regarded as long-term measures.

Other fiscal action can have a more immediate and predictable effect on total savings within an economy. There are, for example, several fiscal and institutional reforms which could stimulate household expenditure in the Federal Republic of Germany and Japan and some action has been taken.[20] In the United States, however, attempts to modify the savings behaviour of households have been more limited. For example, there were attempts during the discussions of tax reform legislation to raise the cost of house mortgages and other consumer borrowing to their market rates by depriving interest payments of their tax deductible status, but these efforts failed.

Capital flows

The key concern for the international community is how the external deficit of the United States will be financed in the future. As the amount of outstanding dollar-denominated debt has grown, foreign investors have become increasingly reluctant to accumulate more. The more doubtful they become about the prospects for elimination of the deficit within a few years, the greater the risk of a sudden loss of confidence in the dollar. This could precipitate an upheaval in financial markets that could breed global recession. This, in turn, could be a factor pushing more indebted developing countries into default.

The scale and rapidity of the recent change in the external assets and liabilities of the United States has been enormous. At the beginning of the 1980s, the United States' net external assets were larger than those of any other country in the world. Subsequent heavy net borrowing reversed the status of the country from net creditor to net debtor: its net indebtedness to the rest of the world stood at roughly $400 billion by the end of 1987 (see table IV.5). Although the two figures

16 R. Dornbusch and J. A. Frankel, "Macroeconomics and protection" in *US Trade Policies in a Changing World Economy*, R. M. Stern, ed., (Cambridge, MIT Press, 1987).

17 P. R. Krugman and R. E. Baldwin, "The persistence of the U.S. trade deficit", *Brookings Papers on Economic Activity*, 1 (1987). According to Feldstein, *op. cit.*, "trends in American and foreign productivity and tastes require the real value of the dollar to fall at least 2 to 3 per cent a year just to maintain a trade balance once it is established".

18 OECD, *Economic Outlook*, December 1987.

19 If a relative contraction were to happen spontaneously—say, because of a slowing growth in consumer expenditure—the need for action would be temporarily delayed, but only till recovery took place.

20 A tax reform bill passed by the Diet in September 1987 virtually ended substantial tax privileges enjoyed by small savers on their interest income. In the Federal Republic of Germany, a 10 per cent withholding tax on interest income will be introduced in 1989.

are not directly comparable,[21] this is roughly equivalent to the total indebtedness of all the countries in Latin America.

The external imbalances of the United States and the other leading developed market economies will not diminish quickly. The present current account deficit of the United States amounts to over 3 per cent of its gross national product (see table VII.1), and a return close to equilibrium therefore implies large adjustments in both domestic expenditure and domestic production. The proportion of the gross national product spent on domestic consumption and/or investment has to contract by approximately 3 per cent and the domestic resources engaged in the production of exports and substitutes for imports have to rise by about the same proportion. The experience of the heavily indebted countries in the 1980s indicates that such a switch is manageable only over several years. Even in such a highly flexible economy as the United States, the process is likely to be a lengthy one. Moreover, a condition is that, in the interim, there will continue to be a net inflow of capital to finance the current account deficit.

In the earlier years of the increasing current account deficit of the United States, some part of its financing came from a reduction in foreign lending by United States banks, but the main source was the upsurge in private capital flows, particularly from Japan. Much of this capital was channelled into purchases on the United States securities market, notably purchases of United States Federal Government securities.

The large-scale accumulation of dollar-denominated assets by foreign private investors was based on their expectation that the total return which they would obtain from these assets would be greater than that which they could earn on equivalent assets at home. On short-term assets, this meant that the difference in interest rates between the United States and the foreign investors' home country had to be more than sufficient to compensate for any expected depreciation of the dollar. In the period before March 1985, higher interest rates in the United States were reinforced by an appreciating dollar (see figure II.1). Since March 1985, however, any short-term expectations of a stabilization or recovery of the dollar have not been realized most of the time, although longer-term fixed interest securities (as well as shares) have offered the possibility of capital gains for investors who believed that interest rates in the United States would decline. From mid-1984, the United States bond market entered a lengthy period of declining interest rates and rising capital values and, though the spread between United States and foreign rates progressively declined, the total expected return on United States securities appeared to be more than sufficient to offset expectations of further depreciation of the dollar. As a result, over half the United States current account deficit during 1985 and 1986 was financed by long-term capital flows. An important contributory factor was the large-scale participation of Japanese financial institutions placing surplus Japanese funds: these institutions were disposed to put a substantial proportion of their funds in long-term United States assets.

By early 1987, the downward trend in United States interest rates appeared to have bottomed out, while the Louvre Accord only temporarily allayed fears that the dollar would fall further. The inflow of private capital diminished, becoming negative in some months, and financed less than 60 per cent of the United States current account deficit in the first six months of 1987.[22] In order to maintain the dollar in line with the intentions expressed in the Louvre Accord, central banks had to intervene heavily on foreign exchange markets, with the result that a substantial proportion of the United States current account deficit in 1987 was financed by official capital transactions (see chap. IV above).

Despite the attempt in the Louvre Accord to stabilize the exchange rate, the dollar has fallen to lower levels. Interest rate differentials have not changed markedly and it remains to be seen whether, at the new dollar exchange rate, foreign investors will resume the accumulation of dollar-denominated assets on a scale sufficient to finance the current account deficit. Some investors already have large stocks of dollar-denominated assets in their portfolios and will face losses on any further depreciation. To increase further the share of dollar assets in their portfolios would be to enlarge their exposure to the risk of more depreciation. The same holds true for the non-United States central banks which have already intervened heavily to stabilize exchange rates; their reluctance to acquire more dollar-denominated assets is bound to be greater now than it was in early 1987.

Another aspect of the present imbalances is the need for a redirection to developing countries of the capital outflows from the surplus developed market economies that currently flow predominantly to the United States. As indicated above, the present pattern of flows conforms neither with economic rationale nor with general perceptions of global equity. Such a redirection of some part of the present surpluses among the developed market economies is not inconsistent with the need to address the United States' current account deficit. An increase in the developing countries' capital inflows would allow them to increase their imports; some of these imports would come from the United States and contribute to a reduction in that country's trade deficit. Japan has recently been taking positive steps to redirect part of its surplus to the developing countries and actions taken by the international community to increase the flow of official multilateral funds will also assist. However, developing countries that are indebted to private capital markets cannot expect a recovery of private capital flows as long as their debt crisis remains unresolved.

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21 These official figures underestimate the current value of external assets of the United States, primarily because foreign direct investment, the largest single category of external asset, is based on the book value of assets, not market values. Book values are likely to be significant underestimates of the market value of foreign assets since many of the underlying investments were made many years ago. Gold holdings are also not valued at current market prices.

22 OECD, *Economic Outlook*, December 1987.

Narrowing of the imbalances: the possibilities and their effects

It is inescapable that the prospective financing of the United States current account deficit will be resolved in some way. It is also clearly the wish of Governments to accomplish a managed resolution of the problem. If the United States' current account deficit is seen to be contracting, private investors may become convinced that the exchange rate for the dollar will remain stable, at least in the short term. Under these circumstances, an inflow of capital sufficient to finance the deficit may be achieved with only modestly higher interest rates in the United States.

If, however, international measures and domestic fiscal and monetary policies fail to reduce the United States' current account deficit with reasonable speed, the erosion of confidence could precipitate massive international capital movements and a further depreciation of the dollar. Exchange rate stability might be achieved only through a sharp rise in interest rates in the United States, reinforced by the expectation of domestic price increases ensuing from any depreciation. However, interest rates themselves will impinge directly on the narrowing of the deficit through their effect on the net outflow of service payments from the United States. As a result, both expectations regarding inflation and confidence in monetary policy will, because of their effect on interest rates, play an important role in the way the imbalances are reduced.

A rise in interest rates could curtail domestic spending, particularly if falling bond prices spread to other asset prices. For the other leading developed market economies, a renewed depreciation of the dollar and reduced domestic spending in the United States would further hurt their export sectors. Among developing countries, the consequences could be particularly severe for the heavily indebted countries which would encounter higher interest rates and reduced export earnings.

There is also the possibility that the continuing Japanese trade surplus, whatever its size, will not be matched by an outflow of capital. In this case, further appreciation of the yen would ensue, reducing domestic output and income and thereby bringing domestic savings more into balance with domestic investment. Clearly, a deflationary approach of this nature is undesirable from the point of view of both Japan and other countries.

The broad objectives of the exchange rate realignments and fiscal measures implemented since 1985 are to avoid such adverse outcomes and to reduce the imbalances by means of expenditure-switching, both among and within countries. In the case of the United States, the objective has to be to move domestic demand away from imported goods towards domestically produced goods and towards the production of exports, and vice versa for the surplus countries. Particularly in the light of the major adjustments that are in progress in many other countries, both developing and centrally planned, it is difficult to specify the precise impact of such expenditure-switching on economies other than those that will be directly involved. The trickle-down and multiplier effects on other countries will depend on the linkages of the expenditure-switching countries with the rest of the world, in particular on the sectors of their economies that are affected and on those sectors' dealings with the rest of the world.

The major concern has to be with the possible consequences of a slow-down in the external demand of the United States. Such a slow-down is likely to be brought about in part by fiscal contraction designed to reduce the budget deficit and in part by the decline in United States' imports that is likely to be produced by the depreciation of the dollar. The main sources of United States' imports are Canada, Japan, the South-East Asian economies, Latin American countries (particularly Mexico) and, to a lesser extent, individual Western European countries. It is these countries that will be most affected by a reduction in the United States' external demand.

Canada usually suffers disproportionately from a deceleration in the United States, but the next instance may be the exception. Importantly, the Canadian dollar has not appreciated against the United States dollar to the same extent as most of the other major currencies, so that price effects will be less. Meanwhile, economic growth in Canada is currently robust and may be sufficient to offset a negative external shock. In addition, Canadian-United States trade should be stimulated by the gradual entry into force of the free trade agreement that was agreed with the United States in December 1987. At the micro-economic level, the United States automobile industry, which is an important beneficiary of the depreciation of the United States dollar, should continue to be a major market for Canadian exports.

Other exporters to the United States seem unlikely to fare as well. In the case of Japan and Western Europe, evidence indicates that exchange rate realignments have already had a deleterious impact on the volume of exports to the United States. Since exports account for a relatively large proportion of gross domestic product in these economies, the negative consequences of their decline are likely to be sizeable unless offset by an expansion of other components of demand.

Despite the heavy dependence of their exports on the United States market, the South-East Asian economies have so far suffered little from United States' efforts to improve its trade balance because, until 1988, their currencies appreciated less than others against the dollar. To the contrary, they have experienced a depreciation *vis-à-vis* most of the other major currencies, particularly the yen. This has served to stimulate their exports, both to the countries concerned and in third markets where they compete with exports from Japan and Western European countries. As noted above, however, this advantageous position has enabled these exporters to generate huge current account surpluses and to accumulate large foreign exchange reserves. Their success in export markets has now given rise to pressure for an upward valuation of their currencies and a liberalization of

their imports. The sensitivity of these economies to a general slow-down in the industrial countries has been documented elsewhere;[23] the implementation of the proposed measures to reduce their current account surpluses would amplify this negative effect.

The Latin American countries are likely to be affected more adversely than those in Asia from any slow-down in import demand from the United States. Earlier in the 1980s, the exports of many of these countries, particularly some of the major debtors, benefited from the United States' expansion. More recently, they have encountered some resistance to the continued increase in their exports to the North American market, with the result that any further decline in United States' imports seems likely to have a disproportionately adverse effect on the countries in the region. Depressed export earnings would in turn aggravate these countries' debt-servicing difficulties and reinforce the negative influence that these are having on their economies and on their imports from the rest of the world.

The objective of the major developed market economies is to offset these negative consequences of a slow-down in the United States by a policy-induced acceleration in Western Europe and Japan. Even if the stimulus in these countries, however measured, is equal to the contraction in the United States, the distribution of its effects is likely to differ. An increase in the demand for imports by Japan, for example, will be particularly beneficial to the countries of South-East Asia and will offset the probable set-back to their exports to the United States. These countries may also benefit, although to a lesser extent, from accelerated growth of domestic demand in Western Europe.

The major external beneficiaries of an expansionary fiscal policy in certain Western European economies are likely to be other countries within that group, particularly with the efforts being made to introduce a single market within the European Economic Community by 1992. Increased economic co-operation between Western Europe and the centrally planned economies would enable the latter to benefit from the expansion of the former. Successful implementation of the structural adjustment efforts now under way in Africa should place those countries in a better position to exploit the increased export opportunities that would arise from a stimulation of the Western European economies. Latin America, on the other hand, does not have strong economic ties with Europe, so that the acceleration in Western Europe is unlikely to offset the effects that the slow-down in the United States would have on the region.

These general patterns will be modified by the sectoral pattern of the expansion and contraction that takes place in the expenditure-switching countries. Among the developed market economies, for example, there are mixed efforts to reform the widespread system of agricultural subsidies. Some movement in this area, albeit politically sensitive, could be an ingredient of some of the fiscal measures that have to be implemented in the adjusting countries. The elimination or reduction of subsidies on agricultural products would be one means of reducing the domestic budget deficits of the developed market economies, but would also raise the world price of agricultural products. This would be to the benefit of those producers that would be viable at the higher but unsubsidized price, but would impose a cost on importing countries. These include some of the centrally planned economies, as well as many of the developing countries.

Other measures would have a similarly differentiated effect. For example, it is widely felt that a part of the response by Japan to its present savings-investment imbalance should be to increase investment in housing. Construction has a low import-intensity and the only sizeable international spillover effect in such a case might be an increased demand for timber, domestic appliances and similar items. Similarly, a reduction in defence expenditure by the United States Government, while reducing the fiscal deficit, would have little direct effect on the trade balance or on the economies of the rest of the world.

A revival of international capital flows to the developing countries has to form part of an orderly solution to the problem of reducing the prevailing imbalances among the developed market economies. The channelling of surplus savings from the large creditor countries to the developing countries would enable the latter to increase their imports and some part of this increased import demand would be met by larger exports from the United States. The current account surpluses of the leading developed market economies would be mirrored less in the deficit of the United States and more in the deficits financed by capital flows into developing countries. This would conform more closely with the reasonable expectation—borne out by most historical experience—that capital should flow from the economically more mature economies to the more recently developing countries.

Having emerged as the foremost capital exporters in the world, the Federal Republic of Germany and Japan have an enhanced role to play in the revival of capital flows to developing countries. The reversal of the net transfer of resources to the developing countries has occurred largely because of the collapse of commercial bank lending and the escalation of debt service payments. For the majority of developing countries, a revival of commercial lending would not be an appropriate means of responding to their need for increased financial resources. The quest must therefore be for increased flows of official development finance. Such flows have not grown appreciably during the 1980s (see chap. IV). The countries that currently have large surpluses on their balance of payments can lead the way in reviving flows of official development finance (as some of the energy-exporting countries did at the time of their large surpluses), but the responsibility should not be theirs alone.

