UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1996

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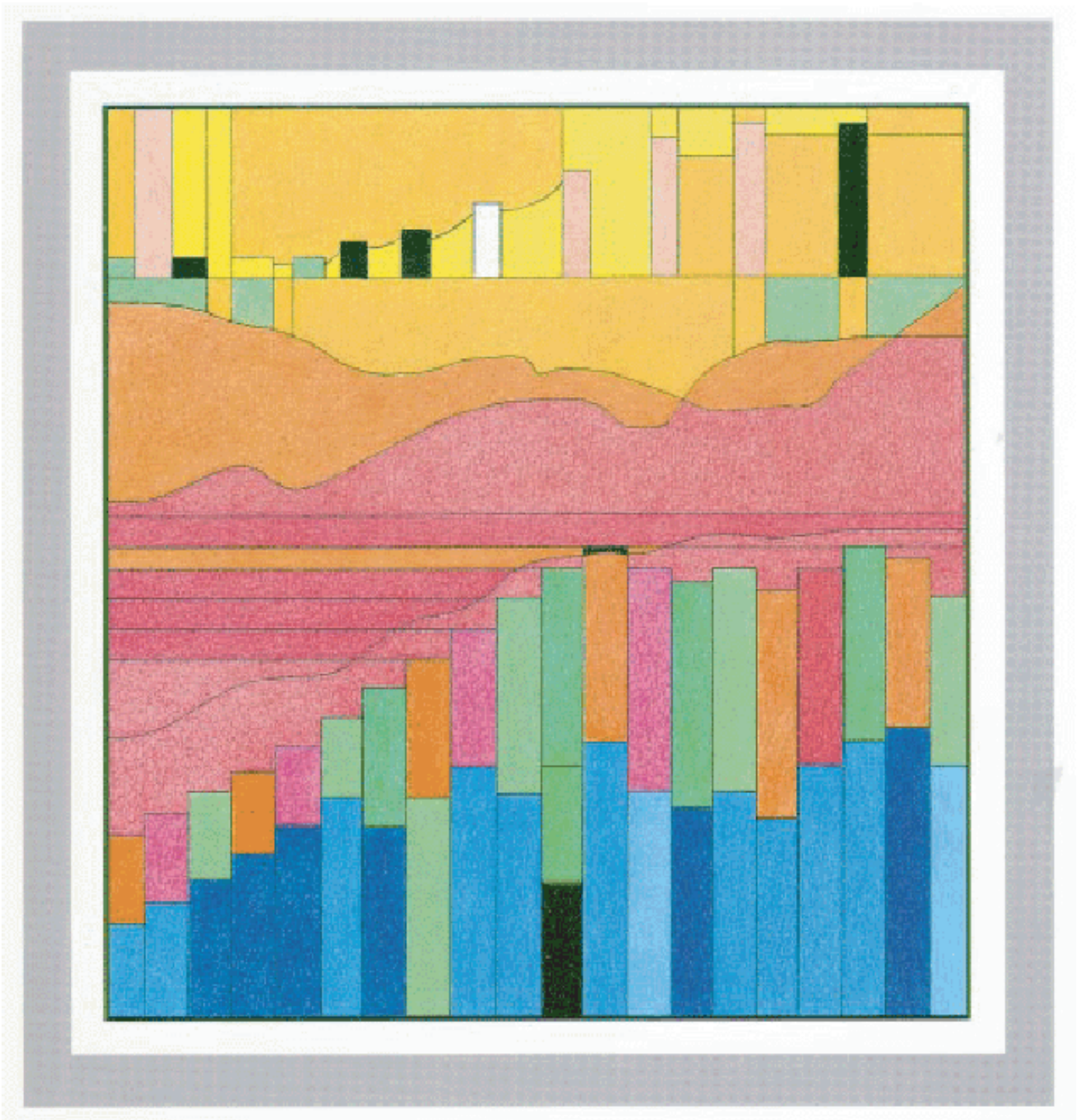

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
GENEVA

TRADE AND DEVELOPMENT REPORT, 1996

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This Report is dedicated to the memory of Shahen Abrahamian

FOREWORD

This 1996 *Trade and Development Report* explores the interaction of trends in the international economy with the prospects of developing countries. It compares current economic performance with that of preceding years, and examines future economic prospects at the regional and global levels. In doing so, *Trade and Development Report 1996* sheds light on some of the pressing policy issues facing developing countries and the international community as a whole.

Drawing upon themes of the ninth session of the United Nations Conference on Trade and Development, held in May of this year in Midrand, South Africa, this year's Report focuses on the essential ingredients of successful development strategies, bearing in mind the growing importance of globalization and liberalization.

Over the past several decades the economies of East and South-East Asia have achieved growth rates that surpass - often by a significant margin - those of most other countries. This has given rise to searching questions regarding policies that best promote growth and development.

This year's Report examines the Asian development experience by examining how, over time, the national economies in the region have interacted with each other through patterns of trade and investment that have enhanced the growth and development of all. The analysis reveals the role played by government policies in attempting to guide the reaction of the private sector to market forces to enhance their contribution to development. The Report also begins the task of examining the relevance of the Asian experience for other developing countries in drawing specific policy lessons applicable to them.

Boutros Boutros-Ghali
Secretary-General of the United Nations

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Classification by country or commodity group

The classification of countries in this Report generally follows that of the UNCTAD *Handbook of International Trade and Development Statistics 1994*.[1] It has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area. As noted in the Foreword to the *Handbook*, the classification differs from that used previously, in particular as regards regional and total aggregates for developing countries.

The term "country" refers, as appropriate, also to territories or areas.

References to "Latin America" in the text or tables include the Caribbean countries unless otherwise indicated.

Unless otherwise stated, the classification by commodity group used in this Report follows generally that employed in the *Handbook of International Trade and Development Statistics 1994*.

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 1995* refers to *Trade and Development Report, 1995* (United Nations publication, Sales No. E.95.II.D.16).

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

The term "billion" signifies 1,000 million.

The term "tons" refers to metric tons.

Annual rates of growth and change refer to compound rates.

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

Use of a hyphen (-) between dates representing years, e.g. 1988-1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 1990/91, signifies a fiscal or crop year.

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

A dash (-) or a zero (0) indicates that the amount is nil or negligible.

A dot (.) indicates that the item is not applicable.

A plus sign (+) before a figure indicates an increase; a minus sign (-) before a figure indicates a decrease.

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

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[1] United Nations publication, Sales No.E/F.95.II.D.15.

Abbreviations

ACP	African, Caribbean and Pacific (group of States)
AFIs	Arab financial institutions
ASEAN	Association of South-East Asian Nations
BIS	Bank for International Settlements
CEPAL	Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe)
CEPR	Centre for Economic Policy Research (London)
CFA	Communauté Financière Africaine (franc zone)
CIS	Commonwealth of Independent States
c.i.f.	cost, insurance and freight
DAC	Development Assistance Committee (of OECD)
DC	developing country
DMEC	developed market-economy country
DRF	Debt Reduction Facility (of IDA)
EC	European Community (or Communities)
ECA	export credit agency
ECE	Economic Commission for Europe
ECGD	Export Credits Guarantee Department (United Kingdom)
ECLAC	Economic Commission for Latin America and the Caribbean
ECU	European currency unit
EEC	European Economic Community
EFF	Extended Fund Facility
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
ESAF	Enhanced Structural Adjustment Facility (of IMF)
ESCAP	Economic and Social Commission for Asia and the Pacific
EU	European Union
EXIM	Export-Import Bank (United States)
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
f.o.b.	free on board
FY	fiscal year
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GFCF	gross fixed capital formation
GNP	gross national product
GSP	generalized system of preferences
HIPCs	heavily indebted poor countries
IBRD	International Bank for Reconstruction and Development (World Bank)
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund

IOSCO	International Organization of Securities Commissions
JETRO	Japan External Trade Organization
KOTRA	Korea Trade Promotion Corporation
LDC	least developed country
LIBOR	London Interbank Offered Rate
MERCOSUR	Southern Common Market
MFA	Multi-Fibre Arrangement
MFI	multilateral financial institution
MFN	most favoured nation
MITI	Ministry of International Trade and Industry (Japan)
NAFTA	North American Free Trade Agreement (Canada-United States-Mexico)
NBER	National Bureau of Economic Research
NBTT	net barter terms of trade
NGO	non-governmental organization
NIEs	newly industrializing economies
NIESR	National Institute of Economic and Social Research (London)
NRI	Nomura Research Institute (Tokyo)
NTMs	non-tariff measures
ODA	official development assistance
OLS	ordinary least squares
OECD	Organisation for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
R&D	research and development
RAP	Rights Accumulation Programme
SAF	Structural Adjustment Facility
SAP	Structural Adjustment Programme
SDR	special drawing right
SILIC	severely indebted low- income country
SITC	Standard International Trade Classification
SMEs	small- and medium-sized enterprises
SSA	sub-Saharan Africa
STF	Systemic Transformation Facility (of IMF)
STFF	Short-Term Financing Facility
TNCs	transnational corporations
TRIMs	trade-related investment measures
TRIPs	trade-related intellectual property rights
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
UNU	United Nations University
VAT	value added tax
WIDER	World Institute for Development Economics Research
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

OVERVIEW

Global trends

The economic recovery that began in 1993 after one of the deepest recessions in the postwar era continued throughout 1995. However, as foreseen in *TDR 1995*, the growth of world output for the year as a whole (2.4 per cent) was smaller than in the previous year (2.8 per cent). The recovery has been much weaker than after earlier recessions and output is below potential levels. Indeed, growth in both 1994 and 1995 disappointed the official expectations that the world economy was entering a new era of sustained market-driven growth in excess of 3 per cent which would allow unemployment in the North to be lowered and average per capita income in the South raised. Prospects for 1996 are for a continuation of this slower growth, with more rapid expansion in some regions and feeble growth in others.

The outlook for developing countries is once again brighter than for the developed world. Overall, expansion in the South continues to outpace that of the North, but rapid growth is highly concentrated in a small number of southern countries. Asia will again be the most rapidly expanding region, and China will continue to be one of the fastest-growing economies, although at a rate below the levels of previous years. Africa will outperform Latin America for the second consecutive year, and with growth exceeding 3 per cent may even succeed, for the first time in many years, in raising per capita incomes. In Latin America, on the other hand, the modest overall increase in the growth rate (to less than 2.5 per cent) will not result in any significant increase in per capita incomes. In the transition economies of Central and Eastern Europe 1996 may well be a turning point. Growth was robust in Central Europe, and the decline in output in the countries members of CIS has slowed.

Growth in *Africa* in 1995 was favoured by an improvement in many commodity prices, which accounted for much of the 10 per cent increase in export earnings, double that of 1994 and unprecedented for many years. But private capital inflows, including FDI, continued to fall. Although growth was broadly based throughout the region, some countries succeeded in achieving rates of over 5 per cent, while in others conditions continued to deteriorate, often due to political unrest and armed conflict. Moreover, drought was responsible for output declines in the Sahel countries and some other areas. Prospects for the region remain uncertain, and even under optimistic assumptions levels of wellbeing reached in the past will not be quickly restored: those countries that performed well in 1995-1996 will need to sustain their high rates of growth for more than a decade in order to bring real per capita incomes back to their levels of 20 years ago.

While the impact of the Mexican crisis of December 1994 on international financial markets was contained thanks to an international rescue operation, its effects on growth in *Latin America* were more severe than had been originally expected. The growth rate for the region fell from almost 5 per cent in 1994 to less than 1 per cent in 1995 as net capital inflows dried up. For the region as a whole, a trade

surplus and a net negative transfer reminiscent of the debt crisis of the 1980s reappeared. In the two economies most directly affected, Argentina and Mexico, swift external adjustments were made, but at considerable cost to economic growth, which fell sharply in 1995. Brazil (which ran a trade deficit for the first time in many years) and some other countries chose to slow down the economy rather than rely on capital inflows to finance mounting external deficits or resort to devaluation and risk reigniting inflation. The crisis has also laid bare the fragility of fiscal balances and the financial system in a number of countries. Few managed to avoid its adverse consequences. Chile, however, has continued to sustain, for the twelfth consecutive year, an annual growth rate matching that of East Asia, while maintaining budget and trade surpluses and keeping inflation to single-digit levels.

The fundamental question of how to maintain both price stability and a sustainable payments position, while achieving steady growth high enough to reduce poverty and catch up with more advanced countries, remains a challenge in much of the region. Until the Mexican crisis, capital flows appeared to provide a temporary solution, by enabling domestic investment to diverge from domestic savings and allowing time for the completion of structural reforms so as to close the savings gap. Prices were kept stable through use of the exchange rate instrument and trade liberalization, while capital inflows were more than sufficient to close the mounting external deficits associated with growth and currency appreciations. There is now much greater recognition, even in countries where there is once more a substantial net capital inflow, that this is not a viable solution in the long run. Consequently, external imbalances are being contained, but to bring deficits to sustainable levels and preserve price stability growth has been sacrificed for the time being. Maintaining stability depends on resuming growth, which in turn means raising domestic savings and investment and increasing export competitiveness. The Asian experience discussed in Part Two of this Report holds some useful lessons in these respects.

Most *Asian developing countries,* including those in South Asia, continued to grow rapidly in 1995. Despite measures to cool the economy, expansion in China exceeded 10 per cent, and there was none the less a large trade surplus. In most other East and South Asian countries, however, fast growth was associated with a widening current account deficit and a moderate acceleration of inflation. The balance of payments has been a matter of concern, particularly in some South-East Asian countries, where debt servicing and profit remittances associated with FDI came on top of trade deficits which had been widening as a result of a slowdown in exports. The payments gap was financed by continued inflows of FDI and liquid funds attracted by relatively high domestic interest rates.

A virtuous circle, involving trade and investment, has continued to underpin rapid industrialization and growth in East Asia, the region which has continued to provide the most dynamic impetus to world trade. The share of Asian developing countries in world trade now exceeds that of either the United States, the European Union or Japan. The trade of the United States, as of the European Union and of Japan, with the Asian developing countries is greater than trade among those developed countries themselves. Trade among Asian developing countries is also growing much faster than trade among developed countries, which is one of the major reasons why world trade has risen faster than world output.

Growth experiences in *Central and Eastern Europe* in 1995 were varied. In Central Europe recovery is now well under way. Output rose on average by 5.3 per cent in 1995 and inflation has been brought down in most countries. However, even though exports rose rapidly, external deficits widened considerably, financed by massive inflows of capital. Following extensive trade liberalization, industry has apparently been unable so far to generate sufficient export earnings to finance the surge in imports associated with accelerated growth. In some respects, these countries face difficulties similar to those faced by many Latin American economies.

In the rest of Central and Eastern Europe, comprising mainly the CIS members, output continued to decline in 1995, but at a slower pace. In the Russian Federation, some progress was made in economic stabilization, supported by a sizeable standby loan from IMF, and there was also a large increase in the current account surplus. Although there is some evidence that the declines in output in these countries may be bottoming out, the outlook is still uncertain.

The current recovery in the developed world has been slower than during the previous two cyclical expansions, with growth falling from 2.8 per cent in 1994 to 2.0 per cent in 1995. The deflationary gap has consequently widened further and unemployment has risen by almost one third since the beginning of the decade, reaching a level (some 34 million in mid-1996) reminiscent of the interwar years. Even for the employed, real earnings have not been rising for several years. No real improvement is in sight for 1996, when growth in these countries is expected to fall on average to below 2 per cent.

The United States continues to enjoy its third longest cycle of postwar expansion, although the economy slowed down considerably in 1995, with growth falling to 2.0 per cent from 3.5 per cent in 1994. This overall performance is markedly better than that of Japan, which has been confronted with the challenge of adjustment to shifts in international competitiveness while still suffering from debt deflation. It is also better than that of the European Union, where measures taken to restore fiscal balance and reduce public debt so as to attain greater macroeconomic stability and also to meet the conditions for monetary union, have been an important restraint on growth.

As discussed extensively in past issues of *TDR*, in recent years the Japanese economy has encountered a number of serious difficulties caused by, *inter alia*, currency appreciations, heightened foreign competition, external pressures to reduce the trade surplus and debt deflation. The trade surplus has been diminishing rapidly as a result of a slowdown in exports and a surge in imports, partly reflecting the relocation of production abroad to low-cost countries. While this contributed much to the dynamism of trade and investment in East Asia as part of the "flying geese" process (described in Part Two of this Report), and more generally to growth and industrialization in the developing countries of the region, it has been at the cost of domestic investment, production and exports. The challenge for Japan is how to make the structural adjustment required to avoid further rises in unemployment while shifting from the present dependence on external demand to dependence on demand from the home market as its economy matures. Success will require switching from investment in manufacturing to investment in infrastructure and technology-intensive services, and allowing wages to rise relative to profits so as to stimulate consumption. Recently the Government has taken measures in this direction by introducing a major new fiscal package.

Fiscal stances in other developed economies have been contractionary. In the United States current plans will lead to the elimination of the budget deficit by the year 2002. In Western Europe, fiscal retrenchment has put downward pressure on employment and growth. Low growth itself has enlarged cyclical budget deficits, but these are not allowed to act as automatic stabilizers. Instead, expenditure cuts are being made in order to meet the convergence conditions for the third stage of monetary union. Consequently, recourse to monetary policy will be necessary to offset the effects on aggregate demand of these budgetary reductions and ensure that monetary union is not at the cost of low or zero growth.

In recent years, monetary policy in the major industrial countries has generally paid relatively little attention either to unemployment, except when it was falling, or to growth, except when it was accelerating. Such an approach was perhaps initially justified, in view of the then prevailing rate of inflation, but price stability has now become the norm and inflation has settled at its lowest level for over 30 years. None the less, the tendency to dampen upturns quickly while leaving downturns to work themselves out has continued.

The experience of the United States in the past two years illustrates the difficulties that have emerged in balancing considerations of inflation and growth. Monetary policy was tightened in early 1994 in order to pre-empt the inflation that was feared in view of tight labour market conditions. But unemployment subsequently fell by at least 1 percentage point, to below the level then considered compatible with stable inflation, and over 3 million jobs were created. Still, inflation has remained subdued as unit labour costs were kept down. This experience suggests that the rate of unemployment compatible with price stability may be well below that generally assumed by monetary authorities.

At about 11.5 per cent, current unemployment in Europe is certainly far above the rate that could be safely considered compatible with stable inflation. With inflation under 2 per cent in both Germany and France, there is scope to lower interest rates.

Financial markets are often said to limit monetary expansion. However, monetary policy itself exerts a major influence on the behaviour of these markets. Bond prices tend to fall when employment prospects improve, not so much because markets themselves anticipate inflationary pressures as because they believe that the monetary authorities will do so and hence push up interest rates. Because of the greater integration of financial markets, rising interest rates in expanding economies tend to be transmitted even to countries that lag behind, making it very difficult for them to initiate recovery, as has already twice been the case in the 1990s.

The risk of deflation is real if monetary policy continues to focus on combating inflation while attempts are made to improve fiscal balances. Without sufficient growth the adjustment to shifts in dynamic competitive forces associated with greater integration of markets and rapidly changing technology is much more difficult, and thereby also the pursuit of the process of globalization and the freeing of trade and payments.

External financing and debt

There continue to be great disparities in the experience of developing countries and transition economies regarding the availability of external financing from the international capital markets. A minority of countries raise significant sums in the forms of equity and various types of debt from this source, while the remainder - the great majority - continue to depend more heavily on official financing, including export credits.

For the major recipients of funds from the international capital markets 1995 was marked by the sequel to the Mexican financial crisis at the beginning of the year. But, even for Latin American countries, the consequences of the crisis for bank loans and issues of debt instruments were short-lived. Financing for Argentina and Brazil began to revive as early as the second quarter, while Mexico re-entered the international securities markets in the second half of the year. The crisis had more lasting effects in the markets for internationally issued equities of developing countries of all regions. After their recent expansion, such issues remained at a level similar to 1995. However, internationally issued equities by developing countries are increasingly dwarfed by institutional investors' direct purchases of domestically issued equities in emerging financial markets.

In recent months some countries experienced surges in capital inflows which, as earlier in the 1990s, have posed problems for macroeconomic policy. The countries affected were not only from Asia and Latin America but also, for the first time, from Central Europe.

Economies without access to international financial markets continued to fare less well in 1995. International bank lending to Africa contracted again. Moreover, the revival of export credits during 1994 was not sustained into 1995. For the majority of developing countries and transition economies the official insurance cover associated with export credits continues to be available only on restrictive conditions or remains completely unavailable. These limitations not only lead to higher transaction costs in trade but also indicate low creditworthiness for the countries concerned.

* * *

Recent episodes of international financial instability such as the disruption of the EU Exchange Rate Mechanism and the Mexican crisis have led to widespread reconsideration of appropriate policies for fostering more orderly financial markets and handling crises due to volatile capital movements.

One school of thought believes that convergence of macroeconomic policies, particularly as regards inflation, interest rates and fiscal deficits, would by and large suffice to produce stability. However, seeking to attain particular targets for such variables would generally be regarded as too deflationary by some countries and too inflationary by others. Moreover, the concepts underlying advocacy of policy convergence, which link the determination of exchange rates to such economic fundamentals, have only a tenuous connection to indicators widely used to guide the day-to-day decisions of traders in the currency markets.

Ideas put forward in this context have also included international lender-of-last-resort facilities and steps other than policy convergence for reducing international financial instability. So far, initiatives in IMF have addressed an expansion of financing under the General Arrangements to Borrow and improvements in available information regarding countries borrowing from international financial markets. International debate has also focused on monetary union, better arrangements for handling countries' debt problems as they emerge (to prevent their becoming full-blown financial crises), improved prudential supervision of banks and securities firms, tax and tax-like measures to restrain currency speculation, and new methods of official intervention in foreign-exchange markets. Progress has been made on some of these fronts, but proposals such as a tax on currency transactions or on profits from currency trading would require the solution of difficult technical problems and the attainment of international consensus. The difficulties associated with various proposed measures none the less need to be seen in conjunction with the likely costs of failing to deal adequately with present policy lacunae: continuing recurrences of international financial instability can be prejudicial to orderly trading relations and, more generally, to coherence in global economic policy making.

* * *

The debt situation of many heavily indebted poor countries (HIPCs) - the majority of which are LDCs - continues to be extremely difficult. Concern over their plight has led to substantial cancellation of ODA debts by some donors and increasingly concessional rescheduling by Paris Club creditors. However, studies on the impact of the Naples terms, which were adopted in December 1994, indicate that for a significant number of countries the debt situation would remain unsustainable even with the full implementation of those terms, mainly on account of the sheer burden of their multilateral debt as well as of non-Paris Club bilateral debt. Progress toward a solution concerning non-Paris Club bilateral debt is advancing only slowly and still lacks a coherent framework. Debt owed to multilateral financial institutions (MFIs) now accounts for an important and rising portion of total indebtedness and an even larger share of total debt service in HIPCs. While MFIs have adopted schemes to alleviate the debt burden of poor countries, their scope has been limited, given the severity of the problem, and pressure has been growing for these institutions to take stronger action.

The solution to the debt problems of HIPCs requires bolder measures. For these countries, approaches involving only part of the total debt have clearly not worked satisfactorily. An effective debt strategy needs to be comprehensive, covering all components of debt, and should involve equitable burden sharing among all creditors. The framework for action to resolve the debt problems of HIPCs, which was recently proposed by IMF and the World Bank, constitutes the first official recognition of the need for a comprehensive debt strategy and represents a commitment to act decisively to ease the burden of multilateral debt. It offers hope for debt-distressed LDCs as well as other poor countries with proven track records of economic reform and structural adjustment to attain debt sustainability.

The endorsement of the framework by both the Development Committee and the Interim Committee at their spring 1996 meetings, as well as by the G-7 during the Lyons Summit, augurs well for the

success of this initiative. Appropriate flexibility in the application of certain conditions determining country eligibility, as well as in the timing of enhanced multilateral action, would contribute to ensuring a lasting and rapid solution to the debt crisis. The differences that have arisen concerning the contributions to be made by various creditors also need to be ironed out, so as to arrive at an equitable burden-sharing arrangement that is acceptable to all. Of vital importance in this respect is the extent of enhanced relief to be extended by Paris Club creditors. The assessment of contributions from all creditors should be based on additionality of resources, so as to prevent diversion of scarce development funds for debt relief. For MFIs, any proposal regarding the use of their resources must ensure that the financial integrity of the institutions is preserved and that their credit rating is unharmed. Among proposals put forward which would meet these criteria are the sale of a portion of IMF gold stock and the use of part of the reserves of the World Bank. It will be important to define clearly the modalities of the various contributions to be made, taking into account the difficulties that some MFIs might experience in meeting their financial contributions, and how coordination among all the parties concerned could best take place. The severity of the situation faced by a number of HIPCs, in particular the LDCs, calls for additional efforts from all concerned. For eligible debtors, continued strong commitment to reform would be required, not only to safeguard against moral hazard but also, and above all, to enable them to create the right conditions for sustained growth, thus ensuring the successful resolution of the debt crisis. It is urgent to formulate a workable plan of action for decision at the Annual Meetings of IMF and the World Bank in October 1996.

Export-oriented growth and industrialization in East Asia

The past three decades have witnessed an unprecedented pace of growth and industrialization in a small group of East Asian countries, comprising the Republic of Korea, Taiwan Province of China, Hong Kong and Singapore. Per capita income in these first-tier newly industrializing economies (NIEs) rose at an average rate of almost 7 per cent per annum during that period. A second tier of NIEs has now emerged (Indonesia, Malaysia and Thailand) for which average annual growth in the past decade has been 6 per cent. A third tier is now emerging, including notably China, where high growth rates have been sustained over a number of years.

A common feature of all these economies has been a strong growth of exports of manufactures. Indeed, trade has been an integral part of the industrialization process. East Asian experience holds useful lessons in three areas. First, it points to the need for, and the ways and means of, establishing a dynamic interaction between exports and investment in the industrialization process. Second, it shows how it is possible to mobilize and make full use of natural resource endowments and abundant unskilled labour. Third, it demonstrates the need for industrial upgrading and moving up the technological ladder in order to raise productivity and per capita incomes and shows how this can be done.

The experience of the first-tier NIEs is relevant in all three respects, though less so with respect to natural resources in view of their poor endowments. That of the second-tier NIEs is relevant with respect to the first two, and in particular has important lessons for LDCs that are rich in natural resources. The second-tier NIEs, which have not yet completely acquired the skills and technology needed to move to a more advanced stage of industrialization, can also learn from the experience of the first tier in upgrading. Moreover, the diversity of experience in East Asia demonstrates the range of options available to other developing countries in pursuing outward-oriented strategies.

Although some interpretations of this East Asian experience have highlighted the benefits of rapid liberalization of foreign trade and finance and deregulation of domestic markets, to the detriment of the role of the State, the reality is much more complex. As discussed extensively in *TDR 1994*, in most countries the State provided a necessary complement to, and sometimes corrective influence on, the market, particularly by promoting a rapid pace of capital accumulation and technological progress that was linked to exports.

No doubt competition in foreign markets has exerted an important discipline over enterprises, thereby promoting efficiency. However, the principal rationale for the strategy of export-oriented industrialization that these countries pursued has been different. Initially they had no significant capital goods sector and produced mainly consumer goods. Exports, together with some limitation of imports of consumer goods, allowed domestic industry to expand without a corresponding growth in domestic consumption, thereby helping to raise domestic savings. They also provided the foreign exchange needed for capital goods imports and access to advanced foreign technology as part of the strategy of catching up based on imitating technology leaders.

While success in raising savings and investment depended crucially on export growth, export expansion in turn required new investment. Thus, rapid growth required mutually reinforcing dynamic interactions among savings, investment and exports. That all the East Asian NIEs have been successful in bringing about such a growth nexus is evidenced by their sustained and rapid increases in savings and investment and in exports, in both absolute and relative terms.

But successful export orientation in East Asia has not been confined to the macroeconomic level. It has been accompanied by structural changes, from resource-based to labour-intensive, and subsequently to technology-intensive, production and exports, and by increased penetration of northern markets, particularly the fastest-growing ones. Not only have the East Asian NIEs succeeded in expanding their manufacturing exports to the North much faster than other developing countries, but also they have experienced a much smaller decline in their manufacturing terms of trade than Latin America and the LDCs.

The first-tier NIEs quickly moved out of resource-based production and exports and into low-skill-intensive manufactures, employing active investment and export promotion policies, whereas the second-tier NIEs relied much longer and more heavily on exports of primary commodities. However, in the latter countries, too, export expansion has gone hand-in-hand with the growth of savings and investment. Consequently, they have been much more successful than other resource-rich developing countries in diversification and processing in the primary sector. From almost complete dependence on raw material exports in the mid-1960s, they have reached a position where such exports account for only one third of total export earnings, compared with closer to two thirds in Latin America.

The development of labour-intensive manufacturing was very rapid in the first-tier NIEs. By contrast, in part due to their greater natural resource endowment, the shift to manufacturing has been slower in the second tier. From an early date, the first-tier NIEs also started building technology- and scale-intensive industries, in anticipation of the difficulties they would encounter in competing in international markets for labour-intensive products because of increases in domestic wages and/or the emergence of low-cost producers in other countries. Thus, rather than seeking to maintain competitiveness by keeping down wage costs, they chose to upgrade rapidly as a way of raising productivity, exports and incomes.

The challenge for policy was considerably stronger as production became more scale- and technology-intensive and the investment climate more uncertain, necessitating new forms of intervention to support infant industries, including subsidies and protection from foreign competition, industrial and technology policies, and measures to accelerate investment in both human and physical capital. Simultaneously, support for older-established industries was withdrawn as they matured and became competitive in world markets, earning the foreign exchange necessary to build the next generation of infant

industries. Import substitution and export promotion were thus integral parts of a comprehensive long-term strategy of industrialization.

First-tier NIEs have also succeeded in combining industrial upgrading with market dynamics by penetrating the fastest-growing OECD markets. Although in the early 1960s they were no better placed than other developing countries in respect of producing goods that were to prove to be the most dynamic in international trade, by the early 1990s high-skill, high-technology goods accounted for well over half of total export earnings in the Republic of Korea, Taiwan Province of China and Singapore, which was over twice the proportion for most other major exporters of manufactures.

Although infant industry programmes in larger first-tier NIEs have concentrated on building domestic capital and intermediate goods industries, it would not have been possible for them to gain access to the requisite technology without establishing close links with foreign firms, which have taken a variety of forms. In most cases a selective approach to FDI complemented efforts to strengthen domestic capabilities. In Singapore a more open-door policy toward FDI has been followed, using various incentives to guide investment to higher-level activities. Hong Kong stands out as an economy attracting FDI within a more *laissez faire* policy framework. It has also been less successful in upgrading its industrial base. While its unique location compensates for these deficiencies, enabling it to go on to the stage of providing a wide range of modern services, its very uniqueness makes it doubtful whether Hong Kong is a model for most other developing countries.

The second-tier NIEs appear to have moved into technology-intensive products rather more rapidly and with heavier reliance on FDI. Exports of such products, however, have a considerably larger import content than those of the first-tier NIEs, and consequently a much lower domestic value added content. This evolution of industrial output and exports in the second-tier NIEs is currently raising concerns over insufficient technological and supply linkages between TNC-dominated export sectors and the rest of the economy. Appropriate policies to fill this industrial hiatus need to be found. In this respect, the second-tier NIEs, like many other middle-income developing countries, have much to learn from the experience of the first-tier ones.

Large current account deficits that are of more immediate concern in the second-tier countries are related to the same phenomenon. Dependence on extensive reinvestment of profits of TNCs when there are large external deficits is a potential threat to payments stability; without upgrading and strong linkages with domestic suppliers so as to raise the domestic value added content of exports in industries dominated by foreign firms, FDI will tend to remain footloose. In consequence, the economy will be highly vulnerable to interruptions in the reinvestment of TNC profits, as competition increases from low-cost locations elsewhere.

* * *

The fact that so many rapidly growing economies are concentrated in East Asia gives strong grounds for suggesting a regional dynamic may be at work. This dynamic is associated with a regional pattern of industrialization which has not only proceeded in waves, but also involved a constantly shifting regional division of labour whereby the upgrading of economic activity from resource-based and labour-intensive industries to increasingly sophisticated manufactures by the lead economies has opened up opportunities for less developed countries to participate in the regional division of labour. This "flying geese" pattern of industrialization has involved both regional trade and regional investment as vehicles for transferring new goods and technology among countries. Indeed, close to one third of total exports to countries in developing East Asia originate from elsewhere in the region, and the figure is closer to one half if Japan is included. Similarly, over half of the stock of FDI in four ASEAN countries originated from elsewhere in East Asia, and the proportion is much higher for China.

Regional dynamics were less important for industrialization in the first-tier NIEs than in the second tier. Japan did not constitute an important market for the labour-intensive products of these countries in their earlier stages of development, largely because it had not yet phased out many of its labour-intensive industries. Nor did it play an important role in the industrialization of these countries, partly because it was not at that time a major international investor in manufacturing, and partly because of the policy choices of the first-tier NIEs themselves.

The mid-1980s were a turning point in the strengthening of regional dynamics, with Japan playing an increasing role, both in trade and FDI, vis-à-vis the second-tier NIEs. Japan's emergence as a major international investor was initially reflected in a large increase in flows to the first-tier NIEs, but attention quickly switched to the second tier in the late 1980s, and to China in the early 1990s. Export promotion measures, including a more liberal approach to hosting FDI in the second tier, coincided with strong wage and exchange rate pressures in Japan and in the first tier, which made the second-tier countries attractive locations for Japanese firms facing increased competition on world markets. Similarly, there has been an upsurge in Japanese imports of labour-intensive and electronic goods from East Asia. Recent trends suggest that Japan will become an increasingly important market for the output of all the East Asian NIEs. Indeed, in 1994 China ran a small trade surplus in manufactures with Japan.

More important, the strengthening of regional dynamics has been associated with increased trade and investment among the developing countries of East Asia. Following Japan, the first-tier NIEs began investing in the second tier and for much the same reasons. Moreover, in some cases they have become not only more important investors in other developing countries of East Asia, but also more important trading partners. In 1994, the first-tier NIEs absorbed twice as much in manufacturing exports from the ASEAN countries as Japan.

However, the position of the second-tier NIEs in this regional dynamic is far from certain. The recent upsurge of FDI from Japan appears to represent a one-off adjustment to an abrupt shift in competitiveness, and with the growing economic presence of China and the emergence of new locations such as India and Viet Nam, their position may become more precarious if they do not find the right policy response.

Government policies have played an important role in fostering East Asian regional integration, which could be characterized as a recycling of comparative advantage. The experience of East Asia suggests that - with proper policies - South-South cooperation could play a decisive role in fostering outward-oriented development through closer trade and investment links. Indeed, such cooperation may become increasingly important in the light of broader developments in the global economy.

* * *

It is possible to detect a creeping pessimism among policymakers looking for lessons from East Asia. Indeed, on some accounts the experience is already of more archaeological interest than contemporary relevance, at odds with a globalizing and liberalizing world. For some, export-led growth no longer holds out the dynamic prospects it did earlier because of the heightened competitiveness in the world economy. Indeed, on some accounts a simultaneous export push by a large number of developing countries could flood the market and significantly reduce world prices. This "fallacy of composition", familiar to exporters of primary products, provides the backdrop for pessimism over prospects for manufactured exports. A second argument against replicability of East Asian export success is more straightforward and relates to diminished national policy autonomy after the Uruguay Round.

But these concerns, while meriting careful consideration, tend to equate replication with cloning. Indeed, the East Asian countries have differed among themselves in terms of export dependence as well as the pace of export promotion, and it would be foolish to suggest that India or China, for example, must achieve the same per capita exports or imports as the first-tier NIEs. The replication of East

Asian industrialization implies different degrees of export orientation in manufactures for different levels of per capita income, industrialization and resource endowments and varying sizes of population.

Moreover, the very rise of East Asia has itself profoundly altered the question of replication. The East Asian NIEs not only provide new markets for other developing countries, but are also a source of capital goods and technology. More generally, although the markets in the South are still smaller than the North, many are growing much faster. There is thus considerable scope for increased trade and FDI among developing countries.

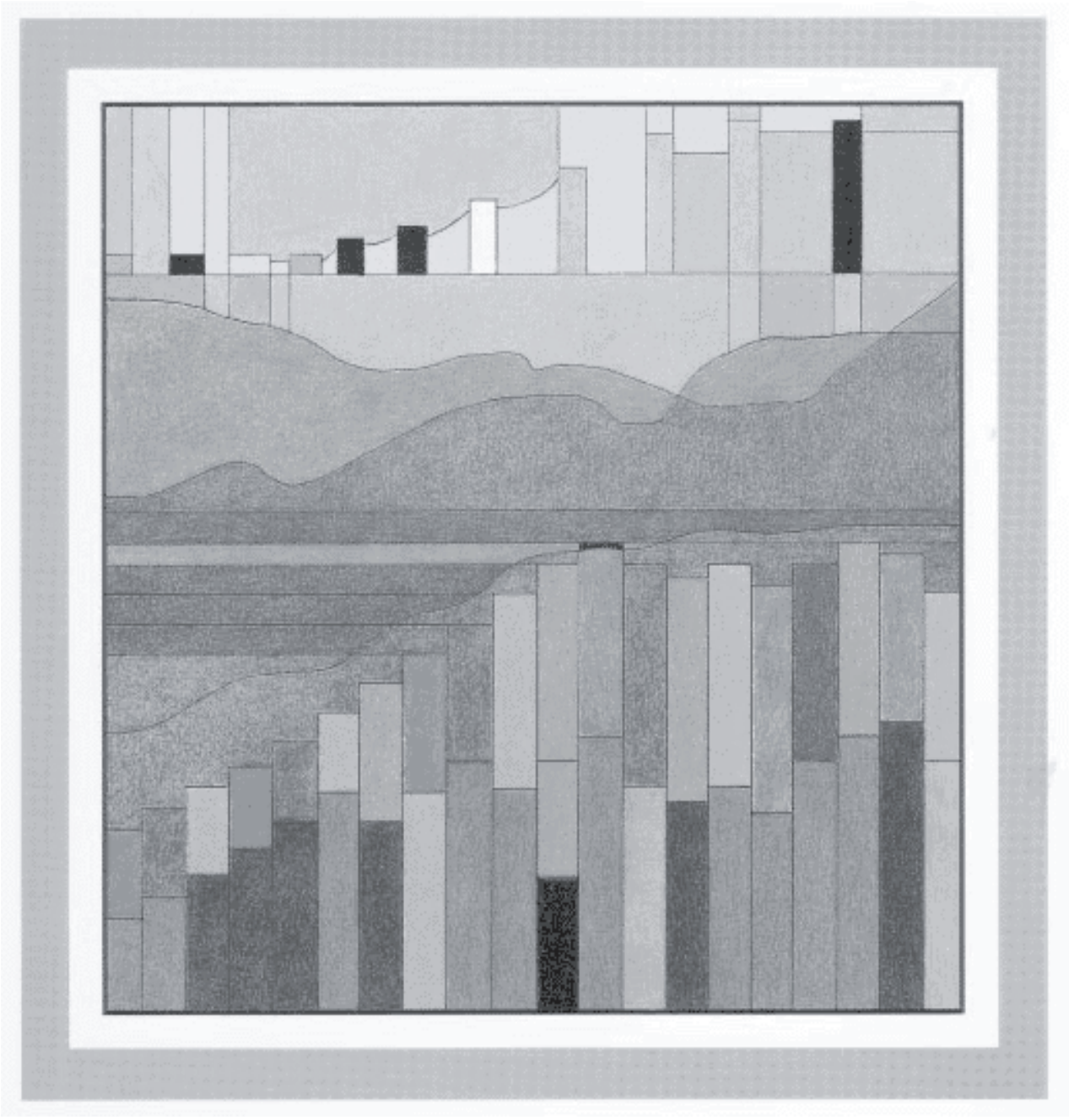
In the light of these developments, the fallacy of composition in manufactured exports should not be seen as an immediate constraint on export promotion. Indeed, taking a traditional export good such as clothing, if the commitments made in the Uruguay Round are duly implemented, the scope for export expansion in the South will be considerable; a tripling of southern clothing exports over the next decade is far from unrealistic, giving ample scope for a new generation of NIEs to expand their exports without adverse effects on their terms of trade.

However, exploiting the opportunities provided by the Uruguay Round depends in part upon the existing generation of NIEs' diversifying into new export lines and, in part, on preventing the imposition of any new protectionist measures against exports from developing countries. Thus, replicability of the East Asian experience in this sense depends very much on the success of industrial policies in the South in upgrading and diversifying, and on the success of macroeconomic policies in the North in accelerating growth and reducing unemployment. There is enough uncertainty on both these scores to suggest that developing countries might benefit from international assistance in formulating export strategies which, when taken together, minimize the risk of fallacy of composition.

The conclusion of the Uruguay Round has clearly opened up new export opportunities and improved security of market access compared to the situation when the East Asian NIEs began to industrialize. In this regard, it has encouraged outward-oriented strategies. At the same time, it has closed or narrowed some policy options pursued by the East Asian NIEs. Certainly, the scope for lengthy periods of protection, resort to extensive trade-related subsidies and performance standards and lax enforcement of intellectual property rights has been reduced. However, in many areas critical to the East Asian experience, such as investment and savings, research and development, and regional policies, there remains ample room for active policy measures that needs to be fully utilized. In any case, it is necessary to avoid exaggerated claims regarding either opportunities or limitations and to stress the need for objective analysis of the options which remain open to developing countries when seeking to emulate the experience of the East Asian economies.

Rubens Ricupero
Secretary-General of UNCTAD

GLOBAL TRENDS



Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Overview

1. World output and trade

World output grew by 2.4 per cent in 1995, in continuation of the recovery that began in 1994 after three years of sluggish growth averaging just over 1 per cent per annum (table 1). However, this was a weaker performance than had generally been expected at the beginning of the year, following the momentum of accelerated growth in 1994 of 2.8 per cent (from 1.1 per cent in the previous year). The slowing down in the growth of the world economy which was predicted in *TDR 1995* is not expected to be reversed in 1996.

In developed countries, the expected sustained recovery gave way to widespread signs of a slowdown in economic activity in the second half of 1995, particularly in the European Union. While Japan made important progress towards the end of 1995 in recovering from a long period of stagnation, growth in the United States was modest, the lowest since 1991. Consumer confidence weakened in Western Europe on account of the uncertain employment prospects, and the net result was a significant fall in output in the developed market-economies as a whole, from 2.8 per cent in 1994 to 2.0 per cent in 1995. Despite the continued non-inflationary expansion in the United States and a stronger-than-expected recovery in Japan, there may be a further decline in 1996 if recovery is delayed further in Europe. The chances of such an outcome will increase unless monetary policy is eased further, so as to permit real interest rates to fall enough to offset the deflationary impact of budget cuts.

Growth of 4 per cent in developing countries as a whole (excluding China) continued to outpace that of developed countries in 1995, and the gap is likely to widen in the current year, with most regions expected to maintain or improve their growth performance. Only a relatively modest recovery is expected in Latin America, where the repercussions of the Mexican peso crisis in 1995 proved to be much deeper than anticipated by even the most pessimistic forecast, and nearly brought the expansion in the region to a halt. In contrast, growth in developing African countries in 1995 was not only broadly based but also the highest for this region since the beginning of the decade, and is expected to be higher still in 1996. Growth in developing countries in Asia continued to be outstanding throughout 1995, accelerating to 6.3 per cent (China excluded), which was triple that of the developed market-economy countries. China continued to be one of the fastest-growing countries in the world, maintaining for the fourth year in succession a rate of more than 10 per cent. Continued high growth is expected in 1996.

