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Department of International Economic and Social Affairs

WORLD ECONOMIC SURVEY 1985

Current Trends and Policies in the World Economy

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NOTE

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PREFACE

The crucial role of international trade in reinforcing global demand was evident in 1984, as the growth of world output gradually regained the pace of the late 1970s. Yet the geographical spread of the recovery remained limited, and economic growth in half of the developing countries was still so low that income per capita either continued to fall or stagnated. This uneven recovery, its sources and the policies conditioning its transmission, as well as its short-term prospects, are the focus of the *World Economic Survey 1985*.

Several critical and deep-seated problems endanger the achievement of a more stable and sustained growth process. The number of persons unemployed in many developing and developed countries is exceptionally high. Nominal and real interest rates remain high and volatile. Commodity prices have again become depressed and some are below their low levels of 1982. Protectionism has yet to be rolled back, despite the economic rebound.

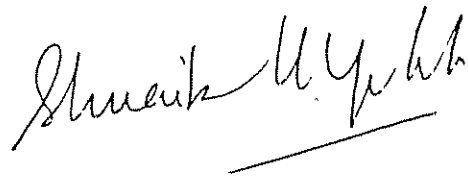
In addition, a reverse transfer of resources out of the capital-importing developing countries has occurred for the first time in 1984. The abrupt reduction in capital inflows and the continued high interest burden have necessitated continuation of severe adjustment programmes and heightened social and political tensions. These are unsustainable in the medium term. At the same time, massive external imbalances among major industrial countries and greater volatility of exchange rates have produced undesirable side-effects and much uncertainty in the world economy.

World economic growth has already begun to slow down in the early months of 1985, a trend that is likely to continue through this year and the next. Macro-economic policy stances are at least partly responsible for the fragile state of the recovery. When so many countries in all regions are simultaneously cautious or obliged to reduce their current account deficits, there is danger that the interaction among them could bring about greater restriction than intended individually or desirable globally. Clearly, a strong, sustained and better balanced growth pattern in the industrial countries would allow for continued expansion of world trade. Changes in policy stances as well as an enhancement of international economic co-operation, as summarized in the concluding chapter of the *Survey*, would better sustain global expansion, and foster international stability.

For the developing countries in particular, an improving international economic environment is crucial for raising the prospects of increases in growth and standards of living. Increasing world trade is an important stimulus to the renewed growth of developing countries, as is enhanced economic co-operation among the developing countries. At the same time, enlarged financial flows to the developing countries are required, especially to the low-income countries affected by the continuing economic crisis in Africa.

The *Survey* was prepared in the General Analysis and Policies Division of the Department of International Economic and Social Affairs, on the basis of information available at 1 April 1985.

It is hoped that in addition to supporting the work of the Economic and Social Council and other United Nations bodies, the *World Economic Survey 1985* will be of interest to Governments and the general public.



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

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EXPLANATORY NOTES

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

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

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

A blank in a table indicates that the item is not applicable.

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

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

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

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

Reference to "tons" indicates metric tons and to "dollars" ($) United States dollars, unless other-wise stated.

Annual rates of growth or change, unless otherwise stated, refer to annual compound rates. In most cases, the growth rate forecasts for 1984 and 1985 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 acronyms and abbreviations have been used:

CMEA	Council for Mutual Economic Assistance
DAC	Development Assistance Committee of the Organisation for Economic Co-operation and Development
ECLAC	Economic Commission for Latin America and the Caribbean
EEC	European Economic Community
FAO	Food and Agriculture Organization of the United Nations
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
IDA	International Development Association
IMF	International Monetary Fund
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development

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
SDR	Special drawing rights
UNCTAD	United Nations Conference on Trade and Development

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

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

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

Centrally planned economies:	China, Eastern Europe, Union of Soviet Socialist Republics
Developed market economies:	North America, southern and western Europe (excluding Cyprus, Malta and Yugoslavia), Australia, Japan, New Zealand, South Africa
Developing countries:	Latin America and the Caribbean area, Africa (other than South Africa), Asia (excluding Japan), Cyprus, Malta, Yugoslavia

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

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

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

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

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

Part One

WORLD ECONOMIC CONDITIONS: MAIN FEATURES, POLICIES AND PROSPECTS

Chapter I

INTRODUCTION: THE WORLD ECONOMY AT MID-DECADE

The significant expansion of world output and international trade that took place in 1984 is giving way to more modest rates of growth in 1985 and the prospect of a further deceleration in 1986. A new cyclical upturn may then follow, although the timing and strength of such an upturn is extremely difficult to forecast. What seems likely is that the average rate of world economic growth for the middle years of the decade will be more than twice the rate of the period 1980-1983. While this is a much welcomed recovery from the worst international recession of the post-war era, it falls short of global needs. The middle years of the decade will continue to be characterized by unusually high rates of unemployment and still inadequate progress against world poverty.

During these years the world economy is expected to grow at a slower pace than in the late 1970s. The impulses that led to a strong recovery in North America and to a dramatic rise in its imports began to weaken in the second half of 1984. In the current year, the rate of increase in North America's gross domestic product is expected to be only about half the rate of nearly 7 per cent achieved in 1984. This should produce a slowdown in the global economy, since no substantial acceleration of growth is likely to occur elsewhere - in other developed market economies, centrally planned economies or developing regions.

The transmission of growth impulses has been uneven, particularly when compared to previous recoveries. While international trade has provided a considerable stimulus to the growth of the exporters of manufactures, primary commodity exporters have continued to face weak external demand. Moreover, many countries have continued to confront tight international financial markets. Interest rates in real terms have remained high and several developing countries have experienced a considerable net outflow of resources. Partly because of these factors, there have been wide disparities in economic performance among both developed and developing economies.

The growth momentum recently achieved by most in the developing economies in Asia, including the most populous ones, was maintained in 1984. Latin American countries experienced a slight rebound in economic activity from the depressed 1982-1983 levels, partly as a consequence of increased exports. Growth in sub-Saharan Africa, however, continued to be constrained by the weak expansion in agriculture in most countries in the region. The weakness was particularly severe in the 20 countries for which a drought-related food emergency has been declared. Since domestic and external impulses for growth in developing countries are not going to change markedly in the near future, growth rates will remain generally weak. Thus, even by the second half of the decade, the large majority of developing countries will not have recovered fully from the dramatic set-back suffered in the early 1980s.

The Japanese economy, largely on account of buoyant exports, has experienced robust growth since mid-1983, while the economies of Western Europe are gradually converging to a somewhat higher rate of growth in domestic product, but one still insufficient to make any dent in unemployment. Countries in Eastern Europe and the Union of Soviet Socialist Republics have maintained in the current year, especially in industry, the growth momentum reached in the second half of 1983. Domestic impulses for growth remained strong in China and its economic expansion continued at a rapid pace in 1984 and early 1985.

The continuation of the cyclical slow-down in North America into 1986 and its dampening effect on the rate of growth of other regions should lead to a further slowdown of the world economy in that year. Although individual countries will be affected with varying degrees of intensity, on the whole the slow-down is expected to be moderate.

The shape of the next cyclical upturn is still uncertain. On the one hand, there are some encouraging signals pointing to an upswing after 1986. Fixed investment has increased markedly in some of the large developed market economies and is picking up in many other countries. Inflationary pressures in developed market economies have subsided and price increases in the near future are likely to remain modest. In many developed and developing countries, room for policy manoeuvre has widened. In the centrally planned economies, an acceleration in the pace of output growth appears possible in the course of the implementation of their five-year plans for 1986-1990. The large, most populous, developing and developed economies of Asia have gained, and are likely to maintain, considerable momentum at mid-decade. According to this scenario the post-1986 upturn, as distinct from the recent recovery, could be characterized by some convergence in the growth rates of the developed countries, less instability in key economic variables, and a resumption of development in a less restricted number of developing countries.

On the other hand, the world economy has proved to be fragile. Past recoveries have often been short-lived. If current problems are not tackled, it is likely that a significant upswing will not occur in 1987. Persistent protectionist pressures and the possibility of

additional restrictive trade measures, the considerable fiscal deficit and trade imbalance in the United States of America, protracted adjustments in the European economies that prevent them from attaining high rates of growth in domestic product and in import demand, slow progress in the resolution of the debt problem, and critical economic conditions in sub-Saharan countries all indicate how hazardous the path towards a strong and broad-based world recovery remains.

Indeed, changes in policy stances to deal with the problems outlined above could significantly affect the course of events in the second half of the 1980s. A more stable and supportive international economic environment would ease some of the current strains and uncertainties and allow many countries to resume growth sooner. In particular, joint actions to halt and roll back protectionism, to support more decisively the multilateral financial institutions and to harmonize macro-economic policies among large developed countries would go a long way towards improving the international economic environment. Such actions will not, however, remove the need for sound economic policies. Even in the event of a much improved international environment, most countries will still be confronted with hard policy choices. Many low-income countries still have to put in place more effective policies to expand agricultural production rapidly and to increase savings and investment, which could prove difficult to achieve without unduly worsening their already depressed consumption levels. Several inflation-ridden countries also confront particularly difficult choices, since indexation mechanisms and expectations of continuing high inflation rates have become entrenched. For developed countries, it is still necessary to consolidate recent gains in the fight against inflation and, at the same time, to create jobs at a faster pace.

Prevailing uncertainties

These policy choices will have to be made against a background of pervasive uncertainty which complicates the smooth functioning of the world economy. This uncertainty is due in part to the increase, since the early 1970s, in the volatility of some of the most critical economic variables, such as interest rates, exchange rates and fuel prices, but it was also induced by novel policy stances and seemingly unsustainable or inconsistent national strategies. In certain cases, particularly in some European economies, current policies have taken longer than expected to bear fruit. In the meantime, as unemployment has increased, pressures to change current policies so as to expand employment opportunities have become more intense. In other cases, fiscal and trade imbalances have accumulated, creating conditions that might eventually disrupt the domestic economy - as well as the international economic system - in the event of there being no modification of existing policies. Many countries have continued to enact measures that tend to restrict international trade flows in spite of their declared intentions to the contrary. Moreover, among large industrial countries there is still an apparent inconsistency in the different targets they have set for their monetary policies and fiscal balances, which have had some undesirable effects on such key macro-economic variables as exchange rates and interest rates. Serious exchange rate misalignments, as measured against underlying trade trends, persist. Thus expectations of an eventual redirection of policies, even in major countries, still loom large and add to existing uncertainties.

The developing countries in particular have been adversely affected by rapid changes in the international economic environment. Swift changes in product and capital markets have required prompt adjustments by national economies in the early 1980s. For developing countries with rigid economic structures and low resource mobility, particularly the least developed countries, rapid adaptation to changing conditions proved difficult; in some of them, and in several other developing countries, there was a significant delay in redirecting economic policies. Partly as a result of this, the costs of adjustment rose and development faltered. While a prompt response to changed international economic conditions was, and remains, necessary, excessive instability in certain key markets has clearly been inimical to growth and development. The volatility of capital flows, interest rates and primary commodity prices has continued to make more difficult the formulation and implementation of long-term national economic strategies. It has also made private investors in developing countries very cautious about committing investment funds. Indeed, the recent policy thrust in many developing countries towards an increased reliance on market forces requires a modicum of stability in key markets, and would certainly benefit from a less volatile international environment.

Adjustment and trade policy

Economic policy in most developing, centrally planned and developed market economies through much of the 1980s has focused on adjusting domestic economies to a rapidly changing external environment. In general, the success of adjustment processes requires an expansion of investment to switch production capacity towards tradable goods, among other reasons. In particular, developing countries and some centrally planned economies need to expand exports to facilitate debt service payments. It is not clear, however, whether the prospective growth of aggregate world imports will be high enough to accommodate the intended export growth of all the adjusting countries taken together.

In this regard, encouraging developments have been

seen in efforts to intensify regional trading arrangements among socialist countries of Eastern Europe, among developing countries, and among the developed market economies of Western Europe, which have recently agreed to enlarge the membership of the European Economic Community. There is concern, however, that the strong surge in imports into the United States is likely to subside as the economy slows down and the dollar either stabilizes or depreciates. More generally, there is still concern that, after a year of vigorous recovery,protectionist pressures remain strong in the world economy.

The expectation that a strong recovery would bring about a roll-back of the protectionist measures enacted in the late 1970s and early 1980s was not fulfilled. In the recent past, liberalization measures have, on the whole, been outweighed by the introduction or intensification of non-tariff restrictions. These restrictions have been eroding credibility in accepted trade norms and have adversely affected trade-related investment. This is cause for serious concern since sustained world economic growth and progress towards the solution of the debt problem require a smooth expansion of international trade. The call for a new round of trade negotiations is a positive development, but this does not diminish the need for more immediate action. In particular, what is required is the prompt implementation of all the agreements of the Tokyo Round and of the 1982 GATT Ministerial Meeting, and a lowering of those barriers that today put a virtual ceiling on the trade levels of a large number of goods.

Wider imbalances in the United States economy

Despite the strong recovery of the United States economy in 1984, the budget deficit remained high. Since the Federal Reserve Board adhered to a firm non-inflationary stance, the financing of the United States budget deficit was achieved by capturing a significant share of world savings. This meant that upward pressures on real interest rates continued well into 1984. High interest rates and the overall strength of the United States economy encouraged further capital inflows and the dollar appreciated further, and that in turn, was a decisive factor in widening the United States trade deficit. While the volume of imports grew by more than 25 per cent, the strength of the dollar worsened the competitive position of some traditional United States exports and led to an intensification of protectionist pressures in that country.

Although in the recent past the large fiscal deficit in the United States has provided an important stimulus to final demand, the continuation of large budget deficits is likely to aggravate financial strains. Interest payments on the national debt already represent a significant share of government expenditures. An increase in the national debt at a pace similar to that of the recent past would rapidly escalate interest payments. This, in turn, would widen the structural deficit and exert a significant upward pressure on interest rates.

There is also growing concern regarding the sustainability of the large trade imbalance and, therefore, of the substantial current account deficit. Only a continuation of capital flows to the United States at the current rate would allow the situation to continue without strong downward pressures on the dollar. Such inflows are, however, contingent on the perceptions economic agents have of the relative strength of the United States and on their desire to accumulate dollar-denominated assets. The recent shift of the United States economy to a net debtor position, if accompanied by a change in expectations, could lead to considerable downward pressure on the dollar. This would increase the chances of either a rapid response by the Federal Reserve Board, leading to a jump in interest rates, or a rapid depreciation of the dollar, with disruptive effects on international financial markets, trade and investment.

The above considerations underline the critical importance of addressing disequilibria in the federal budget and the current account. In the current year, the United States federal budget deficit will be significantly higher than in previous years. However, the present administration indicated early in the year the need for a substantial reduction in the rate of growth of fiscal expenditures, starting in the fiscal year beginning October 1985, the objective being a gradual decrease in the federal budget deficit in that and the following years. A sizeable reduction in the federal budget deficit would not only ease pressures in financial markets but could also lead to a less restrictive stance being taken by the Federal Reserve Board. As a result, demand for dollar-denominated assets might subside, causing the dollar to depreciate somewhat and the trade and current account deficits to start narrowing.

The sluggishness of European economies

The improvement in some aspects of the economic performance of Western Europe in 1984 has given grounds for optimism and has led to an increase in business confidence in the region. None the less, there is still little evidence that the rate of economic growth will show any marked acceleration in the near future. The restructuring of public expenditure that is taking place in a framework characterized by fiscal discipline, the cautious monetary policies being pursued partly as a result of uncertainties over the movements of interest rates and exchange rates in international capital markets, the persistent rigidities in some segments of the labour market, and the protracted process of industrial restructuring together constitute, at least in the short run, an

impediment to a more dynamic economic expansion. Thus, in the aggregate, growth rates in these economies in 1985 and 1986 will not differ much from those of 1984 and average rates of unemployment will remain at the two-digit level.

Nor is economic growth in Eastern Europe likely to accelerate substantially in the immediate future. The economies of Eastern Europe have experienced a considerable recovery since 1983, but lingering problems prevent a quick return to high growth rates. Investments are advancing only at a modest pace, while persistent payments difficulties in some of these economies are allowing for only moderate increases in imports from hard currency areas.

Western Europe's trade plays an important role in its own and in the global economy. The region absorbs more than a quarter of the total exports of the developing countries and about a fifth of those of Eastern European countries, while Western Europe's exports to the two groups represent a significant share of its GDP. The hesitant recovery of Western Europe and the import constraints of those groups could therefore perpetuate a kind of vicious circle, unless past patterns are broken. Conversely, an upswing in Western Europe would boost import demand, aid the recovery of primary commodity prices, and ease the payments constraints of its partners. An improvement in the balance of payments of the latter would provide a significant impetus to world import demand and, in turn, to the economic growth of Western Europe.

Many countries in Western Europe now have more room for policy manoeuvre as a result of the significant slow-down in domestic inflation that has taken place, their lower budget deficits, the decrease of interest rates in international markets, and their steadily improving balance-of-payments position. Several of these countries could therefore use some fiscal stimulus to expand more rapidly. Such a stimulus assumes special importance at this juncture, when global demand may falter as the United States Government, in the downward phase of the business cycle, tries to correct its fiscal imbalance.

The debt overhang

Rapid export growth and recent debt reschedulings are giving a number of large debtor countries breathing space and allowing them some growth in imports. On the creditors' side, the financial situation has also improved. International commercial banks have significantly increased contingency reserves and their profits have generally recovered. Despite these developments, there is no room for complacency, however. Most developing countries with relatively large debts continue to face considerable balance-of-payments constraints, rates of growth markedly below historical trends, high unemployment, and major difficulties in expanding productive investment. In the large majority of such countries, real per capita incomes either stagnated or fell for the fourth consecutive year in 1984. No dramatic turnabout is envisaged for the current year.

In fact, underlying financial conditions have not fundamentally changed. Many debtor developing countries, particularly those in Latin America, have managed, through stringent adjustment measures, to achieve a considerable surplus in their balance of trade. The 20 largest debtor developing countries increased their aggregate surplus from less than $20 billion in 1983 to more than $30 billion in 1984. On the other hand, the increase in the United States prime rate and the London Inter-Bank Offer Rate (LIBOR) of 1984 led to a rise in interest payments and absorbed some of the gains achieved in the trade balance. Total debt outstanding continued to increase. Despite the rapid increase in exports, the ratio of interest burdens to export revenues remained virtually unchanged and many countries - some of them for a second consecutive year - effected a negative resource transfer.

The lack of progress in reducing the abnormally high ratio of interest payments to export revenues is cause for serious concern. In 1984, the ratio remained above 20 per cent for the group of large debtors and for many other countries of Africa and Latin America; in several of these countries it was over 35 per cent. If this situation persists, the positive results of rescheduling are likely to prove ephemeral. It is therefore crucial for the debtor countries that the decline in the prime rate and LIBOR that took place in late 1984 should continue and that further declines should take place, if possible. Otherwise, the slow-down in the growth of international trade envisaged for the current year and 1986 could lead to insurmountable payment pressures in the following years. The strains will not only retard development but might again threaten the stability of the international financial system.

Critical economic conditions in sub-Saharan Africa

Most countries in Africa south of the Sahara continue to face extremely difficult economic conditions. Their deep-rooted development problems, particularly in agriculture, are being exacerbated by a protracted drought and desertification in many areas. With the exception of a few countries, agricultural production did not increase to any significant extent in 1984 and in many areas per capita food production actually fell. Low, in many cases declining, export revenues and per capita incomes prevented a rapid expansion of food imports, thereby aggravating the food crisis. At present, nearly 30 million people face hunger and starvation in the region. Without massive food aid efforts, including

assistance for food distribution, the costs in terms of death and malnutrition, especially among children, could escalate sharply. The efforts of most of these countries to bring production in both the industrial and agricultural sectors nearer to capacity levels are still constrained by a tight domestic and external financial situation. International reserve levels in the majority of these countries have not recovered, and remain at unusually low levels, often preventing them from importing any products other than those required to satisfy their basic food needs.

The serious agricultural situation has led many African countries to re-evaluate and redirect their development efforts. National food strategies which take into account short-term conditions as well as the requirements for long-term growth, are being formulated and implemented. International support for these efforts remains critical for their success. Emergency assistance, in particular food aid, will, however, be required now and for some time to come, since most countries in the area remain very vulnerable. Despite a reorientation of policies and increased domestic efforts, erratic weather conditions will continue to cause considerable difficulties in some countries. Agricultural and food production may decline further, at least in the near future. Without a prompt and appropriate response from the international community to meet these crises, efforts to change long-term conditions may be jeopardized.

Restoring the multilateral framework for development

Despite the significant recovery in some industrial countries and a substantial pick-up in international trade, economic growth in developing countries has remained weak. The legacy of the global recession of the early 1980s is still affecting a large number of developing countries, so that at mid-decade, in half of the developing countries, per capita incomes are still below the levels attained in 1980. Investment levels have not yet recovered in many of these countries and, consequently, rapid growth in the near future is unlikely. This indicates that these countries will have to make enormous efforts to see an improvement in living conditions before the end of the decade. It also underlines the important role that more vigorous and sustained economic growth in the industrial countries and an enhanced system of international economic co-operation have to play in supporting domestic efforts by developing countries.

While there is a definite need for improved international economic co-operation, what is in fact being observed is a gradual erosion of the multilateral framework for development. New ways to bypass international trade rules have been found, thus preventing developing countries from taking full advantage of the international division of labour. The initial progress towards enacting measures to stabilize primary commodity prices has come to a halt. In the 1980s, concessional and non-concessional official flows have grown at a slower pace than in the previous decade. Access to compensatory financing, although somewhat expanded, has recently been jeopardized by conditionality requirements.

The domestic policies of any individual country will remain decisive in determining its growth performance. There is no substitute for policies to improve resource allocation, enhance the efficiency of public and private corporations and mobilize domestic savings. Nevertheless, the restoration of development at a global level certainly requires actions to stem the protectionist tide, increase market access for the exports of developing countries, and provide multilateral development institutions with growing resources. Increasing support for the multilateral financial institutions is of critical importance at this juncture. The prolonged global recession of the early 1980s has left many developing countries with insufficient international reserves and, generally, a worsened balance-of- payments position. Moreover, even with extraordinary efforts, many developing countries are not likely to obtain any significant access to fresh funds from private financial markets before the end of the decade.

An increased flow of official resources to support investments, particularly in trade-related activities, could prove crucial not only in accelerating growth but also in solving the balance-of-payments problem in the longer term. Official credits could also prove to be catalytic for developing countries which would like to avail themselves of increased private flows. These credits often pave the way for direct investment and increased flows from international commercial banks. There is a third compelling argument for a larger flow of official resources. The very difficult situation of the least developed and other low-income countries, in particular the critical situation of sub-Saharan countries, make necessary an increased flow of multilateral aid at this juncture. Multilateral financial institutions are an effective and efficient means of channelling such necessary official development assistance.

Concern over the lack of progress in resolving international monetary and financial issues has led many countries to reiterate their call for an international conference on money and finance for development. In effect, not only has progress in this area been insufficient in the 1980s but there seems to have been increased hesitancy on the part of major industrial countries to support substantive changes. However, the strengthening of the Bretton Woods institutions, and other more recent multilateral financial agencies, should remain an important objective. They are a critical part of the multilateral system, and the restoration of the multilateral framework requires their enhancement. Without it, development in the coming years could falter just as it did in the early 1980s.

Chapter II

MAIN FEATURES OF THE CURRENT RECOVERY

During 1984 and the first half of 1985, the economic recovery that commenced in the United States in late 1982 broadened and many economies, both developed and developing, slowly emerged from the protracted and disruptive recession of the early 1980s. The rate of growth of aggregate global output has risen from less than 3 per cent in 1983 to an estimated average of 4 per cent in 1984-1985, as growth in both the developed market and developing countries accelerated. Aggregate output of the centrally planned economies as a group has continued to expand at a significantly higher rate than in the period 1980-1982 (see table II-1).

Table II-1. Growth of world output and trade, 1979-1986[a]

(Percentage)

	1979	1980	1981	1982	1983	1984[b]	1985[c]	1986[c]
Gross domestic product								
World	3.4	2.0	1.7	0.7	2.7	4.6	3.6	3.2
Developing countries	5.0	3.2	1.3	-0.4	0.2	2.9	3.3	3.6
Developed market economies	3.1	1.2	1.5	-0.2	2.4	4.6	3.2	2.5
Centrally planned economies[d]	3.0	3.4	2.3	3.9	5.2	5.5	4.9	4.7
International trade								
World import volume	5.2	1.2	1.4	-1.2	2.0	9.0	6.0	4.5

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

[a] The classification of countries into the various analytical groups is shown in the explanatory notes at the beginning of this document. Output data for these country groups and for each member country are aggregated with weights estimated on the basis of 1980 prices and dollar exchange rates.

[b] Preliminary estimates.

[c] Forecasts (based on Project LINK and other institutional forecasts).

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

The economic expansion of the United States observed in 1984 has continued into early 1985, albeit at a more moderate pace. This has lent strong support to the renewal of domestic economic activity in Canada, Japan and some of the Western European economies, and has induced export-led growth in several developing country groups, especially East Asia and, to a lesser extent, Latin America. The revival of demand in developed market economies, especially in Western Europe, has also facilitated Eastern Europe's export expansion, which in turn has made it possible to alleviate the severe import constraints of the early 1980s and thus to accelerate the overall growth pace. In addition, there has been a continuation of strong self-sustained growth in China and India, the world's two most populous countries. Similarly, the Soviet Union has continued to grow, although at a more moderate rate, mainly because of gains in industrial production.

Significant but uneven growth

Despite the recent improvements in the overall world economic situation, the performance and the degree of progress of individual economies has been far from uniform. Aggregate growth rates (see table II-1) tend to mask the fact that a large number of countries, mostly the smaller economies in the developing areas, have not yet participated to a significant degree in the ongoing recovery, and to defuse the issue. Furthermore, in spite of a rather sharp acceleration since 1983, the rate of growth of real output in the developing countries has been only marginally higher than the rate of population growth. It is expected that real per capita income for the group as a whole at the end of 1985 will remain well below the level reached in the late 1970s.[1] In more than half of the 83 developing countries for which data are available, real per capita incomes either

[1] With an average rate of population growth of 2.5 per cent per annum, the population of the developing countries will have grown by almost 16 per cent during 1980-1985, while aggregate real output will have expanded by only 11 per cent.

stagnated or continued to fall in 1984 (see table II-2). Nearly all of the decline in real per capita income during 1980-1985 has been concentrated in Latin America, owing to the adverse ramifications of the debt situation, and in Africa, largely because of the severe drought and a weak export performance. The South and East Asian developing regions, in contrast, have made a remarkable gain in real per capita income during the same period.[2]

Table II-2. Number of countries with growth rates of real GDP at or below the rate of growth of population, 1979-1984

	Total sample size	1979	1980	1981	1982	1983	1984[a]
World	112	26	47	50	66	63	46
Developing economies	83	24	29	37	54	55	44
South and East Asia	14	2	3	0	4	3	2
West Asia	10	3	4	4	6	7	5
Western hemisphere	23	6	6	13	21	20	13
Africa	32	12	15	20	22	23	23
Mediterranean	4	1	1	0	1	2	1
Developed market market economies	22	1	6	11	10	8	2
Centrally planned economies[b]	7	1	2	2	2	0	0

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

[a] Based on preliminary data.
[b] Per capita net material product.

For the developing countries as a whole the average growth rate of real GDP in 1984, although substantially higher than in 1983, was only 3 per cent; this was 2 percentage points below those countries' average growth in the late 1970s (see table A-1). Real GDP in the energy exporters and energy importers grew on average by about 2 per cent and 3.5 per cent, respectively, which represented a significant decline in comparison to their average growth rates in the latter half of the 1970s. Finally, the unweighted mean growth rate in the period 1983-1984 was decidedly lower than in the corresponding recovery period of 1976-1977.

In 1984, Africa and the western hemisphere, despite their improved performance, still grew at 2.5 to 3 percentage points below their average growth rates of the late 1970s. The South and East Asian economies, on the other hand, grew at rates only slightly below their average trend rates (see table A-1). In general, the distribution of real GDP growth rates has remained quite skewed. Of the 83 developing countries for which data are available, 46 grew by 2.5 per cent or less, while only 16 countries achieved growth rates higher than 5 per cent in 1984 (see table A-1).

The overall rate of growth of developing countries in the western hemisphere in 1984 was only 2.7 per cent. The low rate of growth was strongly influenced by the economic situation and policies of the major debtors in the region. That group, which accounts for most of the region's aggregate GDP, has been following intensive adjustment policies to curb aggregate domestic demand, policies necessitated by the sharp intensification of their external payments difficulties resulting from the abrupt decline in the availability of external sources of finance. For those countries, the major source of output growth in 1984 was the rapid rise in exports, particularly of manufactures. Domestic growth impulses, on the other hand, have remained exceedingly weak.

The most disturbing feature of the world economy in 1984-1985 has been the precarious economic situation of developing countries in Africa. In 1984, the aggregate GDP of these countries grew by only 1.5 per cent, which is about half the rate at which their population increased. Although in a few countries the economic situation is beginning to show some improvement, it is still considered unlikely that the growth rate of real per capita income for the group as a whole will be positive in 1985.

[2] Annual rates of population growth being of 3.0 per cent in Africa, 2.5 per cent in Latin America and 2.1 per cent in South and East Asia, the respective cumulative growth of real per capita GDP in the period 1980-1985 for these regions is the following: for Africa and Latin America, losses of 15 per cent and 5 per cent, respectively; for South and East Asia, a gain of almost 20 per cent.

In a large number of these countries, domestic economic activity, particularly in agriculture and related processing sectors, has been sluggish for over a decade. The drought that has affected most of Africa, in some countries for the third year in a row, has caused further disruption to production. Superimposed upon these adverse domestic growth factors has been the impact of the unfavourable external economic environment. In 1984, unlike other developing countries which benefited from the global recovery, nearly all African developing economies had to face up to comparatively weak export demand. Their terms of trade *vis-à-vis* developed countries remained basically unchanged, after declining in 1982-1983.

Within the group of developed market economies, there has been considerable diversity in economic performance on account of the substantial divergence in initial conditions, as well as in the different mixes of macro-economic policies. Although the variation in growth rates has narrowed somewhat since the latter part of 1984, North America and the developed countries of the Pacific region, particularly Japan, are continuing to grow at rates that are 1 to 2 percentage points higher than Western Europe's average annual growth rate of 2.5 per cent (see table A-1). Even within Europe, however, there has been significant unevenness in economic performance (see table A-2); the northern countries have been growing at a higher rate than the European average, in contrast to France and several smaller economies.

These disparities in economic performance have also been reflected in the abnormally large differences in unemployment rates within the group (see tables A-3 and A-4). While the unemployment rate in the United States still remains high by historical standards, it has nevertheless been declining rather sharply. In contrast, there were more than 19 million persons unemployed in Europe in late 1984, which represented an increase of 3 million persons over 1982. Even more alarming is the youth unemployment rate in Europe, which has rapidly increased to rates of 20 to 30 per cent in several countries. In the United States, on the other hand, the number of unemployed persons fell by 2 million to a total of less than 10 million persons, as nearly 7 million new jobs were created, mostly in services and high technology industries; the youth unemployment rate declined from 17 per cent to 13 per cent during the same period. By contrast, the record on inflation has been more favourable and far more uniform. Inflation rates have continued to decline in nearly all countries within the group and they show a clear convergence (see tables A-3 and A-5).

For the group of developed market economies, it is clear that the experience of 1983-1984 differed significantly from that of the earlier cyclical recovery of 1976-1977. Both the average unemployment rate and its degree of variation, as measured by the standard deviation, have risen, while the average rates of output growth and inflation were significantly lower than in the earlier recovery.[3] There has also been a sharp decline in the degree of variation in inflation rates during the present cycle. The substantial decline in the rate of increase in unit labour costs that has taken place in nearly all developed countries since 1981, and falling or stagnating commodity prices, have been the major factors in reducing inflation rates. In turn, a combination of more moderate rates of increase in nominal wages and marked improvements in labour productivity levels have been the main cause for the slow-down observed in the rates of increase in unit labour costs. Improvement in labour productivity is normally of a pro-cyclical nature but, in several Western European countries, a substantial portion of the gain has resulted from continued labour shedding in manufacturing sectors. In the United States, in addition to the decline in the rate of increase of unit labour costs, the substantial

[3] Comparing the means and standard deviations of the real GDP growth rates, inflation and unemployment rates of the developed market economies, and those of the real GDP growth rate of the developing countries, in 1976 (the previous period of cyclical rebound) and 1984, the following results emerge:

	1976		1984	
	Mean	Standard deviation	Mean	Standard deviation
GDP growth rate				
All developed market economies	4.1	2.2	2.0	1.8
Seven major developed market economies	5.2	0.7	3.6	1.8
All developing economies	6.0	5.4	2.3	3.8
Inflation rate				
All developed market economies	12.2	6.4	7.1	5.3
Seven major developed market economies	10.0	4.5	4.7	2.3
Unemployment rate				
All developed market economies	4.5	2.0	8.0	5.3
Seven major developed market economies	5.3	1.9	8.7	2.8

appreciation of the dollar exchange rate has been a crucial factor in the remarkable improvement in inflation performance. Although the convergence in rates of growth of output has lagged behind that of inflation rates, the major source of variation in output growth rates in 1984 has been the diversity in growth patterns among the seven major developed market economies, particularly between the major European economies and the United States.

A critical factor for the sustainability of output growth as well as for the favourable inflation outlook in the developed market economies has been the sharp rebound in their investment outlays. During 1983-1984, business fixed investment in the seven major industrial countries as a group increased by almost 18 per cent cumulatively in real terms. The increased level of investment in most of those countries came about mainly because of the rapid rise in capacity utilization rates and the substantial improvements in business profits. This rapid rate of growth in investment was, however, largely accounted for by the substantial rise in investment demand in Japan and the United States. In fact, the strength of investment demand in these two countries during the present recovery was much greater than in the previous cyclical rebound of 1976-1977, despite the very high real interest rates of recent years. By contrast, the rate of increase in business investment in the major European economies during 1983-1984, though significant, was only half that of 1976-1977. In most developed countries, particularly the United States, a greater portion of the new investments was concentrated in the services sector and the high-technology industries.

An unusual and disturbing feature of the present recovery is the acceleration of inflation in a large number of developing countries. The average rate of inflation, as measured by the rate of change in the consumer price index, for developing countries as a group increased substantially, from 69 per cent in 1983 to more than 100 per cent in 1984, although there were important differences between and within subgroups. The average annual rate of inflation in the South and East Asian developing countries remained steady at levels well below 10 per cent and in some countries even declined, but inflation rates in West Asia and the western hemisphere experienced precipitous rises. In Africa, although the acceleration of inflation was less than in the above-mentioned regions, the average inflation rate was still in excess of 20 per cent per annum. The frequency distribution of inflation rates for a sample of 79 developing countries reported in table A-3 clearly shows that the degree of disparity increased significantly between 1982 and 1984. The number of developing countries with annual inflation rates of 5 per cent or less increased from 4 to 19, while the number of countries with annual inflation rates of 50 per cent or more also increased from 7 to 12.

Not only was there a larger difference in the average inflation rates of the different subgroups of developing countries than in earlier periods, but the acceleration took place at a time of severe underutilization of resources in these countries and a sharp abatement in inflationary pressures in the developed market economies. A major source of the increase in inflation rates has been cost pressures associated with the large and widespread currency devaluations that have been implemented in response to severe external balance constraints in recent years, particularly in Africa and Latin America. In a number of these developing countries, the devaluation of the local currency has been a part of the stabilization policy packages required by international banking and lending institutions as a condition for assistance for those in balance-of-payments difficulty.

Growth and trade dynamics

The recent upswing is unlike previous cyclical recoveries in that the major direct or indirect force behind it has been the unprecedented surge in import demand in one country - the United States. The latter's trade linkages and commodity composition of import demand have been the main determinants of the transmission of growth impulses during the present recovery.

After nearly four years of virtual stagnation, the volume of world trade increased by an estimated 9 per cent in 1984. This substantial increase has been a key reinforcing element in the autonomous recovery of several large industrial economies; it has also been the decisive factor in the export-led growth in a number of developing economies.

For the first time since 1979, the volume of world trade in 1984 began to expand at a significantly higher rate than world output, thus restoring the historical relationship between the two aggregates. Preliminary estimates indicate that this relationship will continue to hold in 1985, but, in comparison to the earlier recovery phase, the present rebound in trade volume is unusually lopsided (see table II-3). Nearly half of the rise in world trade in 1984 stemmed from the sharp increase in imports into the United States and its main trading partner, Canada, while import demand in Europe and in most developing countries remained sluggish. This has been the case mainly because of the rather weak recovery in the former group and extensive expenditure-reducing and expenditure-switching policies that have continued to weaken import demand in the latter group.

Among the developing countries, it was mainly the major exporters of manufactures in South and East Asia that experienced normal rebounds in import demand.

Table II-3. Geographical composition and quantum changes of world imports, 1976-1984

(Percentages)

Country or country group	Share in world trade[a]		Annual rate of change of import quantum	
	1976	1983	1976-1977	1983-1984[b]
World	100.0	100.0	8.0	5.4
Developed market economies	70.3	66.0	8.3	8.2
United States	11.5	15.3	16.0	19.0
European Economic Community	35.3	33.3	7.5	4.5
Japan	6.8	7.1	6.0	6.0
Developing countries	20.3	23.5	8.7	-0.6
Capital-surplus countries	3.6	5.0	24.6	-7.0
Capital-importing countries	16.7	18.5	5.3	2.0
Centrally planned economies[c]	8.0	9.8	5.1	4.4

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and *Direction of Trade Yearbook* and other official national and international sources

[a] Shares are based on merchandise imports valued in terms of dollars at current prices
[b] Preliminary.
[c] Eastern Europe and USSR only

Although imports of many energy-importing developing countries experienced a moderate pick-up in the latter part of 1984 and in early 1985, present import levels remain significantly below the previous peak reached in 1981. Moreover, because of falling oil prices and only a moderate increase in the volume of oil exports, the import demand of the energy-exporting developing countries has also been sluggish. In fact, a distinct feature of the world recovery has been the relative insensitivity of energy demand, particularly oil demand, to the economic recovery of industrial countries in the period 1983-1984.[4] Even the import demand of the capital-surplus countries, which enjoy high levels of international reserves, is expected to remain weak after a sharp decline of 20 per cent in that period. The import demand of the centrally planned economies, on the other hand, grew at a significant rate in 1983-1984 and was only marginally lower than the rate registered in 1976-1977.

The developments in the import demand of developing countries in recent years have had two important implications for the world economy. First, the reduction in import levels during 1982 and most of 1983 and the weak rebound in 1984 and early 1985 had a significant negative impact on the economic growth of the developed economies, particularly the more open economies of Western Europe. This is the opposite of what occurred in the recession years of 1974-1975, when the import demand of the developing countries remained strong and provided an important stimulus to the growth of the developed market economies.[5] Secondly, intermediate and capital goods constitute a major part of the imports of most developing countries. Since these are important determinants of industrial production and investment, the recent declines in imports have severely affected manufacturing output and the level of investment - and hence potential productive capacity.[6]

[4] Because of substantial energy conservation efforts in industrial countries in the 1970s, both energy consumption per unit of real output (GDP) and the share of oil in energy consumption have fallen significantly in recent years. Consumption of oil per unit of real GDP in developed market economies declined by more than 20 per cent between 1973 and 1983. For a detailed study of the experience of Western Europe, see Commission of the European Communities, *European Economy*, No. 16 (July 1983), pp. 31-59. See also Morgan Guaranty Trust Company of New York, *World Financial Markets*, January 1985.

[5] Estimates indicate that the favourable impact of the rise in the exports of the developed market economies to the developing countries during the 1975 recession amounted to 1 per cent of the real GDP of the developed economies. This is almost equal to the estimated negative impact of the decline in the developed countries' exports to the developing countries during the 1982 recession.

[6] Imports of machinery and transport equipment (Standard International Trade Classification (SITC) Revision 2, sect. 7) in 1979-1981 constituted between 35 and 40 per cent of the total imports of the developing countries.

In fact, the reductions in imports that a number of major debtor developing countries have been forced to make in order to achieve large trade surpluses and so meet the scheduled interest payments on their external debt have had important adverse effects on fixed capital formation which, in turn, has led to a weakening of autonomous sources of growth. Only those developing countries, such as Brazil and Mexico, which had extensive import-substitution industries already in place have been able to limit the damage from import compression.

In addition, the simultaneous and sharp increases in the trade surpluses of Japan and Western Europe in 1983-1984, which are expected to continue in 1985, indicate that, because of the relative weakness of their domestic demand, these economies have not been able to support the world economic recovery on the demand side.[7] Because of the existence of excess capacity in their manufacturing sectors and the weakening of their currencies *vis-à-vis* the dollar, these countries have, however, been able to meet the United States demand for imports in a non-inflationary manner and, through exports of financial capital, to meet the excess demand for savings in the United States that arose partly because of its large budget deficit.[8]

Nevertheless, it should be noted that the income elasticity of import demand in Europe and Japan is significantly lower than in the United States.[9] That is, even if domestic demand in Japan and Western Europe had been stronger, their imports would not have risen as sharply as North America's, although the disparity in import growth rates would have been far less.

Much of the asymmetry in import growth rates among the developed countries during the period 1983-1984 can, therefore, be explained by the cyclical demand imbalance between North America and the rest of the world, and by the significant differences in the income elasticities and in the commodity composition of their demand for imports. None the less, large changes in relative international price competitiveness among the major industrial countries began to play a more prominent role in determining trade flows in 1984-1985 than they had in 1982-1983. These large changes in competitiveness, which usually affect trade flows after a considerably longer time-lag than do income changes, have resulted from sharp swings in, and persistent misalignments of, key exchange rates. The misalignments first manifested themselves in 1981 and have become more severe in recent months.

Output-trade linkages and diversity of experiences

There is little doubt that the net effect of North America's recovery on many economies, during the period 1983-1984, has been both positive and significant. There are, however, two major issues concerning the United States recovery that must be considered here. First, the positive influence of the direct impact of the economic rebound in the United States and the gains derived from it have been unevenly distributed across countries and commodities, thus accounting, at least in part, for the diversity observed in economic performances in the period 1983-1984. Secondly, since 1983, a sharp decline in the external lending of United States banks has been accompanied by a marked increase in the capital flows from the rest of the world, particularly from Japan but also from some of the developing countries, into the financial markets of the United States.

These net inflows of capital, which have further intensified in early 1985, have presumably been attracted by the higher profitability of investment and the higher real rates of interest in the United States than in most other major industrial economies (see table A-6). The imported capital has definitely played an important role in the buoyancy of business investment and thus in the economic growth of the United States; by bidding up the exchange rate of the dollar, it has also helped to dampen inflation in the United States. Not all of the outcomes in this regard, however, have been positive for the United States. The effect of exchange rate appreciation on import prices has had a contractionary effect on the profitability of import-competing industries in the United States and has caused a significant erosion in the shares of United States manufacturing and farm products in international markets.

In sum, however, it is clear that the economic rebound in the United States, which through trade linkages has

[7] While ratios of imports to exports for Japan and Europe had been relatively stable during the period 1975-1977 (that is, from the trough to the peak of the previous recovery cycle), they declined sharply in 1982-1984. This also indicates that demand developments in Europe and Japan during the recent cyclical recovery have not facilitated the transmission of growth impulses as much as in the previous cycle.

[8] In regard to the increasing dependence of the United States on imported financial capital, see the comments of Mr. Paul Volcker, Chairman of the Federal Reserve Board, in *Financial Times* (London), 21 February 1985, pp. 1, 24 and 47.

[9] An empirical study of price and real income elasticities in 1964-1981 for Japan and the United States found that Japan's income elasticity of import demand is substantially less than that for the United States. For example, for every percentage point increase in the GDP growth rate, the volume of imports into the United States would increase, on average, by 2.7 percentage points, while in Japan it would increase by only 1.2 percentage point. Differences in income elasticities of import demand for manufactures are even more glaring: 3.1 for the United States compared to only 1.2 for Japan. Income elasticities for the major European economies lie somewhere between the estimates for Japan and the United States. For more details, see Commission of the European Communities, *European Economy*, No. 16 (July 1983), pp. 132-136.

benefited a number of developed and developing countries, has been favourably influenced by financial flows from the rest of the world. What is less clear is the extent to which the outflow of financial capital from those countries and the persistently high real interest rates, in part induced by the increasing size of the federal budget deficit in the United States, may have hurt or dampened the strength of recovery in the rest of the world.

Because of the strong rebound in domestic activity and the sharp decline in the price of imports expressed in dollars, the overall volume of merchandise imports of the United States increased by almost 40 per cent between 1982 and 1984. Imported manufactures, which constitute almost two thirds of the total imports of the United States, increased even more rapidly - by almost 60 per cent during the same period. Since the latter half of 1984, the growth rate of output has slowed down but, because of the appreciation of the dollar and its dampening effect on import prices, United States imports have continued to increase at a relatively high rate during the first quarter of 1985.

Hence, given the composition of the import demand of the United States and its existing trade linkages, the direct effect of economic expansion in the United States has mainly benefited the major exporters of manufactures, in both developed and developing countries. On the basis of partial data for 1984, it seems that at least the direct effect of the United States recovery has bypassed many of the smaller developing economies, particularly those that mainly export primary commodities. The impact of the recovery in the United States on developed economies has also been far from uniform.

Some of the aspects of the international transmission of growth are reflected in table II-4. For the developing countries, for example, the ratio of the level of their merchandise exports to the United States to their GDP is 3.7 per cent. As they experienced an estimated 20 per cent rise in their exports to the United States in 1984, the initial contribution (that is, not taking into account the secondary effects) of this rise was tantamount to an increase of 0.7 percentage point (20 per cent multiplied by 3.7 per cent) in their GDP in 1984.[10] Using the same procedure, the initial contributions of change in net trade (exports minus imports) *vis-à-vis* the United States to GDP growth rate in 1984 were as follows: energy-exporting developing countries, 0.5 percentage

Table II-4. World trade and output linkages: share of exports in GDP, 1982[a]

(Percentage)

Exports by country and country group[b]	Ratio of exports to GDP[c]	Trading partners						
		Developing economies			Developed market economies			
		All	Energy exporters	Energy importers	All	U.S.	Japan	EEC
Developed market economies	15.8	5.0	1.8	3.1	10.2	1.8	0.5	5.8
United States	7.2	2.6	0.6	2.0	4.4		0.7	1.7
Japan	13.2	6.2	2.2	4.0	6.7	3.4		1.6
European Economic Community	26.3	6.2	2.4	3.8	18.2	1.8	0.3	12.9
Developing market economies[d]	22.4	7.2	1.2	6.0	14.3	3.7	3.0	5.5
Energy exporters	35.5	10.8	0.7	10.1	23.0	4.3	7.1	10.2
Energy importers	16.5	5.3	1.3	3.9	10.4	3.4	1.3	3.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Direction of Trade Statistics Yearbook 1983*, OECD, *Main Economic Indicators 1983* and other official international sources

[a] Trade in services is not included. The figures in each line represent bilateral merchandise exports of the country or group of countries *vis-à-vis* the countries or groups in the columns divided by the GNP of the former. All figures are calculated from output and trade figures in current prices and dollar exchange rates.

[b] GNP data for Canada, the Federal Republic of Germany, Japan and the United States.

[c] The overall export-to-GDP ratio includes trade with the centrally planned economies.

[d] The developing country groupings used in this table are those of IMF (1982 classification), excluding China, Greece, Hungary, Romania, Portugal and South Africa. Greece and Portugal are included in developed market economies in this table.

[10] Taking into account the secondary effects, the final impact on the GDP growth rate would be even larger. Assuming an international trade multiplier of 2, which approximately measures the size of the secondary effects, as much as 1.4 percentage point of the 3.3 per cent GDP growth rate of developing countries in 1984 may be accounted for by the rise in their exports to the United States. This calculation, of course, takes into account the fact that imports of these developing countries from the United States during 1984 did not rise significantly.

point; energy-importing developing countries, 1.0 percentage point; Japan, 1.0 percentage point; European Economic Community, 0.4 percentage point.[11]

When the experience of developing countries during the present recovery is analysed on a less aggregate basis several important features emerge. First, the countries with stronger trade links to the United States have, on average, experienced higher export growth. Thus aggregation by groups leads to an underestimation of the benefits accruing to countries with stronger trade links with the United States and an overestimation of the gains of those with weaker trade links. For example, economies in Latin America and East Asia have benefited from the United States recovery far more than economies in other developing areas.