For its part, the Government of Japan has already indicated that the recycling of its external surplus is to be one of three key points of its future international economic co-operation. Another point is the promotion of comprehensive

23 Susan M. Schadler, "Effect of a slow-down in industrial economies on selected Asian countries", *IMF Staff Papers*, vol. 33, No. 2 (June 1986), p. 345.

co-operation that combines economic assistance and direct investment to the developing countries with import expansion from them. The third point is not only to increase ODA but also to improve its quality.

A Japanese plan for recycling a total of $30 billion into the developing countries was introduced at the IMF-World Bank meeting in December 1986. In May 1987, the Government of Japan announced specific measures to increase its economic co-operation with the developing countries. In this package, Japan proposed the recycling of an additional $20 billion over the following three years. It also accelerated the previous plan to double ODA by 1992 so that it will double in 1990 (from $3.8 billion in 1986).

The first plan to recycle $10 billion involved loans of SDR 3 billion to IMF, the establishment of the Japan Special Fund (JSF) at the World Bank, and a contribution to the Inter-American Development Bank (IDB) and the African Development Bank (AfDB). The second plan (for recycling a further $20 billion) includes the setting up of a fund similar to JSF in both IDB and the Asian Development Bank (ADB), granting permission to the World Bank to raise private funds on the Tokyo market (about $8 billion), providing loans through the Overseas Economic Co-operation Fund (OECF) and undertaking co-financing with multilateral institutions such as the World Bank through OECF, the Export-Import Bank (EIB) and private banks (about $9 billion), and providing direct untied loans through EIB (about $3 billion). This latter $20 billion is intended to come from private investors in Japan through the purchase of bond issues by the multilateral development agencies and through co-financing arrangements with these agencies.

Although most of the recycling of funds is to be done through the multilateral institutions, it is noteworthy that the Japanese Government is considering the introduction of untied loans. One of the main purposes of recycling funds is to help indebted developing countries promote export industries in order to reduce their foreign debt burden. The Ministry of International Trade and Industry (MITI) has set up teams to discuss the kinds of industries that could be developed in Argentina, Brazil, Chile, Mexico and other indebted countries. EIB has also established a group to study the recycling of funds to the developing countries. Under the present Export-Import Bank Act, EIB untied loans are limited to Government and governmental institutions and it is prohibited from investing in joint-stock enterprises in foreign countries. The study group has therefore proposed measures that will increase the scope of the functions of the EIB. These include permitting investment in foreign projects (in addition to loans) and expanding the possibilities for untied loans to private enterprises by allowing the Japanese Government to take part of the risk in the projects. As a first project in this recycling of funds, EIB agreed with IDB in December 1987 to provide co-financing of about $18 million in a project to develop a mine in co-operation with Venezuela's state bauxite corporation. Since the loans are untied, the procurement of the equipment and material for the project is not limited to Japan.

An enlargement of the activities of the multilateral development agencies to support growth-oriented adjustment is another important means of restoring the flow of capital to the developing countries. As indicated in chapter IV, several new initiatives by the multilateral financial institutions are being implemented and should lead to some increase in United States exports over the next few years.

In addition to new flows, a reduction in the existing debt overhang might also make an important contribution towards a narrowing of the United States' trade deficit, even though the extent to which debt reduction measures, in themselves, would reduce the deficit is unclear. A reduction in interest payments would enable the indebted countries to increase their demand for exports from the United States (among other countries) and would reduce the United States' trade balance. At the same time, United States' income from interest payments would also be reduced, so that the net benefit to the current account deficit is uncertain. If, however, the reduction of the debt burden were accompanied by enlarged capital flows from the surplus countries to the developing countries, the indebted countries would be able to grow faster and there could be a multiplier effect on their imports from the United States, to the ultimate advantage of that country's trade and current account deficits.

Some conclusions

The consequences of the imbalances among the developed market economies for the developing countries were, in large part, a side-effect of the constellation of the similar, but independent, approaches to monetary policy that the developed market economies combined with disparate fiscal policies to combat inflation and to reinvigorate the private sector of their economies. The sustained revival and growth of demand in the United States and its weakness elsewhere joined with high interest rates and the earlier liberalization of international capital movements to produce huge capital flows and wide swings in exchange rates among the developed market economies. These same circumstances also contributed to a weakening in the demand for exports from developing countries and a reduction in primary commodity prices, while simultaneously presenting indebted countries with sharply increased debt service burdens. The result was that the balance-of-payments deficits of most developing countries were narrowly confined; in particular, countries in sub-Saharan Africa have experienced acute balance-of-payments constraints and the most heavily indebted countries have remained in the grip of severe debt-servicing difficulties. The huge imbalances among the developed market economies are themselves not the direct cause of these tight payments balances among developing countries, but the two are closely linked in origin.

Some progress has been made in reducing the huge external and internal imbalances that confront the leading developed market economies. Considerably more adjustment will have to take place over the next few years. Ideally, this ad-

justment would be undertaken in an environment of high, but sustainable, world economic growth, the benefits of which would be distributed equitably among the world's population. In reality, the heritage of the recent past seems to imply that the adjustment is going to have to take place in a world of slow economic growth. As indicated in chapter II above, on the basis of present policies, economic growth in the developed market economies is expected to be lower in 1988 than in 1987 and to slip again in 1989. Fiscal policies are, on balance, shifting to a more restrictive stance and real long-term interest rates remain high. For developing countries, these are not conditions which promise either firm commodity prices, bouyancy in export volume or an easing of the debt-servicing burden.

In a period when economic growth is weak and confidence in the future is fragile, the risks arising from the adjustment process among the developed market economies are heightened. The issue is whether adjustment can be accomplished without major disturbance to world economic activity arising either because of large destabilizing shifts in exchange rates or interest rates or because the deflationary effects of the necessary changes in trade balances are not adequately countered.

The risks of such damaging instability in international financial markets remain considerable. It is without historical precedent that the principal reserve currency of the world should belong to a country that has also become the world's largest net debtor: in the past, reserve currencies have been underpinned by the trading strength of the reserve currency country and by its status as a large net creditor. The present exceptional development, moreover, has taken place against the background of large-scale deregulation and integration of international financial markets. Private markets have come to dominate in the determination of exchange rates at a time when the principal reserve currency is in a highly vulnerable state.

Central banks are the other principal actors influencing exchange rates. With their powerful capacity to intervene in foreign exchange and domestic financial markets, central banks have been active in smoothing out short-term and medium-term shifts in exchange rates, particularly by arresting any incipient speculative lurches. They have been less successful in imposing on the market their views about the longer-term equilibrium exchange rate. There is a diversity of informed opinion on that issue, and what happens in exchange markets is a contest in their credibility.

Currently, there is extensive discussion of possible guidelines for international co-operation to stabilize exchange rates, but it essentially involves the strengthening of co-operation among central banks to reduce short-term instability. Even such limited co-operation is not always easy to attain, and it is not enough for exchange rate stability in the longer term. Recent experience has amply demonstrated that exchange rate movements are shaped by macro-economic policies as a whole and through their interaction both within and among countries.

The present primary macro-economic concern has to be that economic growth will be sustained. Fiscal policies have not only to accommodate the decrease needed in the United States' trade deficit, but also to counter the deflationary effects of a contraction in net exports elsewhere. The main concerns are whether the United States will go further to reduce its budget deficit and whether the Federal Republic of Germany will assume a sufficiently expansionary stance.

In the former, action appears stalled in an election year, but the slowing growth in consumption expenditure may make enough room for greater net exports in the short term. In the Federal Republic of Germany, vigorous efforts have been made to reduce fiscal deficits in the 1980s, both to combat inflation and to permit tax cuts. Moreover, the country now has a large excess of domestic savings over domestic investment and both inflation and economic growth are low. In these circumstances, the rationale for a fairly tight fiscal discipline appears weak. It is argued that the widespread rigidities in the economy cause any fiscal expansion to be partially dissipated in higher prices. However, it would also augment real domestic demand and that would help to raise the low rate of domestic investment which now depresses future growth potential. At the same time, it would enhance the possibility for other Western European countries to accelerate their domestic growth.

Japan too has a special role to play as the world's largest capital exporting country. Larger flows of public capital to the developing countries and the restoration of flows of private capital are part of the solution to the internal imbalances that prevail among the developed market economies. It is encouraging that Japan and other developed market economies have been taking steps to direct larger flows of public capital to these countries. It is equally important that flows of private loan capital be restored. These would make possible a more sustainable distribution of current account surpluses and deficits among the different groups of countries in the world.

Chapter VIII

GROWTH AND ADJUSTMENT IN SMALL AND MEDIUM-SIZED DEVELOPING COUNTRIES DURING THE 1980s

The average rate of growth of the developing economies declined sharply during the 1980s. During the 1970s, the combined gross domestic product of these economies had been growing at an annual rate of 5.5 per cent; but it grew at only 1.7 per cent during the period 1981-1987.[1] Per capita gross domestic product increased at about 3.2 per cent during the 1970s; in the latter period it actually declined.

However, the growth experience has been diverse. Some countries continued to grow fast, a few even faster than before, many others slowed down and, in a considerable number of cases, fell back. The *World Economic Survey 1987* examined the economic growth of a small number of fast-growing developing countries in the 1980s and analysed a number of factors that might have accounted for the difference between their growth performance and that of other developing countries. The present chapter briefly examines the diversity of growth experience of a sample of developing countries, within the context of their overall adjustment to a lower growth path, and inquires why their growth rates differed. A sample of 35 countries were chosen from small and medium-sized countries. The reason for focusing on that group was that such countries are generally more exposed to external shocks than larger countries.[2]

Diversity around a declining trend

There has always been a large diversity of growth rates among the developing countries, and there is little evidence that this diversity has increased. If anything, it has tended to decline during the 1980s for some major groups of developing countries (see table VIII.1). This suggests the importance of external factors.

Table VIII.1. Dispersion of GDP growth rates

	1971-1980	1981-1986
All developing countries (83 countries)		
Mean annual growth rates	4.6	1.0
Standard deviation	3.2	3.4
Net energy-importing countries (58 countries)		
Mean annual growth rates	4.0	1.6
Standard deviation	2.7	2.5
Net energy-exporting countries (25 countries)		
Mean annual growth rates	6.2	−0.3
Standard deviation	3.6	4.7
Africa (32 countries)		
Mean annual growth rates	3.1	0.5
Standard deviation	2.7	3.0
Western hemisphere (23 countries)		
Mean annual growth rates	4.5	0.0
Standard deviation	2.4	2.0
South and East Asia (14 countries)		
Mean annual growth rates	5.9	4.4
Standard deviation	2.3	1.8

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

Note: The number of countries in parentheses indicates the maximum number for which data were available.

For the developing countries as a whole, the mean growth rate has declined considerably and there has been only a modest increase in the dispersion of growth rates around the mean, as shown by the standard deviation.[3] For the group of net energy-importing countries, which comprise by far the larger number of countries, the dispersion tended to decline, while the growth experience of the net energy-exporters has become more diverse. One reason for the increased diversity among the energy-exporters is the emergence of a number of small producers who managed to increase the output and export of oil when the major producers were contracting theirs. In both the western hemisphere and South and South-East Asia the dispersion has declined, while in Africa it increased slightly.

The difficulty of individual developing countries in escaping the pull of the pervasive decline in growth performance during the 1980s is also evident from the shrinking number of success stories. During the period 1971-1980, and in a sample of just over 80 countries, 32 could be termed success stories; in the period 1981-1987, only about 11 could be so described (using, somewhat arbitrarily, a cut-off point of 5.5 per cent annual growth for the definition of success during the period 1971-1980. For 1980-1987, a lower figure of 4.5 per cent was used, taking into consideration an environment of lower growth rates).[4] An interesting fact is the comparatively stable and high growth rates of large countries. The

1 These figures exclude China.

2 The criterion for selection was that the population should range between 1 million and 50 million. In selecting countries, consideration was also given to a balanced geographical distribution of the sample and the need to ensure a fair representation of structural diversity of the economies selected from each region.

3 The differences in the standard deviation in the two periods are not statistically significant.

4 See *World Economic Survey 1987* (United Nations publication, Sales No. E.87.II.C.1 and corrigendum).

mean growth rate for the five countries in table VIII.1 whose population in mid-decade was 100 million or more was 5.7 per cent during the period 1971-1980 and 4.4 per cent during 1981-1987.

Growth of GDP in the sample countries

Table VIII.2 presents the growth rates of GDP in the 35 countries or areas selected. The rates of growth of these countries declined, on the average, from 4.9 per cent during the 1970s to 2.7 during the period 1981-1987. The growth rate picked up somewhat during 1986-1987 but not enough to make a difference to the average for the period. The number of high-growth countries, by the criteria used above, declined from 17 to 9. The decline was widespread. Of the 35 countries in the table, 27 had a lower rate of GDP growth in the 1980s than in the 1970s, and in many cases the fall has been drastic. Another notable feature of the growth performance of the selected countries is its wide disparity among regions. The growth rate of the African and Latin American economies fell sharply during the 1980s. Asian countries, on the other hand, experienced only a modest decline in growth rates.

Table VIII.2. Growth of GDP

(Average annual percentage change)

	1971-1980	1981-1987		1971-1980	1981-1987
Africa	4.3	2.3	Honduras	4.8	1.4
Cameroon	3.7	5.3	Jamaica	-0.7	0.6
Congo	4.5	2.2	Perú	3.8	1.7
Cote d'Ivoire	6.7	-0.1	Uruguay	3.3	-1.0
Egypt	6.9	2.8			
Ethiopia	2.6	2.0	Asia	6.6	5.5
Ghana	0.6	1.8	Burma	4.2	5.2
Kenya	6.0	3.2	Hong Kong	9.8	7.4
Morocco	5.5	2.2	Malaysia	8.0	4.0
Senegal	1.3	2.0	Nepal	2.1	3.6
Somalia	4.1	2.8	Oman	6.9	10.0
Tunisia	7.0	2.9	Philippines	6.2	0.7
Zambia	1.3	1.0	Republic of Korea	8.2	8.4
			Singapore	9.1	5.8
Latin America	4.2	0.6	Sri Lanka	4.7	4.5
Argentina	2.2	-0.8	Thailand	6.9	5.2
Bolivia	4.5	-2.0			
Chile	2.5	1.4	Mediterranean	5.3	3.0
Colombia	5.5	3.1	Turkey	4.7	5.2
Costa Rica	5.6	1.0	Yugoslavia	5.8	0.8
Ecuador	8.9	1.5			
Guatemala	5.6	-0.5	Average of all countries[a]	4.9	2.7

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

[a] The averages, including those of the regions, are simple arithmetic means.

The diversity of growth experience during the 1980s

The fall in the rate of growth of a large majority of developing countries and the large diversity of growth experience of the individual countries are both major features of the world economic scene of the 1980s. The first attests to the deterioration of the international setting; the second points to the differing ability of the individual countries to withstand the shocks as well as the difference in their initial reaction to external shocks.