Finally, 1995 witnessed a notable improvement in the performance of the transition economies

Table 1

WORLD OUTPUT, 1991-1996

(Percentage change)

Region/country	*1991*	*1992*	*1993*	*1994*	*1995[a]*	*1996[b]*
World	0.6	1.4	1.1	2.8	2.4	2.4
Developed market-economy countries	0.9	1.6	0.7	2.8	2.0	1.9
of which:						
United States	-1.0	2.7	2.2	3.5	2.0	2.2
Japan	4.0	1.1	0.1	0.5	0.9	2.1
European Union	1.5	1.0	-0.6	2.8	2.5	1.3
of which:						
Germany	5.0	2.2	-1.2	2.9	1.9	0.5
France	0.8	1.2	-1.3	2.8	2.2	0.9
Italy	1.2	0.7	-1.2	2.2	3.0	1.5
United Kingdom	-2.0	-0.5	2.3	3.8	2.4	2.2
Central and Eastern Europe[c]	-11.7	-13.4	-8.3	-10.1	-2.6	0.3
Developing countries	2.9	3.6	3.7	4.7	4.0	4.5
of which:						
America	3.5	2.5	3.4	4.9	0.7	2.4
Africa	1.9	0.7	0.1	2.6	2.8	3.1
Asia	2.8	5.0	4.6	5.1	6.3	6.1
China	8.4	14.3	14.0	11.8	10.2	9.0
Memo item:						
World exports (volume)	3.0	4.5	3.1	8.9	8.0	7.3

Source: UNCTAD secretariat calculations, based on data in 1990 dollars.
a Estimate.
b Forecast.
c Including the Baltic States and the members of CIS.

of Central and Eastern Europe, where the fall in output averaged no more than 2.6 per cent, after double-digit declines in all but one of the previous years since 1990. This improvement is expected to continue throughout 1996, with the first signs of a revival of output for this group of countries as a whole. However, differences in growth performance among these economies have become even more pronounced than before.

The growth of world trade slowed down somewhat in volume terms (table 2), affecting all regions, with the major exception of exports from Latin America (where imports, on the other hand, declined sharply). None the less, the volume of world trade expanded at twice the pace experienced during the economic slowdown at the beginning of the 1990s. In value terms the growth of exports and imports was much higher, largely because of the weakness of the dollar in the first half of the year and the continued strength of primary product prices, such as oil and non-ferrous metals.

More important, the value of world trade has continued to expand faster than world output for the sixth consecutive year. This development in the traditional relationship between trade and output growth can be explained in terms of four new

Table 2

EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS, 1993-1995

(Percentage change in volume over previous year)

	Exports			Imports		
Grouping/region	1993	1994	1995[a]	1993	1994	1995[a]
World	3.1	8.9	8.0	1.2	10.2	8.5
Developed market-economy countries	-1.2	9.1	8.4	-2.9	10.2	8.3
of which:						
United States	4.6	11.4	13.7	11.7	15.0	12.0
Japan	-1.9	1.9	4.6	3.8	13.8	13.1
France	-1.0	6.6	8.4	-3.8	7.2	5.3
Germany	-1.7	10.2	5.3	-6.3	6.0	3.1
Italy	11.6	10.5	9.4	-9.1	10.5	5.6
United Kingdom	0.2	11.7	6.1	0.4	6.4	1.5
Developing countries[b]	10.2	9.8	12.7	7.9	8.9	11.7
of which						
America	11.8	9.9	10.5	7.3	14.4	2.8
Africa	5.2	0.0	3.7	3.3	-4.3	4.6
West Asia	11.4	-2.3	4.8	-1.6	-5.8	5.9
Other Asia	10.3	14.1	14.0	11.4	14.9	15.0

Source: UNCTAD secretariat, based on national and international sources.
a Preliminary.
b Including China.

aspects of world trade which are the result of greater integration of markets:

> ... the rise of intra-trade, trade in similar goods between similar countries; the ability of producers to slice up the value chain, breaking a production process into many geographically separated steps; the resulting emergence of supertraders, countries with extremely high ratios of trade to GDP; and the novelty that provokes the most anxiety, the emergence of large exports of manufactured goods from low-wage to high-wage nations.[1]

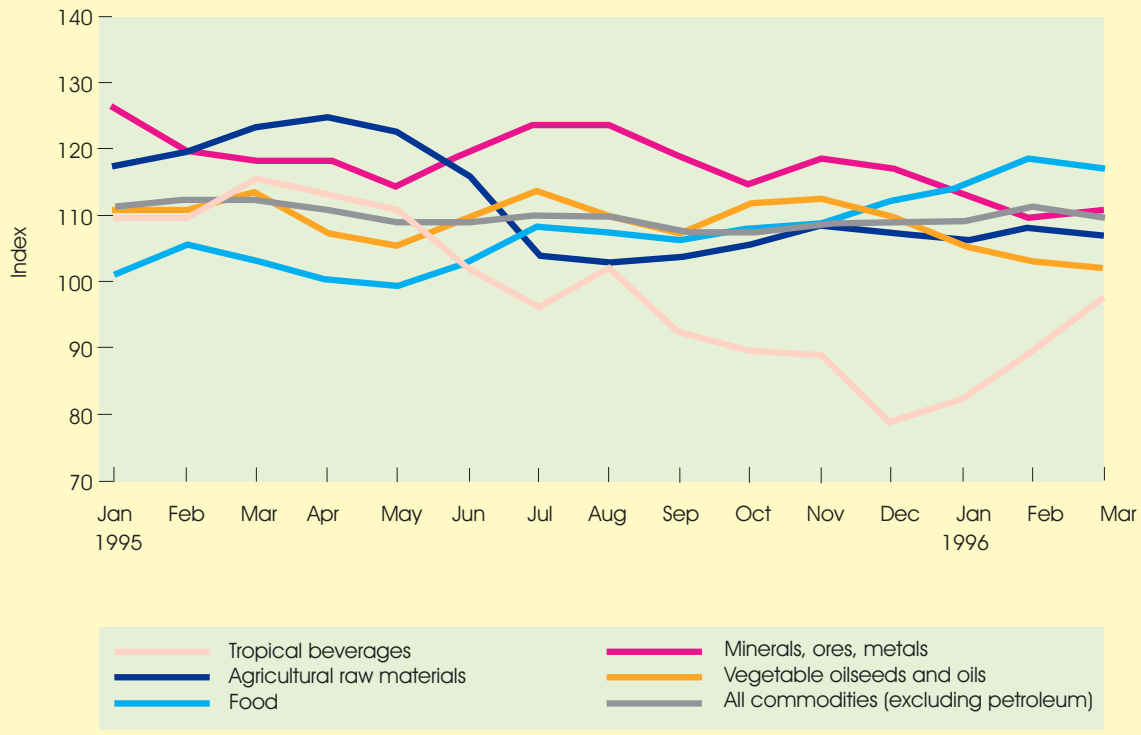
Developing countries continue to take on increasing importance in determining the performance and patterns of world trade. Trade among developing countries has grown much more rapidly than trade among the developed ones. Furthermore, trade between developing and developed countries has been more dynamic than trade among the latter countries themselves.

As discussed in greater detail in Part Two, chapter I, the dynamism of trade in Asian developing countries is now such that these countries are able not only to maintain their own growth momentum, but also to exert a marked influence on other countries, including the developed countries, through the growing integration of world trade. The share of 10 developing Asian economies[2] in world trade (imports plus exports) in 1995, excluding trade among EU countries, was over 19 per cent. This is very close to the share of EU (19.5 per cent) and greater than that of the United States (17.7 per cent) or Japan (10.2 per cent). In 1994, the trade of the United States with the Asian developing countries (about $272 billion) was greater than its

Chart 1

WORLD COMMODITY PRICES, 1995-1996

(Index numbers, 1994=100)



Source: UNCTAD, *Monthly Commodity Price Bulletin*.

trade with either EU ($218 billion) or Japan ($176 billion).[3] Similarly, the trade of both EU and Japan with the Asian developing countries (around $229 billion and $283 billion, respectively) exceeded by a large margin trade between themselves ($94 billion).

World exports of services also increased rapidly in 1995, although less so than merchandise exports.[4] Exports of services such as insurance, banking and telecommunications rose particularly fast. While trade in services was most dynamic in Asia, it was also strong in Western Europe. Trade in primary commodities also expanded well during 1995, due to favourable price developments, especially in metals and oil. None the less, manufactures remained the most dynamic element of world trade, especially in the area of telecommunication and office equipment.

2. Commodity prices

As a result of the continuing slowdown in economic activity, especially in the developed countries, the recent surge in non-oil commodity prices, which started in 1993, showed signs of coming to an end.[5] Many prices, including those of minerals and metals, started to decline during the first half of 1995, and by December non-oil primary commodity prices as a whole averaged 2 per cent less than in January, remaining relatively stable during the first quarter of 1996; some recovery for tropical beverages, mostly coffee, was offset by declines for other commodities, including vegetable oilseeds and oils, agricultural raw materials, mineral ores and metals (chart 1 and table 3). In particular, non-food prices appear to have peaked in recent months, not only for agricultural raw

Table 3

WORLD PRIMARY COMMODITY PRICES, 1993-1996

(Percentage change over previous year)

Commodity group	*1993*	*1994*	*1995*	*March 1996[a]*
All commodities[b]	***-3.5***	***17.1***	***10.0***	***0.7***
Food and beverages	***1.9***	***19.3***	***5.4***	***4.3***
Tropical beverages	6.1	75.0	1.1	9.7
Coffee	10.3	112.3	0.7	13.7
Cocoa	1.9	24.8	2.7	-2.9
Tea	-4.9	-4.4	-10.3	-3.7
Food	0.7	10.1	5.9	4.7
Sugar	10.6	19.7	10.8	4.9
Beef	6.6	-10.9	-18.2	-10.4
Maize	3.7	1.3	23.5	-5.5
Wheat	1.7	4.9	30.5	13.9
Rice	-6.6	33.6	-10.1	6.2
Bananas	-7.4	-0.5	0.1	42.9
Vegetable oilseeds and oils	0.0	24.4	10.3	-6.8
Agricultural raw materials	***-3.2***	***14.2***	***13.1***	***-0.7***
Hides and skins	28.6	30.6	4.3	0.0
Cotton	0.0	37.5	22.3	-5.7
Tobacco	-21.7	-2.0	-1.2	0.0
Rubber	-3.8	39.3	38.6	-2.1
Tropical logs	-5.0	2.8	-5.2	-2.7
Minerals, ores and metals	***-14.7***	***13.6***	***20.0***	***-5.4***
Aluminium	-9.2	29.6	22.3	-2.7
Phosphate rock	-10.6	0.0	0.0	0.0
Iron ore	-11.0	-9.5	5.8	6.0
Tin	-15.4	5.9	13.7	-1.5
Copper	-16.2	20.6	27.2	-12.5
Nickel	-24.4	19.8	29.8	-0.9
Tungsten ore	-39.9	24.1	49.6	-0.6
Crude petroleum	***-11.4***	***-4.1***	***9.3***	***8.1***
Memo item:				
Manufactures[c]	***-5.8***	***2.1***	***8.1***	***..***

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

a Change from December 1995.

b Excluding crude petroleum.

c Unit value index of exports of manufactures from developed market-economy countries.

materials, such as wool, where prices have been under pressures from both low demand and sales from stockpiles, but also for metals, demand for which has been low. Even cotton prices, which had continued to rise during early 1995, were stable for the remainder of the year.

Sharp price increases for industrial raw materials (20 per cent over the 1994 level), especially for aluminum, copper, lead, nickel, and tin, and also for agricultural raw materials (13 per cent) and vegetable oilseeds and oils (10 per cent), reflected the strength of demand. The lowest rates of price increase were for food and beverages, mainly due to supply considerations. Prices of temperate zone foodstuffs held up particularly well. World grain stocks were nearly at the lowest level for 20 years as prices approached unprecedented levels, especially in Western Europe, where production capacity had been reduced. In the United States drought and lower planting subsidies reduced supplies, especially of wheat and maize. While grain harvests were also down in Central and Eastern Europe, there was some increase in Australia. World demand, however, has been increasing rapidly, especially in East Asia, where rising living standards have led to higher consumption of grains for livestock.

In contrast, the prices of foodstuffs produced in developing countries have been weak and for tropical beverages they declined throughout most of 1995. In particular, difficulties with the stock retention programme of the Association of Coffee Producing Countries (ACPC) and lower consumption led to declines in coffee prices. While cocoa prices have been somewhat firmer, their prospects remain very uncertain, as do also those for sugar, in view of the existing surplus. An exception to this general trend for developing countries is rice, the price of which held up on account of reduced exports from Viet Nam and China due to increased domestic demand. China became a net importer of rice for the first time in many years. It can be expected that price movements for commodities produced by developing countries will remain relatively subdued over the longer term because of productivity growth in agriculture, the declining raw material content of industrial production and low income elasticities of demand for most foodstuffs.[6]

Owing to the increase in demand on account of an unusually hard winter in the North, oil prices showed substantial recovery in 1995, but nevertheless remained at their lowest level in real terms for over 20 years. While OPEC had decided to freeze output levels for the second year running, other countries, especially suppliers of North Sea oil, Canada, and Mexico, increased their output. The difficulties in enforcing production quotas for OPEC members, for which oil revenues are of such importance to their economies, and the agreement to allow Iraq to resume limited sales under United Nations supervision, suggest a period of prolonged weakness in the oil market.

On the whole, price movements in 1995 were less favourable to the developing countries than they were in 1994. In particular, export prices for many small producers in Africa and Latin America, such as those of tropical beverages, weakened markedly in 1995; on the other hand, the increases in the prices of grain contributed to swell the import bills of many low-income, net-importing countries in Africa.

B. The world economy: erratic and uneven growth

The turning point in the current global growth cycle now appears to have been reached in 1994. In both 1994 and 1995 official expectations that the world economy was entering a new era of sustained market-driven growth in excess of 3 per cent were disappointed, and with them vanished the hope of falling unemployment in the developed countries and rising per capita incomes in the developing countries in conditions of price stability.

One of the original motives for introducing stabilization policies in a number of developed and developing countries was the expectation that lower inflation and better macroeconomic balance would provide the basic conditions for a return to high and stable growth. These policies have been generally successful in providing macroeconomic stability. For example, the hyperinflation which once plagued Latin America has been eliminated.

In the developed countries persistently high rates of inflation, which had once been thought a permanent feature of modern post-industrial economies, have been eliminated and price stability has now become the norm. Trade imbalances, in particular between the United States and Japan, and fiscal deficits in the United States, which were seen as the cause of instability in the 1980s, are not only declining rapidly, but are predicted to largely disappear. Fiscal balances have already been largely restored in many countries which had suffered from deficit-inflation-devaluation cycles, while in others, particularly in Europe, there has been increased emphasis on budget consolidation.

However, despite the success in reducing macroeconomic imbalances, most countries have not attained high and stable growth. In the major industrial countries inflation rates have been kept extremely low and stable by historical standards - at their lowest level for 30 years. By contrast, growth rates have become more erratic, around levels which are not always sufficient to allow full utilization of labour and capital. In the United States, where performance has been the best since the 1960s, quarterly fluctuations in output have caused continual uncertainty and turbulence in financial markets. In Europe, two nascent recoveries since 1991 have been reversed virtually before they had set in. In Japan, both the depth of the post-1990 recession and the speed of recovery in early 1996 were unprecedented.

This contrast between inflation and growth derives in large part from the mix and stance of macroeconomic policies. While discretionary fiscal stance has generally been contractionary, monetary policy has continued to concentrate on keeping inflation low. As discussed in greater detail in *TDR 1995*, real short-term and long-term interest rates in OECD countries have risen to unusually high levels. Furthermore, increased interest rate instability has led to greater fluctuations in effective demand and output. Economic policy has not been able to combine stable prices with sustained output growth sufficient to provide high and stable levels of employment; unemployment in OECD countries has risen to levels not experienced since the inter-war period.

The risk of deflation is real if monetary policy continues to focus solely on inflation while attempts are made to improve fiscal balances through demand restraint. Noting that "the adjustment to fiscal restraint ... can be disinflationary", the Bank for International Settlements has argued that:[7]

> In view of the inflationary experience of industrial countries over the last three decades, it is not surprising that the phrase "price stability" has been generally interpreted to mean a very low level of inflation. By this standard, price stability has been reached, or almost reached, in a large number of countries in the industrial as well as the developing world. ... This is not to deny that an inflationary threat still exists. ... Yet it remains true that the forces bearing on the price level are now more balanced than they have been for some decades. Thus, it is perhaps the right historical moment to recall the advice of Keynes and Wicksell in the early 1920s ... that it was appropriate as well as feasible for central banks to resist both inflation and deflation. At a time of rapid social and economic change, with attendant implications for social order and relative prices, it is all the more important that price stability be pursued as an anchor for rational and forward-looking decisions on all fronts.

But low and erratic growth is not restricted to developed countries. With the notable exception of Chile, and to a lesser extent, some smaller economies, it has not proved possible in Latin America to sustain the growth that was enjoyed in the early 1990s. Only Asia and Africa seem to have escaped this pattern. The reasons for the relative success of developing Asia in achieving sustainable expansion and stability are investigated in more detail in Part Two. In Africa, on the other hand, performance in recent years has been around a growth trend which has been only mildly positive.

Again, the problem of unemployment does not concern developed countries only; it is also present in a number of Latin American countries, as well as in Africa, where it often takes the form of disguised unemployment. It seems that in most countries there is still unexploited potential for higher growth without any appreciable risk of accelerating inflation.

Whatever the causes underlying unemployment in specific countries, it remains true that adjustments to rapidly changing technology and increasingly competitive international markets are made more easily when there is a strong expansion of output. Factors impeding expansion also make

adjustment to dynamic competitive market conditions more difficult. To achieve sustained expansion, Governments still have to find the right balance between stability and growth in the design of their policies so as to ensure that benefits accrue equitably among and within countries. Continued support for the market economy and the system of free trade and payments depends on their finding this balance.

1. Developed market-economy countries

Economic recovery in the industrial economies faltered in 1995, with growth falling from 2.8 per cent in 1994 to 2.0 per cent. Indeed, the current recovery has been slower than during the previous two cyclical expansions, partly because of the priority given to improving fiscal positions, and partly because of the emphasis of monetary policy on containing inflation. For EU countries, fiscal consolidation was determined by the desire to meet the targets set by the Maastricht Treaty. Only in Japan, which was going through an unusual period of prolonged economic weakness, was there a strong expansionary impetus, aimed at lifting the economy out of recession.

Also notable in the present cycle is the failure of real wages to increase in line with productivity and output. While this has been an important factor in keeping inflation low, it has also held back consumer expenditure, which has consequently provided less stimulus to growth than in the past. Profits have been on a rising trend in most countries, but private investment has lagged.

(a) United States

The current expansion of the United States economy, which started in 1991, is now its third longest in the postwar period. Although growth slowed down in 1995 and is expected to remain at moderate levels throughout 1996, economic performance has been markedly better than in most other industrial countries.

Throughout the current expansion, wage increases have remained moderate, and sustained productivity gains, particularly in manufacturing, have contained cost pressures. Price increases in the services sector have also been limited. Consequently, inflation has been well below the levels attained at comparable phases of past business cycles, and is expected to remain below 3 per cent for the fifth year in succession. The government budget deficit has fallen to around 2 per cent of GDP, and the finally agreed budget for the current fiscal year should reduce the deficit to below 2 per cent. If the agreement is implemented in full, it is expected to produce a surplus, net of debt service, for the third year in succession, and reduce the overall deficit to zero by the year 2002.

At around 5.5 per cent, unemployment is the lowest of all the major industrial countries except Japan. In 1995 alone over 2 million new jobs were created, more than offsetting job losses through restructuring, and providing a net addition of jobs that reduced unemployment. Over 50 per cent of jobs created in the private sector during 1995 were in "high wage" industries, where average wages are above the 1993 median wage of all industry.[8] This suggests that the United States has entered a phase of "creative destruction", with the introduction of new technology creating new jobs faster than it is destroying them through corporate restructuring and downsizing.

This adjustment has been greatly helped by the depreciation of the dollar. Despite the turnaround in its trade balance with Latin America after the Mexican currency crisis, exports rose slightly in volume in 1995. The pattern of imports has also undergone marked changes; in particular, imports of automobiles from Japan have been increasingly replaced by output from Japanese transplant factories in North America. The overall trade deficit has thus continued to shrink, reflecting declining imports from Japan and improved balances with Western Europe, China and other Asian countries.

Economic expansion has been accompanied by stronger cyclical fluctuations. After three years of acceleration, growth fell in the first quarter of 1995 by 0.5 per cent on an annual basis, owing primarily to two factors. First, there was a sharp fall in exports to Latin America following the peso crisis. Second, monetary policy continued to be tight, even though growth was slowing down as a result of the impact of inventory accumulation on production. The Federal Reserve continued its policy of what it called "pre-emptive" strike against potential inflationary pressures, raising the federal funds rate in February 1995 with the aim of bringing down the rate of expansion to its estimate of non-inflationary growth potential.[9] However, as employment started falling, the rate was reduced in July and again in December; the economy re-

covered around mid-1995 as exports and consumer spending regained their 1994 levels. But growth in 1995 as a whole was lower than in the previous three years, on the basis of comparable figures.[10] At an average 5.9 per cent, the federal funds rate in 1995 was almost twice that of 1993, while consumer price inflation was lower by about half a percentage point.

At the beginning of 1996 the economy again appeared to be poised on the threshold of a recession. Interest rates were reduced in January and in the event the economy grew by 2.3 per cent in the first quarter. The financial markets nevertheless reacted sharply at the beginning of March to the announcement of an exceptionally large number of new jobs created in February, and pushed long-term interest rates above 7 per cent, as expectations of a further reduction in official rates were quickly transformed into expectations of tight monetary policy.

The rise in long-term interest rates, together with fiscal consolidation, could exert a dampening influence on demand and taper off growth towards the end of the year. The consumer spending spree which has so far been the main expansionary factor cannot continue, as consumer debt as a proportion of personal income is at record levels. The overall outlook for the United States is for growth to remain relatively stable in 1996.

(b) Japan

After four years of stagnation, with annual growth averaging 0.5 per cent, the Japanese economy started to expand in 1995. Expansion accelerated throughout the last quarter of the year, to reach an annual rate of around 3 per cent. There was an even stronger recovery in the first quarter of 1996, to an annual rate of over 12 per cent, the fastest growth in 23 years.

A number of factors explain this faster-than-expected recovery. First, the Government introduced a series of special public spending packages, of which the latest, equivalent to 2.5 per cent of GDP, took effect in September 1995, to boost the economy through public works, land purchases and low-interest loans. Public investment is reported to have risen by 27.2 per cent during the first quarter of 1996 over the same period of 1995, and private consumption and investment by 5.1 per cent and 7.4 per cent, respectively.

A second factor was that the yen continued to decline from its earlier peaks against the dollar, thanks also to concerted intervention by the monetary authorities in both Japan and the United States. The real effective exchange rate was, in mid-1996, more than 20 per cent below the peak of April 1995. The consequence has been a substantial improvement in enterprise profits, as export prices had not been adjusted and cost reduction measures introduced in response to the 1995 appreciation have already started to take effect.

Finally, the discount rate was reduced in September 1995 from 1.75 per cent to a record low of 0.5 per cent. The policy of maintaining a low discount rate has allowed the banking system to earn large intermediation spreads, thereby contributing to removing an important part of bad loans from banks' books. Similarly, it has also helped the corporate sector to restructure its balance sheets, creating room for expansion.

However, there is considerable uncertainty over the prospects for growth in 1996-1997. The recent recovery was from a very low base; there was virtually no growth in the first quarter of 1995. More important, the recovery was based on one of the biggest fiscal and monetary boosts ever introduced in Japan. More recently, a new package was introduced, since the fiscal stimulus from the preceding one appeared to be petering out. The general government budget deficit is expected to exceed 5 per cent of GDP this year, and the Ministry of Finance has already announced that 1997 will be the year in which fiscal reconstruction commences, with measures to reduce government spending and to increase taxation.

Thus, the pace of recovery will depend on the extent to which private demand rises to offset the smaller fiscal stimulus, and that in turn depends much on monetary policy. Inflation should not be a cause for concern. Retail prices continued to fall during 1995, and although the falling value of the yen caused some increase in import prices, wholesale prices were still declining at the beginning of 1996. Real long-term interest rates have been rising since the end of 1995, and by spring 1996 they were approaching those of the United States, which is experiencing rather different domestic conditions. There is concern that tightening would be inappropriate when the prospects for continued economic expansion are so uncertain. Moreover, a rise in interest rates may encourage the reversal of international speculative positions

based on borrowing in yen to invest in higher-yielding dollar assets, thus placing upward pressure on the yen. Furthermore, since there still remains a large stock of unrecoverable loans, particularly in smaller banks and non-bank institutions, continuation of the policy of low interest rates will also be helpful for the stability of the banking system. Finally, the reduction of the trade surplus continues to dampen growth and is expected to continue to do so despite a real depreciation of the yen. In these conditions, private consumption will remain the only possible source of stimulus.

The pace of the current cyclical recovery is thus conditioned by the conflict between fiscal reconstruction, which will reduce demand, and tighter monetary policy, which risks reversing the depreciation of the yen. However, as discussed below (Part Two, chapter I), cyclical policy may not be sufficient to restore Japan to a sustainable growth path with stable employment. Indeed, despite recovery, unemployment is expected to rise in 1996. The challenges facing the country should be seen in the context of a structural adjustment required to move the economy anyway from a dependence on exports for growth that is more appropriate to a developing country toward a more balanced system characteristic of a mature industrialized economy. The Government has recognized the need for measures to shift the focus from external to internal demand, and the recent monetary and fiscal packages have certainly been helpful in addressing this problem. Since neither inflation nor the external balance is a cause for concern, it is important that monetary and fiscal policy continue to be conducted with a view not only to cyclical problems, but also to structural ones.

(c) European Union

Slower growth in the European Union is the primary explanation of the weak performance of developed market-economy countries in 1995. It was the result of a sharp cyclical downturn in Germany and France, and in countries with currencies that remained closely linked to the deutsche mark. This is the second time that recovery in the northern continental European economies has not followed through to sustained expansion. In 1993 expansion in Germany, led by domestic investment, was cut short when United States interest rates were raised and the international bond market collapsed. The recent recovery began with an unexpected expansion in German investment and exports during the autumn of 1994. Although conditions had already started to weaken by the third quarter of 1995, matters were compounded by the rise in interest rates transmitted from United States bond markets.

When trade was the dominant linkage between economies, asynchronous cyclical growth patterns tended to be a force for stability, with expanding economies providing export markets and additional demand for those experiencing a downturn. By contrast, now that international financial markets have become more integrated, the rising interest rates that accompany cyclical expansion are transmitted to countries that lag behind, making their recovery more difficult. This is what appears to have occurred in those continental Western European countries which have lagged behind growth in North America and the United Kingdom.

The German economy started to show signs of weakness early in 1995, and by the last quarter of the year output had flattened out. One reason therefor was that the major construction boom which had been a driving force of the economy after unification had come to an end. Many of the subsidies applied in the western *Länder* have run their course, while in the eastern *Länder* much of the necessary reconversion has been achieved.

Unexpectedly low growth produced a shortfall in government revenues in 1995 and a deficit (3.6 per cent of GDP) that was higher than projected. In order to hit the Maastricht target of 3 per cent, spending will need to be cut over and above what is already planned, and some planned tax reductions postponed. In response to the continued weakness of the economy, the Bundesbank reduced interest rates throughout 1995 and so far has continued to do so in 1996, bringing the discount rate to an unprecedentedly low level of 2.5 per cent in April. As noted, this has not prevented domestic long-term interest rates from rising alongside world interest rates; in real terms they are higher than in both the United States and Japan. Given the importance of long-term rates in the financing of investment, the impact of the action by the Bundesbank has been limited. The Bank has been reluctant to reduce rates while monetary growth remains outside the desired range, despite the fact that: output has been declining; capacity utilization is below both the long-term average and the peak experienced at the height of the reunification process; the average rate of monetary expansion over the last two years has been only 4 per cent; it is generally agreed that the buildup of

M3 does not represent potential inflationary pressure; and the inflation rate seems to have stabilized at around 1.5 per cent.

Given these policy restraints, the economy will depend on private consumption and on exports for recovery. With unemployment at 4 million, consumers are cautious and building up their savings. Export expansion will depend on movements in exchange rates and labour costs, both of which are now adjusting rapidly. While these elements of adjustment should be enough to avoid recession, further monetary relaxation will be needed in order to offset the effect of the restrictive fiscal policies and provide cyclical support to the economy.

The weak performance of the German economy has slowed down growth not only in EU countries closely tied to it through the European Monetary System, such as Austria, Belgium, Luxembourg, the Netherlands and France, but also in other countries of the Union such as Italy and the United Kingdom, which had achieved export-led growth as a result of currency depreciation when they suspended their participation in EMS in 1992.

As in Germany, slow growth in France increased the cyclical fiscal deficit, pushing it to 5 per cent of GDP. Plans have been announced to make deep budget cuts in order to meet the convergence conditions for the third stage of European monetary union, but the overall deficit is expected to remain in the region of 4 per cent. The Bank of France has followed closely the policy of the Bundesbank and been able to reduce the differential for short-term interest rates substantially, virtually eliminating it for long-term yields. This success has been interpreted in financial markets as an indication that the third stage of European monetary union will embrace at least France and Germany. Inflation has remained around 2 per cent, excess capacity is still high and there is no evident pressure on wages or demand. Thus, as in Germany, there are certainly no supply constraints on expansion.

In Italy and the United Kingdom the contrast with most other EU countries reflects in part the increased competitiveness gained through their exit from EMS in 1992. Both countries managed to keep inflation stable despite very large devaluations. However, in both countries the rate started to rise in 1995 and steps were taken to tighten monetary policy. Interest rates in the United Kingdom were increased early in the year, and in Italy the increase was even greater. Demand slackened quickly in the United Kingdom and inflation remained broadly in line with government targets, permitting a more expansive monetary policy by the end of the year. In Italy inflation fell back from peaks of around 6 per cent, but at mid-year was still above the 4 per cent target set by the central bank. Output growth fell in both countries to an annual rate of about 2 per cent by the end of the year. It is expected to stabilize around that level in the United Kingdom, while in Italy it is expected to continue to decline as the Government continues to generate primary budget surpluses of 2-3 per cent of GDP.

The EU member countries continue to face a challenge posed by the approaching deadline for the third stage of monetary union, which has made fiscal retrenchment the order of the day. All the major continental European countries have announced additional expenditure cuts designed to bring their deficit down to the target of 3 per cent of GDP. For most countries, however, achieving this target is rendered doubly difficult, since their current expenditures are automatically rising and their tax receipts falling as a result of the fall in their growth rates and the rise in unemployment. Simulations for France suggest that a 1 percentage point improvement in the budget deficit ratio would bring about a 1 percentage point reduction in GDP growth from the baseline forecast.[11] If this relationship is correct, and were to hold generally, it implies that policies aimed solely at achieving budget deficit targets would bring growth to a temporary halt. It thus provides a rough indication of the burden that would fall on other policies (in most countries primarily monetary policy) in order to ensure that growth continues.

Aside from country-specific factors, the failure to sustain recovery has been to a large extent due to the decision to use fiscal policy to assure convergence to the conditions set down for the third stage of monetary union, while not easing monetary policy sufficiently to offset the effect of fiscal reductions. When growth is sluggish, budget deficits tend to rise due to cyclical factors, and greater deficits tend in turn to act as an automatic stabilizer. Under such conditions, attempts to raise taxes or to lower spending would eliminate the normal automatic stabilizing properties of the budget, thereby depressing growth and raising budget deficits further, and necessitating additional cuts to meet the criteria. A more active use of monetary policy in support of growth would help countries avoid such dangers.

A further policy dilemma confronts member countries where very high interest rates are being used to combat inflation, but where interest payments account for a large part of the public sector deficit. In such a situation there is a potential conflict between measures needed for meeting the inflation target (high interest rates) and those that would help meet the deficit requirement (lower interest rates).

As can be seen from the above, meeting the convergence conditions in accordance with the established schedule for the third stage of monetary union constitutes a formidable challenge for EU member countries. It is consequently hardly surprising that questions have been raised in some quarters as to whether flexibility will be needed in determining whether the convergence conditions have been met and in fixing the date for the start of the third stage, or in respect of both of these questions. Success, however, depends on meeting the challenge. This in turn, requires that, within the context of national strategies for achieving the targets, all policies be geared toward supporting growth. As mentioned above, in some countries there is now a strong case for adjusting monetary policies to that end.

Conditions are likely to improve during 1996 as currency adjustment and growth in the United States sustain exports from EU and other Western European countries. But any sustained recovery will depend importantly on the response of monetary policy to the deflationary fiscal restrictions as countries attempt to qualify for the third stage of monetary union, scheduled for 1999.

2. Latin America

The impact on international financial markets of the Mexican crisis of December 1994 was speedily contained through rapid adjustment measures by the Mexican Government and an international rescue operation led by the United States and IMF which prevented the collapse of the peso from spreading into a possible major global financial crisis. In sharp contrast to the prolonged financial difficulties following the Mexican crisis of 1982, Mexico and other Latin American countries had all returned to the financial markets by the autumn of 1995, notwithstanding a sharp fall in capital flows in most instances.

However, the consequences of the crisis for the region's economic performance have been much more serious. Net capital flows to the region fell sharply, and for the first time since the early 1990s the region as a whole ran a trade surplus and made a net resource transfer abroad; according to some preliminary estimates by ECLAC, net capital inflows in 1995 were around $22 billion, while net payments of profits and interest were almost $40 billion.[12] After a relatively strong upsurge in economic activity in the region which began in 1991, growth fell to 0.7 per cent in 1995 from 4.9 per cent in the preceding year (see table 1).

The financial crisis affected the countries of the region in different degrees, and variation in performance has widened significantly. In Mexico, output fell 7 per cent, exceeding even the relatively pessimistic forecast made by the UNCTAD secretariat in *TDR 1995*. Urban unemployment reached 6.4 per cent.[13] As a result, per capita income returned to pre-1980 levels. The swing in output was equally large in Argentina, where GDP fell by 2.5 per cent, after increases of over 7 per cent in previous years, and unemployment rose to 18.6 per cent.[14] Uruguay was also affected, through its close economic links with Argentina, with output declining by 1.5 per cent, after a 5.1 per cent growth in 1994.

Growth slowed down in a number of other countries not because of reduced capital inflows and a tightened payments constraint, as in Argentina and Mexico, but because the Mexican crisis laid bare the risks involved in relying on capital inflows to finance large and widening external deficits brought about by surges in consumption and imports. Since the priority given to inflation ruled out large-scale devaluations, countries such as Brazil, Colombia and Peru adopted tight monetary policies in order to moderate growth and bring external deficits to sustainable levels. Consequently, inflation was lower almost everywhere, including Brazil, which succeeded in bringing the rate down to around 20 per cent per annum in 1995 from more than 20 per cent per month in previous years; a notable exception, however, was Mexico, where the sharp devaluation resulted in a substantial increase in the price level.

Growth was lower in all the major countries except Chile, where GDP rose by 8 per cent, as its trade balance improved on account of the exceptionally favourable evolution of world prices for its exports. Chile has thus been able to sustain, over some 12 years, an average growth rate approaching that of East Asia while bringing inflation

down to single-digit rates. Central American economies, too, were able to maintain or increase their growth rates in 1995, on the basis of gains in exports and increased investment.

In both Mexico and Argentina the improvement in payments positions was due primarily to exports. The swing in the trade balance of Mexico from 1994 to 1995 of over $25 billion resulted mainly from a 33 per cent increase in export revenue brought about by a sharp fall in the external value of the peso and in domestic demand. Exports from Argentina likewise rose substantially; while the exchange rate was fixed in nominal terms against the dollar, the real effective exchange rate fell in 1995, thanks to low inflation in Argentina relative to its trading partners, the weakness of the dollar and a large appreciation of the *real* in Brazil, its main trading partner in MERCOSUR. The higher export revenues were due to increases in both prices and volume; import demand was buoyant in some countries of the region, especially Brazil, and there was a good agricultural harvest. By contrast, for the first time in many years Brazil ran a trade deficit in 1995, in spite of a number of measures taken to deal with the worsening payments position, including reintroduction of tariffs on some consumer durables. As capital inflows revived in 1995, exerting upward pressure on the currency, a number of measures were introduced to slow them down (see Part One, chapter II). However, with the tightening of monetary policy to slow down the economy, real interest rates shot up, reaching almost 40 per cent, providing an additional stimulus to capital inflows. Consequently, net capital inflows were double those of 1994. With the continued use of the nominal exchange rate as an anchor, the result was a real appreciation of the currency and a widening of the external deficit. The balance of payments also worsened in Colombia and Peru.

The payments crises have brought into the open macroeconomic fragility in two areas extensively discussed in *TDR 1995*: fiscal balances and the financial system. In countries where the removal of external constraints in the early 1990s had made a major contribution to fiscal consolidation, budget imbalances re-emerged with the turnaround in the payments position, contraction in economic activity and/or currency devaluations. These difficulties were often aggravated by financial problems. The financial sector has been the most fragile element in Latin American adjustment, not only because of the severity of deflation and very high real interest rates, but also because unsustainable external payments positions were closely associated with unsustainable external balance sheet positions of firms in many sectors. In Mexico, high interest rates, deflation and a sharp devaluation caused widespread financial difficulties, particularly as the exchange-rate risk passed on to bank borrowers rapidly became an increased credit risk. In Argentina, loss of dollar deposits and the rise in interest rates created serious problems for banks by bringing about a sharp reduction in domestic reserves. Government support was necessary; however, there was no formal institutional arrangement for a lender-of-last-resort role by the central bank. A series of ad hoc measures which circumvented the limitation on money creation consequently had to be introduced in order to provide short-term liquidity to the economy. The measures included creation of a private bank restructuring trust fund, financed by $2 billion of government bonds and a $500 million IMF loan.[15] Similarly, in Brazil both financial rescue operations and the rising interest burden of government debt played an important role in the sharp deterioration of the public finances.

The short-term growth prospects for Latin America are for some improvement, with some positive growth in Mexico and Argentina and moderate growth in Brazil. In Chile there is expected to be some slowing down of growth; the recent decline in copper prices may lead to some worsening of the external payments position, since copper accounts for over 40 per cent of export earnings. Again, concern over increasing budget and payments deficits may lead to slower growth in Colombia and Peru. However, as discussed in greater detail in *TDR 1995*, the fundamental question of how to maintain both price stability and a sustainable payments position while growing steadily at rates high enough to reduce poverty and catch up with more advanced countries appears to remain unresolved in much of the region.

3. Developing Asia

At the other extreme of the growth spectrum was China. At 10.2 per cent, growth in 1995 in China was at a double-digit level for the fourth consecutive year. Nevertheless, it was significantly lower than in previous years, because of contractionary macroeconomic policies designed to maintain growth at sustainable rates, as well as to

correct internal and external imbalances. China's continuing integration into the world economy is starting to influence regional trade patterns. For example, strong domestic demand continued to draw in imports from neighbouring economies, especially Taiwan Province (via Hong Kong). As a consequence of this entrepôt trade, Hong Kong has replaced the United States as Taiwan's leading trading partner.

Strong export growth and constrained import demand, aided by the substantial depreciation of the currency, which initially was as much as 40 per cent, turned the 1994 trade deficit into a substantial surplus in 1995. The fast growth of exports was accompanied by further diversification into manufactures which, however, still consist mainly of low value-added items such as toys, textiles, footwear and apparel.[16]

Inflation remains high; retail prices have risen at double-digit rates since 1993, peaking at 21.7 per cent in 1994 before falling to 14.8 per cent in 1995.[17] The stabilization programme, initiated in mid-1993, consisted primarily of measures to slow the growth of the money supply and of administrative controls on prices aimed at keeping the budget deficit within manageable limits and strengthening controls on investment.[18]

While other Asian developing countries as a whole did not match the performance of China, their 6.3 per cent average growth rate was roughly double that of the best achieved by the industrialized countries and slightly higher than the 5.1 per cent attained in 1994.[19] There was, however, much variation at both the subregional and the country level. For the newly industrializing economies (first-tier NIEs), the average increase was slight, from 7.5 per cent to 7.7 per cent; only in the Republic of Korea was there any acceleration of growth (from 8.4 per cent to 9.2 per cent), mainly because of a sharp recovery in agriculture. In the other three economies there was a slight deceleration. In contrast, all countries of ASEAN-4 and most countries in South Asia were able to maintain or even accelerate their rates of growth.[20] The fast-growing economies of East and South-East Asia, in particular those of ASEAN-4, have succeeded in sustaining high and rising rates of domestic investment, and Hong Kong and Singapore have become net exporters of capital. In 1995, the share of gross domestic investment in GDP was around 40 per cent in Indonesia, Malaysia and Thailand, and that of domestic savings about 35 per cent.[21] As examined in greater detail in Part Two below, for ASEAN-4 in particular, inward foreign direct investment has been accompanied by the relocation of production from Japan and the first-tier NIEs in response to the appreciation of the yen and rising wage costs in the latter countries.

Trade, especially imports, continued to be very buoyant, reflecting high investment in infrastructure and its concomitant demand for capital goods. For the fourth consecutive year not only did import growth in the region exceed that of exports, but also it generally exceeded world import growth by a wide margin. The expansion of imports slowed down during the year, reflecting in the main slower economic expansion in Indonesia and Singapore.

With the exception of Viet Nam, government budgets in most countries have remained in broad balance. Hong Kong, Singapore and Thailand, for example, have had budget surpluses for several years and a number of other countries for the past two years. The achievement of budget balance by the Philippines, despite a heavy burden of debt service, is particularly worthy of note.

In some countries, such as the Republic of Korea, Indonesia, Malaysia, Thailand, the Philippines and Viet Nam, rapid income growth has generated inflationary pressures. Widening deficits on invisibles account due to debt service and payments related to foreign direct investment have increased current-account deficits,[22] which in Malaysia and Thailand reached 10 per cent and 8 per cent of GDP, respectively, raising concern about their sustainability. In Singapore, on the other hand, there was a further significant improvement in the current-account balance. Tighter monetary policies have been initiated by a number of countries to correct these growing internal and external imbalances. Monetary policies have been the primary instrument used to dampen inflationary pressures, although the levels of inflation (ranging from 4 per cent to 15 per cent) were relatively low.

Maintaining tight monetary policy became more complicated in several countries because large inflows of short-term funds attracted by high domestic interest rates relative to international rates generated excessive growth of the money supply.[23] A variety of measures, including higher reserve requirements for banks, direct restrictions on credit, and controls to limit financial inflows, were instituted in some cases. While the outcome has been

varied, the most positive results have been achieved by Malaysia. In some countries, such as the Republic of Korea, policies took the form of measures to restrict the foreign investment plans of conglomerates *(chaebols)* by requiring that 20 per cent of the financing be raised domestically.

The export competitiveness of developing countries in Asia was much enhanced by the appreciation of the yen during the first half of 1995 (subsequently reversed, however, as noted below), the effects of which were most evident in the Republic of Korea, Japan's leading trading partner. In that country total export earnings rose by almost one third in 1995, more than twice the already fast pace of increase achieved in 1994. Exports to the developing countries in the region also expanded rapidly. Exports to developing countries in Asia accounted for about 18 per cent of total exports in 1993, up from 10.4 per cent in 1980 and 11.2 per cent in 1990. Moreover, those countries were becoming important markets for exports from Japan, and not only in their capacity as production bases for Japanese firms. Rising consumption has also made those markets attractive to Japanese exporters.