Secondly, the larger and more diversified economies with large production capacity have been better able to meet the sharp rise in external demand for their products than the smaller economies. Among the Latin American economies, for example, only Brazil and Mexico have been able to respond rather quickly to relative price changes and, by taking advantage of their large but underutilized production capacity, to increase sharply exports to North America. This recourse has not been available to many smaller developing countries.[12] In addition, improvements in international price competitiveness have played an important role in creating external demand, while the degree of responsiveness of domestic factors of production to changes in relative prices of traded and non-traded goods has helped determine the capacity to expand exports. This has been the case in a number of large developing economies that mainly export manufactures, in most of which the existence of substantial underutilized capacity in the manufacturing sector permitted expansion of output without significantly raising costs. Otherwise, certain production bottle-necks and an even sharper rise in domestic prices would have resulted. This, in turn, could have undermined international trade flows. In the case of most developing countries, however, the bulk of exports consists of primary commodities of which only a small percentage is consumed domestically. That is, a suppression of aggregate domestic demand in the case of these countries is unlikely to have any appreciable impact on export revenues.[13]

Thirdly, for a number of the developing countries, particularly the smaller economies and some of the major debtor energy-exporting countries whose export earnings grew only modestly, a substantial part or even all of the rise in export earnings in 1984 was offset by increases in interest payments on their external debt.[14] Indeed, capital outflows continued unabated in a few developing countries during 1984. These outflows, by adversely affecting the level of funds available for domestic investment, may also have exerted downward pressure on domestic growth in several developed and some developing countries. In Europe, the net outflow of capital has been large and exchange rates of key currencies *vis-à-vis* the dollar have been under pressure throughout 1983-1984 and in the early months of 1985. Some countries, in order to relieve the pressure on their exchange rates and to stem capital flight, continued their tight monetary policies. Real interest rates thus remained high - a situation hardly conducive to fostering a robust recovery.

Finally, the high degree of dependence of the European economies on each other and the smaller, but still important, degree of interdependence between Europe and the developing economies have played a critical role in shaping some of the features of the current recovery. Table II-4 sheds some light on both these aspects of global trading relationships. The ratio of intra-group exports of EEC to the group's aggregate GDP is about 13 per cent, while the sum of the similar ratios of EEC exports to Japan, the United States and the developing countries combined is only 8 per cent. This strongly suggests that a rebound in trade within EEC - which also applies to Europe as a whole - would be more stimulative to the group's GDP growth than a similar rebound in exports to countries outside the group. Hence, the sluggishness in Europe's recent recovery can, at least in part, be explained by the relative weakness of demand within the group; this, in turn, through feedback effects, has generated only modest growth impulses for the individual economies within the group.

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[11] The approximate figures for the initial impact (that is, not taking into account the secondary effects) for the major EEC economies (not reported in table II-4) were: Federal Republic of Germany, 0.8 percentage point; France and the United Kingdom, 0.3 percentage point each; Italy 0.5 percentage point. It should be pointed out, however, that the overall contribution of the trade sector to the GDP growth rate of some of these countries, particularly the Federal Republic of Germany, has been less than the above figures would suggest. This is because, for the Federal Republic of Germany and some other countries, part of the stimulus arising from improvements in the real trade balance *vis-à-vis* the United States in 1984 was offset by increased imports from third markets, such as France and some smaller European economies.

[12] For a more detailed analysis of this argument concerning the Latin American developing countries, see Economic Commission for Latin America and the Caribbean, "Preliminary overview of the Latin American economy during 1984" (LC/G.1336, 17 January 1985)

[13] For more details, see E. Eshag, *Fiscal and Monetary Policies and Problems in Developing Countries*, (Cambridge, Cambridge University Press, 1983), pp. 240-241

[14] For example, in 1984, while the oil exporters of Latin America increased their exports by $2.5 billion, their net payments of interest and profits also increased by $2.5 billion.

Similarly, the ratio of the Community's exports to the developing countries to its GDP is 6.2 per cent, which is almost three times the ratio of its exports to Japan and the United States combined. It should be noted, however, that in regard to trade with developing countries, the EEC countries as a group, in comparison to either Japan or the United States, are far more dependent on exports to Africa - a region that has been especially depressed in recent years. For their part, the developing countries as a group depend more on the European markets for their exports than on either Japan or the United States, although there are important exceptions. The East Asian exporters of manufactures, for example, depend more heavily on the markets in North America and Japan. Nevertheless, the mutual dependence of Europe and the developing countries, two groups that have been particularly depressed economically in recent years, goes a long way towards explaining their sluggish recovery in the period 1983-1984.

Intensification of imbalances

The process of recovery during the past two years, besides producing a significant acceleration of growth rates in many countries, has produced certain imbalances that, given present trends and policies, are likely to remain, perhaps even worsen, in the years to come. The persistence of major disequilibria in the world economy may well threaten the prospects for longer-term sustained global expansion. Equally threatening are the consequences of sharp and abrupt adjustments in the real and financial variables.

Among the major signs of disequilibrium in the world economy are persistent misalignments of key exchange rates, high nominal and real interest rates by past standards, movements of financial capital in volumes never witnessed before, large and progressively increasing current account imbalances in a number of developed countries, and perverse capital account and unusual trade balance developments in a number of capital-importing developing countries.

Initially, the main source of these imbalances was the lopsidedness in the rates of growth of domestic demand in the major developed countries. For example, between the end of 1982 and the beginning of 1985, domestic demand in real terms increased by nearly 16 per cent in the United States, while it rose by only 6.1 per cent in Japan and 3.8 per cent in Western Europe. In effect, major differences in macro-economic, particularly fiscal, policies have played a crucial role in bringing about the observed differences in growth patterns.

The differences in the timing of the cyclical rebounds were important in producing large trade imbalances. Countries that recovered earlier experienced a sharp rise in their imports while demand for their exports remained sluggish, resulting in a deterioration of their trade balances. The opposite was true for those countries that lagged behind. The trade balance (on an f.o.b. basis) of the United States deteriorated sharply, from a deficit of $37 billion in 1982 to a deficit of about $110 billion in 1984, while that of the other industrial countries, particularly Japan, and some of the developing countries began to experience sharp improvements. During the same period, the major debtor countries, by increasing their exports and compressing their imports, increased their trade surpluses by more than $25 billion, while the net energy-importing developing countries reduced their combined deficit by more than $30 billion.

Under normal circumstances, as the growth rates of domestic demand begin to converge and exchange rates adjust in accordance with the fundamentals - in particular current account positions, inflation rates and GDP growth rates - the external imbalances begin to be corrected, but during 1984 and early 1985 the opposite occurred. The major reason for this worsening of the imbalances was the misalignment of key currencies. The dollar became progressively stronger even when the current account deteriorated and the inflation rate and the rate of growth of output converged to the levels of its trading partners. That is, some of the underlying economic factors, particularly the worsening of trade deficit, would indicate that the dollar should be much weaker *vis-à-vis* other major currencies than is actually the case.

The strength of the dollar comes partly from high current and expected future interest rates and partly from the perception of international investors that, somehow, profitability of investments in the United States is, and will remain for the foreseeable future, higher than in other countries.[15] Since early 1984, capital has been flowing into the United States at an annual rate of around $100 billion. Interest rates in the United States, however, are likely to remain high as long as the present mix of macro-economic policy, namely, expansionary fiscal and tight monetary policy, is kept in place. The demand on the part of international investors for dollar-denominated assets has overwhelmed the negative expectations that

[15] Two recent studies show that profitability of invested capital has improved relatively more in the United States than in either Japan or the EEC countries as a group in recent years. Results of a study by the Commission of the European Communities (*European Economy*, No 22 (November 1984), pp 77-93) that shows that the gross rates of return on invested capital (enterprises excluding housing) in the United States have been significantly higher than those in the EEC and Japan since the mid-1970s are reported in table VI-8 below. Another study (*OECD Economic Outlook*, December 1984, pp 82-85) also indicates similar results.

fundamentals have generated, so that the dollar has appreciated when the fundamentals have clearly signaled its fall.

By lowering import prices in the United States and by making that country's products more expensive in the international markets, the strength of the dollar is now the major force behind the worsening of the United States current account position. Hence, contrary to any previous experience, the capital account surplus has become the driving force behind the worsening of the current account deficit in the United States. Moreover, while real interest rates in the United States remain high, many developing countries, particularly the major debtor countries, will be forced to continue to run large trade surpluses, both by attempting to increase exports and by compressing their imports, in order to service their external debt.

The emergency in sub-Saharan Africa

The economic situation in many African countries, which had seriously deteriorated during the global recession of the early 1980s, on balance did not improve in the course of 1984. Overall output in sub-Saharan Africa increased by less than 1 per cent, which was far from sufficient to match the nearly 3 per cent rate of population growth. As shown in table II-5, the rate of growth of real GDP during the past four years has on average been declining, and was clearly negative for a large number of countries. This implied a sharp deterioration in per capita income levels, which for some countries had not improved to any significant extent in the previous decade. Current forecasts for a resumption of positive growth in per capita incomes in 1985 and beyond are not at all encouraging. In fact, most indicate that, given the prevailing environment, it is unlikely that growth in sub-Saharan Africa will equal population growth during the rest of the decade.[16]

Table II-5 Developing countries in sub-Saharan Africa: average annual rates of increase in key variables, 1971-1984

(Percentage)

	1971-1975	1976-1980	1981-1984
Real GDP			
Total	4.4	2.6	-0.9
Energy importers	2.6	1.9	0.1
Energy exporters[a]	5.9	3.1	-1.8
Agricultural production			
Total	1.3	1.9	1.5
Per capita	-1.7	-1.3	-1.7
Food production			
Total	1.3	2.1	1.4
Per capita	-1.7	-1.1	-1.8
Cereals			
Total	1.3	1.8	-2.1
Per capita	-1.7	-1.5	-5.2

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

[a] Angola, Cameroon, Congo, Gabon and Nigeria

Food situation in drought-stricken countries

The acute severity of the famine that is afflicting countries across the Sahel and over much of eastern and southern Africa has become a major global concern. Although fewer countries were seriously affected by the drought in 1984 and 1985 than in 1983, the crisis is more severe in terms of human suffering and lost

[16] Based on projections of Project LINK (4 March 1985) and other forecasts

production opportunities.[17] The hardship experienced in 1983 has intensified in some countries: more people have been threatened by starvation and have already starved, as a result of further declines in food supplies, additional livestock losses, and continuing logistical difficulties. The prospects for the immediate future are not very encouraging, partly because of continuing weather uncertainties, but also owing to a very severe outbreak of crop diseases and further desertification as a consequence of the persistent drought in certain areas. The social, economic and human costs of this calamity can be only partially assessed at this stage.

According to estimates at the end of 1984, about 30 million people - roughly one fifth of the total population of the 20 sub-Saharan countries - are severely affected by the famine; of these about 10 million have had to abandon their communities in search of food and water. About half of the migrants were in overcrowded temporary shelters in early 1985. Many children have already died of hunger-related causes in 1984 and a large segment of the population in the affected countries face permanent physical and mental damage from chronic malnutrition.

The countries stricken by the current drought include the entire spectrum of the agro-ecological zones. Even those with a favourable ratio of population to arable land, including Angola, Mozambique and the Sudan, or with a good potential for increasing agricultural production (Lesotho, Senegal, United Republic of Tanzania and Zambia) are nevertheless suffering from food shortages. In some of the former countries, civil disturbances or an influx of refugees or both have disrupted agricultural production and food distribution, magnifying the effects of the drought. In the latter group, crop failures have widened the structural food deficits. Coupled with the contraction of export earnings, this erosion of food self-sufficiency has slowed down the pace of other domestic economic activities.

Although severe famine conditions have prevailed in all 20 drought-emergency countries, the threshold of famine and the prospects of early recovery vary with the agro-ecological zones. The incidence of large-scale population displacement is higher in the pastoral zones and in the marginal areas with sedentary farming populations. Even this process occurs in stages and culminates in large-scale population movements after the exhaustion of local food reserves, livestock, and sources of water. In arid and semi-arid areas, over the last decade, an estimated 25 per cent of the usable pastoral land has been destroyed by increasing grazing pressures, and the remaining areas rendered vulnerable to the process of desertification. Reductions in flows of streams and in the replenishments of shallow water basins have curtailed livestock production, hydroelectric power generation and irrigation. In a number of the northern countries there have already been far-reaching negative consequences for the traditional ways of life in the predominantly nomadic-pastoral societies.

The famine is the consequence of three years of substantial declines in agricultural production per capita in the drought-stricken countries (see table II-6). Per capita cereal production, in particular, has dropped by

Table II-6. Sub-Saharan Africa: agriculture, food and cereal production per capita, 1975-1984[a]

(Annual rates of growth)

	1975-1984	1981	1982	1983	1984
Sub-Saharan Africa					
Agriculture	-1.7	0.3	-0.8	-7.0	0.2
Food	-1.5	0.7	-1.2	-7.2	0.2
Cereals	-3.1	1.4	-5.2	-14.8	1.2
20 drought-stricken countries					
Agriculture	-2.5	1.6	-3.7	-4.9	-4.3
Food	-2.4	2.8	-4.5	-6.0	-5.2
Cereals	-4.8	9.8	-13.4	-10.8	-15.9

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on FAO, *Production Indices*.

[a] Country indices weighted by 1974-1976 gross value added in agriculture expressed in 1975 prices and dollars

[17] FAO, *Food Outlook*, No. 2 (1985), p. 4. See also the reports of the Secretary-General on the critical social and economic situation in Africa (E/1984/68 and Add 1, 26 April and 5 July 1984) and on the review of the emergency rehabilitation and reconstruction situation in food-aid and drought-affected countries (A/39/594, 23 October 1984), and the report on the emergency situation in Africa (SG/CONF.2/1, 22 February 1985).

about one third since 1981. In 1984, production levels were below the average reached in the mid-1970s in 14 of the 20 countries (see table A-7). Although growth in agricultural output was positive in some countries in the early 1980s, 1984 was an especially bad year for production in 17 countries, and in the 3 others the recovery has only partly compensated for the set-backs experienced in the previous years. The magnitude of the output set-backs has been considerable, especially in Burundi, Chad, Ethiopia, Kenya, Lesotho, Mali, the Niger, Rwanda, the Sudan and the United Republic of Tanzania.

Faced with the crisis in food production, the African countries, with the assistance of the international community, have been almost wholly preoccupied with emergency relief efforts. It is beyond doubt that substantial foreign assistance is still needed to come to grips with the current shortages of food, the displacement of wide segments of the nomadic population in the most seriously affected countries, the shortage of seed for next season's planting, and the enormous losses of breeding livestock.[18] This fact has been recognized by the international community, which has made relief and rehabilitation in Africa a clear priority for action.

Sub-Saharan Africa in the international economy

While the African drought has heavily influenced total output levels in the sub-Saharan region, a number of international factors have also had a role in determining the short-term behaviour of output and incomes. One such factor has been the uneven recovery of export earnings. In many countries export revenues remained weak, affecting not only domestic incomes but also government revenues and thus fiscal balances. In 1984, the global demand for and therefore the international prices of primary commodities, including those exported by the sub-Saharan countries, have continued to be weaker than would normally be expected at this phase of the international economic cycle. In fact, since the second half of the year, the prices of many commodities have been sliding downwards, resulting for some commodities in a lower average price in 1984 than in 1983 (see table II-7). For the energy exporters also, the fall in international petroleum prices has further eroded export revenues. Together, these price trends have had debilitating effects on many of the sub-Saharan countries that depend for the bulk of their foreign exchange revenues on exports of primary commodities.

A second growth-determining factor is the volume of imports, which is estimated to have fallen in 1984 for the region as a whole, adding another year to the overall period of contraction thus far in this decade. From 1981 to 1984, the average decline in real imports was on the order of 5 per cent a year. This reduced import capacity was however the result not only of adverse trends in international trade but also of cut-backs in international financial flows.[19] Official development assistance, in particular, has stagnated in real terms (see table II-7). Fourteen sub-Saharan countries restructured their official or commercial bank debt or both through 28 multilateral debt renegotiation exercises in 1983-1984, but the new terms by themselves have not allowed for a relaxation of the balance-of-payments constraint on imports. Indeed, in early 1985 many countries were accumulating debt-servicing arrears at a rapid pace.

It is widely recognized that domestic policy reforms need to be implemented for a higher and sustained rate of growth and for a smoother and more efficient adjustment to changing international economic conditions.[20] Yet under the impact of natural disasters and unusually adverse weather conditions in some areas, combined with severe balance-of-payments constraints across the sub-Saharan region, there has instead been a massive retrenchment, a weakening of institutions, and much human suffering. Because an increasing proportion of domestic and foreign resources is necessarily being allocated to relief activities, investment in infrastructural rehabilitation and the restoration of production capacity is being curtailed.

In view of the present situation in Africa and the limited capacity of most of the African countries to interact with the global economy, even a sustained recovery of the world economy is not likely to bring marked relief to much of Africa in the near future. The external debt situation of sub-Saharan Africa will continue to exert a significant constraint of its own. Despite the fact that a substantial portion of the debt is on concessional terms, total interest payments absorbed over 10 per cent of

[18] The scale of the emergency in the 20 drought-stricken countries is such that $1.5 billion of additional funds will be required to meet the most urgent needs of those countries. FAO has estimated that the sub-Saharan region will need 9.6 million tons of food aid in 1985, of which 6.7 million tons will be required in the 20 drought-stricken countries. There are three major short-term issues of particular concern to the international community: aid pledges thus far have remained short of targets, deliveries have not been made on time, and the logistic obstacles to the movement of food aid inside the affected countries remain severe; see FAO, *Food Outlook*, No. 2 (1985), pp. 4-6)

[19] The most dramatic change concerned new commitments by private lenders to low-income Africa, which fell from $1.4 billion in 1980 to $149 million in 1983. Lending from official sources contracted by 33 per cent in nominal terms over the same period; see World Bank, *World Debt Tables*, 1984-1985 edition (Washington, D.C., 1985).

[20] See *World Economic Survey 1984* (United Nations publication, Sales No. E.84.II.C.1), pp. 15-20 and 98-104; World Bank, *Toward Sustained Development in Sub-Saharan Africa: A Joint Programme of Action* (Washington, D.C., 1984), "Progress in implementation of food plans and strategies in Africa" (WFC/1985/2, 25 February 1985); and *Sub-Saharan Africa: Towards Oblivion or Reconstruction, Journal of Development Planning*, No. 15, (United Nations publication, Sales No. E.85.II.A.6).

Table II-7. Developing countries in sub-Saharan Africa: international trade, reserves and ODA, 1979-1984

	1979	1980	1981	1982	1983	1984
			Billions of dollars			
Merchandise exports						
Total	39.0	52.1	38.8	33.9	31.0	33.0
Energy importers	16.5	19.0	15.2	13.9	13.8	14.5
Energy exporters	22.5	33.1	23.6	20.0	17.2	18.5
Merchandise imports						
Total	32.3	44.9	42.9	43.7	36.6	32.5
Energy importers	18.9	24.0	20.9	21.2	19.3	19.0
Energy exporters	13.4	20.9	22.0	22.5	17.4	13.5
			Months			
Import coverage of reserves						
Total	2.0	2.2	1.5	1.1	1.2	1.4
Energy importers	1.3	3.0	1.1	1.2	1.5	1.4
Energy exporters	0.9	3.7	2.9	1.1	0.9	1.4
			1977 = 100			
Prices of main export commodities						
Cocoa	87	69	55	46	56	63
Coffee	74	66	45	49	55	62
Copper	152	166	133	113	122	105
Cotton	108	132	118	102	118	114
Groundnut oil	103	102	123	69	84	120
Sugar	119	353	208	104	104	64
			Billion of dollars			
Real net ODA disbursements[a]	7.0	7.6	7.9	8.0	7.7	...

Source. Department of International Economic and Social Affairs of the United Nations Secretariat, based on UNCTAD, *Monthly Commodity Price Bulletin*, IMF, *International Financial Statistics* and *World Economic Outlook* (Washington, D.C., 1984) and OECD, *Development Co-operation, 1984 Review* (Paris, 1984)

[a] In 1982 prices and exchange rates (nominal dollar values deflated by the ODA deflator of DAC member countries)

foreign exchange earnings in 1984, a share that will not fall in the next few years without a significant increase in export revenues. Moreover, payments of principal during 1985-1987 will be between two and three times the payments made during 1981-1983 for the group of countries as a whole.

Both the immediate and the structural aspects of the situation in the region have been in the forefront of concern about Africa and have motivated the Secretary-General of the United Nations to launch a special initiative to focus international attention on the present crisis, to help in mobilizing additional resources and to improve through concerted action the efficacy of international assistance efforts. Substantial development assistance measures are required to help countries to tackle the endemic causes of the problems that have plagued Africa for over a decade and to embark most rapidly on the needed recovery, rehabilitation and reconstruction activities. Apart from the emergency assistance to alleviate the severity of the drought, substantial resources from abroad, in financial and other forms, have to be mustered.

The international community has increasingly recognized the importance of seeking to meet these needs. This has been reflected, for example, in resources pledged to fund a Special Facility for Sub-Saharan Africa in the World Bank and in the substantial pledges of assistance made at the Conference on the Emergency Situation in Africa in March 1985. Nevertheless, despite these and a number of bilateral and other commitments, projections still point to a decline in net concessional capital flows to sub-Saharan Africa over the next several years in the light of the curtailment of some flows and the increases in scheduled amortization. The international resource mobilization effort is still incomplete.

Chapter III

MACRO-ECONOMIC POLICY STANCES AND THE SHORT-TERM OUTLOOK

Caution, restraint and adjustment

The global policy setting during the early months of 1985 which will determine economic performance in the short term has on the whole changed very little since 1984. The dominant policy in many countries of all country groupings is characterized by caution and restraint. This policy mode, which has strongly conditioned the process of recovery, particularly outside North America, has emerged as a consequence of important changes in the policy aims and in the stated priorities of the majority of developed market economies since the late 1970s. The fundamental economic priority in most industrial countries has decidedly changed; rather than aiming for full employment and steady growth through heavy government intervention and market regulation, their goal is to achieve low inflation and growth through increased reliance on market forces. The reinforcement of market mechanisms that has been widely advocated by many Governments basically comprises the deregulation of product, factor and financial markets and, in a number of countries, the privatization of publicly owned enterprises. Accordingly, although with some major exceptions, there has been widespread adoption of rules for stricter control of monetary aggregates and far less emphasis has been placed on fiscal stimuli. The overall thrust of policy in the developed market economies in 1985 has, therefore, remained anti-inflationary while only cautiously accommodating the rise in the level of economic activity through changes in the targets for monetary aggregates.

In most European countries and in Japan, Governments have continued to reaffirm their commitment to the policy objective of reducing the role of the public sector in economic activity. In compliance with the oft-stated goal of "fiscal discipline", there has been widespread curtailment of public sector spending - more often a reduction in the inflation-adjusted rate of increase of public spending. As an essential part of the new fiscal programme, there has also been a concerted effort on the part of Governments to reduce the ratio of the budget deficit to GDP. An important exception has been the fiscal policy stance of the United States, which has in fact been highly expansionary since 1982. Despite the stated desire of the United States Government to reduce the size of the public sector in the economy and to curtail the ratio of the Government's budget deficit to GDP, both ratios have been increasing. On the other hand, the monetary policies of Japan, the United States and Europe have been far less divergent than the stances on fiscal policy, and have continued to follow a cautious path of accommodating the recovery in output growth while keeping inflationary expectations in check.

It should be stressed, however, that in general the monetary authorities in Europe and, to a lesser extent, in Japan have had less room for manoeuvre than those in the United States. In the recent past, what has strongly influenced the adoption of cautious policies in Europe and Japan, and in some instances necessitated excessively restrictive stances, has been the new situation of large external imbalances, massive movements of financial capital, and the resulting sharp swings in exchange rates and interest rates. Monetary policies have been less accommodating and interest rates higher than desired levels, particularly in some of the major European economies during 1984 and early 1985, to prevent further erosion of their currencies *vis-à-vis* the exceptionally strong dollar and to stem the outflow of financial capital.

Macro-economic policies in a large number of developing countries and some of the centrally planned economies of Eastern Europe have also been highly restrictive. The policy stance in these countries has been strongly influenced by the emergency adjustment programmes put in place in response to the earlier external shocks. Particularly in the major debtor countries, the restrictive policies have remained in place because of the continued international financial constraints.

In sum, at least in the short run, the macro-economic policy stance in most developed market economies - with the notable exception of the United States - and developing countries has not been conducive to a strong rebound in domestic demand. Policy makers, especially in the developing countries, have been mainly concerned with the effects of external economic developments, such as the evolution of international interest rates, exchange rates and balance-of-payments constraints, on their domestic economy. These policy constraints have in turn been crucial factors in explaining the large reliance of many countries on external stimuli for their economic growth and in bringing about the observed lopsidedness in economic performance during the present phase of the recovery.

Policy inconsistencies in developed market economies

The major issues of concern to policy makers in the developed market economies largely relate to continuing macro-economic policy inconsistencies between the United States and the other major developed countries.

They include, especially, the relatively weak recovery and high unemployment rates in Europe, the international debt crisis, the high variability of key exchange rates, the massive flows of capital, and rising protectionism in trade. A common thread relating these issues to one another and to the overall policy stance within the group is the prospective evolution of nominal and real interest rates over a period of time.

A major distinguishing feature of the present recovery, in comparison to previous recoveries, is the high level of *ex post* real interest rates in the developed market economies.[1] Table III-1 sets out the main macroeconomic indicators for the major developed countries, and shows that, during the 1976-1977 recovery phase, real interest rates (short-term and long-term) were very low or negative, and the differentials between interest rates in the United States and the average of the major developed market economies were quite small. During the present recovery, the opposite has occurred. Not only have real rates become much higher but also large differentials, particularly in long-term rates, between the United States and the average of the major industrial economies have persisted.

There are several competing explanations for the high and rising real interest rates of the early 1980s. A prominent one is that the combined effect of tight monetary and expansionary fiscal policies in the United States led to high rates there and, given the increasing integration of capital markets in recent years, to a subsequent adjustment of interest rates in the rest of the world. Another explanation centres on the high and rising current and prospective budget deficits in the United States. It is also argued that the demand for world savings has grown while the supply has fallen, the reasons being the sharp rebound in world investment demand on the one hand and the deterioration in the current account position of the capital-surplus developing countries on the other. Finally, attention has been directed to the deregulation of financial markets and the removal of interest rate ceilings in several major developed countries, and also to the higher risk premiums, particularly in long-term bond rates, caused by a greater degree of uncertainty. It is possible that all of the above explanations are, in fact, correct and that each has been an important factor in explaining the rise in real interest rates in the early 1980s. There is some empirical evidence, though still preliminary and somewhat tentative, that tends to give more support to the view that high real interest rates have come about chiefly because of the current policy mix in the United States and the policy responses in the other major industrial countries.[2] In any event, if there were no major change in policy stances, because of massive capital flows into the countries with initially higher rates of interest, rates should, perhaps with some time-lag, tend to equalize among the major economies.[3]

The figures given in table III-1 for the rates of change in the real money supply and in the income velocity of money indicate that monetary policy in most of the major developed market economies was quite restrictive in 1982 and 1983. That is, the rate of increase in real money balances, together with the declining income velocity of money, accommodated only a very low rate of growth in real output. The rise in demand for money, induced by nominal interest rates and inflation rates declining from their peak levels in 1980-1981, was unexpected and led to abrupt declines in the income velocity of money. This helps to explain why in several countries there was a further tightening of monetary conditions, perhaps in excess of what the policy makers had initially intended.

In 1984, however, monetary policy in the United States on the whole became relatively more accommodating, particularly as income velocity began to increase. On the other hand, the policy stance in some of the major European economies, mainly because of their fear of a further depreciation of their currencies *vis-à-vis* the dollar, remained fairly restrictive - that is, it did not accommodate more than a 2 to 2.5 per cent annual growth in real output. Moreover, whereas several major European economies succeeded in effectively decoupling their interest rates from those in the United States

[1] The nominal interest rate (via the so-called Fisher equation) is defined as the real interest rate plus the expected inflation rate. There used to be a belief among classical economists that expected real interest rates are constant and that changes in the nominal interest rates would mirror changes in the expected rate of inflation. Experience since 1979 has clearly demonstrated, however, that real interest rates can change significantly because of monetary and fiscal disturbances. Since there is no agreement about how to calculate the expected rate of inflation, in most instances the current rate of inflation (or a moving average of past inflation rates) is utilized to deflate the nominal interest rate to obtain a measure of the "real" interest rate. The rate of interest derived in this manner is usually called the *ex post* real rate of interest. For a more detailed discussion of the variability of real interest rates, see Eugene Fama, "Short-term interest rates as predictors of inflation", *American Economic Review*, No. 3 (June 1975); and F. Mishkin, *A Rational Expectation Approach to Macroeconomics* (Chicago, University of Chicago Press, 1983).

[2] For a detailed discussion and empirical evidence on the causes of high real interest rates, see Oliver Blanchard and Lawrence Summers, "Perspectives on high world real interest rates", *Brookings Papers on Economic Activity*, No. 2 (1984), pp. 273-324; and comments by Alan S. Blinder in the same journal, pp. 325-330.

[3] The empirical evidence in this regard is scant and it is generally quite difficult to establish the direction of causation. A recent empirical study of the linkage of short-term real rates between the United States and Europe found that real interest rates in the United States are exceedingly high by historical standards and that there is a significant but less than perfect association between the real interest rates in the United States and those in Europe, but that the direction of causality is not clear; see Robert Cumby and Frederic S. Mishkin, "The international linkage of real interest rates: the European-United States connection", National Bureau of Economic Research, Working Paper No. 1423 (Cambridge, Mass., August 1984).

Table III-1. Major developed market economies: monetary and fiscal policy stance, 1976-1984

(Percentages)

	1976	1977	1981	1982	1983	1984[a]
Rate of change in real broad money supply (M2)[b]						
Major industrial economies	5.5	4.8	1.6	3.8	5.2	3.5
United States	8.5	5.0	0.7	4.7	7.5	3.7
Four major European countries	1.5	4.3	-0.8	1.9	-2.4	2.1
Rate of change in income velocity of money (M2)						
Major industrial economies	-0.2	-1.0	0.5	-3.2	-3.0	-1.4
United States	-1.8	-1.0	2.5	-5.0	-4.5	3.0
Four major European countries	3.0	0.5	0.5	-0.7	-1.7	0.8
Real interest rates[c]						
Major industrial economies						
Short-term	0.0	-1.0	4.3	4.0	4.5	5.3
Long-term	1.5	1.2	4.2	5.5	6.2	7.3
United States						
Short-term	-0.2	-0.6	4.5	5.0	5.0	5.5
Long-term	2.5	1.0	4.1	6.5	6.6	8.3
Four major European countries						
Short-term	-0.1	-1.5	4.4	3.1	2.9	4.1
Long-term	0.7	0.3	3.8	3.7	4.3	5.0
Nominal interest rates						
United States						
Short-term	5.0	5.3	14.0	11.0	8.7	9.5
Long-term	7.7	7.5	13.9	13.0	11.1	12.4
Structural changes in general government financial balances[d]						
Average of major industrial economies (excluding the United States)	0.1	0.4	0.2	0.7	0.3	0.3
United States	1.3	0.2	0.9	-1.3	-0.6	-0.5

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

[a] Preliminary.

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

[c] Interest rates deflated by the rate of change in GNP deflator. Short-term rates are the bank rate or the call money rate. Long-term interest rates are the yield on long-term government bonds.

[d] Change in structural budget balance as a percentage of nominal GNP. A positive sign indicates a move towards restriction (surplus) and a negative sign indicates the opposite (deficit). These figures are based on OECD, *OECD Economic Outlook*, No. 36 (December 1984), table 3.

during most of 1984, they were forced to raise their interest rates and to tighten further their monetary stance at the end of the year, mainly because of impending outflows of capital and currency depreciations.

The fiscal policy stance is best measured by excluding changes in government budget deficits that result from cyclical movements in the rate of economic activity. Table III-1 gives a measure of only the change in structural budget balances. The figures indicate that in the early 1980s fiscal policy in the United States has been highly expansionary while in the other major industrial economies, taken together, it has actually been highly contractionary. In the period 1981-1984, the structural budget balance, as a percentage of GDP, in the major developed economies, excluding the United States, moved towards surplus (contraction) by a total of 1.3 percentage point, while that of the United States moved towards deficit (expansion) by 2.4 percentage points. Given that the United States economy constitutes nearly half of the aggregate GDP of the seven major developed economies, this would indicate that for the group as a whole the structural balance moved towards deficit (expansion) by 0.5 percentage point of the group's GDP during the same period. The evidence strongly supports the view that the policy mix of the major developed market economies as a whole during the early 1980s has been that of a fairly tight monetary stance together with an expansionary fiscal policy.

Rising levels of public sector debt in nearly all developed economies in recent years have been an important fiscal development, which has led to expectations on the part of world financial markets of continuing high real interest rates in years to come. In 1984, the ratio of public sector debt to GDP for the group as a whole exceeded 50 per cent. This represented an increase of 11 percentage points over the same ratio in 1970. As the direct result of both rising debt levels and rising interest rates, public sector interest payments have become an increasingly important contributor to structural budget deficits. For the developed market economies as a whole, the ratio of interest payments on public debt to GDP increased from 2 per cent in 1970 to nearly 5 per cent in 1984.

Such a rapid accumulation of public debt makes the structural budget balances highly sensitive to changes in interest rates in the medium term. In fact, this situation can have destabilizing effects on both the national and the international economy.[4] Like a vicious circle, policy mixes such as those described above result in high interest rates which, in turn, lead to even larger structural budget deficits in the future. As the experience of the last two decades has clearly shown, persistent public sector structural deficits and attempts by monetary authorities to monetize those deficits eventually rekindle inflationary pressures. In this context, the future stance of monetary policy is an additional source of uncertainty in financial markets.

Hence, if the current mix of macro-economic policies does not change significantly, it is virtually certain that high real interest rates will remain an important feature of the world financial system in the foreseeable future.

Adjustment policies in developing countries

For the vast majority of developing countries the first half of the 1980s has been the most difficult period since the depression years of the 1930s. It has been a period of arduous testing of their economic resilience and of their ability to adjust in the face of abrupt changes in the global economic environment. Policy makers in these countries have had to deal with a sequence of external shocks that have led to internal economic and social imbalances and dislocations of increasing magnitude and complexity.

The deep and protracted recession in industrial countries in 1981-1983 and its adverse impact on the export volume and the terms of trade of developing countries, the energy price increases of 1979-1981, the steep rise of international interest rates since 1981 and the sharp cut-back in international lending since 1982 have combined to hit many energy-importing developing economies extremely hard. Although the severity of the external shocks varied substantially across developing countries, the abrupt cut-off in the supply of external finance, even to several energy exporters, left nearly all of them struggling with the prospect of current account deficits that could not be financed.

Given the urgent need to redress the external imbalances and the fact that key factors affecting their current account balances were beyond their control, most developing countries reacted initially by compressing imports through measures of expenditure reducing and switching, such as real exchange rate changes, wage policies and a host of import controls. That is, in most instances the adjustment policies embarked upon were on an emergency basis and *ad hoc* in nature. Several developing countries have, however, been implementing medium-term structural adjustments by allowing more flexibility to critical prices, including interest rates and real wages, and by improving management techniques. The objective has been to achieve a high rate of growth of productive capacity, particularly in the tradable goods sector.

Nevertheless, the overall stance of macro-economic policy in a large number of developing countries during 1984, and continuing into 1985, has remained restrictive. The exception is a number of Asian economies whose successful export drive and superior "creditworthiness" have to a large extent ensured their continued access to external finance. For many other developing countries, however, the overriding policy objective in 1985 is still to improve their current account positions, even if this entails continued losses of employment and low output growth in the short run.

Although the data on the pertinent policy indicators for all developing countries are not yet complete, it appears that in a large number of countries there have been significant reductions in the rate of increase of public sector expenditures and in the size of government budget deficits. In several countries, moreover, the rate of increase in the money supply has declined noticeably. In addition, there have been changes in regard to two

[4] In the medium term, the stability of the ratio of the stock of debt to GDP depends on the ratio of the budget deficit to GDP, the nominal growth rate of output and, most importantly, the level of the nominal rate of interest. In fact, the situation is stable if the growth rate of nominal GDP exceeds the nominal rate of interest over the medium term. If that relation does not hold, then the public sector is required to reduce the deficit (or increase the surplus) on the non-interest portion of its financial balance to guarantee financial stability. For a study of budgetary issues of members of the Common Market and issues related to medium-term financial stability, see Commission of the European Communities, *European Economy*, No. 22 (November 1984), pp. 122-135.

important policy-determined prices, namely interest rates and exchange rates, which have significant short-term as well as long-term economic consequences. In a large number of countries, nominal interest rates have been raised significantly to curb domestic demand for borrowing, to encourage a higher rate of saving and to discourage capital flight. For the first time in years, some developing countries have begun to experience positive real interest rates. In general, many high inflation countries, particularly those under IMF-sponsored adjustment programmes, have made serious efforts to allow nominal interest rates to reflect the rate of inflation.

The most widely implemented policy measure, however, has been sharp currency devaluation to curb import demand, help promote exports and improve the efficiency of resource allocation. In a large number of developing countries, especially those with IMF arrangements, nominal devaluations have been far greater than the difference between the domestic and international rates of inflation, thus resulting in sharp depreciation of real exchange rates. Although currency devaluations have helped to boost exports and curtail imports, they have also generally entailed high short-term costs. Apart from the losses of real income brought about by the resulting acceleration of the inflation rate, real depreciations of currency have had important fiscal repercussions. In particular, they have raised considerably the amount of real domestic resources required to service the external debt.[5] Consequently, many Governments have been forced to increase tax rates, and to expand the tax base, in order to reduce budget deficits and to compensate not only for the effects of devaluation but also for the erosion of tax revenues caused by the decline in incomes, profits and import levels.

The degree of policy restrictiveness has varied substantially from case to case depending on the magnitude of the imbalances to be corrected, the options available in regard to external financial arrangements, and the nature of the political constraints faced by the Governments. Many low-income countries, in particular countries in sub-Saharan Africa, have had very little room for policy manoeuvre: their international reserves have remained at unusually low levels, their capacity to import has not increased to any significant extent and substantial resources have had to be used to compensate for the pervasive set-backs in food production. In addition, these countries are highly dependent on ODA, and for them an increase in the level of such assistance is the most critical factor that would enable them to climb back to the path of sustained growth, but the level of such assistance to them has virtually stagnated in real terms. Meanwhile, most of them have suffered sharp declines in their terms of trade. Several have been under the high conditionality programmes of IMF and have therefore been following very restrictive policies. The plight of African countries in the sub-Saharan region and their policy responses are discussed in detail in chapter II above.

In the course of 1984 and until February 1985, more than 30 developing countries - including 17 African and 11 Latin American - drew from IMF resources under conditional facilities, primarily under stand-by arrangements. Among them are nearly half of all the major debtor countries, namely, those with a gross external debt in 1984 of $10 billion or more. The major debtors with IMF programmes account for nearly 50 per cent of total debt outstanding and more than a third of the aggregate GDP of the developing country group. Thus the success or failure of these countries' adjustment programmes would have an important impact not only on the global debt problem but also on world trade and output growth in the medium term.

Despite the significant improvement seen in the external accounts of the developing countries and the progress made by many of them in 1984 towards achieving a more manageable external debt position, the debt problem has refused to go away. The large-scale debt restructuring, rescheduling of amortization payments, and additional lending effected during 1984 were conditional on the continuation of severe and radical adjustment policies on the part of the major debtor countries. Obviously, despite short-term progress in regard to external accounts and debt positions, the short-term costs of those policies, in terms of lost output and employment, have been quite high. In addition, adjustment programmes have often entailed perverse changes in income distribution that in several cases have heightened internal social and political tensions. In fact, falling real wages, sharp rises in interest rates and increases in tax rates have caused abrupt declines in the levels of disposable income of the more vulnerable segments of the population in a large number of developing countries. Most of the Governments concerned, particularly those that have achieved great improvements in their external positions, are now seeking less restrictive and more flexible adjustment programmes than those currently required by the creditors under the auspices of IMF. On the other hand, there are fears in the international financial community that if monetary and fiscal measures are relaxed, allowing for higher rates of output growth, the external imbalances may reappear in the medium term. It is argued that a loosening of macroeconomic policy before complete fiscal discipline and sharp reductions in inflation rates have been achieved would jeopardize the improvements that have been made regarding both the current account positions and the relative burden of external indebtedness.

[5] Carlos F. Diaz-Alejandro, "Latin American debt: I don't think we are in Kansas anymore", *Brookings Papers on Economic Activity*, No. 2 (1984), pp. 335-403.

During 1984, several large-scale debt reschedulings, contingent upon the adoption of adjustment programmes, were negotiated among the Governments of the debtor countries, IMF and the major international commercial creditors. Of particular importance to the international financial community were the agreements reached with the largest debtors - Argentina, Brazil and Mexico - as they signalled that the debt crisis had apparently been brought under control. The wave of relative optimism thus generated helped to allay fears in certain financial centres of an impending disruption in the international monetary system, and this reduced the prevailing high degree of uncertainty.

Nevertheless, since late 1984 a number of the major debtor countries have encountered increasing difficulties in meeting some of their domestic policy targets as envisaged in their adjustment agreements. The severity of the austerity measures to which they agreed poses an increasingly serious political problem for the Governments of the debtor countries. Non-compliance with the monetary and fiscal targets has led in some cases to difficult renegotiations and in others to a temporary suspension of the IMF loan programmes.

In contrast to most other developing economies, adjustment to the external shocks in Asian countries began earlier and was done more gradually and with greater access to external financing. This has allowed the policy mix in many of these countries to accommodate significant increases in the rate of growth of real GDP - in some cases along historical trends. Even among the major debtor countries the situation has been less unfavourable for the Asian economies. Although relative debt levels, as measured by the ratios of total external debt to GDP and its composition of short-term versus medium- and longer-term maturities, are quite similar between the Asian and Latin American major debtors, there are significant and important differences between these regions in their capacities to service the debt. Most importantly, the Asian economies are, on average, more open than the Latin American countries. Therefore, for a given level of GDP and external debt, the ratio of debt service to export earnings is far smaller for the Asian debtors than the Latin American. In addition, the Asian exporters of manufactures have, on average, a firmer hold on their export markets which, in turn, tend to be more dynamic than those faced by the Latin American exporters. Even so, the sustained economic growth in the United States and the developed countries of the Pacific region, particularly Japan, remains a critical factor for the continued economic success of the East Asian developing countries.

It is important to note that the debt-service ratio, which is frequently used by lending institutions as one of the indicators of "credit-worthiness", and thus as a determinant of the amount of new external financing, is in general more sensitive to external factors than to domestic policies and adjustment programmes - at least in the short run. In fact such a ratio is usually very sensitive to changes in international interest rates, the growth rate of the industrial countries, and the degree of trade protectionism in those countries.

The energy-exporting countries, although in general less affected by the debt problem, have also been following restrictive policies. Because of the impact on both their export and government revenues of the glut in oil markets and the resultant declining trend of oil prices in international markets, most of these countries have been forced to take drastic action in regard to their current budgetary commitments and their longer-term development programmes. The policy stance, even in countries with substantial levels of international reserves and accumulated assets, has been quite restrictive. The type of policy followed in most of these countries has been similar to those of non-oil countries; the emphasis has been on trimming the size of the government sector's deficit and scaling down large investment projects, while encouraging a more active role for the private sector. In general, however, many of these countries, unlike the net energy importers, have avoided sharp devaluations of their currencies *vis-à-vis* key world currencies.

In contrast to most developed countries, which have elected to follow restrictive monetary and fiscal policies in response to their internal economic problems, the policies of retrenchment in developing countries have been necessitated largely by external imbalances brought about by external shocks. Although there have been major differences among the developing economies in regard to both policy stance and the international economic environment facing them, in most cases the continuation of contractionary macro-economic policies has been made inescapable by severe cut-backs in the supply of external finance.

Moreover, the experience of 1983-1984 has clearly demonstrated to the developing countries that, although domestic policies and the reforms and effectiveness of their adjustment programmes are important for determining whether or not they regain their growth momentum, the economic condition and macro-economic policies of the developed countries have an even greater impact. For a great majority of developing countries in all country groups, whether energy exporters, major exporters of manufactures, commodity exporters or major debtors, the rate of economic growth, the level of interest rates and the degree of openness of the import markets of the developed market economies will remain critical factors for their long-term development.

Main developments in the centrally planned economies

The gradual strengthening of economic activity in the developed market economies has had fairly significant repercussions on virtually all centrally planned economies, but to markedly different degrees. The growth process in countries such as China and the Soviet Union has remained largely an autonomous one, although in both countries exports, particularly of fuels, contributed measurably to the sustainability of imports and overall growth. In sharp contrast to these vast economies with their great variety of natural and other resources, the Eastern European members of the group are much more dependent on trade, not least for their fuel needs. Furthermore, the latter economies since the early 1980s - and earlier in the case of Poland - have been affected much more strongly by global economic events than countries that can pursue largely autonomous economic policies. The upturn in the pace of economic growth in some of the major economies in Western Europe in particular has therefore been of considerable importance to the recovery in Eastern Europe since mid-1983. As for the Asian centrally planned economies other than China, they do not trade very intensively and the bulk of their trade is in any case conducted with other centrally planned economies, so that the impact on them of fluctuations in global levels of economic activity and of shifts in the economic policies of the developed market economies has been far smaller than in Eastern Europe.

The financial crisis of 1982-1983 and the global recession, which sharply curtailed the import demand of market economies, have had important implications for short-term economic policies in Eastern Europe. Those disturbances were superimposed on the adjustments necessitated by the earlier shifts in relative prices and the significant deterioration in the terms of trade of the fuel-importing countries, both with the market economies and the fuel exporters of the Council for Mutual Economic Assistance (CMEA). Consequently, in action similar to the externally induced policy manoeuvres in major debtor developing countries, several Eastern European economies have had to resort to absorption-compressing adjustment policies in order to curtail import demand and to free goods for export. Most of these policies were adopted on an emergency basis with little region-wide or even national dovetailing of economic policies and thus had more or less important ripple effects on the course of economic policies within Eastern Europe. The nature of these policies as well as their results have, however, differed in several respects from the adjustment efforts characteristic of developing countries, as analysed in greater detail in chapter VI.

There were sharp differences in the overriding short-term objectives of macro-economic policies embedded in the 1984 plans of China, the USSR, Eastern Europe and the other planned economies. While the USSR was bent on maintaining the comparatively buoyant development attained in 1983 and China aimed at sustaining the rapid pace of growth registered in the past five years, all Eastern European countries sought to strengthen their recovery, but largely within the framework of policy objectives elaborated in the earlier years of the decade.

In the countries of Eastern Europe, a modest recovery from the unusual growth slow-down of the early 1980s had started in mid-1983, chiefly owing to the fact that Poland reversed its declining output trend, which had started in 1979. None the less, as in the previous years, a high policy priority was still accorded to the external sector in 1984, reflecting the need of those countries to avert a worsening of their current account positions as a consequence of a further deterioration in their terms of trade.[6] Without exception, the Eastern European countries aimed at a current account surplus, especially in convertible currency relations, in order to service and compress their external debt.

The chief means to generate further improvements in external accounts, especially in relations with market economies, was the promotion of rapid export growth. At the same time, the import restrictions that had been adopted to moderate and restructure domestic demand were retained. Although the Eastern European countries had already accomplished substantial adjustments to the changes in domestic growth conditions and in the external environment, Governments on the whole remained cautious in setting growth targets. However, as a result of the significant easing of supply bottle-necks and of more efficient use of material inputs, the balance-of-payments constraint could be loosened in the course of plan implementation. This afforded a faster pace of output growth without jeopardizing the current account objective.