The environment in which economic growth takes place is never purely economic. As in any other phase of world history, non-economic issues have influenced the pace of economic development in the 1980s and, for many countries, these issues have assumed greater importance during this period than before. More wars have been fought during the 1980s than in any previous decade in history. Twenty-two wars, each accounting for a thousand deaths or more annually, were being waged in 1987. Seven of these were in the sample countries. Military expenditure as a proportion of GNP increased from 4.5 per cent in 1980 to 5.4 per cent in 1986 and was higher, on the average, in the 1980s than in the 1960s and the 1970s. In 1984, military expenditure in an average developing country was higher than expenditure on health and education combined. Increased military expenditure has its counterpart in international trade in arms. Between 1980 and 1984, exports of arms from the developed countries grew at a much faster rate than economic assistance to developing countries. The dollar value of world arms exports increased by about 37 per cent between 1980

and 1984, while world trade in current dollars showed no increase.[5]

The international economic setting

The rate of growth of the developed market economies, which had already declined in the 1970s to about 3 per cent from about 5 per cent in the 1960s, fell further, to barely 2 per cent during the period 1980-1987. Accompanying this was a sharp reduction in the growth of world trade, from about 5 per cent in the 1970s to less than 3 per cent in the 1980s. International trade and growth in the developed economies were thus weaker engines of growth for the developing countries than before.

Falling or stagnant demand depressed prices of primary commodities to record low levels. Slow supply response to changed demand conditions aggravated the fall in prices. As primary commodities, including oil, still account for about 70 per cent of the exports of the developing countries, the decline in prices meant a large reduction in their export earnings and real income. Falling commodity prices were one of the two major external shocks for the developing economies during the 1980s.

The other major shock to the developing countries in the 1980s was the sudden realization that the debt burden they had accumulated over the years had become too large. As described in detail in numerous reports, many developing countries borrowed heavily in the international capital markets during the 1970s. Some of the borrowing by many energy-importing countries was "recycling" to support their balance of payments after a sharp increase in oil prices in the early 1970s.

While debt accumulated and export earnings fell, the cost of debt-servicing rose sharply. The real rate of interest, that is, nominal rates corrected for inflation or change in export prices, rose to high levels. The average debt-service/GNP ratio for the sample countries increased from 2.4 per cent during the period 1971-1980 to 4.7 per cent during 1981-1986. For 32 of the 35 countries for which information is available for both periods, the debt-service/GNP ratio increased; for 20 countries it doubled. The sudden contraction of loans from commercial creditors and only a modest increase in official flows led to a major drop in net capital inflows to virtually all these countries. As interest rates and, hence, interest payments remained high, for many of these countries net financial flows, as explained in chapter IV, became negative.

Factors underlying growth differentials

Though external shocks of the type briefly described above had a general impact, the growth performance of some countries was far better than in others. The importance of quantifiable factors that might explain growth performance over a period of time varies from country to country, and some of these factors are intercorrelated, so that the effect of each is not easy to determine. There are also large residuals in the causes of economic growth, residuals for which a satisfactory explanation has not yet been found.[6]

The following paragraphs represent a brief attempt to test some hypotheses about the role of a number of factors reflecting both domestic economic structure and policies and the impact of external economic shocks. The factors selected are: (a) growth of agricultural output, (b) domestic savings ratio, (c) investment ratio, (d) government savings ratios, (e) rate of inflation, (f) growth of imports, (g) growth of exports, (h) the share of exports in GDP, (i) the impact of terms of trade and (j) the burden of debt-servicing, indicated by (*i*) debt-servicing/GNP and (*ii*) debt- servicing/export ratios. A series of simple regression analyses were undertaken to examine the importance of each of these factors as possible explanations of the difference in GDP growth rates among the sample countries. The results are given in table VIII.3.[7]

Since a large proportion of the total domestic output consists of agricultural production in many developing countries, and because of the close link between growth in agriculture and development of other sectors of the economy, growth of agricultural output would be expected to explain a part of the difference in the growth of GDP among countries. The rate of growth of agricultural production during the 1980s was much higher in the fast-growing developing countries than in the slow-growing countries.[8]

For the present sample of countries, however, growth of agricultural output appears unrelated to the growth of GDP. The main reason is that the importance of agriculture in the national economy varies widely from country to country. Agriculture is unimportant in Hong Kong and Singapore, for example, while in Burma, Ethiopia and Ghana it accounts for over 40 per cent of the gross domestic product. The conclusion changes and the expected picture emerges when a cluster of five countries or areas are excluded, two of which are Hong Kong and Singapore. For the reduced sample of 26 countries, there is a significant statistical relationship between the growth of agriculture and the growth of GDP during the 1980s (see table VIII.3, equation 1).

The expected long-term relationship between domestic savings and growth held strongly for the sample countries during the 1980s; countries that grew fast also had a higher rate of savings (see equations 2 and 3). The average ratio of savings to GDP for the sample countries remained practically unchanged, at the 1970s level of about 19 per cent. In a number of countries, on the other hand, the ratio actually increased and the long-term association between the savings ratio and the growth of GDP remained valid in the turmoil of

5 Ruth Leger Sivard, *World Military and Social Expenditure 1987-88* (Washington, D.C., World Priorities Inc., 1987).

6 Such residuals were once called, in a slightly different context, a "measure of our ignorance". See M. Abramovitz, "Resource and output trends in the United States since 1870", *American Economic Review*, Papers and Proceedings, vol. XLVI (May 1956).

7 Except for equation 12, only simple regression analyses were undertaken, mainly because many of the factors considered here are intercorrelated (e.g., savings and investment).

8 See *World Economic Survey 1987* (United Nations publication, Sales No.E.87.II.C.1 and corrigendum), chap. VIII.

Table VIII.3. Factors underlying growth differentials: results of regression analysis

Eq. No.[a]	Dependent variable	Number of countries[b]	Constant	Independent variable/regression co-efficients											R^2
				GAGR	SAVR	INVR	GSVR	RINFL	GREX	GRIM	TTR	SHEXP	DSGNP	DSX	
1.	GGDP	26[c]	0.07 (0.12)	0.81 (3.54)[d]											0.34
2.	GGDP	25[e]	0.14 (0.14)		0.13 (2.81)[d]										0.26
3.	GGDP	27	0.79 (0.83)		0.09 (2.10)[d]										0.15
4.	GGDP	27	−0.67 (−0.56)			0.14 (2.89)[d]									0.25
5.	GGDP	23	2.16 (4.53)[d]				0.33 (2.62)[d]								0.25
6.	GGDP	27	1.97 (5.15)[d]					−0.45 (−3.27)[d]							0.30
7.	GGDP	31	2.72 (6.67)[d]						0.19 (3.17)[d]						0.26
8.	GGDP	27	2.68 (6.46)[d]						0.13 (2.39)[d]						0.19
9.	GGDP	27	2.77 (6.94)[d]							0.17 (2.97)[d]					0.26
10.	GGDP	27	3.16 (6.11)[d]								0.48 (2.91)[d]				0.25
11.	GGDP	27	2.07 (3.50)[d]									0.02 (1.29)			0.06
12.	GGDP	27	2.45 (3.28)[d]								0.46 (2.92)[d]	0.03 (1.76)			0.34
13.	GGDP	35	3.92 (4.88)[d]										−0.27 (−1.94)[d]		0.10
14.	GGDP	21	6.42 (13.17)[d]										−0.65 (−7.90)[d]		0.77
15.	GGDP	11	3.05 (6.37)[d]										−0.90 (−6.26)[d]		0.81

Table VIII.3 (Continued)

Eq. No.[a]	Dependent variable	Number of countries[b]	Constant	Independent variable/regression co-efficients											R^2
				GAGR	SAVR	INVR	GSVR	RINFL	GREX	GRIM	TTR	SHEXP	DSGNP	DSX	
16.	GGDP	32	4.50 (4.83)[d]											−0.11 (−2.56)[d]	0.18
17.	GGDP	11	6.18 (11.72)[d]											−0.39 (−9.32)[d]	0.91
18.	GGDP	16	8.85 (11.74)[d]											−0.32 (−9.42)[d]	0.86

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

Notes: The variables have been abbreviated as follows:

GGDP:	Growth of GDP.
GAGR:	Growth of agricultural output.
SAVR:	Savings ratio.
INVR:	Investment ratio.
GSVR:	Government savings ratio.
RINFL:	Rate of inflation.
GREX:	Growth of exports.
GRIM:	Growth of imports.
TTR:	Terms of trade.
SHEXP:	Share of exports in GDP.
DSGNP:	Debt-service/GNP ratio.
DSX:	Debt-service/exports ratio.

[a] All equations estimated (except equation 6) are linear. Equation 6 is log-linear.

[b] The number of countries varied according to availability of data or when inclusion or exclusion of a limited number of countries made a significant difference, or, as explained in the text, when there were distinct subgroups evident from the cluster of observations.

[c] Excludes Republic of Korea, Hong Kong, Singapore, Sri Lanka, Cameroon.

[d] Significant at the 5 per cent level.

[e] Excludes Turkey and Yugoslavia.

the 1980s. The association between the two variables was significant in both the 1970s and the 1980s.[9]

There is similarly a strong relationship between investment and the growth of GDP: countries with a high investment ratio also have a better growth performance (see equation 4). As with the savings ratio, the average investment ratio for the sample countries remained virtually the same during the period 1981-1986 as in the 1970s. But there were large changes in the ratio for a number of countries. Nevertheless, the relationship between the investment ratio and growth of income for the sample countries on the whole remained strong, even stronger than for savings.[10]

An over-expansive fiscal policy has generally been considered harmful for growth in circumstances of capacity constraints. Such policies can normally be expected to raise prices rather than output. For the sample countries, a high rate of government savings, defined as the surplus of current government revenue over current government expenditure, was found to be closely associated with the growth of GDP (see equation 5). This suggests that a large or growing fiscal deficit can easily become a constraint to growth. Likewise, a prudent fiscal policy tends to be associated with a higher rate of growth of output.

One of the major differences between the fast-growing countries and other countries in the 1980s was their rate of inflation;[11] the former group had a much lower rate of inflation than the latter. For the present sample of countries, there is a significant inverse relationship between growth and inflation. Countries growing faster tended to have a lower rate of inflation (see equation 6).

While the growth of world trade has slowed down, export-oriented policies and the structure of exports have played a significant role in the growth performance of individual countries. In an atmosphere of sluggish total export demand, some developing countries have none the less managed to increase their exports. For the sample countries, there is a significant positive relationship between growth of exports and the growth of GDP during the 1980s (see equation 7).

This does not mean that in a period of slow growth of world trade, all developing countries could expand their exports substantially at the same time. The importance of export-oriented production structure and policies does, however, stand out as an explanation of differences in growth performance among the small and medium-sized countries.

The causal relationship between the growth of GDP and the growth of imports is complex. Successful import substitution could lead to faster overall growth. On the other hand, countries that are able to increase imports or maintain them at a high level, and thus meet their needs for investment goods and intermediate inputs, generally grow faster than other countries. Equation 9 shows some association between import increases and overall growth. It is also significant that, in a situation where the availability of external finance to the developing countries fell drastically, countries that succeeded in maintaining a high level of imports were generally also those that succeeded in expanding their exports.[12]

Two aspects of the external shocks of the 1980s—terms of trade and debt-servicing burden—were examined. Between 1980 and 1987, the terms of trade of the developing countries deteriorated at an average annual rate of about 3 per cent, giving a cumulative decline of more than 20 per cent over the period. This represented a large loss of real income for the developing countries, the loss for the individual countries depending on the importance of external trade in the economy as well as the extent of deterioration in its terms of trade.

A terms-of-trade loss has several effects, not all of which can be easily compensated. It implies a decrease in aggregate demand which can be compensated by macro-economic policies. It also implies a decrease in real absorption which can be compensated with additional capital inflows. However, none of these policies is likely to function smoothly enough to fully compensate for the effects of deteriorating terms of trade. Moreover, there is often a problem in the transfer of resources from activities that have become unprofitable because of international price changes. Factor mobility is usually low in developing countries. Thus, it should be expected that changes in terms of trade—particularly when sustained—would influence the growth of gross domestic product. For the sample countries, this was indeed the case: there was a significant association between changes in the terms of trade and growth of GDP during the 1980s. Equation 10 in table VIII.3 shows that a 1 per cent deterioration in the terms of trade was associated with a 0.5 per cent decline in real GDP. The relationship is strengthened when account is also taken of the importance of exports in GDP: the larger the share of exports in GDP and the larger the change in terms of trade, the greater the change in GDP (equation 12).[13]

Debt-servicing essentially means a transfer of a part of the gross domestic product abroad. The larger the debt-service payment, the lower the domestic absorption is expected to be, other things remaining the same. While theoretically a decrease in domestic absorption might affect only real consumption expenditures, in most cases real investment is also affected, and hence the growth of gross domestic product in the medium to long term.

For the full sample of countries examined here, there is no statistically significant relationship between growth and

9 The coefficient of correlation between the savings ratio and growth of GDP for the 21 countries for which data were available was 0.40 for the period 1971-1980 and 0.54 for 1981-1986. Both are statistically significant at the 5 per cent level.

10 The coefficient of correlation between the investment ratio and the growth of GDP for the 21 countries for which data were available was 0.73 for the period 1971-1980 and 0.55 for 1981-1986.

11 See *World Economic Survey 1987* (United Nations publication, SalesNo.E.87.II.C.1 and corrigendum), chap. VIII.

12 The coefficient of correlation between the growth of exports and the growth of imports for the sample countries was a statistically significant 0.46.

13 The $\bar{R}^2$ increased from 0.19 to 0.28 when the variable of export as a proportion of GDP was added.

debt-service/GNP ratios. But an examination of the scatter diagram suggests the existence of two distinct clusters of countries, calling for a breakdown of the sample into two sub-samples. As shown in table VIII.3 (equations 14 and 15),[14] for both sub-samples there is a highly significant inverse relationship between growth of GDP and the size of debt-service payments. By itself, the debt-servicing burden "explains" about 80 per cent of the difference in the growth rates among countries. The conclusion is sustained when the relationship between the debt-service/export ratio and growth is examined: the statistical association between the two is even more significant for both sub-samples of countries (see equations 17 and 18).[15]

There is also evidence that debt-servicing influences growth through savings and investment. A significant inverse statistical relationship exists between the debt-service/export ratio and the savings and investment ratios in the sample countries.[16]

This preliminary examination of the association of various factors with the growth rate does not permit any far-reaching conclusions about the mechanisms at work, especially since rapid output growth might itself be expected to promote higher savings ratios, government revenues and investment demand and also relieve some inflationary pressures. But the results are so far consistent with the hypotheses that capital formation does indeed play an important role in fast growth, that fiscal prudence and price stability are conducive to better growth performance and that agricultural growth deserves special attention in the many countries where this sector is large.

It would be of special interest to compare the importance of domestic and external factors, but this would require a more elaborate study. The findings are consistent with the hypothesis that both internal and external factors have a strong explanatory value. Two of the external factors considered—terms of trade and debt-servicing payments—showed stronger association with the growth rate than any of the internal ones considered in isolation. Yet, more complex specifications are needed to assess the combined effects of internal and external factors.

Coping with the shocks of the 1980s: the adjustment efforts

The shocks of the 1980s, external or internal, have imposed severe problems of adjustment on many countries. Adjustment is now often suspected of retarding growth, though there is little evidence that usual adjustment programmes actually reduce growth rates, except in the very short run.[17] In practice, adjustment measures call for austerity in a situation in which shocks have already reduced growth, or even an absolute decline in income. They often involve substantial cuts in income and these cuts are not shared equally by the different classes of society. The vulnerable social groups tend to bear a disproportionate share of the burden of adjustment.[18] Real wages have fallen by 20 per cent or more in many countries during the 1980s. Social expenditures have often been the first to be slashed. In some cases the costs have turned out to be too high for the fragile political structure of the country. In a number of countries adjustment programmes have been abandoned or held in abeyance as adjustment fatigue has set in.