In South Asia, the economic reforms being implemented by various countries succeeded in varying degrees in accelerating export growth, attracting more FDI, enhancing foreign exchange reserves and reducing inflation. Outstanding was the continuation of recovery in Pakistan from the three years of slow growth associated with the devastation of its cotton crop; growth was 4.7 per cent in 1995, after 3.8 per cent in the previous year. In most countries of the subregion, however, investment seems to have been stagnating. In India and Pakistan, where investment had stabilized at a relatively high level, large fiscal deficits continued to prevail in spite of efforts to increase revenue through major tax reforms and restrictions on government expenditure. In both countries exports rose sharply. Likewise, in Bangladesh and Sri Lanka, which rely heavily on garments exports, revenues from this source rose by 20 per cent and 35 per cent, respectively, in 1995. However, as in East Asia, the rise in the import bill in both countries was even greater. Several of the smaller countries, including South Asian LDCs, also recorded fast export growth, though generally from a low base in view of their concentration on a limited number of export commodities.

In general, the economic performance of India continued to be strong in 1995. GDP grew at some 6 per cent as the monsoons remained favourable for the eighth successive year. The run-up to the general election of mid-1996 was accompanied by a pause in efforts to strengthen ongoing reforms as well as in the initiation of new ones. In particular, while the regime of administered prices reduced inflation, it resulted in a larger fiscal deficit. The second half of 1995 was marked by turbulence in the foreign exchange and domestic money markets which was countered through the implementation of several short-term policies.

Output in West Asia recovered in 1995, following the mild recession of the previous year. Higher oil prices and earnings helped ease fiscal and external imbalances and contributed significantly to the economic recovery. Declining oil prices in previous years had led to sharp cuts in government expenditure, prompting efforts to rationalize investment and diversify production which are now beginning to bear fruit. Some countries in the subregion, notably Iraq, Kuwait and Yemen, continued to be adversely affected by the aftermath of the 1991 Gulf War. United Nations sanctions on Iraq, and the unsettled political relations between Iraq and other countries, seriously disrupted domestic economic activity as well as trade and financial flows. On the other hand, progress in the peace process in the Middle East played a part in stimulating new investment and reconstruction. For example, as a result of its peace treaty with Israel, Jordan has witnessed an increase in private investment as well as in earnings from tourism.

4. Africa

Growth in developing countries of Africa in 1995 exceeded that of the developed countries, reaching a record for the decade of 2.8 per cent, only slightly below population growth. Most countries enjoyed high rates of expansion, which in several instances reached or exceeded 5 per cent. Contributing factors were primarily the relatively favourable external conditions and improved domestic policy environments and, in some cases, increased political stability.

Export earnings of the region are estimated to have risen by over 10 per cent, or more than double the rate recorded in 1994. While much of the increase was accounted for by higher export prices, the volume of exports also appears to have risen, after a year of stagnation. Higher prices

benefited mainly exports of petroleum, minerals, metals and agricultural raw materials. As regards tropical beverages, prices of coffee and cocoa averaged only slightly above their 1994 levels and even started to weaken noticeably during the year, while tea prices fell substantially.

The recovery of oil prices resulted in an increase of 10.5 per cent in the export earnings of oil-exporting countries of the region in 1995, reversing the decline in the previous year. Similarly, the relatively larger increase in the prices of minerals, ores and metals than those of other primary commodities stimulated mining exports in Zimbabwe, whereas Zaire and Zambia were unable to take full advantage of this price trend because of supply conditions. Revenues from tourism also increased in 1995 in a number of countries, including Egypt, Kenya, Tunisia, Uganda and Zimbabwe.

Following renewed competitiveness when the CFA franc was devalued in January 1994, recovery continued in most countries of the franc zone.[24] The devaluation not only led to greater flows of private and official resources, but also enabled the participating countries to take full advantage of favourable market conditions for their exports of primary commodities. In Côte d'Ivoire it also resulted in higher investment and manufacturing output. On the whole, progress in the western part of the franc zone was more rapid than in the central part.

Drought in sub-Saharan and northern Africa led to a decline in the GDP of Morocco, Zambia and Zimbabwe. The drought in Morocco, the third in four years, resulted in a widening of the budget and current account deficits as well as in higher inflation. Some countries, such as Angola and Mozambique, enjoyed relative stability after years of civil and political conflicts. GDP growth in Angola amounted to 4.0 per cent in 1995, in contrast to a decline of 5.9 per cent in the previous year.[25] On the other hand, social unrest, civil strife or political crises continued to disrupt production and other economic activities and impede reforms in various countries, including Algeria, Burundi, Rwanda, Sierra Leone, Somalia and Sudan. Output in Sudan, for instance, fell by 2.8 per cent in 1995, after an increase of 1.7 per cent in 1994. Political instability, more than any other factor, has been responsible for the poor economic performance of both Nigeria and Zaire in recent years. In Zaire, GDP declined by a further 2.3 per cent in 1995, having fallen by 7.4 per cent the year before.

During 1993-1995 FDI and other private capital flows to sub-Saharan Africa as a share of GDP amounted respectively to only 0.9 per cent and 0.1 per cent, compared to 1.1 per cent and 2.0 per cent for Latin America and as much as 3.1 per cent and 2.5 per cent for East Asia.[26] In 1995, the flow of FDI and portfolio investment to sub-Saharan Africa (excluding South Africa) declined by $1.2 billion. In addition, such flows (which include flows to oil-producing Nigeria) remain heavily biased in favour of the energy and mining sectors in a few other countries, such as Algeria, Nigeria and Tunisia.

In many countries, import bills were swollen by higher grain prices, diverting scarce foreign exchange resources from other uses. Food shortages persisted in drought-affected areas, especially in the Sahel countries. Moreover, as noted above, recent trends in commodity prices suggest that the recent price recovery may be coming to an end for many of the commodities exported by the region.

5. Central and Eastern Europe

Economic performance generally improved in Central and Eastern Europe[27] in 1995, with most countries experiencing higher rates of output growth or smaller declines than in 1994. For the region as a whole output declined by 2.6 per cent, which was substantially below the 10.1 per cent decline in 1994. There was, however, greater variation among countries in 1995, reflecting differences in initial conditions and in the degree of progress achieved through the use of different strategies, economic policies and market reforms to deal with specific problems and difficulties. Particularly noteworthy was the acceleration of growth in Central Europe to 5.3 per cent from 4.0 per cent in 1994. In the Baltic States growth averaged less than 1 per cent, as in the previous year. Output in CIS continued to decline, at an average rate of only around 5 per cent, against almost 15 per cent in 1994.[28]

Recovery is now well under way in a number of Central European economies. With the exception of Hungary, where growth fell to 2.0 per cent in 1995 from almost 3 per cent in 1994 because of demand restraints aimed at correcting large macroeconomic imbalances, output in countries members of the Central European Free Trade

Agreement (Czech Republic, Hungary, Poland and Slovakia) rose at rates varying from 5 per cent to 7 per cent, primarily on account of domestic demand expansion. With moderately accelerating rates of growth in the past two or three years, these countries constituted the core group which has been both leading and pulling ahead of other European countries in transition toward a market economy. There was a remarkable acceleration of growth in Albania and Romania, where the rate almost doubled, to reach over 13 per cent and 7.0 per cent in 1995, respectively. In Romania, however, this achievement was at the cost of excessive expansion of bank credit, rising inflation, declining external reserves and a growing current-account deficit, necessitating corrective macroeconomic policy measures. Also worth noting was the recovery in Yugoslavia following implementation of the February 1994 programme to end hyperinflation. For the other Central European countries for which data are available output declined only in Croatia and The former Yugoslav Republic of Macedonia.

Although trade among the Central European countries is beginning to revive, they still depend mainly on the major EU markets for their exports. Despite slow growth of those markets, most of the countries continued to enjoy high export growth in 1995 at an average estimated rate of 28 per cent, exceeding the growth of world trade for the third consecutive year. However, despite good export performance, both trade and current-account balances deteriorated as their increase in imports was about one third higher than that of exports. The current deficit of an estimated $9 billion was more than offset on capital account by a net capital inflow of over $31 billion, which was triple the net inflow ($10 billion) of the previous year.

By contrast, intra-CIS trade has shown no tendency to rise. However, while the degree of openness of those economies is less than in Central Europe, their good export performance equalled that of the latter countries in 1995. In the Russian Federation, there was an increase in the current account surplus of some $10 billion in the first three quarters of 1995 over the same period of 1994, due entirely to increased merchandise exports.

The transition process in the Baltic States so far has advanced more slowly than in most of Central Europe, reflecting their later start in the process of systemic transformation and the more difficult initial conditions stemming from the need to adjust to changes in their economic relations with the other former Soviet republics. Economic recovery continued during 1995 in Estonia and Lithuania, but at a modest pace, whereas Latvia suffered a setback partly because of a major crisis in the banking sector.

There was considerable variation in 1995 in economic performance among the CIS members. For example, whereas Armenia and Georgia had positive GDP growth rates, elsewhere output continued to fall, by as much as 10 per cent or more in Azerbaijan, Belarus and Ukraine, because of delays in policy implementation or because those policies which had been implemented have not yet had time to exert their full effect. Nevertheless, progress with stabilization during 1995 arrested the steep declines in output in a number of countries, most conspicuously in the Russian Federation, which accounts for some 70 per cent of total CIS output. After several false starts, Russian economic stabilization policy appears to be achieving some success; the decline in output was sharply reduced, from nearly 13 per cent in 1994 to only 4 per cent in 1995.

Closely associated with the economic recovery in 1995 in the majority of all these Central and Eastern European transition economies was a sharp decline in the rate of inflation. In most countries, the rise in both consumer and producer prices was smaller than in the previous year, the principal exceptions being Yugoslavia, which failed to consolidate the success of its 1994 stabilization programme, and Tajikistan, where high inflation again set in. In Hungary also the inflation rose, following the introduction of a stabilization programme in March 1995 which included a sharp currency devaluation and an import surcharge imposed to counter the effects of a high import intensity of consumption. In some countries, the fall in the inflation rate was dramatic.[29] Inflation was also lower in most countries of the CIS, where it had continued to accelerate in 1994. However, in most of these countries it continued to be in double, and in a number of cases even in triple, digits. Inflation also has remained high (25-40 per cent) in some of the Central European economies, but in a number of them the annual rate had fallen below 10 per cent by the end of 1995.

There were notable differences both in the policy adopted towards price stabilization and in the determinants of the process. In Hungary, Poland, Romania and the Baltic States, as well as in

some countries which have advanced further down the path of transformation and where progress has been facilitated by relatively stable nominal exchange rates and strong gains in labour productivity, it is proving difficult to bring inflation below the current annual rate of 25-40 per cent. On the other hand, in the CIS, national experience appears to be similar to that of countries which had initiated macroeconomic stabilization earlier. The results were encouraging in most cases, although price stability is still far from having been achieved. The stabilization programme introduced in the Russian Federation in 1995 has attracted considerable attention regarding both its design and the instruments used for its implementation. In order to conform to the conditionality of the standby loan of $6.25 billion accorded by IMF and in view of the monitoring of the economy by the Fund, tight fiscal and monetary measures were taken to maintain relative stability of the rouble, including the introduction in July 1995 of a trading band of 4,300-4,900 roubles to the dollar (i.e. the exchange rate would be allowed to fluctuate within these limits). As a consequence, the pressure on import prices was considerably eased, while exports became less competitive.

Despite the progress so far achieved, output in all countries is still significantly below levels that prevailed before the breakup of the USSR. For Central and Eastern Europe as a whole in 1995 it was less than 65 per cent of the 1989 level. The extent of decline, however, varies significantly among the three groups of countries, ranging from 15.2 per cent for Central Europe to 53.4 per cent for the Baltic States. For the countries of CIS, the loss of output in 1995 amounted to nearly 44 per cent (in other words, output was some 56 per cent of its 1989 level), reflecting primarily conditions in the Russian Federation, where output was 40 per cent lower than in 1989.[30] Only in Poland was output in 1995 anywhere near former levels.

C. Short-term outlook

The slowing down of growth in the world economy is likely to continue during the remainder of 1996. The volume expansion of world trade growth is expected to fall to a rate of around 7 per cent for the year as a whole, compared to 8.0 per cent in 1995, but trade will thus continue to increase faster than output. The bright point in the short-term outlook is the continued resilience of developing countries to external shocks, including the stagnation in a number of industrialized economies, and their ability to maintain recent trends in the growth of both their output and their trade. However, the crisis of the Mexican peso is a reminder of the risks posed by the volatility of international capital flows.

While growth in the United States is expected to be at much the same rate as in 1995, expansion in Japan is likely to slow down after the high growth of the first quarter, and EU is unlikely to see the much-expected recovery in 1996. Growth in the developed-market economies will probably again be smaller than in 1994 and may not even reach the 2.0 per cent achieved in the preceding year. Growth in the European Union will be more than 1 percentage point lower than in 1995, at around 1.3 per cent, on account of the halving of the rate in Italy and France and a much sharper drop in Germany; in the latter country, recovery will only arrive late in the year, keeping the annual rate for 1996 around 0.5 per cent. Inflation, which was once the constraint on faster expansion, continues to remain at historically low levels, even in those countries where growth has been faster than was considered compatible with wage and price stability.

Among the developed market economies, only the United States and the United Kingdom have been able to combine wage and price stability with falling unemployment. Elsewhere in Western Europe, levels of unemployment have surpassed those of the Great Depression and will continue to rise if the growth of the economies is no faster than is

indicated by short-term forecasts. There has consequently been a weakening of support for monetary union among those who, rightly or wrongly, attribute job losses to the implementation of policies required to achieve the convergence conditions for the third stage. As highlighted in *TDR 1995*, there is also the risk that growing imports from developing countries will likewise be blamed for job losses and lower real wages, especially in relatively low-skill occupations, where output competes directly with imports. High unemployment thus risks increasing resistance to policies directed toward achieving important objectives - monetary union in Europe and the full integration, through trade, of developing countries in the world economy.

In the developing countries as a whole there is expected to be a slight acceleration of growth in 1996. Although the expansion in Asia will be marginally lower than last year, a somewhat faster rate of recovery is expected in Latin America. As a result of strong expansion in some African countries, the African region is expected to see an increase in GDP per capita for the first time since 1985. The international environment should be favourable to such an outcome, as non-oil commodity prices are expected to remain relatively firm. In addition, good rainfall has generally returned to northern and southern Africa and good harvests are predicted for 1996 throughout the continent. In several countries efforts will continue towards reconstruction and restoration of political stability after long periods of civil and political turmoil. However, as always, for most countries the outcome will depend greatly on fluctuations in commodity prices, weather, demand in developed market economies, political stability and policy reforms.

Economic performance in Latin America is expected to improve somewhat, although growth is not likely to reach 3 per cent. Policy will focus on strengthening the financial sector and restoring capital inflows, while continuing the liberalization process. Further progress is expected in lowering inflation and in reducing trade and fiscal imbalances. Chile, Colombia and Peru should continue to grow quite rapidly, while Brazil may experience a slowdown as a result of high real interest rates. The adverse effects of the Mexican foreign exchange crisis will continue to affect performance in Argentina, Mexico, Uruguay and Venezuela. Argentina is still suffering from high unemployment despite signs of recovery and a revival of confidence in its banking system. In Mexico itself, the severe difficulties faced by the banking system remain to be resolved and continue to constrain recovery.

Growth in Asia is expected to moderate slightly in 1996, primarily because of the need to implement anti-inflationary policies in response to overheating in several countries. Investment will continue to be an important source of growth. In addition to the continuation of the trend in the flow of FDI in recent years, greater public investment to relieve bottlenecks in infrastructure will be undertaken in several cases, notably Hong Kong, Indonesia, Malaysia, Singapore and Thailand. Despite the reversal of the yen appreciation of early 1995, exchange rates are likely to remain at competitive levels and structural reforms to promote exports will continue. However, there is increased concern over the sustainability of large current account deficits in South-East Asia, particularly with the slowdown of exports in recent months.

Early in March 1996, the Eighth National People's Congress of China approved the country's ninth five-year economic plan (1996-2000), which includes the following major targets for 1996: GDP growth of 8 per cent, an inflation rate of 10 per cent, and fixed investment corresponding to 32 per cent of GDP. The Government recognizes the need for close vigilance in macroeconomic policy in order to safeguard and extend the results of stabilization. In the external sector, further liberalization will take place as the country seeks to become a member of the World Trade Organization. It is likely that the growth target will turn out to be pessimistic, as often happened in the past. Provided that macroeconomic policy stays on course and inflation remains under control, the outcome may well be a growth rate of 9 per cent.

In Central and Eastern Europe growth is expected to be positive in 1996, after what appears to have been a bottoming out in 1995. Significant macroeconomic imbalances, however, will continue to persist in all countries. Inflation, though lower, can be expected to persist, generally at relatively high levels, since bank credit and money creation are still being used to finance a significant proportion of government expenditure. 1996 may well be the year in which output begins to revive in the Russian Federation after successive years of major declines. The convertibility of the rouble could prove to be a key element in this respect. Given

the size and importance of the Russian economy, expansion in that economy will, in turn, provide significant support for the recovery of other countries in the group.

D. Uncertainty in short-term forecasting

With the increasing globalization of the world economy, countries have become increasingly interdependent, both within and outside their own regions, in terms of trade, investment and financial flows. Economic forecasting for a given country consequently involves making judgements with respect to the direct and immediate impact of economic variables in the country on those of economies to which it is closely linked. Moreover, the nature of these linkages appears to have undergone some change in so far as some shocks or repercussions are now apparently transmitted at a relatively greater speed than previously.

These considerations are reflected to a large extent in table 4, which compares forecasts of GDP growth for 1995 given by various international organizations and research institutions for selected OECD countries with the actual outcome. On the whole, the earlier the forecast was made, the more optimistic was the outlook. (Compare, for example, the predictions of OECD published in December 1994, or those of the United Kingdom's National Institute of Economic and Social Research in February 1995, with most of the others in the table, which were made later in 1995.) Most forecasts even failed to anticipate the slowdown of economic activity in Germany, France and other EU countries, of which there were clear indications by the second half of the year.

The actual rate of GDP growth of 2.0 per cent in the United States in 1995 is in principle not directly comparable with the predictions given in the table because of a change in the method of computation.[31] Nevertheless, even allowing for this change, all the forecasts for the United States, except those of the UNCTAD secretariat and project LINK, proved to be too optimistic, as were also all the forecasts for the United Kingdom, Germany and France. Only for Japan and Italy was the actual outcome within the range of the forecasts.

A similar degree of uncertainty is discernible with respect to forecasts by the same institutions for 1996. As can be seen from table 5, the projections of OECD and EU, both of which were made toward the end of 1995, are distinctly more optimistic than all the others. Among the others, there is a clear convergence of forecasts only for the United States, where expectations of recovery and expansion of output are firmer, as they are also for the United Kingdom.

There is also substantial discrepancy among the later forecasts for Germany, which range from 0.5 per cent (UNCTAD) to 2.0 per cent (LINK), reflecting differing perceptions of the current economic situation with respect to likely consumer behaviour or exchange rate movements. Partly because of close ties with Germany, the forecasts for France are in a similar range (0.9-1.6 per cent), while in Japan, they range from 1.5 per cent to 2.7 per cent because of uncertainties regarding the impact of the packages of measures successively introduced to stimulate the economy. The greater interdependence and closer linkages within and among groups of countries imply that errors of prediction are likely to be highly correlated, particularly in respect of forecasts for EU countries.

Table 4

GDP GROWTH IN SELECTED OECD COUNTRIES IN 1995: COMPARISON OF ACTUAL GROWTH WITH FORECASTS BY VARIOUS INSTITUTIONS

(Percentage)

Country	LINK (April 95)	ECE (June 95)	OECD (Dec. 94)	OECD (June 95)	EU (April 95)	IMF (May 95)	NIESR (Feb. 95)	NRI (May 95)	UNCTAD (June 95)	***Actual***
United States	2.8	3.0	3.1	3.2	3.2	3.2	3.5	3.3	2.7	2.0
Japan	1.2	2.5	2.5	1.3	1.6	1.8	0.8	0.7	0.5	0.9
Germany	2.9	3.0	2.8	2.9	3.0	3.2	2.8	2.8	2.5	1.9
France	3.2	3.0	3.1	3.0	3.1	3.2	2.8	2.7	2.5	2.2
Italy	2.8	3.0	2.7	3.0	3.3	3.0	3.4	2.6	3.0	3.0
United Kingdom	3.0	3.0	3.4	3.4	3.1	3.2	3.5	2.8	2.8	2.4

Source: Table 1 for actual growth rates; *TDR 1995*, table 4, and *OECD Economic Outlook*, June 1995, for forecasts.

Table 5

ALTERNATIVE FORECASTS OF GDP GROWTH IN 1996 FOR SELECTED OECD COUNTRIES

(Percentage)

Country	*LINK*	*ECE*	*OECD*	*EU*	*IMF*	*NIESR*	*NRI*	*UNCTAD*
United States	2.0	2.0	2.7	2.3	1.8	2.2	2.0	2.2
Japan	2.0	2.0	2.0	2.3	2.7	2.4	1.5	2.1
Germany	2.0	1.0	2.4	2.4	1.0	1.0	0.8	0.5
France	0.9	1.5	2.2	2.4	1.3	1.6	1.2	0.9
Italy	2.2	2.0	2.5	3.0	2.4	1.4	2.1	1.5
United Kingdom	2.2	2.0	2.7	2.7	2.2	2.4	2.0	2.2
Memo item:								
Total OECD	2.0[a]	2.0[b]	2.8	2.6[a]	1.8[a]	2.1	1.9	1.9

Source: United Nations, University of Pennsylvania and University of Toronto, "Project Link World Outlook," (mimeo), post-LINK meeting forecast (May 1996); ECE, *Economic Survey of Europe in 1995-1996* (United Nations publication, Sales No. E.96.II.E.1); *OECD Economic Outlook* (December 1995); Commission of the European Communities, *European Economy, Supplement A* (December 1995); IMF, *World Economic Outlook* (April 1996); National Institute of Economic and Social Research (London), *National Institute Economic Review* (May 1996); Nomura Research Institute (NRI), *Quarterly Economic Review* (May 1996); and table 1.

a European Union.

b Excluding Australia, Iceland and New Zealand.

Notes

1 Paul Krugman, "Growing World Trade: Causes and Consequences," *Brookings Papers on Economic Activity*, No. 1, 1995, p. 332.

2 China, Hong Kong, India, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan Province of China and Thailand.

3 These figures for Asian developing countries include also Australia and New Zealand. However, trade of the United States, EU and Japan with those two countries is marginal.

4 See "Overview of world trade in 1995 and outlook for 1996" in *WTO Focus*, No. 10, May 1996 (table 1).

5 Some prices, however, have remained high during recent months because of temporary factors.

6 For a discussion of the prospective longer-term decline in the terms of trade of primary commodities see, for example, World Bank, *Global Economic Prospects and the Developing Countries, 1996* (Washington, D.C.: The World Bank, 1996).

7 Bank for International Settlements, *66th Annual Report*, Basle, June 1996, pp. 164-165.

8 *Economic Report of the President*, *1995* (Washington, D.C.: US Government Printing Office, 1995), p. 54.

9 For a fuller discussion see *TDR 1995*, Part Two, chap. I, sect. B.1.

10 The Bureau of Economic Analysis of the Department of Commerce has recently shifted to the use of a chain-weighted procedure to measure GDP growth, in an attempt to avoid overestimation inherent in the traditional method of using the prices of a particular base year to value production during periods of substantial economic change, such as occurred with the spectacular fall in computer prices. In that instance, changing the base period to more recent years would result in a significant drop in both the share of the computer industry in real GDP and in the contribution of this rapidly expanding industry to GDP growth, and hence in a not insignificant drop in GDP growth for recent years. The new approach amounts to the computation of an index which is the geometric mean of values based on current prices and those of the preceding year. The chain-weighted procedure, however, is not without its limitations and disadvantages. For practical purposes, current prices are not so readily available and are subject to revision, so that available quarterly or monthly GDP data would not be as up-to-date and reliable as when prices of a base period are used. In addition, an error in any of the elements in the chain will remain uncorrected, so there is a tendency for such errors to cumulate over time. A more serious difficulty is the fact that components of GDP no longer add up to the total.

11 *ING Bank Notes, France*, 26 April 1996.

12 ECLAC, *Preliminary Overview of the Latin American and Caribbean Economy 1995* (United Nations publication, Sales No. E.95.II.G.18), table A.14. (For a detailed discussion of capital flows to Latin America see Part One, chap. II).

13 *Ibid.*, table A.4.

14 *Latin American Weekly Report*, No. 18, 16 May 1996, p. 212.

15 M. Carrizosa, D.M. Leipziger and H. Shah, "The Tequila Effect and Argentina's Banking Reform", *Finance and Development*, Vol. 33, No. 1, March 1996. However, such measures did not lead to reduction of the ratio of liquid reserves to the monetary base below the statutory minimum of 80 per cent.

16 Future export performance may, however, be adversely affected by the recent reduction of the rebate on the input value-added tax on goods made for export.

17 Nomura Research Institute (Tokyo), *Quarterly Economic Review*, May 1996, p. 51.

18 Major initiatives were taken in 1995 in respect of banking and the regulation of investment. A new Commercial Banking Law came into effect on 1 July 1995, which is intended to lay the foundations for the conversion of the various major specialized banks and other smaller banks into full-fledged commercial banks. New regulations governing foreign investment, listing the priority areas where foreign investors would be encouraged, were issued in June 1995. The priority areas are agriculture in general, infrastructure and power generation, mining, high technology, energy and environmental conservation. The intention is to direct investment away from luxury construction and low-technology sectors.

19 For a fuller discussion of the developing economies of East Asia, see Part Two.

20 The first-tier NIEs and ASEAN-4 are defined as in Part Two - i.e.: first-tier NIEs: Hong Kong, Republic of Korea, Singapore and Taiwan Province of China; ASEAN-4: Indonesia, Malaysia, Philippines and Thailand.

21 *Asian Development Outlook 1996 and 1997* (Hong Kong: Oxford University Press for the Asian Development Bank, 1996), appendix tables A.7 and A.8.

22 Large inflows of capital, however, have more than covered the deficits and led to an accumulation of

foreign exchange reserves in many countries. Moreover, the large increase in Malaysia's imports in 1995, for example, was primarily accounted for by exceptional imports of aircraft and ships.

23 See Part One, annex I to chapter II.

24 For details concerning devaluation of the CFA franc, see *TDR 1995*, box 1.

25 Economic Commission for Africa, "Report on the Economic and Social Situation in Africa, 1995" (E/ECA/CM/21/3), Addis Ababa, March 1995, table A-2, and *ibid., 1996* (E/ECA/CM.22/4), Addis Ababa, April 1996, table A-2.

26 World Bank, *Global Economic Prospects and the Developing Countries, 1996* (Washington, D.C., 1996), table 1-1.

27 In the review of this region three groups of countries are distinguished: the Commonwealth of Independent States (CIS), which includes some Central Asian countries; the Baltic States (Estonia, Latvia and Lithuania); and the remaining countries of the region (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia, The former Yugoslav Republic of Macedonia, and Yugoslavia), collectively termed "Central European" countries. This classification broadly follows that used by the secretariat of ECE, and differs from that now used in the UNCTAD *Handbook of International Trade and Development Statistics*.

28 For specific country detail, see United Nations Economic Commission for Europe, *Economic Survey of Europe in 1995-1996* (United Nations publication, Sales No. E.96.II.E.1), table 3.1.1.

29 For instance, the rise in consumer prices fell from 97.5 per cent in 1994 to 2.0 per cent in 1995 in Croatia, from almost 5,000 per cent to 176 per cent in Armenia, and from nearly 500 per cent to 30 per cent in the Republic of Moldova (see Economic Commission for Europe, *op. cit*, table 3.4.1).

30 See Economic Commission for Europe, *op. cit.*, appendix table B.1. For the Russian Federation, the loss of output from 1989 to 1994 is now officially acknowledged to be of the order of one third, rather than one half as was previously believed on the basis of production data only (see *TDR 1995*, Part One, chap. I, sect. A.4).

31 See note 10 above. Based on the new method, growth has been calculated to have been about 0.5 percentage points lower than previously calculated (IMF, *World Economic Outlook,* May 1996, box 2).

Chapter II

INTERNATIONAL FINANCIAL MARKETS AND THE EXTERNAL DEBT OF DEVELOPING COUNTRIES

A. Recent trends in private external financing

During 1995 there were substantial increases in most major categories of financing from the international financial markets, the principal exception being new international equity issues. As illustrated by table 6, these increases were accompanied by significant changes in the relative importance of the different categories. The expansion was driven principally by conditions in developed countries. For example, the large rise in syndicated bank credits reflected the impact of heavy merger and acquisition activity in the United States and the United Kingdom, greater recourse to financing in this form by companies of continental Western Europe (which appear to be reducing their traditional reliance on borrowing from domestic sources), and refinancing operations prompted by falling interest rates for major currencies (exemplified by the figures in table 7) and by lower spreads on Eurocurrency loans. The maintenance of developing countries' share of syndicated bank credits was due to borrowing by entities in South and South-East Asia. An exception to the generalization about the predominant influence on financing trends of developments in the OECD area concerns international equity issues, a category of financing for which the share of developing countries has increased in the 1990s. Issuance of equities in external markets by entities in developing countries became more difficult in the aftermath of the Mexican financial crisis, and stagnated in 1995.

The recent expansion of international financing has been accompanied by a progressive blurring of the distinction between different categories of such financing. As was noted in last year's *TDR*, this blurring has been especially evident in the case of external bonds, on the one hand, and Euro- medium-term notes (EMTNs), on the other. The former are debt instruments underwritten by syndicates of banks and issued on a one-off basis at medium- and long-term maturities. By contrast, EMTNs are "continuously issued" at intervals pursuant to a facility or "programme" agreement with the institutions responsible for distribution. Originally EMTNs carried relatively short maturities and were not underwritten, so that they did not provide a guaranteed source of funding. However, with expanding use, the maturities of EMTNs have become much longer in many cases, and they are now frequently underwritten by issuing syndicates.[1] The many advantages of EMTNs in comparison with bonds, such as their lower upfront costs and the greater flexibility of issuing procedures, help to explain the increase in their relative importance as a source of financing indicated by table 6.

The growth of the total claims of banks in the BIS-reporting area[2] on developing countries (including the European economies in transition) increased (after adjustment for movements of exchange rates) for the second consecutive year, as shown in table 8. The region contributing most to

Table 6

SELECTED CATEGORIES OF INTERNATIONAL FINANCING AND SHARES OF DEVELOPING COUNTRIES AND EUROPEAN TRANSITION ECONOMIES THEREIN, 1991-1995

(Billions of dollars and percentage shares)

Category	*1991*	*1992*	*1993*	*1994*	*1995*
External bond offerings					
Total ($ billion)	308.7	333.7	481.0	428.6	460.6
Share of developing countries[a]	3.9	5.9	11.8	11.9	10.3
Syndicated credits					
Total ($ billion)	116.0	117.9	136.7	236.2	368.4
Share of developing countries[a]	25.2	16.6	16.7	10.7	11.8
Eurocommercial paper programmes					
Total ($ billion)	35.9	28.9	38.4	30.8	44.6
Share of developing countries[a]	2.8	11.8	7.8	6.5	19.1
Committed borrowing facilities[b]					
Total ($ billion)	7.7	6.7	8.2	4.9	3.1
Share of developing countries[a]	58.4	25.4	18.3	59.2	29.0
Other non-underwritten facilities[c]					
Total ($ billion)	44.3	99.0	113.6	222.1	340.6
Share of developing countries[a]	1.8	4.5	6.2	5.4	5.3
International equities[d]					
Total ($ billion)	23.4	23.5	40.7	44.9	41.0
Share of developing countries[a]	20.0	17.9	18.7	24.1	25.9

Source: OECD, *Financial Market Trends*, February 1996; UNCTAD secretariat estimates.

a Including the transition economies of Central and Eastern Europe.

b Multiple-component facilities, note issuance facilities and other international facilities underwritten by banks, excluding merger-related stand-bys.

c Non-underwritten syndicated borrowing facilities, including medium-term note (MTN) programmes but excluding Eurocommercial paper.

d Including international placements of equity for privatizations.

this expansion was South and South-East Asia, which now accounts for almost 50 per cent of the total stock of such banks' claims on the developing world. This share reflects not only superior creditworthiness among borrowing entities in the region but also the more full-fledged participation of its new (offshore and onshore) financial centres in global financial markets. In contrast with the increases in bank claims experienced by the other regions in table 8, Africa once again registered a substantial decrease.

As shown in table 9, the vigorous growth of export credits to developing countries in 1994, which was accompanied by marked declines in the proportion of countries in different regions experiencing net outflows of such financing, was not sustained in the first half of 1995. The slower increase was strongly influenced by a substantial net outflow from Latin America, for which the number of countries experiencing such outflows almost doubled from the second half of 1994 to the first half of 1995. (Factors affect-

Table 7

SELECTED INTERNATIONAL INTEREST RATES

(Period averages in per cent per annum)

Currency	Long-term rates[a]			Short-term rates[b]		
	1994	1995	1996 (Jan-Mar)	1994	1995	1996 (Jan-Mar)
United States dollar	7.41	6.81	6.07	5.07	6.10	5.33
French franc	7.52	6.93	6.35	5.95	6.61	4.53
Deutsche mark	6.94	7.65	6.90	5.35	4.57	3.38
Japanese yen	4.50	3.37	3.30	2.36	1.26	0.72
Pound sterling	8.05	8.25	8.07	5.80	6.91	6.19

Source: IMF, *International Financial Statistics*, May 1996, and OECD, *Financial Statistics Monthly*, various issues.

a *United States:* government bonds ("composite" over 10 years); *France*: public and semi-public sector bonds; *Germany:* public sector bonds with maturities of 7 to 15 years; *Japan*: central Government bonds (10-year benchmark); *United Kingdom:* 20-year government bonds.

b London inter-bank offered rate (LIBOR) on six-month deposits.

ing the cost of export credits are discussed further in section C.)

Increasingly the availability of external financing from private sources for developing countries is affected not only by the traditional categories of international bank lending, export credits and externally issued securities but also by foreign investment in financial instruments issued on domestic financial markets and by intra-regional flows of foreign direct and portfolio investment (which are not reflected in the categories of financing included in tables 6, 8 and 9). For example, the issues of international equities by entities in developing countries and economies in transition covered by table 6 amounted to about $10.5 billion in 1995, while preliminary estimates indicate that total external portfolio equity investment in emerging financial markets amounted to $25 billion.[3] Intra-regional financial flows have recently been expanding not only in the form of direct but also of portfolio investment. In 1994 more than 17 per cent of the figure for net external portfolio equity investment in emerging financial markets of $39.9 billion in 1994 also originated in such markets.[4] In the early 1990s direct purchases of securities by emerging markets mutual funds which invested in developing countries (including economies in transition) amounted to less than $10 billion a year, but in 1993 such purchases rose to $18 billion and in 1994 to $64 billion.[5]

As documented in previous issues of the *TDR*, access to financing from the international financial markets continues to be concentrated among a relatively small number of developing countries and economies in transition. For example, three Latin American countries (Argentina, Brazil and Mexico) accounted for 42 per cent of net issues of international bonds by such countries, and six countries of South and South-East Asia (China, India, Republic of Korea, Malaysia, Philippines, and Thailand) for 45 per cent.[6] Excluding the Philippines, the latter countries, together with Indonesia, were responsible for 60 per cent of borrowing in the form of international syndicated bank credits, and three countries from Latin America and South and South-East Asia (Argentina, Brazil and Republic of Korea) for more than 100 per cent of net issues of Euro-notes.[7]

The major recipients of funds were unequally affected by the aftermath of the Mexican financial crisis. As noted in last year's *TDR*, the initial effects of this crisis were felt not only by other Latin American countries but also further afield, in Asian

Table 8

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA[a] VIS-A-VIS DEVELOPING COUNTRIES AND EUROPEAN TRANSITION ECONOMIES, 1993-1995

	1993	1994	1995	Stock end-1995
	Percentage increase[b]			*$ billion*
All developing countries[c]	2.7	7.4	12.9	745
of which in:				
America	1.1	0.9	3.0	237
Africa	-7.7	-6.4	-7.5	41
West Asia	1.4	-2.7	4.5	91
South and South-East Asia[d]	8.9	20.5	29.7	368
Central Asia[e]	..	102.0	30.6	1
Europe[f]	-8.0	-4.6	8.0	6
Central and Eastern Europe	-4.0	-15.5	3.3	86
All borrowers[g]	5.1	4.2	9.2	7926

Source: BIS, *International Banking Statistics 1977-1991* (Basle, 1993) and *International Banking and Financial Market Developments*, various issues.

a Including certain offshore branches of United States banks.

b Based on data for end-December after adjustment for movements of exchange rates.

c Excluding offshore banking centres, i.e. in Latin America: Barbados, Bahamas, Bermuda, Netherlands Antilles, Cayman Islands and Panama; in Africa: Liberia; in West Asia: Bahrain and Lebanon; and in South-East Asia: Hong Kong, Singapore and Vanuatu.

d Including Oceania.

e Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyztan, Tajikistan, Turkmenistan, and Uzbekistan.

f Malta and former Yugoslavia in 1993; thereafter, also Bosnia and Herzegovina, Croatia,The former Yugoslav Republic of Macedonia, and Slovenia.

g Including multilateral institutions.

emerging financial markets. However, the more lasting impact involved principally Latin American borrowers. For example, net external issues of debt securities by this group turned sharply downwards in the first quarter of 1995, becoming negative for both bonds and Euro-notes.[8] The recovery in the second quarter was due mainly to issues by Argentina and Brazil; a revival of issues by Mexican entities began only in the third quarter. As shown by table 10, the experience in 1995 of major Latin American borrowers regarding the yield spreads on international bond issues was mixed, Argentina and Brazil witnessing some rise.

Partly as a result of more difficult conditions, since mid-1995 few countries have issued international debt securities for the first time or after a prolonged absence from the international financial markets. Mauritius issued its first international bond in the autumn of 1995. The other main new entrants were from Central and Eastern Europe. They included Slovenia in late 1995 and Romania in the spring of 1996, the latter after achieving reentry into the market for syndicated bank loans in early 1995. There have recently been several improvements in the credit ratings accorded by the major agencies, Moody's and Standard and Poor's, to the sovereign foreign-currency debt of developing countries and economies in transition. These improvements included the attribution of "investment grade"[9] by Moody's to the debt of Colombia (which had already received such a

Table 9

TOTAL EXPORT CREDITS[a] TO DEVELOPING COUNTRIES AND EUROPEAN TRANSITION ECONOMIES, BY REGION

A. Prevalence of negative flows

(Percentage of the number of countries in the region or grouping)[b]

Country	1991		1992		1993		1994		1995
	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half
All developing countries[c]	42	40	41	39	35	46	45	30	43
of which in:									
Africa	46	36	42	48	52	60	64	44	52
America	41	41	51	46	38	43	38	24	46
West Asia	71	36	57	36	14	50	57	36	57
South and South-East Asia[d]	24	48	17	17	30	45	27	15	36
Central Asia[e]	..	..	..	..	..	..	12	12	-
Central and Eastern Europe[f]	0	57	43	29	43	29	29	43	43

B. Net flow and stock in mid-1995

(Millions of dollars)

Country	1991	1992	1993	1994	1995 (first half)	Stocks (end-June 1995)
All developing countries[c]	5900	17201	13154	18592	4658	281845
of which in:						
Africa	1361	2583	-444	-39	994	66833
America	3712	4641	4657	2642	-1935	72435
West Asia	2472	1687	2173	487	1140	46815
South and South-East Asia[d]	-1244	8348	6058	15560	4299	90366
Central Asia[e]	..	..	..	533	107	1316
Central and Eastern Europe[f]	10406	8015	5929	-2074	370	53493

Source: BIS and OECD, *Statistics on External Indebtedness, Bank and Trade-related Non-bank Claims on Individual Borrowing Countries and Territories*, new series, various issues.

a After adjustment for effect of movements of exchange rates.

b Excluding countries for which data are not available.

c See note **a** to table 6.

d Including Oceania; and from 1993 China, Democratic People's Republic of Korea, Mongolia and Viet Nam.

e Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyztan, Turkmenistan and Uzbekistan.

f Up to 1993, figures include Czechoslovakia and the former USSR: thereafter they include Belarus, Czech Republic, Estonia, Latvia, Lithuania, Moldova, Russian Federation, Slovakia and Ukraine.

Table 10

YIELD SPREADS ON INTERNATIONAL BOND ISSUES, BY TYPE OF BORROWER, FOR SELECTED LATIN AMERICAN COUNTRIES, 1994-1996

Country	Yield spread[a] (basis points) 1994	1995	1996 (Jan. - May)
Argentina			
Public	303	451	437
Private	396	419	519
Brazil			
Public	433[b]	419	471
Private	395	435	451
Mexico			
Public	240[b]	407[b]	408
Private	436	397	514

Source: UNCTAD secretariat estimates.

a The yield spread is the difference between the bond yield at issue and the prevailing yield for the bonds of OECD countries denominated in the same currency and with a comparable maturity.

b Estimate based on two bond issues or a single issue.

rating from Standard and Poor's), Slovakia, Tunisia, Poland and Slovenia (the last two of which also received an "investment grade" rating from Standard and Poor's). For the three European countries mentioned the improvements are part of a rating history marked by steady progress for five economies in transition, namely Czech Republic, Hungary, Poland, Slovakia, and Slovenia, since 1992 (when Hungary was the only one of the five to have received a rating for its debt).[10] The sovereign foreign-currency debt of all these countries now carries an "investment grade" rating from at least one of the two agencies.

B. Private external financing for selected countries: similarities and contrasts

1. Introduction

As noted in section A, even among developing countries and economies in transition that were major recipients of funds from the international financial markets there was significant variation in the pattern of their major categories of financing in 1995. Such variation already existed in the earlier 1990s, as may be seen from table 11. Generally, the share of international bank lending in the total for the categories of international financing distinguished in the table was larger for the Asian than for the Latin American countries, reflecting mainly the fact that (with the exception of the Philippines, for which the share was atypically

Table 11

EXTERNAL FINANCING FOR SELECTED DEVELOPING COUNTRIES BY MAJOR CATEGORIES, 1991-1994

Country	Total	of which		
		Bank loans	Internationally issued portfolio investments[a]	Foreign direct investment
	($ billion)	(Per cent)		
Latin America				
Argentina	31.4	8	47	45
Brazil	21.4	8	64	28
Chile	7.9	25	25	49
Colombia	4.7	9	26	65
Mexico	63.0	15	51	34
Venezuela	9.0	27	36	38
South and South-East Asia				
China	110.2	18	13	70
India	9.1	30	56	14
Indonesia	37.7	65	14	21
Malaysia	32.2	35	7	57
Philippines	7.2	13	53	35
Republic of Korea	34.0	39	52	9
Singapore	25.6	24	7	70
Thailand	39.0	62	16	22

Source: World Bank, *Financial Flows and the Developing Countries*; and IMF, *Private Market Financing for Developing Countries*, November 1995; and BIS, *International Banking and Financial Market Developments*.

a International bonds and international equity issues.

small) the former region was much less affected by the aftermath of the debt crisis of the 1980s. Thus, if the Philippines is excluded, the share of international bank lending for the Asian countries ranges from 18 per cent to 65 per cent, while of the Latin American countries only Chile and Venezuela have shares above 20 per cent, those of the other four falling in the range of 8 per cent to 15 per cent. With respect to foreign direct investment, the range for the shares of Asian countries is wider than for those of Latin America, the figures for the latter lying between 28 per cent and 65 per cent and those for the former between 9 per cent and 70 per cent. Greater dispersion also characterizes the shares of Asian countries represented by internationally issued portfolio investments, the range being from 7 per cent to more than 50 per cent.