The impetus to an acceleration in the increase of activity levels in Eastern Europe stemmed from demand as well as supply factors. Though significant changes in domestic demand have occurred over the past two years, especially with respect to investments, the fastest rising demand component was exports, especially to countries outside the CMEA region, which outstripped the growth of output. The increase of exports to Western Europe at a pace exceeding the assumptions embedded in the plans made possible a cautious relaxation of

[6] This deterioration was fairly significant within the CMEA trading area. Intra-CMEA trade prices are patterned after the average world market prices of the preceding five years. 1984 was the first year in which the full impact of the second oil price shock of 1979-1980 was funnelled into the CMEA price formula. As a result, intra-CMEA fuel prices continued to rise markedly in 1984, while world prices were on the decline.

constraints on input supplies from abroad, which had hampered the achievement of plan targets in previous years. This easing in turn allowed most countries of the group to expand further the level of industrial activity. The externally related adjustment process pursued in Eastern Europe since the early 1980s, especially in Poland and Romania, was continued, albeit in a more balanced and less restrictive manner than before.

The foreign trade sector thus contributed significantly to sustaining the revival of output growth in Eastern Europe. However, since output accelerated faster than income uses, in order to generate the increased external surplus, the impact of trade on domestic absorption, on balance, remained negative for the third year in a row in most countries. The muted transmission of output recovery to domestic demand stemmed in large part from weak investment levels. The upturn in investment activity in the second half of 1983 was not sustained for very long, except in Poland and Romania, where previous cut-backs had been more extensive. In fact, the relaxation made possible by the external improvement appears to have been utilized primarily to ease supply constraints in some consumer markets. This marked a return, except in Poland, to one major feature of the adjustment policies pursued before the financial crisis, namely, the protection of levels of living already attained. This has been one of the major differences between adjustment policies in centrally planned and in developing countries.

As shown in table A-8, there has been a noticeable improvement in the short-term economic situation of all Eastern European countries.[7] The 5 per cent pace of economic activity in 1984, although below post-war trends, represents a substantial acceleration compared to the period 1979-1982, when output stagnated. There were strong recoveries in industrial activity, excellent harvests and pronounced gains in economic efficiency in nearly all countries. The latter was facilitated, on the supply side, by a cautious reformulation of investment policies and plans, some reorganization of economic planning and administrative procedures to foster efficiency, the removal of bottle-necks, and a more efficient use of material inputs. Together with the general benefits of growth acceleration for productivity levels, these supply factors afforded sizeable increases in average efficiency levels, even though capital productivity continued to lag behind expectations in most countries.

The chief beneficiary of the improved external situation has been industry, which expanded well above planned levels in all countries except Bulgaria, but the overall growth performance was also significantly affected by excellent crops. Agricultural output surged by about 7 per cent over the preceding year and was the highest ever achieved by the group as a whole. Not only did this give an important boost to the acceleration of overall output growth and to higher capacity utilization in processing sectors; it also freed scarce foreign exchange and continues to provide an extra degree of policy freedom for the remainder of 1985.

In contrast to Eastern Europe, economic growth in the Soviet Union in the early 1980s benefited markedly from terms-of-trade gains and the gradual easing of major bottle-necks, especially in transportation. Energy resources and growing revenues from energy exports in particular facilitated the financing of grain imports required by successive below-plan harvests without a substantial deterioration in current account. However, in contrast to the upturn witnessed in Eastern Europe, in 1984 economic growth in the Soviet Union slowed from 4.2 per cent to about 3 per cent - below planned levels. This deceleration stemmed mostly from the stagnation in agriculture, where grain output was below plan for the sixth year in a row.[8] The failure to reach output targets in key energy sectors also adversely affected growth. Owing to special circumstances,[9] non-agricultural import demand of the USSR slackened in 1984, so that the country contributed little to the expansion in global demand. At the same time, additional efforts had to be made to maintain hard currency export revenue levels because of weakening oil prices. On balance, this produced a further, albeit slight, increase in the external surplus.

The strong output growth registered in China during the first three years of the current five-year plan[10] continued in 1984. In spite of ongoing institutional reforms that are partly aimed at increasing profitability and fostering greater efficiency, the economy in 1984 expanded by about 12 per cent - well above the already very high 9 per cent growth achieved in the previous year. Continued above-average performance in agriculture, buoyed by favourable weather and the ongoing agricultural reforms first started in 1979; a more balanced, though very rapid expansion, in industry; and continued high growth of investment activity were the chief factors contributing to the rapid expansion observed in 1984. While China maintained a substantial current account surplus in 1984, its level declined appreciably from the preceding year's. In that sense, China can be said to have contributed to expanding global demand for tradable goods. The largest beneficiary was Japan, but imports from the developing countries also rose, by one quarter in current value.

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[7] Individual country results are shown in detail in table VI-1.

[8] No official crop output figures are available, but the grain harvest is estimated to amount to about 166.5 million tons as against the roughly 240 million tons planned; see FAO, *Food Outlook*, No. 2 (1985), p. 21.

[9] Especially the completion of several large import-intensive pipeline projects.

[10] All major output targets for 1981-1985 were reached - or nearly - by the end of 1983.

The outlook for growth in the short to medium term in the centrally planned economies is uncertain at this stage. In Eastern Europe, plans for 1985 continue to emphasize the external priority. There is therefore no impetus to any strong acceleration of output growth. The outlook is similar for the Soviet Union, where recovery in agriculture from the adverse performance in 1984 is anticipated and the industrial expansion will continue at roughly the pace obtained in 1984 (about 4 per cent). Detailed plans for the other countries are not yet available, but general policy discussions suggest cautious expansion, with the exception of China, where a moderation of growth may be required in order to focus on industrial reform.

Growth in Eastern Europe in 1985 is not likely to diverge significantly from the average pace observed in 1984 as further economic adjustment remains the number one priority. The margin by which output growth exceeds investment growth is indicative of the intention to maintain the external surplus, particularly with convertible currency countries, at or near 1984 levels while allowing domestic final consumption to move ahead somewhat faster than proved feasible in the past five years or so.

The medium-term outlook depends in important respects on the policies and plans for 1986-1990, which may inaugurate institutional as well as policy shifts in many countries. In the case of China, the comprehensive industrial reform to be introduced gradually during the rest of the decade, as announced in October 1984, involves considerable restructuring of the urban economy, but the scope, modalities and precise timing of the industrial reform are yet to be worked out, probably in the course of 1985. A first phase of the reform was launched in early 1985,[11] comprising a set of measures that will eventually be incorporated into a comprehensive industrial price reform. This encompasses the gradual removal of acknowledged irrationalities in the price system which will have an impact on both the level and the structure of prices.

For the European centrally planned economies, it remains of crucial importance to work out a joint approach to the modernization of their economies. The first economic summit of the CMEA members in 15 years, which took place at Moscow from 12 to 14 June 1984, and the follow-up CMEA Council session (Havana, 29-31 October 1984) do not yet appear to have sufficiently narrowed the differences in the approaches to achieving a substantial acceleration of economic growth in the region. Both meetings have made it clear, however, that important policy initiatives, especially to dovetail national plans and to harmonize the interests of selected manufacturing enterprises of different countries, are in the offing, probably in conjunction with the new five-year plan cycle.

A particularly important aspect of the medium-term growth outlook is the course of investment policies. In the first half of the 1980s investment retrenchment has been considerable; in spite of a modest recovery in 1983-1984, levels of investment run well below their long-term trend. Given the deep-seated problems facing these countries, far-reaching changes in the structure of output and consumption are required. A resumption of investment growth is essential if the centrally planned economies are to continue to adjust to the new external economic environment as well as to the ongoing changes in domestic growth conditions.

The medium-term and long-term implications of the recent sluggish investment activity are as yet unclear. They hinge on the degree to which these countries will be able to step up factor productivity growth. This depends importantly on CMEA-wide economic policies and on how the issues will be concretely dealt with in the new medium-term plans.

Whether the recent retrenchment will inevitably impair future growth depends on the sustainability and strengthening of the recovery in the years to come. An important support for such a course would be either to raise investment levels sharply, which is difficult to achieve since it would require further reductions in levels of living, or to restructure the investment process in conjunction with other improvements in the allocation and use of available resources. The changes in economic mechanisms that are currently being sought in several countries may in time benefit the investment process. Another crucial consideration is the buoyancy of the world economy. To the extent that the latter is sustained, the continued moderate growth of investment envisaged for the rest of the decade may nevertheless offer an opportunity, by changing investment priorities, to foster output growth chiefly on the basis of factor productivity gains through greater integration within CMEA and more intensive trade relations with the market economies.

Short-term outlook for the world economy

The short-term outlook for the world economy for the next two years, based on information available in early 1985, is reasonably optimistic, although the diversity of output growth rates within both developed and

[11] *China Daily* (Beijing), 9 January 1985, p. 1

developing country groups and the declines in per capita incomes in some of the poorest developing countries are likely to continue. These projections are, as usual, strongly conditioned by the assumptions made concerning the prospective values of key global economic variables and the policy parameters in the major developed market economies. Nevertheless preliminary indicators for the performance of several large economies during the first quarter of 1985 conform rather closely to the model-generated projections.[12]

The major assumptions embedded in the baseline projections are achievement of the fiscal and monetary policy targets announced in the developed market economies; a fairly smooth and orderly adjustment in international financial and exchange rate markets - in other words, it is assumed that there will be no abrupt shifts in expectations; only a marginal decline in dollar-denominated oil prices in nominal terms between 1985 and 1987; no prospective rise in trade protectionism on the part of developed countries during the projection period; and growth in line with the experience of 1983-1984, on average, in the centrally planned economies.

The forecast for global output is for an average annual rate of increase of about 3.5 per cent in 1985-1987. This projected growth rate, although representing a drop of 1 percentage point in comparison to the 1984 rate, is significantly higher than that of the early 1980s and only marginally below the rate registered in the late 1970s. The path of the projected expansion over the period is not smooth, however; it is forecast that the pace will ease to 3 per cent in 1986 and rebound slightly, to almost 4 per cent, in 1987, mainly on account of a projected cyclical slow-down and recovery in the United States.

The salient features of the baseline forecast for 1985-1987 are presented in table III-2. The volume of world trade is expected to grow at 6 per cent in 1985, which would represent a drop of 3 percentage points in comparison with 1984 - largely because of the anticipated slow-down in the rate of increase in the United States import volume. However, the average rate of growth in 1985-1987 is expected to be 5 per cent per annum, which is about 1 percentage point below that of 1976-1980.

On the whole, the growth forecast for the developing countries - with the exception of South and East Asian economies - in 1985-1987 is disappointing. In fact the projected average growth rate of output in 1985-1987 is just over 3.5 per cent, which is almost 1.5 percentage point below that of 1976-1980. The output growth rates forecast for the developing countries, although showing gradual improvements for all regional groupings during the projection period, also indicate that there will be further decline in per capita GDP for Africa as a whole in 1985-1986 and only a modest increase in 1987. Although Latin America on aggregate is expected to experience positive per capita income growth, this is not so for all members of the group. Furthermore, the rates of per capita income growth forecast for the group are far below those attained over the post-war period as a whole.

Another salient feature of the projections is the gradual convergence of real GDP growth rates in the developed market economies, particularly in 1985 and 1986. Western Europe as a whole is expected to grow at a steady rate of about 2.5 per cent, while the United States economy is forecast to experience a mild slow-down, induced mainly by inventory adjustments.

The economic performance projected for the developed market economies in 1985-1987 suggests several differences from that in the latter half of the 1970s. First, the GDP growth rates of Western Europe and Japan are projected to be significantly smaller, whereas the United States economy is projected to grow at about the same rate. Secondly, average inflation rates are expected to converge further to a level that, on average, is much lower than that of the 1970s. The most remarkable improvement in this respect is that of Western Europe, which shows a 5 percentage point drop in comparison to the average rate in 1976-1980. Thirdly, the unemployment rates projected for North America and Western Europe are substantially higher than those of the earlier period. Particularly disturbing is the very high rate of unemployment projected for Western Europe, which is double the average rate in 1976-1980. In fact, in contrast to Japan and North America, the unemployment rate in Western Europe is forecast to continue to increase, albeit only marginally, during the projection period, despite the steady rate of output growth. This rise in the unemployment rate can be attributed to a significant extent to structural rigidities in labour markets and, although to a far smaller degree, to inadequate levels of aggregate demand.

The outlook for trade associated with those projections for 1985-1987, but not included in table III-2, is for large imbalances in the external positions of developed market economies. The trade deficit of the United States is projected to increase sharply, from $120 billion in 1985 to more than $150 billion in 1987. On the other hand, the trade balance positions of the other developed market economies, particularly the Federal Republic of Germany and Japan, are expected to

[12] The projections are mainly based on Project LINK's baseline forecast, prepared for the Secretariat in early March 1985. The key exchange rates are flexible in the LINK system and the nominal effective exchange rate of the dollar depreciates only gradually and smoothly during the projection period.

Table III-2. Short-term outlook for the world economy, 1985-1987

(Average annual or annual percentages)

	Actual		Projections			
	1976-1980[a]	1981-1984[a]	1985	1986	1987	1985-1987[a]
World volume of trade	6.0	3.3	6.0	4.5	4.5	5.0
Real GDP						
Developing countries	5.0	1.1	3.3	3.6	4.3	3.7
Africa	4.4	-0.3	3.0	3.0	3.5	3.2
South and East Asia	5.9	5.2	5.0	5.0	5.5	5.2
West Asia	4.0	-1.1	2.0	2.5	4.0	2.8
Western hemisphere	5.2	-0.2	3.0	3.5	4.5	3.7
Developed market economies	3.4	2.0	3.2	2.5	3.8	3.2
Western Europe	3.0	1.0	2.5	2.2	2.6	2.4
Japan	5.1	3.8	4.5	4.0	3.8	4.1
North America	3.6	2.6	3.4	2.4	4.5	3.4
Centrally planned economies[b]	4.5	4.2	4.9	4.5	4.5	4.6
Inflation rate						
Western Europe	10.0	8.0	5.7	4.7	4.5	5.0
Japan	4.4	2.1	2.0	2.0	1.7	1.9
North America	7.4	5.8	4.5	4.4	4.3	4.4
Unemployment rate[c]						
Western Europe	5.5	9.5	11.0	11.1	11.1	11.0
Japan	2.1	2.5	2.1	2.1	1.9	2.0
North America	5.4	8.8	7.2	7.0	6.9	7.0
Memorandum items:						
Value of developing country exports[d]	22.1	-5.0	5.0	7.0	10.0	7.3
United States prime rate of interest	10.1	14.1	10.3	11.1	12.0	11.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on projections of Project LINK (4 March 1985), and other national and international sources

[a] Geometric averages, except unemployment rates and interest rate, which are arithmetic averages

[b] Output growth rates for the centrally planned economies refer to plans for net material products in 1985 and Secretariat estimates for other years

[c] Number of unemployed persons as a percentage of the civilian labour force.

[d] In terms of dollars

improve strongly during the same period. In contrast, the projections for the trade balances of the different developing country groups indicate only a slight change relative to their positions in 1984.

For the centrally planned economies the plan strategies now being implemented aim at stabilizing expansion at about the pace attained in 1983-1984 rather than at speeding up output growth. The plans for Eastern Europe forecast growth of about 4.8 per cent for 1985,[13] on the basis of a moderate slowing in the growth of industry and little growth in agriculture over the very good levels attained in 1984. The expansion of investment levels will at best equal that of 1984 - about 3.5 per cent,[14] subject to external developments. Above-plan export performance will permit a relaxation of import constraints; this in turn will benefit industrial production as well as domestic consumption and, to a lesser extent, investment levels. There may be a gradual shift in the distribution of income uses in favour of investments, which would ease the pressing need for modernizing productive capacities and for achieving faster structural adjustments, but no spectacular shift in policies can be expected in the short run.

[13] That rate derives importantly from the ambitious 10 per cent pace of growth planned in Romania.

[14] It should be noted in this connection that only Bulgaria and Romania are planning a 6 to 8 per cent increase in investment activity, while Czechoslovakia and Hungary are planning for minor growth (1-2 per cent) and others for stabilizing 1984 levels

Although the next medium-term plans are not yet available, it is clear from current policy discussions that the rate of growth in 1986-1987 is not likely to diverge significantly from that of 1984-1985, except in China. Priority given to restructuring for domestic reasons (China and USSR) or due to external constraints (Eastern Europe) will remain in effect and constrict the degree of flexibility available to planners.

Given the current interest of policy makers, particularly in the European planned economies, in experimentation with alternative management systems and behavioural rules, two or three more years of cautious policies with domestic and external adjustments may provide the necessary leeway for accelerating growth in the latter years of the next medium-term plans. Even then, however, growth is not expected to exceed the 5 per cent level. The ultimate effects of the industrial reform envisaged in China are difficult to predict, but it is not likely to bear fruit quickly or in a spectacular way. China may be able to maintain an average growth rate of 6 to 7 per cent in the second half of the 1980s.

An important determinant of these forecasts, especially in the case of Eastern Europe, is the external environment. If the European market economies can sustain their recovery and perhaps even slightly accelerate their pace of expansion, it would offer most Eastern European countries, through export promotion, an extra degree of flexibility in designing somewhat more ambitious output and distribution strategies. Another important determinant that bears on the European centrally planned economies is the likely evolution of the depth and scope of CMEA-wide economic co-operation. Greater harmonization of the institutional and policy modifications currently sought by many members, in conjunction with economically warranted specialization, especially in the manufacturing sectors of Eastern Europe, may become a critical determinant of feasible activity levels in Eastern Europe.

Major threats to the projected growth rates of output and trade for the developed and the developing country groups are intimately associated with the possibility of a serious disruption in the international financial and trading system. From the global perspective, the important areas of concern are the prospects of sharp swings in exchange rates among key currencies, particularly relative to the dollar; abrupt and large increases in the level of international interest rates; and any further escalation of trade protectionism. These areas of concern, as argued in chapter VI, are in fact intimately interrelated. For example, a sharp decline in the value of the dollar *vis-à-vis* other currencies could lead to a sharp rise in United States interest rates, especially in the case of a shift in expectations on the part of the international financial community. This in turn could lead to much lower output growth rates in developed countries, to further increases in the already high unemployment levels, and thus to heightened protectionist pressures. These factors, as argued earlier in this chapter, could have a destabilizing effect upon developing countries, particularly the major debtor countries.

A scenario with particularly adverse effects on the world economy in the medium term is one that allows for the possibility of a sudden reversal, or even a levelling off, of capital inflows into the United States which have been helping to finance part of the budget deficit. The lowering of the global demand for dollar-denominated assets could lead to a precipitous decline in the value of the dollar *vis-à-vis* other key currencies. Furthermore, given the present and prospective mix of macro-economic policies in the developed market economies, the abrupt decline in the level of capital inflows into the United States could lead to higher interest rates there, as well as in other major developed market economies.

Part Two

MAJOR DEVELOPMENTS AND POLICY NEEDS IN INTERNATIONAL TRADE AND FINANCIAL RELATIONS

Chapter IV

UNEVEN INTERNATIONAL TRADE PERFORMANCE

International trade in 1984 provided countries with diverse and uneven export opportunities. The major beneficiaries of the surge in trade were largely those countries in which manufactures provided a major share of export earnings and those with strong trade ties to the more rapidly growing markets. At the same time, international commodity prices saw their cyclical recovery cut short in 1984, while the surge in exports in a number of sensitive sectors brought about a stiffening of protectionist barriers.

Changing pattern of world trade

In recent years significant shifts have occurred in the direction of trade flows, in response to differences in the strength of import demand associated with differences in growth performances, import elasticities and exchange rate movements among the various importing countries. Shifts in import demand have, in turn, elicited changes in export patterns, both in terms of the commodity structure of exports and the sources of supply.

There has been a particularly strong geographical concentration of trade growth, with countries of the Asia and Pacific region providing the major export thrust and the United States the strongest import absorption. As a result, considerable changes in import shares have been taking place within the developed market, developing and centrally planned economies, while the shares of these groups themselves are not significantly different from what they were at the start of the decade (see table IV-1). In the developed market economies, there was a particularly strong growth in 1984 in United States imports (over 25 per cent in volume terms) and a slower, yet significant, recovery of Western European imports (close to 7 per cent); the share of world imports accounted for by the United States rose from almost 13 per cent in 1980 to over 17 per cent in 1984, while Western Europe's share fell from over 38 per cent to under a third. Within the developing countries, the most notable changes between pre-recession and post-recession trade shares were seen in the regional aggregates, where a falling share of Latin America and the Caribbean and sub-Saharan Africa may be contrasted with a rising share of South and East Asia and the Pacific.

The primary determinants of the change in trade patterns were differences in domestic income growth and changes in exchange rates. With respect to the latter, the appreciation of the dollar strongly supplemented the impetus to United States imports provided by the growth of domestic income. In most of the rest of the world, currency devaluations, import controls and low levels of economic activity served to dampen import growth.[1] In Latin America and Africa, in particular, widespread balance-of-payments constraints and severe adjustment programmes have also served to restrain import levels directly. In Asia, a substantial growth of imports took place in a number of countries, both for processing into rapidly growing exports and for domestic use.

Imports of the developing countries as a whole have been under severe constraint relative to both past trends and development needs. The effect over the past few years has been a particularly sharp curtailment of imports from developed market and centrally planned economies. The former countries supply over three fifths of the imports of developing countries, but about 80 per cent of their exports are manufactures, which have suffered the largest cut-backs. As financial strains on most developing countries caused postponement or abandonment of many investment projects and scarce foreign exchange was allocated to meet the most pressing import needs, a relatively large share of the decline in imports fell on manufactures. Whereas the total value of exports from developed market economies to developing countries declined by 16 per cent from 1981 to 1983, exports of manufactures fell by over 27 per cent.

In contrast, the curtailment of developing country imports from other developing countries appears to have been less severe, dropping by about 8 per cent from 1981 to 1983. In 1984, while developing country imports from developed countries appear to have continued to contract, albeit slightly, the imports from other developing countries grew robustly, by about 12 per cent. Part of the increase was the result of larger petroleum shipments made necessary by rising levels of economic activity, but important gains were also recorded in non-fuel trade, both interregional and intra-regional.

In part, the growth in intra-developing country trade reflects the increasing diversity and complementarity of the output of these countries. The emergence of certain developing countries as internationally competitive producers of manufactures and semi-manufactures formerly supplied by industrial countries has not only enabled them to capture export markets previously served by the latter but has also increased their demand for

[1] There is also a valuation effect of exchange rate changes which reduces the dollar value of imports of countries whose currencies depreciate *vis-à-vis* the dollar. This factor accentuates some of the changes in import shares, but does not alter the direction of change

Table IV-1 World imports: shares of major countries and country groups, 1980-1984

(Percentage of current dollar value)

	1980	1982	1984[a]
Developed market economies	69.6	66.6	68.7
Japan	7.0	7.0	6.9
United States	12.7	13.5	17.3
Western Europe	38.4	34.8	32.4
Developing countries	21.8	24.5	22.0
Capital-surplus countries	4.0	5.2	4.2
Capital-importing countries	17.8	19.3	17.8
Latin America and Caribbean	4.9	4.5	3.3
South and East Asia and Pacific	6.8	8.1	8.6
Sub-Sarahan Africa	2.3	2.3	1.6
Centrally planned economies	8.6	8.9	9.3
World	100.0	100.0	100.0
Memorandum item: index of world import volume (1980=100)	100.0	100.7	112.3

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

[a] Preliminary estimate

imports from other developing countries of raw materials and intermediate inputs used in the production of such goods. The increase in developing country trade may also reflect in some measure the role played by special clearing arrangements and counter-trade agreements in facilitating exchanges that might not otherwise have occurred in view of the foreign exchange shortage experienced by the vast majority of developing countries.

All in all, while sales to developed countries provided the most dynamic export opportunities for developing countries in 1984, trade among developing countries also showed encouraging growth, especially when set in the context of the overall import constraints faced by so many members of the group. As recently agreed advances in numerous regional integration schemes and interregional co-operation efforts are implemented,[2] the framework may be put in place for a further strengthening of the growth of trade among developing countries.

Among the centrally planned economies, there have been divergent trends. As a result of the severe adjustment pressures of the early 1980s, the Eastern European countries had made especially sharp cut-backs in the volumes of imports from the market economies, together with modest cut-backs in imports from socialist countries. Despite a measure of import recovery in the past two years, these changes have not been fully reversed. Meanwhile, imports of the USSR from the market economies grew somewhat more rapidly than imports from within the group of centrally planned countries until 1984. The drop in imports from market economies in that year was severe until about the third quarter, owing to reduced non-food import needs particularly as a result of the completion of several large-scale and rather import-intensive pipeline projects. Starting with the fourth quarter, however, large grain imports became necessary as a result of the harvest shortfall. On balance, whereas the volume of imports from market economies stagnated, that from other centrally planned economies rose by about 9 per cent. It is also noteworthy that, in contrast to previous years, imports from developing countries, especially into Eastern Europe, surged in dollar terms while exports declined, especially in the case of the USSR.

There has been a relative intensification of trade relations among centrally planned economies, largely arising from a diminution of their trade relations with market economies.[3] At the same time, policy efforts to work

[2] These advances have been regularly reported in *G-77 Bulletin* (New York). See also "Major recent developments in economic integration and co-operation groupings of developing countries", report of the UNCTAD Secretariat (UNCTAD/ST/ECDC/2(3)), 15 October 1984.

[3] For further details, see Economic Commission for Europe, *Economic Survey of Europe in 1984-1985* (to be issued as a United Nations publication), chap. 5, sect. 5.3 (iv)(b).

out an approach to accelerate the economic integration of the centrally planned economies are continuing. The next cycle of medium-term national and regional plans may provide the opportunity to enact substantive changes in the regional integration format.

Manufactures in export growth

One effect of the shifts in overall import shares described above has been to change world demand for different classes of internationally traded goods; given the respective weights of the United States and Western Europe in world trade, it was the shifts in the shares of their imports that largely determined the changes. World demand for non-fuel commodities and chemicals fell relative to the demand for some manufactures, particularly machinery and transport equipment, which make up less than a quarter of Western Europe's imports whereas they have comprised almost 30 per cent of United States imports (over 35 per cent in 1984). The share of food, beverages and raw materials in United States imports has been less than two thirds of the share of the same commodities in Western Europe's trade.[4]

The shift in the product composition of global trade has provided stronger opportunities for countries whose exports are relatively concentrated in manufactures than for countries which are primarily commodity exporters. Among developing countries, for example, greater export opportunities accrued to countries of South and East Asia and the Pacific, where over half of export earnings are in manufactures, than to Latin America and the Caribbean (less than a fifth) and developing Africa as a whole (well under 10 per cent). Conversely, about three quarters of developing Africa's exports have been mineral fuels, compared to almost half of Latin America's and roughly a fifth of Asia's (excluding the Middle East).

Countries which have been relatively intensive suppliers of the more rapidly growing markets for manufactures were more favourably positioned to expand their exports in 1984. In particular, the United States has been the largest market for the manufactured exports of Japan and Canada, accounting for about a third of Japan's manufactured exports and over four fifths of Canada's. These countries enjoyed particularly large increases in exports in 1984.

In addition, the exporters of manufactures in the developing countries of Asia and the Pacific have faced rather buoyant conditions; they ship about a third of their manufactured exports to the United States and roughly the same share to significantly growing Asian markets, including in particular other developing countries, as well as China and the developed market economies in the region. A similar situation arose for Japan: in addition to its United States markets, its substantial Asian markets - especially China - have been growing at a marked pace.

The United States market has also been absorbing in recent years over a quarter of the manufactured exports of Latin America, providing a major opportunity for export growth in 1984. In contrast to the case of the Asian developing countries, however, other major markets for Latin American manufactures have been less buoyant, Western Europe in particular.

The major impact of the relatively slow growth of Western European demand for manufactures has been felt in Europe itself; about three quarters of Western European manufactured imports are supplied by countries within the region. Indeed, only about an eighth of Western Europe's manufactured exports in recent years were shipped to the markets which became the most buoyant in 1984.

The substantial 1984 growth in world trade in manufactures, together with the slower growth of trade in fuels and other commodities, created a very substantial growth in world trade of about 9 per cent in volume terms. For the developed and developing economies on average, it was a year of larger export growth than they had experienced since the late 1970s (see table A-9). The developing countries as a whole showed the greatest dynamism. Reversing a cumulative decline of over 17 per cent since 1980, the volume of their exports grew by nearly 8 per cent. Exports from the developed market economies as a group rose by over 9 per cent, with exports from Canada and Japan increasing far above the average, by almost 20 and 16 per cent, respectively. Exports from the USSR and the Eastern European centrally planned economies rose by over 5 per cent, led by an increase in the latter in excess of 7 per cent. Chinese exports grew by about 10 per cent.

The uneven growth of import markets described above, together with valuation changes arising from exchange rate movements, has changed the pattern of shares in world exports. As may be seen in table IV-2, the developed market economies and the centrally planned economies have each increased their shares in aggregate. Within the largest trading group, the developed market economies, the rise in the Japanese trade share has more than offset the fall in the Western European share.[5] Among the developing countries, the strongest performance has been shown by the countries of South and East Asia and the Pacific. The most dramatic developing country losses in export shares arose largely as a consequence of changes in the international

[4] More precisely, about 11 per cent of United States and 17 per cent of Western European imports of commodities in sections 0, 1, 2 and 4 of the Standard International Trade Classification (SITC), Revision 2

[5] Western Europe's export volume has nevertheless grown faster than the volume of world trade, at an annual average of about 4 per cent thus far in the 1980s, compared to only 2 per cent for the world as a whole and almost 8 per cent for Japan

Table IV-2. World exports: shares of major countries and country groups, 1980-1984

(Percentage of current dollar value)

	1980	1982	1984[a]
Developed market economies	64.4	64.5	65.7
Japan	6.6	7.6	8.9
United States	11.2	11.6	11.4
Western Europe	35.5	34.0	32.6
Developing countries	26.8	25.2	23.8
Capital-surplus countries	10.9	8.5	6.0
Capital-importing countries	15.9	16.7	17.8
Latin America and Caribbean	4.7	4.9	5.3
South and East Asia and Pacific	6.1	7.0	7.9
Sub-Saharan Africa	2.5	1.9	1.9
Centrally planned economies	8.8	10.3	10.5
World	100.0	100.0	100.0

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

[a] Preliminary estimate.

market for petroleum, although the weakness of non-fuel commodity markets since 1980 has also been a contributing factor

Major developments in commodity markets

A marked softening of commodity prices, affecting energy prices as well as non-fuel commodities, was one of the major unexpected developments of 1984. In the petroleum sector, despite the first increase in world oil consumption since 1979, prices fell through the year as a whole for an average decline of 2.5 per cent if measured in dollars (measured in SDRs, there was a small increase in price - under 2 per cent - resulting from the rise of the dollar during the year).

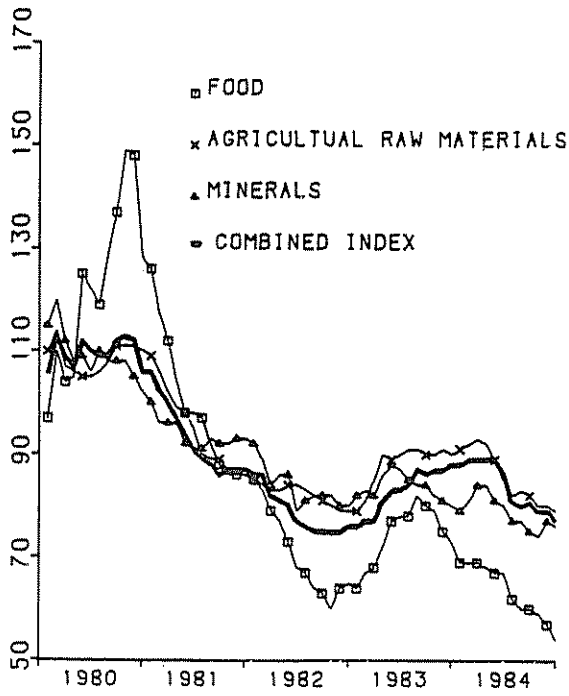
The cyclical upswing in non-fuel commodity prices that began in 1983 was cut short in 1984 for most commodities. In fact, despite the reactivation of the world economy, the index of dollar prices of non-fuel primary commodities exported by developing countries ended 1984 at a level some 30 per cent below its end-1980 value and only slightly above the trough reached in the midst of the recession in late 1982 (see figure IV-1). The index had declined steadily in the recession years of 1981 and 1982, for a drop totalling 34 per cent in dollar terms. Subsequently, throughout 1983 and the first quarter of 1984, prices generally rose, without however regaining their 1980 level; they remained basically unchanged during the second quarter of 1984, but then resumed their descent. For 1984 as a whole, commodity prices were about 1 per cent higher than they had been in 1983 (see table A-10), although average prices ended 1984 about 13 per cent below their value at the end of 1983.

Although commodity prices were much affected by the rise of the dollar exchange rate, a pattern similar to the above is seen when prices are measured in a currency composite. In particular, measured in SDRs, non-fuel primary commodity prices at the end of 1984 were 15 per cent below their end-1980 value. During 1981 and 1982, the SDR commodity price index fell 21 per cent. From early 1983 into the second quarter of 1984, SDR commodity prices rose somewhat but then fell back 10 per cent by the end of the year. For 1984 as a whole, prices rose 5 per cent but again, measured from year-end to year-end, they fell 7.5 per cent.

Although specific policy and market factors have been important determinants of recent trends in the prices of individual commodities, as discussed in more detail below, there were also a number of more general factors which accounted for the performance of different groups of commodities.

For minerals and non-food agricultural products, the recovery in price was aborted in early 1984 by a combination of factors. First, suppliers of certain industrial

Figure IV-1
Export price indices of major commodity groups, 1980-1984[a]



Source: UNCTAD. *Monthly Commodity Price Bulletin*

[a] Indices of dollar prices; 1979-1981 = 100

inputs, eager to respond to favourable market conditions after several lean years, reacted strongly to the price stimulus, contributing to an ensuing glut that caused prices to fall. In the petroleum sector, a pick-up in world demand in late 1983 and early 1984 signalled an increased opportunity for export sales, leading to a larger increase in world export volume than had been anticipated. Increased export revenues were very much sought by a number of large-scale exporters that have been under intense balance-of-payments pressure. Also, owing especially to years of collective discipline among member countries of OPEC, many countries had substantial idle production capacity available for use.

Second, the overall stimulus to commodity demand arising from the world recovery was generally weak. Not only was the pace of economic revival in Europe generally slow, but in a number of European countries - France, the Federal Republic of Germany, Sweden and the United Kingdom - extensive labour strife depressed even further the level of industrial activity in early 1984. Even though industrial production subsequently picked up in most of them, by then growth in the United States had begun to slow down so that the demand impulse was largely neutralized. Third, the 1984 rebound in interest rates increased the actual financial cost of carry-over stocks, thus tending to lower target inventory levels. These levels may have been further reduced, however, in anticipation of a possible slow-down in economic activity which, it was feared, might be triggered by the rise in interest rates themselves. Finally, the gathering strength of the dollar in foreign currency markets, particularly after March 1984, acted as a damper on the quantities of imports demanded in local currencies for several commodities; in other words, the dollar appreciation raised the local currency cost of those imported commodities whose international prices tend to be dominated by markets in which the dollar is the main currency used by purchasers and suppliers.

In the case of most food and beverage commodities, the price increases that had occurred in 1983 stemmed less from demand-pull factors linked to the recovery than from supply deficiencies caused mainly by adverse weather conditions in many parts of the world. Likewise, the subsequent decline of prices was largely a reflection of actual and anticipated output gains in 1984/85 associated with improved weather.

Prospects and the policy environment for commodities

Considering that the overall price trends noted above (and the individual price trends discussed below) are expected to continue, it appears that the price outlook for most commodity producers is not encouraging. In the near future, the sizeable producers' inventories for most commodities and the continued existence of significant idle capacity in some sectors virtually precludes a significant recovery in prices, even if demand levels are sustained, interest rates continue to fall and the dollar weakens. In the longer term, the prospects for a number of commodities - particularly among the metals and other industrial inputs - are clouded by technological changes and shifts in the pattern of demand, which seem to indicate a reduction in the consumption of raw materials per unit of output.

For most food items, weather conditions will remain the single most important determinant of price, although protectionist practices, notably in the case of dairy products, meat and sugar, and changes in tastes and dietary standards (for instance, away from beef, butter, some caloric sweeteners, coffee and pork) will continue to be important price determinants. Income and population growth differentials among countries, as well as the further growth of domestic capacity to substitute for some imported commodities will, likewise, play an important role in determining international prices for these commodities.

For many industrial inputs and for fuels, the main medium-term potential for a downward shift in demand comes from further miniaturization and substitution. At the same time, however, new uses are being found for a number of substances such as gallium and certain purified rare earth compounds in high-technology fields. Technological developments and the major effort towards energy conservation first triggered by the oil price increase of 1973 have, over the course of a decade, led to the development of numerous new products, new designs, new production methods and new materials, which are now being embodied in new investments. Not only is less energy consumed per unit of output in many sectors, but some of the traditional industrial inputs have been displaced by new substances which can be produced with less energy or whose weight, strength and durability render them superior for a variety of industrial uses. In some cases, the properties of the new substances are so superior to those of the materials they replace that the switch-over process tends to be irreversible. Examples include the replacement of copper wire by fibre optics in the field of telecommunications and of certain types of steel by plastics and aluminium alloys in the transportation industry. In other cases, such as the use of natural instead of synthetic rubber or of cotton instead of polyester, substitution can work both ways, the choice depending basically on relative prices. The improvement in processes for recycling minerals and the general propensity of services to rise as a proportion of total GDP are also factors that tend to lower the basic material input requirements of production and therefore tend to weaken fuel and raw material prices.

Downward pressure on the prices of industrial inputs has also been exerted from the supply side, however. The emergence of new low-cost producers with limited absorptive capacity and a pressing need to earn foreign exchange, coupled with the reluctance of traditional suppliers to shed some of their redundant productive capacity, has been a factor. Another factor has been a tendency for countries to substitute domestic production for imports whenever appropriate, as part of the overall effort to strengthen their balance-of-payments position.

With regard to the related issue of price volatility, recent experiences in individual commodities have demonstrated the importance of international commodity agreements, while raising concern for the future of such agreements. That is, even in the face of generally adverse conditions, the range of price variation of those commodities for which there have been effective agreements has been lower than for other commodities. In view of this, the difficulties in completing negotiations on renewing a number of individual commodity agreements and the slow pace in implementing the Integrated Programme for Commodities in UNCTAD and the Common Fund, in particular, are a source of disappointment and concern. In a generally more volatile international economy, the Integrated Programme for Commodities remains an important approach to greater stability in a limited arena. Until enough Governments agree to take such steps, however, commodity exporters will have to incorporate into their planning the prospect of substantial price instability. The international community might take such factors into account in evaluating the adequacy of the capacity and functioning of multilateral mechanisms for compensatory financing of export earnings fluctuations, in particular the Compensatory Financing Facility of IMF.

Major developments in individual commodity markets

In addition to the broad commodity price trends described above, there were a number of significant developments in respect of specific goods, involving changes in market structures, government policies and substitution in demand among commodities. These have an important bearing, *inter alia*, on the prospective role of commodity exports in strategies for structural adjustment and growth. As a report on energy resources has recently been issued,[6] the present discussion is limited to a consideration of non-fuel commodities.

[6] Report of the Secretary-General on trends and salient issues in the development of energy resources (E/C.7/1985/4), 7 March 1985

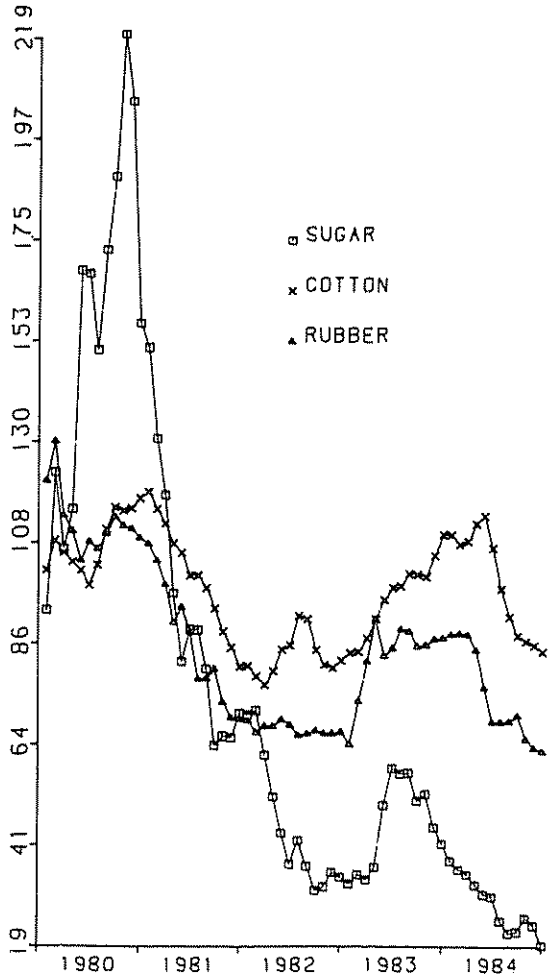
Food

Of all the commodities, food items as a group have experienced the largest average price decline in recent years. In the two-year period between October 1980 and October 1982, average food prices in dollar terms dropped by 40 per cent; they then rose until August 1983 but have since fallen to their lowest level since 1972.

The most extreme case is that of **sugar** (see figure IV-2), where international prices have plummeted practically without interruption from their peak of over $US 0.40 per pound in late 1980 to only $0.035 per pound at the end of 1984, well below the production costs of even the most efficient producers. The basic reason for the price collapse is a persisting excess supply which over the years has led to the accumulation of vast inventories, enough by the end of 1984 to meet the entire world demand for six months. Large increases in supply have been the result of favourable weather conditions in most traditional developing country exporters, as well as increases in production for domestic consumption in some of the large traditional sugar importers, such as China, India and the USSR. The prospect for 1984/85 is for a further global production increase of about 5 per cent.

The sugar price support programmes in EEC and the United States have also played an important role. Artificially high domestic prices in these markets, in conjunction with marked changes in diet and taste, particularly in the United States, have moreover induced massive substitution of other caloric and non-caloric sweeteners. As a result, EEC has become the world's second largest sugar exporter and the United States has found it necessary to restrain imports through quotas which have been in effect since 1982 and have been successively tightened, most recently in January 1985. Indeed, it has been estimated that if sugar protection in industrial countries were removed, the world export

Figure IV-2
Export price indices of selected major crops, 1980-1984[a]



Source: UNCTAD, *Monthly Commodity Price Bulletin*
[a] Indices of dollar prices; 1979-1981=100.

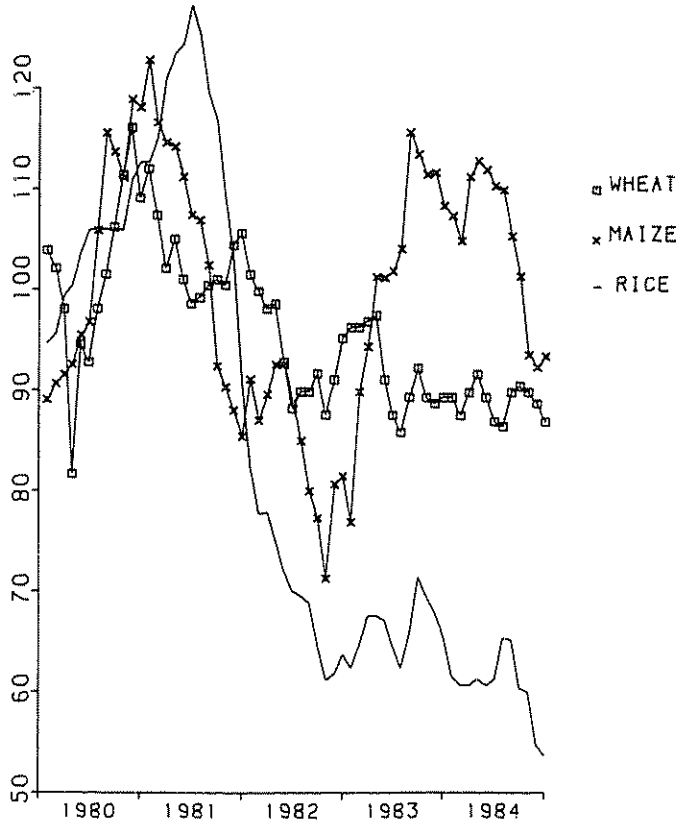
[7] Joachim Zietz and Alberto Valdes, "The costs of protectionism to less-developed countries: an analysis for selected agricultural products", World Bank, January 1985, mimeographed.

market share of developing countries would increase from about a third to well over half and their export earnings would multiply between 2.5 and 5 times.[7]

In past years, market trends in sugar prices have been tempered by the operation of a buffer stocking scheme under the International Sugar Agreement. In the future, such smoothing of market swings will be absent, owing to the failure of producing and consuming countries to agree to a new Agreement with economic provisions to replace the one which expired at the end of 1984.

Wheat prices have been under relatively consistent downward pressure since 1980, ending 1984 at fully 25 per cent below their end-1980 level (see figure IV-3). That pressure derived from a number of good crop years

Figure IV-3
Export price indices of major cereals, 1980-1984[a]



Source: UNCTAD, *Monthly Commodity Price Bulletin*.
[a] Indices of dollar prices; 1979-1981=100

at the global level, arising both from favourable weather and policy measures aimed at increasing food self-sufficiency. Overall production has increased by close to 9 per cent over the last three years and world stocks at the end of the 1983 crop year reached their highest level since 1978. Although wheat production in the United States was deliberately cut back in 1983/84 by some 12.5 per cent as part of the wheat price support programme, and although weather conditions caused production losses of the order of 10 per cent in the USSR and 20 per cent in Argentina, world wheat tonnage still rose, owing to substantial output growth in China and India and a strong Australian crop after a year of drought. Thus, whatever upward pressures on wheat prices arose from increased human consumption and higher demand for animal feed (a switch-over from higher cost protein meal), they were clearly insufficient to raise and maintain prices. Barring major unforeseen events, wheat prices are expected to remain at present levels throughout 1985.

Rice has shown the greatest price volatility of the cereals, the main reason being the high geographical concentration of rice production. With over 85 per cent of total production and some 60 per cent of exports originating in South and East Asia and China, weather conditions in Asia constitute an important short-run determinant of the world market price. Indeed, much of the international price weakness from 1982 to 1984 was accounted for by weather-related improvements in crop yields, particularly in China, India and Thailand, not to mention the beneficial effects of recent agricultural reforms in China. Barring unforeseen events, the price of rice is expected to remain low, as supply is likely to exceed demand once again in 1985.

Changes in **maize** prices have also largely reflected changes in global output. A relatively strong recovery in prices through much of 1983 and the first half of 1984 was linked to a decline of some 20 per cent in global output, resulting mainly from policy- and weather-induced production cutbacks in the United States and crop failures in South Africa, which were only partly offset by higher tonnages in other countries. Towards the end of 1984, however, maize prices swiftly declined in anticipation of a bumper crop in 1984/85.

Tropical beverages

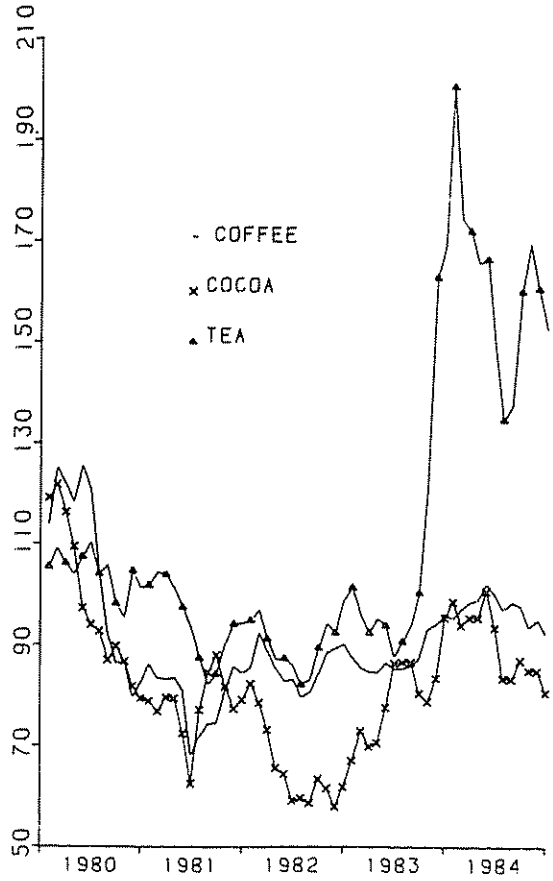
Supply factors were paramount in determining the price behaviour of tropical beverages, although policy measures have also had an impact. Upward pressure on **coffee** prices in 1983 resulted from a 15 per cent production shortfall; this, in turn, led to an increase in supplies to the market through changes in the International Coffee Agreement: between December 1983 and May 1984, supply quotas were increased four times, by one million bags each time, as prices pushed against the agreed upper price limit. Since then, prices have stayed within the bounds set by the Agreement and are expected to remain there throughout 1985 - barring frosts in Brazil - as production levels recover and the new, enlarged global quota of 59 million bags takes effect.