The nature and severity of the shocks have varied from country to country. The responses have also been different, in part because the assessment of the nature and magnitude of the shocks has been different and in part because of ideological differences concerning the policy instruments to be used. They also depended on the political strength of the decision makers and the availability of resources. Political will also often determined whether policy decisions were followed through over a sufficiently long period of time.

Almost all external shocks require adjustment in the balance of payments. Reduction of current account deficits has thus been a major objective of adjustment efforts during the 1980s, and the adjustments undertaken have been very large. For the 35 sample countries, the trade deficit declined from $35 billion in 1980 to $10 billion in 1986. If Egypt is excluded, the deficit shrinks from $34 billion to $2 billion. In 23 of the 35 countries, the trade deficit was reduced or turned into a surplus. Balance-of-payments adjustments which are neutral in their effect on growth involve increases in exports accompanying a reduction in imports. This has happened in only 10 countries; in 12 countries both imports and exports in current dollar terms declined. As one study

14 The two sub-samples are:
(a) For equation 14: Burma, Cameroon, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Egypt, Honduras, Hong Kong, Jamaica, Kenya, Malaysia, Morocco, Peru, Singapore, Sri Lanka, Thailand, Tunisia, Turkey and Zambia (21 countries);
(b) For equation 15: Argentina, Bolivia, Ethiopia, Ghana, Guatemala, Nepal, Philippines, Senegal, Somalia, Uruguay and Yugoslavia (11 countries).

15 The two sub-samples are:
(a) For equation 17: Ethiopia, Ghana, Guatemala, Honduras, HongKong, Nepal, Philippines, Senegal, Singapore, Uruguay and Zambia (11 countries);
(b) For equation 18: Argentina, Bolivia, Cameroon, Chile, Colombia, Costa Rica, Côte d'Ivoire, Egypt, Jamaica, Kenya, Malaysia, Peru, Somalia, Sri Lanka, Thailand and Tunisia (16 countries).

16 For the four sub-samples of countries mentioned in notes 14 and 15, and countries for which all the data were available, the coefficient of correlation between saving and debt-service/export ratio and between investment and debt ranged from 0.43 to 0.70, in all cases significant at the 5 per cent level.

17 See IMF, *Fund-Supported Adjustment Programs and Economic Growth* (Washington, D.C., November 1985), p. 20.

18 See, for example, Giovanni Cornia, Richard Jolly and Frances Stewart, eds., *Adjustment with a Human Face*, vol. I (Oxford, Clarendon Press, 1987).

points out, in the context of adjustment and growth and while examining changes in imports and exports during the period 1980-1985, "a decline over five years of both exports and imports is not an indicator of vigorous growth".[19] In 10 countries, both imports and exports increased. The same countries also had growth rates that were generally higher than the average for the sample countries.

A fact that emerges from the adjustment efforts of the developing countries during the 1980s is that attempts at maintaining domestic demand at an unsustainable level rarely succeed and only aggravate the effects of the shocks.[20] In a number of cases, attempts were made to sustain economic activity through expansion of public consumption. In other cases, fiscal prudence was abandoned in favour of stepped up public investment in order to shore up demand. This only increased fiscal deficits and fuelled inflation, making future adjustment more difficult. The failure to prevent an increase in real wages has caused the collapse of adjustment programmes through increased imports, reduced exports and widened trade deficit. On the other hand, there were cases of timely demand restraint which obviated problems of adjustment later on. Sound fiscal management has played a major role not only in reducing current account payments imbalances but in facilitating the structural changes needed. The experience of a number of countries suggests that "cautious demand management is essential for the effective pursuit of structural adjustment".[21]

An appropriate exchange rate policy is often a crucial element in an adjustment programme. Indeed, an overvalued currency, by making exports uncompetitive, is frequently a major factor giving rise to balance-of-payments problems for individual countries in the first place, even though in the 1980s these considerations have been overshadowed by the fall in commodity prices and increased debt-service payments. Overvaluation has tended to retard industrial growth by discouraging exports and encouraging indiscriminate import-substitution and has made agricultural production for export unremunerative. Import-led booms in some of the sample countries during the late 1970s and early 1980s, based on overvalued currencies, have been short-lived and had to be followed by large devaluations. In a number of cases devaluation, as a part of a well worked out adjustment programme, has led to substantial increases in exports during the 1980s. However, devaluation has failed to achieve this result when, for example, inadequate attention was given to the structure of production and export or when its effects have been nullified by other measures. A frequent experience has been that a large devaluation was followed by gradual appreciation as inflation eroded the original change in the value of the currency.

For some countries, the tying of their exchange rate to a major currency, though imparting some benefits, has exacerbated the problem of adjustment. For example, as the French franc appreciated against the dollar from the mid-1980s, the African countries that are members of the CFA franc zone found their currencies overvalued and their exports hurt, without the benefit of cheaper imports since most of them came from France.

Another major element in most adjustment packages is monetary policy. Although the structural nature of inflation in some countries sometimes makes the association of money supply with inflation less obvious, a large expansion of money supply generally fuels inflation. On the other hand, tight credit policies designed to raise the rate of interest in order to encourage savings, can discourage investment.[22] An IMF survey of adjustment measures does suggest that "tighter monetary and credit policies would result in a fall in the growth rate in the first year after they were implemented".[23]

Experience with the adjustment programmes in the 1980s suggests that they rarely succeed without adequate and timely availability of external resources. Most programmes that could be called a success were accompanied by a large infusion of external resources. There were numerous instances where non-availability of finance, often because of disagreements between IMF and the country in need of adjustment, meant postponement of adjustment. Many times, available finance was too little or came too late.

While the adverse conditions of the 1980s came as a surprise to many countries, in retrospect, they appear in many instances at least partly the result of past policies. Indiscriminate import substitution in a large number of countries stands out as a case in point. Past neglect of agricultural development, through inappropriate pricing policies leading to deterioration of the agricultural terms of trade *vis-à-vis* the rest of the economy, has aggravated the problems of many countries. In other instances, countries coped better with the difficulties of the 1980s because of the good performance of the agricultural sector. Similarly, the political difficulty of reducing food subsidies was often aggravated by the fact that they were kept in place for so long that the necessary change appeared too large. The problem of external debt provides another important example. A failure of policy in many countries saddled with a large debt burden in the 1980s is their inadequate attention to the growth of the

19 See Paul Streeten, ed., *Beyond Adjustment, the Asian Experience* (Washington, D.C., IMF, 1988), p. 11.

20 See, for example, Paul Streeten, *op. cit.*; Lance Taylor, *Varieties of Stabilization Experience: Toward Sensible Macro-economics in the Third World, prepared for the World Institute for Development Economics Research (WIDER) (Helsinki, 1987); L. R. Jayawardena, A. Maasland and P. N. Radhakrishnan, Stabilization and Adjustment Programmes and Policies, Case Study on Sri Lanka*, United Nations University/World Institute for Development Economics Research, May 1986; economic surveys of the regional commissions; and World Bank and IMF research documents. The discussion of adjustment programmes that follows in this chapter draws on these studies. Countries have not been named because some developments reported relate to a particular period in the adjustment efforts of a country and not to other periods.

21 Bijan B. Aghevli, Insu Kim and Hubert Neiss, "Growth and adjustment: experiences of selected sub-continent countries" in Paul Streeten, *op. cit.*, p. 52.

22 Jayawardena and others, *op. cit.*

23 See IMF, *Fund-Supported Adjustment Programs and Economic Growth* (Washington, D.C., November 1985), p. 24.

export sector during the 1970s when their debt was growing rapidly.

Favourable circumstances often conceal the inception of difficult problems of adjustment which should not have been impossible for the policy makers to detect. Adjustments to favourable developments can be almost as important as those needed to cope with adverse circumstances. Large inflows of capital have led to overvaluation of currencies in some countries, brewing problems for the future. The commodity booms of the late 1970s had similar effects in a number of countries. Temporary bonanzas from surging revenues led short-sighted borrowers to extensive overborrowing, without objections from lenders who were equally short-sighted, and to careless investment in unviable projects. In a few countries, loans were used more to foster consumption than to further investment.

Annex I

SELECTED INDICATORS OF THE SOCIO-ECONOMIC ATTAINMENT OF WOMEN

Quantification of the economic activities of women is an important issue in the current discussion among economists and social scientists regarding the contribution made by different agents to the development process. The work of women is ignored in the accounts of the world economy when it is done in the confines of the family rather than the market-place. This invisible part of the world economy is slowly gaining recognition, although it is hard to assess because it does not have a market value.

Child-rearing is an undeniably essential activity in all societies, and it is a serious anomaly that the rearing of children is excluded from national accounts. Likewise, meal preparation and caring for the elderly are excluded from gross domestic product estimates. The activities of the informal sector, where women's work accounts for a considerable share, are often not reflected in statistical data. Indeed, the contribution of women—and for that matter also of children—to agricultural activities in developing countries is largely unrecorded or underrecorded, except when it materializes in sales of the household in a somewhat organized market or when rewards for agricultural work are of a monetary nature.

The published data give the impression that in developing countries the majority of women play no role in the economy. Part of the reason for the deficiencies in the data can perhaps be attributed to a lack of understanding of the role of women in economic activity—it being considered, for instance, that a woman tending to the family vegetable plot or collecting firewood is simply engaged in "housework". Yet, an understanding of how an economy functions is essential for successful government policy, and without a knowledge of what and how much different members of society produce, and how they produce it, economic management is less than adequate. Moreover, the compilation of gender-specific statistics and greater research into the economic role of women were proposed in the Nairobi Forward-looking Strategies for the Advancement of Women.[a]

Efforts have recently been made to improve the statistical coverage of the role of women in economic activity. The economic crisis has set-back data gathering and compilation in a large number of developing countries. This has also affected statistics reflecting the role of women. Nevertheless, there is still enough information to draw a realistic picture at the global and regional levels. Some of the more important indicators at the global and regional levels are presented below.

Table A.I.1 shows the contribution of women to the increase in employment during the past decade. Although only a limited number of developing countries are represented in the data, it can be seen that, during the past decade, about 40 per cent of the newly employed were women. In the industrialized countries, where data are available, women entered the labour force in even greater numbers. In Western Europe, the increase in the employment of women compensated for a fall in the employment of men and still allowed for an overall increase in employment.

Table A.I.2 shows the economically active population by sector and gender. In 1980, 63 per cent of the world's economically active population were men, and 37 per cent were women; 31 per cent of the economically active population were men working in agriculture, and 20 per cent were women. In no group of countries, according to conventional definitions, did women constitute a majority of the total economically active population. However, in the Soviet Union, which is shown separately, women did constitute a majority in 1970.

Table A.I.1. Contribution of females and males to increases in employment (Mid-1970s to mid-1980s)

	Percentage increase due to change in employment of	
	Females	Males
Developing countries[a]		
Africa	37.9	62.1
Asia	43.4	56.2
Latin America	39.5	60.5
Developed market economies		
North America	62.2	37.8
Western Europe	151.1	-51.1
Centrally planned economies[b]		
Eastern Europe	71.4	28.6
USSR	46.7	53.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on selected years and countries from International Labour Office, Year Book of Labour Statistics; data files of the Economic Commission for Europe; and Statistical Yearbook of the Council for Mutual Economic Assistance, 1987.

[a] Weighted averages, based on a sample of countries.

[b] Socialized sector only.

In the developing countries, women constituted a smaller share of the recorded economically active population than in the industrialized countries. However, this could be a reflection of the statistical deficiencies mentioned earlier. In sub-Saharan Africa, for instance, women in agriculture made up

[a] See *Report of the World Conference to Review and Appraise the Achievements of the United Nations Decade for Women: Equality, Development and Peace, Nairobi, 15-26 July 1985* (United Nations publication, Sales No. E.85.IV.10), chap. I, sect. A, paras. 130 and 312.

33.5 per cent of the economically active population in 1980, compared to 42.7 per cent for men. However, in North Africa the comparable figures were 6 per cent and 41.5 per cent. This does not appear to be a realistic picture of the differences in the actual contribution of women to agriculture between the two parts of the continent.

The reported figures do, however, show that women play an essential role in agriculture, which is the largest sector throughout the developing countries. The importance of this sector to the successful performance of these countries (particularly in sub-Saharan Africa, where women's role is comparatively the greatest) requires that countries examine the role of women in agriculture so as to enhance their contribution.

In Africa, men and women have separate roles in the production of household food and cash crops. They also have different managerial and financial control over the production, storage and sale of surplus food and crops. Women are primarily responsible for the cultivation of traditional food crops, providing specific nutrients for the diet. They also process food, especially for family consumption, but also for the market. Men usually work in the cash crop economy,

Table A.I.2. Composition of the economically active population by gender and sector 1970 and 1980

(Percentage)

		Females				Males			
		Total	Agric.	Indus.	Serv.	Total	Agric.	Indus.	Serv.
World	1970	36.0	20.9	5.4	9.7	64.0	34.1	14.3	15.6
	1980	36.9	19.5	6.1	11.3	63.1	31.3	14.9	17.0
Developing countries	1970	29.1	20.7	3.0	5.3	70.9	45.2	10.6	15.1
or areas	1980	29.0	18.6	3.4	7.0	71.0	41.1	12.2	17.7
Asia	1970	28.2	21.0	3.2	3.9	71.8	47.3	9.6	14.9
	1980	27.1	18.7	3.4	5.1	72.9	44.4	11.0	17.4
Western Asia	1970	27.2	23.3	1.3	2.6	72.9	39.9	13.0	20.0
	1980	25.5	20.3	1.5	3.7	74.5	28.4	17.5	28.5
East and Middle	1970	28.2	20.8	3.4	4.0	71.8	47.8	9.4	14.6
South Asia	1980	27.2	18.5	3.5	5.2	72.8	45.5	10.66	16.7
Africa	1970	36.1	30.8	1.3	4.0	63.9	46.0	7.2	10.7
	1980	35.7	28.9	1.8	5.0	64.3	42.5	8.9	12.9
North Africa	1970	11.2	6.0	1.6	3.6	88.8	50.4	14.2	24.3
	1980	13.4	6.0	2.8	4.7	86.6	41.5	18.0	27.1
Sub-Saharan	1970	41.0	35.6	1.3	4.1	59.0	45.2	5.8	8.0
Africa	1980	40.1	33.5	1.6	5.1	59.9	42.7	7.1	10.1
Latin America	1970	21.7	3.9	4.3	13.5	78.3	36.7	18.9	22.7
and Caribbean	1980	26.3	3.8	5.2	17.2	73.7	28.0	20.6	25.1
Hong Kong, Malaysia,	1970	31.9	17.6	6.8	7.6	68.1	26.4	15.6	26.1
Republic of Korea,	1980	34.4	13.9	9.0	11.5	65.6	18.4	19.2	28.1
Singapore									
China	1970	41.7	34.6	3.1	4.0	58.3	43.7	7.0	7.6
	1980	43.2	33.9	5.2	4.1	56.8	40.3	8.8	7.7
Developed market	1970	34.7	4.1	8.8	21.8	65.3	7.8	28.4	29.0
economies	1980	38.1	2.6	8.5	27.0	61.9	5.1	26.2	30.7
North America	1970	36.1	0.8	7.4	27.9	63.9	3.8	24.8	35.2
	1980	41.5	0.7	7.8	32.9	58.5	2.9	23.0	32.6
Europe	1970	32.4	3.6	9.7	19.2	67.6	9.3	32.6	25.7
	1980	35.9	2.9	8.8	24.2	64.1	6.1	29.2	28.8
Australia,	1970	30.9	1.5	7.0	22.5	69.1	7.3	29.4	32.4
New Zealand	1980	36.9	2.0	6.8	28.1	63.1	5.6	25.4	32.0
Japan	1970	39.0	10.3	10.2	18.5	61.0	9.3	24.3	27.4
	1980	37.7	5.3	9.9	22.5	62.3	5.9	24.3	32.1
Eastern Europe	1970	44.2	17.0	12.7	14.5	55.8	15.6	26.4	13.8
	1980	45.6	11.5	15.5	18.5	54.4	11.3	28.1	15.0
USSR	1970	50.6	13.3	15.8	21.4	49.4	12.3	21.8	15.2
	1980	49.4	10.4	16.2	22.9	50.6	9.6	22.9	18.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data supplied by the International Labour Office.

either in plantations or on their own land, normally producing goods for export and not for local consumption. On the basis of sample surveys, it has recently been estimated that often more than 60 per cent of all agricultural work is done by women.[b]

Figures for one small group of developing countries or areas have been given to illustrate trends that will emerge as developing countries industrialize. Those chosen were a few fast-growing exporters of manufactures: Hong Kong, Republic of Korea, Malaysia and Singapore. In these areas, the share of women in the economically active population grew between 1970 and 1980. The increase in the percentages of both male and female employment in industry and services came from a sharp fall in the contribution of agriculture to overall employment. By 1980, fewer men were employed in agriculture than in services, a situation that should soon apply in the case of women.