Available information does not make possible a fuller picture of countries' receipt of different categories of external financing, which also include investment in financial instruments issued in domestic financial markets. As noted in section A, such investment by emerging market mutual funds has recently been rising rapidly, and it is also known, for example, that a large proportion of short-term debt instruments recently issued by the Government of Mexico has been held by external investors.[11] Moreover, it is reasonable to assume that the progressive incorporation of several developing countries into the global network of financial markets has been accompanied by increases in holdings of domestically issued financial instruments by both financial and large non-financial firms for the purposes of both investment and

risk management. Thus, countries' vulnerability to sudden financial outflows due to external portfolio disinvestment cannot be inferred simply from the shares of categories such as those in table 11 in their total financing from international capital markets. Rather, such vulnerability is associated with perceptions of countries' creditworthiness and economic performance, the possibility of herd behaviour by international investors (such as that manifested towards not only Latin American countries other than Mexico but also other emerging financial markets at the beginning of 1995), and other imperatives of international portfolio management (which include considerations related to exchange-rate risk as well as to returns on investments denominated in their local currencies).

2. Capital inflows and outflows: selected issues and policy responses

In the previous sub-section attention was drawn to some broad distinctions between patterns of external financing from international financial markets for major Asian and Latin American recipients in the early 1990s. Table 12 (which also includes figures for three Central European countries) enables a preliminary review to be made of more recent trends. However, owing to the widespread lack of data concerning the net inflow of portfolio investment, an updating to 1995 of figures for the shares of major categories of external financing (such as those in table 11) was not possible at the time of writing.[12]

Three of the countries shown (China, Taiwan Province of China and Venezuela) ran surpluses on current account in at least two of the three years 1993-1995. For the other countries in the table such surpluses were relatively infrequent. In view of the traditional association of FDI with a more durable commitment by investors to the recipient economy it is notable that the proportions of balances on current account represented by such inflows fall within a wide range.[13] At one extreme China's surpluses on current account were accompanied by large inflows of FDI. The Asian countries for which deficits on current account were associated with relatively large FDI were Indonesia, where FDI as a proportion of the deficit varied from 58 per cent to 95 per cent, and Malaysia, where it varied from 69 per cent to 179 per cent. The proportion was lower for Thailand, varying between 1 per cent and 21 per cent. For the Latin American countries shown in table 12 there is greater variation, reflecting fluctuations in both FDI and balances on current account.[14] Thus, for Chile FDI as a proportion of the current account deficit varied from 19 per cent to 767 per cent, for Argentina from 12 per cent to 118 per cent, and for Peru from 24 per cent to 100 per cent. In the case of Mexico, for the two years in which it ran substantial deficits on current account, the proportions are relatively low (19 per cent and 28 per cent). The proportions for the Central European countries shown in the table also fall within a wide range - for Hungary, for example, between 27 per cent and 140 per cent and for Poland between 29 per cent and 75 per cent.

The negative net flows of FDI of Taiwan Province of China throughout 1993-1995 and of the Republic of Korea in 1993-1994 reflect substantial outflows. The flow of FDI from firms of Taiwan Province of China to neighbouring countries, for example, was part of a rapid expansion of Asian intra-regional FDI in 1993-1995, which is estimated by Baring Securities to have increased from $17 billion in 1992 to $40 billion in 1993, $52 billion in 1994, and perhaps as much as $60 billion in 1995.[15] The corresponding figures for intra-regional FDI in Latin America are much lower, only $4 billion in 1993 and $11 billion in 1994.[16]

For Latin America preliminary figures make possible a more fully articulated survey of certain major financial flows affecting the capital account in 1995. The discussion which follows focuses especially on selected countries from the region which have recently raised substantial sums of money from international financial markets.

According to initial estimates of ECLAC,[17] the net flow of capital to Latin American countries in 1995 amounted to $22.4 billion.[18] The fall from the previous year's figure of $44.9 billion was to a significant extent accounted for by the net outflow from Mexico and Venezuela of $20.5 billion. As already mentioned in section A, flows to the major Latin American recipients of financing from the international capital markets other than Mexico were also adversely affected during 1995 by the Mexican crisis. However, for many categories of external financing the impact was concentrated mainly in the first quarter of the year, and the following nine months were characterized by a return to higher levels of lending.

Mexico's net flow on capital account (without allowance for exceptional financing, mainly in the form of the package put together in response to the crisis) was negative to the tune of $16.9 billion, largely, it appears, on account of a contraction of foreign portfolio equity investment amounting to $27.5 billion.[19] The ECLAC estimate for Argentina is a small net capital outflow of $0.4 billion in 1995 following the inflow of $10.9 billion in 1994. However, this estimate has to be reconciled with more recent figures from other sources, pointing to substantial inflows for major categories of external financing for which data are available.[20] The apparent inconsistency between this estimate of Argentina's overall net capital inflow and those for several of its constituents seems likely to reflect underestimates by ECLAC of net issues of international debt securities (which increased to $3.7 billion in the fourth quarter, a level more than double that of the second quarter), and possibly also of net FDI.[21] Brazil's total balance on capital account was $28 billion in 1995. This figure reflects large net inflows in the form not only of internationally issued securities and international bank lending but also of net purchases of domestically issued instruments.[22] A substantial proportion (at least 65 per cent) of both the net issues of international debt securities and net international bank lending was accounted for by Brazilian banks. As noted in recent issues of *TDR*, this net inflow reflects the consequences of Brazilian banks' taking advantage of relatively cheap finance available from international financial markets for profitable on-lending in the local currency. The opportunities for such interest-rate arbitrage are illustrated for short-term borrowing and lending in table 13, but banks also engaged in operations of this kind through longer-term borrowing in forms such as international bonds.

The ECLAC estimate of net capital inflows into Chile in 1995 was $0.3 billion.[23] In view of other evidence suggesting significant net portfolio investment in Chile's financial markets in 1995,[24] the overall figure cited above for the country's net capital inflow may be an underestimate, reflecting, *inter alia*, the unavailability of certain data at the time the estimate was made. Colombia's net balance on capital account was $4.2 billion.[25] Peru's total net capital inflow in 1995 was $4.6 billion.[26] This probably included substantial net purchases by foreigners of domestically issued financial instruments (probably mostly equities). Venezuela experienced a negative balance on capital account of $3.7 billion.[27]

As also noted in the annex to this Report, large capital inflows can create problems for macroeconomic policy, as has been the experience of countries in Latin America, Asia and (most recently) Central and Eastern Europe. Some recipient countries have adopted a largely or completely non-interventionist response, allowing the inflows to be reflected in changes in their exchange rates or money supplies (or both). More frequently, however, attempts to overcome the problems have led to shifts in macroeconomic policy (including tighter monetary policy, fiscal sterilization and higher reserve requirements for banks) and to measures bearing more directly on the capital account of the balance of payments. The latter measures have been in the form of taxes and tax-like restrictions on capital transactions designed to increase their costs and thus to reduce their profitability, the imposition of controls over such inflows, and on occasion the relaxation of controls over outflows.

Among Latin American recipients of large net capital inflows Argentina, for example, has adopted a non-interventionist stance, while others have resorted in varying degrees to offsetting measures of macroeconomic policy and to actions directed at transactions affecting the capital accounts. Actions of the latter kind in 1995 included both the introduction of new measures and the adjustment of those taken in earlier years.

For example, for the first time Peru deployed such measures in the form of adjustable reserve requirements for banks. Brazil extended the scope of its transaction taxes on foreign purchases of financial instruments to additional categories of debt and to investment in privatization funds. The minimum maturity on external bond issues by Brazilian companies was raised from two to three years, and a tax of 20 per cent was imposed on withdrawals within 18 months by foreign investors from certain types of mutual funds. Brazil also forbade purchases and sales by foreigners of financial futures and options, with the objective of preventing the construction of synthetic positions in the country's financial instruments which would make possible avoidance of transaction taxes. Chile, a country which is in the process of becoming a significant source of investment and other forms of financing for its neighbours, continued to expand the scope of measures designed to control the pace of its net capital inflows. Reserve requirements were extended to various portfolio investments, including purchases in the secondary market of American Depository Receipts (ADRs). Restric-

Table 12

FEATURES OF THE BALANCE OF PAYMENTS AND EXTERNAL FINANCING OF SELECTED COUNTRIES IN ASIA, CENTRAL EUROPE AND LATIN AMERICA, 1993-1996

(Billions of dollars, unless otherwise specified)

	ASIA															
	China				Indonesia				Republic of Korea				Malaysia			
	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]
Current account balance	-11.7	6.5	17.2	..	-2.1	-2.8	-7.8	..	1.0	-3.9	-9.0	-4.1	-2.8	-4.1	-8.4	..
Per cent of GDP	*-2.1*	*1.3*	*2.6*	..	*-1.3*	*-1.6*	*-4.0*	..	*0.3*	*-1.0*	*-2.0*	..	*-4.4*	*-5.9*	*-10.0*	..
Net direct investment	23.1	31.8	38.0	..	2.0	2.1	4.5	..	-0.8	-1.7	1.5	..	5.0	4.3	5.8	..
Net portfolio investment[a]	3.0	3.5	..	..	1.8	1.1	..	..	10.5	6.9	..	..	-0.7	-1.6	..	..
Securitized debt claims (per cent of total external debt)	8.8	11.0	..	..	2.3	3.6	..	..	21.0	21.3	..	..	16.9	15.5	..	..
Bank claims (per cent of total external debt)[b]	54.6	51.6	..	..	42.2	41.7	..	..	68.4	61.1	..	..	57.7	53.5	..	..

	ASIA (cont.)								CENTRAL EUROPE							
	Taiwan Province of China				Thailand				Czech Republic				Hungary			
	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]
Current account balance	6.7	6.2	5.0	1.5	-7.0	-8.4	-13.5	..	0.7	-0.1	-2.1	-0.5	-4.3	-4.1	-3.0	-0.8
Per cent of GDP	*3.0*	*2.6*	*1.9*	..	*-5.6*	*-5.9*	*-8.3*	..	*2.2*	*-0.2*	*-4.6*	..	*-11.1*	*-9.8*	*-6.9*	..
Net direct investment	-1.5	-1.1	-1.1	..	1.5	0.1	2.3	..	0.6	0.8	1.0	0.3	2.3	1.1	4.2	0.4
Net portfolio investment[a]	1.1	0.9	0.5	..	5.5	2.5	..	..	1.6	0.8	..	-0.1	3.9	2.5	..	0.2
Securitized debt claims (per cent of total external debt)	2.2	8.8	..	..	5.5	5.4	..	..	30.8	31.0	..	..	43.7	50.0	..	..
Bank claims (per cent of total external debt)[b]	90.2	84.4	..	..	66.3	71.4	..	..	58.8	67.6	..	..	32.0	29.3	..	..

Table 12 (concluded)

	CENTRAL EUROPE (cont.)				LATIN AMERICA											
	Poland				*Argentina*				*Brazil*				*Chile*			
	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]
Current account balance	-5.8	-2.5	-2.4	0.1	-7.5	-10.2	-3.3	..	-	-1.2	-17.9	..	-2.1	-0.8	-0.3	..
Per cent of GDP	*-6.7*	*-2.8*	*-2.1*	..	*-2.9*	*-3.6*	*-1.1*	..	-	*-0.2*	*-2.5*	..	*-4.6*	*-1.5*	*-0.5*	..
Direct investment	1.7	1.8	1.8	-0.3	6.3	1.2	3.9	..	0.8	2.0	3.1	..	0.4	0.9	2.3	..
Portfolio investment[a]	-	-0.6	..	0.2	8.0	..	..	..	12.3	44.7	..	..	0.7	1.0	..	..
Securitized debt claims (per cent of total external debt)	-	-	..	..	11.5	17.4	..	..	8.7	12.8	..	..	4.5	3.5	..	..
Bank claims (per cent of total external debt)[b]	24.6	18.2	..	..	42.5	42.2	..	..	63.6	62.8	..	..	58.0	62.5	..	..

	LATIN AMERICA (cont.)															
	Colombia				*Mexico*				*Peru*				*Venezuela*			
	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]	1993	1994	1995	1996[c]
Current account balance	-2.1	-3.0	-3.8	..	-23.4	-28.8	-0.2	-0.5	-1.7	-2.3	-0.9	..	-2.0	2.5	1.7	..
Per cent of GDP	*-4.0*	*-4.9*	*-5.0*	..	*-6.4*	*-7.6*	*-0.1*	..	-	-	*-1.6*	..	*-3.3*	*4.2*	*2.2*	..
Direct investment	0.9	1.0	1.2	..	4.4	8.0	4.1	..	0.4	2.3	0.6	..	-0.5	0.2	0.2	..
Portfolio investment[a]	0.1	0.3	..	..	28.4	7.6	..	..	0.2	0.6	..	..	0.6	0.3	..	..
Securitized debt claims (per cent of total external debt)	3.5	5.9	..	..	17.0	20.0	..	..	-	-	..	..	11.0	11.5	..	..
Bank claims (per cent of total external debt)[b]	46.0	48.6	..	..	62.8	61.4	..	..	19.2	21.8	..	..	61.2	57.6	..	..

Source: Data of BIS, ECLAC, IMF, World Bank, OECD, and J.P. Morgan. For more details see the text at the end of the Notes to this chapter.

a Externally issued bonds, other securitized debt instruments and equities.

b At end of year.

c First quarter.

Table 13

REPRESENTATIVE EXCHANGE-RATE-ADJUSTED MONEY-MARKET RATES OF INTEREST IN BRAZIL AND DIFFERENTIAL RETURNS AS COMPARED WITH UNITED STATES RATES

(Returns, and differential returns, in percentage points after adjustment for changes in exchange rates for the dollar)[a]

	1994	1995
Return		
Monthly average	4.69	2.43
Annualized monthly average	73.36	33.46
Differential return [b]		
Monthly average	4.34	1.99
Annualized monthly average	66.56	26.62

Source: UNCTAD secretariat estimates, based on data of IMF (*International Financial Statistics*, various issues) and Instituto de Economia do Sector Publico (Brazil).

Note: The Brazilian rates of interest relate to "hot money".

a Exchange rate adjustments on the basis of end-of-month exchange rates.

b Difference between return and that on United States Treasury bills.

tions were placed on banks' use of the formal foreign-exchange market, with the objective of reducing currency speculation. The restrictions were intended to reduce liquidity in the spot market and make it more volatile, thus increasing the risk associated with certain currency transactions. These measures were accompanied by a reduction of the minimum size of ADR issues by Chilean companies. At the same time, there was a continuation of the policy of selectively liberalizing restrictions on capital outflows. The range of permissible foreign investment options for Chilean banks and institutional investors abroad was broadened, thus facilitating international portfolio diversification and treasury management.

Examples of policy responses by Asian countries to large capital inflows since mid-1995 are provided by Thailand and Indonesia. In Thailand external capital inflows during the first quarter of 1996 were associated with an expansion of foreign assets of no less than 50 per cent of the country's monetary base. At the time of writing Thailand's response had not taken the form of measures directed specifically at the inflows but rather of credit controls, of the imposition on banks of a shift to cash deposits with the central bank for reserve requirements hitherto held in the form of liquid assets, and of larger and more stringent capital requirements.[28] In Indonesia capital inflows in early 1995 led to an expansion of credit by the financial system substantially in excess of the targets of monetary policy. So far the response has been an increase in reserve requirements and a widening of the central bank's intervention band for the exchange rate. The latter measure provides additional policy flexibility to the authorities, and is also intended to increase the foreign-exchange risk associated with capital inflows.[29] Another Asian country which has experienced a large net capital inflow in early 1995 is the Philippines. The inflow has been reflected in a rise in reserves of 30 per cent in the first five months but has not yet brought a policy response from the Government.[30]

An interesting recent development is that analogous problems for macroeconomic management posed by capital inflows are now being experienced for the first time by a number of Central and Eastern European economies, and in some cases have led to policy responses similar to those already tried in Latin America and Asia. At the

beginning of 1996 Slovakia increased the intervention band for the country's exchange rate from 3 per cent to 6 per cent.[31] In February the Czech Republic increased its intervention band from 1 per cent to 15 per cent, a step taken in response to a capital inflow of $8.4 billion in the early months of 1996.[32] Net capital inflows into Poland have also recently substantially increased.[33] In the first two months of 1996 they are estimated to have reached $2.1 billion, of which about $0.5 billion was FDI and about $1 billion was short-term. The response to the resulting rise in reserves has so far taken the form of sterilization, but such a policy may eventually conflict with the Government's objective of promoting investment through low interest rates.

C. The terms of export credits and trade financing arrangements

As noted in section A, although net flows of export credits to developing countries increased in 1994 and the first half of 1995, the experience of different regions varied widely, those to sub-Saharan Africa being negative in 1994, as were those to Latin America in the first half of 1995. Moreover, the countries of Central and Eastern Europe registered a substantial net outflow in 1994. The relative importance of export credits as a source of external financing also differs among major regions. For example, the share of the external debt of countries of sub-Saharan Africa accounted for by export credits was 28 per cent at the end of 1994, while for Asia and Latin America it was respectively 13 per cent and 18.5 per cent.[34] The conditions on which this category of external financing is made available are also of more general interest as an indicator of countries' creditworthiness, and the same is true of the conditions attached to credit insurance from the private market. Thus, for example, these conditions are generally correlated with the costs of financing and payments arrangements other than credit insurance for imports, such as charges on letters of credit. The prevalence of high costs and restrictive conditions on credit insurance for developing countries serves to bring out in another way the general point already made in section A that, in spite of the recent revival of external financing for certain developing countries and economies in transition, access to such financing for the great majority of these countries remains highly restricted.

Export credits are determined by the interaction of demand and supply. Thus they respond not only to costs but also to economic conditions in recipient countries, and in particular to the pace of investment, owing to the role of export credits in the financing of capital goods. But the discussion which follows focuses principally on the cost side and its relation to financing and payments arrangements more generally.

The costs of private export credits[35] consist of interest, premiums on official insurance, and various other transaction costs associated with restrictive conditions on which such insurance cover is made available. The interest rates on the financing of exports to developing countries are either commercial rates (linked to the rates at which the providers of the finance can borrow) or minimum rates for lending in different currencies under the OECD Arrangement on Guidelines for Officially Supported Export Credits, the so-called OECD Consensus.[36] The insurance premiums typically consist of a basic rate, which varies with characteristics of the credit such as the payments arrangement used and the maturity of the loan.[37] Supplementary premiums may then be added to the basic rates at levels which reflect a country's creditworthiness and recent record of making international payments.[38] For less creditworthy borrowers official insurance is generally provided only subject to various restrictive conditions relating to the proportion and amount of the credit for which cover is available, the limit on the amount of money below which the exporter or bank can exercise discretion in granting insured credits, the length of the period after the occurrence of non-payment before claims are met (the claims-waiting

Table 14

COMMERCIAL INTEREST REFERENCE RATES[a]

Currency		1995 High	1995 Low	1996 (up to May) High	1996 (up to May) Low
Australian dollar		11.3	9.1	9.6	8.7
Austrian schilling		8.3	7.1	6.9	6.3
Belgian franc		9.3	7.8	7.7	7.2
Canadian dollar	(1)[b]	10.2	8.0	7.6	6.8
	(2)[c]	10.2	8.4	8.1	7.5
	(3)[d]	10.3	8.5	8.5	7.9
Danish krone		9.1	7.9	7.5	6.8
Finnish markka		10.6	7.9	7.8	7.1
French franc		9.0	7.8	7.5	6.9
Deutsche mark		8.3	6.7	6.6	6.0
Irish punt		9.8	8.5	8.1	7.5
Italian lira		12.3	10.3	10.8	9.4
Japanese yen		4.7	2.5	3.4	2.4
Netherlands guilder	(1)[b]	8.3	6.4	6.2	5.6
	(2)[c]	8.5	7.0	6.9	6.3
	(3)[d]	9.1	7.9	7.8	7.3
New Zealand dollar		10.0	8.2	9.9	8.1
Norwegian krone		8.7	7.4	7.0	6.7
Spanish peseta		13.1	11.5	11.6	9.6
Swedish krona		11.9	10.0	9.7	8.7
Swiss franc		6.5	5.2	5.2	4.9
Pound sterling		9.7	8.5	8.5	7.9
United States dollar	(1)[b]	8.7	6.8	7.1	6.1
	(2)[c]	8.8	6.9	7.3	6.4
	(3)[d]	8.8	7.0	7.5	6.5
ECU		8.9	7.4	7.2	6.6
SDR[e]		7.4	6.6	..	..

Source: OECD press releases and publications.

a Minimum interest rate for officially supported export credits denominated in specified currencies or weighted averages of currencies advanced by participants in the OECD Arrangement on Guidelines for Officially Supported Export Credits (the OECD Consensus).

b Maturity of less than five years.

c Maturity of from five to eight-and-a-half years.

d Maturity of more than eight-and-a-half years.

e The SDR rate was abolished from 31 August 1995.

period), and the types of security required (which may consist of a guarantee from a national public entity in the importing country or a letter of credit issued by one of its banks and confirmed by a bank in an OECD country). Although the effect on the costs of export credits may be hard to quantify, such restrictions all entail increases. If perceptions of a country's creditworthiness become sufficiently unfavourable, export credit insurance may cease to be available even at high premiums and with extremely restrictive conditions. However, not all export credit agencies (ECAs) necessarily cut off insurance cover for a country at the same time. It should also be emphasized that the avail-

Table 15

TERMS[a] OF INSURANCE COVER AVAILABLE TO SELECTED REGIONS FROM SELECTED EXPORT CREDIT AGENCIES[b]

(Number of instances[c] in which EXIM, ECGD or NCM applied specified terms)

	Normal terms[a]		No cover[a]		Restrictive conditions[a]	
Region / period	Short-term[d]	Medium- and long-term[e]	Short-term[d]	Medium- and long-term[e]	Short-term[d]	Medium- and long-term[e]
Africa						
Late 1994/early 1995	9	11	20	45	43	16
Late 1995/early 1996	9	11	18	45	45	16
Latin America						
Early 1995	8	13	4	18	40	21
Early 1996	8	13	5	16	39	23
South and South-East Asia[f]						
Early 1995	17	18	4	15	33	21
Early 1996	17	21	4	11	33	22
Central and Eastern Europe						
Late 1994	3	3	8	13	13	8
Late 1995	3	6	8	13	13	5

Source: Exporter's regional guides and credit surveys in *Project and Trade Finance,* various issues.

a Normal terms apply when cover is available to a borrower subject to no restrictive conditions. Such conditions include surcharges and restrictions on the availability of insurance cover and reflect mainly the perceived riskiness of the provision of financing to the borrower in question. The number and stringency of the conditions vary. For some borrowers cover is not available on any terms.

b The Export-Import Bank (EXIM) of the United States, the Export Credits Guarantee Department (ECGD) of the United Kingdom, and the Nederlandsche Creditverzekering Maatschappij (NCM).

c Each country for which information is available corresponds to two instances for the terms available on its insurance cover for short-term credits, one for EXIM and one for NCM, and likewise to two instances for the terms available on its cover for medium- and long-term credits, one for EXIM and one for ECGD.

d Insurance cover for credits with maturities up to 180 days, except in the case of credits from EXIM for certain equipment goods and bulk agricultural commodities, for which maturities up to 360 days are also classified as short-term.

e Insurance cover for credits other than short-term.

f Including Oceania.

ability of official export credit insurance and interest obligations should not be regarded as independent determinants of the cost of export credits. The risk premiums included in the interest rates on trade financing, which can represent a substantial proportion of total rates, may well be significantly reduced for credits carrying official insurance or guarantees.

As is shown in table 15, for the majority of developing countries and economies in transition credit insurance cover is available from EXIM, ECGD and NCM only on restrictive conditions or not at all. Even for the countries of South and South-East Asia cover was available on normal terms in early 1996 only in approximately one third of instances.[39] For countries of Latin America the proportion was about 15 per cent for short-term and 25 per cent for medium- and long-term credits, while the proportions for Africa were respectively 13 per cent and 15 per cent and for Central and Eastern Europe 13 per cent and 25 per

Table 16

CHANGES IN TERMS[a] ON INSURANCE COVER AVAILABLE TO SELECTED REGIONS FROM SELECTED EXPORT CREDIT AGENCIES[b]

(Number of instances)

Region	From late 1994/early 1995 to late 1995/early 1996: *More favourable terms*[a]	*Less favourable terms*[a]
Africa	3	0
Latin America	10	9
South and South-East Asia[c]	7	1
Central and Eastern Europe	3	0

Source: Exporter's regional guides and credit surveys in *Project and Trade Finance*, various issues.

a All instances in which there has been a change in the terms of export credit insurance cover available from EXIM, ECGD or NCM between the categories, "normal cover", "no cover", and "restrictive conditions". (For "instances" and these three categories see notes a and c to table 15) Such changes are recorded separately for short-term and for medium- and long-term credits.

b The Export-Import Bank (EXIM) of the United States, the Export Credits Guarantee Department (ECGD) of the United Kingdom, and the Nederlandsche Creditverzekering Maatschappij (NCM).

c Including Oceania.

cent (the latter figure having doubled since early 1995). Cover was completely unavailable much more frequently in the case of medium- and long-term credits than of short-term credits, the proportion of instances being almost two thirds for African countries (in comparison with 25 per cent for short-term credits), 54 per cent for countries of Central and Eastern Europe (33 per cent for short-term credits), 31 per cent for Latin American countries (10 per cent for short-term credits), and 20 per cent for countries of South and South-East Asia (7 per cent for short-term credits).

Generally, the conditions associated with the availability of official credit insurance are characterized by a fairly high degree of inertia. But, as shown in table 16, during 1995 there were several shifts between the three categories according to which these terms are classified. This greater variability was particularly notable for Latin America, where, for example, Brazil was accorded "normal terms" by EXIM and Venezuela experienced unfavourable shifts from both ECGD and NCM. The terms associated with the provision of private credit insurance also shift slowly, and here 1995 was no exception. The main movements in this market involved countries of Central and Eastern Europe, two of which (Bulgaria and Poland) experienced an improvement in the terms on which credit insurance was available from this source.

The prevalence of restrictive conditions for both official and private credit insurance cover reflects not only perceptions of borrowers' creditworthiness but also restrictions on supply due to operating constraints of the institutions writing the insurance. For private insurers such constraints are not easy to document, but for ECAs they reflect partly long-term obligations to be self-supporting in their commercial operations. Widespread interruptions of debt service have been reflected in the profit performance of ECAs since the mid-1980s. But, as is shown in table 17, this performance has been improving since 1992, so that it is reasonable to assume that pressures on ECAs from this source to impose restrictive conditions have begun to diminish.

Perceptions of borrowing countries' creditworthiness and their relation to transactions costs in their trade are also evident from data other than the conditions associated with official export credit insurance, such as the preferred payment terms in the export credit and collection surveys in the bi-weekly *Financial Times* newsletter, *International Trade Finance*. The preferred payments terms in these surveys are "open account", "sight draft" or "cash against documents (CAD)", "unconfirmed letter of credit", "confirmed letter of credit", and "cash in advance".

Under *payment on open account* an invoice is sent to the importer at the same time as the shipping of the goods, payment being specified within a predetermined period. This arrangement requires no intermediary, so that the associated transaction costs are at a minimum. However, it is also based on trust and is used mainly in trade between entities (such as inter-related companies) with a history of satisfactory transactions. The terms *sight draft* and *CAD* refer to transactions in which the documents conferring title to goods are released to the importer only against payment by sight draft or on his acceptance of a time draft. A sight draft or bill

Table 17

PROPORTION OF EXPORT CREDIT AGENCIES[a] IN SELECTED OECD COUNTRIES THAT INCURRED CASH-FLOW DEFICITS, 1985-1994

(Percentage)

	1985	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*
Proportion:	74	70	83	65	65	71	83	83	54	33

Source: Information supplied by the Berne Union.

a 1985-1989: 23 agencies in 19 countries; 1990-1991: 25 agencies in 20 countries; 1992-1994: 24 agencies in 20 countries.

of exchange is an unconditional order addressed by one party to another, requiring the latter to pay a specified sum on demand or at a fixed future date. Since such a bill is a negotiable instrument (which can be turned into cash immediately), the exporter thus obtains greater security than in the case of payment on open account. This arrangement does not require the interposition of a bank, and the associated costs are low. In the case of a time draft, payment is to be made at a specified time in the future (so that there is an additional risk that the accepted draft may not be paid at maturity). A *letter of credit* is a written undertaking by a bank in response to the instructions of the applicant (the importer) to make payment to the beneficiary (the exporter) against prescribed documents. It provides the exporter with insurance against the commercial risk of non-payment by the importer since its validity is independent of the underlying transaction. However, especially when the bank issuing the letter of credit is a local institution in the importer's country, the exporter is not protected from political risk resulting from events in the importer's country such as the unavailability of foreign exchange or the imposition of foreign-exchange controls which make fulfilment of the contractual obligation impossible. This risk can be removed by a *confirmed letter of credit* under which another bank, typically in the exporter's country, adds its commitment to pay to that of the issuing bank. Confirmation of the letter of credit results in charges by the confirming bank additional to those of an unconfirmed letter of credit (which consist of the fees of the issuing bank and others associated with arranging for the payment to be made). In the case of *cash in advance*, delivery of the goods is authorized by the exporter only after actual receipt of money from the importer. This arrangement is used for transactions with a particularly high risk of non-payment. The first two of the preferred payment terms in the surveys of *International Trade Finance* are appropriate for transactions carrying low degrees of payments risk, and the latter three for successively greater degrees.[40]

The distribution of countries of different regions by recommended payments terms is shown in table 18. It can be seen that 85 per cent of developed countries benefit from the terms associated with lowest payments risk and transaction costs, whereas for regions consisting of developing countries and economies in transition the proportions vary from 25 per cent (for South and South-East Asia) to zero. For developing countries and economies in transition the greatest concentration of preferred payments terms is to be found in the categories of confirmed and unconfirmed letters of credit. Correspondence between rankings of countries' creditworthiness on the basis of recommended payments terms in *International Trade Finance*, on the one hand, and the restrictiveness of conditions associated with official credit insurance, on the other, is imperfect. Nevertheless, the distribution of countries according to the former broadly confirms the prevalence of unfavourable perceptions evident in the latter.[41]

Table 18

RECOMMENDED PAYMENTS ARRANGEMENTS FOR SELECTED DEVELOPING COUNTRIES AND TRANSITION ECONOMIES OF CENTRAL AND EASTERN EUROPE

(Percentage distribution)[a]

Region / Arrangement	Open account	CAD[b] sight draft	Unconfirmed letter of credit	Confirmed letter of credit	Cash in advance
Latin America	-	12	68	20	-
Africa	-	-	48	41	10
South and South-East Asia	6	19	44	31	-
Central and Eastern Europe	-	-	42	50	8
Memo item:					
Developed countries	31	54	15	-	-

Source: *International Trade Finance*, 19 January 1996.
a Data refer to the situation in early 1996.
b Cash against documents.

D. Renegotiation and reduction of bank debt

Since mid-1995 renegotiation and restructuring of debts to commercial banks have continued for countries from all regions. A number of Latin American countries and a major transition economy are at various stages of restructurings involving a spectrum of different options to creditors in accordance with the approach adopted in major renegotiations since the beginning of the 1990s. Some low-income countries have undertaken buy-back operations with multilateral and bilateral official support. Moreover, there has been progress towards an agreed distribution of liabilities associated with external debts among the new States of Central and Eastern Europe. These negotiations have covered the debts of the former USSR and the external assets, as well as liabilities, of the former republics of Yugoslavia (and in the latter case involve issues on which definitive agreement has not been reached).

In October 1995, Peru reached an agreement in principle to restructure $4.2 billion of principal and $3.5 billion of interest arrears. The menu of options for creditor banks includes a buy-back and a 45 per cent discount bond. In the same month, Panama reached an agreement to restructure $2 billion of principal and $1.5 billion of interest arrears owed to banks. Options for creditor banks include a 45 per cent discount bond with a 30-year maturity and a par bond with an increasing interest rate (both bonds having grace periods). Expectations that the debt problems of major countries in Latin America had definitively receded were set back by the Mexican crisis which began in late 1994. As is documented above, the virtual exclusion of major countries of this region from international securities markets which followed the outbreak of this crisis proved short-lived. However, Venezuela is now thought likely to initiate negotiations on rescheduling that portion of its debt to commercial banks which was not part of the restructuring agreement in 1990.

Following completion of lengthy negotiations on the status of its commercial bank debt after the breakup of the USSR, in November 1995 the Rus-

sian Federation reached an agreement to reschedule $25.5 billion of principal and $7 billion of interest arrears. The principal will be repaid over 25 years, with a seven-year grace period, at a margin over the interbank lending rate. Of the interest arrears, $500 million will be paid at closing and $1.5 billion by the end of 1996; the balance will be exchanged for interest notes with a 20-year maturity (with the same grace period and interest rate as apply to rescheduled principal).

In June 1995 Algeria concluded an agreement with its creditors to reschedule $3.2 billion of commercial bank debt, a figure which includes $1.5 billion already rescheduled in February 1992. The rescheduling covers 71 per cent of the total $4.5 billion outstanding. The rescheduled debt is to be repaid according to new maturities at a margin over the interbank lending rate.

In May 1996 Viet Nam agreed in principle with its bank advisory committee on a menu of options to restructure its $900 million of debt to commercial banks. The options for creditors include a cash buy-back and par and discount bonds, both with 30-year maturities. Interest arrears are to exchanged for past-due-interest bonds with 18-year maturities. The package includes debt reduction of 50 per cent.

Nicaragua, Sierra Leone and Albania completed buy-backs of commercial bank debt in 1995. In November 1995 Nicaragua bought back $1.1 billion of its outstanding commercial bank debt, or 81 per cent of the total of $1.4 billion, as part of a deal also involving cancellation of some interest claims. The buy-back was funded by a grant of $40 million from the IDA Debt Reduction Facility,[42] a $40 million loan from the Inter-American Development Bank, and grants from the Governments of the Netherlands, Sweden and Switzerland. The purchase price was 8 cents per dollar. In August 1995 Sierra Leone completed a buy-back of $234 million of commercial bank debt. $160 million was bought back in May 1995 for 15 cents on the dollar and the remaining $74 million in August for 8 cents on the dollar. The cost of $31.5 million was met from the IDA Debt Reduction Facility and from bilateral European donors. In July 1995, under the sponsorship of the IDA Debt Reduction Facility, Albania reached an agreement with its creditor banks which comprised conversion of the $130 million of debt into 30-year par bonds, whose principal is collateralized by zero-coupon United States Treasury bonds of the same maturity, and the buy-back of $370 million at 26 cents on the dollar. The debt was mostly short-term and trade-related and included interest arrears. In order to make the par bonds close in value to the buy-back option, each bondholder received the right to a pro-rata share of the distribution of an Income Fund consisting of a managed portfolio of emerging market instruments. The proceeds of the Fund will be invested with the aim of generating income comparable to the value of interest payments on the par bonds. The cost of the operation was $97 million, of which $55 million were provided by Albania, $24 million by the Debt Reduction Facility, and the rest by other sources.

E. Official debt

The severe difficulties that heavily indebted poor countries (HIPCs)[43] continue to experience in servicing their debt and the perception that the debt overhang poses a serious impediment to growth and development have thrust the multilateral debt issue into prominence. Debt owed to multilateral institutions accounts for an important and rising portion of total indebtedness and an even larger share of total debt service for these countries. It has become increasingly clear that existing debt relief mechanisms will not suffice to bring the debt burden of a significant number of these countries to a sustainable level. It is now generally agreed that a lasting solution to their debt problems requires a comprehensive and coordinated approach, involving stronger measures and a sharing of the burden among all creditors, including multilateral financial institutions (MFIs). The

framework for action to resolve the debt problems of HIPCs, which was proposed by IMF and the World Bank and welcomed by both the Interim Committee and the Development Committee at their spring 1996 meetings, is an official recognition of the need for a comprehensive debt strategy and represents a commitment to act decisively to ease the burden of multilateral debt. It addresses the concerns of the 29 debt-distressed LDCs which are categorized by IMF/World Bank as HIPCs. The proposal offers hope for LDCs and other poor countries with a proven track record of economic reform and structural adjustment to attain debt sustainability. It is in the interest of all parties concerned that growth in these countries be resumed as rapidly as possible.

1. Multilateral debt

(a) Recent developments regarding the multilateral debt of HIPCs

In 1994, the total multilateral debt of HIPCs amounted to around $62 billion, of which almost 70 per cent was concessional. With multilateral debt accounting for the bulk of new loans, its share continued to rise, reaching over 25 per cent of the total external debt of $241 billion in 1994. Multilateral debt service in that year amounted to over $4 billion, representing over 46 per cent of total debt service (see table 19), or about 9 per cent of exports of goods and services.

The grave difficulties which these countries continue to encounter in servicing their debt are reflected in actual debt service payments to all creditors, amounting in 1994 to just over one third of debt service due.[44] As a result, arrears continued to mount, reaching $74 billion by the end of that year. However, since priority has been given to the servicing of multilateral debt, the problem of arrears is relatively much greater for bilateral debt. Although practically all HIPCs registered arrears, those with protracted arrears (i.e. of six months or more) with the World Bank and IMF number only four. As shown in table 19, debt profiles vary considerably among countries, with multilateral debt accounting for over 50 per cent of total debt in 13 cases.

As for the structure of multilateral debt by source, the World Bank was the largest creditor in 1994, accounting for 55 per cent of the total; followed by the regional development banks (22 per cent) and IMF (12 per cent).[45] Net transfers from multilateral financial institutions to the group as a whole have consistently been positive and substantial, totalling over $2 billion in 1994.

(b) Current policies affecting the burden of multilateral debt[46]

Three MFIs - the World Bank, IMF and the African Development Bank - dominate the multilateral debt scene. Together, they accounted for over 82 per cent of the multilateral debt of HIPCs in 1994, so that action taken on their debt would be critical to the resolution of the multilateral debt problem. In addition to measures by MFIs, an innovative scheme entirely financed by bilateral donors was recently established in Uganda, involving the creation of a multilateral debt fund (see box 1).

(i) Increased concessionality of debt

The soft windows of MFIs were established to support the development efforts of low-income countries. The debt crisis reinforced the importance of and the need for providing financial support, on terms more closely suited to debtors' capacity to pay, not only for development projects but also for implementing policy reforms and overcoming chronic balance-of-payments difficulties. This is a good preventive approach, and for those countries already encountering serious debt-servicing problems improving the concessionality of debt has eased their burden, as it led in effect to implicit refinancing of loans contracted on near-commercial terms with funds secured on softer terms. This was the basic strategy adopted by the Bretton Woods institutions to provide debt relief.

The International Development Association (IDA), the soft window of the World Bank, is the most important channel for providing highly concessional financing to low-income countries. In 1994, it accounted for 44 per cent of the multilateral debt of HIPCs. The cessation of non-concessional IBRD lending in almost all of these countries and the sustained rise in IDA disbursements have resulted in significant positive net transfers from the Bank. Net transfers from the World Bank rose sharply (by 78 per cent) in 1994, reaching $1.4 billion.

Table 19

DEBT STATISTICS FOR HEAVILY INDEBTED POOR COUNTRIES, 1994

(Millions of dollars and percentage shares)

Country	Debt			Debt service			Debt service due	Arrears	Net transfers on debt-creating flows	
	Total	Multilateral	Share of multilateral (Per cent)	Total	Multilateral	Share of multilateral (Per cent)			Total	Multilateral
All HIPCs	**240 725**	**62 157**	***25.8***	**9 085**	**4 223**	***46.5***	**26 654**	**74 017**	**-2 370**	**2 174**
Angola	10 609	159	*1.5*	74	-	-	1 085	4 747	69	33
Benin	1 619	856	*52.9*	41	22	*53.7*	52	42	86	94
Bolivia	4 749	2 539	*53.5*	343	215	*62.7*	426	137	131	128
Burkina Faso	1 126	927	*82.3*	44	37	*84.1*	43	47	100	88
Burundi	1 126	937	*83.2*	41	30	*73.2*	41	13	16	19
Cameroon	7 275	1 664	*22.9*	374	237	*63.4*	1 068	983	88	71
Central African Republic	891	632	*70.9*	23	20	*87.0*	80	65	20	38
Chad	816	633	*77.6*	15	11	*73.3*	25	49	55	60
Congo	5 275	717	*13.6*	555	174	*31.4*	1 524	1 076	-262	85
Côte d'Ivoire	18 452	3 695	*20.0*	1 274	606	*47.6*	2 144	3 646	-919	154
Equatorial Guinea	291	120	*41.2*	2	2	*75.0*	22	110	15	5
Ethiopia	5 059	2 196	*43.4*	92	50	*54.3*	414	1 022	178	216
Ghana	5 389	3 370	*62.5*	343	165	*48.1*	322	150	182	27
Guinea	3 104	1 376	*44.3*	97	36	*37.1*	244	559	77	115
Guinea-Bissau	816	369	*45.2*	7	4	*57.1*	69	222	19	9
Guyana	2 038	787	*38.6*	97	66	*68.0*	165	148	-51	-20
Honduras	4 418	2 171	*49.1*	433	283	*65.4*	468	217	36	-88
Kenya	7 273	3 159	*43.4*	888	251	*28.3*	1 356	100	-597	-62
Lao People's Dem. Rep.	2 080	576	*27.7*	20	7	*35.0*	20	-	56	59
Liberia	2 056	769	*37.4*	15	15	*100.0*	160	1 469	-14	-15
Madagascar	4 134	1 683	*40.7*	60	49	*81.7*	419	1 425	-	21
Mali	2 781	1 340	*48.2*	130	61	*46.9*	198	406	21	94
Mauritania	2 326	916	*39.4*	105	70	*66.7*	188	364	42	60
Mozambique	5 491	1 266	*23.1*	91	36	*39.6*	361	1 159	191	226
Myanmar	6 502	1 458	*22.4*	173	35	*20.2*	577	1 778	-111	-23
Nicaragua	11 019	1 363	*12.4*	183	70	*38.3*	1 463	5 816	-65	132
Niger	1 570	888	*56.6*	66	31	*47.0*	242	65	7	49
Nigeria	33 485	4 807	*14.4*	1 916	812	*42.4*	5 799	10 238	-1 818	-201
Rwanda	954	762	*79.9*	6	6	*85.9*	32	70	-18	14
Sao Tome and Principe	252	167	*66.3*	3	2	*85.2*	9	58	7	12
Senegal	3 678	2 075	*56.4*	197	154	*78.2*	465	289	-74	28
Sierra Leone	1 392	479	*34.4*	146	124	*84.9*	186	90	38	71
Somalia	2 616	938	*35.9*	-	-	-	171	1 519	-	-
Sudan	17 710	3 016	*17.0*	1	-	-	1 271	13 390	7	7
Togo	1 455	764	*52.5*	24	21	*87.5*	112	196	44	35
Uganda	3 473	2 411	*69.4*	152	104	*68.4*	173	313	186	201
United Rep. of Tanzania	7 442	2 855	*38.4*	174	114	*65.5*	548	2 472	108	91
Viet Nam	25 115	512	*2.0*	300	13	*4.3*	2 456	9 494	88	291
Yemen	5 959	1 207	*20.3*	145	61	*42.1*	360	2 550	13	53
Zaire	12 336	2 804	*22.7*	66	7	*10.6*	1 294	5 539	-201	-5
Zambia	6 573	2 794	*42.5*	369	223	*60.4*	602	1 984	-120	2

Source: UNCTAD secretariat calculations, based on *World Debt Tables 1996* (Washington, D.C., 1996), Vol. 2.