Cocoa production declined in both 1982/83 and 1983/84 as a result of poor weather conditions, particularly in West Africa, causing a sharp rise in cocoa prices (see figure IV-4). Prices have since declined in anticipation of a better 1984/85 crop, as well as in response to the failure of producing and consuming countries to negotiate a new cocoa agreement that would resume buffer stock operations (suspended since mid-1982) or set export quotas. Without the signing of a new cocoa agreement with pricing provisions or a turn for the worse in the weather, cocoa prices are expected to continue slipping throughout 1985.

The dramatic increase in **tea** prices - particularly between September 1983 and January 1984 when they more than doubled - was triggered by substantial crop losses in India and Sri Lanka, aggravated by the fact that the former imposed a partial ban on tea exports to ensure that domestic needs would be adequately met. Exportable surpluses from these major producers were thus sharply reduced at a time when stocks in importing countries were relatively low on account of high carry-over costs. The reaction was near-panic buying, which pushed up prices. Since May 1984, when India's export ban was lifted, prices have mostly declined, though in September/October they rose again as India reimposed controls. Tea prices are expected to remain unchanged throughout 1985, as the downward pressure on prices resulting from increased production is largely offset by upward pressure emanating from rising incomes and

Figure IV-4

Export price indices of tropical beverages, 1980-1984[a]



Source: UNCTAD. *Monthly Commodity Price Bulletin*

[a] Indices of dollar prices; 1979-1981=100.

population growth among the large Asian consuming countries.

Agricultural raw materials

The prices of agricultural raw materials have generally been less volatile than those of other crops, although they too followed the pattern of a fall in the early 1980s and a partial recovery in 1983, followed by a return to recession-level prices. **Cotton** price increases of 1983 and early 1984 were caused by policy-induced crop reductions in the United States and disappointing harvests in Pakistan and South America, as well as by a renewed, albeit modest, growth in consumption after several years of stagnating demand. The volume of international trade in cotton, however, did not similarly recover. This was partly accounted for by the fact that China, traditionally a major importer, has become increasingly self-sufficient in cotton. Income declines and foreign exchange restrictions in debt-constrained developing country cotton importers have also played a role, as has the fact that falling petroleum prices

lowered the threshold at which synthetic substitutes become competitive. Price declines since May 1984 were linked to expectations of a large cotton crop in 1984/85 and of a weakening in demand, as the recovery in the United States slowed down and oil prices continued to fall.

Demand factors have weighed perhaps more heavily in determining **rubber** prices than is the case with any of the other agricultural commodities. From a record level of $US 0.75 per pound in early 1980 - induced by the massive switch-over from synthetic rubber in the wake of the 1979 oil price increase - natural rubber prices fell to their trough of $0.365 per pound at the beginning of 1983 (see figure IV-4). A persistent contraction of demand linked mainly to lower automobile sales in developed market economies was largely responsible for the fall in rubber prices. Accordingly, under the International Natural Rubber Agreement of 1979, buffer stock purchases of 260,000 tons were effected in an effort to keep prices from slipping even lower. In 1983, an expansion in consumption, again tied to automobile sales, together with the need to rebuild depleted stocks, propped up prices. Rubber prices nevertheless started to decline again in 1984, as demand growth lost momentum and inventories reached desired levels. At the end of the year, rubber prices had fallen almost to the trigger price at which the buffer stock manager must buy to try to stem further price declines. The high level of buffer stock purchases already made severely constrains the intervention latitude of the buffer stock manager, however. If difficulties emerge in renewing the Rubber Agreement when it expires in 1985, rubber prices may fall to new lows.

Metals, minerals and ores

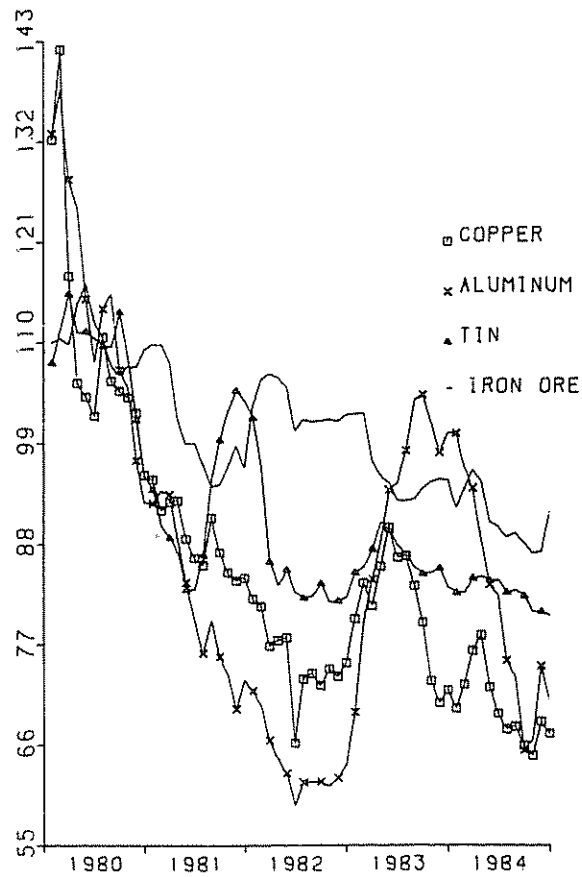
In the case of metals, minerals and ores, prices on average have shown a steady downward path since early 1980, with an overall decline of 37 per cent over the period. At the end of 1984, mineral prices in current dollars stood at their lowest level since 1978. The main factor behind the secular decline in most mineral prices has been a persistent supply/demand imbalance caused mainly by low levels of consumption.

Between 1980 and 1983, the demand for **copper** declined at an average rate of 2.5 per cent per year. In the meantime, despite substantial cut-backs in the United States, averaging nearly 20 per cent over the period, global mine output continued to expand. This was largely the result of a major production and export drive undertaken by Chile and Zaire, two of the largest copper producers; unlike producers in the United States, they found it profitable to expand production even at depressed prices, given their lower production costs and their urgent need for foreign exchange and fiscal revenues. Although the demand/supply balance appears to have improved somewhat in 1984, the current high level of users' and producers' stocks virtually precludes the possibility of copper prices rising in the near future.

The **aluminium** market showed a relatively more pronounced cyclical pattern: during the recession years, aluminium production declined but not as fast as demand. Though production cut-backs during the period were fairly widespread, the most substantial reductions occurred in Japan and the United States, where production declined by 65 and 28 per cent, respectively. With recovery in 1983, demand picked up, as did supply, although at a much lower rate. The resulting price increases, the first in years (see figure IV-5), generated optimism about a major market turn-about and triggered some speculative buying which raised prices even higher.

Figure IV-5

Export price indices of major minerals, 1980-1984[a]



Source: UNCTAD, *Monthly Commodity Price Bulletin*

[a] Indices of dollar prices; 1979-1981=100.

This led producers to expand production too fast. Once industrial demand weakened, the downward pressure on prices was exacerbated by speculative selling, on the expectation that the anticipated market turn-about would not materialize after all.

Apart from the impact of cyclical phenomena, the aluminium industry is also undergoing structural changes that have increased the volatility of aluminium prices. Once very heavily dominated by a few large corporations that were vertically integrated from bauxite mines to metal fabrication, a number of new, low-cost developing country metal producers have emerged in recent years which sell output to manufacturers through markets such as the London Metals Exchange. In other words, a significant "arm's length" aluminium market has been emerging in an industry long dominated by intra-corporation transactions.

Despite adverse demand conditions since 1979, **tin** prices have fluctuated along a downward path, to be sure, but within a much narrower range than those of other metals in recent years, owing to the operation of the International Tin Agreement. Over the period, average tin prices declined by an overall 18 per cent, and were prevented from falling even further only by the establishment of export quotas and the active participation of the buffer stock manager, under the authority of the Agreement.

In addition to the recessionary conditions of the early 1980s, tin consumption has been on the decline on account of the substitution of other materials, such as aluminium, glass and plastics, particularly in the packaging industry, and by the development of new methods of coating steel using a lower tin content. Thus, despite production cut-backs averaging over 5 per cent per year since 1980, commercial stocks rose almost sixfold during this period, and the International Tin Council buffer stock - whose manager initiated price support operations in 1981 and continued them as the need arose - had, by June 1984, accumulated stocks totalling 58,600 tons, or about a fifth of world consumption, compared to zero holdings four years before.

The persistence of slack demand has also affected the competitive structure of the industry, as producer rivalries have caused major realignments in market shares, with substantial gains for Brazil (not a member of the International Tin Council), largely at the expense of Bolivia, Malaysia and Thailand (all members). Conflicting interests have also weakened the Council, as the main tin consumer, the United States, and one of the largest producers, Bolivia, refused to adhere to the sixth International Tin Agreement, upon expiration of the previous agreement in mid-1982. Thus, although demand picked up slightly in 1984 and is expected to do so again in 1985 as the recovery widens, the high level of tin reserves and the pressures on tin producers - Council members and non-members alike - to increase supply make a significant recovery in prices a rather remote possibility at this time.

Weak demand has also been a major cause of the decline in **iron ore** prices of about 20 per cent from 1980 to 1984 (see figure IV-5). Weak demand for iron ore was linked to the recession-induced contraction in expenditure on consumer durables and capital goods, two of the largest steel-using industries. However, there also has been a secular deterioration in demand, arising from the progressive substitution of other materials, such as composite plastics, certain types of ceramics and other metal alloys in a variety of industrial uses, and the spread of methods that save iron ore in the production of steel itself or utilize more scrap when changes in ore prices make scrap a relatively low-cost alternative. The progressive shift to a system of managed international trade in steel, as discussed in the section on trade policies which follows, has probably also had a dampening effect on steel use - and thus demand for iron - by keeping prices higher than they might otherwise have been and by generally distorting supply patterns.

Although considerable progress has been made in recent years in the reduction of excess steel capacity, no effort has been launched towards the elimination of redundant iron-ore mining capacity. Indeed, while the mining capacity of the traditional producers has remained basically intact, though largely unutilized, capacity has actually expanded substantially among lower-cost producers such as Brazil and India. The resulting imbalance between supply capabilities and actual demand is likely to maintain iron ore prices at low levels for some time to come.

International trade policies

The long-awaited roll-back of protectionism that was expected to begin as the recession ended has yet to materialize. Countries repeatedly pledge their support for an open, multilateral trading system but, during the first two years of recovery, many actions have still indicated a strong protectionist bias and a willingness to depart from non-discriminatory policies. Indeed, 1984 witnessed a further tightening in the restrictions applied to already highly protected sectors, such as textiles, clothing and steel; continued proliferation of orderly market agreements, voluntary export restraints and other bilateral arrangements in these and other sectors; a growing number of allegations of unfair trade prices, such as subsidies, covering a wide variety of products; an increase in the number of trade restrictions imposed for balance-of-payments reasons; and the escalation of tensions surrounding agricultural trade.

Some of the trade measures taken in 1984 were the lagged response to pressures unleashed during the recession, rather than a reflection of new protectionist forces at work. In the United States, on the other hand, the

rising dollar imposed an additional competitive pressure on import-competing industries, adding fuel to demands for protection. As in previous years, however, a major force behind protectionist actions in industrial countries was the persistence, despite the upturn in economic activity, of high levels of unemployment and unutilized capacity in traditional sectors and the continued accumulation of agricultural surpluses. Accordingly, trade restrictions in industrial countries have tended to be sector-specific. They have also been directed at particular suppliers whose success in penetrating the market was regarded as suspect or injurious, or both. Partly in view of the degree of volatility in exchange rates, import restrictions have largely taken the form of quantitative rather than price-related provisions.

Because of their questionable compliance with or outright violation of the statutes of the General Agreement on Tariffs and Trade (GATT), a large number of these measures have been taken outside its framework. Even legitimate measures under GATT, such as the monitoring of import flows, price investigations and anti-dumping and countervailing actions, which in themselves need not imply protection, appear to have been used in some instances with protectionist intent.

The upturn in economic activity does appear, nevertheless, to have curbed somewhat demands for new measures of protection in a number of sectors where protectionist pressures had been very intense in recent years, such as automobiles and consumer electronics. An important new development in early 1985 was the decision by the United States Government not to press Japan for a renewal of its "voluntary" restraints on automobile exports to the United States, despite vigorous pressure from the United States automobile industry. In addition, Japan has been in the process of implementing a substantial trade liberalization programme, although at a pace its main trading partners, anxious for enlarged export markets, would like to see accelerated. Another positive development in trade policy that occurred in 1984 was the accelerated implementation by all OECD countries of the Tokyo Round tariff cuts.

The recovery did not weaken demands for further protection in declining industries, such as textiles, clothing and steel, where severe problems of overcapacity, unemployment and unprofitability still exist. In these industries, traditional producers have lost their competitive advantage to new low-cost suppliers and have sought to rely on import barriers or subsidies in order to survive. While it is acknowledged that ultimately much of the capacity of these industries will have to be either modernized or closed, it is often argued that a certain degree of temporary protection is needed to ease the transition. The record, however, is not encouraging: many supposedly temporary protective measures in the past have not only become permanent but have increased substantially over a period of time, and in many cases have helped to delay rather than foster structural adaptation in the industries concerned. In fact, it was the recession more than anything else that finally forced action on some long-resisted but much-needed changes, such as the weeding out of inefficient producers, the consolidation of productive facilities into viable operations, and the elimination of excess capacity.

In the developing countries which have faced the need to cope with extremely adverse external payments conditions, import restraints have been largely geared to the rationing of scarce foreign exchange. Apart from quantitative limits, these restraints have often involved the imposition of prior import deposits, as well as the levying of additional duties, which had the added advantage of raising fiscal revenues. If not across the board, the measures have typically applied to broad categories of goods, depending on how essential they were. They have frequently applied also to "invisibles" (for example, travel) and have often been accompanied by lengthy administrative delays. In addition, as part of their adjustment effort, many developing countries have adopted a variety of export-incentive schemes which, when effective, have become the subject of much contention and often of retaliation by trading partners.

Although most trade policy developments in 1984 were concerned with protectionism, several measures were also taken that specifically sought to promote or to continue promoting the export trade of developing countries. One was the renewal of all schemes under the generalized system of preferences. As modifications were made in most schemes regarding product coverage, ceilings, designated beneficiaries, and so on, it is difficult to establish whether, on balance, the schemes were improved or not. What is evident in most schemes, however, is the trend towards greater selectivity in the granting of preferences and the inclusion of "graduation" clauses. In the case of the United States, the scheme also establishes eligibility criteria pertaining, *inter alia*, to offering access to United States exports, enforcing certain rights of workers and respecting intellectual property rights.

A second measure favouring developing country trade was the extension for a third five-year period of the Convention of Lomé, a major trade and financial cooperation agreement between EEC and 65 African, Caribbean and Pacific (ACP) countries. As far as it concerns trade, Lomé III provides duty-free access for virtually all ACP exports to EEC. A third measure was the granting to the United States of a waiver from the GATT most-favoured-nation clause on account of its Caribbean Economic Recovery Act. This permits the United States to provide preferential treatment to a selected group of countries in the area.

Developments in major protected sectors

Recent developments in the **steel** industry seem to point to a considerable measure of adjustment of production structures. For instance, in the United States, there is an ongoing process of rationalization of the sector that has already led to the elimination of some 17 million tons of excess capacity, and a further reduction of 5 to 10 million tons of capacity is expected in the near future. This process has been further reinforced by the passage of legislation which makes steel protection contingent on the reinvestment of profits and modernization of the industry, as well as on the retraining of redundant workers. Meanwhile, in Europe, under the Davignon Plan,[8] by the end of 1985 the industry will have shed 27 million tons of redundant steel-making capacity. Similar restructurings are taking place in Australia, Japan and a few other countries.

Recent developments in international trade in steel mark a further retreat from unrestricted trade flows. As a result of past and more recent measures, virtually all trade in steel is now managed. Within EEC, steel production and trade is regulated by a system of mandatory and voluntary quotas and minimum prices, while imports into the Community are covered by a series of bilateral agreements with its main suppliers - Australia, Brazil, Bulgaria, Czechoslovakia, Hungary, the Republic of Korea, Poland, Romania, South Africa and Spain - besides special informal arrangements with Austria, the Nordic countries and Japan. The agreements establish global ceilings and provide that exports to the Community should not be concentrated geographically, in time or in specific products.

In the United States, major moves to restrict steel imports were made in July 1983 and again in September 1984. As a result of these measures, steel imports are to be kept at roughly 20 per cent of United States steel consumption for the next five years, compared to an estimated 25 per cent in 1983. In subsequent bilateral arrangements, it was agreed that EEC and Japan would retain their share of the market of approximately 5 per cent each and that Canada's share of some 2 per cent would also remain largely unchanged. Thus the full weight of the restrictions fell on a host of smaller suppliers, mostly developing countries, whose collective share of the United States market shrank from 12 per cent to only 6 per cent.

Steel protectionism itself and the strong bias in favour of traditional producers at the expense of more efficient developing country suppliers are indefensible on grounds of either equity or efficiency. It has been estimated that, while exporters to the United States were having to forgo annual revenues of $1.5 billion, the economic welfare cost to United States consumers was $95,000 per job saved.[9] Among the exporters most seriously affected by the curbs are some of the most indebted developing countries, such as Brazil, Mexico and the Republic of Korea.

An even more extreme case of inequity combined with inefficiency is that of **textiles and clothing**, where, after 25 years of progressively tighter restraints against exports from developing countries, the industry is still seeking - and getting - additional import relief at a very high cost to all involved. The economic welfare cost per job saved in the textile sector has been estimated at $169,600 for the United States and $124,700 for EEC in 1980, while the revenue loss for exporters in that year was of the order of $9.3 billion on account of restrictions in the United States and $7.5 billion owing to import curbs in EEC.[10]

Virtually all the trade of developed market economies with other countries in textiles and apparel is now managed. With each renewal of the Multifibre Arrangement, restrictions have become increasingly stringent in terms of product coverage, size of quota and number of affected suppliers. The Arrangement now covers exports from 50 suppliers - China being the latest addition - and contains over 3,000 quotas for a wide range of products, together with a variety of provisions that can be invoked in "exceptional circumstances", to counteract a surge in imports, or to maintain minimum viable production.

The latest increase in activity in this field was triggered by a series of actions on the part of the United States, culminating in the convening of an emergency meeting of the Textiles Committee of GATT in September 1984. In December 1983, the United States had adopted a set of "additional criteria" for monitoring textile and apparel trade, designed to avert a sudden surge in imports in the context of the overall burgeoning of United States imports which was then occurring. In the course of the six months that followed, over 85 citations were made to some 20 suppliers to the effect that the quantitative criteria recently adopted were being exceeded. In July 1984, countervailing duty petitions were filed on virtually all products originating in 13 developing countries. Three weeks later, a new set of interim regulations governing the rules of origin of

[8] See *The European Community's Industrial Strategy*, European Documentation, 1983, p 47

[9] See L. L. Schorch, "The effects of import quotas on the steel industry", United States Congressional Budget Office, July 1984; and O. K. Kalantzopoulos, "The cost of voluntary export restraints for selected industries in the United States and the EEC", World Bank, November 1984, mimeographed

[10] See M. E. Morkre, "Import quotas on textiles: the welfare effects of United States restrictions on Hong Kong", Bureau of Economics, United States Federal Trade Commission, August 1984; C. Hamilton, "Voluntary export restraints on Asia: tariff equivalents, rents and trade barrier formation", Institute for International Economic Studies, Stockholm, Seminar Paper No. 276, April 1984; and O. K. Kalantzopoulos, *op. cit.*

all textile and apparel items entering the United States was adopted, with the stated intention of stopping the circumvention of import quotas through the transshipment of goods.

If the United States was the most active country as regards tightening the protection of the textile and clothing industry in 1984, other countries had filled that role in previous years. What is important is to rectify the situation and an opportunity to do so presents itself in 1985 as the Multifibre Arrangement again comes up for renegotiation before it expires in July 1986. Alternatives are already being examined within GATT for the transformation or eventual dismantling of the Arrangement.

Agriculture is another field in which trade tensions have remained high, aggravated by farm policies in industrial countries that have caused a persistent accumulation of agricultural surpluses, particularly sugar, beef, dairy products and cereals - policies largely shaped to meet sensitive domestic political considerations. In practice, this has meant shielding high-cost local producers from international competition, so that agricultural policy in industrialized countries has frequently relied heavily on trade restrictions to de-link local prices, and thus farm incomes, from international market conditions. In addition, the combination of price-support schemes which foster output expansion, slowly growing industrial country demand, and major efforts by developing and centrally planned economies to enhance their own agricultural sectors have recently made it increasingly difficult to dispose of the farm surpluses of industrial countries through exports. The consequences, discussed above, have been unusually low, even unremunerative, international prices.

The recent decision by the United States and EEC to lower dairy support prices helped to reduce some of the tensions in this sensitive area. Some relief was also provided by the successful negotiation of enlarged quotas for beef and citrus fruits by the United States and Japan, and by an agreement between EEC and New Zealand regarding imports of butter into the Community.

Encouragement could be taken from the fact that some progress is being made in discussions in GATT of policy factors affecting international trade in agricultural goods. At the 1982 Ministerial Meeting, GATT members had agreed for the first time to undertake a thorough examination of their agricultural support policies, recognizing, for practical purposes, the deleterious effect of those policies on trade. Previously, there had long been an unwillingness to see agricultural trade subjected to a set of internationally agreed rules, which is what bringing it into the GATT framework entails. Although that objective is still far from being achieved, the continuing examination of agricultural trade in GATT may be seen as part of a growing awareness of the extent, cost and consequences of agricultural protection. It complements efforts - particularly in the United States and EEC - to curb agricultural support programmes.

Nevertheless, the main issues of contention for most agricultural commodity exporters remain unresolved. One is the permanence of the GATT waiver concerning the United States Agricultural Adjustment Act of 1955, granted to the United States nearly 30 years ago as a temporary measure and under which (sect. 22) the United States restricts imports of such items as sugar, peanuts, cotton and dairy products. Pressure is building to lift the waiver or limit it through a "standstill" provision and a "sunset" clause. The other major complaint is the excessive import protection embodied in the EEC Common Agricultural Policy, as well as the Community's practice of heavily subsidizing the export of its farm surpluses.

Indeed, one of the salient features of agricultural trade disputes in recent years has been the spreading tendency to subsidize exports of farm surpluses to third markets. Over the last two years, the United States and EEC have repeatedly engaged in the competitive subsidization of agricultural exports, notably wheat flour, to a number of developing countries. Tension escalated last October when the Community announced that it would sell surplus butter at half price to the Soviet Union, the Islamic Republic of Iran and a number of other Middle Eastern countries. The United States promptly retaliated by selling surplus butter of its own at subsidized prices to Egypt, and by withdrawing from the International Dairy Agreement, the GATT instrument for enforcing discipline in these matters. Meanwhile, other agricultural exporters legitimately complain that such subsidized exports are encroaching on their own export markets. The case of sugar, discussed above, is perhaps the most egregious example.

Opportunity for liberalization and proposed negotiations

Despite the fact that the record in matters of protectionism in the last few years has been more negative than positive, there are grounds for belief that an opportunity for liberalization is opening. One such factor is the economic recovery; as it has spread, it has served to reduce some of the intensity of protectionist pressures. Another is the ever-widening recognition that the cost of preserving employment through protectionist policy is extremely high; one example is the intensifying resistance in recent years in EEC to the budgetary consequences of its agricultural policies. A third factor is the growing acknowledgement of the interrelations between international trade and financial matters. Recent developments have shown that financial instability in the form of wide exchange rate swings and balance-

-of-payments difficulties engenders protectionism in trade. Lower trade, in turn, holds back growth and makes it more difficult to overcome financial strains, it being especially difficult to service successfully the debts of the developing countries in a protectionist environment. The international financial community, both official and private, has thus become another constituency pressing for trade liberalization.

In addition, within the domestic political nexus, protectionist forces are increasingly having to contend with countervailing trade interests. In the United States, for instance, farmers joined consumer groups, importers and retailers in opposing new curbs on textile, clothing and steel imports. The farmers feared that further import restrictions might result in retaliatory actions that would jeopardize their own exports. In Europe, a realignment of forces is taking shape under which preoccupation with declining industries is being replaced by an emphasis on creating the conditions for Europe to partake more fully in high-technology industries with greater growth and export potential. These forces seek not only to expedite intra-EEC trade, but also to make EEC less defensive and more forward-looking. For its part, Japan has already committed itself to a set of trade and finance measures designed to foster imports. Likewise, a number of developing countries have undertaken major trade liberalization efforts of their own.

If there is, in fact, a nascent broad constituency for trade liberalization, it is appearing at a time when the multilateral trading system has been shaken to its roots, not only by the increase in protection itself, but also by the modality of protection, namely, the marked preference for non-transparent, highly selective measures which contravene established norms. In one sector after another (for example, in textiles, steel, automobiles and some electronics), the larger trading partners have carved up the market among themselves, often leaving only a token residual share to non-traditional suppliers. Such market-sharing arrangements not only prevent marginal producers from increasing their market share but effectively lock out potential new suppliers from the market.

The proliferation of bilateral agreements is a further challenge to the multilateral system. Indeed, to the extent that trade issues have been "resolved" at all in recent times, it has often been largely through the working out of some type of bilateral arrangement, which in itself is an open violation of the principle of non-discrimination on which GATT is based. This is a matter for concern, not only because such arrangements typically work to the disadvantage of the weaker trading partner, but also because they often result in the curtailment of the trade interests of others not even party to the agreement. In this regard, the progressive fragmentation of the trading régime poses a particularly serious threat for developing countries which, in the absence of retaliatory power, rely on the multilateral character of the system to guarantee their trade interests.

The developing countries themselves have found it increasingly necessary to resort to a form of bilateral arrangement, however. That is, they have increasingly required "countertrade" packages under which foreign suppliers of imports receive payment in export goods which it is then their responsibility to market. While arguably better than no trade at all, such barter arrangements do introduce an additional element of inefficiency and rigidity and contribute to the overall fragmentation of the system. These measures were introduced largely as a response to the weakening of trade in the early 1980s and in the face of severe shortages of liquidity.

The need to restore the multilateral character of the trading régime and to bolster the much-eroded authority of GATT are two important reasons for considering the launching of a new round of multilateral trade negotiations. At this juncture, a commitment to prepare for a new round could also mark a broadly agreed decision to find a mechanism by which to effect a phased roll-back of protectionism within a specified period. Interpreted as a new level of commitment to liberalization, such an undertaking would not only assist Governments in resisting further domestic protectionist pressures but might be the only way to overcome the lingering impasse in such unresolved hold-overs from the Tokyo Round as an agreed safeguards clause, without whose solution the GATT system will continue to be under siege.

It remains, however, to persuade the vast majority of trading countries to participate in such a new round of multilateral trade talks. Despite the protectionist actions taken, the major trading countries of the world remain committed proponents of liberal trade, and it is for them to lead the international community to freer trade through the example of their own policy. Indeed, to do so would serve their own best interests. For example, entering into multilateral preparations for a new trade round could be a useful device, in effect warning protectionist forces in their own countries that they faced a time-limit for adjustment behind protectionist barriers.

It would also be necessary for the major trading countries to agree to negotiate the reduction of trade barriers on the major items of export interest to all groups of countries, including items on which GATT principles have been mostly bypassed, such as textiles.[11] This might serve to convince most countries, in particular the developing countries, that they too stand to gain from active participation in the negotiations.

[11] This point has already been made, for example, by the Council of Economic Advisors to the President of the United States; (see *Economic Report of the President* (Washington, DC , United States Government Printing Office, 1985), pp 122-125

The developing countries themselves face a dilemma regarding the degree of their participation in such a new round. In the past, developing countries have not obtained many of the trade concessions that they sought, and have faced tightened restrictions on some of their exports through trade barriers which have largely bypassed GATT. They would thus be justly sceptical about the actual benefit they might reap from a new round. On the other hand, their only possible means of influencing the outcome of such negotiations is active participation in them. Countries which participated in previous rounds of multilateral trade negotiations generally obtained larger concessions on items of export interest to them than did non-participants. Developing countries are already under increased pressure - internal as well as external - to reduce their own trade barriers, but their greater integration into the international economy also requires that they be accorded significantly greater access to developed country import markets.

While the potential benefits of a new round of multilateral trade negotiations appear to be quite substantial, there are several risks attending such an endeavour. One is that much-needed trade liberalization measures may be postponed until the negotiations are concluded, a process that is likely to take several years. Worse still, countries may be tempted to increase protection now and use such measures as bargaining chips for extracting concessions later. There is also the risk that if not enough countries participate, or if those that do are not prepared to make significant compromises, the trading system may be further weakened rather than strengthened by the exercise. It is important, therefore, that until such time as the negotiations are launched countries should abide by their commitments to refrain from further protectionist activities, those that undertake trade liberalization measures unilaterally should be given due credit for those actions in the course of the negotiations, and enough flexibility should be shown to motivate the largest possible number of countries to participate in the negotiations.

In the meantime, it is also important that parallel efforts should be made towards the eradication of "grey area" measures, by either eliminating them altogether or replacing them with tariff equivalents or global quotas, applicable to all parties in a non-discriminatory fashion, which could be gradually phased out. Such actions would not only have merit in their own right but would be auspicious signals for the eventual success of the proposed round of multilateral trade negotiations, whose conclusion may enhance stability and growth in the world economy.

Chapter V

CURRENT ACCOUNT IMBALANCES AND INTERNATIONAL FINANCIAL RELATIONS

The first half of the present decade has been marked by significant shifts in the pattern of current account balances, intimately related to changes in international financial flows. The debt situation of developing countries has figured prominently in the trends and prospects for private financial flows, which in any event are undergoing an evolution in institutional forms that has implications for the access of different countries to private finance. Overall, there appears to be a heightened degree of international instability and uncertainty arising from financial and trade developments in response to which developing countries - indeed, most countries of the world - have been attempting to rebuild the levels of official international liquidity. As the current trends are partly the result of policies already implemented, for example, with respect to official development assistance and other official international finance, there are opportunities to improve upon the current outlook through international policy initiatives.

Changing pattern of current account balances

At the start of the 1980s, current account surpluses were earned mainly by oil exporters, including the United Kingdom and the USSR. The deficits were concentrated in the energy-importing countries, both developed and developing. International capital flowed among a large number of countries so that pressures and opportunities emanating from trade in goods and services largely determined the pattern of current accounts.

By mid-decade, in contrast, a redirection of international capital flows served to reshape the world pattern of current account balances. In particular, as may be seen in table V-1, the current account deficits of the developing countries have been greatly reduced and many of the developed countries have achieved substantial surpluses, especially Japan (see table A-11). On the other hand, the surpluses of the oil-exporting countries have largely been either greatly reduced or turned into deficits. There were major exceptions, including the Soviet Union, which has experienced a steadily rising surplus in the decade, and two high-debt developing country energy exporters, Mexico and Venezuela, whose current accounts shifted from large deficits to substantial surpluses in the face of the international debt crisis.

Table V-1. World balance of payments on current account,[a] by country groups, 1981-1985

(Billions of dollars)

Country group	1981	1982	1983	1984[b]	1985[c]
Developed market economies	-5.5	-5.5	-0.3	-35.5	-43.5
United States	12.8	-1.5	-33.3	-92.0	-115.0
Other countries	-18.3	-4.0	33.0	56.5	71.5
Developing countries	-41.1	-102.8	-76.2	-53.5	-50.5
Capital-surplus countries	58.7	0.3	-12.8	-9.0	-9.0
Other net energy exporters	-26.9	-35.5	-12.1	-4.5	-5.5
Net energy importers	-72.9	-67.6	-51.3	-40.0	-36.0
Centrally planned economies[d]	3.5	16.8	19.9	19.0	15.0
China	-	3.1	2.7	1.0	-2.5
Eastern Europe	-2.7	4.4	6.0	7.0	6.0
USSR	6.2	9.3	11.2	11.0	11.5
Residual balance[e]	43.1	91.5	56.6	70.0	79.0

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

[a] Excluding government transfers
[b] Preliminary estimates, rounded to the nearest half-billion dollars
[c] Forecast, rounded to the nearest half-billion dollars
[d] Trade balances only
[e] The world current account discrepancy reflects timing asymmetries, the balance on services of the centrally planned economies, errors in trade balances and under-recording in the receipts of services. Particularly large sources of discrepancy are investment income channelled through off-shore financial centres and non-factor services exported by the developed market economies to OPEC member countries

Meanwhile, the United States became in 1984 the country with the largest current account deficit ever recorded for a single year. Its deficit for 1985 is expected to be even larger.

The most recent changes in current account balances have arisen from changes in both trade and services flows. In the United States, for example, the large deterioration in the current account deficit in 1984 consisted of a $46 billion worsening of the merchandise trade deficit and a $13 billion decline in the recorded surplus on "invisibles" (that is, services and private transfers).[1] The other developed market economies, in contrast, together added substantially to their current account surplus, although a $32 billion improvement in their aggregate trade surplus was partly offset by a $7 billion deterioration in their deficit on invisibles, principally owing to increased interest payments, especially by the smaller countries. For 1985, a continuation of the same trends is forecast for the United States. For the other developed market economies, the services balance as well as the trade balance should improve, partly on the strength of larger interest earnings by creditor countries.

For the developing countries, the reduction in the deficit position of each of the two main groups was largely due to improvements in trade balances (see table A-12). For the capital-surplus countries, the shrinking of the trade surplus was reversed for the first time since 1980, owing largely to a second year of import cut-backs. For the capital-importing countries, improvements in trade balances reflected continuing or intensified adjustment programmes in both energy exporters and energy importers. For both of the latter subgroups, however, the increased deficits on services reduced improvement in the current account achieved on the basis of trade balances alone. In certain countries, a reduction in overseas employment and contracting activity, due to adjustment efforts of surplus countries, caused services earnings to fall. In certain other countries, civil tensions disturbed tourism earnings. Most significant in aggregate terms, however, was the severe burden imposed by increased interest payments on external debt.

For 1985, only small changes are expected in the current accounts of the developing countries. For the capital-surplus countries, a small improvement in export earnings may serve to offset a decline in net interest earnings, leaving the current account balance essentially unchanged. With respect to the deficit energy exporters as a group, rather modest increases in imports relative to exports should reduce the trade surplus and - with broadly unchanged net service payments - add modestly to the current account deficit. Among the net energy-importing countries, further increases are expected in export earnings, particularly among the exporters of manufactures, as occurred in 1984. With interest-servicing costs for the year not expected to increase significantly, the opportunity is arising for a certain relaxation of import constraints. In almost all cases, though, import volumes are still expected to grow by less than historical rates. The net impact on the current account of the group is expected to be a further small decline, although certain groups of countries, such as the energy-importing countries of sub-Saharan Africa, are not expected to be able to reduce their deficits in 1985.

Among the centrally planned economies, the trade surplus of Eastern Europe improved by a modest amount in 1984, largely as a result of an improving trade balance with the developed market economies, particularly those in Western Europe (see table A-13). The trade balance of the USSR also improved with respect to the developed market economies. The convertible currency current account is estimated to have improved by another $1 billion for Eastern Europe, to roughly $3.5 billion, while that of the USSR improved only slightly over the 1983 level. In China, the policy of expanding imports helped to reduce the trade surplus, though not by as much as the Chinese planners had envisaged at the beginning of the year. Since China's services account is estimated to have been in a significant surplus position, its current account remained in surplus in the order of $2 billion, a somewhat lower level than in 1983. The outlook for 1985 is for surpluses similar in size to those of 1984 for most Eastern European countries. However, the surplus of the USSR is likely to contract, owing to a decline in fuel export earnings and a substantial growth in grain imports. The modernization efforts announced by China, entailing increased technology imports in particular, are likely to reduce its surplus by a substantial amount.

Trade, investment and savings aspects of current account shifts

The significance of the current account swings described above may be highlighted by viewing them from the perspectives of trade, investment and savings. To begin with trade-related factors, the energy-importing developing countries, which have had to face a sequence of external difficulties since the late 1970s, including declining terms of trade, rising interest rates and a severe recession in export markets, saw the ratio of their current account balance to imports rise from about 19 per cent in 1978 to around 27 per cent in 1981 and 1982. In the latter years, in other words, foreign exchange earnings, after deduction of payments for interest and other factor services, covered the cost of less than 75 per cent

[1] The decline in net service earnings is largely the result of the rapidly eroding net foreign asset position of the United States. The United States, from being a net recipient of foreign interest income, is, in fact, becoming a net payer.

of imports. Capital flows (or reserves) were required to pay for the rest.[2] Under strong adjustment measures and restrictions on credit availability due to the international debt crisis, the ratio of the current account deficit to imports fell back to the 1978 level within one year and declined much further in 1984, to about 16 per cent.

Virtually the reverse trend obtained for the United States. The current account surplus of the first years of the 1980s was essentially eliminated by 1982. The current account deficit then rose to almost 12 per cent of imports in 1983 on the strength of a jump in the ratio in the second half of that year, followed by further increases, so as to average about 25 per cent for 1984 as a whole. This, in fact, was the current account counterpart to the growth in import demand that largely fuelled the world recovery of 1984.

A second perspective on the current account relates to the level of domestic investment financed from abroad. From a national accounting point of view, a current account deficit financed by a net capital inflow adds to savings mobilized domestically and thereby permits a higher rate of consumption and investment than would have otherwise have been reached. For example, for the energy-importing developing countries over the period 1978 to 1980, real investment increased, as did the share financed by external resources; the ratio of the current account balance to gross domestic investment rose to over a quarter in 1980 from 16 per cent in 1978. Under recessionary and adjustment pressures, investment fell in 1981 and 1982, while the aggregate level of the current account deficit was roughly maintained, resulting in a rise in the external financing share to about 30 per cent. During the next two years, while current account deficits were brought down sharply, aggregate investments for the group as a whole began to recover, returning in 1984 to roughly their 1980 level in absolute real terms - though not as a share of GDP - according to preliminary data. The net effect was that the externally-financed share of investment fell back below 20 per cent in 1984. In other words, the investments which these developing countries have been making - largely with a view to increasing production of tradable goods so as to meet adjustment requirements - have increasingly been financed out of domestic savings; the net contribution from external resources has fallen.[3]

In contrast, external resources have been making a growing contribution to the financing of consumption and investment in the United States. The net capital outflow from the United States in the early 1980s turned into a net inflow that represented about 6 per cent of United States gross domestic investment in 1983 and more than twice that share in 1984. Well over a third of the increase in United States investment in 1984 was made possible by the expanded inflow of external resources which has been the counterpart to the growth in the current account deficit.

The major sources of savings for transfer to the deficit countries have also changed since the start of the decade.[4] In 1980 and 1981, following the large increase in petroleum prices, the capital-surplus developing countries with limited short-term absorptive capacity found themselves as a whole investing approximately half of their gross national savings abroad. By 1984, however, these countries had become net importers of foreign capital, and the largest surplus was earned in that year by a country with a large domestic absorptive capacity, namely, Japan, which nevertheless made an overseas placement of roughly 10 per cent of its gross national savings.

Export earnings and import behaviour

Countries which have had to reduce their current account deficits in recent years have in effect been less able to increase import levels by drawing on foreign financing or utilizing foreign assets of their own. In other words, the volume of imports of these countries has been limited to an increasing extent to the purchasing power of their exports.[5] Other countries, in contrast, have seen the growth in the purchasing power of their exports outstrip their growth in imports, while capital inflows have underwritten large import increases elsewhere.

In the most extreme case in 1984, the United States was able to expand its import volume at a rate over three

[2] This is not to say that a quarter of imports was directly paid for with import-related financing and the rest out of current earnings. Rather, the group of countries as a whole required net financial inflows of one sort or another equal in value to at least a quarter of imports (imports in the reported ratios are c i f , as a proxy for imports of goods and non-factor services).

[3] The pattern for the deficit energy-exporting developing countries was analogous but more extreme. They moved quickly from a small current account surplus in 1980 to a deficit whose offsetting capital inflow financed about a quarter of investment in 1982 but well under 5 per cent in 1984, the latter at a time when the investment level was still lower, by about a fifth, than the previous peak in real investment reached in 1981.

[4] As may be inferred from table V-1, the largest, consistent source of surplus appears to be unrecorded transactions. Partial evidence suggests that, in addition to unrecorded capital flows, a certain share of the service and interest income of some developed and energy-exporting countries has been understated in their balance-of-payments data, so that their current account surpluses are larger than reported (or their deficits smaller); see IMF, *World Economic Outlook 1983*, appendix A, supplementary note 11.

[5] The volume of imports which can be purchased with export earnings is a concept that should incorporate trade in services; nevertheless, the estimates presented here are restricted to merchandise trade, as up-to-date price indices and data on trade flows of services are incomplete, if available at all, for most countries.

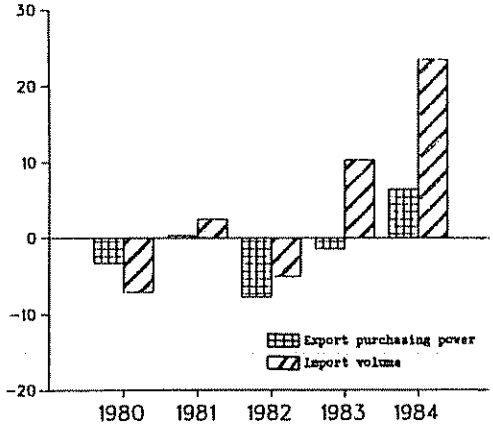
and a half times faster than the expansion in the purchasing power of its exports (see figure V-1). In 1983, import volume had grown by over 10 per cent while the purchasing power of exports actually fell. These developments could occur, of course, because the United States was enjoying an unusually strong capital inflow.

China is another country whose growth in import volume was not matched by growth in the purchasing power of exports in either 1983 or 1984. The Chinese case is different, however. As a result of extremely rapid growth in the purchasing power of exports in the early 1980s, China realized a substantial surplus in its trade and current accounts. While the growth in import volumes seen in figure V-2 for 1983 and 1984 can be explained largely in the context of the recent reform and modernization needs of China, it was facilitated by the higher import capacity that had been achieved.

The pattern shown by the group of capital-surplus developing countries illustrates an opposite development (figure V-3). There, a fall since 1981 in the purchasing power of exports, which for the present is not expected to be recouped, has led after a short lag to a cut-back in the volume of imports to more sustainable levels. Even so, the current account of the group is expected to remain in a small deficit position, at least for the near term.

Figure V-1
Purchasing power of exports and import volume: United States, 1980-1984

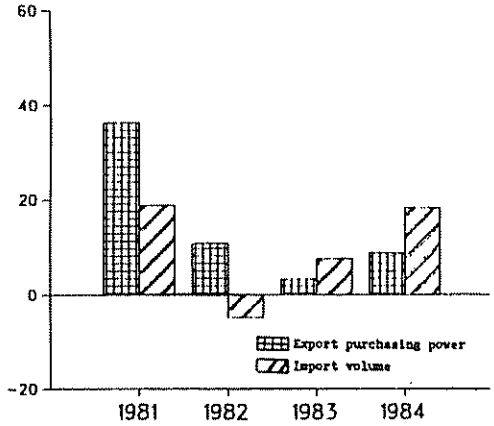
(Annual percentage change)



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

Figure V-2
Purchasing power of exports and import volume: China, 1981-1984[a]

(Annual percentage change)

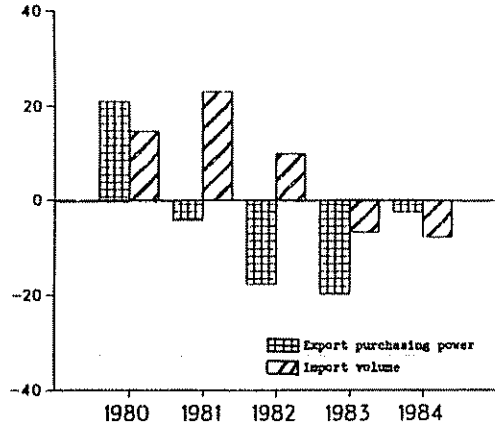


Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national sources

[a] 1980 not available on a comparable basis

Figure V-3
Purchasing power of exports and import volume: capital-surplus developing countries, 1980-1984

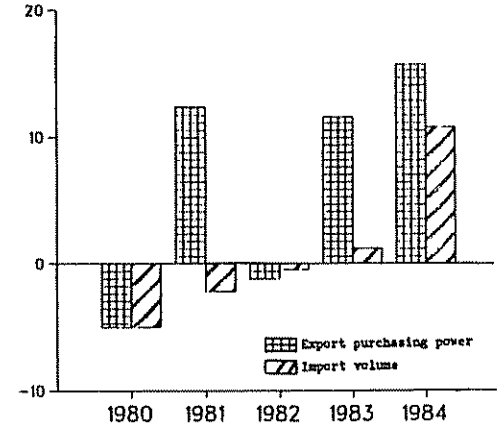
(Annual percentage change)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat (see table A-9)

Figure V-4
Purchasing power of exports and import volume: Japan, 1980-1984

(Annual percentage change)



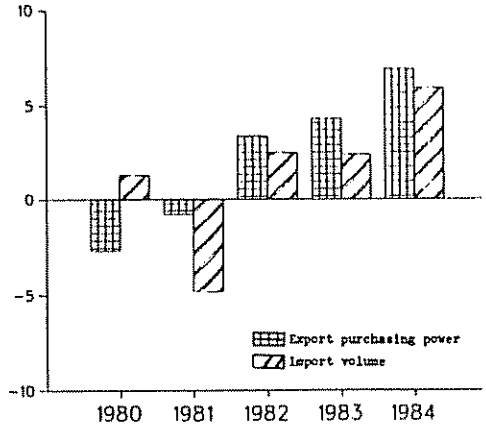
Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*.

Japan is an example of another phenomenon. The sharp expansion in 1983 and 1984 in Japan's purchasing power of exports has not been matched by import growth. Indeed, 1984 marked the first year of the decade with any significant import volume increase. The resurgence in imports, however, had to come about as a consequence of Japan's export surge; not only was it necessary to resupply inventories of imported inputs for the export-led growth but, partly on the strength of export performance, fixed investment also picked up and this required greater imports of machinery and equipment. In addition, however, Japan has been under considerable pressure from its trading partners to expand its imports at a greater and sustained rate. As noted in the discussion of protectionism in chapter IV, Japan is in the process of liberalizing access to its market with the aim of accommodating its partners.

In Western Europe, as in Japan, import growth has not matched the growth in the purchasing power of exports but, in contrast to Japan, exports have experienced relatively modest growth, although with some acceleration in 1984, while import volume has been held down as a consequence of low income growth and the price effects of substantial currency depreciation in international markets.

Figure V-5
Purchasing power of exports and import volume: Western Europe, 1980-1984

(Annual percentage change)

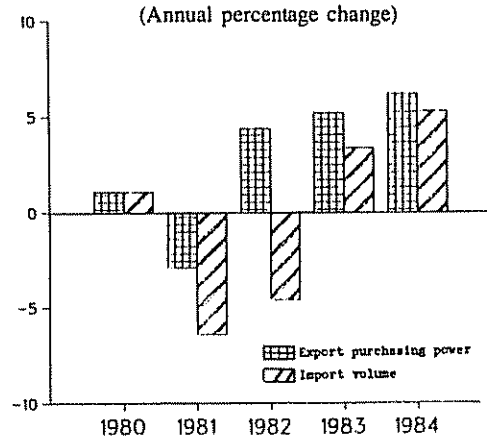


Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*

Finally, the combined effect of world recession and the international debt crisis for the centrally planned economies of Eastern Europe and the capital-importing developing countries is seen in figures V-6 and V-7, respectively. From 1981 for the former and 1982 for the latter, intense efforts were made to curtail import volumes and expand exports within the context of rigorous adjustment efforts. Given the recessionary conditions in the world economy, however, it was difficult for most of these countries to expand the purchasing power of their exports. In 1984, nevertheless, import capacity increased owing to the recovery in developed market economies and the high absorptive capacity of the Soviet market and, as a result, the purchasing power of exports grew substantially for both groups. For Eastern Europe, growth in the purchasing power of exports was sufficient to allow policy makers to ease, albeit cautiously, the severity of import restraints, *vis-à-vis* the market economies. With expanding overall import volumes, the pace of economic activity, especially in industry, could be accelerated beyond planned levels. In the developing countries, the feasible increase in import levels was modest, although it was sufficient to allow a certain revival of industrial activity.