Indeed, the major difference between the employment patterns of these industrializing developing countries and those of the industrialized countries lies not so much in the industrial sector as in the service sector. Although larger than in other developing countries, the service sector in the industrializing countries is still smaller than in the industrialized countries, and the share of women in this sector is generally smaller than that of men.

Latin America is the one developing region where the majority of the economically active women are employed in services. The size of this sector reflects the degree of development and industrialization of this region and the existence of a sizeable middle class. The figure for female participation in agriculture (nearly 4 per cent of the total economically active population in 1980) was markedly lower than that for male participation (28 per cent of the economically active population) probably reflecting a problem of measurement. Surveys may fail to reflect the active participation of women at harvest time if they are conducted at other times of the year.[c]

In the industrialized countries, not only are services the largest economic sector, but women's share in the sector is proportionately higher than that of men. In North America, Eastern Europe and the USSR, more women than men were employed in that sector in 1980.

The overall change in the direction of the world economy may thus require women's potential contribution to economic activity to be more fully realized. The slow-down in population growth is increasing the demand for female labour, industrialization in developing countries is creating a demand for new workers, and the experience of the more developed countries is that most new jobs occur in the service sector, with these being largely occupied by women.

Table A.I.3. Administrative and professional workers as a percentage of economically active females and males

	Administrative and managerial workers[a]		Professional and technical workers[b]	
	Females	Males	Females	Males
World[c]				
Early 1970s	2.0	5.6	9.0	7.2
Early 1980s	2.4	5.1	11.2	8.0
Latest year	3.2	4.5	11.8	7.8
Developed market economies[d]				
Early 1970s	2.4	7.4	11.5	10.0
Early 1980s	3.5	8.0	14.4	11.6
Latest year	4.7	7.6	15.3	12.0
Developing countries[e]				
Early 1970s	0.5	1.3	3.7	2.8
Early 1980s	0.4	1.0	5.1	3.4
Latest year	0.4	1.0	5.4	3.4

Source: International Labour Office, Year Book of Labour Statistics 1987 (Geneva).

[a] International Standard Classification of Occupations (ISCO) 2.

[b] ISCO 0/1.

[c] Based on a sample of 35 countries.

[d] Based on a sample of 14 countries.

[e] Based on a sample of 21 countries.

[b] See Food and Agriculture Organization of the United Nations, *Women in Food Production and Food Security in Africa,* report of the government consultation held at Harare, Zimbabwe, 10-13 July 1984 , p. 4.

[c] Moreover, even when the participation of women at harvest time is properly reflected, the figures might still underestimate the actual contribution of women throughout the year. During harvest periods, not only do all workers tend to work at a much faster pace, but also for longer hours, with the work-week including Saturdays and often Sundays—a rhythm that could not be sustained over the entire year.

Data on the occupations filled by women, and the salaries they earn, show that, although the situation is changing in many respects, there are significant differences *vis-à-vis* men. Table A.I.3 shows the percentage of the economically active men and women in the occupational category that commands the highest salaries and that controls decision-making—administration and management. It can be seen that a smaller percentage of the female economically active population occupy these positions than is the case for men. The estimates are based on a limited number of countries; because of a lack of comparable data, they do not include the centrally planned economies. Yet they do reveal that, while the differences have narrowed since the early 1970s, the shares of men and women are still significantly different.

When figures for professional and technical workers are examined, they show that women occupy proportionally more of these positions than do men: nearly 12 per cent of economically active women are in this category at the present time, compared with 8 per cent of men. This reflects in part the major role that women play in the services sector, which includes many of the occupations that they fill such as teacher or nurse. It also reflects the fact that the higher a person's educational attainment, the more likely will be his or her participation in the labour force.[d] As women are generally a smaller percentage of the economically active population than men, the average educational level of women workers is therefore likely to be higher than that of men.

Table A.I.4 gives the ratio between the wages of men and women in non-agricultural activities for a limited number of countries. It can be seen that, in every country, on average women earned less than men. Data do not permit an assessment of the extent to which this is due to actual differences in responsibilities. Often, within an occupational group, women tend to fill lower-paid jobs than men—teachers, rather than principals in schools, for instance. A comparison between countries is not possible, and conclusions drawn from this limited sample must be tentative. However, the figures, on the whole, show that the difference between men's and women's earnings, as measured, has not narrowed appreciably during the past decade.

Another measure that partly indicates the role of women in the economy comes from figures on the ownership of land. Table A.I.5, which is based on a limited sample of countries, gives the share of men and women among the recorded holders of agricultural properties. Differences are substantial when the shares of men and women are compared. Such differences, however, do not necessarily reflect differences in individual property. To a large extent, the figures show household property that because of tradition or the legal framework, is almost invariably registered in the name of the husband or other adult male in the household. Regarding regional comparisons, the table, for the most part, shows no statistically significant differences.

Not only has there been a slowing down of population growth rates in most countries, but, in addition, longevity has risen sharply. In the developing countries, between 1970-1975 and 1980-1985 life expectancy for men increased by 4.5 years, from 53.4 to 57.9; for women the increase was even greater—5.6 years—from 54.7 to 60.3. The percentage of men and women aged 60 years or older and those aged 75 years and older in the total population for the years 1970, 1985 and, based on present projections, 2000 is shown in table A.I.6. For the developing countries as a whole the percentage is less than half of that of the industrialized countries. However, differences among regions at various stages of development indicate that, with economic growth and im-

Table A.I.4. Male/female wage ratio in non-agricultural activities 1977, 1980, latest year

	1977	1980	Latest year
Developing countries or areas			
Africa			
Kenya	1.07	1.26	1.17
Swaziland	1.84	2.25	1.50
United Republic of Tanzania	1.49	1.18	...
Asia			
Hong Kong	...	...	1.32
Republic of Korea	2.27	2.25	2.04
Singapore	...	1.59	1.45
Sri Lanka	1.01	1.09	1.35
Industrialized countries			
Europe			
Belgium	1.42	1.44	1.34
Czechoslovakia	1.46	1.46	1.46
Denmark	1.17	1.18	1.22
France	1.28	1.26	1.22
Germany, Federal Republic of	1.38	1.38	1.37
Iceland	1.25	1.17	1.12
Luxembourg	1.54	1.55	1.57
Netherlands	1.25	1.28	1.31
Switzerland	1.50	1.48	1.48
United Kingdom	1.39	1.43	1.44
Japan	1.79	1.86	1.92
Australia	1.15	1.16	1.15
New Zealand	1.30	1.30	1.27

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on International Labour Office, *Year Book of Labour Statistics 1987* (Geneva).

Table A.I.5. Persons holding title to agricultural properties in the mid-1980s

(Percentage)

	Females	Males
Africa	8.1	91.9
Latin America	13.6	86.4
Asia	12.1	87.9
Developed countries	13.8	86.2

Source: Based on Food and Agricultural Organization data.

a Based on a sample of four African countries, four Latin American countries, four Asian countries, three European countries and the United States.

d *See The Economic Role of Women in the ECE Region* (United Nations Sales publication, Sales No. E.85.II.E.20), p. 19.

provements in health delivery services, the developing countries can be expected to approach the levels reached in the developed countries. Indeed, in all regions, except Africa, which has a high fertility rate, the proportion of elderly people in the population is expected to continue to increase. Thus, most countries will be faced with the same challenge of providing an active life and adequate services for their aging population, the majority of whom, particularly among those aged 75 or older, will be women.

The figures for the developed countries show not only that the elderly have increased as a percentage of the population, but also the difference between the numbers of elderly men and women has widened. In the Soviet Union, for example, it is currently estimated that in the age groups 60 and over and 75 and over, there are twice as many women as men. These demographic changes make it even more essential to address the issue of preparing women for full and long-term participation in economic activity.

Education of women is an area where there has been measurable progress during the past three decades. At the global level, illiteracy among adults has dropped from 32.9 per cent in 1970 to 27.7 per cent in 1985, whereas during the same period the world adult population rose from 2.3 billion to 3.2 billion. According to the estimates of the Office of Statistics of the United Nations Educational, Scientific and Cultural Organization, however, there were still about 890 million illiterate persons aged 15 years and above, that is, 129 million more than in 1970; 63 per cent of these were women.

Illiteracy remains a problem in the developing countries: the illiteracy rate is 54 per cent in Africa, 36.3 per cent in Asia and 17.3 per cent in Latin America and the Caribbean. The proportion of adult women who are illiterate in these regions is 34.9 per cent, as compared with 20.5 per cent of men. The highest illiteracy rates are to be found among rural populations and in the poorer suburbs of large cities.

Gaps in the education process are also found in the developed countries. In these countries, functional illiteracy—that is, the level inadequate to cope with the complex and rapidly changing requirements of economic life—is not as easily measured as absolute illiteracy but is perceived to be an obstacle to long-term growth in many countries. In the developing countries, increases in enrolment rates are themselves measures of educational improvements for men and women. Though improvements have been made, much remains to be done to eliminate the considerable disparity in the provision of education at all levels.

Table A.I.7 shows that, at the primary and secondary levels, there has been an overall but steady lessening of the

Table A.I.6. Percentages of the total population aged 60 and over and 75 and over

		Females			Males		
		1970	1985	2000	1970	1985	2000
World	60 and over	4.7	4.9	5.4	3.7	3.9	4.5
	75 and over	1.0	1.3	1.4	0.7	1.1	0.9
Developing countries	60 and over	3.2	3.4	4.0	2.8	3.1	3.7
	75 and over	0.6	0.7	0.9	0.5	0.9	0.7
Africa	60 and over	2.7	2.6	2.6	2.3	2.2	2.2
	75 and over	0.5	0.5	0.5	0.4	0.6	0.4
Latin America and Caribbean	60 and over	3.2	3.6	4.1	2.9	3.1	3.5
	75 and over	0.6	0.8	1.0	0.5	1.0	0.8
South Asia	60 and over	2.8	3.1	3.8	2.9	3.0	3.5
	75 and over	0.5	0.6	0.7	0.4	0.8	0.6
China	60 and over	3.8	4.4	5.4	3.1	3.8	5.1
	75 and over	0.8	0.9	1.3	0.6	1.1	1.0
Industrialized countries	60 and over	8.5	9.6	10.6	5.8	6.2	7.7
	75 and over	2.1	3.0	3.4	1.2	1.9	1.7
North America	60 and over	7.8	9.4	9.3	6.0	6.8	6.7
	75 and over	2.2	2.9	3.4	1.4	2.2	1.9
Europe	60 and over	9.7	10.4	11.4	6.5	7.2	8.4
	75 and over	2.5	3.5	3.7	1.4	2.1	2.0
Japan	60 and over	5.9	8.4	11.7	4.8	6.1	9.2
	75 and over	1.3	2.2	3.4	0.9	2.1	2.0
Oceania	60 and over	5.9	6.8	7.2	4.8	5.5	5.8
	75 and over	1.6	1.9	2.3	1.0	1.7	1.4
USSR	60 and over	8.1	9.0	10.6	3.9	4.1	6.9
	75 and over	1.8	2.7	2.8	0.7	1.1	1.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Global Estimates and Projections of Population by Sex and Age: the 1984 Assessment. (ST/ESA/SER.R/70).

Table A.I.7. Percentage of females in total school enrolment

Regions	Year	Primary level	Secondary level	Tertiary level
Industrialized countries	1970	49	50	41
	1980	49	51	48
	1985	48	51	49
Developing countries	1970	42	34	29
	1980	44	39	35
	1985	44	39	37
Europe[a]	1970	49	51	43
	1980	49	52	47
	1985	48	52	48
North America	1970	49	49	41
	1980	49	50	51
	1985	49	49	53
Oceania	1970	48	48	34
	1980	48	49	44
	1985	48	49	47
Africa	1970	39	30	22
	1980	43	35	27
	1985	44	35	28
Asia[b]	1970	41	35	27
	1980	42	39	32
	1985	43	39	32
Latin America and the Caribbean	1970	49	48	35
	1980	49	50	43
	1985	48	51	45

Source: United Nations Educational, Scientific and Cultural Organization, Statistical Yearbook, 1987 (Paris).

[a] Including the USSR.

[b] Including Japan.

traditional bias against women, as measured by their percentage of participation in total enrolment. A major change has been the sharp increase in relative female participation at the tertiary level in the developed countries—from 41 per cent in 1970 to 49 per cent in 1985.

In the developing countries, female enrolment at the primary level in 1985 was 44 per cent of total enrolment, at the secondary level 39 per cent and at the tertiary level 37 per cent compared with 42 per cent, 34 per cent and 29 per cent in 1970, as shown in table A.I.7. This improvement suggests that in the future the literacy rate for women will be fairly close to that for men. In the developing countries the female enrolment rate declines with an increase in age, with the decline being greatest from the primary to the secondary levels.

During the 1980s, school enrolment of boys and girls between the ages 6 and 11 in the industrialized countries is almost 100 per cent, and secondary education between the ages 12 and 17 shows a high participation rate for girls (see table A.I.8). As one goes higher up the ladder to advanced education at the university level, the percentage rate for females increases significantly over time. These data indicate that more females have been participating in advanced education, and equality at the university level has almost been achieved in Europe. In North America, female participation at the university level has gone beyond parity, surpassing male enrolment ratios in 1985. In Oceania, female enrolment has risen substantially over the years, yet proportionately fewer younger women than men—19.1 per cent versus 21.8 per cent—between the ages 18 and 23 were studying in 1985.