Box 1

THE UGANDA MULTILATERAL DEBT FUND

Even after a commercial debt buy-back and a stock-of-debt operation on Naples terms, Uganda's debt situation remained unsustainable because of the heavy burden of multilateral debt, which accounted for almost 70 per cent of its total debt and debt service in 1994. With the financial support of a group of donors (Austria, Denmark, Netherlands, Sweden and Switzerland), the Uganda Multilateral Debt Fund (UMDF) was established in July 1995. The creation of UMDF involved a comprehensive assessment of debt sustainability in which the Government of Uganda played a leading role, in consultation with the donors and the Bretton Woods institutions. It was made possible by Uganda's good policy track record, and donor contributions are contingent on continued adjustment efforts. To further safeguard against moral hazard, there are specific commitments on fiscal and reserves management, as well as limits on new borrowings.

It needed only pledges in principle from three major donors of around $30 million to launch the Fund. This had a catalytic effect in generating pledges from other donors. However, the request for contributions from IMF and the World Bank was not successful. The UMDF will pay a portion of the debt service as it falls due, with donors providing an up-front contribution, to the extent possible, at the beginning of each financial year. Allowance has been made to provide donors with flexibility with regard to payment methods and timing. The Fund is managed by the Government of Uganda. Such responsibility has encouraged improvements in debt management, as well as in fiscal and reserves management. Coordination is achieved through the annual Consultative Group meeting and local quarterly meetings called by the Government, with the participation of donors and the Bretton Woods institutions.

The UMDF is the first country fund which focuses on multilateral debt relief. Its efficient payments method has avoided even transitory arrears. As for the possible applicability of this approach to other LDCs or to other poor countries, it would require the existence of a global coordination mechanism to establish clear criteria of need and adjustment track records and, of course, willing donors. In some donor countries, such as those that have launched this fund, there is strong political support for debt relief based on the perception that the debt overhang is a key barrier to development in some poor countries, and that debt relief is more valuable than other forms of aid because removing the overhang would improve growth prospects for debtors and reimbursement prospects for creditors.

The IMF/World Bank proposed framework for action to resolve the debt problems of HIPCs includes as options the creation of a special (multi-country) trust fund and/or single-country trust funds to which multilateral development banks and bilateral donors could contribute. Thus, country funds similar to UMDF could very well fit into this scheme.

Source: M. Martin, "A Multilateral Debt Facility: Global and National", Report to the Group of 24, 31 March 1996, to be reproduced in UNCTAD, *International Monetary and Financial Issues for the 1960s*, Vol. VIII (forthcoming).

The Enhanced Structural Adjustment Facility (ESAF) is regarded by IMF as the centrepiece of its strategy to resolve the debt problems of HIPCs. For these countries as a whole, concessional debt to the Fund increased substantially over the past two years - by 24 per cent in 1994 and a further 41 per cent in 1995. This led to a largely enhanced share of concessional debt in total IMF debt in 1995, of 72 per cent, compared with 56 per cent in 1993. It also led to the reversal of the protracted negative net transfers from the Fund, which had lasted for a decade (1984-1993). These countries accounted for a large proportion of total IMF concessional lending, reaching 69 per cent in 1995. Current terms for ESAF loans are an interest rate of 0.5 per cent, a maturity of 10 years and a grace period of five-and-a-half years. The concessionality of ESAF loans is expected to be enhanced in the context of the proposed HIPC debt initiative, through extension of maturities and grace periods.

In the face of serious budgetary constraints in major donor countries, the replenishment of the soft windows of MFIs has been under threat. The process of negotiating IDA-11 replenishment, which covers fiscal years (FY) 1997-1999, proved lengthy and complex. The decision by the United States Congress to appropriate only $700 million for FY1996 instead of the $1.25 billion annual commitment for IDA-10 resulted in a conflict between the traditional burden-sharing formula and adequate replenishment. This led to agreement on the adoption of extraordinary measures in Tokyo in March 1996, including the creation of a one-year Emergency Trust Fund for FY1997 to which all donors, except the United States, are to contribute over SDR 2 billion, while the United States clears its outstanding IDA-10 commitments. The United States will be excluded from decision making and from procurement contracts for activities financed by the Emergency Trust Fund. Subsequently, there will be a two-year replenishment of IDA's general resources, to which all donors will contribute a total of SDR 5 billion. Another SDR 7.5 billion will come from past donor contributions, reflows and IBRD transfers, resulting in a package totalling close to SDR 14.5 billion over FY1997-1999. While less than originally hoped for, this amount will nevertheless allow a continuation of IDA activities at currently planned levels, although estimated contingency requirements are largely unfunded. However, the IDA-11 replenishment represents a significant decline from that of IDA-10 of SDR 16 billion which had been agreed to in December 1992. The drop in donors' contributions is substantial, from SDR 13 billion to SDR 7 billion. The latter amount is significantly less than what IDA is likely to require in the future, even after taking into account increasing reflows.

The Enhanced Structural Adjustment Facility, too, faces funding problems. At the October 1995 meeting of the Interim Committee, there was consensus on the establishment of a self-sustained ESAF. The Facility's existing resources are expected to last up to 1999 and it is projected that by 2005 there will be enough resources to finance lending of about SDR 0.8 billion a year on a self-sustaining basis. However, for the interim period 2000-2004, there is a need to secure financing for annual loan commitments of about SDR 1 billion and associated subsidy requirements totalling SDR 2.1 billion. Among the options proposed to finance the principal component are use of IMF's General Resources Account and further borrowing by the ESAF Trust from bilateral sources. As for the subsidy, the following possibilities, which could be combined, were mentioned: bilateral contributions; investment income on the profits from a modest sale of IMF gold; use of resources in the Second Special Contingent Account (SCA-2), with these resources first refunded to member countries and then rechannelled to the Fund; and limited early use of amounts accumulating in the ESAF Reserve Account, which would imply a lower level of self-sustained ESAF operations.[47]

The funding impasse over the seventh replenishment of the African Development Fund, the soft window of the African Development Bank (AfDB), finally ended in May 1996 with an agreed replenishment of around $2.6 billion, which is $400 million short of the amount requested. The impasse lasted for more than two years as donors wanted assurance of tighter credit policies and management controls. There has been no new loan approval from the African Development Fund since 1994. The payment of sums pledged was made conditional on the Bank's restructuring and continued implementation of recommended reforms. The Bank recently adopted a credit policy based on World Bank criteria, which would restrict lending to low-income countries to soft loans and have the effect that only 12 countries would be eligible for non-concessional loans. However, private sector projects assessed to have a commercial rate of return can be provided loans on non-concessional terms in any African country. The new credit policy should help reconcile the imbalance between the degree of concessionality of loans and income levels of borrowers.

(ii) Other measures

The Rights Accumulation Programme (RAP) was introduced by IMF in 1990 for countries with protracted arrears to the Fund at the end of 1989. In accordance with a phased schedule, a country can accumulate rights to future drawings of Fund resources up to the amount of arrears outstanding at the beginning of the programme, while establishing a track record on policy performance. Zambia was the third country to have successfully completed a RAP in December 1995, following Peru and Sierra Leone. Facilitated by bridging finance provided by several donors, Zambia cleared its $1.2 billion arrears with the Fund, thereby considerably reducing the total of outstanding arrears to the Fund, since Zambia had the second largest arrears. There remain, however, four LDCs (Liberia, Somalia, Sudan and Zaire) with substantial

arrears, totalling almost $2.8 billion in January 1996 and accounting for virtually all arrears to the Fund. Sudan's arrears amounted to $1.6 billion, representing 55 per cent of the total. The World Bank has a similar programme, but arrears of the same four countries were much smaller, amounting to $415 million at the end of FY1995 and comprising 17 per cent of total arrears to the Bank. Arrears with the African Development Bank, currently running at around $800 million, remain an acute problem. In May 1996, 24 countries were in default to the Bank,[48] of which 6 countries alone - Zaire, Congo, Cameroon, Angola, Liberia and Somalia - accounted for 75 per cent of the total. In its effort to control arrears, AfDB recently approved the following measures: tightening the policy on sanctions; systematic application of directives on loan cancellation; and enhanced coordination with the Bretton Woods institutions.

It should be noted that the settlement of protracted multilateral arrears since 1990 has depended critically on bilateral financial support, through loans, grants, Paris Club reschedulings and bridge financing. This has been the case for countries with large financing requirements relative to quotas and those that have cleared arrears without recourse to the RAP. Support groups have typically been led by one or two creditor countries with particularly strong ties to the debtor. For example, a support group provided $65 million in grants to help Haiti clear its arrears to IMF and other multilateral institutions in December 1994.[49]

The Fifth Dimension facility of the World Bank, which is largely financed through IDA reflows, allocated supplemental IDA resources of $178 million in FY1995 to 12 adjusting HIPCs, in order to assist them in meeting interest payments on their outstanding IBRD debt.

(c) A comprehensive approach to the debt problems of HIPCs

At the start of the debt crisis in the early 1980s, the prevailing view among official creditors was that the problem was one of liquidity. The strategy adopted was continued financial flows in conjunction with adjustment programmes to restore growth and debt servicing capacity, together with refinancing and rescheduling provided by bilateral creditors. In time it became evident that the problem was one of solvency and that the debt overhang was hampering development efforts. The most direct means of eliminating the overhang was, of course, debt reduction. While originally resisted by bilateral creditors, eventually debt reduction became an accepted principle of debt negotiations in the context of the Brady Plan deals for commercial bank debt and reschedulings on Toronto terms since 1988 within the framework of the Paris Club for official bilateral debt. This strategy, combined with sustained adjustment efforts, proved effective in resolving the debt problems of middle-income countries, but the situation of the heavily indebted poor countries continued to deteriorate, even in several countries pursuing policies acknowledged as sound. The low level of development in most of these countries, characterized by structural rigidities, weak institutions and administration, poorly functioning markets, and deficiencies in skills and infrastructure, prevented a rapid and strong response to reform efforts. There were other impediments to growth, such as adverse terms of trade and climatic conditions and, in some countries, poor implementation of adjustment programmes and the crippling effects of civil strife. Concern over the continuing plight of poor countries led to substantial cancellation of ODA debts by some donors and the adoption by Paris Club creditors of London terms in December 1991 and of Naples terms in December 1994 (see subsection 2(a) below on the Paris Club terms). However, studies on the impact of the Naples terms, including the assessment provided in *TDR 1995*, indicate that for a significant number of countries, even with the full implementation of the Naples terms, the debt situation would remain unsustainable mainly on account of the sheer burden of their multilateral debt as well as of non-Paris Club bilateral debt.

There has been growing pressure for stronger action from MFIs. The implicit refinancing of non-concessional debts by loans on concessional terms, while leading to some reduction in the present value of the debt, offers no exit prospect and would not resolve the overhang problem. Moreover, pressure to lend to prevent the build-up of arrears could distort lending decisions. The strategy adopted also runs the risk of an allocation pattern favouring countries with large multilateral debt and detrimental to countries that have been able to manage their debt well. The existing schemes, which involve contributions to soft windows and debt relief facilities and also the creation of support groups, absorb a large volume of bilateral resources. These resources have lately been under increasing budgetary constraints, with a risk of diverting scarce development funds for debt relief. The focus on

multilateral debt has also raised the issue of the preferred creditor status of MFIs. This status is widely acknowledged, but there are different interpretations of what it implies. For MFIs, it means exemption of multilateral debt from debt rescheduling and reduction. The application of this principle has resulted in growing arrears on bilateral debt, despite write-offs and the provision by many bilateral donors of new financing on a purely grant basis to poor countries, in order to avoid the consequences of being in arrears on multilateral debt, particularly that owed to the Bretton Woods institutions.[50]

It has become evident that the solution to the debt problems of HIPCs requires bolder measures, going beyond the existing framework. The fragmented approach used so far has clearly not worked satisfactorily. An effective debt strategy needs to be comprehensive, covering all components of debt, and should involve equitable burden sharing among all creditors, including MFIs. Such an approach would require coordination among all parties concerned.

(i) Debt sustainability analysis

At their meetings in October 1995, the Interim Committee and the Development Committee requested IMF and the World Bank to continue their work on how to address the debt problems of HIPCs, including country-specific analysis of debt sustainability. In response to the request, the two institutions have recently undertaken a detailed and comprehensive analysis of debt sustainability for a number of countries. Debt sustainability implies the ability to meet fully current and future debt obligations without unduly compromising growth. The methodology employed involves the choice of a time horizon, projections of principal macroeconomic variables and capital inflows, and focusing on the evolution of two key debt indicators. Threshold ranges of 20-25 per cent for the ratio of debt service to exports and 200-250 per cent for the ratio of the present value of debt to exports were used as indicators of sustainability. These conventional thresholds served as a starting point, but other risk indicators[51] were also considered, especially in borderline cases. The fiscal burden of external debt service is particularly relevant for HIPCs, as their debt is primarily public debt and past experience with debt crises indicates that, in a number of countries, the principal problem has been the fiscal burden rather than balance-of-payments difficulties.

Recent debt burden indicators for HIPCs are presented in table 20. During 1992-1994, only 5 of the 41 countries had, on average, a ratio of present value of debt to exports of less than 200 per cent, and only 6 had ratios of debt service to exports lower than the threshold range. For the fiscal indicators, 1994 scheduled debt service was greater than 50 per cent of government current expenditure in 22 countries and represented over 50 per cent of government revenue in 25 countries. In 13 countries, it even exceeded total government revenue. Current debt burdens are clearly unsustainable for most HIPCs. However, debt sustainability prospects are likely to evolve, and the question is whether with the full use of existing mechanisms the debt burden will reach sustainable levels within a reasonable period.

The preliminary results of the debt sustainability analysis indicate that the situation of eight countries has been classified as "unsustainable". These are the countries with debt indicators remaining above threshold ranges for more than 10 years despite adherence to sound policies and full use of existing debt relief mechanisms. Twelve other countries face a heavy debt and debt service burden in the medium term; for them judgment on sustainability would depend on country-specific risk factors.[52]

(ii) A framework for action

The IMF and the World Bank proposed a framework for action to resolve the debt problems of HIPCs for discussion at the April 1996 meetings of the Interim and Development Committees. The two committees welcomed the proposed framework and endorsed the following six principles to guide such action: (1) the objective should be to target overall debt sustainability on a case-by-case basis; (2) action should be envisaged only when the debtor has shown, through a track record, the ability to put to good use whatever exceptional support is provided; (3) new measures should build, as much as possible, on existing mechanisms; (4) additional action should be coordinated among all creditors involved, with broad and equitable participation; (5) actions by multilateral creditors should preserve their financial integrity and preferred creditor status; and (6) new external finance for the countries concerned should be on appropriately concessional terms. The Committees also agreed that further action beyond existing mechanisms was needed, including contributions by MFIs from their own resources, contributions by bilat-

Table 20

DEBT BURDEN INDICATORS FOR HEAVILY INDEBTED POOR COUNTRIES, 1992-1994

(Percentage)

Country	1992-1994[a] Debt to exports: Nominal value	Debt to exports: Present value[b]	Debt to GNP: Nominal value	Debt to GNP: Present value[b]	Debt service to exports	1994 Scheduled debt service to: Govt. current expenditure	Scheduled debt service to: Government revenue
Angola	302	278	204	188	32	63	98
Benin	272	142	82	43	11	45	46
Bolivia	457	332	85	62	46	35	31
Burkina Faso	201	104	38	20	12	24	28
Burundi	891	388	111	48	40	31	33
Cameroon	303	250	79	65	36	68	111
Central African Republic	464	243	79	41	22	39	68
Chad	400	195	70	34	13	23	48
Congo	434	370	292	249	52	47	63
Côte d'Ivoire	557	486	263	228	64	79	91
Equatorial Guinea	435	308	177	126	14	105	111
Ethiopia	608	383	77	49	38	30	31
Ghana	392	242	84	52	27	37	29
Guinea	402	255	94	59	31	82	74
Guinea-Bissau	1 934	1 280	328	217	106	123	144
Guyana	479	345	563	405	31	102	92
Honduras	347	271	134	104	41	65	54
Kenya	307	225	114	84	39	36	29
Lao People's Democratic Rep.	791	214	149	41	7	6	6
Liberia	374	339	142	128	8	..	..
Madagascar	694	495	160	114	71	100	166
Mali	523	288	115	63	31	65	75
Mauritania	469	327	226	158	60	113	87
Mozambique	1 367	1 039	444	337	95	141	183
Myanmar	600	442	38	28	32	6	7
Nicaragua	2 879	2 579	804	720	172	409	415
Niger	544	322	82	48	45	52	110
Nigeria	277	250	109	99	38	75	105
Rwanda	1 142	533	93	44	47	22	80
Sao Tome and Principe	2 082	1 101	788	418	97	78	183
Senegal	253	166	77	50	23	48	50
Sierra Leone	835	637	203	156	93	99	111
Somalia	4 711	3 745	321	254	150	..	..
Sudan	3 384	3 057	188	169	87	196	189
Togo	367	226	112	69	25	54	99
Uganda	1 285	733	99	56	89	33	31
United Republic of Tanzania	1 005	719	317	228	79	62	74
Viet Nam	638	524	198	162	44	17	15
Yemen	239	189	176	139	30	12	24
Zaire	706	594	136	114	46	624	608
Zambia	592	465	217	170	49	152	186

Source: World Bank, *World Debt Tables, 1996* (Washington, D.C., 1996) , Vol. 1; IMF, *Official Financing for Developing Countries*, Washington, D.C., December 1995.

Note: Exports include goods and services.

a Average of three annual ratios.

b The present value of debt takes account of differing borrowing terms and is calculated by discounting future debt service, defined as the sum of interest payments and principal repayments over the next 40 years. The discount rates used are the interest rates charged by the OECD countries for officially supported export credits (Commercial Interest Reference Rates), except for IBRD loans and IDA credits, which are discounted using the latest IBRD lending rates, and obligations to IMF, which are discounted at the SDR lending rate.

eral donors and appropriate action by the Paris Club and by other creditors. They requested IMF and the Bank, in close collaboration with other concerned parties, to put forward specific proposals as soon as possible, with the aim of reaching a decision by the next IMF/World Bank Annual Meetings, to be held in October 1996.[53] At the Lyons Summit in June 1996, the G-7 also acknowledged the need for additional action, in particular to reduce debts owed to multilateral institutions and non-Paris Club bilateral creditors. Paris Club creditors were urged to go beyond the Naples terms, where they deemed appropriate. The G-7 looked forward to a concrete solution being agreed to by next autumn at the latest.[54]

The proposed framework for action offers eligible countries a commitment by the international community to ease their debt burden in order to bring about debt sustainability, on the basis of an extended period of proven policy performance. It involves two stages. The first stage would build on the existing three-year track record needed to qualify for a stock-of-debt operation from the Paris Club and would involve the use of existing mechanisms for concessional financing and debt relief. At the end of the first stage, a comprehensive assessment would be made of a country's debt situation and prospects for sustainability. If the analysis suggested that the stock-of-debt operation would not produce a sustainable situation, an additional three-year track record would be needed to qualify for comprehensive treatment of the stock of debt under the HIPC initiative. A consultative group meeting would be convened to agree on a financing plan and identify required additional relief. From the beginning of the second stage, bilateral and commercial creditors, multilateral institutions and also bilateral donors could provide enhanced assistance. At the end of the second stage, the Paris Club would agree on a stock-of-debt operation with increased concessionality and the MFIs would undertake to reduce the present value of their claims to a level consistent with overall debt sustainability.

At least 8, and as many as 20, countries could qualify for additional assistance on the basis of the debt sustainability analysis described above. Once an internationally approved programme, within the proposed framework, has been adopted, potential candidates will have two years in which to participate, after which there would be a review to determine whether the programme should be extended in time, so as to include other eligible HIPCs.

An illustrative IMF/World Bank costing exercise shows that of the 19 potentially eligible countries (excluding Sudan), 13 would need additional debt relief (beyond current mechanisms) under the initiative to reduce their present value of debt-to-export ratios to below 200 per cent by their completion dates. A broad estimate of the cost of such relief is $5.6 billion in present value terms. Should official bilateral and commercial creditors provide up to 90 per cent reduction on eligible debt, the cost to multilateral creditors would be $2 billion. If they granted up to 80 per cent debt reduction, the cost would be $3.2 billion. Estimated total costs would rise to $7.7 billion with nominal export growth two percentage points lower than the baseline growth. Costs would be much higher if Liberia, Sudan and Somalia were included.

This is the first concrete proposal for multilateral debt action agreed to by both IMF and the World Bank. It represents an important change in their official position, in that they now accept that the multilateral debt problem requires measures beyond current schemes. This is a most welcome initiative. However, close attention will need to be given to the following specific features of the framework for action to ensure a lasting and rapid solution to the debt crisis.

- *Debt sustainability*: The assessment of debt sustainability is expected to play a key role in determining country eligibility and the amount of relief to be provided. A number of studies presented empirical evidence suggesting threshold levels for debt indicators lower than those used in the debt sustainability analysis of 20-25 per cent for the ratio of debt service to exports and 200-250 per cent for the ratio of the present value of the debt to exports.[55] In view of their importance in the proposed initiative, great care must be taken in establishing such thresholds so as to ensure that countries following sound policies will not revert to a crisis situation some time after the conclusion of the programme. The choice of the time horizon for reaching sustainability is also an important factor in determining eligibility. A 10-year period appears too long in view of the fact that many HIPCs have already been in an unsustainable situation for some considerable time.

  The highly uncertain nature of projections of relevant economic variables and the wide margins of error to which such projections are

normally subject call for great care to be exercized in the assumptions to be made on, for example, export growth and capital flows, which have a bearing on future debt indicators.

- *Required track record and the timing of debt reduction*: A satisfactory policy track record by the debtor is clearly an essential ingredient in any new approach. However, some flexibility in the application of the requirement of a track record over a six-year period before the final debt settlement, as well as in the timing of enhanced debt relief, may be desirable as there will be gains to all from assisting eligible HIPCs in resuming growth and normal debtor/creditor relations as rapidly as possible.

- *Contributions of individual MFIs*:[56] Each multilateral institution is expected to contribute in broad proportion to the present value of its outstanding exposure to the countries involved, as of the start of the second stage. An approach indicated is for MFIs to choose from a menu of options to reduce the burden of their claims. This menu could include the provision of grants to pay a portion of the multilateral debt service as it falls due or prepay part of the outstanding stock at the completion date; and/or the provision of concessional funding in greater amounts and with enhanced concessionality. While there appears to be logic and equity in this proportionality, as it implies that each institution would be assuming responsibility for past lending decisions, the capacity to offer relief varies among MFIs. Some may be in a comparatively weak position and may, therefore, need support should difficulties arise in meeting their expected contributions.

(d) Financing multilateral debt relief

In order to avoid introducing distortions in the country allocation of development assistance, it is essential that the resources underpinning any scheme within the framework described above be additional. Additionality implies the release of funds which are not already intended to be used for development purposes. Additionality could also be achieved by creating new resources, such as through a special issue of SDRs. Alternatively, part of a general allocation of SDRs could be set aside for multilateral debt relief. However, there is little political support for the SDR options. A special issue would require amending the IMF Articles of Agreement. Moreover, the use of SDRs carries market-related interest rates, so that there would still be a problem of financing interest subsidies.

Concerns have been raised with regard to the heavy burden imposed on bilateral donors by existing debt relief schemes, especially in the light of the fiscal constraints they confront. These restraints have led to growing demands for greater contributions from MFIs through the use of their own resources. The HIPC initiative is likely to strengthen these demands, since it calls for substantial additional efforts from bilateral creditors with respect to bilateral debt. However, any proposal concerning the use of MFIs' resources must ensure that the financial integrity of the institutions is preserved and that no prejudice to their credit rating would result. Among the various measures proposed which would meet the additionality criterion and are unlikely to affect the financial integrity of the institutions are:

- *Sale of a portion of IMF gold reserves*: IMF's contribution to reducing the debt burden of HIPCs is expected to involve ESAF, and it is therefore important that ESAF be placed on a sound financial footing. The financing of the continuation of ESAF had been under discussion even before the HIPC initiative was put forward. For this purpose, the Managing Director of IMF has proposed the sale of a minor portion, (around 5 per cent) of the IMF gold stock and investing the profits from the sale. The Fund holds more than 103 million fine ounces of gold, which are valued in its accounts at around SDR 35 per ounce. The current market price for gold is about $380-$390 per ounce. The investment income from the proposed gold sale would enable it to finance half of the required resources for the subsidy account needed to sustain a volume of operations of SDR 1 billion per year for the period 2000-2004. To avoid disruptions in the gold market, the sale could be phased, as was done during the previous gold sales to finance the Trust Fund.[57] To allay fears that such a gold sale might set a precedent for future sales for less legitimate purposes and in order to reach a solution, it has been proposed to formally limit the amount of gold reserves that IMF can sell by amending the Articles of Agreement. At the Lyons Summit, the G-7

called on the Fund to consider optimizing its reserves management in order to facilitate the financing of ESAF.

As for IMF's direct contribution to the HIPC initiative, various options involving ESAF are being considered to reduce the present value of its claims. This is expected to be achieved largely through greater concessionality in ESAF lending to eligible countries by extending maturities and grace periods. The proposed gold sales would provide some margin to accommodate part of the costs of the Fund's contribution to the initiative, assuming that bilateral donors provide one half of the subsidy requirement for the interim period. While in the past the subsidy account was largely financed by donors, some of them have expressed reservations in connection with financing the interim ESAF.

- *The use of net income, surplus and reserves of multilateral development banks (MDBs)*: The principal mechanism for MDBs' participation in the HIPC initiative is through the creation of trust funds (multi-country and/or single-country funds), to which both MDBs and bilateral donors can contribute. The World Bank is considering the provision of grants to the trust fund from allocations of IBRD net income and/or surplus. In that event additionality would not be clear-cut. The net income of IBRD for FY1990-1995 averaged over $1.2 billion per year. The net income for a particular year is subsequently allocated to maintaining a target reserves- to-loans ratio; making transfers to IDA and the Debt Reduction Facility[58] and transfers for similar purposes; and to surplus. The surplus consists of earnings from prior years, which are retained until a decision is made on their disposition or conditions for specified uses have been met. In FY1995, the surplus amounted to $226 million. To ensure additionality, allocation for the HIPC trust fund needs to be associated with changes in reserves allocation or with raising net income through, for example, cutting costs. Reserves have increased significantly since 1990, particularly in the last two years, both in absolute and in relative terms. The reserves-to-loans ratio, which was 10.8 per cent in FY1990, rose to 14.3 per cent in FY1995. Reserves amounted to over $17 billion on 30 June 1995. A number of financial analysts consider the Bank's reserve policies as excessively conservative, especially as, in addition to reserves, it has loan-loss provisions equal to 3 per cent of total loans outstanding plus the present value of guarantees. These provisions amounted to more than $3.7 billion at the end of FY1995. There is, therefore, considerable room for the use of reserves to finance multilateral debt relief, although such use could affect the Bank's earnings, as they are also a source of income. Among the other measures proposed by the World Bank to contribute to the HIPC initiative at the second stage are: supplemental IDA allocations over and above basic IDA allocations to ensure positive net transfers; and the selective use of IDA grants to prevent an increase in the present value of the debt due to the Bank as a percentage of exports. These measures involving the use of IDA resources would not be additional, but would certainly provide relief and programme support to beneficiaries. The management of the Bank has proposed the allocation of $500 million in 1996 to the debt relief initiative and substantial amounts in subsequent years. It is expected that the overall contribution of the World Bank will be of the order of $2 billion.

(e) Conclusion

A lasting solution to the debt problems of poor countries must address both long-term and immediate needs. For the long term, it is important to provide sufficient development finance on terms and levels consistent with the recipient's capacity to pay. This can be achieved through the adequate replenishment of the soft windows of MFIs, which would benefit all low-income countries. The difficulties encountered recently in connection with the replenishment of the soft windows raise concerns about the longer-term prospects of multilateral development assistance.

For a significant number of heavily indebted poor countries with an unsustainable debt burden, a special mechanism would be needed to address their debt overhang problems immediately and to ensure debt sustainability for the future, as existing schemes are clearly inadequate to deal with their critical situation. The framework for action proposed by IMF and the World Bank provides a comprehensive and coordinated approach to resolve their debt problems and is guided by sound principles. However, some flexibility in the application of certain conditions determining country eligibility, as well as in the timing of enhanced multilateral

Box 2

MEASURING CONCESSIONALITY

In the past few years the Paris Club has adopted new terms for developing debtor countries, involving debt reductions that may be as large as 67 per cent. Since such reductions can be applied only to non-ODA debt, the definition of ODA debt is of crucial importance.

The definition of concessionality used over the years by the Paris Club has been that of OECD's Development Assistance Committee (DAC). The IMF, which had in the past also used this definition, has introduced a new one which reflects the recent evolution of interest rates.

Under the DAC definition, which was originally established in 1969, ODA loans are those (of more than one year) provided by Governments or official agencies which meet two criteria: first, they must be administered with the promotion of economic development and welfare of the developing countries as their main objective; second, they must be concessional in character, with a grant element of at least 25 per cent using a discount rate of 10 per cent.

The continued use of a fixed discount rate of 10 per cent has posed problems in recent years, due to the marked decline of interest rates in virtually all countries as compared with the early 1980s. Indeed, a loan can meet the DAC definition even if, compared with the market rate of the currency concerned, it is clearly a commercial loan. For instance, with a 10 per cent discount rate, a fixed-rate loan with a 10-year maturity and a 5-year grace period would qualify for the DAC definition of a concessional loan if its rate of interest were less than 5.2 per cent (a rate which has been above market rates in some developed countries in the past 18 months). The difference in market rates at any point in time among major developed countries also raises issues of the comparability of concessionality among donor countries.

Recognizing these problems, OECD has used since 1987, in the framework of its Arrangement on Guidelines for Officially Supported Export Credits (often referred to as "the OECD Consensus"), a formula based on individual OECD countries' market interest rates, known as Commercial Interest Reference Rates (CIRR), to assess the discount rates for calculation of the grant element.[1] Using this discount rate, a loan must have at least a 35 per cent grant element to be considered concessional; for LDCs the threshold is 50 per cent. In 1994, it was decided that for loans contracted after 31 August 1996 the discount rate used would be CIRR plus a margin reflecting the maturity of the loan. It is interesting to note that these two definitions of concessionality (that of DAC and that of the Consensus) coexist within OECD. Consequently, today a 10-year loan in yen, with five years of grace and a 4 per cent interest rate, for example, would conform to the DAC definition of concessionality but not to that of the OECD Consensus.

The IMF has moved in the direction of the OECD Consensus definition, and has applied a CIRR-based discount rate and a 35 per cent grant element from October 1995 in assessing the concessionality of loans in the context of limits on foreign borrowing in IMF arrangements.

Under the Naples terms, ODA debt - defined according to the DAC criteria - is rescheduled over 40 years, with a grace period of 16 years and at an interest rate at least as concessional as the original one. The implied reduction in net present value (NPV) terms for ODA debt - over and above its original grant element - is likely to be less than the 67 per cent applied to non-ODA debt.

Under the Naples terms, the discount rate used to calculate NPV is the "appropriate market rate", i.e. the interest rate determined bilaterally between the debtor and each individual creditor country. The appropriate market rate is usually very close to the CIRR. If the interest rate on rescheduled ODA debt equals the original rate but is not lower than the appropriate market rate, no NPV reduction can be obtained - a situation which might arise, for example, in the case of ODA loans in low-interest currencies, such as the yen. Even if the ODA debt rescheduling rate, as well as the original one, were, say, 2 per cent, as compared with a 7 per cent appropriate market rate, the effective NPV debt reduction could be as low as 30 per cent, under reasonable assumptions on the residual maturity of the original ODA debt.

Box 2 (concluded)

The adoption by the Paris Club of a new definition of ODA loans, along the lines of that used in the OECD Consensus, would better reflect the reality facing debtors and creditors. In that event, a significant portion of currently defined ODA debt, especially that denominated in low-interest currencies, would be classified as non-concessional and could thus benefit from NPV reduction of 67 per cent under the Naples terms.

[1] For the definition of CIRR and movements in the rates in 1995 and early 1996, see table 14 above.

action, may be justified to ensure a lasting and rapid solution to the debt crisis. The differences that have arisen concerning contributions of various creditors also need to be ironed out, so as to arrive at an equitable burden-sharing arrangement that is acceptable to all. Financing such contributions should be based on additionality of resources to prevent further diversion of scarce development funds for debt relief. Furthermore, it is important to define clearly the modalities of the various contributions and how coordination among all the parties concerned could best take place. The problems of some MFIs in meeting expected financial contributions must also be addressed. It is urgent to formulate a workable plan of action for decision at the Annual Meetings of IMF and the World Bank in October 1996.

The severity of the situation faced by a number of heavily indebted poor countries calls for additional efforts from all parties concerned. For eligible debtors, continued strong commitment to reform would be required, not only to safeguard against moral hazard, but also, and above all, to enable them to create the right conditions for sustained growth, thus ensuring the successful resolution of the debt crisis.

2. Bilateral debt

Following the adoption of the Naples terms in December 1994, the number of countries which went to the Paris Club in the first half of 1995 increased substantially: during that period 13 agreements were signed. Thereafter, however, activity at the Paris Club declined markedly, with 10 agreements during the ensuing 12 months, thereby resuming a downward trend which could already be noticed in the early 1990s. A large number of countries still remain in need of debt rescheduling: as of June 1996, about half of the 36 countries which had not graduated from the Paris Club had no current agreements in effect. For more than half of them, the Paris Club agreement had expired more than one year earlier and substantial arrears were accumulating. One of the main obstacles to their achieving a new rescheduling was the difficulty encountered in reaching a new agreement with IMF.

The debt situation of many developing countries, especially the HIPCs, remains extremely difficult despite the efforts made to alleviate their debt burden through increasingly concessional rescheduling at the Paris Club and additional bilateral debt relief, as noted in the preceding sub-section. The Naples terms, while alleviating the bilateral debt burden, have at the same time revealed the extent of the multilateral debt burden for a number of developing countries, as well as of the burden of non-OECD official bilateral debt. While the international community is actively considering the multilateral debt problem, progress toward a solution of debt to non-OECD creditors is advancing very slowly and lacks a coherent framework. This is illustrated by the treatment of the debt due by countries in sub-Saharan Africa to the Russian Federation and to Arab countries, which is reviewed in the annex to this chapter.

(a) Recent developments concerning implementation of the Naples terms

Since the late 1980s, Paris Club creditors have applied increasingly concessional terms to the debt rescheduling of the heavily indebted poor countries.

These terms have evolved from a reduction of debt service payments by a third under Toronto terms agreed in 1988 to a 50 per cent reduction under the London terms (also referred to as enhanced Toronto terms) adopted in 1991. The Naples terms of December 1994 further increased the level of concessionality, to 67 per cent, in response to the enduring debt distress of HIPCs. Such a reduction can be applied either to debt service payments (flow rescheduling) falling due during a relatively short consolidation period (up to three years) or to the stock of eligible Paris Club debt (stock-of-debt operation). The possibility of applying the reduction to the stock of debt, one of the major innovations of the Naples terms, was designed to provide eligible debtor countries with an exit from the debt rescheduling process as the beneficiary would no longer need to go to the Paris Club for further rescheduling.[59] The Naples terms have also added a new feature by allowing debt that has already been reduced through previous rescheduling on either Toronto or London terms to be further diminished so as to achieve a percentage reduction on the original claims of either 50 per cent or 67 per cent. This is referred to as the "topping up" principle. In the past, such claims could not be further reduced, but could, at best, be rescheduled on non-concessional terms. Only non-ODA debt is eligible for reduction under Naples terms, which raises the question of the definition of ODA debt (see box 2).

Since adoption of the Naples terms in December 1994, 19 HIPCs (roughly half of this group of countries) have rescheduled their Paris Club debt on those terms (as of 30 June 1996). Most of them received the maximum reduction, namely 67 per cent. Only three countries, (Cameroon, Guinea and Honduras), obtained the smaller reduction, of 50 per cent. Stock-of-debt treatment was granted to only five countries: Bolivia, Burkina Faso, Guyana, Mali and Uganda, the remaining 14 countries being accorded flow rescheduling.

The extent of Paris Club debt relief has continued to be determined by the balance of payments financing requirements as assessed during negotiations on IMF-supported programmes. In virtually all cases, all pre-cutoff-date debt that was never rescheduled or that was rescheduled on non-concessional terms was reduced. In flow reschedulings, the topping up principle was not always applied. Some countries benefited from it in respect of their claims restructured under Toronto terms; very few did so in the case of the debt restructured more recently under London terms.

The pace of stock-of-debt agreements, though accelerating in the first half of 1996, remained modest, largely due to the fact that only a few countries had completed the three-year probationary period required by Paris Club creditors before considering a stock-of-debt reduction under Naples terms.[60] Two such reduction agreements were signed in 1995 and three in the first half of 1996, and all involved the 67 per cent option.[61] With the exception of Uganda,[62] all of them covered not only the stock of debt that was never rescheduled, or that was already rescheduled but never reduced, but also debt restructured on Toronto and London terms; to the latter category of debt, the topping up principle was fully applied. However, none of the stock-of-debt agreements concluded to date has covered moratorium interest[63]: such a possibility nevertheless exists under the Naples terms, whereby moratorium interest can be rescheduled or reduced, depending on the debtor country's specific circumstances. This exceptional feature was included to take account of the fact that in the early years following a stock-of-debt operation moratorium interest tends to be higher than under a flow rescheduling.

In the case of Uganda, the reduction agreement implies a reduction (in net present value terms) of 17 per cent in its total Paris Club debt, and of 3.2 per cent in its total outstanding debt. For Bolivia, the impact is greater (partly as a result of the more extensive coverage of the agreement): the reduction will amount to about 31 per cent of its total Paris Club debt and 11 per cent of its overall external debt. For Mali, Guyana and Burkina Faso the impact will be much smaller, mainly because of the level of Paris Club debt (before any debt reduction) in relation to their total external debt. It should be noted that, even after the 67 per cent stock-of-debt reduction under Naples terms, debt indicators for Bolivia, Guyana and Uganda are such that these countries are still considered as having potential debt sustainability problems, which may necessitate additional debt relief measures under the proposed HIPC debt initiative described in the preceding sub-section.

Finally, in a very few cases, the Paris Club has continued to agree to exceptional deferral of payments on arrears on post-cutoff-date debt.[64] In the past two-and-a-half-years, four countries benefited from this exceptional treatment. The period of deferral (over which the arrears have to be paid) has varied from two to three years.[65]

Box 3

GRADUATION FROM THE PARIS CLUB: THE CASE OF THE RUSSIAN FEDERATION

In April 1996, a five-day Paris Club meeting took place to restructure the debt contracted or guaranteed by the former Soviet Union and for which the Russian Federation had assumed responsibility. The Paris Club creditors agreed to a comprehensive rescheduling of the debt with a view to supporting Russian stabilization efforts and avoiding the need for further rescheduling. The agreement involves restructuring in two stages: a flow rescheduling, followed by a stock-of-debt operation. It is hoped that this will provide an exit strategy for the country.

The flow rescheduling covers 100 per cent of the principal and interest payments due from January 1996 to 31 March 1999 on debt that was never rescheduled, as well as on that resulting from the three previous Paris Club agreements (of 1993, 1994 and 1995).[1] This debt is rescheduled over an unusually long period of 21½ years, including 3 years of grace. As in the three previous agreements, part of the debt contracted after the cutoff date (determined to be 1 January 1991) was also rescheduled; payments on such debt due over the period 1996-1998 were rescheduled, though with a somewhat shorter maturity, of about 17 years. Furthermore, the moratorium interest and short-term debt that were rescheduled in the previous agreements were also rescheduled, on the same terms as those granted on post-cutoff-date debt.

In the second stage, principal payments falling due on or after 1 April 1999 are to be rescheduled, also with a maturity of 21½ years, including 3 years of grace. This restructuring covers only the debt resulting from the three previous agreements and excludes all post-cutoff-date debt. For this stock-of-debt operation to be implemented, a number of conditions have to be met, including, for instance, the approval by IMF of the review of the 1997 and 1998 programmes, as well as of the final quarterly review scheduled under the Fund's extended arrangement, and the fulfilment of financial obligations due up to 31 March 1999.

The agreement with the Russian Federation is exceptional for two reasons. The first is the substantial amount involved (about $40 billion), the largest in the Paris Club's history. The second is that it is a stock-of-debt operation on non-concessional terms, the first of its kind in the Club's 40 years of existence. This agreement is along the lines of London Club restructuring of commercial bank debt outside the Brady Plan framework. The other stock-of-debt restructurings which took place within the Paris Club, either on Naples terms or those agreed to in 1991 for Poland and Egypt, included a reduction in the present value of debt.[2]

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[1] For the last three months of the consolidation period, the percentage of debt rescheduled falls to 40 per cent for debt that was never rescheduled.

[2] For the terms accorded Poland and Egypt see *TDR 1992*, box 2.

(b) Middle-income countries

Over the past 18 months, only 5 of the 23 rescheduling countries belonged to the middle-income category, among which were Croatia and The Former Yugoslav Republic of Macedonia, which signed their first agreements with the Paris Club in 1995. One of the most notable features of the treatment applied to the debt of this group of countries has been the increasing use of graduated repayment schedules whereby, following a short grace period, payments take place with a progressively increasing amortization schedule.[66] The most interesting new development was the treatment granted to the Russian Federation for its debt restructuring in April 1996. The Paris Club had hitherto retained the flow approach to deal with the debt of middle-income countries. In contrast, the agreement with Russia allows for the rescheduling of the stock of debt as of 1 April 1999 (see box 3). Some other middle-income debtor countries would also like to benefit from a com-

prehensive rescheduling through a stock-of-debt operation. It remains to be seen, however, whether the Russian agreement signals a change in the Paris Club practices regarding middle-income countries, or whether it is truly an "exceptional" rescheduling, as were those for Poland and Egypt five years ago. If it does indeed signal a change, other middle-income countries (not eligible for Paris Club debt reduction) might be able to benefit from a comprehensive debt approach similar to that applied to the Russian Federation. ■

Notes

1 K. Clifton, "MTNs: a vision of the future", *Euromoney*, March 1996.

2 The claims of BIS-reporting banks include not only loans but also in most cases various categories of international securities among the assets in the institutions' portfolios.

3 Baring Securities, *The Financial Silk Road ... A Fifth Wave of Global Money. Cross Border Equity Flows,* Vol. I (London, September 1995), p. 9.

4 *Ibid.*, p. 24.

5 D. Folkerts-Landau, T. Ito *et al.*, *International Capital Markets: Developments, Prospects, and Policy Issues*, World Economic and Financial Surveys (Washington, D.C.: IMF, August 1995), p. 51. An emerging markets mutual fund is defined as one that holds at least 60 per cent of its assets in securities of developing countries.