Figure V-6
Purchasing power of exports and import volume: Eastern Europe, 1980-1984

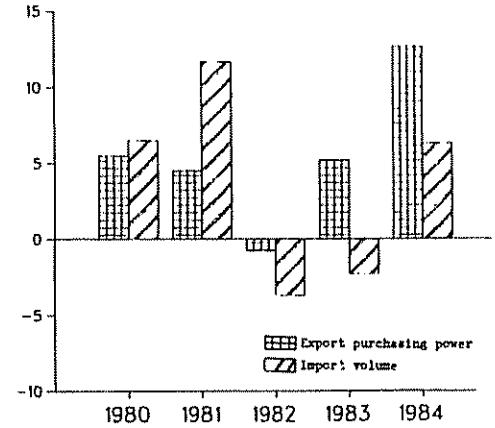
(Annual percentage change)



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

Figure V-7
Purchasing power of exports and import volume: capital-importing developing countries, 1980-1984

(Annual percentage change)



Source: Department of International Economic and Social Affairs of the United Nations Secretariat (see table A-9).

International capital movements, interest rates, and the reverse transfer of resources from developing countries

While gross domestic output in the developing countries has been slowly recovering from the crisis years of the early 1980s, the growth in national income is lagging behind, partly as a result of especially large net interest payments to foreign capital. In fact, considering interest and capital flows together, there was a net transfer of resources out of developing countries in 1984, reversing a trend that had dominated the international financial relations of developing countries in the entire post-war era. This reverse transfer resulted from the combination of the increase in interest payments and a greatly reduced net inflow of new capital from abroad. Indeed, there has been a redirection of private flows towards developed market economies, particularly, the United States.

The United States as a magnet for capital flows

For the first time since the First World War, the United States became a net debtor to the rest of the world in early 1985. This change is all the more remarkable because the United States had reached its peak as a net creditor to the world only as recently as 1982, when it finished the year with a net asset position of $149.5 billion. The swift elimination of this net creditor position was almost entirely the result of major changes in net financial flows, as the other components of the United States capital account have changed by smaller amounts. Indeed, United States official reserve assets have remained largely unchanged since 1982. In addition, although the United States has been experiencing unusually large net inflows of direct investment since 1981, including $27 billion in 1984 alone, the dollar value of the net direct investment position of the United States has remained significantly positive; it was $93 billion in 1983 and preliminary indications suggest that it still exceeded $50 billion at the end of 1984.

The net financial inflows to the United States have come from almost all its major trading partners, especially in 1984 (see table V-2). The largest national source has been Japan, which accounted in 1984 for over a third of the overall net inflow. Direct flows from the other developed market economies accounted for a fifth, although substantial additional inflows from developed market economies were channelled through the off-shore financial centres, principally in the Caribbean. As Eastern Europe continued in 1984 to experience a trade deficit *vis-à-vis* the United States, the financing counterpart meant, in effect, that Eastern Europe remained a modest net importer of capital from the United States.

Table V-2. Net international financial flows to and from the United States, 1981-1984[a]

(Billions of dollars)

	1981	1982	1983	1984[b]
Canada	-9.7	-0.7	0.7	6.1
European Economic Community	-16.6	-14.6	-1.3	10.9
Japan	11.6	13.6	17.6	31.5
Other developed market economies[c]	-2.3	-0.3	2.9	1.1
Eastern Europe	-3.3	-3.0	-1.8	-2.2
Off-shore banking centres and developing countries[d]	4.6	-0.4	18.1	42.3
Total	-15.7	-5.5	36.3	89.6

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

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

[b] Including preliminary fourth-quarter data.

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

[d] Including China.

The sharpest changes in the direction of net United States international financial flows, however, have been the shifts *vis-à-vis* the off-shore banking centres and the developing world. From rather balanced flows in 1981 and 1982, these groups became net suppliers to the United States of $18 billion in 1983 and over $40 billion in 1984. The first two years of the decade had been characterized by large gross inflows to the United States, especially from energy-exporting countries, but these were offset by outflows to the energy-importing countries as the United States financial system, in particular the banks, participated in the "recycling" process. In 1982, there was a reduced but still significant inflow from energy-exporting countries, largely at the expense of a reduction in the assets held by those countries in other financial markets, principally the United Kingdom. At the same time, the net United States outflow to the capital-importing developing countries was cut as a consequence of the international debt crisis. By 1983 and 1984, the energy-exporting countries were no longer redeploying their assets among markets but drawing on them to help finance their own current account deficits. These outflows, however, were substantially exceeded by a large inflow of finance to the United States arising from a net relocation of funds from the off-shore banking centres. At the same time, the net flow of private credit to the capital-importing developing countries continued to shrink.

The bulk of the net financial inflows to the United States from all directions has been mediated by the international banking system. While transactions in securities have made a substantial contribution - particularly in the form of foreign private purchases of United States government obligations - they have been overshadowed by banking flows. Although the data concerning such flows are far from complete, a number of significant developments appear to have taken place in 1984. First, the recorded flow of funds into banks located within the United States appears to have slowed, although this was due to a virtual cessation of the build-up of funds lent by the banks' own overseas branches to their home offices. The attraction of United States bank deposits as a placement for dollar investments remained strong for foreign investors. Second, the flow overseas of United States bank credit slowed to a trickle in 1984, a dramatic contrast to the $104 billion increase in foreign credits that occurred in 1982. Finally, United States non-banking concerns have themselves borrowed heavily, both from the financial institutions of other developed market economies and through the Caribbean banking centres.

The components of the net inflow of financial capital to the United States themselves suggest the causes. A revival of the demand for credit by the United States private sector accompanied the rebound from economic recession. In response, banks switched their lending to domestic borrowers from overseas where borrowing was relatively slack. United States banks - as well as the United States Government which was seeking to fund its unusually large budget deficits - also found it necessary, given monetary stringency, to offer higher interest rates for much of 1984. This apparently served to mobilize substantial foreign and domestic dollar balances. Foreign confidence in the dollar was very high, based not only on the dollar's role as the primary international transaction currency but also on the observed success of the United States authorities in reducing domestic inflation and attaining recovery. Indeed, investors abroad seem to have been adjusting their financial portfolios - and real assets, such as real estate - into greater holdings of dollar-denominated investments. In addition, foreign exporters to the United States appear to have kept their earnings in dollar assets to an unusually large degree instead of converting them to local currency.[6] Together, these factors have led to the marked appreciation of the dollar throughout the recovery period.

How long the United States will continue to attract such large capital inflows and thereby increase its net debtor position with the rest of the world is uncertain. The heavy weight of short-term banking transactions in the capital inflow, as well as the overwhelming volume of flows that moved in a short period of time, suggest that these funds are potentially volatile and could leave the United States at a rapid pace but with most of the rest of the world economy on a slow growth trajectory, many segments still caught up in adjustment processes, and dollar interest rates still high, the United States is likely to remain an attractive placement for investable funds, at least in the short run. Nevertheless, concern about when and in how orderly a fashion the United States will adjust its trade and fiscal deficits could yet turn these funds into "hot money" anxious to find placements denominated in other currencies.

Reverse transfer of resources from developing countries

In the developing countries, the combination of reduced net inflows of foreign capital and high interest rates on external debt was sufficient in 1984 to bring about an unprecedented overall negative or reverse transfer of resources (see table V-3). That is, the net result of all the international financial relationships of these developing countries taken together was a transfer of real goods and services to the rest of the world. Countries, in effect, make such a transfer in either of two ways. A country can either supply official international reserves to the rest of the world, where they will be used to purchase real goods and services, or it can transfer purchasing power by not spending all its foreign exchange earnings on imports of goods and services. In 1984,

[6] That is, there appears to have been a continuation and intensification of a phenomenon originating in 1983; see "Financing the U.S. current account deficit", *Federal Reserve Bank of New York Quarterly Review*, summer 1984, pp. 24-31.

Table V-3. Net resource transfer to the capital-importing developing countries, 1978-1984[a]

(Billions of dollars)

	1978	1979	1980	1981	1982	1983	1984[b]
Net transfer mediated through all credits[c]							
Net capital flow	48.3	51.2	59.9	62.3	47.8	44.7	37.5
Net interest paid	-11.6	-17.4	-23.8	-35.3	-49.5	-47.7	-50.5
Net transfer	36.7	33.8	36.1	27.0	-1.7	-3.0	-13.0
Net transfer mediated through direct investment							
Net flow of investment	7.3	9.9	9.9	14.6	11.8	8.7	8.0
Net dividends	-9.1	-10.9	-13.3	-13.2	-12.6	-10.6	-11.5
Net transfer	-1.8	-1.0	-3.4	1.4	-0.8	-1.9	-3.5
Net transfer mediated through official grants	6.6	10.3	10.8	11.3	10.2	10.0	10.0
Total net transfer	41.5	43.1	43.5	39.7	7.7	5.1	-6.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics*, national data and Secretariat estimates

[a] Net flow of foreign financial resources available for imports of goods and services (that is, after payment of income on foreign capital outstanding). All flows are inflows minus outflows of residents and non-residents. Sample of 88 countries for which adequate data are available.

[b] Preliminary estimate, rounded to the nearest half-billion dollars.

[c] Including all official bilateral and multilateral credits, including use of IMF credit, and all private credits, short and long term.

the second method was the dominant one used by the developing countries since in aggregate their reserves rose (they had been heavily utilized previously) and they realized a very substantial foreign trade surplus.

In general, a negative net transfer of resources by an individual country or group of countries is not a cause for concern. Indeed, a net outward transfer is considered routine for many developed market economies, some centrally planned economies and, in the recent past, even for the developing countries whose earnings from petroleum exports far exceeded their domestic absorptive capacity. It is also considered normal for individual developed and centrally planned economies, and the developing countries, to experience net inward transfers. Such transfers reflect international resource reallocations in response to changing econonomic trends in different countries and are usually thought to contribute to the efficient working of the world economy.

The premature, abrupt and unexpected occurrence of a negative transfer for the capital-importing developing countries as a whole indicates a malfunctioning of the world economy, however, although interpretation of developments at so aggregative a level must be made with caution. It was not the case that all developing countries were making net transfers of resources abroad; rather, the negative transfers of a number of countries were so large that they more than offset the positive transfers still received by the other countries. Meanwhile, those developing countries that were making such large outward transfers still had the same underlying ability to make productive use of external resources as they had a few years before, when they were the recipients of substantial net inflows.

For the near term, there is little prospect of returning to a strongly positive net transfer situation. The various categories of capital flows to developing countries are not expected to grow rapidly, and interest rates are expected to remain on the high level of recent years, while the fluctuations around that trend have the potential to cause major disruptions in their own right.

In the developing countries and in other countries, developed and centrally planned, the growth of external debt has been dominated over the past decade by international banking flows. Credits have generally been granted at adjustable interest rates or on a short-term basis with periodic roll-overs, in each case exposing the borrowers to fluctuating and often unpredictable interest-servicing requirements. Coupled with unsynchronized fluctuations in export earnings, interest payment obligations have become a particularly heavy burden for developing countries in recent years. Indeed, in 1984 a substantial portion of the increase in export earnings was unavailable for import expansion as it was needed for the high interest payments on external debt. As may be seen in table V-4 for capital-importing developing countries, a $23 billion surplus in the balance of trade

Table V-4. Interest and direct investment income in the current account balance of the capital-importing developing countries,[a] 1980-1984

(Billions of dollars)

	1980	1981	1982	1983	1984[b]
Balance on goods and non-capital services	-22.8	-44.4	-35.1	0.2	23.0
Direct investment income (net)	-13.3	-13.2	-12.6	-10.6	-11.5
Interest payments (net)	-23.8	-35.3	-49.5	-47.7	-50.5
Current account balance	-59.9	-92.9	-97.2	-58.5	-39.0

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

[a] Sample of 88 countries for which adequate data are available
[b] Preliminary Secretariat estimate, rounded to the nearest half-billion dollars

and non-capital services in 1984 was more than absorbed by net interest payments of over $50 billion, to which were added more than $11 billion in net dividend payments.

However, the sharp increase in interest-servicing costs and current account deficits between 1980 and 1982, and the sharp cut-back in current account deficits after 1982 were both concentrated in a rather limited group of developing countries, namely, the major debtors. Excluding the 20 largest debtor countries, the aggregate current account deficit of the remaining capital-importing countries rose by about a quarter from 1980 to 1982, with all of the change occurring in 1981, before falling back to under the 1980 level by 1984. The 20 largest debtors, in contrast, expanded their current account deficit by 80 per cent from 1980 to 1982 and have since cut back to a current account deficit that in 1984 was almost $18 billion below the 1980 level (see table A-12). While the access of the latter countries to international commercial bank lending permitted their current account deficits to grow rapidly in the early 1980s, a substantial number of them faced a cut-off of new lending by the commercial banks in the context of the debt crisis that began in 1982. As a result, these countries were forced to make especially sharp cut-backs in their import levels, largely determining the rapid drop in the current account deficit of the developing countries as a whole in 1983.

Towards an international policy on the instability of interest burdens

Whether through economic contraction or lasting adjustment, current account deficits of the developing countries have now fallen to such a degree that, except in isolated cases, further reduction will be hard to achieve. Furthermore, by early 1985, there was somewhat less concern about the ability of debtor countries to service their interest obligations. Overall, despite a rise in average interest rates in 1984, the share of foreign exchange earnings needed to pay gross interest on foreign debt fell slightly as a result of export growth. On the other hand, interest payments have remained a very substantial burden for developing countries, absorbing on average over 15 per cent of foreign exchange earnings. In certain cases, new interest arrears were incurred during 1984 and it was repeatedly recognized during second-round negotiations to restructure debt-service obligations that interest rates and fees charged by the commercial banks should be reduced.

In this regard, it was a welcome development when interest rates in international capital markets receded in the second half of 1984. With lower cost of funds to financial institutions, floating interest rate charges on outstanding commercial bank loans to developing countries have fallen, as have interest charges on certain official credits, including World Bank loans issued since July 1982. Interest rates on new officially supported export credits covered by the OECD arrangement on export credits have also been reduced.[7]

The discussion has thus far been in terms of "nominal" interest obligations, that is, the amounts of interest payments actually due to creditors. There is, however, a second factor influencing the burden of the current servicing of external debt, namely, the effect of international price changes on the real value of the debt outstanding. When international prices of developing country exports fall, as they did in 1984, the real cost of servicing those countries' external debt rises above

[7] The most recent reduction was on 15 January 1985, in accordance with the Arrangement on Guidelines for Officially Supported Export Credits agreed to in October 1983; see *OECD Observer*, No. 125 (November 1983), p. 19

the nominal cost, reflecting the increased real value of the debt as measured in terms of the volume of exports necessary to repay the debt in full. Analogously, an improvement in the developing country's terms of trade reduces the real cost of debt servicing. This valuation loss or gain is a real addition to or subtraction from cost which should be considered in conjunction with nominal interest payments in evaluating the real current burden of the debt. The real interest rate on total debt outstanding in 1984, measured in this way, was not the nominal average rate of about 8.5 per cent but about 10 per cent.[8] As may be seen in table V-5, 1984 was the fourth year in a row in which the real interest rate exceeded the nominal rate.

Table V-5. Real interest rate on the external debt of the capital-importing developing countries, 1980-1984

(Percentage)

	1980	1981	1982	1983	1984[a]
Average nominal interest rate[b]	9.2	10.6	10.2	8.3	8.5
Average change in export prices[c]	29.5	-0.9	-8.3	-3.1	-1.5
Implicit average real interest rate	-20.3	11.5	18.5	11.4	10.0

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based in part on World Bank Debtor Reporting System and data of the Bank for International Settlements.

[a] Preliminary estimate, rounded to the nearest half percentage point.
[b] Estimated interest payments for the year divided by the average of total debt levels at the beginning and the end of the year, all measured in dollars.
[c] Change in dollar-based export price index.

Burdensome as existing interest payments on external debt are, the medium-term possibility of a new surge in interest rates cannot be excluded, even with expected lower average nominal and real interest rates in 1985. What is the state of preparedness for such an eventuality? If the past is any guide, a further increase in the external interest burden, arising from higher nominal interest rates coupled with depressed export markets, is likely to lead to the accumulation of new debt-servicing arrears on the part of a number of debtor countries that might not, for domestic political reasons, reapply severe contractionary policies. In that case, bankers and officials would probably re-enact the recent drama, seeking emergency assistance for the debtor countries to enable them to remain current enough in their payments to avoid obliging the banks to treat their loans as non-performing assets. Confidence in the banks might again be shaken, perhaps with new demands for closer regulation of their activities.

There is no shortage of suggestions of international policy initiatives which might obviate this scenario. One broad class of suggestions entails instituting a "cap" on interest rates charged on floating rate debt, for example, capitalizing part of interest obligations when market rates rise above the ceiling. Banks have not favoured such proposals as they are seen to jeopardize bank earnings when interest rates - and thus the cost of their own funds - rise. Such innovations might serve to discourage new voluntary bank lending when there is instead a desire to see it expand on better terms.

A second class of suggestions argues that international interest rate fluctuations do not differ in substance from international commodity price fluctuations, since in both cases prices are the result of international market and policy factors and are largely beyond the control of individual countries. In recognition of the harmful effects of commodity market fluctuations, especially on developing country producers, IMF has long operated the Compensatory Financing Facility. The Facility has already been extended to permit drawings in response to adverse trends in cereal import costs; it could similarly be extended to cover interest rate fluctuations. The idea of such an extension is not completely new,[9] and its implementation would be no more difficult in principle than that of the cereal import facility. It would be an act of prudence by the international community, and would increase the confidence of the private sector that the debt-servicing capacity of debtor countries would not be undermined after all the major adjustment efforts made by them in the first half of the 1980s.

[8] This estimate is an average of diverse developing country experiences, depending in individual cases on the currency composition of debt and the product mix of exports. The impact of real interest rate developments on individual countries also differs according to the size of debt outstanding relative to GDP.

[9] A suggestion for a facility of this type, while not formally to be included in the Compensatory Financing Facility, was incorporated in the proposal for an IMF debt-refinancing subsidiary made by the Federal Minister for Planning and Development of Pakistan in his address to the Economic and Social Council on 6 July 1984.

The Compensatory Financing Facility, if expanded to include interest payments, would serve as a fall-back for both lenders and borrowers whose debt-servicing arrangements have been restructured on the basis of assumptions about trends in trade and interest rates that could prove to be too optimistic. It might then help stave off the need for yet another round of debt renegotiations. If the trade and interest rate assumptions are in fact realized, the Facility would not be drawn upon but, in the meantime the degree of uncertainty would be lessened in debtor countries and confidence would be higher on the part of creditors.

Short-term prospects for private and official resource flows to the developing countries

In view of current trends and prospects, no resurgence of net financial resource flows to the developing countries is anticipated in the short term. In the area of direct foreign investment, as recently discussed elsewhere,[10] this is in spite of numerous recent measures by host countries to enhance their attractiveness to private direct investors. In addition, the private capital which has left a number of developing countries during periods of uncertain or crisis conditions, especially since the late 1970s, does not appear poised for a return flow. Fragmentary evidence suggests, however, that the rate of outflow, at least, has greatly slowed. In the area of foreign private and official credit flows, the outlook is for no more than modest improvements in flows.

Debt constraints on the growth of private credit

A resurgence of net credit flows to the developing countries entails, by definition, an acceleration in the growth of their external debt. As the debt crisis has already been a major preoccupation of the international community for the past three years and is still not resolved, a large-scale increase in debt does not seem very likely in the near term.

The debt crisis has involved an unprecedented number of cases in which countries could not honour their commitments to service their external debts on the dates specified. The reasons have been analysed extensively elsewhere.[11] Not surprisingly, the earlier confidence of the banks in the soundness of sovereign-risk lending to many developing countries crumbled, and the process whereby the funds with which to repay maturing loans were in effect raised from new loans was disrupted. Major debtor countries therefore needed to service their debts out of current - greatly reduced - foreign exchange earnings, which could not be done.

By 1984 it still could not be done to the full extent required, in most cases. Rather, what replaced the almost automatic payment of debt servicing out of new loans for the debt-crisis countries was a series of renegotiations involving the creditor banks, the debtor country Governments and IMF, whereby debt-servicing obligations were postponed and new loans often provided to help cover interest payment obligations. After the first set of debt renegotiations in 1982-1983, it became widely realized that debtor countries were being asked to pay unusually high fees and spreads over base interest rates and that the revised amortization schedules were still not feasible. The subsequent renegotiations have lowered debt-servicing costs and lengthened maturities considerably. If these again prove unrealistic, there will undoubtedly be yet further restructurings of the debt. Meanwhile, even outside the context of new formal debt restructuring exercises, but within the context of economic adjustment programmes, the provision of new private loans is being negotiated with the support of IMF and the international development finance institutions.

In this manner, and with the process working more smoothly in some cases than in others, existing commercial bank debt is being managed and a modest volume of new loans is being provided. International bankers seem to be less afraid that hundreds of billions of dollars in loans may have to be regarded as non-performing assets. Generally, their loans are still being serviced but they are viewed as less liquid than previously - although the emerging secondary market in these loans provides a limited degree of liquidity. Even if the banks are less nervous about the risk to their own institutions, however, they are apparently not eager to increase their exposure through new loans.

Although the commercial banks themselves may not soon again become major net lenders of medium-term finance to the developing countries, the possibility of renewed credit flows from the international private sector as a whole need not be discounted; but for this to take place the capital markets would have to assess positively the debt-servicing capacity of the borrowing countries.

The perception of debt-servicing capacity depends, *inter alia*, on export performance. In this regard, a positive development was the slight fall in 1984 in the ratio of debt to foreign exchange earnings from the peak

[10] Report of the Secretariat on recent developments related to transnational corporations and international economic relations, (E/C.10/1985/2, sect. IV.C), 26 February 1985.

[11] See, for example, R. Dornbusch and S. Fischer, "The world debt problem", Report to the Group of Twenty-four (UNDP/UNCTAD project INT/81/046, September 1984); "Adjustment policies and renegotiation of the external debt" (E/CEPAL/G.1299 and Corr.1, 21 February 1984); *The Debt Crisis and the World Economy*, report by a Commonwealth Group of Experts (London, 1984); and *World Economic Survey 1984* (United Nations publication, Sales No. E.84.II.C.1), pp. 11-15.

it had reached in 1983. For the capital-importing developing countries as a whole, however, the ratio is still some 20 per cent above the average for the late 1970s and early 1980s. Most projections show a continuing fall in the ratio for the rest of the decade, although without its returning to the levels of the pre-debt crisis years.[12] It is not known how much of an improvement is needed in indicators such as the debt-to-exports ratio to convince the private capital markets to resume voluntary lending. It appears the view of individuals linked to financial institutions that a net outflow of resources from the highly indebted countries will continue during the rest of the 1980s.[13] All in all, prospects do not seem bright for any substantial upsurge in private capital flows to the developing countries, at least during the middle years of the present decade.

Concern for the growth of official flows

In the light of the important contribution that official flows have made to the external financing of developing countries in the past, and in view of the constrained prospects for private flows, attention must be focused on the outlook for an adequate overall increase in official flows. The growth of official development assistance has been under particular restraint for much of the present decade and will apparently continue to be so for years to come. To a certain degree this arises from budgetary limitations in donor countries. On the other hand, as certain other categories of expenditure, most notably defence spending, are not similarly blocked by budgetary considerations, it seems that other factors are also operating.

In fact, many donor countries have become increasingly concerned about the effectiveness and efficiency of aid in promoting development.[14] In this regard, there have recently been efforts to improve the co-ordination and policy dialogue among donors and recipients. A heightened importance is accorded to effective monitoring and evaluation, taking into account the administrative, technical and financial capacities of recipients. To the degree that such efforts indeed improve the effectiveness of aid in implementing the development policy of the developing countries, they should be welcomed. Not only do they yield the direct benefit of increasing the growth in output and income from a given volume of resource transfers, they also demonstrate the substantial contribution which ODA can make to development and thereby help rebuild the constituency for larger aid programmes.

Despite the considerable flow of official concessional co-operation from the developed market economies, centrally planned economies and capital-surplus developing countries - exceeding 1 per cent of GNP in a number of donor countries in recent years - the outlook is disconcerting. Available budgetary data indicate that 1985 may be the third year in a row of no significant growth in total real ODA flows. Significant increases in the ODA efforts of some member countries of the Development Assistance Committee of OECD are expected to be coupled with stagnant or possibly declining flows from a few of the largest donors;[15] nor are the centrally planned economies of Eastern Europe and the Soviet Union expected to increase their overall aid flows, as the majority of these countries also remain under considerable adjustment constraints.

Financial co-operation among developing countries themselves continues to be constrained by the effect of falling petroleum prices on donor government budgets. Commitment data for the major Arab national and regional development institutions show development assistance being cut back at a slower rate, however, in 1984 (see table A-14). Project and technical assistance financing continued at a much reduced pace, while import financing grew. The institutional mechanisms for such financial co-operation among developing countries - such as the San José agreement under which Mexico and Venezuela supply oil at concessional rates to Central America and the Caribbean - are nevertheless being renewed.

The overall slow-down in concessional financial co-operation is reflected in the flows of the major multilateral development institutions. While current disbursements, drawing on earlier commitment levels, continue to grow, current and prospective commitment levels do not hold out the prospect of significant further growth in flows. Indeed, owing to a disappointing new funding agreement and the time-consuming processes needed for legislative approval in donor countries, a 17 per cent contraction in commitments was

[12] A number of such projections are presented and analysed in *The Debt Problem: Acute and Chronic Aspects*, *Journal of Development Planning*, No. 16 (to be issued as a United Nations publication).

[13] At the same time, these individuals seemed relatively optimistic that a new debt-servicing crisis would be avoided. Financial and economic consultants linked to the United States capital market have appeared to be somewhat more cautious, while non-banking sources in European capital markets have appeared more cautious still (information based on a series of interviews undertaken for the Secretariat in 1984 with bankers and private analysts involved in the capital markets in the United States and Europe).

[14] See OECD, *Development Co-operation, 1984 Review*, report by the Chairman of the Development Assistance Committee, November 1984, chap. III.

[15] One noteworthy development at the end of 1984, however, was the expanded aid commitment in the third Lomé Convention - ECU 8.5 billion ($6 billion) over a five-year period. Contributions are expected from a larger number of countries (the entry of Portugal and Spain to the Community is anticipated) and the number of recipient countries will also be greater. In all, the same level of real resources, at least, is expected as in Lomé II, while the focus of aid programmes has been somewhat altered; for details, see *European Community Newsletter*, vol. I, No. 5 (New York, December 1984).

programmed for fiscal year 1985 for the highly concessional International Development Association (IDA) of the World Bank.

It had been hoped that a $3 billion fund might be mobilized in 1984 to supplement the $9 billion pledged for the seventh replenishment of IDA. While that goal had to be set aside, it did prove possible in early 1985 to mobilize about $1.1 billion for a Special Facility for Sub-Saharan Africa in the World Bank. Following upon an earlier 50 per cent increase in resources for the African Development Fund of the African Development Bank for the period 1984-1986 and the increased emphasis on sub-Saharan Africa in the lending programmes of the World Bank itself, the beginnings are seen of the effort by the international community to focus attention on the special needs of the developing countries of sub-Saharan Africa, as called for in the Declaration on the Critical Economic Situation in Africa (General Assembly resolution 39/29, annex).

More generally, the prospects for highly concessional multilateral financial assistance remain mixed.[16] On the one hand, for example, lending by the Asian Development Fund, the soft-loan window of the Asian Development Bank, declined in 1984 as major arrears developed in agreed contributions. On the other hand, after extensive consultations, a breakthrough was finally achieved in early 1985 in the negotiations for the second replenishment of the International Fund for Agricultural Development (IFAD). It now appears that IFAD, which has ongoing projects aiding the rural poor in more than 80 developing countries, will be re-funded for the period 1985-1987 by member countries of OPEC and OECD, the latter accepting a relatively greater share of the financial burden in the light of the reduced financial capacity of OPEC countries.

At the level of non-concessional flows, the World Bank (including the International Finance Corporation) and the regional development banks are maintaining a significant average pace of expansion in lending commitments, owing to recent selective and ordinary capital increases but, in spite of the special adjustment-related financing efforts discussed below, the pace of disbursement on project loans has been hampered by the recession and the strict adjustment programmes adopted by many recipient countries, under which local government shares of project costs could not always be met. Indeed, various recent lending initiatives of multilateral development banks have sought to overcome precisely this difficulty. In addition, the external debt-related difficulties of a number of countries have hampered projects that depended upon co-financing through official export credit agencies and the international commercial banks. Nevertheless, the flow of funds through the multilateral institutions, together with official bilateral flows, has acted as a cushion against the collapse in private flows during the last few years. The ability to maintain such official flows in the future will depend on decisions not yet taken for the next round of capital funding of the institutions themselves.

While ODA and flows from multilateral development institutions are primarily directed at long-term development needs, the international community has also provided major assistance for balance-of-payments adjustment per se, led in this case by IMF. The Fund not only negotiated adjustment programmes with countries having balance-of-payments difficulties and helped to mobilize private sector funds in conjunction with debt restructuring, but also provided substantial funds in support of adjustment programmes. The latter activity changed sharply in 1984, however. For the first time this decade, the level of outstanding loan commitments made in support of Fund-approved adjustment programmes dropped as the volume of expired and cancelled lending agreements exceeded that of new arrangements. The actual flow of IMF resources to the developing countries remained positive, although at little more than a third of the 1983 level (see table A-15). Especially hard hit were the low conditionality resources, which provided no net flows in 1984, while almost three fourths of the higher conditionality flows were accounted for by four extended arrangements which continued from 1983.

The reduced flow of IMF resources reflects both positive and negative developments. The positive side is that the extreme phase of the debt-related payments crisis of certain countries has passed and the payments situation of a number of Asian borrowers in particular has improved. The negative side is the concern that the Fund is retreating from its role of providing resources in support of those adjustment programmes which recognize the need for structural changes to attain a sustainable balance-of-payments situation. In fact, the average length of adjustment programmes agreed with developing countries in 1984 was only slightly above one year (14 months), compared to almost two years in 1980 and 1981 (22 months). Particularly noteworthy was the absence of any new longer-term adjustment programmes under the Extended Fund Facility.

It is the case, of course, that the Fund co-operates with the World Bank, that the Bank operates a programme of structural adjustment lending and support for sectoral policy reform, and that the development-oriented expertise of the Bank might be more intensively utilized together with that of the Fund to assist countries in the design of medium-term adjustment efforts.

[16] In at least one important sector, namely, technical assistance funded by the international community, the sharp decline in the flows in the early 1980s was arrested in 1984. A detailed analysis of 1985 funding flows will be contained in the report of the Director-General for Development and International Economic Co-operation on the operational activities for development of the United Nations system to the General Assembly at its fortieth session.

However, if the Governors of the Bank and the Fund wish to specialize international co-operation for structurally-oriented adjustment in the World Bank, they should take steps to ensure that the resources of the Bank are adequate to the task.

Under the current 1984-1988 lending programme of the Bank, the volume of resources valued in 1984 dollars allotted for structural adjustment and programme lending is the same as was actually committed during the previous five-year period. The Bank is however seeking to place continued emphasis in 1985 on structural adjustment and sectoral policy reform and to further implement its Special Action Programme. Assuredly, the future of such initiatives is subject to the review currently under way in the Bank on its future role. Continuing them at an appropriate level will be contingent on a positive response to the proposal by many interested Governments to discuss a general capital increase of the Bank in 1986.

Recent changes in international private capital markets and medium-term prospects for developing country access

While the redirection of international capital flows described above has been taking place, a process of institutional change has been under way in the financial markets themselves, which is likely to affect the future access of various groups of countries, in particular the developing countries, to large-scale finance in the medium and long term. The major vehicles for large-scale credit flows since the second half of the 1970s have been loans jointly provided by syndicates of international commercial banks - or "clubs" where the number of participating banks was smaller - and by bonds floated on one or more foreign capital markets. In 1982 and 1983, the total activity in arranging these and related financing operations experienced a decline without precedent since their rise burgeoned in the 1970s. The two most general and significant factors accounting for the decline were a reduced demand for funds owing to the global recession and contractionary adjustment policies, and the cut-off of voluntary lending to the high-debt countries which were then entering into debt-servicing crises.

With a renewal of world economic growth and the spread of the recovery process to more parts of the world economy, a resurgence of activity on international markets was expected. In 1984, as seen in table V-6, total funds raised grew by 44 per cent. During the last two years, however, the markets have changed in a number of significant respects. These differences involve the mix of market participants, the nature of their borrowing activities, and the financial instruments utilized.

A change of most serious consequence has been the decline of the private markets as a whole as a source of medium-term and long-term credit to the developing countries. In fact, after subtraction of the "involuntary" bank lending to debt-crisis countries which was extended in 1983 and 1984 as part and parcel of negotiated debt-restructuring packages, gross lending to the developing countries would have totalled only $21 billion in 1983 and $22 billion in 1984.

The decline in gross credits extended to developing countries was almost entirely the reflection of the decline in bank lending to them, which has accounted for about 90 per cent of their total medium-term and long-term market borrowing. Indeed, a major contribution to the continued decline in 1984 in the overall extension of bank loans, as seen in table V-6, was the decline in lending to developing countries.

There has been an increase in borrowing by certain segments of the market, including selected developing countries, the centrally planned economies - in particular the German Democratic Republic, Hungary and the USSR - and a number of corporations and Governments of developed market economies. More than 10 per cent of that gross lending activity has however represented advanced refinancing on the part of borrowers seeking to improve upon the terms of loans and facilities arranged in past years. There were also indications of the conversion of short-term bank credits to longer-term obligations. Indeed, the average spreads which the banks add to their lowest interest rates to determine total interest charges have come down from their 1983 peak and average maturities have lengthened from their 1983 trough. In all, the more restricted number of borrowers with access to this market have been able to win improved terms from the banks. They also frequently found that bank syndicates offered to lend significantly more than the borrowers initially sought to borrow.

Changing activities of international banks

The era of rapid growth in syndicated bank lending appears to have ended. From 1978, a year in which the volume of gross recorded international medium-term and long-term bank lending doubled to $74 billion from its 1977 level, until 1981 when such lending peaked at $148 billion, commercial banks dominated international private capital flows, especially to the developing countries. Since the debt crisis set in, banks and official bank supervisory agencies have been reassessing bank lending strategies.

In the 1970s, whenever it appeared that the capacity of commercial banks to make large additions to their outstanding medium-term loans to the capital-importing

Table V-6. Gross medium-term and long-term financing on international markets, 1981-1984

(Billions of dollars)

	1981	1982	1983	1984
Total funds raised by:				
Developed market economies	137.2	123.2	113.7	180.9
Developing countries	54.2	45.3	34.9	32.9
Centrally planned economies	2.1	1.1	1.2	3.6
Other (development institutions)	7.1	9.5	8.0	9.8
Total	200.6	179.1	157.8	227.2
Breakdown by type of financial instrument				
Total bank commitments	147.7	103.6	80.7	115.7
Loans	94.6	98.2	67.2	60.3
Market back-up facilities[a]	53.1	5.4	13.5	55.4
of which, non-merger related	14.0	5.4	9.5	27.2 [b]
Total bonds	52.8	75.5	77.1	111.5
Straight bonds[c]	41.6	60.3	57.6	73.3
Floating rate notes and certificates of deposit	11.3	15.3	19.5	38.2
Total	200.6	179.1	157.8	227.2

Source: OECD, *Financial Statistics Monthly*, and *Financial Market Trends*, No. 29 (October 1984). Country data re-aggregated into *World Economic Survey* country groups.

[a] International credit facilities extended by banks to back up financial securities, such as commercial paper, short-term Euro-notes, certificates of deposit, bankers acceptances and facilities related to corporate mergers. The value of securities actually outstanding under these back-ups is generally less than the total value of commitments shown in the table.

[b] Lower-bound estimate.

[c] Including bonds convertible into equity.

countries had reached its limit, two things happened. First, the major banks increased their exposure to individual countries, eventually reaching levels that with hindsight were seen to be excessive. Secondly, growth in the demand for international credit in the 1970s and the profitability of these operations led to the entry into international lending of waves of new banks from European countries and Japan, from the Arab world and from the regional banking sector of the United States. In the light of recent experiences, however, it is unlikely that there will be a substantial addition to the equity base for international lending through any significant entry of further new banks. In addition, it is unlikely that large banks will expand their loans to developing countries in particular at a rate faster than the growth of their own capital base.

Credit risks now seem to be more conservatively assessed and it can be expected that other fee-earning activities, including various stand-by facilities, will be intensified. Certain forms of international project financing in developing countries will continue, perhaps with greater reliance on co-financing with the World Bank or the regional development banks if it is made available in adequate volumes. General-purpose, sovereign-risk lending to those countries to enhance liquidity in the face of balance-of-payments needs will probably never regain the importance it had in the late 1970s and early 1980s. Trade financing, the original backbone of international commercial banking, will probably increase in relative importance in the international activity of banks, especially the smaller regional banks that had in the past joined in international loan syndications. As in the case of co-financing, however, the support of official export credit guarantee agencies will remain crucial to commercial bank participation in the financing of various categories of trade with a number of trade partners.

Commercial banks seem to be adopting somewhat new emphases in their international activities. Banks have, for example, been providing substantial amounts of contingent credit to guarantee various types of security issues. As may be seen in table V-6, banks provided almost as much contingent credit in support of

financial market issues in 1984 as they made commitments for direct lending. The amounts of contingent or back-up credit fall into two broad categories, namely, guarantees for merger-related activities and other back-ups. The former category, accounting for about half of the total in 1984 and about three quarters in 1981, was responsible for boosting the total of back-up activity to the highs observed in those years and, although such activity was probably extraneous to the normal workings of the international financial markets, it did indicate a substantial interest on the part of banks in providing guarantee facilities *per se*.

From the viewpoint of deepening the efficiency of financial markets, there is also significance in the non-merger-related facilities which banks are increasingly providing for the issuance of such securities as commercial paper and Euro-notes. From the banks' perspective, back-up facilities are desirable as income-earning contingent commitments which do not as such appear in their loan portfolios; the latter have recently been under more intense scrutiny than before by official bank examiners, reflecting the generally heightened concern over the soundness of the international banking system. From the borrowers' point of view, arranging such facilities is worth the expense, as they lower the interest rate below what would have to be paid on unguaranteed securities.

International commercial banks have also become significantly involved in the bond markets themselves, taking up over a quarter of new bond issues for their own portfolios and actively participating in interest rate swaps.[17] In addition, whereas inter-bank deposits were once the main form of inter-bank credit, such lending is to an increasing degree being carried out through the purchase and sale of securities issued by the banks themselves.

A resurgence of international securities markets

In marked contrast to the contraction in medium-term, direct international lending by commercial banks, there has been a major surge in activity on international securities markets. Total bond issues in 1984 rose almost to the level of total bank commitments and far exceeded the commitments of banks for direct lending (see table V-6).

While bonds have certain advantages over bank loans as borrowing vehicles (for example, longer maturities), they also have a major drawback, namely, that they are available to a far narrower range of borrowers. While the developing countries, even after the cut-back in bank lending, still accounted for over a fifth of the medium-term bank loan market in 1984, their share of the bond market, which had never been very high, fell to only 3 per cent. The market primarily serves government and private sector entities of the developed market economies, especially the major corporations, including the major banks. It is also a major source of funding for the international development financing institutions such as the World Bank.

Straight bonds, bearing fixed-interest coupons, a most traditional form of international finance, are now recovering from a period of stagnation in the second half of the 1970s when total issuances ranged between $33 and $36 billion a year. A major reason for the recovery is the progress that has been made in reducing inflation in the economies of the major capital markets. Although there are still significant inflationary expectation premiums built into long-term fixed-interest rates, these rates have fallen dramatically since the early 1980s. Another reason pertains to the changing sources of new funds seeking foreign placement. These are now more heavily concentrated in the developed market economies which have been experiencing surpluses in their current account. Also within the developed market economies, the rise of corporate profits and the growing role of institutional investors have placed a substantial volume of investable funds in the hands of those that are highly familiar with financial markets. A third and related factor is that one major alternative placement of surplus funds in large denominations, namely, large-scale bank deposits, has come to be seen as having a greater measure of risk owing to the perceived potential volume of non-performing loans in bank portfolios and the actual difficulties encountered by certain of the banks. Finally, a number of government policy measures have been taken which tend to reduce barriers to cross-border investment in securities. Perhaps the two most noteworthy instances in 1984 were the removal of withholding tax on foreign payments of bond interest by the United States, subsequently joined by the Federal Republic of Germany and Japan, and the series of steps taken by Japan to liberalize the domestic and off-shore yen capital markets.[18]

A different set of factors has determined the evolution of floating interest rate bonds, which had been a rather marginal feature of the international financial markets until the present decade. They combine certain features of a security, in that they are

[17] These swaps are a recent innovation under which, for example, a well established bank might issue its own fixed interest bond and swap the resultant debt-servicing obligation for a floating interest obligation of a smaller company. The benefit for the company is that instead of variable and unpredictable payments on a floating rate bank loan, the only type of credit to which it had access on its own, it can make fixed interest payments. The benefit to the bank is that it can better match its floating interest rate income from loans with floating interest payments. The benefits from the different interest rates each party can obtain in the market are shared between them. For a more detailed description of interest rate swaps, see *Institutional Investor*, November 1984, pp. 71-84.

[18] See OECD, *Financial Market Trends*, No. 29 (October 1984), pp. 78-80.

marketable medium-term and long-term credits, and certain features of a syndicated loan, in that they are sold to a potentially large number of investing institutions and carry adjustable interest obligations. Banks have thus far been the major purchasers of floating rate notes (FRNs) and the shorter-term, floating rate certificates of deposit (CDs). The banks have sought the flexibility of adding or selling floating rate assets in response to fluctuations in their floating interest deposits and, by the same token, banks have been major issuers of such securities to match increases in their syndicated lending. Indeed, while there exists a limited secondary market in syndicated loan participations, there is a far more active secondary market in FRNs and CDs.[19]

Floating rate notes have thus far served in large part as a complement to inter-bank deposits, but they have also allowed banks to offer some expansion of the type of lending that was concentrated in syndicated loans before the international debt crisis erupted. FRNs are securities and as such have not been a financing alternative for all borrowers who have utilized the syndicated loan market; they nevertheless seem potentially available to more borrowers than is straight bond financing itself, since the major operators in the FRN market, the commercial banks, are familiar with a broader range of borrowers through their trade and syndicated loan experience than are the investors on bond markets generally. The banks are thus relatively more willing to take up the FRN issues of some of their borrowers. As banks make a market in such issues, it may help familiarize bond buyers such as institutional investors with a new issuer, leading not only to FRN sales outside the banking sector but also to a potential ability to float a straight bond issue on the market at a later date. Thus, FRNs may one day become a significant vehicle for broadening the access of developing countries to the bond markets.

The nascent secondary market in syndicated loan participations could also evolve into a mechanism for indirectly expanding the flow of private credits to developing and other capital-importing countries. Banks would be able to expand their own sovereign-risk lending more expeditiously if they were able to reduce their existing loan portfolios by selling loan participations on a secondary market. Easily marketable instruments for so doing do not now exist, although the experience with emerging "transferable loan instruments" of different types may turn out to be instructive.

It is also possible that, over the medium term, the newly burgeoning international bond markets may develop into a substantial source of new capital inflows to those developing countries which once operated on these markets but which have since faced a curtailment of new capital flows as part of their debt crises. Principal and interest on external bonds have generally continued to be paid by these countries without rescheduling. There was evidence of market uneasiness over such securities in 1982 and 1983 in the form of rising yield differentials *vis-à-vis* other government bonds on the secondary market. Nevertheless, a diminishing of yield differentials by 1984 was taken as evidence of a certain relaxation of market concern.[20]

Taken together, FRNs, the secondary market for syndicated loans and straight bonds themselves hold out possibilities for overcoming in time the institutional constraint posed by the commercial banking sector on the expansion of private sector lending to developing countries, in particular the countries that already have large amounts of outstanding bank debt. If the developing countries do not come to participate actively in these new features of the international capital market, only limited growth in net medium-term and long-term private credit flows would be expected.

The existence of adequate financial intermediaries to undertake the transfer of financial resources to the developing countries is however only a necessary condition for increasing their resource flows. For market flows actually to take place on a significant scale will require a broad market perception that the balance-of-payments situations of these countries have attained sustainable positions and that normal economic growth has resumed. For most developing countries, this has not yet happened and, even where payments adjustment has been rather remarkable, the uncertainties now built into the international economy, concerning interest rates and commodity prices, for example, cloud the long-run payments picture.

Official reserves and special drawing rights

It is now almost a decade since an eclectic approach to balance-of-payments and exchange rate policy was formalized in the second amendment to the Articles of Agreement of the International Monetary Fund. The large swings to which the international economy has since been subjected have made the pressures that caused the collapse of the fixed exchange rate system seem feeble by comparison. Although there is a broad interest in seeking to re-create a greater degree of stability and predictability in international monetary and financial relations than has recently been experienced, there has not yet been very much agreement on how to proceed, let alone on what specific reforms are required. Meanwhile, countries individually have no choice but to adapt

[19] For additional details, see "The international market for floating- rate instruments", *Bank of England Quarterly Bulletin*, September 1984, pp 337-345

[20] See IMF, *International Capital Markets: Developments and Prospects, 1984*, Occasional Paper No 31 (August 1984), pp 48-49

to the existing international economic environment. Smaller countries, in particular the developing countries, have been facing the imperative need to rebuild more adequate levels of international reserves with which to smooth the process of adjustment. The opportunity that the international community had to make a contribution in this regard through an allocation of SDRs in IMF was by-passed. Indeed, that failure to act brings into question what role, if any, the SDR will finally come to have as an official reserve asset.

Reserve accumulation and reserve needs in developing countries

In 1982, the capital-importing developing countries utilized over $24 billion of their official international reserve and reserve-like assets to meet their needs for emergency financing arising from the world recession and debt crisis. The need to maintain substantial official reserves in an unpredictable and potentially volatile world economy was underlined that year as never before. Since then, these countries have been rebuilding their reserves, generally at considerable sacrifice in terms of imports forgone, adding about $5 billion to foreign exchange reserves in 1983 and over $17 billion in 1984. The result has been that the reserves of the capital-importing countries as a whole have risen from the equivalent of 2.6 months worth of imports in 1982 to over 3 months in 1984.[21]

The reserve accumulation was primarily the result of export growth; as that growth was highly uneven, so too was the growth of reserves. That is, although the capital-importing developing countries, excluding the 20 largest debtors, account for roughly a third of the reserves of the capital-importing countries as a group, they were responsible for only about 3 per cent of the accumulation of foreign exchange assets in 1984. Indeed, of the 93 countries for which adequate data were available, 24 are estimated to have ended 1984 with reserves below one month's import coverage. All these countries are in Africa or on the Caribbean basin and 17 of them had been in the same situation at the end of 1983.

The sharp accumulation of reserves in 1984 by many other developing countries raises the question whether these countries were merely seeking to replace reserves utilized during the recent recession or whether there has been an upward shift in their demand for reserves. Once it had been widely thought that as countries added greater flexibility to their exchange rate régimes - as has been happening in developing countries since the mid-1970s[22] - the need for reserves would decrease relative to imports. Less reserves would be required to offset imbalances in a country's supply and demand for foreign exchange as exchange rate changes would take on more of the market clearing function. Similarly, it might be thought that less priority would be accorded to holding reserves as the practical necessity for rapid and rigorous programmes of adjustment to the course of international events became more widely accepted.