In Asia and Africa wide differences between the sexes appear at the first two educational levels. The provision of education in the developing countries roughly matches income levels. Thus, in 1985, in Latin America, secondary enrolment for males was 71.2 per cent and for females 69.6 per cent, whereas in Africa the comparable figures were 59.6 per cent for males and 41.8 per cent for females. In Asia, only 48.2 per cent of boys and 35.6 per cent of girls were in secondary education. Although school enrolment in developing countries is low between the ages 18 and 23 for both males and females, a comparatively higher number of women, particularly in Africa and Asia, are affected by inadequate educational resources and opportunities.

In developing countries, young girls in rural and sometimes in urban areas drop out of school because of low family incomes and demanding households. Additional reasons include early marriages and traditional attitudes inhibiting them from acquiring or upgrading skills.

Table A.I.8. School enrolment by age group and sex

(Percentage)

Region	Year	Female			Male		
		6-11	12-17	18-23	6-11	12-17	18-23
Industrialized countries	1970	91.8	74.8	23.2	91.6	77.8	30.0
	1980	92.3	81.3	30.2	92.0	80.4	31.5
	1985	91.6	85.8	33.2	91.5	85.2	34.3
Developing countries	1970	49.4	23.8	4.4	66.2	38.6	9.7
	1980	60.8	33.8	8.5	76.3	46.6	14.6
	1985	65.7	39.6	10.3	79.4	52.1	17.0
Europe[a]	1970	89.6	68.9	20.6	89.3	72.1	25.2
	1980	90.4	77.7	25.1	90.9	76.9	26.0
	1985	89.9	81.1	27.8	89.7	80.4	28.0
North America	1970	100.0	88.1	40.8	100.0	91.3	50.5
	1980	100.0	87.0	50.5	100.0	86.0	47.5
	1985	100.0	95.7	56.7	100.0	95.6	54.1
Oceania	1970	88.7	66.0	8.3	91.1	70.7	15.7
	1980	88.9	68.6	16.0	91.4	60.1	19.8
	1985	87.4	70.2	19.1	89.5	70.4	21.8
Africa	1970	34.4	19.2	2.2	49.4	34.2	6.4
	1980	53.2	34.1	5.3	68.0	50.9	12.0
	1985	60.2	41.8	7.5	71.6	59.6	15.5
Asia[b]	1970	51.5	24.2	4.3	71.1	40.1	10.9
	1980	60.5	30.8	6.7	78.5	44.1	14.0
	1985	65.1	35.6	8.5	81.5	48.2	16.4
Latin America and the Caribbean	1970	71.5	47.5	9.6	70.9	52.1	13.1
	1980	81.6	62.1	16.6	82.5	64.3	24.8
	1985	82.8	69.6	23.4	84.2	71.2	25.8

Source: United Nations Educational, Scientific and Cultural Organization, *Statistical Yearbook, 1987* (Paris).

[a] Including the USSR.

[b] Including Japan.

Education policies should aim at providing a level of education adequate for coping with the demands of a complex society. Failure to do so is frequently a cause of the marginalization of women, with negative effects for society as a whole. Yet, efforts should be made to go beyond the creation of literate—but also unemployed—females. New and more intense educational efforts should try to ensure that full potential capabilities are developed, irrespective of gender, in every country.

Annex II

WERE THE EQUITY MARKETS OVERVALUED BEFORE 19 OCTOBER?

The leading explanations for the stock market crash, as described in chapter IV, emphasize confidence factors which, if restored, might lead to general recovery in equity markets. On the other hand, a number of observers have asserted that stock values were grossly overvalued before the crash. If so, the crash might be viewed as an unusually rapid correction of a speculative bubble.

Evaluating stock prices—or indexes of stock prices—is fraught with uncertainty, even more so than for many other financial assets. Stock prices are driven primarily by expectations of variable dividend flows and attitudes towards risk. The current dividend is a small factor influencing the investor's return; indeed, most of the return that investors expect to receive depends on increases in the price of the stock up to the time the stock is sold to another investor. Nevertheless, analysts of stock prices frequently look at the ratio of stock prices to current dividends—or earnings—as a quick indicator of market sentiment about an individual company's shares. By the same token, if the average price/dividend ratio for all the stocks traded in a particular market rises, it is taken as an indication of rising market sentiment about holding stocks in general. If the average ratio becomes unusually high, it can raise questions about whether the market as a whole has become "overvalued".

Table A.II.1. Characteristics of stock prices of selected developed market economies, 1985-1987

(Percentage)

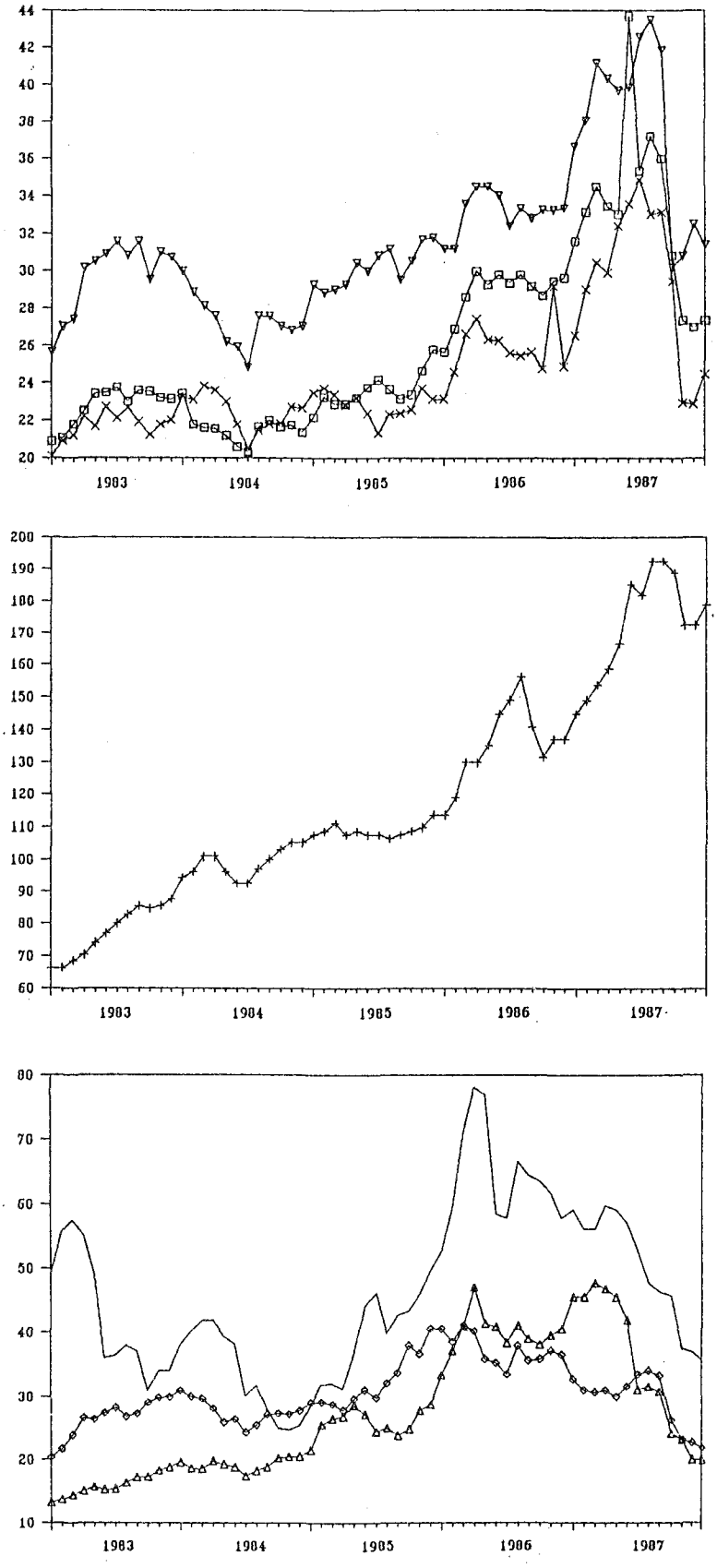
	Canada	France	Federal Republic of Germany	Italy	Japan	United Kingdom	United States
A. Estimated risk premiums embodied in stock prices (u)[a]							
1985	0.6	1.4	2.3	3.5	-0.1	1.9	1.6
1986	1.8	2.4	2.7	4.8	1.1	2.1	3.8
1987:							
January	2.2	1.8	3.2	6.8	1.7	1.8	4.2
February	1.9	1.7	3.5	7.0	2.0	1.8	3.8
March	1.8	2.0	3.6	7.0	2.3	2.2	3.7
April	1.0	1.9	3.7	6.7	2.6	2.4	3.1
May	1.0	1.7	3.9	6.4	2.6	2.4	2.5
June	1.1	1.5	3.5	6.1	2.0	2.2	2.6
July	0.5	2.3	3.2	5.9	1.5	1.8	2.5
August	0.3	1.8	2.9	5.4	1.3	1.3	2.0
B. Estimated degree of overvaluation of stock prices in 1987							
Price/dividend ratios in August							
Actual	43.5	31.6	34.0	47.6	192.2	33.0	37.2
Hypothetical[b]	27.6	31.0	28.5	29.6	77.3	26.3	24.0
Percentage overvaluation	57.8	1.9	19.2	61.2	148.8	25.6	55.1
Decline of price/dividend ratios, August-December	25.5	33.1	32.0	21.4	12.9	26.6	28.0

Sources: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *Financial Market Statistics* (dividend yields) and IMF, *International Financial Statistics* (long-term government bond rates).

[a] Period averages. The risk premium is estimated as the dividend yield (dividends/share price) minus the long-term government bond rate plus the expected average growth rate of dividends. This last term is assumed to be the country's average annual rate of growth of nominal GNP or GDP from 1983 through 1986.

[b] Price/dividend ratio implied by the model in part A, but with the "u" term assumed equal to the average value in the first half of 1987.

Figure A.II.1. Price/dividend ratios in major stock markets



Source: Based on data from OECD, *Financial Market Statistics*.

As may be seen from figure A.II.1, questions of this sort could understandably have been raised in mid-1987 about the stock markets of Canada, Japan, the United Kingdom and the United States. Continental European markets already seemed to be undergoing an adjustment. Were the others simply following in the second half of the year and, if so, why?

One way to approach these questions is to try to model stock price behaviour. What an investor should be willing to pay for a share of stock should, in principle, equal the present value of the expected flow of dividends in perpetuity. If P represents the stock price, D is the current year's dividend payment, r is the interest rate on risk-free government bonds, u is a risk premium required to compensate investors for the uncertainty about the future path of dividends, and g is the expected average growth rate of dividends (r, u and g expressed as decimals), then the theoretical price can be written as an equation:

$$P = \frac{D}{1+r+u} + \frac{D(1+g)}{(1+r+u)^2} + \frac{D(1+g)^2}{(1+r+u)^3} + \ldots .$$

Mathematically, this is equivalent to

$$P = \frac{D}{r+u-g} .$$

The formula can also be expressed in terms of the price/dividends ratio, i.e.,

$$P/D = \frac{1}{r+u-g} .$$

Stock prices—or the stock/dividend ratios—would thus, in theory, rise if expectations (g) improved, and fall if uncertainty or lack of confidence (u) about those expectations increased. Neither of these can be observed directly. However, there are reasonable ways of approximating g—a typical assumption is that it is equal to the recent growth of the country's nominal income—and that together with observations for P, D and r allow us to calculate implicit values of u. These values, in turn, can be tracked over time to see whether stock price behaviour had become unusual.

In particular, one can ask if the implicit u's took on unusually low values just prior to the crash. If so, that would imply that stocks were considered less risky than usual and, if changes in the economic environment did not account for the change, it would suggest that the shares had become overvalued relative to historical norms for prices, dividends and interest rates. Some illustrative calculations for one assumed level of g (based on the growth of nominal output from 1983 to 1986) for the seven major industrialized countries are shown in table A.II.1. In early 1987, estimated values of u did not seem out of line relative to values for all of 1986. However, a rather noticeable drop in estimated u values appeared after spring 1987.

The exercise can be extended by comparing the ratios of stock prices to dividends just before the crash with the ratios that would have resulted if the stock prices were determined by the model and if the value of u were equal to the average value estimated for the first half of 1987. The pattern of actual and hypothetical price/dividend ratios in late summer 1987 varied widely among countries, reflecting factors unique to each country in determining risk premiums. But the shares of each country except France seem to have been overvalued. The degree of correction in the stock/dividend ratios by year-end, however, did not closely follow the estimated amount of overvaluation. Even so, these calculations suggest that, among a variety of explanations for the October crash, one should not rule out its having been a one-shot correction of temporarily overvalued stocks.

Table A.III.1. Developed market economies: annual rates of growth of real gross national product, 1983-1989

(Annual percentage change)

Country or country group	1983	1984	1985	1986	1987[a]	1988[b]	1989[b]
All developed market economies[c]	2.7	4.8	3.0	2.7	3.0	2.4	1.8
Excluding United States	2.1	3.7	3.2	2.5	3.1	2.5	2.2
Major industrial countries[c]	3.0	5.0	3.1	2.8	3.1	2.6	1.8
Canada	3.7	6.1	4.3	3.3	3.9	2.0	2.4
France	0.7	1.4	1.7	2.1	2.1	1.4	1.5
Germany, Federal Republic of	1.9	3.3	2.0	2.5	1.7	1.7	2.3
Italy	0.5	3.5	2.8	2.8	3.1	1.7	1.8
Japan	3.2	5.1	4.7	2.5	4.2	4.1	2.7
United Kingdom	3.7	2.2	3.7	3.1	4.8	2.7	2.4
United States	3.6	6.4	2.7	2.9	2.9	2.4	1.3
Smaller industrial countries[c]	1.3	3.6	2.9	2.2	2.3	2.0	1.9

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

[a] Preliminary estimates.

[b] Forecasts, based on Project LINK.

[c] For France, Italy, the United Kingdom and all the "smaller industrial countries", the measure used is gross domestic product.