6 BIS, *International Banking and Financial Market Developments* (Basle, February 1996), table 12B. (Figures for net issues include adjustments in the form of deduction of scheduled and early repayments, and of addition of implied interest accruals in the case of zero-coupon bonds.)

7 *Ibid.*, tables 8 and 12A. A number of developing countries recorded negative net issues in 1995. Euro-notes in this source comprise but are not necessarily identical to EMTNs.

8 *Ibid.*, tables 10A, 12A and 12B.

9 Debt instruments of less than "investment grade" are often not permitted to be held by certain institutional investors under their regulatory regimes.

10 J.P. Morgan, *Emerging Markets Data Watch*, 10 May 1996, p. 31.

11 According to an estimate quoted by the Mexican Minister of Finance, approximately two thirds of the *tesobonos* maturing in 1995 were held by foreigners. (*Latin American Economy and Business*, March 1995, p. 11.)

12 Figures for the net inflow of portfolio investment in 1993-1994 from IMF, *Balance of Payments Yearbook*, Part I, 1995 (Washington, D.C.: IMF, 1995), which are used for most of the countries in table 12, are those of the analytic presentation, which facilitates comparisons among countries and through time. These figures sometimes differ from those of the standard presentation, which attributes to portfolio investment net inflows included under other headings in the analytic presentation. The differences between the figures in the two presentations are substantial for some countries, those of the standard presentation, for example, being higher for some Latin American countries.

13 With the progressive liberalization of regulatory regimes in emerging financial markets there has been some blurring of the distinction between direct and portfolio investment, since purchases not only of tangible assets but also of shares on stock markets can serve as vehicles for the achievement of management control.

14 In the interests of comparability with the Asian countries, only the World Bank's estimates of net FDI in the Latin American countries are shown in table 13 (which generally differ from those of ECLAC mentioned below).

15 Baring Securities, *op. cit.*, pp. 40-41.

16 *Ibid.*, p. 42.

17 ECLAC, *Preliminary Overview of the Latin American Economy and Caribbean Economy 1995* (United Nations publication, Sales No. E.95.II.G.18), table A.13, which is also the source of the total net capital inflows (balance on capital account) for the individual Latin American countries discussed in this sub-section.

18 This figure may well be an underestimate due to the scale of inflows, according to the most recent statistics, in the last quarter of 1995, of which the ECLAC secretariat would not have been able to take proper account. See the remarks concerning Argentina and Chile below.

19 The figure for the net outflow of portfolio equity investment is from *Latin American Economy and Business*, February 1996, p. 5. Mexico's net FDI was in the range of $4-6 billion as indicated by estimates of ECLAC (*op. cit.*, p. 40) and the World

Bank (*World Debt Tables 1996. External Finance for Developing Countries* (Washington, D.C.: The World Bank, 1996), Vol. 1, table 1.4, one or both of which are also sources for the FDI figures for other Latin American countries discussed below. Net issues of international debt securities, which include both bonds and EMTNs (an instrument with an increasing resemblance to bonds, as explained in section A), amounted to $0.9 billion. The change in the exposure to the country of BIS-reporting banks (after adjustment for the effects of movements of exchange rates) was a diminution of $6.5 billion, reflecting large negative figures in the first nine months of the year. Figures for net issues of international debt securities and the change in the exposure of BIS-reporting banks for Latin American countries discussed in this sub-section are taken from BIS, *International Banking and Financial Market Developments*, tables 5A and 10.

20 The net inflow of FDI was in the range of $2-4 billion. Net issues of international debt securities amounted to $7.8 billion, constituting a rise from the 1994 total of $5.3 billion and a strong recovery in the last three quarters of the year after a negative figure for the first quarter. The increase in BIS-reporting banks' exposure to Argentina (after adjustment for movements of exchange rates) was $2.3 billion.

21 Official Argentine sources indicate a rise in the net inflow on capital and financial account during the fourth quarter of 1995 to a figure almost 2.5 times that of the second and third quarter combined. These sources also point to a substantial positive net capital inflow for the year as a whole, though a lower one than in 1994.

22 The net inflow of FDI amounted to a little more than $3 billion. Net issues of international debt securities were $6.2 billion, reflecting a recovery after a net outflow in the first quarter; and the increase in the (exchange-rate adjusted) exposure of BIS-reporting banks to Brazil was $6.8 billion.

23 Figures for major categories of external financing were as follows: a net flow of FDI in the range of $1.4-2.3 billion, a net increase in international debt securities of $0.1 billion, and a net increase in (exchange-rate-adjusted) exposure of BIS-reporting banks of $1.9 billion.

24 *Latin American Economy and Business* (February 1996, p. 8) cites an estimate of $500 million for (presumably) net foreign portfolio investment in Chile in 1995.

25 This total incorporates a net inflow of FDI of $2.2 billion, net issues of international debt securities of $0.7 billion, and a net increase in (exchange-rate-adjusted) exposure of BIS-reporting banks to the country of $1.8 billion.

26 An estimate of the country's net receipt of FDI was not available at the time of writing, though it is thought to be not much less than the previous year's figure of $2.4 billion. There were no issues by Peru of international debt securities, and the increase in (exchange-rate-adjusted) exposure to it of BIS-reporting banks was $1.2 billion

27 The country's net inflow of FDI amounted to $0.6 billion, while its net issue of international debt securities was a negative $0.4 billion and the (exchange-rate-adjusted) decrease in BIS-reporting banks' exposure to it was $1.6 billion.

28 J. P. Morgan, *Emerging Markets Data Watch*, 26 January 1996, p. 20, and 19 April 1996, pp. 4 and 36. The inflow did lead to discussion in Thailand of the possibility of imposing a transaction tax on currency swaps between the baht and the dollar. See G. Baker, "It's tough to be cool", *Euromoney*, April 1996.

29 J.P. Morgan, *Emerging Markets Data Watch*, 10 May and 14 June 1996.

30 *Ibid.*, 14 June 1996, p. 22.

31 *Ibid.*, 26 January 1996, p. 23.

32 *Central Banking*, Vol. 6, No. 4, Spring 1996, p. 7; and V. Boland, "Czech currency: greater flexibility in exchange rate policy", *Financial Times*, 26 April 1996.

33 J.P. Morgan, *Emerging Markets Data Watch*, 10 May 1996, pp. 7-10.

34 OECD, *External Debt Statistics: the Debt of Developing Countries and the CEE/NIS at end-December 1994 and end-December 1993* (Paris: OECD, 1995), table A.

35 The export credits in table 9 include not only the private lending carrying insurance or guarantees from an export credit agency (ECA), which is discussed in the present section, but also direct lending by OECD Governments, the determinants of which are not discussed here. It is customary to define credits carrying "official" insurance or guarantees as "private export credits". "Official" insurance in this context is in some cases provided by privately owned institutions with officially recognized mandates. However, the sale of the short-term credit insurance operations of the United Kingdom's Export Credits Guarantee Department (ECGD) to the Nederlandsche Credietverzekering Maatschappij (NCM), the consortium of banks and insurance companies which serves as the vehicle for providing export credits in the Netherlands, has led to the omission of new short-term export credits extended by United Kingdom sources from the statistics in table 9. Nevertheless, owing to the availability of data concerning NCM's short-term operations which complement those for medium- and long-term cover from ECGD, the conditions associated with NCM's short-term insurance cover are included in the analysis of this section alongside of those attached to insurance cover from the Export-Import Bank of the United States (EXIM).

36 Maximum and minimum levels for these so-called Commercial Interest Reference Rates for different currencies in 1995 and the first five months of 1996 are shown in table 14.

37 For example, under the short-term "whole turnover" policy of NCM for cash payments against docu-

ments, basic premiums vary between 0.2 and 0.3 per cent of the value of contracts for developed countries, and between 0.6 and 0.7 per cent for developing ones; for repayment periods up to 30 days premiums vary between 0.4 and 0.8 per cent of the value of contracts for developed, and between 0.9 and 1.2 per cent for developing, countries; and for repayment periods between 30 and 90 days they vary between 0.7 and 1.1 per cent for developed, and between 1 and 1.4 per cent for developing ones. See OECD, *Export Credit Financing Systems in OECD Member and Non-Member Countries* (Paris: OECD, 1995).

38 In the case of NCM these supplementary premiums are called "market rate additions" (MRA).

39 The concept, "instance", is explained in note c to table 15.

40 For such a ranking see, for example, D. Briggs and B. Edwards, *Credit Insurance: How to Reduce the Risks of Trade Credit* (New York, etc.: Woodhead-Faulkner, 1988), pp. 25-26.

41 The regional samples of countries for which preferred payments terms are available are significantly smaller than those underlying the analysis of conditions associated with official credit insurance cover, this shortcoming being especially marked for South and South-East Asia.

42 Under the IDA Debt Reduction Facility (established in 1989) money is made available to low-income countries for reduction of their external debt in the form of obligations to commercial banks and suppliers through buy-backs at large discounts on face value. Support is contingent on programmes acceptable to IDA for medium-term adjustment and the management of external debt. Other donors may provide cofinancing in the form of grants in support of individual debt-reduction operations under the Facility.

43 The group comprises 41 countries: the 32 countries classified as severely indebted low income countries (SILICs) in *World Debt Tables 1994-95*, *External Finance for Developing Countries* (Washington, D.C.: The World Bank, 1994); an additional 7 countries that have received concessional treatment from the Paris Club; and 2 lower middle-income countries that have recently become IDA-only countries. For a listing of the countries see table 19.

44 See *TDR 1995*, Part One, chap. II, sect. E.2, for a discussion of the debt problems of these countries since the emergence of the debt crisis.

45 International Monetary Fund, *Official Financing for Developing Countries*, Washington D.C., December 1995, table 21.

46 For a detailed discussion of schemes adopted by MFIs to alleviate the debt burden of poor countries, see *TDR 1995*, Part One, chap. I, sect. E.

47 See the excerpts from the press conference held jointly by the Chairman of the Interim Committee and the Managing Director of IMF, on 23 April 1996 (*IMF Survey*, Vol. No. 25, 6 May 1996). Resources held in the ESAF Reserve Account are meant to be used to make payments of principal and interest for the Loan Account, should actual debt service payments (including interest subsidy) by the debtor be insufficient to cover the amount due. SCA-2 was created in 1990 to safeguard against potential losses arising from purchases made under a successor arrangement after the successful completion of a Rights Accumulation Programme, and to provide additional liquidity to finance such purchases. As of 31 January 1996, holdings in the ESAF Reserve Account amounted to SDR 1364 million and in SCA-2 to SDR 898 million.

48 *Financial Times*, 23 May 1996 (reporting a statement by the President of the Bank).

49 IMF, *Annual Report 1995* (Washington D.C., 1995), p.147.

50 See T. Killick, "Solving the Multilateral Debt Problem: Reconciling Relief with Acceptability" (London: Commonwealth Secretariat, forthcoming).

51 Among the risk indicators considered were the fiscal burden, reserve coverage, aid dependence, export diversity, sensitivity to export shortfalls, resource gap and policy track record.

52 The eight "unsustainable" cases are Burundi, Guinea-Bissau, Mozambique, Nicaragua, Sao Tome and Principe, Sudan, Zaire and Zambia. The 12 other countries with potential debt sustainability problems are: Bolivia, Cameroon, Congo, Côte d'Ivoire, Ethiopia, Guyana, Madagascar, Myanmar, Niger, Rwanda, United Republic of Tanzania and Uganda.

53 See the Communiqués of the Interim Committee (22 April 1996), Development Committee (23 April 1996), and the Group of 24 (21 April 1996), reproduced in *IMF Survey*, 6 May 1996.

54 G-7 Lyons Summit, Economic Communiqué, 28 June 1996.

55 A number of studies, which used different approaches, arrived at consistent results, indicating a critical level of 200 per cent for the ratio of the present value of debt to exports. According to *World Debt Tables 1994-95*, Vol.1 (p. 40), debt profiles and track records of selected SILICs suggested that debt service ratios that consistently exceeded 15 per cent were high and that debt-to-export ratios greater than 200 per cent had generally proven unsustainable over the medium term. In *TDR 1995* (Part One, chap. II, sect. E.1), a benchmark debt service ratio of 20 per cent was used because, over the period 1983-1994, countries in the sample were actually able to make debt service payments equivalent on average to 22 per cent, but only after debt reschedulings and accumulation of large arrears. It must be emphasized that debt sustainability implies the ability to meet debt obligations without resorting to debt relief, rescheduling or accumulating arrears.

56 In addition to the World Bank, IMF and regional development banks, MFIs include other multilateral and intergovernmental agencies, such as the International Fund for Agricultural Development

(IFAD), a number of Arab funds and the multilateral institutions of the European Union.

57 The sales, involving a much larger volume than that currently proposed (50 million ounces), were carried out over a four-year period (1976-1980) and had little discernible depressing effect on the market price.

58 This facility, which is co-financed by donors, provides grants to IDA-only countries for commercial debt buy-backs at a sharp discount.

59 To be eligible for a stock-of-debt operation, a country must fulfil three main conditions: (1) it must establish a good track record with IMF-supported programmes; (2) it must comply with Paris Club bilateral agreements, and (3) Paris Club creditors must be confident that the country will be able to fulfil its obligations under the stock reduction agreement. For details of the Naples terms, see *TDR 1995*, box 3.

60 Debtor countries restructuring their Paris Club debt for the first time under the Naples terms initially receive a flow rescheduling. The agreement signed includes a clause whereby a three-year or, in some cases, a four-year probationary period is required during which a good track record of relations with IMF and with Paris Club creditors has to be established before a stock-of-debt operation can be considered.

61 As noted above, the reduction applies only to non-concessional debt.

62 The Uganda agreement signed in February 1995 reduces only previously rescheduled debt (as there was hardly any eligible debt which had not been rescheduled). It excludes debt restructured in 1992 on London terms.

63 Moratorium interest refers to interest payments on amounts deferred or rescheduled under the rescheduling agreement.

64 The cutoff date is the date prior to which loans must be contracted in order for their debt service to be eligible for rescheduling. Loans contracted after the cutoff date are expected to be serviced in full. The cutoff date is determined at the first Paris Club rescheduling and typically remains fixed in all subsequent reschedulings.

65 Guinea-Bissau obtained particularly generous treatment in 1995, with the rescheduling over 10 years of arrears on post-cutoff-date debt.

66 Graduated payment schedules enable debtor countries to avoid the bunching of debt service obligations which takes place at the end of the grace period in conventional reschedulings.

Sources for table 13

Current account balance and GDP: 1993-1994 were taken from IMF, *International Financial Statistics* and 1995-1996 from J.P. Morgan, *Emerging Markets Data Watch*, except for Argentina, where the current account balance in 1994 was taken from ECLAC, *Preliminary Overview of the Latin American and Caribbean Economy 1995*, December 1995, and for Taiwan Province of China, where both items in 1993-1995 were taken from Central Bank of China (Taipei), *Financial Statistics*. **Direct investment**: 1993-1994 was taken from IMF, *Balance of Payments Yearbook*, Vol. 46, Part I, 1995, and 1995 from World Bank, *World Debt Tables*. *External Finance for Developing Countries 1996*, Vol. 1 (table 1.4), except for Argentina in 1994-1995 and Colombia in 1993-1994, where it was taken from World Bank, *op. cit.*, and for Taiwan Province of China in 1993-1995, where it was taken from Central Bank of China (Tapei), *op. cit.* **Portfolio investment**: 1993-1994 was taken from IMF, *Balance of Payments Yearbook*, Vol. 46, Part I, 1995, and 1996 from J.P. Morgan, *Emerging Markets Data Watch*, except for Colombia in 1993-1994, where it was estimated from World Bank data and BIS, *International Banking and Financial Market Developments*, and for Taiwan Province of China in 1993-1995, where it was taken from Central Bank of China (Tapei), *op. cit.* **Securitized debt claims** were taken from BIS, *op. cit.* **Bank claims** were taken from OECD/BIS, *Statistics on External Indebtedness Bank and Trade-related Non-bank External Claims on Individual Borrowing Countries and Territories*. **Total external debt** was taken from OECD, *External Debt Statistics, 1995 Edition* (Paris, 1995).

Annex to chapter II

SUB-SAHARAN AFRICA'S DEBT TO NON-OECD OFFICIAL CREDITORS

A. Nature of the problem

Developing country debt to non-OECD official creditors[1] is a category of debt for which there has been surprisingly little analysis to date. Possibly, this is because it is generally considered that such debt does not account for a substantial proportion of the total debt of developing countries or that it is mostly in arrears, with little prospect of repayment. In a report on the subject shortly to be published[2] the UNCTAD secretariat dispels these beliefs. There is no comprehensive source of data on this type of debt, but such data as are available indicate that it amounts to at least $245 billion, which represents 12 per cent of total developing country debt and more than 15 per cent of their medium- and long-term debt. If arrears are taken into account, non-OECD creditors accounted in 1995 for almost 20 per cent of scheduled total debt service and for 42 per cent of scheduled bilateral debt service. In addition, although part of this debt to non-OECD creditors is not being paid, the debt nevertheless contributes to the debt overhang of the countries concerned. Uncertainty as to how this debt will be treated does pose a problem, especially nowadays: in the context of a comprehensive approach, where solutions have and are being sought on commercial bank, Paris Club and multilateral debt, the problem of debt to non-OECD creditors cannot be ignored.

Non-OECD creditors have indeed taken a certain number of measures to deal with the debt servicing problems of developing countries. These efforts include tolerating accumulation of arrears and arranging reschedulings, debt cancellations, conversions and buy-backs. To date, however, there has been no formal framework for discussion of non-OECD debt and no consistent implementation of measures to alleviate payments difficulties and reduce the relatively high transaction costs associated with monitoring and negotiating debt bilaterally on a case-by-case basis.

The UNCTAD study mentioned above focuses on sub-Saharan Africa (SSA)[3] for two main reasons. First, non-OECD debt presents a relatively greater problem for SSA than for developing countries in general. It amounted to an estimated $35 billion, or 17 per cent of their total debt. Indeed, non-OECD scheduled debt service in 1995 represented about 19 per cent of total debt service; if arrears are taken into account, the share rises to more than one third. Second, the study emanates from a specific request put forward by African representatives at a seminar organized by UNCTAD in 1994 on strategies for Africa's debt negotiations.

As SSA's non-OECD debt is predominantly to two groups of creditors, the Russian Federation and Arab financial institutions and Governments (which together account for about 85 per cent of both non-OECD debt and debt service of SSA in 1995), the study concentrates on these two categories.[4]

B. Debt to the Russian Federation

Debt owed to the Russian Federation, the single largest non-OECD creditor, accounted for $16.8 billion,[5] i.e. 8 per cent of SSA's total external debt, but for almost half of its total non-OECD debt in 1994.[6] From the point of view of the creditor, however, the picture is different, as claims on SSA represent less than 10 per cent of total developing country debt to the Federation. Such debt, according to the Russian authorities, amounts to $173 billion.[7] Russian claims on SSA are particularly concentrated on three countries - Angola, Ethiopia and Mozambique. In these three countries, the Russian Federation is the major creditor. In two other countries (Guinea and United Republic of Tanzania) such debt also represents a significant share of total external debt. A high proportion of SSA's debt to the Russian Federation - perhaps as much as 90 per cent - is related to purchases of military supplies, and carries highly variable terms. The repayment record of SSA has generally been poor, and arrears have accumulated quickly.

A crucial issue is the exchange rate to be used in placing a dollar value on the debt. Around 80 per cent is denominated in roubles but repayable in hard currencies at the rate of R 0.5854=$1. Since the official exchange rate became market-determined in 1992 it has fallen sharply, reaching R 5,069=$1 as at 12 June 1996. Many debtors have argued that the debt should be revalued according to the current exchange rate, but the Russian Federation has insisted that the old rate continue to apply. It is estimated that revaluing SSA debt at the market rate would cost the Federation over $14 billion and reduce outstanding debt to a marginal sum. The Government has, however, displayed a willingness to adjust the rate in several cases for non-African countries for a variety of reasons, including trade and investment prospects in the debtor country. There have also been difficulties between debtor countries and the creditor country associated with reconciling data on outstanding debt, reflecting the inadequacy of the statistics.

The Russian Federation has utilized a number of methods to deal with the problem of its claims on SSA:

- Rescheduling was a preferred method for all bilateral loans until 1990, by which time more than 150 agreements had been signed with developing countries (most of them during the 1980s). Over 65 of the agreements were with countries in SSA. During 1980-1993, such agreements covered over $20 billion in outstanding debt. Rescheduling terms broadly matched those of the Paris Club at the beginning of the decade, but fell behind after 1988, when Paris Club terms became progressively softer. Rescheduling is now rarely applied to low-income countries.

- Payment of debt via exports of goods was also widely resorted to in the 1980s, and the practice continues for larger developing country debtors. Difficulties arose, however, with regard to the non-transparency of valuation of goods, the quality of goods provided in payment, and the trend toward trade liberalization in both debtor countries and the creditor country. These problems have led to the virtual cessation of such deals with SSA, and this method is unlikely to be much used in future.

- Conversion of debt into local currency payments has been attempted, but much less frequently in recent years as trade links have dwindled. Debt-for-equity swaps were sometimes resorted to in the early 1990s, but due to a number of difficulties there have been few such deals with SSA. These difficulties include finding appropriate partners and projects, and differing expectations between local and Russian partners.

- The sale of debt to foreign intermediaries for either hard currency or goods has also suffered from serious drawbacks, including

disputes over debt valuation, lack of transferable titles, Russian insistence on debt prices which are considered too high by the debtor countries (especially in view of the low prices of their debt on secondary markets), debtors' lack of resources with which to pay intermediaries, and the non-transparency of such operations. The sale of debt to Russian banks and other companies via a system of tenders has similarly encountered adverse circumstances which limit its usefulness.

- Discounted buy-backs by debtor countries of debt to Russian trading organizations have become increasingly popular, because they are more transparent, are based on the international secondary market price, and guarantee immediate foreign exchange receipts. Agreements have been hampered by debtors' lack of foreign exchange, but in recent years increasing amounts of debt to the Russian Federation have been classified as commercial and included in IDA buy-backs, and bilateral donors have been willing to provide grant funding.

The UNCTAD study examines the costs and benefits of the three main options which appear to be most practicable for dealing with the outstanding Russian claims on SSA countries: buy-backs, conversions, and rescheduling on Paris Club comparable terms:

- Further debt buy-backs could be envisaged where the Russian Federation sells its loans at secondary market prices, with debtor payments funded by donor grants, preferably through a non-OECD buy-back facility similar to the IDA-financed Debt Reduction Facility for commercial bank loans. These operations might be particularly interesting in respect of concessionality for the debtor, certainty of payment for the creditor, and transparency and lower transaction costs for both debtors and creditor. They would also allow immediate relief from the debt overhang in participating debtor countries. However, the funding of such operations would present a problem, especially in view of the various existing and potential demands on donor funds to finance other debt reduction facilities. Nevertheless, for a number of small debtors, a relatively small sum would provide tremendous benefit. As an example, in a buy-back operation, $318 million would clear the debt to the Federation of 15 SSA countries, utilizing discount rates equivalent to the secondary market price of the debt, which ranges from 65 per cent to 98 per cent.

- On the basis of a case-by-case analysis of those countries offering the best prospects for joint ventures, conversions could also be considered, provided that the difficulties mentioned above have been overcome.

- Finally, for a number of debtor countries, membership of the Russian Federation as a creditor in the Paris Club would most likely result in the reduction of their debt to that country under the Naples terms. The degree of concessionality which might be provided under this option is clouded by, *inter alia*, the exchange rate issue and the potential classification of a large portion of the debt as concessional.[8] Discussions have taken place on the issue of Russian membership in the Paris Club in recent months, but as yet with no result.

C. Debt to Arab financial institutions and Governments[9]

Total SSA debt to Arab financial institutions (AFIs) and Governments amounts to $12 billion, or 45 per cent of SSA debt to non-OECD creditors.[10] Most of this debt is concessional. Debt to the AFIs is particularly important for six Sahel countries (Mali, Mauritania, Niger, Senegal, Somalia and Sudan); it also represents a significant part of the total loan portfolios of the AFIs. Arrears on such debt have been rising steadily since the mid-1980s, especially as disbursements began to slow down as a result of falling oil prices and growing debt difficulties in many SSA countries during this period. In recent years, growing SSA arrears have become an increasingly serious finan-

cial constraint on some of the AFIs, which have begun to record relatively high arrears relative to capital, reserves and total loans. In absolute terms, of $6.6 billion in total arrears to the AFIs at end-1994, SSA was responsible for $5.1 billion. There is hence a clear need for enhanced debt relief as both creditors and debtors are burdened by the effects of debt overhang, liquidity shortfalls and arrears.

There are precedents for debt relief by Arab creditors. First, AFIs have tolerated arrears in a number of cases; indeed, while according to loan contracts arrears lead to immediate suspension of disbursements, most institutions are more flexible in practice. Several of them allow three to six months of arrears before suspending disbursements. In addition, in spite of public arguments against rescheduling and cancellation, Arab institutions have increasingly refinanced or deferred arrears and current service informally (for instance, through refinancing with new quick-disbursing loans). A few Governments have also bilaterally cancelled large amounts of debt and arrears. Arab creditors have, however, avoided sales on secondary markets, buy-backs or conversions, largely due to the transaction costs involved (staff time and training) and concern regarding the complexities of negotiations and the risk of non-transparency.

As regards the prospects for increased relief, given that most loans from AFIs and Governments are already concessional, there are three main possibilities:

- Rescheduling of arrears and current service over an extended period on terms comparable to those of the Paris Club (40-year maturity and 16-year grace period);
- Debt cancellation by Governments which is extended to the stock of debt instead of being confined mainly to arrears;
- Debt conversion. In spite of the reluctance of Arab creditors regarding conversions, there might nevertheless be projects in which Arab investors could provide valuable expertise, and where Arab NGOs could be involved. A coordinated conversion fund could be established, which would reduce transaction costs by concentrating activities in one institution.

The first two of these proposals may not be significantly more costly to the creditors than the informal procedures applied so far, but would be more orderly and transparent.

Regarding more specifically the problem of debt owed to Arab multilateral institutions, the integration of this debt into wider proposals for multilateral debt relief could be a solution. Indeed, if a multilateral debt facility is established, one might consider whether its resources should not also cover payments due to multilateral Arab institutions.

Finally, the problems faced in trying to deal with the debt to AFIs have been accentuated by poor communication between creditors and debtors, the decision-making procedures in the institutions and, until recently, poor coordination among them. An organized framework for negotiations could reduce transaction costs. The steps recently been taken by the Coordination Secretariat of Arab National and Regional Development Institutions to overcome these problems should be encouraged, together with the enhanced participation by the AFIs on debt issues at Consultative Group and Round Table meetings, especially in view of the new initiative for HIPCs.

* * * * * *

Although the UNCTAD report focuses on the two major non-OECD official creditors, it should be noted that for specific countries other such creditors may be relatively more important. For SSA as a whole, however, it is clear that significant improvement is possible in terms of communication and coordination between debtors and creditors, and in the case of debt to Arab financial institutions and bilateral government debt, among the relevant creditors themselves. It is vital that the issue of non-OECD debt be placed within a comprehensive context in which this category of debt can be considered alongside other types of debt and the need for a sustainable debt position overall. In this regard, increased use of Consultative Groups and Round Tables would prove useful while the Paris Club continues with its present role of generating a consensus among OECD bilateral creditors. ■

Notes

1 The term *"non-OECD official creditors"* is defined here to include all non-OECD official bilateral creditors, together with multilateral financial institutions that have as members only non-OECD countries.

2 *Reducing Sub-Saharan Africa's Debt to Non-OECD Official Creditors: Sharing the Burden*.

3 "Sub-Saharan Africa" in the study excludes South Africa and Namibia.

4 Twelve debtor countries (Angola, Ethiopia, Guinea, Guinea-Bissau, Mauritania, Mozambique, Niger, Sao Tome and Principe, Senegal, Uganda, United Republic of Tanzania and Zambia) are studied in detail in the report; they were chosen for the high share of non-OECD debt in their total debt and their large share of the total non-OECD debt of sub-Saharan Africa.

5 All data related to Russian claims reflect a valuation of rouble-denominated claims at the official exchange rate of R 0.5854=$1. This does not constitute an endorsement by the UNCTAD secretariat or by the debtor countries surveyed of the appropriateness of this exchange rate.

6 Russian claims represented 46 per cent of its total non-OECD debt and 55 per cent of its total non-OECD bilateral debt in 1994.

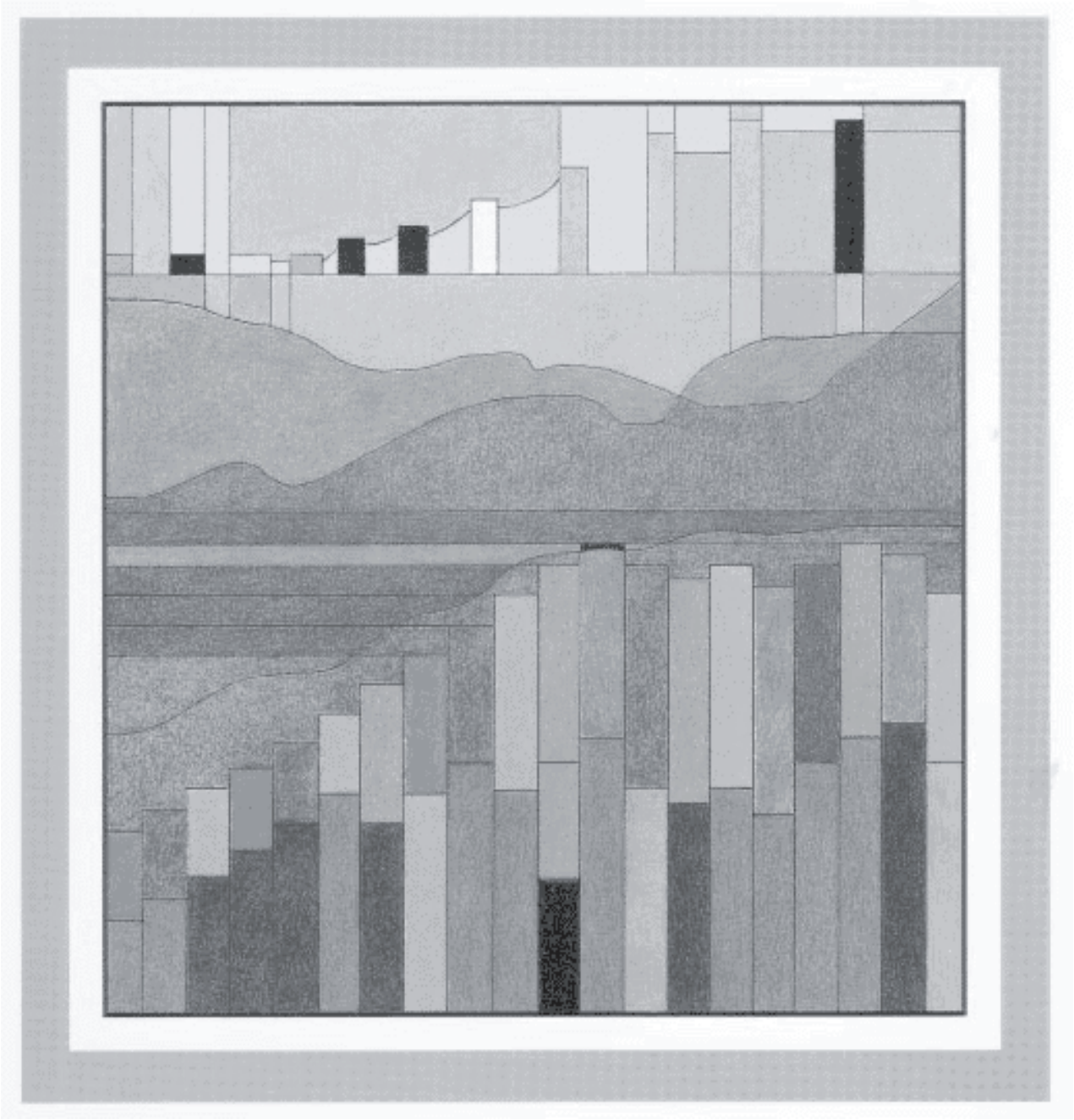
7 It is noteworthy, however, that HIPCs do account for a substantial portion of the total debt because this group includes large non-SSA debtors such as Nicaragua, Viet Nam and Yemen.

8 This classification could lead to pressure for cancellations similar to those provided bilaterally by many OECD countries. On the other hand, under the Naples terms, concessional debt is not reduced.

9 The debt examined here consists of: debt to multilateral development funds (AFESD, AMF, BADEA, the Islamic Development Bank and the OPEC Fund) and to bilateral development funds (such as the Algerian Development Bank, the Abu Dhabi Fund, the Iraqi Fund, the Libyan Arab Bank, the Libyan Arab Foreign Investment Company, the Kuwait Fund, and the Saudi Fund) as well as Government-to-Government loans (especially those granted by Algeria, Iraq, Kuwait, Libyan Arab Jamahiriya, Saudi Arabia, and the United Arab Emirates).

10 Arab bilateral debt represents 33 per cent of the non-OECD bilateral debt of SSA, and Arab multilateral debt about 88 per cent of the region's non-OECD multilateral debt.

RETHINKING DEVELOPMENT STRATEGIES: SOME LESSONS FROM EAST ASIAN EXPERIENCE



Introduction

Rapid growth, rising living standards and increased international competitiveness in the economies of East Asia have caught the attention of policymakers and researchers in other developing regions, as well as in the developed world. A broad debate has consequently opened up on the lessons that can be drawn for meeting the wider challenges of economic development. The region's performance relative to other regions can no longer be regarded as a passing phenomenon. But how such high and sustained rates of growth have been achieved among a large group of economies is still the subject of debate. To date opinion has been divided. On one view, the experience confirms the case for "getting prices right" through the free play of market forces. On another, it points to the limits of price signals as a guide to the process of capital accumulation and technological catching-up, and confirms the benefits to be drawn from appropriate forms of government intervention. Both these interpretations have tended to pose stark choices for other developing countries seeking to emulate the East Asian example: the market versus the State; inward- versus outward-oriented development; investment or exports as the engine of growth.

This issue of *TDR* pursues a different line. In *TDR 1994* the analysis focused on the links between capital accumulation, technological progress and economic growth in the first-tier East Asian newly industrializing economies (NIEs) - Hong Kong, Republic of Korea, Singapore and Taiwan Province of China. It examined possible conflicts as well as complementarities between the State and the market in evolving government-business relations built around a profit-investment nexus animated by strategic policy interventions and appropriate institutions. Building on that research, this year's Report emphasizes the interdependence of exports and investment and its role in accelerating structural change and industrial growth. In particular, it considers the extent to which mutually reinforcing regional trade and investment linkages have added a distinct dimension to the East Asian growth experience. Following the lead of the earlier Report, it also examines the role of policies in linking exports to investment, as well as in upgrading and diversifying export structures. In this context, the complementarity between effective export promotion measures and import substitution policies is examined. Differences among countries in the choice and effectiveness of policies are explored, as well as those within the region between the first-tier NIEs and the second-tier ones (Indonesia, Malaysia and Thailand).

From this perspective the issue of replicating East Asian success outside the region comes into sharper focus. Broadly speaking, outward-oriented development is a dynamic process where investment, imports, exports and industrial upgrading are closely intertwined. Such a process is consistent with varying degrees of import substitution and export orientation, and with concentration on different products and markets. There is thus considerable room for manoeuvre in a pragmatic approach to development policy in a globalizing world, which can accommodate differences in levels of industrial development, natural resource endowments and macroeconomic constraints.

Replication by a large number of countries not only requires the successful pursuit of trade, industrial and technology policies by developing countries, but also open markets in the North. This in turn will depend upon finding solutions to the severe labour market problems which continue to beset many advanced industrial economies. As last year, this year's Report rejects the claim, which has become louder over the past year, that growing import penetration by developing countries of their domestic markets is to blame for these problems, assesses the scope for increased North-South trade, and argues that outward-oriented development in the South and expansionary policies in the North provide the basis for a new global policy dialogue.

However, there are also new challenges confronting policymakers in developing countries seeking to emulate the East Asian type of export-oriented industrialization. In the first place, compared to the first-tier NIEs, they can certainly expect closer surveillance of their domestic trade and investment policies, which will be subject to WTO disciplines. The Report assesses from this standpoint the new trading environment and the scope for permissible policy alternatives for promoting industrialization in the South. Moreover, given the uncertain economic prospects in the advanced industrial economies, the regional success of East Asia not only encourages a fresh look at the potential gains from South-South economic cooperation, but also widens the opportunities for such cooperation.

Chapter I examines the regional dimension of East Asian industrialization and growth, concentrating on trade and investment links among countries. Particular attention is paid to macroeconomic pressures and government policies in shaping the regional integration process. The chapter also assesses the implications of recent shifts in competitiveness for growth and employment in Japan, as well as for industrialization and development of the developing countries of the region. Chapter II seeks to account for the success of the East Asian economies in linking a rapid pace of investment and industrial upgrading to exports. The role of trade and industrial policies in animating an investment-export nexus is emphasized, and differences in export performance among economies in the region are related to differences in policy orientation, including policies relating to FDI and TNCs. The final chapter examines the issue of replicating the East Asian export performance on a large scale. In particular, the danger of a "fallacy of composition" that may arise from widespread efforts to promote low-skill manufactured exports is examined, as well as the potential problems such exports might pose for advanced economies. An assessment is also made of whether the post-Uruguay Round trading regime precludes the policies that underpinned export success in East Asia. ■

Chapter I

INTEGRATION AND INDUSTRIALIZATION IN EAST ASIA

A. The flying geese paradigm

During the past two decades, the economic performance of Japan and a small group of rapidly growing East Asian countries, including the Republic of Korea, Taiwan Province of China, Hong Kong and Singapore (collectively identified as the first-tier newly industrializing economies, NIEs) has attracted considerable attention. More recently, strong growth in a second tier of (South-East) Asian industrializing countries (Indonesia, Malaysia and Thailand) and the re-emergence of China in the world economy have added weight to the idea of a wave of industrial development spreading across a much wider region and focused attention on East Asia[1] as a new growth pole in the world economy.

This regional pattern of industrialization, which has not only proceeded in waves but also progressively involved a regional division of labour based on an industrial and locational hierarchy, has been dubbed as a "flying geese development paradigm."[2] This paradigm provides a description of the life-cycles of various industries in the course of economic development and of the relocation of industries from one country to another through trade and foreign direct investment (FDI) in response to shifts in competitiveness.[3] However, there is more at stake in the flying geese paradigm than pure description. The significance of the paradigm lies in its analysis of the linkages between the different countries in a regional hierarchy, the mechanisms by which development is transmitted from one country to another, the respective roles of policy and markets in this process, and the stability and sustainability of the process itself.

In this process, trade is the most important vehicle for transferring new goods and technology across countries. Imports from the more advanced countries (*senshinkoku)* would allow new goods to be introduced into the "follower" countries (*koshinkoku*). They would also allow the transfer of technology and capital goods needed for their subsequent production in the "follower" economy and, eventually, for their export to other countries. Finally, when a country loses competitiveness in a particular product, its domestic production is phased out and replaced by imports from the "followers", which have succeeded in building up a competitive industry in that product. Thus, this sequence combines the life-cycle of a particular product with a dynamic process of shifting comparative advantage. The outcome is a constantly evolving regional division of labour within a group of economies all striving for the common goal of industrialization.

More recently emphasis has been placed on FDI as an additional channel for "recycling comparative advantage". On this view, FDI both shapes and is shaped by the evolution of comparative advantage between the follower countries and the lead country. Domestic investment withdraws from those sectors suffering from loss of competitiveness (e.g. labour-intensive sectors such as textiles

Box 4

THEORIES OF TRADE AND FOREIGN DIRECT INVESTMENT

There has never been a happy marriage between the theory of international trade and the analysis of the determinants of FDI. Although trade and FDI are often linked through their balance-of-payments effects, such a relationship is a simple accounting one, and does not provide an integrated theory of overall competitiveness. While the standard theory of international trade seeks to explain comparative advantage in terms of inter-country differences, such as in factor endowments, most of the literature on the determinants of FDI concentrates on firm-specific, microeconomic factors. The two approaches are not always consistent; the theory of comparative advantage is based on the assumption of perfect competition, whereas FDI is often explained in terms of market imperfections or failures. Even where a more interactive approach to FDI has been attempted, analysis has concentrated narrowly on corporate strategy; thus, it provides little insight into how macroeconomic factors interact in the decisions on locating production globally.

On the other hand, the neoclassical theory of capital movements based on international differences in thrift and productivity makes no explicit reference to the theory of comparative advantage. Nor does it contribute to the understanding of the determinants of FDI because it leaves open the allocation of excess savings between portfolio and productive investment. Finally, the link between a country's domestic investment and its FDI is not clear. The conventional approach to international capital flows sees no trade-off between the two since it treats thrift and productivity as independent variables. By contrast, where FDI is treated as a substitute for exports, there is an implicit trade-off between domestic capital formation and FDI.

One way of combining the theory of trade with the theory of FDI is to view trade and FDI as alternative ways for a firm to supply foreign markets. In deciding between the two, the firm would naturally compare the costs of investing and operating at home with those of investing and operating abroad. Thanks to the seminal contribution by Hymer[1], it is now generally recognized that foreign firms face certain disadvantages compared to local firms and that in order to be able to compete with the latter they consequently need to enjoy certain comparative advantages based on unmarketable, owner-specific assets such as superior technology and product design and managerial, marketing and distributional skills. In the absence of a market to price these knowledge- and information-based assets, or when market solutions such as licensing suffer from inefficiencies, the production process will need to be organized through subsidiaries in order to capture the rents from firm-specific assets.[2]

Certainly, in order for a firm to invest abroad and compete with local firms, the comparative advantages arising from such firm-specific factors need to exceed the additional costs of operating abroad. However, this is not a sufficient basis for determining whether it is in the interest of the firm to supply foreign markets from its plants abroad rather than at home. The basis for such a decision is provided by the product-cycle hypothesis[3], which sees trade and FDI as successive stages in production for foreign markets. First, the firm innovates and develops a new product within the market, to satisfy domestic demand. Then output of the product is increased as conditions in export markets become favourable for the product concerned. Eventually, the firm is forced to invest abroad as the knowledge embodied in the goods produced is increasingly absorbed by foreign producers. In other words, the firm will decide to invest abroad when trade no longer allows it to capture the rents from its intrinsic assets.

However, none of these intra-firm considerations can explain the evolution of trade and FDI at the aggregate level. Different firms and industries will reach different stages of production at different times, and there is no reason to expect them to move simultaneously from the domestic market to exports, and from exports to FDI. In other words, these theories do not provide much insight into the behaviour of trade and FDI throughout the industrialization process. By the same token, any generalization about the overall pattern and evolution of trade and FDI in industrial societies needs to rely on common, macroeconomic factors that generate more or less uniform influences across the industry. Both the flying geese paradigm and the "four stages" model of Roemer discussed in section C of this chapter aim at such a generalization.

Box 4 (concluded)

Such macroeconomic influences may arise from a number of factors, including a sustained rise in labour costs relative to competitors and/or a permanent appreciation of the currency. Perhaps an equally important factor is the restrictions faced in exporting to foreign markets. Clearly, both tariff and non-tariff barriers to trade will open up the potential for FDI as a means of circumventing the barriers. If a country faces greater barriers to its exports as its share in world trade increases, it is to be expected that the pace of its exports will slow down and that of FDI will take off. Such an outcome is probable when the rising trade share is associated with a balance-of-payments surplus and when the major trading partners suffer from chronic demand deficiency and high and rising unemployment. While historically this situation has not always prevailed, the post-1980 increase in Japan's share in world exports has certainly taken place in the context of slow growth and increased unemployment in its major trading partners in Europe and elsewhere. Under these conditions the factors that tend to restrict exports also provide additional incentives for FDI; from the trading partners' point of view, while imports tend to reduce employment, FDI creates additional jobs.