The demand for reserves has, nevertheless, not been reduced. Indeed, the policy need to rebuild international reserve balances has its fundamental roots in providing a cushion against adverse developments. Unusual degrees of uncertainty surround the future course of certain variables, such as capital flows to the United States and thus the outlook for the United States trade balance and the exchange rate of the dollar. The recent period has also been characterized by a number of unexpected developments, such as the unusually early termination of the cyclical recovery in international commodity prices. Even where recent trends have been positive, as in trade in manufactures and international interest rates, there are a number of "downside" risks against which prudent national policy-making requires preparation. Pressures for reserve accumulation also arise from a desire to assure potential and existing direct investors and foreign creditors that there is minimal risk of balance-of-payments crises and foreign exchange control that would threaten restrictions or delays in capital-servicing payments.

For the preceding reasons alone, it might be suggested that developing countries would attempt to increase their levels of international reserves, but additional factors point in the same direction, some pertaining to the fact that the market value of official reserves is itself unstable. One source of this instability is the changes in the exchange rates of reserve currencies, particularly, *vis-à-vis* the United States dollar, a conventional numéraire of total reserves. Indeed, despite an accumulation of about $5 billion in foreign exchange assets in 1983, the total dollar value of foreign exchange reserves rose by only about $2 billion as a result of the valuation loss arising from the international rise in the dollar in that year. Similarly, in 1984, despite an addition to foreign exchange reserves in excess of $17 billion, the market

[21] Total reserves are conventionally measured to include foreign exchange assets, SDR holdings and reserve tranche positions in IMF, and monetary gold stocks valued at SDR 35 per ounce.

[22] See IMF, *Annual Report 1984*, p. 50.

value of foreign exchange reserves rose by only about $14 billion [23].

A second source of instability in the value of official reserves involves the stocks of monetary gold held as reserve assets. In fact, it is a convention in the statistical treatment of reserves to value the gold component at SDR 35 per ounce, which is a valuation that grew out of the Bretton Woods system but has no practical relevance to contemporary conditions. Perhaps, maintaining the fictional, historical price prevented inappropriate complacency about reserve levels when the market price of gold exceeded $600 per ounce in 1980, compared to about $300 in early 1985. Certainly, should the developing countries - or any large country - attempt to sell a significant quantity of gold, it would sharply reduce the market price. Indeed, it could even be argued that monetary gold is effectively useless as a reserve asset, except perhaps for very small countries whose gold sales or purchases would not disrupt the international market. Whatever the economic rationality in countries continuing to maintain official gold stocks as part of their reserves, there is evidence that the demand for non-gold reserves by the monetary authorities of developing countries is responsive to changes in the price of gold.[24] In this regard, the substantial fall in the price of gold in 1983 and 1984 would also have increased the demand for non-gold reserves.

A further set of factors which creates a greater incentive for reserve accumulation is that the potential supply of borrowed liquidity at the disposal of the developing countries has been greatly reduced. In particular, as discussed above, developing country access to international commercial bank credit has been greatly curtailed, especially for general purpose balance-of-payments loans, as opposed to project or export financing.[25]

In any event, not all developing countries had enjoyed effective access to liquidity from the international banks in the period in which it was readily available. For those countries, the major source of liquidity for balance-of-payments financing was the Compensatory Financing Facility of IMF, supplemented by the smaller STABEX system operated by EEC for the benefit of the associated African, Caribbean and Pacific countries. While the STABEX system has been renewed and expanded with certain modifications under the recently signed third Convention of Lomé,[26] the character of the IMF Facility has greatly changed.

Until September 1983, the Compensatory Financing Facility was the Fund's primary quick-disbursing, low-conditionality credit, used especially by developing country members of the Fund to help finance payments imbalances arising from instabilities in export earnings and cereal import costs. In September 1983, the Executive Board of the Fund approved certain guidelines for use of the Facility which in effect made it an adjunct of the Fund's conditional credit programmes. In particular, a condition for any drawing from the Facility now requires that Fund members be willing to receive Fund missions and discuss whether changes in the their policies are necessary to deal with balance-of-payments difficulties. Where it is deemed necessary, countries must give a reasonable assurance that policies to correct the balance-of-payments problem will be adopted before submitting a request for a purchase under the Facility to the IMF Executive Board. In other words, whatever the relationship between such factors as cyclical commodity price fluctuations, developments in international markets and domestic adjustment requirements, Fund members can no longer regard the Compensatory Financing Facility as a relatively automatic line of official credit to meet temporary, reversible and exogenous balance-of-payments financing needs.

Global reserve accumulation and special drawing rights

The recent efforts to build up reserve levels by those developing countries able to do so has not been a phenomenon unique to developing countries. Indeed, many other economies, both market and centrally planned, facing an uncertain international economy, have engaged in marked reserve accumulation efforts. Considering all the countries for which data are drawn together by IMF but excluding the major reserve-currency countries,[27] the import coverage of reserves

[23] Measuring the market value of reserves in dollars - especially, as here, for the aggregate of capital-importing developing countries - has an inherent rationale, as the dollar is the major transaction currency in international commerce as well as the unit of account for about three quarters of developing country debt. Reserves may also be measured, however, in units of a basket of goods, in particular the quantum unit for the imports of the group of capital-importing developing countries, but to do so would not change the valuation instability arguments; indeed, the standard deviation of total reserve levels valued in units of imports was slightly higher than it was for reserves measured in dollars over the period 1978-1984 (13 per cent compared to 11 per cent). Nevertheless, since import prices valued in dollars fell in 1984, the increase in reserves valued in quantum of imports rose by more than the nominal increase of over $17 billion.

[24] See, for example, G. M. von Furstenberg, "New estimates of the demand for non-gold reserves under floating", *Journal of International Money and Finance*, vol. 1 (April 1982), pp. 81-95.

[25] Indeed, it was the view of the Executive Board of IMF that, but for the reduced access of many developing countries to international financial markets, the 1983-1984 pace of accumulation of developing country reserves might have been more rapid as they would have added to their reserves through borrowing (IMF, *Annual Report 1984*, p. 70).

[26] See *European Community Newsletter*, vol. 1, No. 5 (New York, December 1984).

[27] That is, countries whose currencies are separately identified by IMF in data on the currency composition of foreign exchange reserves, namely, France, the Federal Republic of Germany, Japan, the Netherlands, Switzerland, the United Kingdom and the United States; see IMF, *International Financial Statistics. Supplement on Reserves*, 1983.

has risen from 2.9 months at the end of 1982 to about 3.6 months at the end of 1984. For the developed market economies included in this aggregate, the import reserve ratio rose from 2.0 to 2.4 months, while for China and the Eastern European member countries of the Fund, substantial increases were also registered.

Reserve-currency countries are a special case, with the United States forming a category of its own. Because most international trade and financial transactions are carried out in dollars, the United States has less need than other countries to maintain a large supply of official reserves. Overall balance-of-payments deficits, when they arise, may be financed with dollars themselves rather than foreign currency, as long as the dollar is accepted as the world's major transaction currency. Furthermore, unlike the debt of the other net debtor countries of the world, most United States debt to foreigners is denominated in dollars, so that the debt-servicing crises arising from foreign-exchange shortages which so afflicted other countries in the 1980s would not soon arise for the United States. In addition, to the degree that foreign creditors do not spend their dollar interest income on United States goods, it is they who bear an exchange rate risk of a fall in the dollar. In contrast, in other debtor countries, foreign debt is contracted in foreign currency so that a devaluation of the home currency raises the domestic currency cost of foreign debt-servicing.

The case of the other major reserve currencies, if less pronounced, is somewhat similar. To a significantly increasing extent, the trade of Japan is being invoiced in yen while that of the Federal Republic of Germany was already primarily invoiced in deutsche mark by the mid-1970s.[28] In addition, recent measures to more fully integrate Japanese capital markets into world financial markets, as noted previously, will further the internationalization of the yen.

The special nature of reserve currencies has certain global consequences. First, the growth of the world's supply of reserves is largely a by-product of balance-of-payments deficits of reserve currency countries - and to an unknown degree, the result of money creation in the Euro-currency markets. There is no automatic mechanism by which an appropriate global supply of reserves is brought about.

Indeed, the question of the adequacy of global liquidity is one regularly considered in IMF and other forums. In such discussions, the focus is not on the needs of individual countries or groups of countries but on the needs of the world economy. In the discussions of recent years, most countries, excluding, in particular, a few of the reserve currency countries, have held the view that there was a global shortage of liquidity. Certainly, the recent efforts of so many countries to build up their own reserve levels after 1982 lend particular credence to that view.

The existence of a global liquidity shortage also has a bearing on one responsibility of IMF, namely, the allocation of new supplies of the one internationally-created reserve asset, the special drawing rights in the Fund. That is, before there can be any new allocation of SDRs, the Managing Director of the Fund must be able to report that he finds a broad majority of the voting power of the Fund (85 per cent) agreeing in effect that a global liquidity shortage exists. Since 1981, there has been no such agreement on the existence of a liquidity shortage, even one so small as to warrant a token allocation of SDRs.

Under the amended Articles of Agreement of the Fund, member Governments undertook to make the SDR the principal reserve asset of the international monetary system. The experience over the past decade, and especially since 1981, suggests that the pledge will not be honoured. The Fund's Articles of Agreement, in requiring a consensus of the major member countries before an SDR allocation can be made, were aimed at avoiding a situation of excess world liquidity. This fear has apparently been so overwhelming that the SDR may soon be reduced simply to a unit of account, instead of becoming the major reserve asset. Meanwhile, the world supply of liquidity is being built up more slowly through overall payments surpluses of individual countries, at the sacrifice of import levels forgone in order to accumulate reserves and in correlation with the different abilities of countries to expand their export earnings. The time remains opportune, particularly in the light of the declining role of the SDR, to arrange for a programme of new SDR allocations, to be phased with the continuing recovery of world trade.

[28] See, for example, Jeffrey A. Frankel, *The Yen/Dollar Agreement: Liberalizing Japanese Capital Markets* (MIT Press for the Institute for International Economics, December 1984), p. 37, and Stanley W. Black, "International money and international monetary arrangements", in R. W. Jones and P. B. Kenen, eds., *Handbook of International Economics*, vol. II (Amsterdam, North-Holland Publishing Company, 1985), p. 1159.

Part Three

PERSPECTIVES ON POLICIES IN AN INTERDEPENDENT WORLD ECONOMY

Chapter VI

SELECTED POLICY RESPONSES AND ADJUSTMENTS TO ECONOMIC DISEQUILIBRIA

Since the mid-1970s, the global economy has been beset by socio-economic imbalances and dislocations unprecedented in the post-war period, and quite different in nature and extent from earlier disturbances. Before the past troubled decade, shocks to the global economy were comparatively mild, usually affected only a limited number of countries, and could be mitigated through various flexibilities built into the international trade and financial framework. Especially during the cyclical downturn of the mid-1970s, these accommodations included ample financial resources from official and private financial institutions, and the opportunity for a number of countries to promote exports. The dislocations of the 1980s have not only been world-wide but also, because of the sharp curtailment of the resources for accommodation, much more severe and pervasive.

The recent disturbances in the global economic, trading and financial framework have affected a great number of countries, developed and developing, centrally planned and market economies. While the problems were to some extent of common origin, the nature of the disequilibria differed markedly from one country group to another, as did the policy responses of individual countries. Generalizations about the overall socio-economic situation of groups of countries must inevitably leave out some of the variables that explain the actual course of events in specific countries, but there are certain common features, especially with regard to the experiences of the majority of developing countries and some of the centrally planned economies.

With hindsight it may be said that many of the countries most severely affected by the recent crises could have explored proper adjustment policies well before the severe global recession and financial crisis erupted in the early 1980s. As argued in an earlier issue of this *Survey*,[1] the developing countries that responded at an early stage through domestic policy measures were able to weather the deterioration in the international economic environment fairly smoothly and without extensive dislocations of their domestic activities. This was the case in particular for the majority of developing countries in South and East Asia.

Countries that made adjustments as early as 1979 benefited from a climate that, in comparison with subsequent years, was favourable for export promotion and provided access to official and private financial resources at low or negative real interest rates. In 1982-1984, financing was not available in adequate amounts to the majority of the countries facing payments difficulties, and their problems were further compounded by the marked deterioration in the international economic environment in the period 1981-1982. As a result, although many developing countries have taken stringent measures to reduce their external deficits, service their debts and implement the changes in domestic policies and associated economic structures required to ease the external payments difficulties, a large number of them have not yet overcome their recent external or domestic problems.

The first section of this chapter singles out for analysis some of the developing countries whose wide-ranging policy measures to come to grips with external difficulties have not yet, with some exceptions, been fully successful, although they have reduced current account deficits. For most of these countries there is little prospect of short-term relief; the outlook is for sluggish growth at least in the next few years. Given prevailing growth conditions, these countries have virtually no choice but to continue their adjustment efforts.

The disequilibria in the developed market economies, although not unrelated to those experienced in most developing countries, have been quite different in nature and extent. One reason for the difference is that a few of the largest members of the group were in a position to pursue autonomous domestic economic policies, with little or no regard for their implications for international trading and financial relations. The flexible exchange rate régime and the advanced degree of economic and financial integration of these countries set the stage for modifications in policies that were motivated to a large extent by domestic policy objectives. The second section of this chapter looks at some aspects of the current situation of developed market economies. While the recent disinflationary policies there have been successful in terms of fostering growth and, in some cases, employment, lowering inflation rates and curbing inflationary expectations, they have entailed sizeable macroeconomic imbalances that have to be worked off in the near to medium-term future. The focus in this section is on the fiscal and current account imbalances of the United States that have been partly responsible for the volatility prevalent in financial markets since the early 1980s. Autonomous shifts in domestic policies may help to achieve the required corrections, but a joint reformulation of policy measures by the major developed market economies would be preferable. While such formal or informal policy co-ordination would not by itself forestall cycles, it could substantially reduce the depth and length of recessions.

The centrally planned economies, particularly those that, relative to their economic size, maintain intensive

[1] *World Economic Survey 1984* (United Nations publication, Sales No. E.84.II.C.1), pp. 8-11.

trade and financial relations, including relations with the market economies, have also been affected. The adjustments to the global economic and financial disturbances of the 1980s have been superimposed upon structural changes that began to be made around 1980 in response to the domestic and external economic difficulties that had started in the early 1970s. The impact of the world-wide dislocations has been particularly noticeable in the countries that in the 1970s sought to postpone adjustment to the changing external environment by incurring sizeable convertible currency debts, but policy adjustments, sometimes on an emergency basis, to mitigate the impact of the global disequilibria have been a region-wide phenomenon. The measures taken in Eastern European economies have differed greatly in nature, extent and implications from those pursued in developing countries. The final section of this chapter focuses on the investment policies adhered to in Eastern Europe essentially since the start of the current medium-term socio-economic plans (1981-1985) and contrasts adjustment policies there with those typical of developing countries.

External shocks and adjustment in developing countries

Economic recovery in the developing world from the global recession of 1980-1982 has been very uneven. Most Asian countries, capitalizing on earlier economic reforms, managed to weather the recession and have since then recorded robust economic growth. Most other developing countries, particularly those with large external debts and exporters of primary commodities, have experienced severe difficulties in coping with recent international economic disturbances and consequently have lagged behind the economic rebound in the rest of the world. It is important to note that the unsatisfactory performance of these countries during the 1980s was not caused by a sudden shift of their economic policies in the late 1970s; it stemmed mainly from the severe shocks of the early 1980s.

The marked transformation of the international economic environment in the period 1979-1982 required rapid changes in policies, particularly in countries that had taken a decisive expansionary stance and whose fiscal deficits and external debt had been growing at a fast pace. Even in countries that had until then followed cautious or quite prudent financial policies, a redirection of policies became necessary. Many countries could not adjust swiftly, however, partly because of inherent structural rigidities, while others decided to ease the situation by further borrowing in the belief that their external problems were transitory. This in the end aggravated their situation.

What follows is a brief summary of some preliminary findings of ongoing work on adjustment to external shocks. It presents an analysis of a group of 15 countries, which exhibit a vast diversity of economic conditions and national characteristics and, in a sense, reflect the experience of a much wider spectrum of developing economies. The sample of 15 countries includes energy exporters such as Mexico, Nigeria and Venezuela; more diversified exporters such as Argentina, Brazil and the Philippines; and non-fuel primary commodity exporters such as Costa Rica, the Sudan and Zambia. The other countries in the sample are Chile, the Dominican Republic, the Ivory Coast, Jamaica, Peru and the United Republic of Tanzania.

In response to the significant shocks experienced in 1979-1982, these countries shifted policies. Some did so as early as 1981, while others implemented changes in 1982 or as late as early 1983. By the beginning of 1985, after at least two years of adjustment, their current account deficits had shrunk considerably. Serious problems persist, however, in virtually all of these countries; at mid-decade the pace of their economic growth remains well below post-war trends and growth prospects for the rest of the decade are not particularly encouraging.[2]

Transition to domestic growth and a more viable balance-of-payments position

The process of economic adjustment that so many developing countries were compelled to undertake in the wake of the disruptive and prolonged world recession of 1980-1982 is now entering its second, and more uncertain, phase. In the first phase, the management of the external sector and the servicing of foreign debt took priority. In the contractionary global environment of 1980-1982, in most instances, this phase led to incisive import compression and to a widespread and severe domestic recession. As Governments were compelled to cut drastically public expenditures, consumer subsidies and, in many cases, real wages, the burden of adjustment fell indiscriminately on those segments of the population least able to absorb the hardships.

The upturn of economic activity in the industrial world since 1983, the vigorous expansion of trade associated with it in 1984, and, more recently, the slight decline in interest rates have improved the external payments position of many debtor developing countries, particularly the large Latin American countries. Many of these countries are now moving into the second phase of their adjustment process. More and more policy-makers in selected developing countries are attempting to accommodate domestic growth, while maintaining a viable balance-of-payments position.

[2] Current forecasts of these countries' long-term growth generally suggest that per capita incomes by the end of next decade will be only slightly higher than the levels of 1980.

The challenge now facing many of these countries is to consolidate the progress already made through external adjustment into a process of sustainable growth consistent with national resource potentials and linked to their long-term development objectives and needs. If they are to meet this challenge, it is essential that developments in the international economy should offer these countries the chance to reorient their domestic policies so as to improve their balance-of-payments positions by diverting part of their growing output into exports, rather than by further curtailing incomes, expenditures and imports. Over a period of time, both incomes and imports need to expand if adjustment programmes are to prove effective and, at the same time, compatible with social and political stability. This is required especially to reverse the impact of the same general contractionary conditions on private investment. The measures of economic austerity of the past several years have exerted such pressure on the social and political fabric of these countries that restoration of satisfactory domestic growth appears to be a prerequisite for a successful resolution of the current international debt and adjustment problems.

The combination of adverse international events and inadequate or delayed domestic responses helped to precipitate the macro-economic difficulties of many developing countries in the early 1980s. Conversely, improvements in the international environment coupled with energetic domestic policy measures hold the prospect for the eventual resolution of these problems. In fact, there have been important advances on both fronts in the course of the past two years.

At the international level, the strong revival of world trade has facilitated the transition of major debtor countries from the earlier phase of import compression to the current phase of export expansion: between 1981 and 1983, import cuts of the order of 50 per cent in many of these countries accounted for most of the trade improvements recorded. Since 1984, however, exports have begun to rise, at annual rates ranging from 10 to 20 per cent in major debtor countries. In a few of these countries, particularly in Mexico and Venezuela, this has allowed for some import expansion, but in many other countries, including Argentina, Brazil, Nigeria, Peru and the Philippines, import volumes in 1984 contracted further, bringing the cumulative decline since 1981 to more than 60 per cent for some of them.

These developments have been reflected in the patterns of trade and current accounts. The trade accounts of the nine Latin American countries included in the sample, from a combined deficit of $5.5 billion in 1981, showed a combined surplus of $36.5 billion in 1984 (see table VI-1). The trade surplus in 1984 was just sufficient to cover foreign interest obligations, so that current accounts for the group as a whole were in virtual balance. In other countries under adjustment, current account deficits were generally reduced, albeit at a much slower pace; in the Ivory Coast and the Philippines, for example, they were halved between 1981 and 1984, to about $0.5 billion and $1.5 billion, respectively.

The revival of domestic economic activity has been accompanied by important shifts in underlying relative prices brought about by adjustments in exchange and interest rates. These price changes have tended to improve incentives for export-promotion and import-substitution activities. The full impact of the shifts in incentives will be felt only in the medium term, however. In the short run, these measures have generally been inflationary, but in countries with excess capacity in some sectors, the restructuring of incentives has contributed to promoting output without strongly aggravating inflationary tendencies.

Led by a firm expansion of exports, economic activity in several debtor countries revived in 1984 (table VI-2). The pace of growth was particularly significant in large countries, such as Brazil and Mexico, but also in Chile and Costa Rica. This sharp reversal of the trend of deceleration seen since 1979 was however insufficient to arrest the alarming increase in levels of unemployment that took place during the same period. Furthermore, domestic inflationary pressures have intensified in the majority of the 15 countries in this group.

In view of the current fragile state of the economies of most of these countries and the severe recessionary experience of the early 1980s, the recent acceleration of inflation presents a vexing dilemma. So far many countries have been unsuccessful in correctly diagnosing the sources of inflation and in taking appropriate policies to curtail it without compressing output. Even in industrial countries, the failure of macro-economic policies to cope with inflation since the late 1960s has been reflected in successive cycles of recession associated with rising costs in terms of lost output and higher levels of unemployment. In fact, the latest prolonged and deep recession of these countries has dramatically illustrated the substantial costs involved. The subsequent period of low inflation also testifies to the tenacity with which disinflationary policies were pursued and the gains that resulted. It may also indicate an important shift in underlying inflationary forces in the world economy.

At the global level, it appears that the way in which the industrial countries made the transition from the higher inflation cycles of the 1970s to the present low inflation cycle, leaving part of the developing world to contend with the problem of stagflation, helps to explain one of the sources of the current inflation in developing countries, namely the sudden run-about in their trade position and the resulting transfer of real

Table VI-1. Selected developing countries: evolution of components of the current account, 1980-1984

(Billions of dollars)

	1980	1981	1982	1983	1984
Trade balance deficit (-) or surplus (+) on goods and services					
Energy-importing countries					
Latin American sample	-11.31	-3.83	-1.78	7.46	14.58
Others	-4.17	-4.06	-3.15	-1.89	-0.41
Energy-exporting countries					
Latin American sample	3.37	-1.69	2.76	20.12	21.98
Others	5.29	-5.60	-6.73	-3.96	1.80
Net interest payment outflow (+) or inflow (-)					
Energy-importing countries					
Latin American sample	11.34	17.01	20.73	18.45	18.87
Others	1.53	2.09	3.06	3.09	3.12
Energy-exporting countries					
Latin American sample	7.83	12.05	15.97	14.38	16.97
Others	-0.38[a]	-0.27[a]	0.53	0.53	0.79
Current account deficit					
Energy-importing countries					
Latin American sample	21.14	22.37	22.27	11.434	5.22
Others	5.67	6.00	6.14	4.94	4.39
Energy-exporting countries					
Latin American sample	3.62	12.06	11.74	-7.59	-7.23
Others	-5.29	5.85	7.70	4.73	0.70
Ratio of interest payments to exports of goods and services (percentage)					
Energy-importing countries					
Latin American sample	27.30	37.40	52.50	45.01	40.34
Others	11.80	14.40	23.20	23.90	23.00
Energy-exporting countries					
Latin American sample	16.20	22.03	32.90	31.20	33.00
Others	-1.39[a]	-1.41[a]	3.87	4.84	6.90

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *Balance of Payments Statistics*, and ECLAC, "Preliminary overview of the Latin American economy during 1984" (LC/G 1336, 17 January 1985)

Energy-importing countries
Latin American sample: Argentina, Brazil, Chile, Costa Rica, Dominican Republic and Jamaica
Others: Ivory Coast, the Philippines, Sudan, the United Republic of Tanzania and Zambia
Energy-exporting countries
Latin America sample: Mexico, Peru and Venezuela
Others: Nigeria

[a] The minus sign indicates interest received on foreign assets

resources. The transfer of resources has affected inflation both directly, by reducing the domestic supply of goods and services, and indirectly, through the real exchange rate depreciations required to promote exports and discourage imports.

While this global perspective on the transmission of inflation points to the importance of external payment disequilibria and exchange rate devaluations in exacerbating inflation in developing countries, the role of domestic factors should not be overlooked. In some countries, the lagged effects of too expansionary fiscal and monetary policies were also important determinants of higher inflation rates. Moreover, several developing countries, particularly those in the southern cone of Latin America, relied extensively on foreign capital inflows to achieve various economic objectives in the second half of the 1970s. An unintended effect of this was a

Table VI-2. Selected developing countries: aggregate output growth and inflation, 1976-1984

(Annual percentage change)

	Rate of growth of real GDP				Rate of increase in consumer price index			
	1976-1978	1979-1982	1983	1984 [a]	1976-1978	1979-1982	1983	1984[b]
Energy-importing countries								
Argentina	0.8	-1.0	3.1	2.0	251.4	132.4	343.8	619.2
Brazil	6.8	3.2	-3.2	4.0	41.3	84.8	142.0	196.7
Chile	7.2	1.9	-0.8	5.5	114.8	24.5	27.3	19.9
Costa Rica	6.8	-1.4	2.3	5.0	4.6	38.6	32.6	11.6
Dominican Republic	5.6	4.1	3.9	1.5	8.1	10.3	4.8	20.3
Ivory Coast	9.1	2.5	-1.0	-1.0	17.5	11.9	5.9	4.3
Jamaica	-2.6	-1.0	1.8	-2.0	18.6	18.9	11.6	27.8
Philippines	6.4	4.2	1.2	-5.5	7.2	14.7	10.0	50.3
Sudan	4.3	1.6	0.2	-2.0	12.7	26.7	30.6	27.9
United Republic of Tanzania	5.9	0.4	3.1	0.0	10.0	24.6	27.1	34.8
Zambia	1.1	-0.4	1.6	-2.0	18.3	12.0	19.6	20.0
Energy-exporting countries								
Mexico	5.3	6.3	-5.3	3.0	20.7	32.8	101.9	64.5
Nigeria	3.8	-2.3	-5.4	-0.7	20.8	12.7	20.0	38.8
Peru	0.5	3.1	-10.8	0.6	43.1	66.4	111.2	110.2
Venezuela	5.8	-1.6	-4.8	-1.5	7.5	14.9	6.3	11.6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*, and ECLAC, "Preliminary overview of the Latin American economy during 1984", January 1985

[a] Preliminary estimate.
[b] Preliminary estimate. Average rate of change for 1984 up to the latest month available compared to the same period in 1983

significant overvaluation of their exchange rates which counteracted domestic inflationary forces. When foreign borrowing was no longer feasible, the current inflationary pressures were considerably exacerbated by the repressed inflationary potential of the 1970s.

External shocks of 1979-1983: extent, measurement and policy response

The worsening in the early 1980s of the external economic environment facing the energy-importing countries was triggered not only by the second oil price increase of 1979-1980 but also by the abrupt shift towards a more restrictive policy stance in the major industrial countries. The disinflationary policies adopted in several of the latter, particularly the United States, and the simultaneous deregulation of financial markets, touched off an unprecedented rise in international interest rates and led to a prolonged economic recession in the industrial countries. This recession and the high interest rates placed many developing countries in a highly vulnerable position, particularly those with large foreign debt levels and the exporters of primary commodities. In the end, energy exporters were also affected as oil markets began to weaken during 1981.

The ensuing deterioration in the current accounts of these countries, in conjunction with the precipitous rise in the ratios of their debt service to exports and to GNP, triggered the financial crisis of 1982. Since resources available from private financial markets all but dried up, these countries were suddenly faced with an adjustment problem that differed in scope and nature from that posed by the global disturbances of the mid-1970s. At that time, the global policy consensus was predicated on the notion that the shocks were transitory. Accordingly, the energy-importing developing countries were encouraged to weather the shocks through recourse to private financial markets, which recycled the resources of surplus energy exporters.

The magnitude of the problems caused by the sharp contraction of private financial markets was compounded by the interest rates. This was in sharp contrast to the situation of the second half of the 1970s, when international interest rates fell significantly below the growth rates of the nominal export earnings, in dollar terms, of developing countries. From 1973 to 1980, when

nominal interest rates averaged an annual 10 per cent, the dollar value of the exports of the 15 countries grew at an average rate of 25 per cent per annum. On the basis of their strong export performance and their substantial investment growth, many of the developing countries, particularly exporters of manufactures and middle-income countries, were perceived to be good credit risks. This view was held not only by the private financial community but also by multilateral institutions, which - tacitly or explicitly - encouraged it.

Foreign borrowing enabled countries to avoid adjustment through devaluation or through curbing domestic aggregate demand. It helped to reduce inflationary pressures and to offset the negative effects of higher energy prices through an appreciation of real exchange rates: from 1973 to 1980, the average real effective exchange rate of the currencies of energy-importing Latin American countries rose by 20 per cent and that of a sample of African countries by 28 per cent.[3] In turn, the overvaluation of real exchange rates had, temporarily, a positive effect on those investment activities with a high import content.[4] Together with other factors, the real appreciation of currencies during this period encouraged imports to grow rapidly, often much faster than real GDP, which led to a worsening of the trade balance and current account positions.

The adverse impact of overvalued exchange rates on the current account deficits was often aggravated by growing fiscal deficits, expansionary monetary and credit policies, and negative real interest rates. In many countries, interest rates were kept below the rate of inflation, often by as much as 10 to 20 percentage points. Expansionary fiscal policies, particularly in the late 1970s and early 1980s, led to large budgetary deficits and, because of an accommodating monetary stance, to a rapid expansion of domestic credit. Between 1978 and 1982, the ratio of total credit to GDP increased more than twofold in Argentina and by only slightly less in Mexico, Nigeria and Venezuela. As these policies tended to provide an immediate stimulus to domestic demand, while their stimulus to supply was generally impeded by structural rigidities and by delays in investment projects, they put pressure on prices and rendered payments positions highly vulnerable to external shocks.

In these circumstances, the unexpected global shocks of the early 1980s had a particularly severe impact on the payments position of many indebted countries. They were suddenly confronted by three crises at the same time: a sharp surge of their debt-service payments, a substantial decline in their terms of trade, and a shrinkage in the markets for their exports. As a consequence, their current account deficits ballooned. For the six Latin American energy importers as a group, deficits rose from 25 per cent of exports of goods and services in 1976-1978 to about 45 per cent in 1979-1982. The rising deficits for the four African energy importers were of roughly the same order of magnitude (table VI-3).

A typical method of measuring the approximate direct balance-of-payments effects of the external shocks is to compare the actual values of the main components of the balance of payments with what they would have been in the absence of the shocks. Thus, the negative effect on the current account of the rise in real interest rates, for instance, can be estimated by comparing actual interest payments with the payments that would have been made if real interest rates had not risen. Similar procedures can also be used to obtain estimates of the effects on current account balances of a deterioration in the terms of trade and a reduction in the demand for exports.

The combined effect of the three shocks gives a mixed picture for the energy-exporting countries. Over the period 1979-1981, a favourable terms-of-trade change predominated over the negative effects of the interest rate change and the weakening of export volumes; the latter two became predominant thereafter. In the case of the energy importing countries, the effects of these shocks were substantial. Figure VI-1 shows the combined effect, expressed as a percentage of GDP, of the terms-of-trade deterioration, the rise in real interest and the slow-down in the volume of exports over the period 1979-1983.[5] It shows that all countries experienced adverse shocks during this period, ranging from 3 per cent to 20 per cent of their GDP. Countries such as Chile, Costa Rica, the Ivory Coast, Jamaica and Zambia experienced severe external shocks amounting to more than 10 per cent of their GDP. For the African energy-importing countries, external shocks were dominated by the deterioration of their terms of trade; they were also strongly affected by shortfalls in export earnings due to recession in the industrial countries, particularly in Europe. In contrast, major debtors among the Latin American countries did not suffer from

[3] Based on real effective exchange rate indices of individual countries aggregated with GDP levels for each sample. The Latin American sample includes Argentina, Brazil, Chile, Costa Rica, the Dominican Republic and Jamaica. The African sample includes the Ivory Coast, the Sudan, the United Republic of Tanzania and Zambia. For detailed information on exchange rates, see table VI-5.

[4] For a discussion of the effect of currency overvaluation on investment behaviour, see Rudiger Dornbusch, "External debt, budget deficits and disequilibrium exchange rates", National Bureau of Economic Research, Working Paper No. 1336, April 1984.

[5] These estimates are closely comparable with those obtained by other studies. See, for instance, Bela A. Balassa, "Adjustment policies in developing countries, 1974-1983" World Bank Staff Paper No. 675, November 1984. A later publication of the Department of International Economic and Social Affairs will contain a more detailed analysis of some methodological aspects of measuring external shocks and policy responses.

Table VI-3. Selected energy-importing developing countries: indicators of external conditions, 1973-1983

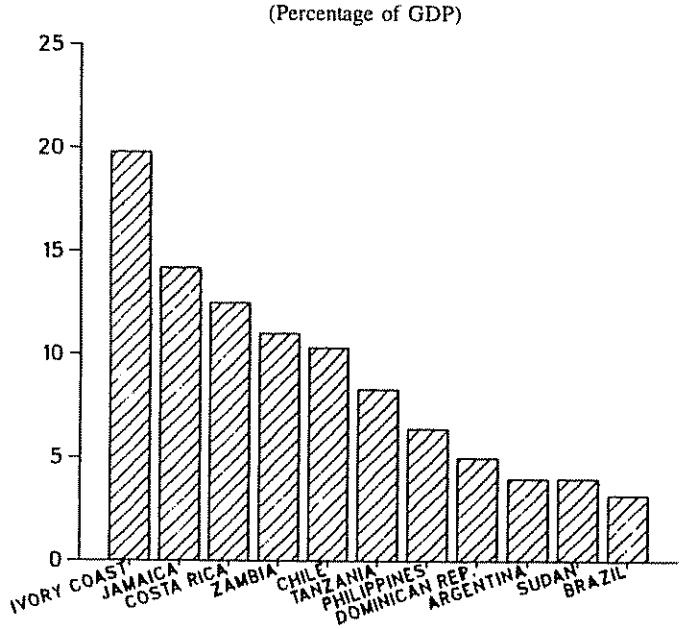
	1973-1975	1976-1978	1979-1982	1983
		Average annual percentage		
Real interest rate [a]	1.26	0.77	5.73	5.74
		Average annual rate of growth		
Volume of exports				
Latin American sample	3.90	11.50	7.20	11.50
African sample	-5.20	4.40	2.40	1.60
		Average annual rate of change		
Terms of trade				
Latin American sample	-3.90	-2.20	-7.20	0.56
African sample	-3.50	-4.10	-9.20	2.80
		Percentage share		
Ratio of current account deficit to exports of good and services				
Latin American sample	37.20	24.78	45.50	26.70
African sample	24.30	18.30	44.70	36.60

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on various national and international sources, including IMF, *International Financial Statistics*, and ECLAC, *Statistical Yearbook for Latin America. 1983*

Latin American sample: Argentina, Brazil, Chile, Costa Rica, Dominican Republic and Jamaica
African sample: Ivory Coast, Sudan, United Republic of Tanzania and Zambia

[a] LIBOR deflated by the United States GDP deflator

Figure VI-1
Selected energy-importing developing countries: effects of external shocks on current account deficits, 1979-1983



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

reduced demand for their exports as much as they did from higher interest rates. In countries such as Argentina and Chile, the interest rate effect accounted for more than 50 per cent of the total impact of the shocks experienced over the period.

Table VI-4 further illustrates the effect of the deteriorating international environment of the early 1980s on the external payments position of selected countries. Between 1979 and 1982, the combined impact of deteriorating terms of trade, reduced demand for exports and higher real interest rates added $76.1 billion to the aggregate current account deficits of these countries; this equalled about 76 per cent of the actual deterioration of their overall payments position. It can also be seen from the table that the magnitude of the shocks steadily escalated between 1979 and 1982. By 1982, in fact, all of the actual deficit of $27.7 billion could be attributed to the impact of the measured external shocks.

Table VI-4. Selected energy-importing developing countries: [a] sources of deterioration in the current accounts, 1979-1983

(Billions of dollars)

	1979	1980	1981	1982	1983	1979-1982
Actual trade deficit (-) for goods and services	-8.68	-15.48	-7.89	-4.33	5.56	-36.38
Terms-of-trade effect[b]	4.31	11.26	10.40	22.40	18.84	48.37
Export volume effect[c]	1.36	0.91	-1.90	5.05	7.59	5.42
Adjusted deficit (-) on trade accounts[d]	-3.01	-3.31	0.61	23.12	31.99	17.41
Interest payments on debt (gross)	8.78	12.88	19.11	23.77	20.95	64.54
Interest rate effect (gross)[e]	2.50	4.85	8.90	10.52	9.35	26.77
Interest rate effect (net)[f]	1.90	3.80	7.50	9.09	8.36	22.29
Terms-of-trade effect plus export volume effect plus interest rate effect	7.57	15.97	16.00	36.54	34.79	76.08
Actual deficit (-) on current account	-17.07	-26.82	-28.37	-27.71	-16.37	-99.97
Adjusted deficit (-) on current account[g]	-9.50	-10.85	-12.37	8.83	18.42	-23.89

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and *Balance of Payments Statistics*, and ECLAC, *Statistical Yearbook for Latin America, 1983*.

[a] Argentina, Brazil, Chile, Costa Rica, Dominican Republic, Jamaica, Ivory Coast, Philippines, Sudan, United Republic of Tanzania and Zambia.

[b] The terms-of-trade effect is the sum of export and import price effects. Export and import price effects for each country in the sample are calculated on the basis of the differences between actual price movements and the United Nations price index of manufactured exports by developed countries.

[c] For each country in the sample, the export volume effect is calculated as the difference between the actual and the projected volumes of the exports of goods and services, using a price index constructed by the Secretariat. The latter extends the export price index of the base years with the United Nations price index of manufactures. The projected volume of exports assumes a continuation of the volume trends of the 1970s. Actual volumes are measured in 1976-1978 prices.

[d] Actual deficit on trade account plus terms-of-trade effect and export volume effects.

[e] Based on the difference between the 1976-1978 average real interest rate (LIBOR deflated by the United States GDP deflator) and nominal rates. Interest payments for each year were calculated by applying rates to the total external debt at the end of the previous year. That debt comprises disbursed and outstanding public and publicly-guaranteed debt with a maturity of at least one year, excluding debt to commercial banks, plus all short- and medium-term debt to commercial banks as reported to the Bank for International Settlements.

[f] Includes the offsetting earnings from foreign bank deposits.

[g] Actual deficit on current accounts plus sum of terms-of-trade effect, export volume effect and net interest rate effect.

Resource transfer and adjustment responses

The task of adjusting to the external shocks of the early 1980s was severely complicated by the burden of servicing foreign debt and the need to cope with a lower supply of external finance. In most of the developing countries, interest payments alone claimed a substantial portion of export earnings; in some countries, including Argentina and Brazil, they reached 50 per cent of export revenues of goods and services in 1982.

Since then, these ratios have declined gradually, but only slowly. To the extent that capital inflows in the last three years have fallen significantly short of outflows of interest payments and profits, these countries have had to run large trade surpluses to cover the differences. This has entailed in many cases a substantial transfer of resources to creditor countries.

Under these conditions, adjustment to recent external shocks has involved both a large reallocation of resources to the tradable sector and a significant reduction in the level of domestic demand, particularly investment. In other words, the adjustment responses can be characterized as reflecting simultaneously "domestic recession" and "increased tradability". The relative weight borne by these components has varied from country to country, depending to a large extent on the individual capacity to replace imports by domestic production in a relatively short period of time. In countries with highly diversified economies and flexible production structures, such as Brazil, the need for demand contraction has been relatively less pressing than in countries with more rigid production structures and a more limited import-substituting industrial sector. None the less, given the overriding need to turn trade positions around in a very short time, all countries have had to contract demand more severely than they would have otherwise. In the process, Governments have resorted to restrictive policies by cutting back public expenditures, holding down real wages, raising interest rates and devaluing domestic currencies. The degree of restrictiveness and the timing of these policy applications have varied from country to country, depending on the severity of the shocks they received, the degree of wage and price flexibility, and the fiscal structure. In general, however, public investment expenditure has borne the brunt of the adjustment effort. In a few countries, real wages have fallen sharply; in Argentina and Mexico, for instance, they fell by more than 20 per cent over the period 1982-1983.[6]

A widely implemented policy measure has been a marked depreciation of the exchange rate in an attempt to shift domestic and foreign demand to domestically produced tradables. For many of these countries, currency devaluations in the past several years have, in fact, exceeded the differential between the domestic inflation rate and that recorded by their major trading partners, so that their currencies have depreciated in real terms. In eight of these countries there has been a real depreciation, relative to the 1976-1978 period, ranging from about 2 per cent in Peru to about 50 per cent in Costa Rica (see table VI-5).

Table VI-5. Selected developing countries: index of real effective exchange rates, 1973-1983 [a]

(Period average over 1976-1978=100)

	1973-1975	1979-1982	1983
Energy-importing countries			
Argentina	107.1	63.3	116.1
Brazil	110.9	105.7	133.1
Chile	88.3	93.5	107.4
Costa Rica	91.9	126.6	149.1
Dominican Republic	110.6	98.2	85.7
Ivory Coast	117.8	86.5	102.2
Jamaica	112.6	109.5	92.1
Philippines	99.6	91.8	97.4
Sudan	117.5	96.9	117.8
United Republic of Tanzania	104.1	89.0	54.1
Zambia	105.7	100.4	100.0
Energy-exporting countries			
Mexico	84.8	91.1	124.8
Nigeria	145.6	91.5	68.8
Peru	81.1	109.3	101.8
Venezuela	98.9	96.9	74.6

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

[a] Defined as the domestic currency value of a composite, with import value weights, of foreign exchange rates adjusted by a ratio of price indices. This ratio is defined as the relationship between a composite of consumer price indices in major trading partners and domestic consumer price indices, weighted with import values. An increase (decrease) shows a depreciation (appreciation) of the real effective exchange rate

[6] Based on *Latin American Economic Up-date and Monthly Economic Indicators* (Washington, D.C., Wharton Econometric Forecasting Associates, December 1984)

One result associated with these exchange rate adjustments has been the recent improvement of the trade balances of these countries in goods and services. With the exception of the Sudan, the countries whose currencies had depreciated in real terms in 1983 relative to the average value of their currency in 1976-1978 recorded improvements in their trade balance. At the same time, countries such as the Dominican Republic, Jamaica, Nigeria, the Philippines and the United Republic of Tanzania, whose currencies appreciated in real terms during this period, all experienced a deterioration in their trade balances.

Besides devaluation, a country's trade balance can improve through such factors as changes in economic activity, improved foreign demand for its exports and commercial policies. The rather close relationship between real depreciations and improvements in trade observed in this sample of countries, in the time frame studied, nevertheless suggests the important role that real devaluations have played in the recent adjustment experience of these countries.

Sharp drop in the level of investment

Probably the most disturbing feature of recent adjustment experiences, apart from the incisive fall in living standards, has been the widespread and sharp drop in the level of investment. In a large number of these countries, including Argentina, Brazil, Mexico and the Philippines, total investment fell by at least 20 per cent in real terms in 1982-1983. Nor is the investment outlook for the near future very promising. The factors that led to a substantial decrease in investment levels in the first half of the 1980s are still present. Public investment is likely to remain constrained by generally depressed public revenues and fiscal austerity. In countries where inflation rates are still high, a recovery in public investment will be even more difficult. Uncertain economic conditions will continue to make private investors excessively cautious. Moreover, since interest payments will continue to absorb a large part of export revenues, balance-o-payment constraints are likely to persist. This is bound to inhibit rapid increases in imports of machinery and equipment, and is likely to discourage an early resumption of foreign direct investment.

While these features point to several short-term factors that are likely to continue to dampen investment demand, the outlook for the supply of foreign or national savings is not particularly encouraging. Growth in net flows of official financing, under current policies, will remain modest and no rapid resumption of fresh flows from commercial banks is in sight. Furthermore, the fall in per capita incomes in 1982-1983 and the substantial increase in interest payments leave little room for increased domestic savings. In fact, in large countries of Latin America, interest payments abroad absorb from 4 to 8 per cent of GDP.

In sum, unless there is a dramatic reversal in the debt situation in these countries, investment will increase at a modest pace and growth will remain comparatively slight during the rest of the decade. As argued in chapter III, the debt situation depends importantly on the international environment, including the buoyancy of growth in industrial countries and the level of interest rates. If current forecasts are correct, that is, if there are no substantial changes in the policies of major industrial countries, the very substantial adjustment efforts undertaken by this sample of developing countries at a very high social cost will pay little dividend for the rest of the decade.

Imbalances in developed market economies

Magnitude of the imbalances

During the present recovery in several major developed market economies, progressively larger internal and external imbalances have emerged. This is unlike earlier experiences, when the initial cyclical rebound was normally followed by movement towards equilibrium. In contrast to the recovery of 1976-1977, in the past two years either the ratio of the budget imbalance to GDP or the ratio of the current account imbalance to GDP has progressively increased in most of the major industrial economies; in some, both ratios have risen. Moreover, projections indicate that these trends are likely to continue in 1985 (table VI-6).

These imbalances have been most pronounced in the United States, where both the federal budget deficit and the current account deficit have increased substantially in recent years; in 1983-1985, they were much greater than any previously recorded (see figure IV-2). In Western Europe and Japan, on the other hand, budget deficits in relation to aggregate output have been either stable or declining, while current account imbalances have been increasing in the direction of growing surplus (table VI-6).

These imbalances have been most pronounced in the United States, where both the federal budget deficit and the current account deficit have increased substantially in recent years; in 1983-1985, they were much greater than any previously recorded (see figure IV-2). In Western Europe and Japan, on the other hand, budget deficits in relation to aggregate output have been either stable or declining, while current account imbalances

Table VI-6. Major developed market economies: government budget deficit and current account balance, 1975-1985

	United States [a]		Japan	Western Europe [b]
	(billions of dollars)	(as a percentage of GNP)	(as a percentage of GDP)	(as a percentage of GDP)
Government budget deficit (-)				
1975	-53.2	-3.6	-2.6	-5.5
1976	-73.7	-4.5	-3.8	-4.0
1977	-53.6	-2.9	-3.8	-3.3
1982	-127.9	-4.2	-3.4	-5.6
1983	-207.8	-6.4	-3.3	-5.5
1984	-185.3	-5.2	-2.2	-5.4
1985 [c]	-222.2	-5.8	-0.8	-4.8
Current account balance [d]				
1975	18.1	1.2	-0.1	-0.0
1976	4.2	0.2	0.7	-0.5
1977	-14.5	-0.7	1.6	0.1
1982	-9.2	-0.3	0.6	-0.5
1983	-41.6	-1.3	1.8	0.1
1984	-105.0	-2.9	2.6	0.0
1985[c]	-130.0	-3.7	3.2	0.4

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *OECD Economic Outlook*, No. 36 (December 1984), Commission of the European Communities, *European Economy*, No. 22 (November 1984), and Council of Economic Advisers, *Economic Report of the President* (Washington, D.C., United States Government Printing Office, 1985)

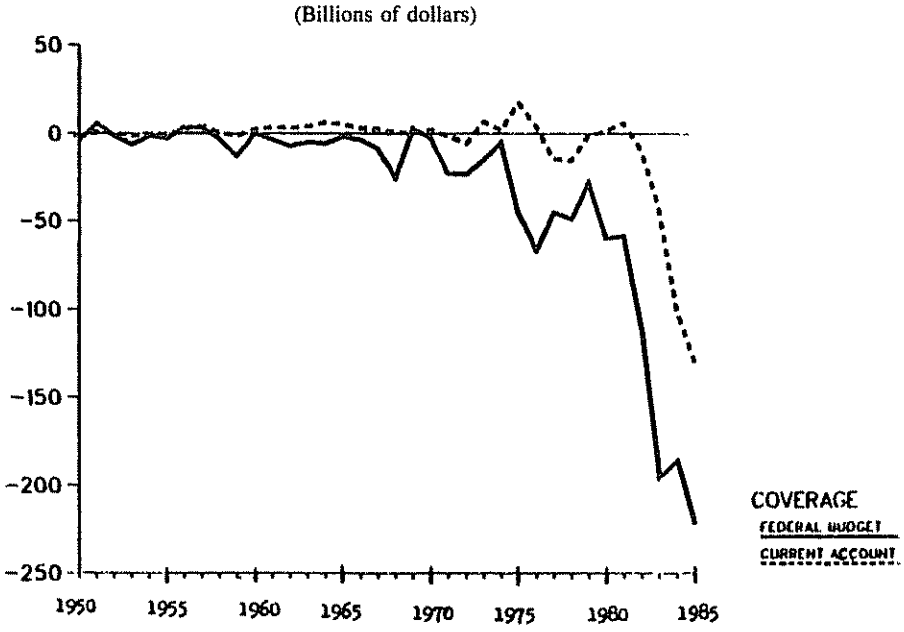
[a] Federal government budget deficit.
[b] Weighted average of countries within the EEC; the budget deficit is defined as current receipts minus total expenditures of general government
[c] Forecast
[d] Including official transfers

have been increasing in the direction of growing surplus (table VI-6).