Table A.III.2. Developed market economies: unemployment rates, 1980-1987

(Percentage of total labour force)

	1980	1981	1982	1983	1984	1985	1986	1987
Australia	6.0	5.7	7.1	9.9	8.9	8.2	8.0	8.1
Austria	1.9	2.5	3.5	4.1	3.8	3.6	3.1	3.9[a]
Belgium	8.8	10.8	12.6	12.1	12.1	11.3	11.2	10.9
Canada	7.4	7.5	10.9	11.8	11.2	10.4	9.5	8.8
Denmark	6.5	10.3	11.0	11.4	8.5	7.3	6.3	8.5[a]
Finland	4.6	4.8	5.3	5.4	5.2	5.0	5.3	5.0
France	6.3	7.4	8.1	8.3	9.7	10.2	10.4	10.8
Germany, Federal Republic of	3.0	4.4	6.1	8.0	7.0	7.2	6.5	6.5
Greece	3.9	4.0	5.8	7.9	8.1	7.8	7.4	8.7[a]
Iceland	..	..	0.7	1.0	1.3	0.9	0.7	0.7[a]
Ireland	6.1	8.9	11.4	14.1	15.6	17.4	18.0	18.7[a]
Italy	7.5	8.3	9.0	9.8	10.2	10.5	10.9	11.5[a]
Japan	2.0	2.2	2.4	2.6	2.7	2.6	2.8	2.8
Luxembourg	..	..	1.2	1.6	1.7	1.6	1.4	1.2[a]
Netherlands	6.0	8.5	11.4	12.0	11.8	10.6	9.9	9.6
New Zealand	2.2	3.6	3.5	5.6	5.7	4.1	5.5	5.7[a]
Norway	1.6	2.0	2.6	3.4	3.1	2.6	2.0	2.1
Portugal	7.6	8.1	7.3	7.9	8.4	8.5	8.5	8.7[a]
Spain	11.2	13.9	15.8	17.2	20.0	21.4	21.0	21.1
Sweden	2.0	2.5	3.2	3.5	3.1	2.8	2.7	1.9
Switzerland	0.2	0.2	0.4	0.9	1.1	0.9	0.8	0.8[a]
United Kingdom	6.4	9.8	11.3	12.5	11.7	11.2	11.2	10.3
United States	7.0	7.5	9.5	9.5	7.4	7.1	6.9	6.1

Sources: OECD, *Main Economic Indicators* (Paris, March 1988), and OECD, *Employment Outlook* (Paris, September 1987).

[a] Estimates by the Department of International Economic and Social Affairs of the United Nations Secretariat.

Table A.III.3. Developed market economies: rates of change of GNP deflator and consumer prices, 1981-1987

(Annual percentage change)

Country or country group	1981	1982	1983	1984	1985	1986	1987[a]
GNP deflators							
All developed market economies[b]	8.8	7.2	5.3	4.6	4.4	3.8	3.6
Major industrial countries[b]	8.7	6.7	4.7	4.1	3.9	3.0	3.1
Canada	10.8	8.7	5.1	3.3	3.2	2.9	2.9
France	11.2	11.2	9.8	7.4	5.7	4.8	3.0
Germany, Federal Republic of	4.0	4.4	3.3	2.0	2.2	3.2	2.0
Italy	16.3	16.6	14.2	10.0	8.3	8.1	6.1
Japan	3.2	1.9	0.8	1.2	1.7	1.6	0.9
United Kingdom	12.0	7.6	5.6	4.6	5.6	3.9	5.6
United States	9.6	6.4	3.9	3.9	3.7	2.0	3.0
Other industrial countries[b]	9.5	10.2	8.2	7.4	7.1	7.9	6.0
North America[b]	9.7	6.6	4.0	3.8	3.6	2.0	3.0
Western Europe[b]	9.7	9.3	7.7	6.2	5.6	5.5	4.2
Developed Asia[b]	4.3	3.4	2.1	2.2	2.7	3.2	2.5
Consumer prices							
All developed market economies[b]	10.4	7.9	5.7	5.4	4.9	3.2	3.6
Major industrial countries[b]	10.1	7.2	4.9	4.8	4.2	2.2	2.9
Canada	12.4	10.8	5.8	4.3	4.0	4.1	4.4
France	13.4	11.8	9.6	7.4	5.8	2.5	3.3
Germany, Federal Republic of	6.3	5.3	3.3	2.4	2.2	-0.3	0.2
Italy	19.5	16.5	14.6	10.8	9.2	6.0	4.6
Japan	4.9	2.8	2.0	2.2	2.0	0.6	0.1
United Kingdom	11.9	8.6	4.6	5.0	6.1	3.4	4.2
United States	10.4	6.1	3.3	4.3	3.5	2.0	3.6
Other industrial countries[b]	11.5	11.0	9.4	8.4	8.0	7.3	6.3
North America[b]	10.6	6.4	3.5	4.3	3.5	2.2	3.7
Western Europe[b]	11.7	10.1	8.0	7.0	6.1	3.8	3.5
Developed Asia[b]	6.2	4.8	3.8	3.2	4.1	3.7	3.4

Sources: IMF, *International Financial Statistics;* and OECD, *Economic Outlook.*

[a] GNP deflators for 1987 are estimates by the Department of International Economic and Social Affairs of the United Nations Secretariat, based on Project LINK and other official national and international sources.

[b] Rates of change in individual countries are aggregated by using value of output in 1980 in dollars as weights.

Table A.III.4. Growth of exports to the developed market economies from the leading exporters of manufactures among the developing economies

(Percentage change in current dollar values)

	1985	1986	1987[a]
Argentina	1.2	-9.1	-3.0
Brazil	0.6	-6.9	8.8
Hong Kong	-3.6	20.7	19.7
India	-4.1	3.9	19.7
Malaysia	-6.5	-1.5	17.5
Philippines	-11.0	-0.3	11.3
Republic of Korea	6.4	30.6	40.0
Singapore	0.4	6.7	30.8
Thailand	3.	29.1	25.7
Yugoslavia	7.8	27.0	19.1
Total	-0.2	11.1	22.8

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

[a] January-October.

Table A.III.5. Balance of trade with developed market economies of 10 leading exporters of manufactures among the developing economies[a]

(Billions of dollars)

		1980	1984	1985	1986	1987[b]
All developed market economies						
Exports		76.9	99.1	98.9	109.8	105.9
Imports		84.4	82.7	82.0	9.1	89.4
	Balance	-7.5	16.4	17.8	13.7	16.5
United States						
Exports		23.4	42.4	42.8	45.9	46.3
Imports		24.4	30.0	22.1	23.7	22.2
	Balance	-1.0	12.5	20.7	22.2	24.1
Europe						
Exports		32.9	31.6	31.9	37.6	32.5
Imports		29.6	24.7	26.0	33.8	28.5
	Balance	3.3	6.9	5.9	3.8	4.0
Japan						
Exports		14.6	17.3	16.7	18.2	18.8
Imports		23.0	26.3	25.3	30.8	30.8
	Balance	-8.4	-9.0	-8.6	-12.6	-12.0

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

[a] Argentina, Brazil, Hong Kong, India, Malaysia, Philippines, Republic of Korea, Singapore, Thailand and Yugoslavia.

b January-October.

Table A.III.6. Current account balances of the developing countries
(Billions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987[a]
Surplus energy exporters (8 economies)								
Merchandise exports	216.9	199.3	153.3	120.1	109.8	94.6	59.7	75.5
Merchandise imports (f.o.b.)	-76.6	-91.4	-94.4	-86.3	-75.7	-59.5	-52.6	-50.7
Balance of trade	140.3	108.0	58.9	33.8	34.0	35.0	7.0	24.8
Net services and private transfers	-34.5	-43.2	-42.7	-39.3	-36.3	-27.0	-15.7	-19.2
Current account	105.8	64.8	16.2	-5.5	-2.2	8.0	-8.6	5.6
Deficit energy exporters (19 economies)								
Merchandise exports	140.9	139.9	125.9	121.4	132.5	125.5	89.7	103.0
Merchandise imports (f.o.b.)	-108.0	-128.9	-116.1	-97.1	-96.4	-91.9	-80.5	-82.5
Balance of trade	33.0	11.0	9.9	24.2	36.2	33.7	9.3	20.5
Net services and private transfers	-30.9	-38.3	-44.8	-34.9	-36.4	-37.2	-30.2	-30.5
Current account	2.1	-27.3	-34.9	-10.6	-0.2	-3.5	-20.9	-10.0
Energy-importing countries (98 economies)								
Merchandise exports	200.9	214.7	204.1	211.5	240.4	236.8	261.7	318.4
Merchandise imports (f.o.b.)	-258.3	271.0	-249.5	-240.3	-247.8	-241.6	-257.1	-309.3
Balance of trade	-57.3	-56.3	-45.3	-28.8	-7.3	-4.8	4.6	9.1
Net services and private transfers	-11.5	-15.7	-19.4	-16.4	-22.5	-17.7	-13.5	-13.6
Current account	-68.8	-72.0	-64.7	-45.2	-29.9	-22.5	-8.9	-4.5
Surplus exporters of manufactures (3 economies)[b]								
Merchandise exports	56.5	65.0	63.7	70.3	85.0	87.0	108.1	139.3
Merchandise imports (f.o.b.)	-61.5	-67.9	-64.3	-66.9	-74.3	-75.4	-87.1	-114.1
Balance of trade	-5.0	-2.9	-0.7	3.3	10.6	11.6	20.9	25.2
Net services and private transfers	-2.4	-2.8	-1.0	-1.3	-3.5	-1.2	1.6	1.8
Current account	-7.4	-5.7	-1.6	2.1	7.1	10.4	22.5	27.0
Other energy importers (95 economies)								
Merchandise exports	144.4	149.7	140.5	141.2	155.5	149.8	153.7	179.1
Merchandise imports (f.o.b.)	-196.8	-203.1	-185.1	-173.4	-173.5	-166.2	-170.0	-195.2
Balance of trade	-52.4	-53.4	-44.7	-32.2	-18.0	-16.4	-16.3	-16.1
Net services and private transfers	-9.1	-12.9	-18.4	-15.1	-19.0	-16.5	-15.1	-15.4
Current account	-61.5	-66.3	-63.1	-47.3	-37.0	-32.9	-31.4	-31.5
All capital importers (117 economies)								
Merchandise exports	341.9	354.6	330.1	332.9	373.0	362.4	351.5	421.4
Merchandise imports (f.o.b.)	-366.2	-399.9	-365.5	-337.5	-344.2	-333.5	-337.6	-391.8
Balance of trade	-24.4	-45.3	-35.5	-4.6	28.8	28.9	13.9	29.6
Net services and private transfers	-42.3	-53.9	-64.2	-51.2	-58.9	-54.9	-43.7	-44.1
Current account	-66.7	-99.2	-99.6	-55.8	-30.1	-26.0	-29.8	-14.5
China								
Merchandise exports	18.5	22.0	21.1	20.7	23.9	25.1	25.8	39.5
Merchandise imports (f.o.b.)	-21.2	-20.3	-16.9	-18.7	-23.9	-38.2	-34.9	-43.2
Balance of trade	-2.8	1.7	4.2	2.0	0.0	-13.1	-9.1	-3.7
Net services and private transfers	0.3	0.3	1.6	2.4	2.4	1.6	2.0	3.3
Current account	-2.4	2.0	5.9	4.4	2.4	-11.5	-7.2	-0.4

All developing countries (126 economies)								
Merchandise exports	577.3	576.0	504.4	473.7	506.7	482.1	436.9	536.4
Merchandise imports (f.o.b.)	-464.1	-511.6	-476.8	-442.5	-443.8	-431.3	-425.1	-485.7
Balance of trade	113.2	64.4	27.7	31.2	62.9	50.8	11.8	50.7
Net services and private transfers	-76.5	-96.9	-105.2	-88.1	-92.8	-80.3	-57.4	-60.0
Current account	36.7	-32.5	-77.5	-56.9	-29.9	-29.5	-45.6	-9.3

Sources: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of IMF and official national and other sources.

[a] Preliminary estimates.

[b] Hong Kong, Republic of Korea and Taiwan, Province of China.

Table A.III.7. Official reserves and ratios of reserves to current expenditures of the capital-importing developing countries

	1980	1981	1982	1983	1984	1985	1986	1987[a]
				Billions of dollars				
Level of reserves[b]	108.6	98.1	80.3	81.8	93.9	103.0	98.6	112.2
of which:								
Energy exporters	44.5	39.8	28.8	31.3	36.4	38.9	33.0	42.5
Energy importers	64.0	58.4	51.5	50.5	57.5	64.2	65.5	69.7
Fifteen heavily-indebted countries[c]	50.0	41.7	26.3	27.5	39.6	40.9	32.7	39.8
Sub-Saharan Africa[d]	3.9	3.4	2.8	3.0	3.1	4.1	5.1	5.5
				Number of months				
Coverage of current expenditures[e]	2.7	2.2	1.8	2.1	2.4	2.7	2.7	2.8
of which:								
Energy exporters	3.2	2.4	1.9	2.4	2.7	3.0	2.9	3.6
Energy importers	2.4	2.1	1.8	2.0	2.3	2.6	2.6	2.4
Fifteen heavily-indebted countries[c]	3.1	2.3	1.6	2.1	3.0	3.2	2.8	3.1
Sub-Saharan Africa[d]	1.1	1.0	0.9	1.1	1.1	1.5	1.7	1.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data of IMF 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.III.8. Development finance commitments of Arab national and regional development institutions[a]

(Millions of dollars)

	1982	1983	1984	1985	1986	1987[b]
Functional composition						
Project finance (loans or equity)	2 085.8	1 410.2	1 158.2	999.6	1 163.1	615.8
Technical assistance (grants and loans)	52.9	24.2	20.9	42.1	37.1	51.8
Import financing (grants, loans and leasing)	436.4	506.0	768.3	603.9	658.6	380.1
Balance of payments (OPEC Fund loans)	83.5	25.5	3.7	-	5.8	11.4
Other (grants)[c]	35.0	6.4	7.4	6.1	0.9	0.8
Total	2 693.6	1 972.3	1 958.5	1 651.7	1 865.5	1 059.8
Geographical distribution						
Africa	1 458.4	841.7	864.5	616.4	1 008.5	564.4
West Asia	425.6	424.1	544.0	485.8	378.1	157.3
Other Asia and the Pacific[d]	655.0	507.3	393.4	393.6	314.1	220.9
Other[e]	154.6	199.2	156.6	156.0	164.8	117.3
Total	2 693.6	1 972.3	1 958.5	1 651.7	1 865.5	1 059.8

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] January-August.

[c] 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.

[d] Including China.

[e] Including international agencies and organizations.