It should, however, be pointed out that, even when an inverse correlation is observed between exports and FDI at the industry or the aggregate level, it is not always possible to conclude that the latter replaces the former. Exports may simply be constrained by rising costs, currency appreciation or increased protectionism, while firms respond by investing abroad. Thus, the choice is not between exporting and investing abroad, but between FDI and losing an important part of the market. Moreover, investment abroad could prevent further deterioration in the external position of the country if it allows the firm to develop and become more competitive in the home market or third markets vis-à-vis other foreign firms.[4] Finally, FDI may even help improve the exports of the home country through the provision of, first, capital goods and, then, intermediate inputs to foreign subsidiaries of parent companies. In such cases, one may or may not observe an inverse relationship between FDI and trade, but in any case such a relationship does not necessarily indicate causality. This may also explain why empirical studies on the relation between FDI and trade are inconclusive.[5]

[1] S. H. Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investment* (Cambridge, MA: M.I.T., 1976), Monographs in Economics, No. 14.

[2] These considerations are also broadly valid for the so-called "complex FDI strategies", whereby the production process is "sliced up" among different locations and intra-firm trade is of growing importance. Even ignoring the empirical question of how far this slicing up has actually progressed, the focus on corporate strategies is no more successful in providing an integrated theory of trade and FDI in the sense discussed here.

[3] R. Vernon, "International Investment and International Trade in the Product Cycle", *The Quarterly Journal of Economics*, Vol. 80, May 1966.

[4] See R. E. Lipsey and M.Y. Weiss, "Foreign Production and Exports in Manufacturing Industries", *The Review of Economics and Statistics*, Vol. 63, No. 4, November 1981.

[5] See J. P. Agarwal, "Determinants of Foreign Direct Investment: A Survey", *Weltwirtschaftliches Archiv*, Vol. 116, No. 4, 1980, for an earlier, and G.C. Hufbauer, D. Lakdawalla and A. Malani, "Determinants of Direct Foreign Investment and its Connection to Trade", *UNCTAD Review*, *1994* (United Nations publication, Sales No. E.94.II.D.19), for a more recent survey of these studies. The studies do not always, however, distinguish among manufacturing, services and natural-resource-oriented flows of FDI. Certainly, FDI in natural resources does not replace trade and domestic investment; and in ancillary services, such as sale and service networks, it is often complementary to trade.

and footwear), and production is relocated where labour is cheaper in order to supply both foreign and home markets. However, aggregate investment does not diminish in the advanced economy because its industry is constantly being restructured and upgraded, and resources are reallocated to higher-skill, higher-technology products, where it now enjoys comparative advantage. In this model, therefore, there is no trade-off between aggregate domestic investment and FDI; global investment continuously increases, promoting trade flows. In the host country, FDI raises living standards and provides employment for those displaced by the migration of older activities to the "follower" countries. On this account, FDI is trade-oriented and benignly complementary to the host country's economy. The flying

geese pattern of FDI is governed by shifts in competitiveness brought about, in part, by macroeconomic factors, and is often contrasted with alternative patterns where FDI is governed by the "microeconomic" interests of transnational corporations (TNCs) to defend oligopolistic advantage.[4] Thus, this paradigm offers an integrated analysis of trade and FDI at the aggregate level which a firm-based approach cannot provide (see box 4).

This chapter makes a critical assessment of this paradigm as applied to the East Asian experience. It examines trade and investment linkages among countries in East Asia at different levels of industrialization, the role played by the more advanced countries in the hierarchy, particularly Japan, and the macroeconomic factors underlying the changes in trade and investment flows within the region. The chapter also explores the extent to which government policy has been central to the flying geese pattern of development, and discusses whether this pattern always generates a mutually reinforcing, harmonious process of industrialization, or also contains some conflictual elements.

A main lesson that emerges from the assessment is that there is considerable scope for developing countries at different levels of industrialization to benefit mutually from the flying geese pattern of trade and FDI. As long as they pursue appropriate industrial and technology policies, these countries can move up the industrial hierarchy through accelerated capital accumulation and the adaptation of advanced technology in such a way that shifts competitiveness to the mutual advantage of all countries and does not lead to unmanageable domestic dislocations and adjustment problems, or to trade frictions. Consequently, there is considerably more scope for South-South cooperation in industrial development than is generally believed.

However, with economic maturity the speed of upgrading slows down considerably, since moving up in the technology scale increasingly depends on innovation. This poses different policy challenges for the lead economy from those faced by developing countries further down the industrial hierarchy. Focusing on these concerns brings into sharper perspective the regional role of Japan, which has become much greater in recent years and has been associated with serious regional imbalances in trade and FDI flows. The response of Japan not only will determine whether or not the Japanese economy will enter a new post-industrial stage with low growth and high unemployment typical of other major industrial countries, but also will affect the fortunes of the developing countries of the region, and, indeed, prospects for the wider regional integration process.

B. Role of policy and markets in the flying geese process

The first important issue is whether or not industrial development in line with the flying geese paradigm has been a market-driven process. There can be little doubt that it implies a more outward-oriented development strategy. However, this does not mean that a mutually beneficial flying geese pattern of investment, trade and industrialization emerges spontaneously. Policy intervention would be needed if markets fail to generate signals about the possible evolution of comparative advantage so as to allow producers and investors to anticipate difficulties that existing industries may face, or if producers and investors fail to respond to market signals because of a number of impediments and imperfections, including problems of information and coordination and of adjustment costs, or because firms' responses to price signals do not generate a mutually reinforcing process of industrialization for all the countries concerned.

Policy intervention has indeed taken place, at two levels. For the more advanced economies, notably Japan, phasing out obsolescent industries and supporting "sunrise" industries have often required considerable government intervention to help private enterprises to relocate production abroad through FDI and/or to move to different products, where they could create new comparative advantages. As examined in greater detail in *TDR 1994*, these interventions were formulated in the context

of a consistent, overall industrial policy designed to tackle a series of closely interrelated and mutually reinforcing market failures which typically held back the process of investment and innovation, and the type of industrial policy used worked through the interaction of government policy and the competitive strategies of private firms. The need for policy intervention did not lessen with the progress of industrialization in Japan. Indeed, as discussed in section H below, the response of domestic firms to recent shifts in competitiveness poses serious policy challenges.

From the Japanese perspective, outward FDI, government support and regional integration strategies have been closely interrelated. There is indeed substantial empirical evidence that corporations in Japan continue to work closely with the Government, even after they have moved abroad.[5] Often, the Government has also worked with Governments of other countries to support an orderly, sequential transfer of industries in response to changing comparative advantage among the ranks of developing countries in Asia. In this context, the flying geese paradigm has served partly as a rationale for the country's official development assistance (ODA) and economic cooperation programmes to support the activities of Japanese firms in South-East Asia. In particular, ODA for the development of infrastructure has been seen as preparing the recipient countries elsewhere in the region for FDI and as a means of promoting their export industries.[6] This factor also helped Japan to extend its national concepts of industrial policy to other countries of the region. It has, for instance, been suggested that officials of the Ministry of International Trade and Industry (MITI) have tried to reproduce in South-East Asia some of the instruments of industrial policy used in Japan.[7] Similar conclusions can also be reached from the more recent wave of regional FDI from first-tier NIEs. Thus many of the positive international spillovers within East Asia have been ultimately generated because of the success of the industrial policies of the lead economies, rather than through a purely market-generated process.

The evolution of an export-oriented industrial sector is no more spontaneous and no less difficult for developing than for developed countries. As discussed in greater detail in chapter II below, even the promotion of industries which enjoy comparative advantage arising from existing resource endowments, including labour, require considerable policy effort. The process of industrial upgrading poses even greater policy challenges. Thus, the "followers" need to employ industrial policy, in the form of infant industry protection and export promotion, in order to even the competitive playing field with the more advanced economies. The effective use of FDI in facilitating upgrading and technological catching-up and in promoting exports has also depended on a series of policy initiatives on the part of host Governments. While such policies have often been prompted by the need to respond to market pressures, they were also designed to deal with missing markets or market failures. In this sense, the flying geese paradigm of a mutually beneficial process of industrialization is best described as a market-compatible, rather than a market-driven, process.

C. Harmony, competition and conflict in the flying geese process

Most of the recent accounts of the flying geese paradigm paint a harmonious picture in which East Asian development is presented almost in entirely cooperative terms, while the potentially conflictual and competitive aspects of this process are virtually ignored. Such a harmonious vision is notable particularly with respect to the role of TNCs and FDI. As noted above, there are certainly many instances in which the interests of TNCs and the Governments of the more advanced and the "follower" countries coincide, leading to close collaboration with little or no conflict. Again, there are many instances where the interests of producers and consumers within countries are compatible. However, it would be misleading to assume that no conflict of interest is involved either within or among countries, or between countries and TNCs in the flying geese process. Indeed, as already

noted, an important objective of policy has been to avert potential problems and conflicts by facilitating adjustment to changed conditions of competitiveness, or to bring about desired outcomes by inducing domestic and foreign investors to undertake activities they would not otherwise envisage.

In the original formulation of the flying geese paradigm by Akamatsu, conflicts among and within countries associated with trade were clearly recognized. Thus, it was recognized that the initial penetration of imports into a "follower" country would benefit local consumers but hurt producers. When local firms eventually develop and successfully compete with imports, the follower country as a whole may benefit, while the leading country as a whole may suffer. These dangers are scarcely recognized in more recent versions of the paradigm, which ignore or seriously downplay the costs and difficulties of restructuring. In the course of time both follower and lead countries may be better off as they move up in the industrial hierarchy, but the management of conflicts arising from the immediate impoverishment of producers, and adjustment to new circumstances pose serious challenges to policymakers.[8]

Conflict between countries and TNCs can take many forms. The latter seek to maximize profits from their global operations, rather than those of each and every affiliate separately. Consequently, their interests do not always coincide with those of the host country. The likelihood of conflict is greater when TNCs pursue "complex integration strategies", whereby the production process is "sliced up" among different locations and intra-firm trade is of growing importance. With such strategies the scope for transfer pricing, for example, increases considerably. As noted in another UNCTAD report, "no single country ... in which a part of a TNC system is located can be assured of capturing (or capturing to the same extent as others) the benefits" that are expected to flow from the global activities of TNCs. Although "it can reasonably be assumed that attempts by a TNC to improve its competitiveness would have favourable repercussions on at least some of the national economies within which it is operating",[9] there is no presumption that these national economies are less advanced ones. A host developing country may wish to maximize the local content of TNC production, or to induce TNCs to locate high value-added activities within its borders and maximize spin-offs to the domestic economy by encouraging the local firms to enter the industry. It may also wish to lock TNCs into the national economy and induce them to upgrade their technology in line with the changing needs of national development. Such objectives may conflict with the natural desire of TNCs to safeguard their technological advantages and maximize their flexibility to relocate production in line with their shifting global priorities. Transnational corporations can be a powerful engine for "recycling comparative advantage", but the extent and terms of this recycling are variable, and the more leverage a host country can exert over TNCs, the better the bargain it can strike.[10] Indeed, as discussed in chapter II below, national policies towards TNCs and FDI have played an important role in shaping their contribution to the attainment of development objectives in the East Asian NIEs, and will continue to exert a major influence on the future course of industrialization and development.

What is even less appreciated is the possible conflict of interests between TNCs and the home country. The flying geese paradigm assumes that the lead country can always upgrade its industrial structure and introduce new methods of production and new products as rapidly as other countries catch up. Moreover, the markets for the new products introduced are seen as extensive as those for the products displaced. While these assumptions may be correct at earlier stages of industrialization, they become less valid with maturity. Indeed, it appears that the innovation-imitation lag between the mature economies and the NIEs has shortened considerably over the past two decades, thanks not only to greater flexibility and divisibility in production technology, but also to a rapid pace of accumulation of physical and human capital in the NIEs which has allowed them to introduce rapidly new technologies embodied in capital goods and accelerated the learning and catching-up process.[11] Thus, the lead countries may no longer maintain a pace of technological progress and productivity growth that would allow them to expand simultaneously FDI, trade and domestic investment.

These considerations are indeed consistent with the observed postwar development of the major industrial countries. In this experience, four distinct stages have been identified in the internationalization of manufactured activity.[12] In the first stage the country relies on exports, and its share in world manufactured exports tends to increase. The second stage is the transition "from trade reliance to investment reliance" - i.e. its share in world trade stabilizes while that of FDI starts rising. In the

third stage FDI becomes the main source for supplying foreign markets and the share of the country in world trade declines. In the final stage "neither trade nor investment can save the competitive position" of the country, whose share in global FDI also declines.[13] The transition to industrial maturity in the latter stages has often been associated with a slowdown in growth, loss of manufacturing employment and a shift into services - i.e. de-industrialization.[14]

At the time when this analysis was formulated, i.e. the mid-1970s, Japan, the Federal Republic of Germany, the United States and the United Kingdom were described as being in the first, second, third and fourth stages, respectively. The increased role of Japan in the flying geese process in the past decade appears to be associated with a shift to the third stage, where Japanese outward FDI is no longer generating but replacing exports, and no longer complementing but substituting for domestic investment. These tendencies highlight the kind of conflicts that may arise between the interests of TNCs and the home country, and underlie the recent concern over the "hollowing-out" of Japanese industry discussed in section G below.

D. FDI and regional integration

As noted above, the recent versions of the flying geese paradigm assign an important role to outward FDI by the more advanced countries, notably Japan, as a way of "recycling comparative advantage" to less developed countries. This section describes the intra-regional investment flows and their role in regional integration and industrialization. While the evidence suggests that the pattern of intra-regional FDI is broadly consistent with the flying geese paradigm, until recently such FDI was relatively small compared to the flow of FDI to the region from the United States and Europe, as well as in relation to the overall rate of regional capital accumulation. Indeed, as discussed in chapter II below, there are several important countries in East Asia, including Japan itself, which have developed rapidly without relying heavily on FDI from any source.

In assessing the role of Japanese FDI in the region, it should be noted that Japan has emerged as a major international investor only during the past decade. Ten years ago, in 1985, the outstanding stock (cumulative value) of its global FDI was around $84 billion, equivalent to about one half of the country's total exports in that year. During the second half of the 1980s, however, such investment increased rapidly and steadily, reaching an annual average of $45 billion (table 21).[15] The outflow somewhat decelerated in the early 1990s, but still remained high, at an average annual rate of $38 billion. Consequently, the share of Japan in the world stock of FDI rose rapidly, reaching 12 per cent in 1994, against less than 4 per cent in 1980 (chart 2).

This rapid increase in Japanese FDI has been accompanied by significant changes in its sectoral distribution. Before the 1980s, resource-based investment, particularly in mining and energy, was a major element, accounting for 25 per cent of total outflows. Such investment stagnated throughout the 1980s, and has constituted no more than 3 per cent since 1985. The share of manufacturing investment in total Japanese FDI was higher in the 1970s (35 per cent) than the 1980s (25 per cent), but the decline slowed down towards the end of the 1980s. There was a strong recovery in the 1990s, and in 1994 the share exceeded one third. The tertiary sector has always accounted for an important part of FDI from Japan. Much of it has been in wholesale and retail trade, designed to facilitate access of domestic producers to foreign markets. The Japanese trading companies have been instrumental in this process, handling a wide range of goods and helping exporters to overcome problems of entry, as well as providing them with information on developments in foreign markets. Originally, the establishment and operations of such companies helped obviate the need for producers to locate production facilities abroad. However, they have also played an important role in promot-

Table 21

SECTORAL AND REGIONAL DISTRIBUTION OF FOREIGN DIRECT INVESTMENT BY JAPAN

	Cumulative outflow					*Stock*[a]			
	1951-1970	*1971-1980*	*1981-1985*	*1986-1990*	*1991-1994*	*1980*	*1985*	*1990*	*1994*
Total FDI ($ million)[b]	3577	32920	47152	227157	152798	36497	83649	310806	463604
	(179)	(3292)	(9430)	(45431)	(38200)				
of which to (per cent):									
North America	25.5	27.0	36.4	48.1	43.5	26.8	32.2	43.8	43.7
Europe	17.9	11.6	13.9	21.2	20.0	12.3	13.2	19.1	19.4
Asia	21.0	27.6	20.4	12.4	18.8	26.9	23.3	15.3	16.4
Latin America	15.9	17.0	20.1	10.9	9.6	16.9	18.7	13.0	11.9
Other regions	19.8	16.8	9.2	7.4	8.1	17.1	12.7	8.8	8.6
Primary sector ($ million)[b]	886	7094	4995	5659	4769	7980	12975	18634	23403
	(44)	(709)	(999)	(1132)	(1192)				
of which to (per cent):									
North America	20.8	9.1	13.5	21.5	12.4	10.4	11.6	14.6	14.2
Europe	0.7	12.0	0.1	12.9	13.0	10.8	6.7	8.6	9.5
Asia	35.6	42.2	64.8	23.6	30.0	41.5	50.5	42.3	39.8
Latin America	12.4	18.0	6.1	5.1	10.8	17.4	13.0	10.6	10.6
Other regions	30.6	18.7	15.4	36.9	33.9	20.0	18.2	23.9	25.9
Manufacturing ($ million)[b]	928	11645	11826	57213	47284	12573	24399	81612	128896
	(46)	(1164)	(2365)	(11443)	(11821)				
of which to (per cent):									
North America	23.4	19.0	44.6	57.0	40.1	19.3	31.6	49.4	46.0
Europe	3.9	6.9	10.5	18.3	18.4	6.7	8.6	15.4	16.5
Asia	34.5	36.6	24.9	19.5	31.5	36.4	30.8	22.9	26.0
Latin America	29.6	21.5	15.0	3.0	4.6	22.1	18.7	7.7	6.5
Other regions	8.6	16.0	4.9	2.2	5.5	15.5	10.3	4.7	5.0
Services ($ million)[b]	1763	14181	30331	164284	100638	15944	46275	210559	311197
	(88)	(1418)	(6066)	(32857)	(25160)				
of which to (per cent):									
North America	29.0	42.5	37.0	45.9	46.7	41.0	38.4	44.2	45.0
Europe	33.9	15.3	17.4	22.6	21.2	17.4	17.4	21.4	21.3
Asia	6.6	13.0	11.4	9.5	12.3	12.2	11.7	10.0	10.7
Latin America	10.3	12.8	24.3	13.9	11.9	12.6	20.3	15.3	14.2
Other regions	20.2	16.4	9.9	8.2	7.9	16.8	12.3	9.1	8.7

Source: Ministry of International Trade and Industry, *Statistics on Foreign Investment* and *Overseas Activities of Japanese Enterprises* (in Japanese), various issues.

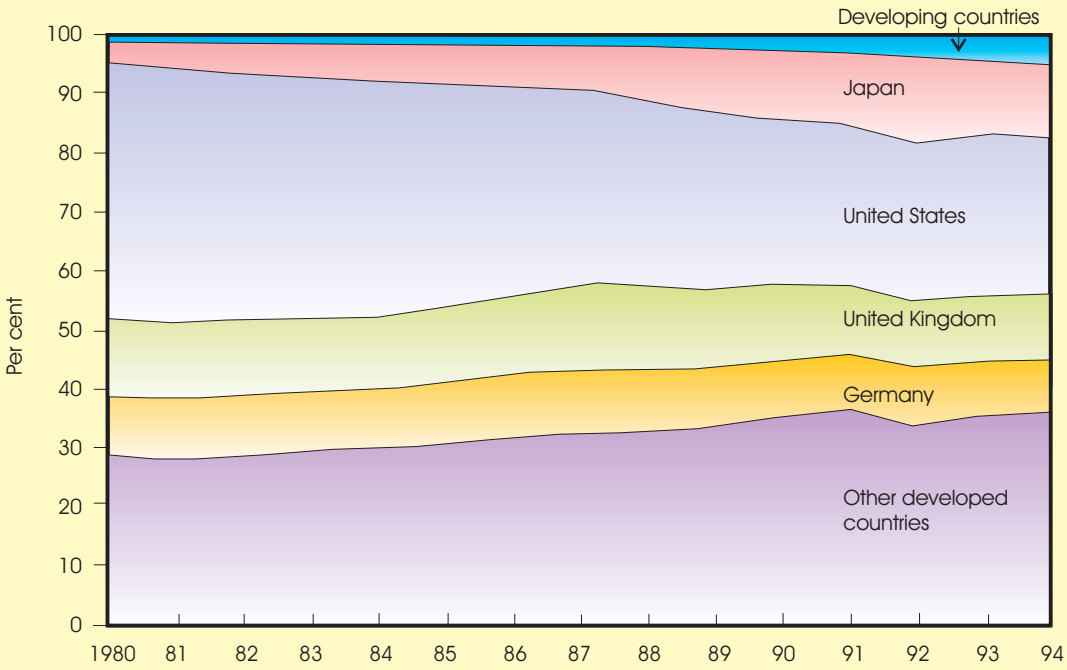
a Cumulative annual outflows valued at historical cost (i.e. cumulation of the flows shown in the first part of the table).

b Figures in parentheses are annual averages.

Chart 2

GEOGRAPHICAL DISTRIBUTION OF WORLD FDI STOCKS, BY ORIGIN, 1980-1994

(Per cent)



Source: UNCTAD data base.

ing Japanese investment abroad, particularly for small investors, when they started relocating production through FDI.

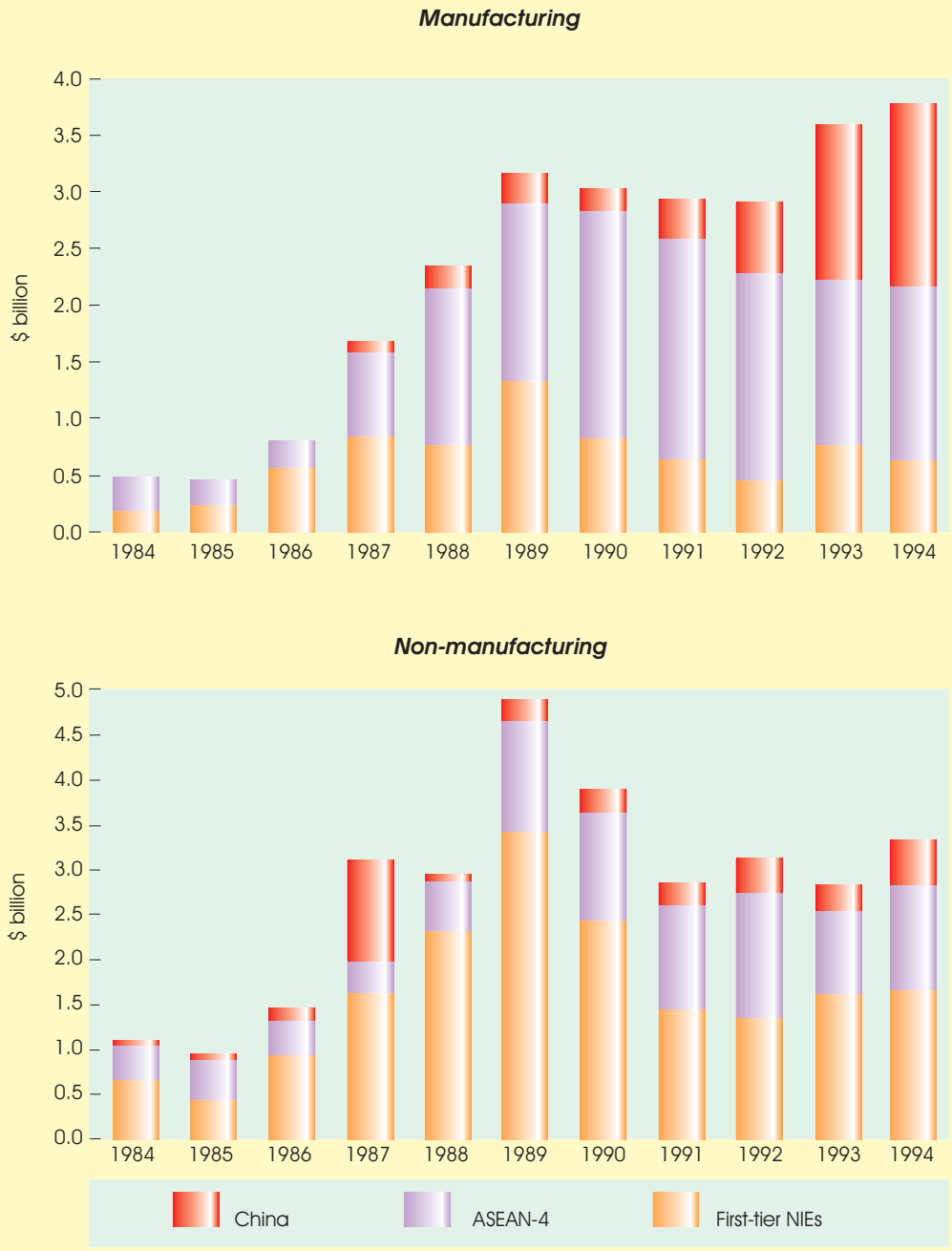
Developing countries have always accounted for a very large proportion of Japanese FDI in the primary sector. At the beginning of the 1980s they also accounted for about 70 per cent of the stock of Japanese FDI in manufacturing. Although there was an important shift in the 1980s in the direction of the flow, from developing countries to the North, this was subsequently reversed, due in particular to a reduction in the flow to North America and increased flows to East Asia, which received about one third of Japanese manufacturing FDI in 1989-1994.

In 1985 almost half of the total flow of Japanese FDI to East Asia was to Indonesia, mostly in natural resource industries and labour-intensive manufacturing.[16] Singapore was also a significant recipient, with a flow of about $2 billion, mostly in manufacturing. Corresponding investment in Hong Kong was somewhat larger, and almost entirely in non-manufacturing. For the rest of East Asia the amounts involved were modest. It is striking that, on the whole, Japanese manufacturing investment in East Asia in 1985 was small, exceeding $1 billion only in Singapore and Indonesia. Since that year, the stock of total Japanese FDI in East Asia has more than quadrupled and much of the new investment has been in manufacturing. It first went to the first-tier NIEs and then to the ASEAN-4, but in the 1990s attention was switched to China (see chart 3).

Until the last few years Japan was the only country in East Asia with significant FDI in the neighbouring countries. In the late 1980s it was joined by the first-tier NIEs, which started shifting some labour-intensive production to less developed countries, including China.[17] Between them, the first-tier NIEs now have a greater stock of FDI in ASEAN-4 than Japan. Indeed, Taiwan

Chart 3

TRENDS IN JAPANESE FOREIGN DIRECT INVESTMENT IN ASIA



Source: Ministry of International Trade and Industry, *White Paper on International Trade 1995 (Summary)*, Tokyo, July 1996.
Note: Figures for 1994 are estimates.

Province of China alone has more FDI in Malaysia than Japan (table 22). Again, a very large proportion of FDI in China originates from Chinese residents in Hong Kong and Macau, as well as from Taiwan Province. It has been argued that much of this apparent FDI is a recycling of funds which originate in the People's Republic of China itself. Domestic firms with money to invest are said to team up with Chinese residents abroad, who invest the money back in China, where it receives

Table 22

COMPOSITION OF THE STOCK OF FOREIGN DIRECT INVESTMENT IN CHINA AND ASEAN-4 IN 1992, BY ORIGIN[a]

(Percentage)

	ASEAN-4[b]				
Origin	*Total*	*Indonesia*	*Malaysia*	*Thailand*	*China[c]*
Hong Kong	..	7.4	3.0	6.6	62.0[d]
Republic of Korea	..	5.7	2.9	1.5	0.9
Singapore	..	4.1	6.7	6.3	..
Taiwan Province of China	..	7.7	22.8	9.2	8.2
Total first-tier NIEs	*25.8*	*24.9*	*35.4*	*23.6*	*71.1[e]*
Japan	26.1	15.7	22.7	38.1	8.4
United States	9.5	6.5	7.0	11.9	8.5
Other countries	38.6	52.9	35.0	26.4	12.0[f]

Source: Ministry of International Trade and Industry, *White Paper on International Trade 1994*, Tokyo, 1994.

a Share of home countries listed in rows in total FDI stock in host countries listed in columns.

b Indonesia, Malaysia, Thailand and the Philippines.

c 1993.

d Including also FDI from Macau.

e Excluding FDI from Singapore, for which no separate data were available.

f Including FDI from Singapore.

the privileges and protection accorded to foreign investors. According to some estimates, 25 per cent of the total flow of FDI to China in 1992 was of this variety.[18]

There appears to have been a strong parallel between FDI from Japan and from the first-tier NIEs in the region, with the latter generally being a stage behind the former, as implied by the flying geese paradigm. This is particularly notable with respect to the Republic of Korea, where, as in the early years in Japan, FDI was initially concentrated in resource-extracting activities aimed at ensuring continued expansion of industrial production. Since the late 1980s, however, manufacturing FDI by the Republic of Korea has surpassed resource-oriented FDI in terms of both numbers of projects and value. It appears that large Korean conglomerates have begun developing global and regional production networks, emulating their Japanese predecessors.

Similarly, from the late 1980s onward the authorities in Taiwan Province of China adopted an active policy of moving labour-intensive industries abroad. An industrial upgrading regulation provided certain incentives, including compensation for losses incurred by investors abroad. In 1993, the Province started to pursue what came to be popularly referred to as the "southbound" policy of investment. Unlike Japan and the Republic of Korea, where FDI is undertaken mainly by large firms, it is the small- and medium-sized enterprises (SMEs) that have accounted for an important part of outward FDI.[19]

Thus, in terms of the sequencing of FDI among sectors and countries, the intra-regional pattern is consistent with the flying geese paradigm. Japan was the first major regional investor, first in primary sectors and then in manufacturing. Its FDI in manufacturing gradually moved from more to less industrialized countries of the region. The sectoral pattern of FDI seems to have continued when, following Japan, the second-tier NIEs also emerged as international investors. However, the evidence does not suggest that the flying geese pat-

tern of regional industrialization has depended entirely or even to a large extent on intra-regional investment. As discussed in chapter II below, FDI did not play a very important role in the industrialization of Japan and the majority of the first-tier NIEs. It has been more important for the second-tier NIEs and China, but, as shown in table 3, FDI inflows from outside the region have been equally or even more important.

E. Intra-regional trade

The flying geese paradigm predicts a certain pattern of trade among countries in the "formation" at different levels of industrialization. Primary commodities (food, raw materials and fuels) make up the bulk of exports of countries at the bottom of the industrialization hierarchy, while their imports consist of all kinds of manufactures. As industrialization proceeds, labour-intensive manufactures account for an important part of exports, while capital goods and other skill- and capital-intensive manufactures constitute a high proportion of imports. As industrial upgrading progresses, capital goods imports continue to be important, but intra-industry trade also emerges in a number of skill- and capital-intensive products. Another implication of the paradigm is that developing countries participating in the process typically run overall trade deficits with the more advanced economies, and capital flows from the latter to the former, including FDI, help to close the external gap. In what follows the evidence on intra-regional trade is examined with a view to assessing the validity of these predictions of the flying geese paradigm.

1. Japanese trade

Table 23 shows the evolution of the trade of Japan since 1985 in selected items with the first-tier NIEs, ASEAN-4 and China. A number of features are worth noting. First, as the flying geese paradigm predicts, Japan has run trade deficits with all three areas in food, raw materials and fuel. The deficit is greater in trade with ASEAN-4 than with the first-tier NIEs, on account of both greater resource endowments of the former countries and their greater reliance on primary exports. Second, there has also been a deficit in clothing and footwear with all three areas. While in absolute terms it is greatest with the first-tier NIEs, the deficit has risen fastest with China, followed by ASEAN-4.

For most other manufactures Japan has a very large and growing surplus with each of the three areas, notwithstanding the fact that generally imports have been growing faster than exports, as indicated by the declines in the export/import ratios in the table. The increase in the trade surplus in these products is explained by the fact that the volume of East Asian goods purchased by Japan was initially very small, when the period of rapid growth in the region began, particularly as regards imports of the ASEAN-4. In 1985, Japan exported manufactures to those countries worth about $7 billion, but imported from them only some $800 million (table 24), yielding a surplus of more than $6 billion. In 1994, the corresponding figures were about $39 billion and $12 billion, giving a surplus of about $27 billion. Thus, exports increased by a multiple of 4.6 but imports by one of 14, yet at the same time the trade surplus more than quadrupled. Clearly, if such trade trends persist, the Japanese surplus with these countries will eventually diminish in absolute value.

Japan accounts for about one half of all external exports of food, raw materials and fuel from the NIEs and China (i.e. excluding trade among the latter countries). In labour-intensive manufactures, Japan does not appear to have been a leading market for the first-tier NIEs during their initial stages of development. For instance, the share of Japan in total clothing exports from the Republic of Korea was quite low (around 15 per cent) in the 1970s, when the latter country was in an early stage of industrialization. Only during the 1980s, when the economy was already rather developed, did Korean clothing exports to Japan really take off; it

Table 23

TRADE OF JAPAN WITH FIRST-TIER NIEs, ASEAN-4 AND CHINA, 1985, 1990 AND 1994

	Trade with first-tier NIEs						Trade with ASEAN-4						Trade with China					
	Trade balance ($ billion)			Export/import ratio			Trade balance ($ billion)			Export/import ratio			Trade balance ($ billion)			Export/import ratio		
Product group	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*
Manufactures	15.7	34.2	63.2	4.0	2.9	3.8	6.2	16.1	26.4	10.0	4.2	3.1	10.4	0.0	-1.5	8.0	1.0	0.9
Of which:																		
Chemicals	1.7	4.5	7.2	4.9	5.4	6.2	0.6	1.5	2.3	5.2	5.6	4.8	0.4	0.2	0.4	2.6	1.3	1.5
Computers and office equipment	0.7	1.7	1.9	7.4	3.2	1.7	0.1	0.1	-0.3	131.4	1.2	0.7	0.2	0.1	0.0	1254.8	2.9	1.2
Electrical machinery	4.7	12.0	22.1	7.7	5.2	5.0	1.1	3.0	7.0	17.4	5.0	3.1	2.3	1.0	2.0	186.6	4.3	2.2
Non-electrical machinery	3.9	10.4	17.2	17.0	10.8	16.3	1.6	6.2	10.4	26.8	22.3	15.6	2.5	1.0	4.7	839.9	8.6	11.6
Road motor vehicles	1.1	2.7	5.0	63.0	12.6	13.0	1.1	3.9	5.6	81.3	148.1	60.2	1.8	0.2	1.4	9241.1	25.3	18.4
Clothing and footwear	-1.3	-4.0	-2.9	0.1	0.0	0.1	-0.0	-0.5	-1.2	0.2	0.0	0.0	-0.5	-2.5	-9.1	0.0	0.0	0.0
Manufactures classified by material [a]	3.6	4.9	8.0	3.5	2.2	2.8	1.5	1.8	2.4	5.7	1.9	1.7	3.4	0.4	1.1	7.1	1.3	1.3
Other manufactures	1.4	1.9	4.7	2.6	1.6	2.2	0.3	0.3	0.2	6.9	1.4	1.1	0.4	-0.3	-2.1	3.6	0.5	0.3
Food, materials & fuels [b]	-2.9	-4.0	-2.4	0.3	0.5	0.7	-15.6	-18.4	-17.7	0.0	0.0	0.1	-4.4	-5.9	-7.4	0.1	0.1	0.1
Unspecified	-0.1	0.4	1.6	0.9	1.6	2.9	0.0	-0.0	-0.2	1.1	0.9	0.7	-0.0	0.0	0.1	0.9	1.4	1.7
Total merchandise trade	12.8	30.7	62.4	2.3	2.2	3.0	-9.4	-2.2	8.6	0.4	0.9	1.3	6.0	-5.9	-8.8	1.9	0.5	0.7

Source: United Nations, *Commodity Trade Statistics* tapes.

a Excluding non-ferrous metals.

b Including non-ferrous metals.

Table 24

EXPORTS OF MANUFACTURES FROM SELECTED EAST ASIAN COUNTRIES, BY MAJOR DESTINATION, 1985 AND 1994

(Billions of dollars)

Exports from	Developing East Asia								Japan	
	Total		First-tier NIEs		ASEAN-4		China			
to	1985	1994	1985	1994	1985	1994	1985	1994	1985	1994
World	102.2	483.8	82.7	281.7	10.2	102.5	9.3	99.6	169.4	377.8
Developing East Asia	19.1	173.2	13.1	101.9	2.9	34.3	3.1	37.0	39.7	142.3
First-tier NIEs	11.9	114.8	6.6	51.9	2.4	28.4	2.9	34.5	20.9	86.0
ASEAN-4	5.1	42.9	4.5	36.2	0.4	4.2	0.2	2.5	6.9	38.8
China	2.0	15.5	1.9	13.8	0.1	1.7	.	.	11.9	17.5
Japan	7.8	50.3	5.9	23.9	0.8	11.7	1.1	14.7	.	.
Other developed market economies	61.7	105.8	53.1	122.0	5.7	46.3	2.9	37.5	100.5	196.4
Rest of world	13.5	54.5	10.5	33.9	0.8	10.2	2.2	10.4	29.2	39.1

***Source*:** UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.

absorbed between 20 and 50 per cent of total Korean clothing exports in 1990, depending on the item concerned. Similarly, in the late 1980s, only a small share of labour-intensive exports (10 per cent or less, according to the item concerned) from ASEAN-4 went to Japan. However, such exports appear to have risen rapidly during the present decade.

Despite the rapid growth of imports, the Japanese market is still of secondary importance for most other manufactured products from East Asia. Per head of population, Japan imports roughly the same amount of manufactured goods from East Asia as does the United States or Western Europe. However, because of their much larger populations, the total manufactured imports of these areas from East Asia are much greater than those of Japan (table 24). Around 10 per cent of total exports of manufactures from developing East Asia currently go to Japan, but the vast bulk of exports is still to other developed market economies, principally in Europe and North America. In recent years, there has been an upsurge in Japanese imports of electronic goods from other East Asian countries, such as telecommunication and sound equipment from Malaysia, electronic micro-circuits from the Republic of Korea, and automatic data processing equipment from Singapore and Taiwan Province of China. This development has received considerable attention, but in fact the scale of such trade is still quite small. In 1993 only some 7-11 per cent of all external exports from China and NIEs of machinery and transport equipment, office machinery, electrical goods and other machinery went to Japan.

A related feature of the trade between Japan and the East Asian developing countries is significant trade imbalances. The latter countries have become of growing importance as a market for Japan, now absorbing more than a third of all its exports (table 25). But since Japan buys comparatively little in return, the result has been an unusual trading asymmetry, with Japan enjoying a large trade surplus with developing East Asia and the latter region enjoying a large trade surplus with industrial countries other than Japan. Nor is this

Table 25

TOTAL EXPORTS OF SELECTED EAST ASIAN COUNTRIES, BY MAJOR DESTINATION, 1980-1994

(Billions of dollars)

Exports from / to		Developing East Asia				Japan	World[a]
		Total	First-tier NIEs	ASEAN-4	China		
World	1980	117.3[b]	70.3	47.0	..	129.5	..
	1985	146.2[b]	100.3	45.9	39.4[c]	175.8	..
	1990	361.7	213.5	86.1	62.1	286.8	..
	1994	591.6	313.8	156.8	121.0	395.3	..
Developing East Asia	1980	23.2[b]	13.3	9.9	..	33.3	127.3
	1985	52.9[b]	17.8	11.9	16.1[c]	42.4	144.5
	1990	110.5	54.5	24.1	31.9	84.8	415.2
	1994	213.2	116.2	51.6	45.4	152.4	648.1
First-tier NIEs	1980	14.4[b]	6.4	8.0	..	19.1	88.0
	1985	17.7[b]	8.5	9.2	15.1[c]	22.6	107.0
	1990	76.7	27.8	18.7	30.2	56.5	266.1
	1994	139.9	58.4	39.9	41.6	93.2	365.8
ASEAN-4	1980	7.8[b]	6.3	1.5	..	9.1	39.3
	1985	9.1[b]	7.0	2.1	1.0[c]	7.3	37.5
	1990	25.1	19.8	3.6	1.7	22.2	95.8
	1994	52.8	41.6	7.4	3.8	40.5	166.7
China	1980	1.0[b]	0.6	0.4	.	5.1	..
	1985	2.9[b]	2.3	0.6	.	12.5	..
	1990	8.7	6.9	1.8	.	6.1	53.3
	1994	20.5	16.2	4.3	.	18.7	115.6
Japan	1980	23.4[b]	7.2	16.2	..	.	139.9
	1985	24.8[b]	10.7	14.1	6.4[c]	.	127.5
	1990	57.1	27.0	21.1	9.0	.	231.2
	1994	81.0	31.8	27.6	21.6	.	272.3
North America	1980	28.7[b]	19.7	9.0	..	34.1	308.0
	1985	50.1[b]	40.7	9.4	3.4[c]	70.6	434.1
	1990	88.5	65.4	17.5	5.6	97.6	632.3
	1994	132.6	75.1	34.6	22.9	124.6	834.3
Western Europe[d]	1980	20.3[b]	13.6	6.7	..	21.5	902.4
	1985	19.5[b]	13.6	5.9	4.5[c]	25.3	779.9
	1990	53.4	38.5	14.9	6.2	63.2	1655.3
	1994	84.4	43.7	24.6	16.1	65.6	1692.8

Source: UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.

a Owing to lack of data, figures for exports from "world" to the countries listed are imports (c.i.f.) as reported by those countries.

b Excluding China, for which no data were available before 1987.

c 1987.

d Including the eastern *Länder* of Germany from 1991.

an example of "triangular trade", since Japan does not use its surplus with developing East Asia to finance imports from the rest of the world. On the contrary, it runs a surplus with both regions. However, as discussed below, present trends suggest that the situation is changing rapidly and that the Japanese trade surpluses with countries both within and outside the region are likely to shrink in the coming years, particularly as outward FDI continues to replace exports.

To sum up, although Japan did not constitute an important market for the first-tier NIEs for their labour-intensive products in their earlier stages of development, it has been playing a greater role vis-à-vis the second-tier NIEs. This is largely because Japan had not yet phased out an important part of its labour-intensive industries in the former instance. Thus, both the pattern and the evolution of trade between Japan and East Asian developing countries are broadly consistent with the flying geese paradigm. On the other hand, while trade imbalances continue to be large, they are likely, as discussed below, to diminish over time if the recent patterns of trade and FDI continue.

2. *Trade among developing East Asian countries*

The first-tier NIEs have emerged not only as major investors in the less developed countries of East Asia, but have also become important trading partners for them. Like Japan, they supply manufactures on a large scale to these countries, but unlike Japan they also purchase manufactures from them on a large scale. In 1994, exports of manufactures from ASEAN-4 to the first-tier NIEs amounted to $28 billion and to Japan to less than $12 billion . Chinese exports of manufactures to the same destinations were about $35 billion and $15 billion, respectively (table 24). Thus, the first-tier NIEs were more than twice as important as Japan as outlets for the manufactured exports of their less developed neighbours. It is interesting to note that the same is also true for trade among the first-tier NIEs, which export far more to each other than they do to Japan (tables 24 and 25).