Since there is no precedent for these recent developments it is not clear whether the prevailing imbalances, if continued unabated, will be sustainable in the medium term. Even if they are not, it is hard to say at this juncture what type of automatic adjustment process is likely to emerge. It is clear, though, that the imbalances have already given rise to a higher degree of uncertainty in international financial markets than would otherwise have existed. This in turn has begun to exact an unwarranted toll from the world economy.

The imbalances have until now been sustained by massive flows of capital from the surplus countries to deficit countries - in the first instance from Japan and Western Europe to the United States. These capital flows have not yet allowed the usual automatic adjustment mechanisms to start to function in either the capital-exporting or the capital-importing countries. Key exchange rates have remained misaligned, differentials in both nominal and real interest rates among major industrial countries have persisted despite massive capital movements, and there are other signs of disequilibrium. Key prices, such as exchange rates and interest rates, remain highly volatile despite convergence of the rates of output growth and inflation among the major economies. More importantly, the disequilibrium in labour markets, particularly in Western Europe, has widened further. Unemployment rates are very high by post-war standards, and still rising in some European countries (see table A-4), in spite of the economic recovery and the significant deceleration in the growth rate of real wages in most countries during the period 1982-1984.

Figure VI-2
Federal budget and current account balances
of the United States, 1950-1985



Source: Council of Economic Advisers, *Economic Report of the President* (Washington, D.C., United States Government Printing Office, 1985)

Of fundamental moment for policy in the current situation is the relative importance, as causes of the present disequilibria, of policy inconsistencies and of fundamental shifts in the world economy. There are indications that the evolving imbalances, particularly those concerning capital movements, may be caused, to a certain degree, by the widening of differentials in the rates of return on invested capital. There are, however, other important determinants of the direction of capital movements, in particular differentials in the rates of return on financial assets, in output growth rates and in labour costs (see tables VI-7 and VI-8). It is apparent that, during 1981-1984, most of these indicators have been strongly in favour of the United States, particularly in comparison to Western Europe. If most of the observed imbalances could, in fact, be attributed to underlying structural changes and the resulting movements of resources across countries, then policy reformulations would not have much effect in the longer term; the movements of capital would continue unabated until the current disequilibria were worked off.

It can be argued that the observed imbalances, even if they emanate from fundamental underlying differences in the economic situation of the major industrial economies, have been greatly exacerbated by inconsistent macro-economic policy mixes within and among these countries. Correction of these inconsistencies can be expected to reduce the imbalances significantly. In order to examine this question it is necessary to trace briefly the emergence of the present policy mixes during the past five years.

In the late 1970s, the majority of developed market economies began to follow a new set of policies in order to overcome internal economic problems associated with stagflation. In nearly all of those countries, rates of inflation and unemployment increased during the 1970s, while output growth rates declined significantly, relative to those of the previous decade (see table VI-7). The reasons for this situation and the problems associated with the policy responses during that period have been discussed in an earlier issue of this *Survey*,[7] and will not be repeated here. However, among the more prominent factors that should be mentioned are small gains in productivity and low rates of investment; deeply embedded inflationary expectations; and heavy regulation of financial markets, particularly in regard to interest rate ceilings. The latter in most instances prevented nominal interest rates from reflecting fully the extent of underlying inflationary expectations, which resulted in very low, in some cases negative, real interest rates. While the increased variability in prices, and the greater degree of uncertainty that it engendered, severely hampered investment decisions, negative real interest rates often made projects with relatively low rates of return seem profitable, although they were inherently non-viable. Speculation in commodities, precious metals

[7] *World Economic Survey 1981-1982* (United Nations publication, Sales No. E 82.II C 1), pp. 8-14.

Table VI-7. Developed market economies: rates of change in real GDP, prices and rates of unemployment, 1961-1987

(Average annual percentage rates)

	All developed market economies	United States	Japan	Europe
Real GDP				
1961-1973	5.0	4.2[a]	10.4	4.7
1974-1980	3.0	2.3[a]	3.8	2.3
1981-1984	2.0	3.6[a]	4.0	1.0
1985-1987[b]	3.2	3.5[a]	4.1	2.4
Inflation rate[c]				
1961-1973	4.5	3.4	5.5	5.1
1974-1980	11.5	10.4	11.3	12.2
1981-1984	6.3	5.7	2.1	8.0
1985-1987[b]	4.4	3.9	2.0	5.0
Unemployment rate				
1961-1973	3.0	4.7	1.2	2.5
1974-1980	5.0	6.7	2.0	4.9
1981-1984	8.2	8.8	2.5	9.5
1985-1987[b]	8.5	7.0	2.1	11.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics*, OECD, *OECD Economic Outlook*, No. 36 (December 1984) and *Historical Statistics 1960-1980*, and Project LINK.

[a] GNP
[b] Projections (see table III-2).
[c] Rate of change in GNP or GDP price deflator

Table VI-8. Selected developed market economies: nominal wages, real interest rates and rates of return on investment, 1967-1984

	United States	Japan	Europe[a]
Hourly wages in manufacturing[b]			
1967-1973	6.3	16.9	9.2
1974-1980	8.6	11.2	14.6
1981-1984	6.2	4.6	9.8
Real long-term interest rates[c]			
1967-1973	1.6	0.6	2.1
1974-1980	0.3	1.6	0.0
1981-1984	6.4	6.3	4.0
Rate of return on invested capital[d]			
1967-1973	10.2	11.9	10.8
1974-1980	8.8	6.4	7.8
1981-1984	7.8	5.0	6.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *Historical Statistics 1960-1980*, Commission of the European Communities, *European Economy*, No. 20 (July 1984) and No. 22 (November 1984), and IMF, *International Financial Statistics*.

[a] European Economic Community
[b] Average annual percentage rate of change.
[c] Arithmetic mean of annual average yields on long-term government bonds deflated by the rate of change of the GDP deflator of the same period.
[d] Arithmetic mean of average gross rates of return on invested capital (enterprises excluding housing), defined as the gross operating surplus as a percentage of the gross capital stock.

and real estate often resulted in higher and quicker rewards than investment in machinery and equipment.

Once the policy makers began to make the eradication of inflationary pressures and expectations their number one priority, macro-economic policy stances changed markedly, in most countries beginning in 1979-1980. The new policies, basically, were to restrain the growth of the money supply and put greater emphasis on the targeting of the monetary aggregates than of interest rates; to reduce the size of the public sector in relation to the total level of economic activity, by lowering tax rates and by attempting to reduce or eliminate structural budget deficits; and to deregulate product, service (particularly financial) and labour markets. In most cases, the immediate result of these policies was a precipitous rise in nominal and real interest rates, and a deep recession, associated with an unprecedented rise in unemployment. In response to these measures, in 1982-1983, inflation rates began to decline rapidly in major industrial countries, even though an economic rebound, particularly in the United States, was taking root. Nominal interest rates also declined from their peak in 1980-1981, but the downturn was less pronounced than that of inflation rates. As a result, very high real interest rates, by post-war standards, emerged in a large number of countries.

Prominent role of United States policies

Among the reasons why a significant, albeit uneven, recovery has taken place in the developed market economies without a resurgence in inflation, the mix of fiscal and monetary policies in the United States - and the overvaluation of the dollar - stand out as the most prominent. A monetary policy that had been essentially restrained since late 1979 was combined with the new tax policy package (Economic Recovery Act) adopted in August 1981. Although the latter sought to cut back expenditures, in conjunction with the abatement of income tax rates, the changes in fiscal expenditures, in fact, affected the composition of total outlays more than their rate of growth. This new direction in macro-economic policies remains virtually intact in 1985. It may be modified in 1986 and beyond because the historically high fiscal deficit - itself a somewhat unanticipated result of current policies - is being increasingly perceived as unsustainable in the medium term.

After half a decade of a rather decisive anti-inflationary stance, which was relaxed only between the third quarter of 1982 and the second quarter of 1983, inflationary expectations have been markedly eroded. Wage rigidities, often considered one of the major reasons for stagflation, have also been considerably reduced, thus laying an important foundation for more sustainable growth. It is important to note, however, that the escalating interest rates of the early 1980s and the severity of the recession that followed in 1981-1982, which left a legacy of pronounced economic distress in a large number of countries, were largely caused by the non-accommodating monetary policy. The most critical impetus for recovery in the United States since late 1982 has come from fiscal measures: substantial cuts in personal income tax rates, generous provisions for the accelerated depreciation of new capital assets, and expanded investment tax credits. This new policy orientation not only raised the level of aggregate demand, it also reversed the investment disincentives of the previously applicable tax rules which had been regarded as an additional cause for stagflation.

The shape of the 1983-1984 recovery in the developed market economies as a group was heavily influenced by the monetary policy of the United States and the overall economic performance there. As discussed in part one, the United States provided a substantial boost to the other developed market economies during this period and, at least in the short run, the performance of these economies continues to be affected by economic developments in the United States. The outlook for the near future is characterized by several uncertainties for the United States as well as for other industrial countries.

Although there has been a widespread and substantial deceleration of inflation, the process by which many developed market economies have emerged from stagflation has several problematic aspects that have to be dealt with if a wider and more durable economic expansion is to hold. The following three stand out. First, despite the sharp recovery in the United States, its federal budget deficit has remained high; it was around 5 per cent of GNP in 1984 and a similar magnitude is expected for the current year (see table VI-6). Secondly, recovery in the United States has been accompanied by a large net inflow of capital, a substantial appreciation of the dollar, and a rise in the current account deficit to unprecedented levels. Finally, while Japan has experienced moderate growth, by post-war standards, recovery in most Western European economies has been quite modest and unemployment rates have continued to increase. One of the most crucial concerns today, therefore, is whether the two first features are consistent with a more balanced and durable recovery in the developed market economies.

Given its huge budget deficit, for the United States to sustain growth led by the private sector, particularly private investment, requires either a steady inflow of foreign capital (and thus a continuation of large-scale current account deficits), or an increase in domestic private savings, or a decrease in government budgetary deficits. Under current conditions, the latter two cannot be counted on, at least in the near term. The ratio of gross private savings to GNP stood at 18.5 per cent in 1984, which is already at the upper end of the range

of magnitudes (15 to 18.5 per cent) recorded in each of the preceding 25 years. The federal budget deficit is expected to widen in 1985. Unless there is a significant departure from the present fiscal stance, the deficit will remain at least as high in 1986 and subsequent years. As a result, net foreign borrowing, which is the counterpart of the current account deficit in the absence of net changes in international reserves, remains a critical source for financing growth in the United States.

During 1984, net foreign borrowing was of the order of $100 billion - about 15 per cent of gross private fixed investment in the United States. Between 1982 and 1984, the increase in capital inflows to the United States was equivalent to about 40 per cent of the increase in private investment.[8] In the absence of this financing, private investment would probably have grown much more slowly. In other words, if the present large capital inflow were to dry up suddenly for some reason, it would be difficult to sustain non-inflationary growth in the United States.

While the perceptions by private agents of the relative economic strength of various countries are important determinants of capital flows, the rate of change in current domestic demand also influences the channelling of such flows. European countries have continued to advocate restraint in public expenditures on the grounds of fiscal responsibility, and to encourage a greater role for the private sector so as to create new employment opportunities. Until now, however, the latter objective has remained unfulfilled. Although this approach has generated a few positive supply-side impulses, it has also had significant negative implications for aggregate demand. Since these economies have experienced only a small rebound in domestic private investment, they have had to depend on a strong export drive, mostly to the United States, for their recovery, which, by past standards, has on the whole remained weak. Combined with increases in current account surpluses brought about by buoyant exports, the decline in budget deficits contributed to an appreciable improvement in the net financial balances of the private sector in most of these countries; but because of only a modest increase in domestic demand, a significant proportion of savings tended to be channelled where demand was strong, namely, the United States.

One of the reasons for strong United States demand for savings was the incentives for private investment provided by the 1981 Economic Recovery Act. In addition to the 25 per cent reduction in personal income tax rates over three years, the Act provided for an accelerated cost recovery system, an increase in investment tax credits on certain assets, and a liberalization of tax benefits for leasing activities. The result of the latter measures has been the drastic lowering, for tax purposes, of the service lives of capital structures and equipment. A recent study[9] indicates that the Act reduced the marginal cost of capital assets by as much as 15 per cent for structures and by 6.3 per cent for equipment. The 1982 Tax Equity and Fiscal Responsibility Act tightened its provisions slightly, although the original effects have remained basically intact. Thus, business investment was encouraged to grow despite high real interest rates.

Many factors have led investors world-wide to favour the United States, on balance: its expansionary domestic demand for goods and services, the characteristics of its product and labour markets, the rapid pace at which new technologies have been introduced, business and consumer confidence, as well as political optimism and stability. The resulting strong demand for dollar-denominated assets has induced a sizeable appreciation of the dollar - a trend manifest even in the first quarter of 1985 despite the high and increasing current account deficit.

For the world economy as a whole, foreign currency transactions amount to about $30,000 billion a year, in contrast to only $3,000 billion for trade in goods and services. The operation of comparatively free capital markets in large industrial countries has been the major determinant of current exchange rates, which consequently play a much weaker role in equilibrating the current account balances among these countries than they used to. This also implies that the United States current account deficit is being propped up to a large extent by net capital inflows. Yet only if capital inflows into the United States can be encouraged on the scale recently seen will the smooth financing of a large current account deficit be possible and the United States economy be able to continue growing in a non-inflationary way.

In sum, although disequilibria in the United States economy are evident, and may even be on the increase, the prevailing mood in financial markets makes the current growth process sustainable, at least in the short run. This does not however imply that the world economy is basically in a temporary phase of adjustment to a more stable and broad-based economic expansion. The significant disequilibria, rather, reflect what is essentially a dynamically unstable process operating in an interdependent economic system.

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[8] Council of Economic Advisers, *Economic Report of the President* (Washington, D.C., United States Government Printing Office, 1985).

[9] Federal Reserve Bank of New York, "What is behind the capital spending boom", *Quarterly Review*, winter 1984-1985, pp. 19-30.

Policy stances and disequilibria in the medium term

The general perception in the United States that in the medium term, and even more so in the long term, the present level of the federal budget deficit is unsustainable has led to renewed efforts to restrain the growth in fiscal expenditures. However, there can be no effective progress on this front before the adoption of the 1986 budget. In the meantime, the national debt continues to increase at a fast pace and interest payments are escalating further, steadily augmenting the bulging structural deficit. The dynamics of national debt accumulation and the implications for the increase in the structural budget deficit via growing interest payments are evident from the data shown in table VI-9.

Table VI-9. Trends in general government deficits and interest payments of the United States, 1980-1985

	1980	1981	1982	1983	1984[a]	1985[b]
			Percentage of nominal GNP			
Actual deficit (-)	-1.2	-0.9	-3.9	-4.1	-3.2	-3.6
Structural deficit (-)	0.7	0.5	0.4	-0.3	-0.8	-2.1
Interest on public debt (net)	1.3	1.7	2.0	2.1	2.4	2.7
			Billions of dollars			
Memorandum items:						
Gross federal debt	914	1 004	1 147	1 382	1 577	1 840
Nominal GNP	2 632	2 958	3 069	3 305	3 661	3 941
			Percentage			
Ratio of debt to GNP	34.7	33.9	37.4	41.8	43.1	46.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *OECD Economic Outlook*, No. 36 (December 1984), and Council of Economic Advisers, *Economic Report of the President* (Washington, D.C., United States Government Printing Office, 1985).

[a] Preliminary.
[b] Forecast

Net interest payments, which in 1984 amounted to more than 14 per cent of total expenditures of the general government, are likely to double in a relatively short period if large deficits persist and the level of public sector debt continues to increase at the current pace. This highlights the crucial importance of putting in place policies for smooth, yet sizeable, reductions in prospective budget deficits. Such reductions would also have a beneficial impact on financial markets, particularly currency markets, and would not abruptly dampen the level of aggregate demand. In the process, the present exchange rate misalignments could gradually be corrected, which would compress prospective current account deficits. Moreover, as already stated by the monetary authorities of the United States, a reduction in the budget deficit would allow for faster monetary growth, which, in turn, would leave more room for policy manoeuvre in other countries - a most welcome development under present circumstances.

The change in the early 1980s towards macroeconomic policies with a stress on disinflation occurred without the developed market economies making any meaningful attempt at policy co-ordination. There were few incentives for policy co-ordination at a time when one major policy goal was to lower the rate of inflation. In the monetary field in particular, the course of policy-making in the developed market economies during the first half of the 1980s can be characterized as a sequential decision process where the United States has taken the lead and other countries have reacted to it. This process, however, has not been smooth, as underlined by the fact that real interest rates are still well above those of the 1970s, although nominal rates have subsided from their 1981 peaks. This continues to be a cause for serious concern.

The strength of the dollar, that these high interest rates helped to buttress, has also become a concern among policy-makers in the United States. The competitive position of United States exports has been severely impaired by the rising value of the dollar, while import-competing industries are increasingly pressing for new measures to restrict imports. The problem has been compounded because recent interventions by monetary authorities in currency markets have not been very successful. Given the present size of currency markets, credible intervention can only occur if the Federal Reserve Board decides to play a decisive role in these markets. This would entail a substantial infusion of liquidity and, possibly, an upward revision of monetary targets.

On the other hand, the strong dollar has been instrumental in the export-led recovery of most developed and many developing countries. It has also eased competitive pressures for their import-competing industries, since imports into the countries of Western Europe as a group have increased only modestly. The net effect has been a substantial trade surplus and, compared to the early 1980s, a significant swing towards current account surplus in Japan and Western Europe. This surplus and the cautious fiscal stance of these countries have facilitated the capital outflow to the United States. In a sense, the system thus far has exhibited a self-stabilizing mechanism that enables the United States - up to a point - to be complacent about its current account imbalance and thus to maintain a level of expenditures above its national income. Under such conditions, there is no strong incentive for the United States to co-operate in terms of policy co-ordination. This is so particularly because the rate of growth in fixed investment in the United States has accelerated markedly since late 1983 and still exceeds the rate of growth of GDP.[10]

The United States current account deficit, however, cannot be sustained at present levels in the long run without an escalation of the net external debt of the United States and, hence, an increase in the danger of a sudden change in expectations and a drop in the value of the dollar. A precipitous decline in the value of the dollar *vis-à-vis* other key currencies, and the increase in interest rates that could result, pose the most serious downward risks to the world economy in the short term. Nor can federal budget deficits be sustained at present levels. That is one major reason why policy makers are seeking to reduce the federal budget deficit by making a substantial effort to restrain the growth in public expenditures. Actually, with the exception of defence and social security outlays, a virtual freeze on other expenditure programmes has been advocated. The effect of a significant restraint in public expenditures on aggregate demand could be very important, particularly during a cyclical deceleration of growth in the United States.

From the point of view of the global economy, there is, then, a case for a more stimulatory fiscal stance by other developed market economies, particularly by those countries whose structural budget deficit is near balance or - as in the Federal Republic of Germany and Japan - is about to swing into surplus. In this context, a co-ordinated, rather than a sequential, policy stance among developed market economies appears crucial. To narrow the disparities in the fiscal stances of major developed market economies, while avoiding even a transitory reduction in global demand, clearly requires timely policy co-ordination. The efforts of the United States to reduce its budget deficit, if unaccompanied by a significant fiscal stimulus on the part of the other major economies, might prove to be too costly for the world economy.

Adjustment and investment policies in the centrally planned economies of Eastern Europe

The centrally planned economies and world-wide disturbances

The global recession and financial crisis of the early 1980s, followed by uneven recovery in many market economies, have had profound impacts on the centrally planned economies, particularly those of Eastern Europe. In the late 1970s, these economies had a fairly wide range for policy choice, but with the advent in 1982 of the global financial crisis in sovereign lending it became difficult to finance their external deficits. As a result, several Eastern European economies had to embrace restrictive adjustment policies, generally on an emergency basis, just like many of the net energy-importing developing countries.[11]

The external pressures for adjustment were most pronounced in Hungary, Poland and Romania, the latter two being forced into debt-rescheduling, but induced shifts in policies have been a group-wide phenomenon. They have had far-reaching repercussions for intra-CMEA economic co-operation, capital formation and the ability of these countries to resume more expansive growth soon.

[10] Thus, in a sense, net inflows of capital can be said to contribute more to capital accumulation than to the increase in consumption

[11] Other centrally planned economies have also embraced adjustment policies, but their experiences fall outside the scope of the present chapter.

As a result of changes in economic policy objectives and greater resource constraints, which have been especially important since the 1970s, all Eastern European countries have been searching for an "intensive growth" strategy which would yield steady gains in factor productivity through structural and institutional changes. As the growth record shows, progress has on the whole been slow because the institutions, behavioural rules and policy instruments of these economies are not sufficiently flexible and do not react promptly to shifts in overall policy. Yet Eastern European decision makers responded to the global recession and international financial problems by taking drastic policy measures that significantly improved current accounts in the short run and quickly alleviated external imbalances. Most countries actually reached a current account surplus in their convertible currency trade in 1982 or 1983, and have maintained or expanded it since.[12]

The recent experience of Eastern Europe therefore stands out with respect to the speed, nature and depth of the policy changes enacted since 1981 and the successes attained in the process. Table VI-10 shows how the adjustment process of Eastern Europe has evolved since 1979. It was different from that of most developing countries and in many ways a unique experience. First, while per capita income levels decreased in three countries,[13] the drop was small and lasted only one or two years, except in Poland. In fact, the per capita income level for the group as a whole had clearly surpassed the previous high of 1979 in 1983.[14] Secondly, throughout most of the adjustment phase, export quantum expanded steadily while import quantum contracted or grew only very slowly. Thirdly, within CMEA, all Eastern European countries experienced a steady terms-of-trade decline of a moderate annual 2 to 4 per cent, but on balance there was little change in their terms of trade with market economies. The impact of the terms-of-trade losses could be contained through substantial increases in the volume of exports, especially to the USSR. Finally, most countries started to adjust to external pressures early, a substantial recovery in investment activity levels has already taken place in all countries but Hungary, most countries resumed production at a more normal pace by the second half of 1983, and all had overcome the immediate external constraints by mid-1983.

Although there are many explanations for the uniqueness of the adjustment process in Eastern Europe, three sets of factors stand out, namely, the existence of a substantial regional market that, as a result of its institutions and policies, can neutralize some outside events and ease or delay the impact of others; the commitment of policy makers to alleviating external constraints quickly by switching expenditures, even at the cost of below-plan performance and possibly of lowering the potential for future growth; and the extent to which decision makers can intervene directly to curb domestic absorption.

The economic situation at the beginning of the 1980s and adjustment policies

The turbulence in world markets in the 1970s affected Eastern Europe with a considerable lag and then only mildly. Its micro-economic impact was curtailed because the planned economies generally cushion the effect of world market fluctuations, especially unanticipated changes in trade prices, on domestic markets. On the whole, the level and composition of domestic demand and supply are therefore managed and guided by different policies from those typical of market economies. Because of their trade dependence, these economies cannot be fully shielded on the macro-economic level; nevertheless, the impact of the major disturbances abroad was muted and delayed by the CMEA trade and finance mechanisms, which insulate members against the immediate and full transmission of fluctuations in world markets.[15] Since these countries conduct about half of their trade among themselves and meet the bulk of their energy import needs[16] from within the group at special prices, CMEA arrangements are important determinants of the concrete setting of external adjustment efforts in the area.

At the end of the 1970s, there were already several inducements to adjust. Sluggish productivity growth had pointed to the need for changes in economic management

[12] The group turned a $5 billion current account deficit in convertible currency relations in 1981 into a surplus of $0 3 billion in 1982, which has steadily increased, to roughly $3 5 billion in 1984.

[13] Czechoslovakia in 1981-1982, Hungary in 1980 and Poland in 1979-1982.

[14] The per capita income levels of the group exclusive of Poland did not decrease in any year

[15] Put briefly, intra-CMEA commerce is planned and transacted at prices that are negotiated bilaterally with reference to world prices averaged over five years. Nearly all trade comes under bilaterally balanced trading agreements with settlements in transferable roubles.

[16] When the first oil crisis erupted in 1973, except in the case of Romania, nearly all oil was procured through CMEA contractual arrangements at prices that were only tangentially, and in any case with a drawn-out lag, dependent on world prices The share has decreased somewhat, but at over four fifths it remains very high indeed

Table VI-10. Centrally planned economies of Eastern Europe: basic economic growth indicators, 1976-1985

(Annual growth rates)

	1976-1980	1981-1985[a]	1981-1984	1979	1980	1981	1982	1983	1984[b]	1985[a]
Bulgaria										
Net material product	6.1	3.7	4.2	6.6	5.7	5.0	4.2	3.0	4.6	4.1
Industrial output	6.0	5.1	4.5	5.5	4.1	4.9	4.6	3.9	4.5	5.2
Agricultural output	0.9	3.4[c]	2.5	6.1	-4.6	5.9	5.2	-7.2	6.8	3.2
Gross fixed investment	4.0	3.6	3.6	-2.2	7.5	10.5	3.6	0.6	0.0	6.1
Export volume	12.8	..	7.1	13.7	12.2	8.4	11.3	4.4	4.4	..
Import volume	3.2	..	4.7	2.1	4.2	9.3	3.2	5.2	1.4	..
Czechoslovakia										
Net material product	3.7	2.3[d]	1.3	3.1	2.9	-0.1	0.2	2.4	3.0	3.0
Industrial output	4.7	3.1[d]	2.5	3.7	3.5	2.1	1.1	2.8	3.9	3.0
Agricultural output	1.8	1.7[cd]	2.4	-3.3	4.8	-2.5	4.4	4.2	3.6	-1.1
Gross fixed investment	3.5	-1.1[d]	-1.2	1.8	1.4	-4.7	-2.3	0.6	1.5	2.0
Export volume	6.3	..	4.6	3.2	4.7	0.5	6.1	5.7	6.2	..
Import volume	2.9	..	0.7	2.2	-1.6	-6.9	2.9	2.0	5.3	..
German Democratic Republic										
Net material product	4.2	5.1	4.3	4.1	4.4	4.8	2.6	4.4	5.5	4.4
Industrial output	5.0	5.1	4.1	4.6	4.7	4.7	3.2	4.1	4.2	3.8
Agricultural output	1.2	0.8[ce]	2.3	3.1	0.7	1.6	-4.0	4.1	8.0	-1.0[f]
Gross fixed investment	3.4	0.5	-0.7	1.4	0.3	2.8	-5.2	-0.0	0.0	0.0
Export volume	5.6	..	7.0	8.9	3.6	8.4	5.4	10.6	3.7	..
Import volume	4.9	..	1.2	6.5	5.1	-6.3	0.4	5.3	5.7	..
Hungary										
Net material product	3.2	2.9[d]	2.1	1.2	-0.9	2.5	2.6	0.3	2.9	2.6[d]
Industrial output	3.4	3.8[d]	2.3	3.1	-1.7	2.4	2.5	1.4	3.0	3.0
Agricultural output	2.5	2.5[cd]	2.3	-1.5	4.6	2.0	7.3	-2.7	2.8	1.0
Gross fixed investment	2.4	0.0	-4.0	0.8	-5.8	-4.3	-1.6	-3.7	-6.5	1.0
Export volume	7.0	..	6.2	12.5	1.0	2.6	7.3	9.4	5.5	..
Import volume	3.9	..	1.3	-3.3	-1.2	0.1	-0.1	3.9	1.2	..
Poland										
Net material product	1.2	-1.3[f]	-1.9	-2.3	-6.0	-12.0	-5.5	6.0	5.1	3.3[d]
Industrial output	4.7	-0.3[f]	-0.6	2.7	-	-10.9	-2.1	6.4	5.3	4.3[d]
Agricultural output	-1.7	2.2[f]	2.4	-1.5	-10.7	3.8	-2.8	3.3	5.7	0.3
Gross fixed investment	-3.0	-6.4[cf]	-5.2	-7.9	-12.3	-22.4	-12.1	9.4	8.0	0.0
Export volume	4.0	..	1.4	6.8	-4.2	-19.0	8.7	10.3	9.0	..
Import volume	1.7	..	-4.8	-1.2	-1.9	-16.9	-13.7	5.2	9.0	..
Romania										
Net material product	7.3	7.1	4.0	6.2	2.8	2.2	2.7	3.7	7.7	10.0
Industrial output	9.5	7.6	3.7	8.1	6.5	2.6	1.1	4.8	6.7	7.5
Agricultural output	3.8	4.7[cd]	4.4	5.5	-4.3	-0.9	7.6	-1.6	13.3	6.4[d]
Gross fixed investment	8.5	5.2	-0.3	4.1	3.0	-7.1	-2.5	2.9	6.1	8.3
Export volume	5.8	..	5.4	2.1	4.4	13.6	-7.6	0.9	16.5	..
Import volume	8.3	..	-7.1	4.0	3.7	-7.2	-22.8	-5.0	9.6	..
Eastern Europe										
Net material product	3.9	3.3	1.8	2.0	0.1	-1.9	0.1	3.9	5.1	4.8
Industrial output	5.6	3.8	2.4	4.5	3.0	-0.6	1.2	4.4	4.8	4.6
Agricultural output	0.8	2.9[c]	2.8	0.8	-3.7	1.8	1.6	0.9	6.9	1.4
Gross fixed investment	2.7	-0.1	-1.5	-1.0	-2.2	-7.2	-4.2	2.4	3.5	3.4
Export volume	6.5	..	5.4	7.6	2.9	1.2	5.5	7.4	7.6	..
Import volume	3.9	..	-0.7	1.7	1.2	-6.4	-4.6	3.4	5.3	..

Source Department of International Economic and Social Affairs of the United Nations Secretariat, based on international and national statistical publications, and plans and plan fulfilment reports

[a] Plan target
[b] Preliminary
[c] Average of the five years over the preceding five years
[d] Mid-point of the range of figures
[e] Production and services of agricultural and food industry combined
[f] Estimate

and in the allocation of resources. A comprehensive reformulation of investment policies had become necessary, partly owing to tightening restrictions on the volume and distribution of funds available for capital accumulation. The growth of the effective labour force had slowed down markedly, while the priorities of social programmes restricted the potential for capital accumulation in many countries. Furthermore, the pent-up demand for infrastructural and "non-productive"[17] investments had grown too much to be ignored. Since most of these projects would not boost material output capacity, or not immediately, they compressed the potential for expanding the capital stock in material production. This made it more difficult to switch to an intensive growth strategy, which is not a simple manoeuvre even in a favourable internal and external environment. Domestic economic conditions in many countries called for a reversal of the deceleration of the growth of capital productivity by speeding up renovation and modernization of plant and equipment. Yet, precisely because of the priority given to easing bottle-necks and capacity constraints in the appropriation of investment funds, the domestic capacity to produce the engineering products required for modernization had weakened markedly.[18]

The need to switch to an intensive growth strategy was magnified by several external changes, namely, the gradual feeding through of world price shifts into CMEA clearing prices, starting in 1975, and modifications of other CMEA trade and finance arrangements,[19] the tightening of supplies of key industrial inputs available at CMEA clearing prices at the time of the second oil shock; and the adverse events in world finance and trade in the early 1980s. In order to come to grips with this new situation, planners made efforts to co-ordinate their plans in the context of CMEA. In addition to regular trade agreements, the CMEA countries had elaborated five Long-term Target Programmes of Economic Co-operation, which presumed considerable harmonization of investment policies in order to boost future output levels quantitatively as well as qualitatively.[20]

In the circumstances, Eastern Europe adopted rather modest growth targets for the first half of the 1980s (see table VI-10),[21] although the full impact of the second oil price increase had not yet been factored into the plans. It was anticipated that a more moderate expansion, or even a contraction, of investment would not unduly constrict aggregate output growth because policy measures were envisaged to improve the utilization of all factors of production, especially capital; to channel funds into modernization, conservation and the more efficient use of primary and intermediate inputs; to boost exports and curb imports, especially in relations with market economies; and to improve the planning and organization of the investment process in order to reduce frozen assets and economize on material inventories. These policy concerns were, however, quickly replaced in the course of plan implementation by efforts to come to grips with a rapidly changing external environment.

Most centrally planned economies had thus embraced a range of adjustments of varying depth and span well before the full impact of the crisis of confidence in financial markets was felt. The measures were generally most incisive in the economies that had to concentrate on restoring short-run external equilibrium, owing to pronounced balance-of-payments difficulties.

Seen in a regional context, the adjustment problems of the Eastern European countries have been at the same time "easier" and "more complex" than those of many developing countries. This paradox stems from the nature of the disequilibria and the means available to work them off. The fact that the bilaterally balanced exchange of largely predetermined trade volumes, especially engineering exports for industrial inputs, made up half or more of their total trade protected the Eastern European countries against outside fluctuations; but the gradual, if steady, deterioration of Eastern Europe's CMEA terms of trade had to be met through increased exports, although for a while special loans from the USSR helped to ease that aspect of the adjustment problem. The bilaterally guaranteed trade volumes were

[17] These countries view their economy as consisting of productive (or material) and non-productive (or non-material) sectors. The latter comprise all services not related directly or indirectly to the production of goods.

[18] One set of domestic problems can be traced to the relatively weak capital expansion in key sectors, including construction, metallurgy and machine-building, because funds had been appropriated particularly for agriculture, energy, raw materials, social programmes and infrastructure.

[19] Including the annual revision of the price reference base, the averaging over the preceding rather than a fixed five-year period, and the rising share of intra-CMEA trade settled in convertible currencies.

[20] Co-ordination of investment activity has been a central preoccupation of CMEA discussions essentially since the early 1970s, but the share of overall investments that these countries co-ordinate has remained rather small, perhaps 5 to 10 per cent in recent years. Co-operation modes usually take the form of a temporary mobility of labour and capital, or a prespecified distribution of future output. The Target Programmes covered energy, fuels and industrial raw materials; non-food consumer goods; agriculture and foodstuffs; transportation; and machine-building. By 1979-1980, however, the constraints on forward-looking development policies had become so severe that it proved to be too cumbersome to pursue comprehensive internal and external adjustments by way of synchronized Target Programmes as originally envisaged. They were therefore limited to a few critical areas, especially fuel and key raw materials. This curtailment itself, after the medium-term plans had been harmonized, must have entailed significant implementation problems.

[21] For details, see "Medium-term growth and trade in the light of the socio-economic development plans of Eastern Europe and the Union of the Soviet Socialist Republics for 1981-1985", *Supplement to World Economic Survey 1981-1982* (United Nations publication, Sales No. E.82.II.C.2), pp. 15-35.

undoubtedly instrumental in maintaining comparatively buoyant economic activity and in mitigating the impact of adjustments on the levels of living of the population in the majority of countries.

At the same time, the bilateral trade and payments arrangements typical of intra-CMEA relations do not generally provide room, for instance, for short-term financial resources that could help to ease the payments difficulties being experienced in convertible currency relations. The individual countries, however, responded to the external crisis unilaterally, that is, without prior consultation with CMEA partners, and mostly on an emergency basis, by, in certain cases, sharply compressing investment activity, shifting the distribution of available funds in a manner contrary to the magnitudes planned, and incisively modifying investment priorities. Since planned trade levels could not be adhered to in a number of cases, the measures adopted in isolation had important ripple effects on trade partners.

A useful way of looking at the adjustment process is to analyse its impact on the components of domestic absorption. Schematically, the Eastern European adjustment programmes have comprised three stages, as broadly evident from the annual changes in the key macroeconomic magnitudes shown in table VI-10. The first centred on the protection of the levels of living of the population already achieved, including real wages and pensions. The second stage, which, except in Poland, coincided with the eruption of the crisis in world financial markets in 1982, was characterized by restraint of both consumption and investment, the promotion of exports of whatever goods could be mobilized, and the drastic slashing of imports, particularly from the market economies. Most countries appear to have entered a third phase in late 1983 or in the course of 1984: restraint is still being applied in both consumption and investment, but imports from convertible currency partners are not as rigidly controlled as in the second phase and the ongoing relaxation of external constraints is benefiting in the first instance consumer market balances.

The measures adopted by Eastern European policy makers during the adjustment phases have included direct as well as indirect policy instruments. Relatively large changes in domestic wholesale prices, and in some cases also retail prices, have occurred, some attributable to devaluations but most stemming from shifts in central price-setting by *fiat* that were designed to curb budget subsidies and steer personal demand. Several countries have also tried to guide investment demand through more active interest rate and credit policies, as well as through other indirect means. These measures were introduced as components of the transition towards a wider use of indirect decision-making instruments as a means to foster intensive growth. Some of these adjustments were also undertaken to alleviate external payments pressures. However, it generally proved to be too cumbersome, socially and politically, to influence in the short run the level and composition of domestic absorption in that way. In the majority of these countries such changes in the "economic mechanisms" are inherently planned and introduced in accordance with medium-term to long-term policy priorities rather than targeted at easing unexpected short-term external disturbances. As a result, adverse movements of retail prices for major segments of personal demand were generally offset by additional social transfers and income adjustments.[22]

The brunt of the adjustment burden was undoubtedly borne by investments as illustrated by the evolution of the distribution of net material product by final uses (see table VI-11). There was a deceleration of growth or even an absolute decline in the level of net accumulation, which is essentially a measure of net investments in fixed assets and changes in inventories. The magnitude of the decline was correlated strongly with the state of the external imbalance. This compression was accomplished by various means: restrictions on the authorization of new projects, postponement or even scrapping of projects already approved but not yet far along in their implementation phase, and changes in the direction of ongoing investment projects. These measures were mainly enacted to come to grips with the sharp increases in the cost of energy, shortages in regional supplies of fuels and raw materials, and tightening external constraints.

It is important to note that the slow-down in investment activity was only partly a response to the external emergency. Many high-level decision makers in Eastern Europe contended that lower, or even negative, growth in investment activity would force an upturn in capital productivity as a result of a concentration of investment funds on key objectives, better organization and management of selected projects, and increased emphasis on modernization.

The actual evolution of annual activity levels (see table VI-10) tended however to confirm the view held by others that rapid accumulation provides the essential means to eliminate disproportions and effect structural changes so as to raise the technical level of production and product quality, and hence factor productivity. Since the share of appropriated investment funds that can be redistributed within rather wide margins is small, given the institutional and behavioural features of these economies, a cut-back in accumulation fragments new investment and adds to the stock of frozen assets, or

[22] None the less, some erosion in levels of living occurred in several countries in response to one or more of the following: small increases in wages and salaries, changes in price levels that were not fully compensated by transfers, involuntary product substitution, longer waiting, and unplanned household savings

Table VI-11. Centrally planned economies of Eastern Europe: distribution of net material product, 1971-1984[a]

(Annual percentage shares)

	1971-1975	1976-1980	1980	1981	1982	1983	1984[b]
Bulgaria							
Consumption	67.6	67.2	67.0	65.5	66.6	70.7	...
Accumulation	32.4	32.8	33.0	34.5	33.4	29.3	..
Czechoslovakia							
Consumption	76.4	75.6	75.1	79.9	80.2	81.8	...
Accumulation	23.6	24.4	24.9	20.1	19.8	18.2	...
German Democratic Republic							
Consumption	76.0	77.0	77.3	78.3	82.0	82.4	..
Accumulation	24.0	23.0	22.7	21.7	18.0	17.6	...
Hungary							
Consumption	77.2	76.5	80.4	82.2	84.2	87.2	88.1
Accumulation	22.8	23.5	19.6	17.8	15.8	12.8	11.9
Poland							
Consumption	61.9	66.1	74.4	79.3	78.4	78.5	77.7
Accumulation	38.1	33.9	25.6	20.7	21.6	21.5	22.3
Romania[c]							
Consumption	66.3	64.7	65.3	71.4	72.2	72.7	...
Accumulation	33.7	35.3	34.7	28.6	27.8	27.3	...

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on international and national statistical publications, and plan fulfilment reports

[a] All data are based on computations in constant prices of various reference years depending upon the statistical practices of the reporting countries

[b] Preliminary.

[c] All but the period averages are Secretariat estimates.

investment projects in progress, contrary to policy intentions. The realization that it is difficult to secure lasting improvements in marginal capital-output ratios at a time of austerity may have influenced the selection of adjustment measures during the second and third phases.[23]

Table VI-12 shows that, in most countries, the compression of investment activity was on the whole largest in the so-called productive sphere. This paradox has two explanations. The non-productive component comprises outlays for the non-civilian sector, whose buoyancy depends on domestic and international political factors only weakly related to the state of the economy. In addition, it includes appropriations for social and related programmes that could not be reversed quickly because of the strong political commitments made earlier, at a time of buoyant growth, to improving rapidly the social infrastructure.

The indicators given in table VI-12 understate the cuts in investment in the productive sphere because of Eastern Europe's amortization practices. Low amortization rates understate the magnitude of economic depreciation, especially when rapid structural change in the world economy accelerates the technological or technical obsolescence of the existing capital stock. Because economic depreciation in these economies far surpassed their rather conservative amortization rates, the real impact on the available productive capital stock must have been larger than may be inferred from the table.[24]

While policy makers in most Eastern European countries succeeded in protecting consumption throughout

[23] See a recent commentary by F. Havasi, the Secretary in charge of economic affairs of the Central Committee of the Hungarian Socialist Workers' Party (*Népszabadság* (Budapest), 7 November 1984, p. 5).

[24] These conjectures can be supported by recent changes, for instance, in Hungary and Romania. In the former, the detailed amortization tables have been abolished and replaced by much more flexible guidelines; enterprises are in fact encouraged to write off investments much more rapidly than before; see *Magyar Közlöny* (Budapest), No. 50 (1983), pp. 1100-1101. In Romania, standard amortization periods in machine-building were reduced by 15 per cent in early 1984; see *Buletinul Oficial* (Bucharest), No. 14 (1984), pp. 1-3. Similar measures have since been introduced in other sectors.

Table VI-12. Centrally planned economies of Eastern Europe: investment trends, 1971-1984

(Annual growth rates)

	1976-1980	1978	1979	1980	1981	1982	1983	1984[a]
Bulgaria								
Total	4.0	0.7[b]	-2.3	7.6	10.5	3.5	0.7	..
Productive	3.6	0.5[b]	-1.6	5.4	12.2	2.8	-0.9	..
Non-productive	5.2	1.5[b]	-4.0	14.3	5.3	6.1	5.3	..
Czechoslovakia[c]								
Total	3.5	4.1	1.8	1.4	-4.6	-2.3	0.5	4.7
Productive	4.4	4.8	3.9	2.5	-3.3	-1.8	0.6	..
Non-productive	0.6	2.8	-2.0	-0.6	-6.2	-5.1	0.4	..
German Democratic Republic[c]								
Total	3.4	2.8	1.4	0.3	2.8	-5.2	0.0	-1.7
Productive	3.3	1.7	1.4	1.2	2.3	-5.0	0.5	..
Non-productive	4.0	6.8	1.2	-3.1	4.3	-5.6	-2.0	..
Hungary[c]								
Total	2.4	5.0	0.8	-5.8	-5.1	-2.2	-2.7	-1.0
Productive	2.5	6.4	0.0	-7.8	-5.0	-2.6	-4.9	..
Non-productive	2.0	0.9	3.9	0.3	-5.4	-1.1	2.7	..
Poland[c]								
Total	-2.6	2.1	-7.9	-12.3	-22.3	-12.1	9.4	10.0
Productive	-4.7	-0.1	-11.2	-12.8	-23.5	-15.3	8.2	..
Non-productive	4.5	9.7	2.3	-11.0	-19.8	-5.7	11.4	..
Romania[b]								
Total	8.5	16.5	4.1	3.0	-7.1	4.0	6.6	6.1
Productive	9.1	16.8	4.2	3.4	-9.1	3.0	8.7	..
Non-productive	7.5	11.8	3.5	0.8	0.8	9.2	-2.9	..

Source. Department of International Economic and Social Affairs of the United Nations Secretariat, based on international and national statistical publications, and plans and plan fulfilment reports

[a] Preliminary.
[b] Current prices
[c] Constant prices of various reference years

most of the first adjustment phase, by 1982 the burden of restraining absorption and imports, and stimulating exports, could no longer be borne chiefly by productive investment. To maintain positive, if moderate, growth without jeopardizing the prospects for recovery and sustained expansion later in the decade, it became necessary to effect cuts also in consumption.

The consumption component in national output uses covers both private and government consumption. Because of the inertia built into most of the latter, the chief burden of restraint had to be borne by private consumption. Although available data are too aggregative to illustrate clearly the type of adjustments that took place at any given time, the overall trends (see table VI-13) are unmistakable: the countries most severely affected by the external emergency actually cut back consumption, including public consumption at the height of the crisis, although the impact remained modest.

The figures in table VI-13 probably do not fully reflect certain changes in consumption patterns. Earlier imbalances in partial consumer markets may have been exacerbated by the adjustment effort and, in turn, consumers may have had to accept substitute goods and services or wait for preferred goods.[25] Nevertheless, because of the importance of government transfers in these economies, the adjustment borne by consumption had a far smaller impact on individual levels of living than would have been the case in most market economies. This can be seen from the evolution of per capita income levels, discussed above.

[25] In the disequilibrium framework of centrally planned economies postulated by János Kornai, this switch-*cum*-queuing usually involves a "welfare loss" that is not reflected by the data; see *Economics of Shortage* (Amsterdam, North-Holland Publishing Company, 1980), pp. 443-517.

Table VI-13. Centrally planned economies of Eastern Europe: growth in consumption components, 1971-1983[a]

(Annual growth rates)

	1971-1975	1976-1980	1981	1982	1983
Bulgaria					
Private	6.0	4.1	5.0	3.6	2.5
Public [b]	7.4	10.5	10.5	-6.1	3.6
Czechoslovakia					
Private	4.8	1.7	1.7	-2.2	2.2
Public	6.8	4.8	4.9	1.8	3.8
German Democratic Republic					
Private	4.9	3.9	2.8	1.4	1.4
Public	8.1	3.1	2.7	0.3	-2.3
Hungary					
Private	4.7	2.6	3.0	1.4	0.5
Public	5.2	5.9	3.0	1.3	2.0
Poland					
Private	8.5	4.3	-4.1	-14.6	6.2
Public	9.8	5.3	-8.1	11.5	1.9
Romania					
Private		6.9	3.7[b]	-1.9[b]	0.5[b]
Public		8.4	-0.5[b]	1.3[b]	0.0[b]

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on international and national statistical publications, and plan fulfilment reports

[a] Reference is to the consumption component of domestic uses of net material product expressed in constant prices of various reference years

[b] Secretariat estimates

The ratio of material inventories to overall output and the ratio of the stock of unfinished projects to total investments are usually rather high in centrally planned economies, when gauged against typical magnitudes in other developed countries. The compression of stocks and the accelerated completion of projects in progress could therefore in principle provide room for short-term adjustment policies without unduly curbing the productive capital stock. While the running down of material inventories offered a fast means of saving on imports or boosting exports temporarily, table VI-14 shows that, on an aggregate and annual basis, the absolute volume of material inventories was compressed only in Hungary in 1983.[26] While in all other countries, and in Hungary except in 1983, the volume of material inventories in the aggregate kept increasing, albeit sometimes at sharply decelerating rates, the reduction of inventories of key goods, either because of import restrictions or of export promotion, hampered smooth adjustment in domestic economic structures and the implementation of plan targets. The experiences of the early 1980s demonstrate that destocking cannot be relied upon excessively without causing severe supply bottle-necks, and hence idling of productive capacities and imbalances in partial consumer markets.