Table A.III.9. Net flow of IMF lending to the capital-importing developing countries, 1980-1987

(Billions of dollars)[a]

	1980	1981	1982	1983	1984	1985	1986	1987
Regular facilities	2.3	5.7	4.2	8.8	4.3	1.1	-0.6	-3.8
Credit tranche drawings	1.5	3.3	1.9	4.0	1.2	1.1	0.3	-1.8
Extended facility drawings	0.7	2.4	2.3	4.9	3.2	0.0	-0.9	-1.9
Special facilities	1.2	-	1.4	2.2	-0.2	-0.8	-2.1	-0.9
Buffer stock financing	-	-	0.1	0.3	-	-0.2	-0.2	-0.1
Compensatory financing	0.3	0.6	1.7	2.1	-	-0.4	-1.4	-0.7
Oil facility	-0.7	-0.7	-0.4	-0.1	-	-	-	-
Trust Fund	1.6	0.1	-	-	-0.2	-0.3	-0.6	-0.6
Structural adjustment facility	-	-	-	-	-	-	0.1	0.5
Total flows	3.4	5.7	5.7	11.1	4.2	0.3	-2.7	-4.6
Memorandum items								
Selected characteristics of higher conditionality lending agreements								
Number initiated during year	28	31	19	33	20	26	31	25
Average length (months)	20	23	14	18	14	16	22	26
Total amount committed	7.5	24.4	2.6	15.7	4.0	3.4	4.0	4.4

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.III.10. International capital flows of the Federal Republic of Germany, 1980-1987

(Billions of dollars)[a]

	1980	1981	1982	1983	1984	1985	1986	1987
Current account[b]	-13.8	-3.6	5.1	5.3	9.7	16.2	37.9	44.3
Long-term capital, net	3.2	3.7	-5.8	-2.7	-7.0	-4.6	16.4	-13.8
Investment abroad of the Federal Republic of Germany	-15.5	-11.9	-11.7	-14.3	-15.8	-21.0	-24.5	-34.4
Direct investment	-4.0	-3.9	-2.5	-3.2	-4.4	-4.8	-9.0	-8.4
Securities	-4.2	-2.7	-4.7	-4.1	-5.5	-10.7	-9.5	-14.2
Long-term credit transactions	-6.1	-4.3	-3.6	-5.8	-5.0	-4.4	-4.7	-10.3
Other	-1.1	-1.1	-0.9	-1.3	-0.9	-1.0	-1.4	-1.6
Foreign investment in the Federal Republic of Germany	18.7	15.6	5.8	11.6	8.9	16.4	41.0	20.7
Direct investment	0.4	0.3	0.8	1.8	0.7	0.7	1.4	1.1
Securities	0.5	0.4	1.1	5.3	6.1	13.0	34.0	18.5
Long-term credit transactions	17.9	14.8	3.9	4.5	2.0	2.6	5.6	1.1
Other	-0.1	-	-	-0.1	-	-	-0.1	-0.1
Short-term capital, net	-3.4	-1.2	4.5	-4.5	-6.2	-14.2	-52.3	-10.6
Net bank flows	-4.9	-4.5	3.3	0.7	-	-9.4	-27.1	-3.1
Enterprises, individuals	1.2	2.6	1.3	-3.5	-5.7	-4.8	-24.8	-5.9
Official	0.2	0.8	-0.1	-1.7	-0.6	-	-0.5	-1.6
Errors and omissions	-1.3	-	-2.5	0.3	2.4	3.3	0.7	5.6
Reserve-related flows	15.3	1.0	-1.3	1.6	1.1	-0.6	-2.7	-25.5

Source: Statistical Supplement to the Monthly Report of the Deutsche Bundesbank, Series 3.

[a] A minus sign (-) indicates an outflow from the Federal Republic of Germany or an addition to reserves; dollar values are converted from deutsche mark at average annual exchange rates.

[b] Including official transfers.

Table A.III.11. International capital flows of Japan, 1980-1987

(Billions of dollars)[a]

	1980	1981	1982	1983	1984	1985	1986	1987
Current account balance[b]	-10.7	4.8	6.9	20.8	35.0	49.2	85.8	86.7
Long-term capital, net	2.3	-9.7	-15.0	-17.7	-49.6	-64.5	-131.5	-137.1
Japanese capital	-10.8	-22.8	-27.4	-32.5	-56.8	-81.8	-132.1	-133.4
Direct investment	-2.4	-4.9	-4.5	-3.6	-6.0	-6.5	-14.5	-19.5
Trade credits	-0.7	-2.7	-3.2	-2.6	-4.9	-2.8	-1.8	-0.6
Loans	-2.6	-5.1	-7.9	-8.4	-11.9	-10.4	-9.3	-16.7
Securities	-3.8	-8.8	-9.7	-16.0	-30.8	-59.8	-102.0	-87.8
Other	-1.4	-1.3	-2.0	-1.8	-3.2	-2.3	-4.5	-8.8
Foreign capital	13.1	13.1	12.4	14.8	7.1	17.3	0.6	-3.7
Direct investment	0.3	0.2	0.4	0.4	-	0.6	0.2	1.2
Securities[c]	13.1	13.2	11.9	14.1	7.2	16.7	0.5	-6.1
Other[d]	-0.3	-0.3	0.2	0.2	-0.1	-0.1	-0.1	1.2
Short-term capital, net	16.3	8.7	-1.5	-3.5	13.3	9.9	56.9	95.7
Non-bank transactions	3.1	2.3	-1.6	-	-4.3	-0.9	-1.6	23.9
Foreign exchange banks	13.1	6.4	-	-3.6	17.6	10.8	58.5	71.8
Errors and omissions	-3.1	0.5	4.7	2.1	3.7	4.0	2.5	5.7
Reserve-related flows	-4.7	-4.2	4.9	-1.6	-2.4	1.5	-13.7	-50.9

Sources: Bank of Japan, *Balance of Payments Monthly;* and Japanese authorities.

[a] A minus sign (-) indicates an outflow of capital from Japan or an addition to reserves.

[b] Including official transfers.

[c] Excluding Gensaki transactions, which are included in short-term capital.

[d] Mainly loans.

Table A.III.12. International capital flows of the United States, 1980-1987

(Billions of dollars)[a]

	1980	1981	1982	1983	1984	1985	1986	1987
Current account balance[b]	1.9	6.9	-8.7	-46.2	-107.0	-116.4	-141.4	-160.7
Net private capital flows	-30.2	-22.6	-19.9	35.4	85.8	106.3	84.3	84.1
United States private capital	-72.8	-100.7	-110.1	-43.6	-13.7	-24.7	-94.4	-74.2
Direct investment	-19.2	-9.6	2.4	-0.4	-2.8	-17.3	-28.0	-38.2
Securities	-3.6	-5.7	-8.0	-6.8	-4.8	-7.5	-3.3	-3.7
Banking flows	-46.8	-84.2	-111.1	-29.9	-11.1	-1.3	-59.0	-33.4
Non-banking flows	-3.2	-1.2	6.6	-6.5	5.0	1.4	-4.0	1.1
Foreign private capital	42.6	78.1	90.2	79.0	99.5	131.0	178.7	158.3
Direct investment	16.9	25.2	13.8	11.9	25.4	19.0	25.1	40.6
Securities, of which	8.1	9.8	13.1	16.9	35.6	71.4	79.1	36.0
Equity shares	4.2	5.1	3.6	6.4	-1.3	4.3	17.0	15.4
Banking flows	10.7	42.1	65.6	50.3	33.8	41.0	77.4	77.9
Non-banking flows	6.9	0.9	-2.4	-0.1	4.7	-0.5	-2.8	3.8
Net official flows	2.1	-5.3	-7.5	-0.4	-5.6	-7.8	33.1	54.7
Foreign official capital	15.5	5.0	3.6	5.8	3.0	-1.1	34.7	44.3
United States official reserves	-8.2	-5.2	-5.0	-1.2	-3.1	-3.9	0.3	9.2
Other United States Government assets	-5.2	-5.1	-6.1	-5.0	-5.5	-2.8	-1.9	1.2
Statistical discrepancy	25.0	19.9	36.1	11.2	26.8	17.9	23.9	21.9

Source: United States Department of Commerce, *Survey of Current Business.*

[a] A minus sign (-) indicates an outflow of capital from the United States.

[b] Including official transfers.

Table A.III.13. Oil balances in selected years
(Millions of barrels per day)

	1985	1986	1987
Developed market economies			
Consumption	34.2	35.2	35.7
Production	17.0	16.9	16.7
Net imports	17.2	18.3	19.0
Developing countries			
Consumption	12.2	12.6	12.9
Production	25.7	28.0	28.2
Net exports	13.5	15.4	15.3
Centrally planned economies			
Consumption	10.5	10.9	10.9
Production	12.3	12.7	12.9
Net exports	1.8	1.8	2.0
Memorandum items			
Saudi Arabia production	3.2	5.0	4.2
Soviet Union production	12.0	12.4	12.6
United States production	10.6	10.2	9.9

Sources: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IEA, *Oil Market Report,* various issues; and *Petroleum Economist, April 1988.*

Note: For each group and year, consumption comprises production plus net imports (or minus net exports), minus stock additions; production includes natural gas liquids and non-conventional oil. (Total net exports do not equal total net imports because of discrepancies in reporting, incomplete data and differences in definitions and conversion factors.)

Table A.III.14. OPEC oil production quotas
(Thousands of barrels per day)

Country	March 1983	October 1984	September 1986	November 1986	January 1987	July 1987
Algeria	725	663	663	669	635	667
Ecuador	200	183	183	21	210	221
Gabon	150	137	137	160	152	159
Indonesia	1 300	1 189	1 189	1 198	1 133	1 190
Iran (Islamic Republic of)	2 400	2 300	2 300	2 317	2 255	2 369
Iraq	1 200	1 200	1 200[a]	1 466[a]	1 466[a]	1 540[a]
Kuwait	1 050	900	900	999	948	996
Libyan Arab Jamahiriya	1 100	990	990	999	948	996
Nigeria	1 300	1 300	1 300	1 304	1 238	1 301
Qatar	300	280	280	300	285	299
Saudi Arabia	5 000	4 353	4 353	4 353	4 133	4 343
United Arab Emirates	1 100	950	950	950	902	948
Venezuela	1 675	1 555	1 555	1 574	1 485	1 571
Total	17 500	16 000	16 000	16 505	15 800	16 600

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on various OPEC press releases.

a Theoretical quota for Iraq.

Table A.III.15. Production of crude oil in developing countries
(Millions of barrels)

Country	1970	1980	1985	1986	1987
OPEC countries	8 508.9	9 781.8	5 869.6	6 590.5	6 459.0
Non-OPEC developing countries	1 021.0	2 019.4	2 883.3	2 882.3	2 982.5
Oil-exporting developing countries	748.7	1 665.7	2 223.9	2 213.9	2 332.3
Angola	37.0	54.2	83.4	102.2	124.6
Bahrain	27.9	17.6	14.8	16.1	15.8
Bolivia	8.2	8.1	6.7	6.6	6.8
Brunei Darussalam	48.8	91.3	6.7	60.7	48.8
Cameroon	–	19.7	48.9	65.7	62.1
Colombia	82.7	47.5	66.5	110.6	141.5
Congo	0.1	24.0	2.6	42.0	43.1
Egypt	119.7	214.6	323.5	296.5	328.2
Malaysia	6.3	96.7	158.8	183.6	170.6
Mexico	157.0	729.5	990.4	886.2	926.3
Oman	121.1	102.4	180.4	197.4	206.2
Peru	25.9	70.4	67.9	65.0	60.8
Syrian Arab Republic	31.0	60.9	67.4	70.6	84.6
Trinidad and Tobago	52.7	80.2	67.1	61.0	59.5
Tunisia	30.3	41.1	39.5	39.2	38.1
Yemen	–	–	–	2.6	3.7
Zaire	–	7.5	9.3	7.9	11.6
Energy-deficient developing countries	272.3	353.7	659.4	668.4	650.2
Argentina	146.2	184.6	172.5	156.8	153.0
Bangladesh	–	–	0.2	0.2	0.2
Barbados	–	0.3	0.7	0.6	0.5
Benin	–	–	2.4	2.7	4.4
Brazil	58.3	64.5	200.7	210.0	205.4
Burma	5.8	11.4	12.0	11.0	8.8
Chile	10.7	11.7	11.6	11.6	10.3
Côte d'Ivoire	–	0.9	10.3	7.4	5.8
Cuba	1.2	2.0	6.3	6.9	7.3
Ghana	–	0.6	0.7	0.2	. .
Guatemala	–	1.5	1.3	1.9	1.4
India	49.7	68.6	218.0	227.9	222.2
Jordan	–	–	–	0.1	1.5
Morocco	0.3	0.1	0.1	0.2	0.1
Pakistan	–	3.5	9.3	14.9	15.2
Philippines	–	3.9	4.1	2.2	1.9
Suriname	–	–	0.7	1.0	0.8
Thailand	0.1	0.1	8.5	12.8	11.4
Total	9 529.9	11 801.2	8 752.9	9 472.8	9 441.5

Sources: Department of Internaitonal Economic and Social Affairs of the United Nations Secretariat, based on *Energy Statistics Yearbook,* 1982 and 1985 (United Nations publications, Sales Nos. EF.84.XVII.4 and EF.86.XVII.13); *Oil and Gas Journal,* 22 and 29 December 1986 and 28 December 1987.

Table A.III.16. Exploration expenditures of major oil companies, 1982-1986

(Millions of dollars)

Company	1982	1983	1984	1985	1986
British Petroleum	1 892	1 433	1 359	1 415	1 011
Exxon	1 773	1 408	1 404	1 495	920
Gulf Oil[a]	752	601	–	–	–
Mobil	847	618	619	702	580
Royal Dutch/Shell	1 495	1 322	1 320	1 462	1 387
Chevron[a]	967	775	1 032	1 054	562
Texaco	1 435	1 110	1 309	802	465
Total	9 161	7 267	7 043	6 930	4 925

Source: OPEC, *Annual Statistical Bulletin, 1986* (Vienna), p. 135.

[a] Gulf Oil merged with Chevron in 1984.

Table A.III.17. Capital investments of major oil companies, in production, 1982-1986

(Millions of dollars)

Company	1982	1983	1984	1985	1986
British Petroleum	2 657	2 109	1 991	1 906	1 315
Exxon	5 557	4 677	5 619	6 066	3 680
Gulf Oil[a]	2 100	1 739	–	–	–
Mobil	2 283	1 938	1 836	1 106	1 317
Royal Dutch/Shell	3 992	3 274	3 986	5 173	2 899
Chevron[a]	1 823	1 315	2 314	1 748	1 142
Texaco	1 185	1 257	1 223	1 298	923
Total	19 597	16 309	16 969	17 797	11 276

Source: OPEC, *Annual Statistical Bulletin, 1986* (Vienna), p. 135.

[a] Gulf Oil merged with Chevron in 1984.

Table A.III.18. Capital expenditure on petroleum by majority-owned foreign affiliates of United States companies, 1982-1988

(Millions of dollars)

	Actual expenditures					Latest plans	
	1982	1983	1984	1985	1986	1987	1988
Developed market economies	11 437	8 939	8 926	8 733	6 055	6 039	6 261
Australia	678	538	436	327	534	536	505
Canada	3 380	2 375	2 547	2 665	1 488	1 650	1 922
Western Europe	7 252	7 670	5 822	5 626	3 829	3 661	3 654
Developing countries	8 270	6 468	4 928	4 620	3 297	3 252	3 547
Latin America	1 915	996	822	950	720	619	628
Africa	2 350	1 778	1 368	1 421	925	918	965
Middle East	638	661	571	437	297	236	234
Asia and the Pacific	3 368	3 032	2 166	1 813	1 354	1 479	1 720
Total	20 760	15 915	14 124	13 673	9 606	9 482	10 010

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", and *loc. cit.*, 1987 and 1988, *Survey of Current Business* (Washington, D.C., United States Department of Commerce, October 1986 and September 1987).

Table A.III.19. Profit margins on crude oil and gas produciton[a]

(Dollars per barrel of oil equivalent)

	United States		Outside United States	
	1985	1986	1985	1986
Revenue	19.99	11.56	25.00	14.50
Lifting cost	4.36	3.93	6.15	4.78
Government take	5.27	0.69	10.21	3.30
Other	(0.04)	0.05	0.06	(0.48)
Exploration	2.35	1.61	1.96	1.66
Margin	8.05	5.28	6.62	5.24

Source: Paper prepared by Robert B. Weaver for the International Herald Tribune and Oil Daily Conference, London, 22 and 23 October 1987.

[a] Margins are on a cash basis before deduction of financing charges, overhead and depreciation.

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