The shortening of the gestation period for new investment projects by appropriating funds otherwise allocated to new start-ups, in principle, offers another promising avenue for adjustment that minimizes output curbs. While this provided some elbow-room, previously appropriated funds could be redistributed only within narrow margins and gestation lags could not be reduced appreciably.[27] One reason for this is that

[26] Even this exception was due largely to a special accounting situation; for details, see *Népszabadság* (Budapest), 30 May 1984, p. 10. There is, however, scattered evidence of severe temporary shortages in material reserves since 1981 in nearly all countries, except Poland where major inventory bottle-necks were first reported in the late 1970s

[27] In 1981 or 1982, the volume of frozen assets was reduced in Czechoslovakia, the German Democratic Republic and Poland, among others. The compression was short-lived and, except in Poland, rather small. Poland quickly averted a further build-up in frozen assets in the late 1970s in order to implement its "economic manoeuvre". In other countries, only a deceleration in the rate of growth could be observed

Table VI-14. Centrally planned economies of Eastern Europe: rate of growth in accumulation components, 1971-1983[a]

(Annual growth rates)

	1971-1975	1976-1980	1981	1982	1983
Bulgaria [b]					
Change in fixed assets	7.5[c]	2.6	12.3	0.4	0.2
Inventory accumulation	15.6[c]	-0.3	12.2	-13.7	-21.8
Czechoslovakia					
Change in fixed assets	10.6	0.9	-11.1	-6.8	-11.2
Inventory accumulation	3.8	1.5	-55.3	16.7	12.9
German Democratic Republic [b]					
Change in fixed assets	3.4	2.2	0.6	-9.0	1.9
Inventory accumulation			-28.1	-87.8	640.0
Hungary					
Change in fixed assets	9.0	-1.8	-15.4	-15.7	-15.3
Inventory accumulation	2.2	-8.7	37.6	1.4	-143.7
Poland					
Change in fixed assets	19.6	-9.2	-24.2	-19.9	9.5
Inventory accumulation	12.0	-29.0	-69.5	400.0	-17.6
Romania					
Change in fixed assets		8.4	-7.1[b]	-3.1[b]	2.9[b]
Inventory accumulation		-2.0	-777[b]	127.9[b]	18.0[b]

Source. Department of International Economic and Social Affairs of the United Nations Secretariat, based on international and national statistical publications, and plan fulfilment reports

[a] Reference is to the accumulation component of domestic uses of net material product expressed in constant prices of various reference years.
[b] Secretariat estimates
[c] Current prices

not all investment decisions are centrally controlled. Retained profits and bank credits are frequently available to finance projects that are in principle discouraged by central policy makers. Moreover, there seem to be many pressures for investments exerted by the lower tiers of the planning machinery. Finally, in many cases the emergency measures of the second phase were not well co-ordinated even at the central level.

Another "reserve for growth" in many of these economies was seen in the underutilization of available capital resources due to idling for lack of spare parts, maintenance or material inputs, and in the possibility of doubling or even tripling work shifts.[28] There are certainly instances where marginal capital-output ratios can be reduced and capital productivity improved through better capacity utilization. However, at a time of sharp shifts in the composition of the desired output structure and in material inventories, fuller utilization of capital resources can be attained only in a few segments of the economy. This is so in part because most projects in progress are generally not very fungible. This severely limited the reallocation that some countries attempted to accomplish.

The relationship between output, imports and investments

In most Eastern European countries, output growth remains heavily dependent on increments in factor inputs,[29] as changes in factor productivity levels continue to be comparatively small, falling far short of the

[28] Idling time, even without sudden work stoppages, of machinery in industry amounts to 15 per cent of overall shift time in Romania; see *Era Socialista* (Bucharest), No. 11 (1984), p. 9. In Hungary, machinery is used for only 53 per cent of total available time; see *Népszabadság* (Budapest), 7 November 1984, p. 5.

[29] The importance of factor input may be gauged from the considerable impact of changes in investment activity on changes in output levels. Estimated relationships for the period since about 1960 indicate that a 1 per cent deviation in investment activity from an exponential trend entails a deviation in output growth from a similar trend ranging between 0.28 per cent for Hungary to a high of 0.50 per cent for Poland. The magnitudes for the other countries are: Bulgaria 0.31, Czechoslovakia 0.49, German Democratic Republic 0.37 and Romania 0.30.

expectations of planners. This has had two peculiar effects in recent years. The deceleration of growth in the effective labour force has induced the Eastern European countries to adopt production technologies that are relatively more capital-intensive. This *de facto* substitution of capital for labour has apparently resulted in diminishing returns on capital in terms of output growth, at least for the time being.[30] The effect on output of diminishing returns on capital has been amplified in some countries by the shift in investments towards the non-productive sphere.

A limited, but quantifiable, impression of the effect of overall adjustment policies on output, investment and trade can be gleaned (see table VI-15) from the constraints on machinery and equipment (henceforth referred to as machinery) as one important component that is especially characteristic of productive investment. It is instructive to recall that policy makers in Eastern Europe at the outset of the current five-year plans were explicitly bent on curtailing investments in new projects and on stimulating renovation and modernization. The intensification of the growth process depends importantly

Table VI-15. Centrally planned economies of Eastern Europe: investment trends, 1971-1984[a]

(Annual growth rates)

	1976-1980	1978	1979	1980	1981	1982	1983	1984[b]
Bulgaria								
Total	4.0	0.6	-2.3	7.6	10.5	3.5	0.7	.
Machinery	1.5	3.2	-10.4	6.9	20.8	7.6	0.8	. .
Construction[c]	5.3	-2.3	1.8	8.7	3.3	4.8	1.9	3.6
Czechoslovakia								
Total	3.5	4.1	1.8	1.4	-4.6	-2.3	0.6	4.7
Machinery	5.9	7.1	3.5	2.8	-7.5	0.7	1.4	2.1
Construction[d]	1.9	2.1	0.6	0.5	-2.6	-4.3	-0.6	6.1
German Democratic Republic								
Total	3.4	2.8	1.4	0.3	2.8	-5.2	-0.0	-1.7
Machinery	3.0	3.0	1.6	0.6	7.0	-8.8	5.9	. .
Construction[d]	3.4	2.2	0.4	-1.3	-1.5	-2.3	-4.6	
Hungary[e]								
Total	2.6	5.5	1.1	-6.7	-6.3	-3.1	-4.9	-1.0
Machinery	1.5	6.8	-2.0	-10.4	-6.1	-1.5	-5.8	-1.5
Construction[c]	2.7	2.6	3.0	-4.1	-5.6	-5.7	-5.2	1.0
Poland								
Total	-2.6	1.7	-7.9	-12.3	-22.3	-12.1	9.4	10.0
Machinery	-2.0	0.7	-4.7	-11.2	-22.9	-26.7	6.1	. .
Construction[c]	-4.0	2.7	-9.1	-15.1	-22.8	-3.8	11.3	.
Romania[f]								
Total	8.5	16.0	4.1	3.0	-7.1	4.0	6.6	6.1
Machinery	11.6	19.9	3.7	5.7	-10.1	9.2	3.7	.
Construction[c]	5.6	13.2	4.2	-0.3	-7.4	-1.6	11.3	. .

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on international and national statistical publications, and plans and plan fulfilment reports

[a] All data are based on computations in constant prices of various reference years depending upon the statistical practices of the reporting countries. Machinery here means machinery and equipment
[b] Preliminary
[c] Construction projects proper
[d] Non-machinery investments
[e] Socialist sector only.
[f] In constant prices of various years, except for 1982-1983 which are in current prices

[30] For some time, the ratio of the percentage change in the capital-labour ratio to the percentage change in the marginal rate of technical substitution between labour and capital (that is, the ratio between the marginal output contribution of labour and the marginal output contribution of capital) - the elasticity of substitution - appears to have fallen considerably short of unity

on the infusion of new technologies embodied in machinery. As the evolution of the implementation attempts has demonstrated, it proved to be rather difficult to reverse construction investment quickly.[31]

The cut-backs in machinery investment were also undertaken as a means of rapidly compressing convertible currency imports. There is ample evidence that shifts in machinery investments have substantially larger repercussions on imports, particularly from convertible currency partners, than on domestic supply.[32] While this is a normal phenomenon associated with developments in Eastern European planned economies, these shifts have been accentuated, especially in the case of the convertible currency component, as a result of the adjustment policies undertaken since the second half of the 1970s, and particularly of the measures taken in response to the new constraints on external commerce and finance. This is also illustrated by the distribution of the sources of supply of machinery investment (see table VI-16), which shows a substantial increase in imports mainly from non-socialist sources in the early 1970s with a very sharp cut-back during the adjustment phase.

Adjustment experience, investment levels and growth potential

The adjustment efforts of the Eastern European economies have thus centred on investments. Although some reduction in per capita income and consumption levels occurred in three countries of the group, on the whole consumers have been protected. While the adjustment policies were quite intense, they had to be adhered to only during a short period of time, except in Poland, where per capita income levels are not expected to surpass the previous high of 1978 until the end of the present decade.

The recovery in the pace of overall economic activity and investments in particular has been made possible by the sharp restructuring of the trade sector and the gradual cutting back of external debt levels through successive external surpluses. The redressing of short-term payments disequilibrium, while undoubtedly welcome, has not yet permitted policy makers to overcome a number of national and regional development problems. In view of the unsynchronized nature of the national adjustment policies pursued during the past years and their effect on endeavours for economic integration within CMEA, the better co-ordination of investment policies remains a key concern of co-operation among the European centrally planned economies.

The recent development experiences of the Eastern European countries have yielded several important insights. These concern in particular the still uneven pace of productivity growth, the fact that "reserves" in the form of unfinished investment projects and material inventories cannot be mobilized in the short run without causing bottle-necks and depressing feasible output levels, and the fact that structural adjustment through changes in management mechanisms and behavioural rules take considerable time to mature and to bear fruit. These and other aspects of recent experiences are bound to have important implications for the medium-term plans (1986-1990) that are currently being elaborated, the depth and scope of regional co-operation within the context of CMEA, and the appreciation of the advantages as well as the drawbacks of greater integration in global finance and trade networks.

Perhaps the most important lesson of the recent past is that growth in these economies still depends considerably on the start-up of new investment projects. As long as the curtailment of investment activity is effected chiefly by administrative intervention, while design and construction organizations remain primarily output-oriented, and enterprises are not very cost-sensitive and persistently overbid for resources, it will be difficult to secure a permanent increase in capital productivity. Administrative intervention may result in an unsatisfactory modernization pace and in a low-investment low-growth syndrome. This raises the question whether the past several years of investment austerity have impaired the potential for attaining a more normal pace of output growth in the medium term.

Investment retrenchment retarded the modernization that policy makers had envisaged, which would appear to indicate that this may be a negative legacy for the future. However, whether the growth slow-down will be prolonged depends largely, but not only, on the feasible level of investment, on how the investment process can be restructured, and on the allocation and use of available resources. With regard to investment strategies, the search is continuing for a workable solution to the

[31] Furthermore, in view of the tightening import constraints, such a policy would not have facilitated the restoration of external equilibrium.

[32] In most countries import substitution is an important feature

[33] The fluctuations in activity levels and in the domestic and foreign components of total investments in machinery can be gauged for four Eastern European countries (Bulgaria, Hungary, Poland and Romania) Table VI-16 indicates that the data are, unfortunately, far from standardized After extracting exponential trends with a kink in 1979 for total, domestic, CMEA-imported and other imported machinery, using alternative specifications, the percentage deviations from trend of the first were regressed on similar deviations for each of the latter four groups The results indicate that the impact on domestic supplies is invariably much smaller than unity (it ranges from 0.42 for Bulgaria to 0.86 for Romania) The impact on imports ranges from 1 29 for Hungary to 2 for Poland However, whereas for CMEA imports the impact magnitude falls between 0 9 for Poland and 1.49 for Romania, the corresponding range for market economy imports is 2.68 for Romania and 4 for Poland Curiously enough, though, the behaviour of Hungary differs here: the impact on other imports (1 2) fell significantly short of the CMEA impact (1 73)

Table VI-16. Selected centrally planned economies: distribution of machinery investments, 1970-1983

(Percentage shares)

	Domestic	Imports	Socialist[a]	Non-socialist[a]
Bulgaria				
1970	47.52	52.48	42.55	9.93
1975	43.29	56.71	38.62	18.09
1979	59.57	40.43	34.16	6.28
1980	61.52	38.48	31.48	7.00
1981	62.84	37.16	28.37	8.80
1982	63.80	36.20	27.83	8.37
1983	66.31	33.69	26.88	6.81
Hungary [b]				
1970	49.02	50.98	30.16	20.81
1975	44.79	55.21	33.48	21.73
1979	45.22	54.78	29.47	25.31
1980	46.13	53.87	31.11	22.76
1981	48.01	51.99	26.13	25.86
1982	49.25	50.75	26.35	24.39
1983	51.70	48.30	26.34	21.96
Poland [b]				
1970	71.34	28.66	21.53	7.13
1975	49.60	50.40	17.97	32.43
1979	60.10	39.90	23.68	16.22
1980	59.20	40.80	24.74	16.06
1981	60.80	39.20	27.50	11.70
1982	76.90	23.10	17.05	6.05
1983	79.30	20.70	15.35	5.35
Romania [c]				
1970	70.24	29.76	15.31	14.45
1975	74.65	25.35	17.06	8.28
1979	69.92	30.08	21.76	8.32
1980	72.27	27.73	21.26	6.46
1981	76.78	23.22	18.77	4.45
1982	80.32	19.68	17.25	2.43
1983	90.41	9.59	8.22	1.38

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national statistical publications. All data are expressed in current prices.

[a] Only Hungary reports socialist and non-socialist imports in domestic prices. Data for the other countries were derived from foreign trade estimates in *valuta* prices, the internal exchange rates and, where appropriate, price shifts. The latter were estimated on the basis of Hungarian trade price indices.

[b] Socialist sector only.

[c] Constant prices of various reference years linked to the 1963 price base.

key problems of the excessive dispersion of funds over too many activities and the comparatively low efficiency of capital investment. The latter is determined partly by technological maturity and resource management, both of which could be improved by modifying the existing economic mechanisms.

In economies where major changes in economic mechanisms have not yet been placed high on the policy agenda, increments in factor inputs will remain a strong determinant of the feasible growth pace. Some expansion in investment activity can be anticipated, although resumption of the fast pace experienced until about the mid-1970s is unlikely in the near future. In consequence, no substantial acceleration of the pace of output expansion can be anticipated without curbing the growth of

consumption levels. Some positive results may be obtained from shifting the structure of investments, from decreasing lead times and from improving financial discipline. However, a strong and lasting compression of capital-output ratios will be difficult to engineer in this way. In economies where the redesign of the economic mechanism is in the forefront of economic policy, quantum growth of investments will probably be of less importance than improvements in productivity through indirect policy instruments and transformations of underlying institutional structures. Nevertheless, given the high rate of technological obsolescence of the existing capital stock in most Eastern European countries, a substantial increase in investment spending needs to be accomplished once these transitions are completed.

The recent past was not very conducive to experimentation with alternative planning methods, policy instruments and institutions, but nearly all Eastern European countries are now attaching major importance to a re-evaluation of their domestic policy instruments and supporting institutions. Given a more favourable global environment for trade and finance, the modest levels of investments that, according to current policy discussions, are envisaged for the next medium-term plans may well be mobilized to ease the dependence of output growth on factor inputs, to narrow the desirable range of domestic policy autonomy, and to foster integration within CMEA without forcibly inhibiting trade with market economies.

Chapter VII

CONCLUSIONS AND RECOMMENDATIONS FOR POSSIBLE ACTION ON SOME KEY ISSUES

The analysis contained in the present *Survey* points to a number of key policy issues on which the international community and Governments should take action. These are summarized below, with an indication, where appropriate, of the way in which current policies could be modified to improve the international economic environment and set the stage for sustained and broad-based expansion in the world economy. Both domestic policies and the international economic climate are vital factors for the success of adjustment in developing, developed market and centrally planned economies alike.

To sustain the growth momentum in the world economy, to help reduce external and internal imbalances and in particular to improve the prospects of indebted countries, a continuous expansion of trading relations is critical. Yet despite the considerable economic recovery, protectionist pressures have intensified and protectionist actions have not subsided. It is urgent that industrial countries adopt standstill provisions and start a gradual dismantling of non-tariff barriers and discriminatory restrictions on trade. In particular, it is important that additional efforts be made to carry forward the unfinished programme of work agreed upon at the GATT Ministerial Meeting of November 1982. Decisive progress in the implementation of that programme should pave the way for a new round of trade negotiations, with the broad-based participation of developed and developing countries.

The large and increasing federal budget deficit and the widening current account deficit of the United States, while important factors behind the swift, non-inflationary recovery, have become a major source of uncertainty and instability in the world economy. A gradual reduction of the United States budget deficit, starting in fiscal year 1986, would be an important step towards removing present uncertainties. Since this reduction may begin at a time when the United States economy is slowing down, but before other industrial economies have started to gather sufficient momentum, a substantial deceleration in the growth of the world economy could occur. Avoiding this would require timely and mutually supportive relaxations of hitherto cautious fiscal stances in those developed countries in a position to do so. There is a case for such relaxations to include tax reductions that could lead to supply-side as well as demand-side stimuli.

Such action on the fiscal front would increase the room for manoeuvre of the Federal Reserve Board of the United States. Monetary policy could be eased without engendering fears of deficit monetization. As a result, interest rates would decrease and allow for more flexibility in monetary policies in other industrial countries. Lower interest rates in international financial markets would also provide much-needed breathing space for debtor developing countries, since balance-of-payments constraints are still weighing heavily on their growth prospects.

The current strength of the dollar *vis-à-vis* most other reserve currencies, despite the underlying trade trends, is a source of tension and protectionist pressures. Since recent experience has shown the limited effect of official interventions, more effective consultations among developed countries will be necessary for achieving increased harmonization of macro-policies and for furthering exchange rate stability. This process could be significantly enhanced by strengthening the surveillance activities of IMF.

The formulation of the five-year plans for 1986-1990 in the centrally planned economies provides a new opportunity to consolidate the progress recently achieved and to lay the foundations for more balanced growth in the long term. The institutional modifications and the acceleration of regional economic integration that may be realized in the course of implementing these plans also provide an opportunity for expanding economic relations with developing countries. In this context, it would be important to explore means to increase the flexibility of trade and financial arrangements with the developing countries.

A resumption of private and public investment in most developing countries is crucial for speeding up the adjustment process and attaining higher growth rates. This requires effective policies to increase domestic savings and to attract official and private capital from abroad.

There is also a role to be played by foreign direct investment, particularly as an instrument for the transfer of technology and skills.

An improvement in the mix of internal adjustment efforts and external financial support seems necessary if countries facing balance-of-payments difficulties are not to resort once again to excessive retrenchment. A more supportive stance by the IMF would be welcome in this regard. In particular, there is a need to restore the original character and form of operation of the Extended Fund Facility and the Compensatory Financing Facility and to smooth the effects of significant changes in interest rates on debtor countries. This requires that the Fund be provided with resources commensurate with these tasks and that the Ninth General Review of Quotas take full account of such requirements.

Increased exports and a return to more normal interest rates are necessary to restore creditworthiness to many developing countries and arrest a further negative resource transfer from them. In the meantime, further debt renegotiations will still be required. This calls not only for extending to all appropriate cases multi-year reschedulings, including reschedulings of official loans negotiated in the Paris Club, but also for more flexible approaches that would allow debtor countries a fall-back position if the behaviour of external factors diverged considerably from that assumed in the agreed negotiation package.

Least developed and other low-income countries continue to be afflicted by stagnation or declines in their per capita incomes and still face weak primary commodity markets. Investment in these countries remains depressed and their international reserve position is very precarious. A larger inflow of bilateral and multilateral ODA, as well as debt relief, is required in the short term to ease some of the most pressing constraints on growth. The increase in ODA needs to be maintained to help these countries to overcome structural rigidities; in particular, in the context of the forthcoming review, resources should be added to bring the seventh replenishment of IDA up to at least previous levels. Further international efforts are required to stabilize primary commodity prices; in particular, the Common Fund for Commodities should be ratified.

There is a strong possibility that under current conditions sound economic projects in developing countries, including those that would expand exports, will not be undertaken either because of financial constraints or for the lack of foreign exchange to import the required machinery and capital equipment. Moreover, at present, multilateral development institutions, in particular the World Bank and regional development banks, are facing resource constraints which preclude a normal increase in their lending activities. An increase in the capital base of these institutions is thus necessary; in particular, it is important to agree on a significant general capital increase for the World Bank within the 1986 fiscal year.

Close attention should continue to be paid to the emergency food situation in sub-Saharan Africa and to the provision of the necessary food aid, including aid for food distribution. Emergency needs apart, further domestic efforts, duly supported by international co-operation, assume special importance for rehabilitating the social and productive infrastructure, particularly in the areas of transport and communications. More effective development strategies and enhanced aid policies are also necessary to improve medium-term and long-term prospects in agriculture and industry.

Bilateral agreements, in particular countertrade, and full use of regional and subregional clearing mechanisms have allowed for a very significant increase in trade among developing countries. There is a strong case for further enhancement of the clearing mechanisms. Since many bilateral agreements were negotiated in response to the stagnation of international trade of the early 1980s and the liquidity crisis faced by many developing countries, those arrangements tend to be of an *ad hoc* and temporary nature. The strengthening of existing trade arrangements and the enactment of more comprehensive ones - regional and subregional - therefore remain important. This process should take due account of policies to encourage interaction among the private sectors of developing countries. In addition, more rapid progress is required in evolving a system of generalized trade preferences among developing countries.

Annex

STATISTICAL TABLES

Contents

Table A-1. Rates of growth of real output, 1976-1985

(Annual percentage change)

	1976-1980	1981-1984	1981	1982	1983	1984[a]	1985[b]
Developing countries [c]	5.0	1.1	1.3	0.4	0.2	2.9	3.3
Net energy exporters	5.2	0.0	1.0	-1.7	-1.9	2.0	3.0
Net energy importers	4.9	1.9	1.6	0.7	1.8	3.6	3.5
Western hemisphere	5.2	-0.2	0.7	-1.4	-2.6	2.7	3.0
Western Asia	3.9	-1.1	-3.5	-4.6	-1.3	1.2	2.5
South and East Asia	6.0	5.2	6.6	3.5	5.5	5.2	5.0
Africa	4.4	-0.3	-0.2	-0.6	-0.5	1.5	3.0
Distribution of growth rates (number of cases):							
Zero or below	10	33	29	35	37	21	...
0.1-2.5	14	24	12	20	19	25	...
2.6-5.0	17	14	18	17	14	21	...
5.1-7.5	29	10	12	9	9	10	...
7.6 and over	13	2	12	2	4	6	...
Developed market economies [c]	3.5	2.1	1.6	-0.2	2.4	4.5	3.1
North America	3.6	2.6	2.6	-2.3	3.7	6.6	3.4
Western Europe	3.0	1.0	-0.1	0.5	1.3	2.3	2.5
Others[d]	4.6	3.6	4.1	2.6	2.3	5.5	4.2
Centrally planned economies [e]	4.5	4.2	2.3	3.7	5.2	5.5	4.9
Eastern Europe	3.9	1.8	-1.9	0.1	3.9	5.1	4.8
Soviet Union	4.3	3.6	3.3	3.9	4.2	3.0	4.0
China	6.0	8.5	4.8	8.3	9.1	12.0	7.0

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

[a] Preliminary estimates.
[b] Forecasts for developed market economies and developing countries, based on Project LINK and other institutional forecasts; for centrally planned economies, the data are based on current plan targets.
[c] Country growth rates aggregated with 1980 output values in dollars.
[d] Australia, Japan, New Zealand and South Africa.
[e] Net material product, 1980 weights.

Table A-2. Developed market economies: annual rates of growth of real gross national product, 1976-1986[a]

(Annual percentage change)

Country or country group	1976-1980	1981-1984	1982	1983	1984[b]	1985[c]	1986[c]
All developed market economies	3.5	2.1	-0.2	2.4	4.5	3.1	2.6
Major industrial countries	3.7	2.2	-0.3	2.6	4.8	3.3	2.7
Canada	3.1	1.5	-4.4	3.3	4.2	2.6	3.0
France	3.3	1.2	2.0	0.7	1.7	1.5	2.0
Germany, Federal Republic of	3.5	0.6	-1.1	1.3	2.5	2.5	2.0
Italy	3.8	0.3	-0.4	-1.2	2.9	2.7	3.0
Japan	5.1	4.0	3.3	3.0	5.8	4.5	4.0
United Kingdom	1.7	1.6	1.9	3.3	2.2	3.5	2.5
United States	3.7	2.7	-2.1	3.7	6.8	3.5	2.5
Other industrial countries	2.7	1.3	0.4	1.2	2.7	2.5	2.3

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

[a] Country growth rates aggregated with 1980 output values in U.S. dollars. For France, Italy, the United Kingdom and all of the "other industrial countries", the measure used is GDP.
[b] Preliminary estimates.
[c] Secretariat forecasts, based on Project LINK country models and other institutional forecasts.

Table A-3. Selected country groups: rates of inflation and unemployment, 1976-1984

	1976-1980	1981-1984	1981	1982	1983	1984[a]
Developed market economies						
Inflation [b]						
All countries	9.0	7.3	10.3	7.8	5.6	5.4
North America	8.8	6.2	10.6	6.5	3.5	4.3
Western Europe	10.1	9.1	11.5	10.1	8.0	6.9
Others	6.5	2.9	6.2	4.7	3.7	3.3
Unemployment [c]						
All countries	5.3	8.2	7.0	8.5	8.9	8.3
North America	5.4	8.8	7.6	9.2	9.8	7.8
Western Europe	5.5	9.5	8.1	9.3	10.0	10.8
Developing countries						
Inflation [b]						
All countries	33.2	61.4	37.3	41.6	68.4	107.5
Net energy exporters	15.4	28.5	18.6	22.8	36.3	37.5
Net energy importers	46.2	84.4	52.5	54.8	91.0	156.7
Western hemisphere	61.1	119.7	64.7	81.3	143.0	224.9
Western Asia	15.3	24.1	19.9	17.7	19.3	41.2
South and East Asia	9.0	9.6	13.4	7.9	8.9	8.5
Africa	17.2	20.0	21.3	12.2	21.0	26.1
Frequency distribution of inflation rates [d]						
Less than 5 per cent per year	4	7	2	4	17	19
5.1-10 per cent per year	25	25	16	27	18	5
10.1-20 per cent per year	37	25	37	29	24	20
20.1-50 per cent per year	5	15	19	12	11	13
50.1-100 per cent per year	7	3	1	4	2	6
Over 100 per cent per year	1	4	4	3	7	6

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *OECD Economic Outlook*, Commission of the European Communities, *Annual Economic Report*, and IMF, *International Financial Statistics*.

[a] Preliminary estimates
[b] Annual percentage change in consumer prices
[c] Number of unemployed persons as a percentage of the civilian labour force
[d] Number of cases from a sample of 79 countries

Table A-4. Selected developed market economies: unemployment rates, 1976-1985[a]

(Annual percentage)

Country or country group	1976-1980	1981-1984	1983	1984[b]	1985[c]
All developed market economies	5.3	8.2	8.9	8.3	8.2
Major developed market economies	5.3	7.5	8.2	7.6	7.5
Canada	7.7	10.5	11.9	11.3	11.4
France	5.3	8.5	8.4	9.5	10.5
Germany, Federal Republic of	3.4	7.0	8.2	8.1	8.2
Italy	7.1	9.4	9.8	10.5	10.7
Japan	2.1	2.5	2.6	2.7	2.6
United Kingdom	6.4	11.6	12.3	12.7	12.7
United States	5.4	8.8	9.6	7.4	7.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on OECD, *OECD Economic Outlook*, and Commission of the European Communities, *Annual Economic Report 1984-1985*.

[a] Number of unemployed persons as a percentage of the civilian labour force
[b] Preliminary estimates.
[c] Forecasts.

Table A-5. Developed market economies: rates of change of GNP deflator and consumer prices, 1976-1985[a]

(Annual percentage change)

Country or country group	1976-1980	1981-1984	1982	1983	1984[b]	1985[c]
GNP deflators						
All developed market economies	8.2	6.3	7.2	5.1	4.3	1.2
Major industrial countries	7.9	6.0	6.7	4.7	4.0	3.9
Canada	9.1	7.3	10.3	5.5	3.2	4.9
France	10.2	9.7	11.9	9.6	5.6	7.1
Germany, Federal Republic of	3.9	3.9	4.7	3.2	3.6	2.5
Italy	17.6	15.1	17.7	15.1	10.2	9.2
Japan	4.4	2.1	1.7	0.7	3.4	1.1
United Kingdom	14.6	6.8	7.1	5.4	3.1	3.3
United States	7.2	5.7	6.0	3.8	3.4	4.0
Other industrial countries	9.6	8.0	9.7	7.5	5.6	5.5
North America	7.4	5.8	6.4	4.0	3.4	4.1
Europe	10.0	8.0	9.3	7.3	5.2	5.2
Others	5.1	2.9	2.9	1.6	3.8	1.9
Consumer prices						
All developed market economies	9.0	7.3	7.8	5.6	5.4	
Major industrial countries	8.8	6.7	7.2	4.8	4.8	
Canada	8.8	8.3	10.9	5.8	4.3	
France	10.5	10.5	11.8	9.6	7.3	
Germany, Federal Republic of	4.0	4.3	5.3	3.3	2.4	
Italy	16.3	15.0	16.6	14.7	10.8	
Japan	6.5	2.9	2.7	1.8	2.3	
United Kingdom	14.4	7.5	8.6	4.6	5.0	
United States	8.9	6.0	6.1	3.2	4.3	
Other industrial countries	9.9	10.0	11.0	9.4	8.3	

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

[a] Country growth rates aggregated with 1980 output values in dollars.
[b] Preliminary estimates.
[c] Forecast.

Table A-6. Major developed market economies: real short-term and long-term interest rates, 1975-1984[a]

(Percentage)

Country	1975	1976	1981	1982	1983	1984[b]
Canada						
Short-term	-3.1	-0.5	6.9	3.6	2.9	7.0
Long-term	-1.6	-0.3	4.2	3.7	5.3	9.0
France						
Short-term	-4.8	-1.1	3.0	2.1	3.3	4.3
Long-term	-2.6	-0.5	3.5	2.9	4.2	6.2
Germany, Federal Republic of						
Short-term	1.7	0.8	7.5	3.8	2.5	3.7
Long-term	3.9	4.3	5.8	5.6	4.5	6.1
Italy						
Short-term	-6.5	-1.0	1.6	1.9	3.0	5.0
Long-term	-5.2	-4.0	1.0	2.5	3.5	4.3
Japan						
Short-term	2.2	1.0	4.7	4.8	5.2	5.6
Long-term	1.2	1.5	6.0	6.0	6.2	7.0
United Kingdom						
Short-term	-13.7	-1.0	3.0	4.0	3.0	3.6
Long-term	-10.5	-0.5	2.5	5.2	5.2	6.7
United States						
Short-term	-3.2	-0.2	4.5	5.0	5.0	5.5
Long-term	-1.0	2.5	4.1	6.5	6.6	8.3
Memorandum item: nominal rate of interest in the United States						
Short-term	5.8	5.0	14.0	11.0	8.7	10.6
Long-term	8.2	7.7	13.9	13.0	11.1	12.8

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on Morgan Guaranty Trust Company, *World Financial Markets*, and IMF, *International Financial Statistics*

[a] Both short-term and long-term rates are period averages net of the change in the GNP deflator. The short-term rate is the bank rate in Canada and the United Kingdom; call money rate in France, the Federal Republic of Germany, Italy and Japan; and the federal funds rate in the United States. The long-term rate for the Federal Republic of Germany is the yield on public authority bonds and, for others, the yield on long-term government bonds

[b] Preliminary estimates.

Table A-7. Drought-affected countries of sub-Saharan Africa: food and cereal production, 1981-1984

	Food					Cereals				
	1981	1982	1983	1984	1984	1981	1982	1983	1984	1984
		(percentage change)			(index[a])		(percentage change)			(index[a])
Angola	-0.6	0.9	0.7	0.2	103	-25.0	0.0	8.1	-3.9	64
Burkina Faso	7.8	0.4	-3.1	-3.3	110	21.1	-4.7	-16.5	-2.4	87
Burundi	4.7	-2.3	3.8	-7.4	103	26.7	-11.1	1.6	-25.4	99
Cape Verde	-2.9	-4.5	-3.9	2.7	119	-64.7	46.6	-31.8	166.7	214
Chad	0.3	-0.3	2.3	-9.4	107	-3.8	-12.8	11.9	-11.3	82
Ethiopia	-1.1	10.3	-1.5	-11.9	111	-5.4	24.5	-6.2	-25.0	108
Guinea-Bissau	4.0	-5.9	-2.3	-0.5	66	22.7	-8.4	-1.6	-1.4	41
Kenya	0.6	9.7	2.2	-2.1	117	14.4	9.9	-3.6	-18.6	77
Lesotho	-1.7	-5.4	-0.3	-10.4	81	-13.2	-27.6	-1.8	-53.3	30
Mali	8.3	-1.3	-3.7	-3.9	114	18.3	-11.5	-10.7	-5.2	68
Mauritania	5.6	-9.0	-1.1	5.7	125	49.8	-58.7	27.9	0.3	91
Mozambique	0.8	-1.5	-18.0	7.4	85	6.6	-6.3	-30.2	9.9	53
Niger	-1.5	0.2	1.6	-12.2	130	-5.2	0.4	2.9	-32.3	106
Rwanda	7.4	6.1	3.6	-7.5	139	5.8	10.6	20.2	-22.6	138
Senegal	31.7	6.1	-27.4	20.4	89	37.3	-16.4	-31.2	48.6	95
Somalia	1.9	2.9	1.2	1.2	118	25.0	0.0	-7.7	-0.8	151
Sudan	15.8	-14.7	1.9	-1.5	109	47.1	-40.3	-6.8	-16.6	78
United Republic of Tanzania	2.2	-4.3	1.2	-1.0	127	-3.6	-1.9	-8.9	-11.4	118
Zambia	-2.8	-4.2	9.7	0.6	98	5.1	-26.0	22.5	-4.9	61
Zimbabwe	29.6	-14.7	-15.9	4.9	88	54.8	-30.3	-37.5	-3.5	59

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on FAO of the United Nations, *Production Indices*.

[a] Average of 1974-1976 = 100.

Table A-8. Centrally planned economies: basic economic growth indicators, 1976-1985

(Annual percentage changes)

Country or country group	1976-1980	1981-1985[a]	1981-1984	1981	1982	1983	1984[b]	1985[a]
Eastern Europe[c]								
Net material product	3.9	3.3	1.8	-1.9	0.1	3.9	5.1	4.8
Industrial gross output	5.6	3.8	2.4	-0.6	1.2	4.4	4.8	4.6
Agricultural gross output	0.8	2.9[d]	2.8	1.8	1.6	0.9	6.9	1.4
Gross fixed investment	2.7	-0.1[d]	-1.5	-7.2	-4.2	2.4	3.5	3.4
Export volume[e]	6.5	...	5.4	1.2	5.5	7.4	7.6	...
Import volume[e]	3.9	...	-0.7	-6.4	-4.6	3.4	5.3	...
Soviet Union								
Net material product	4.3	3.4[f]	3.6	3.3	3.9	4.2	3.0	3.5[f]
Industrial gross output	4.5	4.7	3.7	3.4	2.9	4.2	4.2	3.9
Agricultural gross output	1.6	2.5[d]	2.6	-1.0	5.5	6.1	0.0	6.7
Gross fixed investment	3.4	2.1[d]	3.8	3.8	3.6	5.7	2.0	3.4
Export volume	4.8	...	3.2	1.9	4.6	3.3	3.1	...
Import volume	5.8	...	6.2	6.4	9.7	4.0	5.0	...
China								
Net material product	6.0	4.0	8.5	4.8	8.3	9.1	12.0	7
Industrial gross output	9.2	4.0	9.0	4.1	7.7	10.5	13.2	8
Agricultural gross output	5.1	4.0	9.5	6.6	11.1	9.5	11.0	6
Gross fixed investment	6.5	1.7[d]	9.3	-10.5	26.6	12.6	12.0	10
Export value (in dollars)	20.3	8.1[g]	7.5	14.4	4.5	1.8	10.2	8
Import value (in dollars)	21.2	9.2[g]	4.4	-0.4	-10.3	6.0	19.7	10

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on national statistical publications, plans and plan fulfilment reports

[a] Plan targets.
[b] Preliminary estimates based on plan fulfilment reports and other partial information.
[c] Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland and Romania.
[d] Change in the five-year average output from the average of the preceding five years expressed as an annual compound rate.
[e] Secretariat estimates.
[f] Net material product utilized.
[g] Based on plan data expressed in local currency.

Table A-9. World trade: annual rates of change in volume and prices, 1976-1985 [a]

	1976-1980	1981	1982	1983	1984[b]	1985[c]
Volume of exports						
World	5.2	0.3	-1.9	1.6	8.9	5.0
Developed market economies	6.6	2.2	-1.9	2.2	9.8	5.0
Developing countries	2.1	-4.7	-4.3	-1.3	7.7	5.5
Capital-surplus countries	-1.9	-16.6	-17.9	-12.7	-2.8	2.0
Other net energy exporters	3.0	-7.4	-1.2	2.4	8.2	5.0
Net energy importers	7.8	12.3	6.2	4.6	13.5	8.0
Centrally planned economies [d]	5.7	1.5	5.1	5.4	5.4	3.0
Volume of imports						
World	5.6	1.5	-0.7	1.9	9.4	5.5
Developed market economies	5.6	-2.1	-1.0	3.6	12.0	6.0
Developing countries	5.9	13.8	-1.0	-3.3	3.3	4.5
Capital-surplus countries	11.7	23.1	10.0	-6.9	-7.9	1.0
Other net energy exporters	6.3	23.8	-2.8	-11.6	3.9	4.5
Net energy importers	4.2	6.3	-4.1	2.6	7.4	6.0
Centrally planned economies [d]	4.8	-0.7	2.2	3.7	5.1	4.0
Unit value of exports						
World	12.1	-2.0	-4.3	-3.6	-2.4	-0.5
Developed market economies	9.8	-4.2	-3.6	-3.2	-2.3	0.0
Developing countries	19.1	3.1	-7.5	-6.0	-1.7	-1.5
Capital-surplus countries	23.5	10.4	-4.2	-11.0	-2.0	-2.0
Other net energy exporters	21.0	5.9	-5.5	-5.6	0.2	-2.0
Net energy importers	11.2	-5.4	-9.9	-1.2	-2.2	-0.5
Centrally planned economies [d]	8.7	-0.3	-0.0	-0.3	-4.0	0.5
Unit value of imports						
World	11.6	-2.4	-4.9	-4.6	-2.6	0.0
Developed market economies	12.1	-2.8	-5.2	-5.3	-2.4	0.0
Developing countries	12.1	-2.2	-4.6	-4.2	-2.4	-0.5
Capital-surplus countries	10.5	-3.7	-4.4	-3.2	-2.2	0.0
Other net energy exporters	10.8	-3.6	-4.4	-3.5	-2.3	-0.5
Net energy importers	13.0	-1.0	-4.7	-5.0	-2.6	-1.0
Centrally planned economies [d]	6.8	1.1	-3.6	-0.5	-4.1	0.5
Terms of trade						
Developed market economies	-2.1	-1.5	1.7	2.2	0.1	0.0
Developing countries	6.2	5.5	-3.0	-1.9	0.7	-0.5
Capital-surplus countries	11.8	14.7	0.2	-8.1	0.2	-2.0
Other net energy exporters	9.2	9.8	-1.2	-2.2	2.5	-2.0
Net energy importers	-1.6	-4.5	-5.5	4.0	0.4	0.5
Centrally planned economies [d]	1.7	-1.3	3.7	0.2	0.1	0.5

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

[a] Rates of change in unit values based on indices expressed in dollars
[b] Preliminary estimates
[c] Forecasts, rounded to the nearest half percentage point
[d] Eastern Europe and the Soviet Union only

Table A-10. Rates of change in dollar prices of internationally traded commodities, 1981-1985

(Percentage)

	1981	1982	1983	1984	1985[a]
Non-fuel primary commodities	-15.5	-15.1	5.1	1.2	-1.0
Food	-19.5	-28.3	4.2	-14.9	0.0
Tropical beverages	-18.3	-4.7	4.9	14.1	-3.0
Vegetable oils and oilseeds	-4.2	-21.7	22.2	35.2	-12.0
Agricultural raw materials	-12.8	-13.7	7.3	-2.3	-4.0
Minerals, ores and metals	-13.8	-10.6	0.0	-6.0	1.0
Crude petroleum	10.2	-4.3	-11.6	-2.5	-2.0
Manufactures					
Exported by developed market economies	-6.0	-2.1	-4.3	-3.4	0.5
Exported by developing countries	-1.0	-8.1	-4.4	-3.5[b]	0.5

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on UNCTAD, *Monthly Commodity Price Bulletin*, United Nations, *Monthly Bulletin of Statistics*, and information provided by the National Institute of Economic and Social Research (London).

[a] Forecasts, rounded to the nearest half percentage point
[b] Preliminary estimate.

Table A-11. Developed market economies: balance of payments on current account, 1980-1985[a]

(Billions of dollars)

Country or country group	1980	1981	1982	1983	1984[b]	1985[c]
Developed market economies	-37.5	-5.5	-5.5	-1.1	-35.5	-43.5
excluding United States	-45.9	-18.3	-4.0	34.4	56.5	71.5
Major industrial countries	-9.6	22.5	16.6	6.5	-38.5	-49.5
Canada	-1.4	-5.5	1.7	1.2	2.0	2.0
France	-2.5	-2.8	-9.4	-2.3	1.0	3.5
Germany, Federal Republic of	-8.0	1.4	10.7	10.4	13.0	18.0
Italy	-9.7	-7.9	-5.1	1.0	-2.5	-3.0
Japan	-9.5	6.2	8.1	22.2	37.0	40.0
United Kingdom	11.9	18.4	12.1	7.4	3.0	5.0
United States	8.4	12.8	-1.5	-33.3	-92.0	-115.0
Other countries	-27.8	-28.0	-22.2	-5.4	3.0	6.0
Surplus countries [d]	-2.2	7.9	9.7	10.4	12.5	11.0
Others	-25.7	-35.9	-31.8	-15.8	-9.5	-5.0

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

[a] Excluding government transfers.
[b] Preliminary estimates.
[c] Forecast, rounded to the nearest half-billion dollars.
[d] Netherlands, Norway and Switzerland.

Table A-12. Developing countries: international trade and current account balances, 1979-1984

(Billions of dollars)

	1979	1980	1981	1982	1983	1984[a]
Capital-surplus countries						
Exports	156.3	216.9	198.4	151.7	119.3	113.5
Imports, f.o.b.	-63.7	-79.2	-95.4	-94.2	-87.2	-78.5
Balance of trade	92.6	137.7	103.0	57.5	32.1	35.0
Net services and private transfers	-30.1	-36.2	-44.3	-57.2	-44.9	-44.0
Current account	62.5	101.5	58.7	0.3	-12.8	-9.0
Capital-importing countries						
Exports	243.1	318.8	328.6	307.0	305.3	341.5
Imports, f.o.b.	-267.4	-343.5	-374.8	-344.7	-314.2	-326.0
Balance of trade	-24.3	-24.7	-46.2	-37.7	-8.9	15.5
Net services and private transfers	-29.9	-40.6	-53.6	-65.4	-54.5	-60.0
Current account	-54.2	-65.3	-99.8	-103.1	-63.4	-44.5
Deficit energy-exporting countries						
Exports	98.7	140.2	139.4	126.9	121.2	132.5
Imports, f.o.b.	-83.2	-107.7	-129.0	-118.3	-97.8	-99.5
Balance of trade	15.5	32.5	10.4	8.6	23.4	33.0
Net services and private transfers	-22.2	-30.1	-37.3	-44.1	-35.5	-37.5
Current account	-6.7	2.4	-26.9	-35.5	-12.1	-4.5
Energy-importing countries						
Exports	144.4	178.6	189.2	180.1	184.1	209.0
Imports, f.o.b.	-184.2	-235.8	-245.8	-226.4	-216.4	-226.5
Balance of trade	-39.8	-57.2	-56.6	-46.3	-32.3	-17.5
Net services and private transfers	-7.7	-10.5	-16.3	-21.3	-19.0	-22.5
Current account	-47.5	-67.7	-72.9	-67.6	-51.3	-40.0
Memorandum item: 20 largest debtor countries [b]						
Exports	151.0	201.7	209.9	194.8	192.5	213.0
Imports, f.o.b.	-164.8	-209.4	-231.0	208.8	182.8	-189.0
Balance of trade	-13.8	-7.7	-21.1	-14.0	9.7	24.0
Net services and private transfers	-22.4	-31.1	-45.5	-55.7	-44.7	-45.0
Current account	-36.2	-38.8	-66.6	-69.7	-35.0	-21.0

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

[a] Preliminary estimates, rounded to the nearest half-billion dollars

[b] Algeria, Argentina, Brazil, Chile, Colombia, Egypt, India, Indonesia, Israel, Republic of Korea, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Thailand, Turkey, Venezuela and Yugoslavia (as at the end of 1981)

Table A-13. Centrally planned economies: trade balances, 1981-1984

(Billions of dollars)

	Eastern Europe				USSR				China			
	1981	1982	1983	1984[a]	1981	1982	1983	1984[a]	1981	1982	1983	1984[a]
World	-2 7	4 4	6 0	6 8	6 2	9 3	11 2	11 1	-	3 1	2 7	1 2
Centrally planned economies	-3 2	-1 1	-0 4	-0 5	6 0	4 4	4 0	4 0	0 1	-0 3	-0 4	-0 7
Developed market economies	-2 9	1 3	3 2	4 8	-1 2	-0 1	1 3	2 2	-4 6	-3 7	-4 0	-5 1
Developing countries	3 5	4 2	3 2	2 5	1 4	4 9	5 9	4 9	4 6	7 0	7 1	7 0

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

[a] Preliminary estimates

Table A-14. Arab national and regional development institutions:[a] development finance commitments for developing countries, 1982-1984

(Millions of dollars)

	1982	1983	1983 (first three quarters)	1984 (first three quarters)
Functional composition				
Project finance (loans or equity)	2 085 8	1 410 2	1 094 9	801 5
Technical assistance (grants and loans)	52 9	24 2	22 0	11 0
Import financing (grants, loans and leasing)	436 4	506 0	374 6	519 8
Balance of payments (OPEC Fund loans)	83 5	25 5	24 5	2 2
Other (grants) [b]	35 0	6 4	5 4	7 4
Total	2 693 6	1 972 3	1 521 3	1 341 9
Geographical distribution				
Africa	1 458 4	841 7	613 3	653 9
West Asia	425 6	424 1	292 6	376 2
Other Asia and Pacific [c]	655 0	507 3	416 2	216 2
Other [d]	154 6	199 2	199 2	95 6
Total	2 693 6	1 972 3	1 521 3	1 341 9

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 of ODA commitments by developing countries as reported by OECD (that is, data exclude contributions to most multilateral institutions, bilateral ODA outside the listed institutions, and ODA of non-Arab donors).

[b] Including contributions to IFAD, subscriptions to the UNCTAD Common Fund on behalf of low-income countries, and research projects to be undertaken by various institutions

[c] Including China

[d] Including international agencies and organizations

Table A-15. Net flow of IMF lending to the capital-importing developing countries, 1979-1984

(Billions of dollars)[a]

	1979	1980	1981	1982	1983	1984
Low conditionality flows	0.2	1.2	-	1.4	2.2	-0.2
Buffer stock financing	-	-	-	0.1	0.3	-
Compensatory financing	0.2	0.3	0.6	1.7	2.1	-
Oil Facility	-0.6	-0.7	-0.7	-0.4	-0.1	-
Trust Fund	0.7	1.6	0.1	-	-	-0.2
Higher conditionality flows	1.0	2.3	5.7	4.2	8.8	4.3
Credit tranche drawings	0.7	1.5	3.3	1.9	4.0	1.2
Extended facility drawings	0.3	0.7	2.4	2.3	4.9	3.1
Total flows	1.2	3.4	5.7	5.7	11.1	4.2
Memorandum item: selected characteristics of higher conditionality lending agreements						
Number initiated during year	27	29	31	20	34	20
Average length (months)	18	22	22	14	18	14

Source Department of International Economic and Social Affairs of the United Nations Secretariat, based on IMF, *International Financial Statistics* and *IMF Survey*, various issues

[a] Net flows in SDRs converted to dollars at yearly average exchange rates

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