The evidence thus suggests that there is a rapid process of integration taking place within the smaller countries of East Asia, a process in which even China is becoming involved to some extent. Trade among the countries of East Asia (excluding Japan) has been rising much faster than trade with the outside world, accounting for around one third of their total imports and exports. Although Japan has a huge trade surplus with the rest of East Asia, the latter countries on average now import more manufactures from each other than they do from Japan (table 24). Japan remains the dominant supplier of road vehicles and other machinery, but it has been overtaken in chemicals, electrical equipment and office machinery, where trade among other East Asian countries is now greater than their trade with Japan.

The pattern and evolution of trade among the developing East Asian countries (see table 26) are also broadly consistent with the predictions of the flying geese paradigm. The resource-rich ASEAN-4 have trade surpluses with both China and the first-tier NIEs in food, materials and fuels, while China has a surplus in the same categories with the first-tier NIEs. China also has a surplus with these countries in labour-intensive manufactures, such as clothing and footwear, which has been increasing over the past decade. Its trade deficits with these countries are mostly in technology- and skill-intensive products. A similar pattern is observed in trade between the first-tier NIEs and ASEAN-4. On the other hand, China's trade with ASEAN-4 does not show any clear pattern in labour- or skill- and technology-intensive manufactures.

At present all three areas (first-tier NIEs, ASEAN-4 and China) run large surpluses in manufacturing trade with the developed market-economy countries of Europe and America. For China and ASEAN-4, this surplus reflects their rising exports of labour-intensive items, which now exceed their imports of more sophisticated items such as chemicals, machinery and transport equipment. The picture is more complex for the first-tier NIEs. These countries still have a large trade surplus with Europe and North America in labour-intensive products, but this surplus is diminishing as they develop and shift to more sophisticated products. There has been a spectacular growth in exports of machinery and transport equipment from the first-tier NIEs over the past decade, and these countries now have a large trade surplus in such products with those regions.

These trends in trade thus provide strong support for the flying geese paradigm so far as trade among the NIEs is concerned. While the role of Japan as the lead goose is open to question, among

Table 26

TRADE AMONG CHINA, THE FIRST-TIER NIEs AND ASEAN-4

	Trade of China with:												Trade of ASEAN-4 with first-tier NIEs					
	First-tier NIEs						ASEAN-4											
	Trade balance ($ billion)			Export/import ratio			Trade balance ($ billion)			Export/import ratio			Trade balance ($ billion)			Export/import ratio		
Product group	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*	*1985*	*1990*	*1994*
Manufactures	0.5	8.7	4.8	1.2	1.5	1.2	-0.2	0.2	0.7	0.5	1.2	1.4	-1.2	-3.9	1.0	0.7	0.7	1.0
Of which:																		
Chemicals	0.1	0.3	-2.9	1.6	1.3	0.4	0.0	0.0	0.2	1.3	1.4	2.1	-0.6	-1.2	-2.2	0.2	0.4	0.4
Computer and office equipment	-0.1	0.0	0.2	0.1	1.1	1.3	0.0	0.0	0.0	21.0	2.1	1.7	-0.1	0.3	2.2	0.2	1.3	2.4
Electrical machinery	-0.5	0.8	0.4	0.2	1.3	1.1	0.0	0.0	0.2	7.6	2.5	2.4	0.1	0.0	1.7	1.2	1.0	1.2
Other machinery	-0.4	-1.2	-4.6	0.2	0.5	0.2	0.0	0.2	0.3	8.0	11.6	3.6	-0.5	-1.9	-2.5	0.4	0.3	0.4
Road motor vehicles	0.0	0.6	0.2	1.0	1.3	1.5	0.0	-0.1	0.0	20.3	0.5	3.7	-0.0	-0.0	0.3	0.4	0.6	1.9
Clothing and footwear	0.3	5.5	8.6	39.6	119.1	24.9	0.0	0.0	0.3	111.2	60.1	139.2	0.0	0.3	1.0	2.1	5.1	8.8
Manufactures classified by material [a]	1.1	0.5	-1.1	3.0	1.1	0.9	-0.2	-0.0	-0.5	0.2	0.9	0.6	-0.1	-1.5	-0.6	0.9	0.6	0.9
Other manufactures	0.0	2.1	4.0	1.1	2.1	2.7	0.0	0.0	0.2	3.2	2.0	6.3	-0.1	0.1	1.2	0.7	1.1	1.6
Food, materials & fuels [b]	3.4	3.6	3.6	12.1	3.5	2.0	0.0	-0.5	-1.3	1.1	0.5	0.5	4.1	4.1	5.3	2.7	2.0	2.0
Unspecified	0.0	0.0	-0.1	1.0	0.2	0.2	-0.0	-0.0	0.0	0.1	0.8	14.7	0.0	-0.6	-0.5	1.1	0.4	0.7
Total merchandise trade	4.0	12.3	8.2	1.8	1.7	1.2	-0.1	-0.4	-0.5	0.8	0.8	0.9	3.0	-0.5	5.9	1.5	1.0	1.2

Source: United Nations, *Commodity Trade Statistics* tapes.

Note: Import and export figures for the trade of China used for the compilation of this table are those reported by that country. They can differ substantially from those reported by the partner countries, due to re-exports from Hong Kong .

a Excluding non-ferrous metals.

b Including non-ferrous metals.

the remaining countries it does seem to be the case that industrialization is being transmitted from one wave of developing countries to the next wave by the mechanisms postulated in this paradigm.

F. Macroeconomic influences on East Asian trade and FDI

The evolution of trade and FDI in East Asia has been greatly influenced by a number of macroeconomic developments in Japan, its major trading partners in the West, and the NIEs of the region. In the first half of the 1980s, disparities in the growth of major markets and the appreciation of the dollar gave a major boost to Japanese exports to major industrialized countries. From the early 1980s the dollar rose rapidly, exceeding 260 yen in 1985. Although it appreciated against some other currencies, the real effective exchange rate of the yen fell from 1981 to 1985. Thus, the increase in the share of Japan in world exports of manufactures, which had already begun in the 1960s, continued with greater force in the first half of the 1980s (table 27). As a result, the Japanese trade surplus, which had peaked at $23 billion in 1978 but disappeared in 1979-1980 under the impact of the second oil price shock, started to rise again rapidly, and exceeded $50 billion by the mid-1980s.

As noted above, the surge in exports in the first half of the 1980s was also associated with a sharp increase in Japanese manufacturing FDI in the United States and, to a lesser extent, in Europe, which appears to have been a response to increased protectionism in those markets. In the United States, despite a strong recovery from the 1980-1982 recession, unemployment remained high, and this, together with a mounting trade deficit, gave rise to renewed pressures for protectionism. In Western Europe, on the other hand, despite the external demand stimulus from the United States and improvements in trade balances, recovery remained weak and unemployment continued to rise. There was a widespread resort to non-tariff measures (NTMs) such as voluntary export restraints and anti-dumping and countervailing measures in both regions.[20]

In the second half of the 1980s continuing protectionism, the appreciation of the yen, and increased competition from low-wage, high-productivity producers in East Asia played a crucial role in the switch by Japanese firms from reliance on exports to reliance on investment and production abroad in supplying foreign markets. These pressures accentuated in the 1990s and, together with shifts in competitiveness among the East Asian NIEs, exerted a strong influence on trade and investment.

The Plaza Accord of September 1985 to lower the exchange rate of the dollar was in part a consequence of the threat posed by mounting protection in the United States. The nominal effective exchange rate of the yen rose by more than 50 per cent from 1985 to 1988, and the real effective exchange rate by 40 per cent. The initial reaction of Japanese firms was to resort to what is known as "pricing to market", namely to reduce yen export prices and to take cuts in profit margins on exports.[21] High profits that had been earned while the dollar was appreciating made it easier to accept lower profit margins rather than lose market shares.[22] Japanese firms were also greatly helped by the terms-of-trade gains and by the declines in the prices of imported inputs brought about by the appreciation of the yen, and, even more so, by the collapse of oil prices from their earlier peaks.[23] However, these did not prevent substantial declines in profits from exports.[24]

Exports from Japan fell in volume in 1986 and stagnated in 1987, but the trade surplus rose in dollar terms due to the valuation effect, reaching almost $100 billion in 1987. "Pricing to market" slowed down the adjustment of the United States trade deficit, which rose to $160 billion in the same year. Thus, the decline of the dollar did not bring about a reversal of the protectionist actions that had proliferated in the first half of the 1980s. Instead, new non-tariff measures were put in place.[25]

Japanese producers saw the post-Plaza appreciation of the yen as a permanent shift rather than

Table 27

SHARES IN WORLD EXPORTS OF MANUFACTURES[a] OF FIRST-TIER NIEs AND MAJOR INDUSTRIAL COUNTRIES, 1965-1993

(Percentage)

Period	United States[b]	United Kingdom	Germany	Japan	First-tier NIEs
1965-1969	19.1	10.6	17.1	8.5	2.0
1970-1974	15.4	8.3	17.7	10.3	3.4
1975-1979	14.4	7.9	16.9	11.1	4.8
1980-1985	14.6	6.8	14.8	13.4	6.8
1986-1990	11.9	6.2	15.6	13.3	8.6
1991-1993	13.0	5.9	14.2[c]	12.9	9.0

Source: UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.
a SITC 5-8 less 67 and 68.
b Including Puerto Rico for 1965-1980 and also US Virgin Islands for 1981-1993.
c Including the eastern *Länder* after 1991.

a temporary surge, and responded in three ways. First, they invested heavily at home in order to enhance productivity and cut costs and to upgrade and expand in a number of areas to improve competitiveness. The share of capital formation in GDP rose from about 27 per cent in 1987 to 32 per cent in 1990, reaching the previous high achieved immediately after the first oil crisis, and investment in machinery and equipment alone grew at an unprecedented rate of 15 per cent per annum.

Second, as noted above, they invested heavily in the United States and, to a lesser extent, in Europe in order to supply these markets directly from local plants, and so side-step protectionism and protect profits. Alongside a sharply increased investment in manufacturing in the United States there was also a surge in investment in financing and insurance, and real estate.

Finally, they relocated production to low-cost countries in East Asia with a view to exporting both to third markets and back to Japan, as well as to supplying local markets. The rise of the yen at first benefited more the first-tier NIEs, which received a larger proportion of Japanese FDI than the rest of East Asia. Initially, such investment concentrated in labour-intensive manufactures, but subsequently shifted to technology-intensive sectors as wages rose and the currencies of these countries appreciated against the dollar after 1987, in part as a result of their strong export performance, but also under the pressure from the United States to revalue. Currency appreciation and rising wages in the first-tier NIEs, as well as rising protectionist sentiments against these countries explain why Japanese FDI, particularly in labour-intensive manufactures, has moved away gradually to ASEAN-4 and China.[26] In the latter case it was also easier to enter the domestic market in many products through FDI than through exports.

Japanese firms were greatly helped in this period by government policies (noted in section B above) in phasing out and restructuring non-competitive industries and supporting investment in new areas. New investment was also greatly facilitated by the relaxation of monetary policy as part of the Louvre Agreement, which reduced significantly the cost of financing capital investment by producing a sharp escalation of prices in the stock market. Indeed, an important objective of the Bank of Japan was to facilitate the adjustment of industry to yen appreciation.

The appreciation of the yen and the resiting of production abroad had a major impact on the volume, composition, origin and destination of Japanese imports and exports as well as those of its main trading partners.[27] There was a surge in

Japanese imports, which rose by more than 80 per cent from 1985 to 1990 (table 25), partly stimulated by the expansion of aggregate domestic demand led by the investment boom. As noted above, much of these additional imports, particularly in labour-intensive manufactures, came from the first-tier NIEs, ASEAN-4 and China. Following the investment boom, Japanese exports picked up, increasing in volume by about 4.5 per cent per annum from 1988 to 1990. Moreover, the structure of exports underwent a significant change, from labour- to technology-intensive products. Exports to the three areas rose sharply, particularly in capital goods, associated with the increase in FDI; in 1990 exports to these countries were double their 1985 volume.

Trade and investment among the developing countries of the region have also been influenced by changes in exchange rates and competitiveness. With the exception of Hong Kong, where the currency had been pegged to the dollar since the early 1980s, the currencies of the first-tier NIEs appreciated rapidly against the dollar throughout the second half of the 1980s; the appreciation was around 20 per cent for the Republic of Korea and Singapore and 48 per cent for Taiwan Province of China. Their exports to the United States decelerated as a result of this appreciation, while Europe and Asia became more important markets for these countries. The first-tier NIEs responded to currency realignments and the emergence of strong competition from ASEAN-4 in much the same way as Japan - by upgrading through investment, relocating labour-intensive industries and subcontracting in the less developed neighbouring countries.

As noted above, Taiwan Province of China emerged as the second most important investor in the region. Various surveys suggest that the prime motivations for investment abroad were lower wage costs, utilization of host-country GSP benefits, and access to host countries' domestic markets.[28] Similarly, according to a survey conducted in the late 1980s, the single most important motivation for FDI from the Republic of Korea in ASEAN-4 was the availability of low-cost labour (47.1 per cent), while other factors were their utility as export platforms to industrialized countries (21.6 per cent), and penetration of local markets (13.9 per cent). Accordingly, Korean FDI in South-East Asia was primarily to Indonesia, which has the lowest wage levels in the ASEAN region.[29]

There can be little doubt that the trade and investment patterns in East Asia in the past decade have been the product of corporate strategies and decisions. These have, in turn, been strongly influenced by macroeconomic changes and expectations regarding their permanence. However, government policies have been crucial in this process not only through actions at the sectoral or firm level, but also by influencing overall macroeconomic conditions so as to facilitate adjustment to changes in competitiveness.

G. "Hollowing out" in Japan?

Just as it was adjusting to the post-Plaza exchange rates and competitiveness, Japan faced a new situation at the beginning of the 1990s, namely, a "debt deflation-*cum*-recession" process brought about by the burst of the speculative bubble.[30] The situation was aggravated by another appreciation of the yen, beginning in late 1992. By the end of 1995 the yen had risen against the dollar by two-and-a-half times within a decade, and its nominal effective exchange rate was up by more than two times.[31]

The sharp rise in the yen coincided with considerable improvements in productivity and declines in unit labour costs in the United States and, to a lesser extent, in Western Europe, brought about by industrial restructuring. As after the Plaza Accord, Japanese firms first responded to the erosion of competitiveness by cutting profits; during the first half of the 1990s the dollar price of Japanese exports rose 15 per cent compared to the price of United States exports, while the yen appreciated against the dollar by 40 per cent.[32]

They also shifted to high-value export products. However, unlike post-Plaza, they cut down sharply on domestic investment in order to reduce excess capacity; real gross private non-residential fixed investment fell by 20 per cent from 1991 to 1995, a contraction which is unprecedented in the postwar cyclical behaviour of the Japanese economy.

Japan has found the recent adjustments far more difficult to make than previous ones (the oil crises and the Plaza Accord). Whereas on those occasions the growth of the economy never fell below 2 per cent, real GDP grew by only 1 per cent in 1992, fell in 1993 and has virtually stagnated in 1994 and 1995. For the first time for many years, employment has followed variations in output, and the unemployment rate passed the psychological barrier of 3 per cent in 1995.

During the initial stage of the downturn, there was a clear slowdown in outward FDI, partly due to the recession in the United States and Western Europe and partly to the need for funds for corporate restructuring, further aggravated by the collapse of stock prices in Japan. However, from 1993 onwards, when the dollar declined below 100 yen, Japanese firms increasingly responded to the crisis by relocating production to countries with lower labour costs, mainly ASEAN-4 and (even more) China, and by increasing their procurement from affiliates abroad.[33] These investments made a major contribution to the sharp turnaround in the Japanese trade balance. Import volumes rose sharply, in 1994-1995, by an annual average of over 13 per cent, while exports remained sluggish. Thus, Japan's share in world exports started to decline, while its share in world FDI stock continued to rise. Accordingly, after exceeding $140 billion in 1994, the trade surplus fell sharply, to less than $110 billion in 1995, the first drop in five years.

These developments suggest that a major structural transformation has taken place in Japanese trade and FDI over the past decade. In the first half of the 1980s, Japan continued to rely on exports to supply foreign markets, even though it began to emerge as a leading international investor. During that period FDI was trade-oriented in the way described by the recent formulations of the flying geese paradigm, complementing rather than substituting for domestic accumulation. Thus, Japan's shares in both world exports of manufactures and world FDI increased throughout that period (chart 2 and table 27).

The second half of the decade marks a transition from trade reliance to investment reliance, i.e. to the second stage in industrial development described in section C; Japan's share in world manufactured exports stabilized, while its share in FDI stock continued to rise rapidly. During that period, the complementarity of FDI with exports and domestic investment is less evident. The 1990s mark a gradual transition to the third stage, with FDI becoming the principal means of supplying global markets, competing with, rather than complementing, exports and domestic investment. The combination of currency appreciation, heightened foreign competition, external pressures to reduce the trade surplus and sluggish domestic demand has been forcing Japanese producers to relocate production abroad at the expense of domestic investment and exports. Thus, Japan seems to have entered the mature stage of industrialization, where its share in world exports can be expected to diminish steadily, while its share in world FDI stabilizes, accompanied by a decline in the pace of domestic capital accumulation and the potential growth rate. These developments underlie the recent concern over "hollowing out" of the industrial base in Japan, exemplified by the convening in February 1995 in Tokyo by the Ministry of Foreign Affairs of an International Seminar on Hollowing Out and Internationalization.

Few studies have been made of the effect of FDI on Japan's exports and balance of payments. Estimates by the Economic Planning Agency of Japan suggest that during 1985-1990 the flow of FDI to North America had a large export-inducing effect - albeit one reduced by the increased pressure for greater local procurement in that country - but the export substitution effect was even greater. Moreover, the reverse-import effect also appears to be very small; over 90 per cent of the goods produced in the United States and Europe by subsidiaries of Japanese enterprises are sold locally.[34] These estimates are thus consistent with the above observation that Japanese manufacturing FDI in the United States was largely triggered by a combination of protectionism in that country and loss of competitiveness by Japanese firms after Plaza.

The overall effect on the trade balance of Japanese FDI flows to Asia was also negative. However, unlike that flows to North America, the export-inducing effect was greater than the export-substituting effect, and the overall negative impact on the trade balance was due to a strong reverse-import effect, particularly in electronics and

Box 5

FDI BY JAPAN AND DOMESTIC INVESTMENT

Rather than formulating a theoretical relationship between FDI and gross fixed capital formation (GFCF), an exploratory study is made of the relationship between them by using an auxiliary regression, where the choice of the explained or explanatory variable is arbitrary. The equation first estimated is:

$$FDI_t = \alpha + \beta\ GFCF_t + \epsilon_t \qquad (1)$$

This equation has been estimated for both total and manufacturing investment, using ordinary least squares (OLS). Since time series on GFCF in manufacturing are not consistently available, GFCF in machinery and equipment is used as a proxy. A separate equation for FDI and GFCF in machinery and equipment has also been estimated. The estimates using the logarithms of the nominal values of the variables are reported in the table below. Estimates using the nominal levels of the variables, not reported here, were similar, as were also those using real variables.

While these estimates give a positive long-term relation between the two, they also suggest a structural break.[1] Indeed, the break-point Chow tests reject the hypothesis of the stability of the equation in all its specifications, and the series of recursive coefficients indicate structural breaks in the late 1980s for all the estimates.

Next, two dummies are introduced, one for the intercept and one for the slope of the equation, to determine the structural break. The rationale for using an intercept dummy (as well as a slope dummy) is to capture the effect of changes in competitiveness on FDI (GFCF) that occur independently of their effect on GFCF (FDI). The following equation is estimated:

$$FDI_t = \alpha + \delta\ Dummy + \beta\ GFCF_t + \gamma\ Dummy * GFCF_t + \epsilon_t \qquad (2)$$

where the intercept and slope are given by α and β, respectively, before the break, and by $\alpha+\delta$ and $\beta+\gamma$ after. Estimation results in the table below indicate that there is a shift in both the slope and the intercept. According to the Akaike Information Criterion (AIC), this break is in 1988 for the relation between total FDI and GFCF, and in 1988 or 1989 between manufacturing FDI and GFCF; that is, both dummy variables are equal to zero for 1970-1987 (1988) and unity afterwards. Thus, in all these cases the relationship between domestic and foreign investment is one of complementarity in the former period (as indicated by the positive values of β), and substitutability in the latter (negative value of $(\beta+\gamma)$). It is also noteworthy that the break is much sharper for manufacturing investment than for total investment.

In order to test if the estimated slope for the period after the break $(\beta+\gamma)$ was significant, additional tests were applied. First, joint tests (Wald tests) indicated that the coefficient is significant at the 5 per cent level for the equation using FDI and GFCF in machinery and equipment, but not for the others. Second, the same equation was estimated by changing the definition of the dummy variable, setting it at zero after the break and unity before the break, so that the slope is now given by β and $\beta+\gamma$, respectively. Results indicated that β is negative for all specifications of the equation and again significant at the 5 per cent level for the specification using investment in machinery and equipment.

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[1] Unit root tests (Augmented Dickey-Fuller tests) indicate that these series are all non-stationary, but cointegration tests give a cointegration between the domestic investment and FDI for all the definitions and specifications used in estimating equation (1) above.

Box 5 (concluded)

RELATIONSHIP BETWEEN FDI AND GFCF: OLS RESULTS

Explained variable	*Explanatory variable*	*Dummy = 1 for the period*	α	β	δ	γ	R^2	*F*	*D.W.*	*AIC*
log(FDI)	log(GFCF)	-	-6.325* (-13.234)	1.452* (18.046)			0.934	325.7*	0.658	-2.064
log (FDIman)	log (GFCFmach)	-	-5.291* (-18.316)	1.355* (21.844)			0.956	477.2*	1.069	0.256
log(FDImach)	log(GFCFmach)	-	-7.772* (-22.462)	1.678* (22.583)			0.959	510.0*	0.938	0.616
log(FDI)	log(GFCF)	1988-1994	-6.402* (-10.807)	1.464* (13.575)	1.802* (3.679)	-2.585* (-3.658)	0.960	168.4*	1.124	-2.406
log(FDIman)	log(GFCFmach)	1988-1993	-5.057* (-13.922)	1.294* (15.069)	15.428* (2.880)	-2.651** (-2.841)	0.970	217.4*	1.588	0.029
log(FDImach)	log(GFCFmach)	1989-1993	-8.248* (-23.614)	1.797* (22.192)	27.613* (3.765)	-4.835* (-3.807)	0.980	295.6*	1.501	0.154

Notes: Figures in parentheses are t-coefficients.
* Significant at the 1 per cent level.
** Significant at the 5 per cent level.

electrical machinery; around 25 per cent of Japanese imports of these products from Asia are from the subsidiaries of Japanese firms. Again these features are consistent with the view that Japanese FDI in Asia during 1985 to 1990 was largely of the cost-reducing variety. Indeed, according to figures given by the Nomura Research Institute (NRI), operating profit margins for plants established through Japanese FDI have been consistently higher in Asia than elsewhere.[35]

The effect of Japanese FDI on trade has not been identical for all manufactured products, since changes in competitiveness have not been uniform. The estimates given by NRI, based on trade specialization coefficients (defined as the ratio of the trade balance in each product to the volume of trade in that product) show that since 1985 Japan has maintained its competitiveness in capital goods, suggesting that the FDI has induced exports for such industries.[36] By contrast, loss of competitiveness has been particularly severe in durable and non-durable consumer goods, where most of the reverse imports have been taking place.

However, the positive effect of increased capital good exports associated with FDI is expected to weaken over time while the reverse-import ef-

Table 28

SALES AND PURCHASES BY JAPANESE OFFSHORE MANUFACTURING SUBSIDIARIES, 1993-1995, AND PROJECTIONS UP TO 2000

(Percentage of total sales and purchases)

	Sales to Japan					*Purchases from Japan*				
Subsidiaries in	1993	1994	1995	1998	2000	1993	1994	1995	1998	2000
North America	3.0	3.0	3.0	4.0	5.0	40.0	40.0	40.0	30.0	20.0
Asia	15.0	15.0	15.0	22.5	25.0	40.0	40.0	40.0	35.0	30.0
Europe	1.0	1.0	1.0	1.8	2.0	45.0	45.0	45.0	40.0	35.0
Total, three regions	6.7	6.9	7.0	11.1	13.0	41.1	41.1	41.1	34.1	27.3

Source: Y. Takao and N. Nemoto, "Long-term outlook: Japan's economy in an era of structural change", *Nomura Research Institute Quarterly*, Summer, Vol. 4, No. 2, 1995.
Note: Figures relate to fiscal years beginning in April of the year shown.

fect is strengthened. According to projections by NRI, manufacturing subsidiaries' exports to Japan will increase sharply during the remainder of the decade, while their purchases from Japan will decline (table 28). The projected increase in sales to Japan is particularly notable for Asian subsidiaries. Purchases from Japan by North American affiliates will decline rapidly as a result of increased local procurement, whereas in Asia the decline is not as significant, because of the continued export of capital goods associated with Japanese FDI in the region. Overall, whereas in 1993 foreign subsidiaries of Japanese firms made around 40 per cent of the total purchases in Japan and sold around 7 per cent of their total output to Japan (a ratio of roughly 6:1), by the end of the present decade, this ratio is projected to fall to around 2:1. As a result, Japan's net trade with overseas subsidiaries, which was in the positive in 1992, is expected to be balanced in 1998 and register a deficit there after.

There have been few studies that systematically look at the relationship between Japanese domestic investment and FDI. However, it has been observed that "the decline in domestic nominal capital expenditure since 1992 has been accompanied by a decline in direct investments in North America and Europe, but a continued increase in Asia. ... The data thus suggest that Japanese direct investments into Asia have acted very much as a substitute for investment in Japan, and are likely to continue at a strong pace, even as domestic economic growth is constrained by the yen's appreciation".[37]

This conclusion finds some support in econometric estimates of the relationship between FDI and domestic investment in Japan. As described more fully in box 5**,** regression analysis suggests a structural break in this relationship in the 1980s. The estimates show that, until the late 1980s, total Japanese FDI was positively correlated with total gross fixed capital formation and that the correlation was even stronger in manufacturing. The correlation was reversed by 1988 in both cases. As would be expected, the break was much more pronounced for manufacturing than for total fixed investment, since the latter includes the secondary and tertiary sectors, which are much less affected by changes in exchange rates and relative prices. Thus, whereas during 1970-1988 each dollar of Japanese FDI in manufacturing was associated with about 3 cents of additional investment in domestic manufacturing, from 1988 onwards it was associated with a reduction of almost 6 cents.

H. Medium-term prospects and policy challenges for Japan

1. Growth and employment

The twin problems of a considerable burden of bad debt and loss of competitiveness pose serious structural problems for Japan. As noted above, the economy has gone through four successive years of growth recession, and unemployment reached an unprecedented 3.2 per cent at the end of 1995. Moreover, recorded rates understate the true extent of the employment problem, since a large number of the registered unemployed appear to have withdrawn from the labour market. Unlike most other major industrial countries, during the 1980s employment in manufacturing increased in Japan (table 29), but the sector has registered significant job losses for the first time since 1992, amounting to almost 0.5 million.

Growth and employment prospects are equally gloomy for the rest of the decade. Projections by NRI on the basis of three scenarios are shown in table 30. The standard scenario assumes a moderate but steady increase in the import penetration ratio, from about 14 per cent in 1994 to 21 per cent in 2000. In the slow increase scenario the import penetration ratio rises to about 17 per cent at the end of the decade, whereas in the rapid increase scenario it reaches 25 per cent. Common assumptions include a yen-dollar exchange rate of 100 and realization of the tax reforms planned for 1997.

Even under the "slow increase" scenario, the annual growth of GDP falls short of 2.5 per cent, while the unemployment rate nears 4 per cent. In this scenario the current-account surplus increases every year throughout the decade as a percentage of GDP. That, however, would in all likelihood lead to a further appreciation of the yen, which is inconsistent with the initial assumption about the exchange rate, thereby increasing the import penetration ratio and lowering growth. Thus, on the basis of recent trends and declared policy intentions, the growth rate is likely to remain below 2 per cent per annum and unemployment to exceed 4.5 per cent.[38] The slower growth of the labour force due to the aging of the population now indeed comes as a relief in so far as the unemployment problem is concerned.[39]

The outlook is thus for a much weaker economic performance. The economy grew at an annual rate of about 9 per cent until the first oil shock and at 4 per cent during the past two decades. There now appears to be the prospect of a further decline in the growth rate, which is expected to be halved once more. Such an outcome is not inevitable, but avoiding it requires tackling a number of difficult policy challenges.

2. Policy challenges

Perhaps the most important factor behind the postwar rapid industrialization of Japan was its ability to animate the "investment-profits nexus" - i.e. the dynamic interactions between profits and investment which arise because profits are simultaneously an incentive for investment, a source of investment, and an outcome of investment.[40] In that period, profits were the main source of corporate investment and accounted for an important part of gross domestic savings. A high share of profits in value added, as well as a high retention ratio, played an important role. During the 1960s gross operating surplus in manufacturing value added was around 55 per cent, compared to 25 per cent in the United States and United Kingdom and 35 per cent in the Federal Republic of Germany. High profits continued during much of the 1980s; for the decade as a whole the share of corporate profits in manufacturing value added in Japan exceeded 40 per cent, compared to less than 30 per cent in the other major industrial countries (table 29). Similarly, investment in manufacturing as a proportion of GDP has continued to be much higher than in those countries.

Until recently it was possible to maintain this investment-profits nexus without coming up against the problem of effective demand, because it was complemented by an investment-export nexus; ris-

Table 29

INDICATORS OF MANUFACTURING ACTIVITY IN JAPAN AND OTHER INDUSTRIAL COUNTRIES

(Average percentage share in 1980-1990)[a]

Indicator	*United States*	*Germany*	*United Kingdom*	*Japan*
Employment in manufacturing (1980=100)	94.3	98.5	73.3	113.7
Share of manufacturing in total employment	20.0	34.7	25.0	27.2
Share of manufacturing in GDP	20.1[b]	31.4	21.6	29.0
Share of manufacturing investment in GDP	7.9[c]	8.5	8.2	11.2
Share of profits in manufacturing value added	27.6	26.1	24.3	43.1

Source: OECD, *National Accounts*, various issues.
a Except for employment in manufacturing (index numbers for 1990, 1980=100).
b 1981-1990.
c 1980-1989.

ing exports provided the outlet for the increase in production capacity in manufacturing that had resulted from a very high rate of investment. Indeed, for the economy as a whole exports grew twice as rapidly as investment from 1960 to 1985 in volume terms. The ratio of exports to GDP was under 10 per cent in the 1960s, rising rapidly after the first oil shock, and peaking at 15 per cent in the mid-1980s, before the first appreciation of the yen. Much of this increase was due to manufactures, exports of which indeed rose faster than output.

It now appears that this process is no longer sustainable. Japan has suffered loss of competitiveness in a number of industries as a result of the appreciation of the yen and the emergence of a number of high-productivity, low-wage competitors. It now has much less scope to respond by moving rapidly into higher-skill, higher-productivity sectors. Thus, Japan can no longer rely on the investment-exports nexus to the same extent as in the past in order to sustain the investment-profits nexus. Since capacity in such industries cannot be profitably utilized for exports at the prevailing pattern of world prices, relative wages and exchange rates, profits are squeezed, reducing both the incentive for investment and the source of investment, and slowing down accumulation and growth.

A possible reaction could be to try to cut real wages in order to make up for the loss of competitiveness and regain the markets lost at home and abroad. But this would require a permanently large slack in the labour market, which can only be maintained if demand for labour is kept low; thus, it is a recipe for low growth and high unemployment. Moreover, the extent of wage deflation and unemployment needed may not be trivial since NIEs, including the latecomers, are advancing rapidly in terms of productivity and have considerably lower wages than Japan. Furthermore, as the projections above suggest, in such a low-growth, high-unemployment scenario the decline in the current-account surplus may not be sufficient to avoid triggering further upward pressures on the yen, thereby necessitating further unemployment and wage cuts.

Now that exports are no longer the driving force of private investment, domestic demand needs to replace them if the pace of accumulation and growth are to be maintained at a level compatible with full employment. What is needed, therefore,

Table 30

PROJECTIONS FOR THE ECONOMY OF JAPAN: MAIN ECONOMIC VARIABLES UNDER ALTERNATIVE IMPORT PENETRATION SCENARIOS

(Percentage)

	Standard scenario			*Slow increase scenario*			*Rapid increase scenario*		
	Real GDP growth	*Unemployment rate*	*Current account surplus* [a]	*Real GDP growth*	*Unemployment rate*	*Current account surplus* [a]	*Real GDP growth*	*Unemployment rate*	*Current account surplus* [a]
1996	1.0	3.7	2.0	1.9	3.2	2.6	0.0	4.2	1.4
1997	0.5	4.4	1.7	1.5	3.6	2.6	0.2	4.9	1.1
1998	2.0	4.7	1.8	2.5	3.9	2.8	1.6	5.3	1.0
1999	2.4	4.7	1.9	2.9	3.8	3.1	1.9	5.4	0.9
2000	2.2	4.6	2.0	2.6	3.5	3.5	1.6	5.4	0.8

Source: As for table 28.
Note: For definitions and assumptions see text.
a Percentage of nominal GDP.

is an increase, and not a decrease, in real wages so as to boost consumption. In the short run higher real wages are likely to result in a higher rate and mass of profits by allowing fuller capacity utilization and pro-cyclical improvements in labour productivity. Over the longer term, the Japanese economy is unlikely to regain the rates of accumulation and profits attained when exports were the driving force. However, an income redistribution from profits to wages could help to sustain a higher rate of accumulation and greater profits than are possible under the current pattern of income distribution and effective demand.

Such redistribution, together with a continued upgrading of industry, may help Japan to avoid the kind of de-industrialization involving substantial job losses in manufacturing that has been experienced by most other industrialized countries.[41] However, it cannot expect to attain the same growth in manufacturing employment as in the past, since goods cannot simply be redirected from exports to the domestic market. It would be difficult to maintain the rate of output expansion of products such as automobiles and electronics, which have so far accounted for an important share of total exports, since possibilities of absorption by the domestic market are limited. Thus, the pattern of investment needs to change, away from traditional manufactures towards high-tech goods and non-tradeable public and private services, including, as discussed in *TDR 1995*, public investment in infrastructure.[42]

Judging from the recent debate in Japan, it appears that there is now a consensus that the problems faced are structural rather than cyclical, and that a major policy effort is needed to overcome them. Indeed, failure to act at an early stage may aggravate the problem considerably; a vicious circle could develop in the form of a low-growth, high-unemployment hysteresis discussed in *TDR 1995*. The experience of other major industrial countries shows that once allowed to persist, high unemployment and low growth can easily become structural features of the economy, even though initially they may have simply been conceived as temporary phenomena necessitated by adjustment to supply shocks. It is not inevitable that Japan take the same route.

I. Prospects for East Asian NIEs

In the context of the flying geese paradigm, a secular decline in growth in Japan can be expected to have important implications for the sustainability of the growth process in the East Asian NIEs. More specifically, if the advance of the lead goose falters, can the followers proceed at the same pace as before? Certainly, the answer to this question differs for the first- and second-tier NIEs and China, since their interaction with Japan in trade and FDI varies considerably.

As discussed above, the slowdown in Japanese growth has been associated with a considerable relocation of production in the second-tier NIEs through FDI. These inflows of FDI have been a major source of external financing for Malaysia and Thailand, which presently run substantial current-account deficits, reaching 8-10 per cent of GDP. The main questions related to the sustainability of a high rate of growth in these countries are thus to what extent they will continue to depend on such FDI inflows and whether the flows can be expected to continue over the coming years.

For two reasons the flow of FDI to the second-tier NIEs may not continue at its recent pace. First, part of the recent inflow from Japan represents a one-off adjustment to a sharp shift in competitiveness which is unlikely to be repeated. Second, a number of more attractive, low-cost locations have been emerging in South Asia which can divert an important part of FDI in labour-intensive manufactures by Japan and the first-tier NIEs. Thus, the second-tier NIEs may be unable to sustain large current-account deficits over the longer term; they need to reduce their trade deficits so as to minimize the risk of serious balance of payments problems and a sharp slowdown in growth. As discussed in the next chapter, much will depend on their success in enhancing their export potential through upgrading.

But what happens in Japan will also be important, involving both positive and negative elements. As discussed above, the slowdown in Japan has been taking place in the context of a sharp rise in imports from developing East Asia, and the trade effects of Japanese FDI are expected to reinforce the tendency of the regional trade imbalances to narrow. However, over the long term continued slow growth in Japan will limit exports to that market.

As also pointed out above, the dependence of growth on Japanese FDI and exports to Japan is considerably less in the first-tier NIEs than in the second-tier. Moreover, they do not suffer, as do the second-tier, from large external deficits. At the moment they enjoy a relatively large trade surplus with Western Europe and North America in labour-intensive products while running a large deficit with Japan. However, the surplus may diminish rapidly or even disappear as wages in these countries rise. Moreover, although they are now beginning to export more sophisticated products to Western Europe and North America, the evolution of such exports may be subject to the same forces as have limited trade between those two regions, and have recently been affecting Japanese firms. Big firms from the first-tier NIEs, such as Daewoo and Samsung, are already going transnational and beginning to invest on a large scale in Europe and North America. Although some of this investment may initially stimulate exports of intermediate and capital goods from their home countries, a more important effect is likely to be an overall loss of exports.

A process can thus be envisaged very much like that currently faced by Japan: replacing potential exports to Europe and North America by FDI. Since the slowdown in Japan will eventually affect their exports to that market also, they may need to turn their attention to more dynamic markets in the South. In this respect, the further development of capital goods industries can present important opportunities not only to expand their exports to other developing countries, but also to reduce their dependence on capital goods imports from more advanced industrial countries.

Although it is an important recipient of Japanese FDI and its trade with Japan is significant, China is likely to be less influenced by the evolu-

tion of the Japanese economy than the second-tier NIEs. On the other hand, the behaviour of the Chinese economy itself will exert a strong influence over whether or not the recent growth momentum in East Asia can be maintained over the longer term. The sheer size of its economy suggests that any integration of China and the developing countries of East Asia is likely to be asymmetrical. Because of its enormous population, trade will never be as important for China as it is for the smaller countries around it. However, for the same reason, China can still be an important market for the smaller developing countries and an important supplier of manufactures. It enjoys a unique situation of combining an almost "unlimited" supply of unskilled labour with an adequate supply of highly-skilled labour to back up its industrialization process in the foreseeable future. Rising wages of unskilled labour in the industrializing coastal region of China are likely to be held in check by inward migration from the rest of the country. Consequently, labour-intensive manufactures and non-traded services can be kept relatively cheap and the cost of living kept low in the coastal region, which, in turn, can allow skilled workers to enjoy a comparatively high standard of living, with earnings which are nevertheless low by international standards. Taken together, these factors allow China to attain much greater diversification at an earlier stage of development than did the NIEs, producing sophisticated manufactures, including capital goods, as well as labour-intensive products. As discussed in chapter III, a rapid shift to more sophisticated exports by China and the first-tier NIEs could create important opportunities for South-South trade and lessen the dependence of developing countries on trade with the North. ■

Notes

1 Unless otherwise specified, the designation "East Asia" will be used throughout Part Two of this report to refer to the whole region, including Japan, the first-tier NIEs, the second-tier ones (Indonesia, Malaysia and Thailand) and China. The term "ASEAN-4" refers to the three second-tier NIEs and the Philippines.

2 The flying geese paradigm was originally formulated in the 1930s, when Japan was still a comparatively poor country, seeking to catch up with the more industrialized countries of Europe and America. The original formulation was by K. Akamatsu in 1932, in an article (in Japanese) entitled "The Synthetic Principles of the Economic Development of our Country". Few of Akamatsu's writings on this subject are available in English. A notable exception is "A Historical Pattern of Economic Growth in Developing Countries", *The Developing Economies*, Vol. 1, No.1, March-August 1962. For a further discussion of the evolution of this paradigm, see UNCTAD, *World Investment Report 1995* (United Nations publication, Sales No. E.95.II.A.9), box V.4, and P. Korhonen, "The Theory of the Flying Geese Pattern of Development and its Interpretations", *Journal of Peace Research*, Vol. 31, No. 1, 1994.

3 The original formulation of the flying geese paradigm described the change in industrial structure over time, starting with a concentration on labour-intensive textile industry, shifting gradually to more demanding activities, such as the chemical industry, then further to steel and automobiles and so on. As the scale of each industry rises to a peak in this process before gradually disappearing due to loss of competitiveness, successive stages are described as inverted V-shaped curves; hence the metaphor of flying geese. Subsequently, this metaphor has also been used to describe the shift of industries from one country to another, with the inverted V-shaped curves representing the evolution of the same industry in different countries over time.

4 These themes have been developed by K. Kojima in a number of articles: "Reorganization of North-South Trade: Japan's foreign economic policy for the 1970s", *Hitotsubashi Journal of Economics*, Vol. 13, No. 2, Feb. 1973; "A macro-economic Approach to Foreign Direct Investment", *ibid.*, Vol. 14, No.1, June 1973; "International Trade and Foreign Investment: Substitutes or Complements", *ibid.,* Vol. 16, No. 1; "Macroeconomic versus International Business Approach to Direct Foreign Investment", *ibid.*, Vol. 23, No. 1, 1982; and "Japanese and American Direct Investment in Asia: A Comparative Analysis", *ibid.*, Vol.26, No.1, June 1985. See also K. Kojima and T. Ozawa, "Micro- and Macro-economic Models of Direct Foreign Investment:

Toward a Synthesis", *ibid.*, Vol. 25, No.1, June 1984; T. Ozawa, "The Flying Geese' Paradigm of FDI, Economic Development and Shifts in Competitiveness", mimeo. (Geneva: UNCTAD, 1995); and P. Phongpaichit, *The New Wave of Foreign Direct Investment in ASEAN* (Singapore: Institute of Southeast Asian Studies, 1990).

5 See, for example, *Overview of the Policies Towards Small- and Medium-Sized Enterprises* (in Japanese), annual report (1990) of the Agency for Small and Medium-Sized Enterprises (Tokyo: Government of Japan, 1990), p. 64.

6 Ministry of Foreign Affairs, *Japan's ODA 1994: Annual Report*, Tokyo, 1995, p. 27.

7 D. Unger, "Japan's Capital Exports: Moulding East Asia", in D. Unger and P. Blackburn (eds.), *Japan's Emerging Global Role* (Boulder, Colorado: Lynne Rienner, 1993).

8 For a recent discussion of this issue see Ha-Joon Chang and Robert Rowthorn (eds.), *The Role of the State in Economic Change* (Oxford: Clarendon Press, 1995).

9 UNCTAD, *World Investment Report, 1995, ...,* p. 134.

10 These issues are discussed in greater detail in *Multinationals and the National Interest* (Washington, D.C.: Office of Technology Assessment, United States Congress, September 1993). See also M. Panic, "Transnational Corporations and the Nation State", paper presented at a UN/WIDER Conference on "Transnational Corporations and the Global Economy" held at King's College, Cambridge, September 1995.

11 See A.H. Amsden, *Asia's Next Giant : South Korea and Late Industrialization* (New York: Oxford University Press, 1989); and "The Diffusion of Development: The Late-Industrializing Model and Greater East Asia", *The American Economic Review*, Vol. 81, 1991.

12 See J.E. Roemer, *U.S.-Japanese Competition in International Markets: A Study of the Trade-Investment Cycle in Modern Capitalism*, University of California at Berkeley, Institute of International Studies, Research Series, No. 22, 1975.

13 While Roemer does not attempt to present these stages as a unified theory of trade and investment, his analysis is an extension, at the macroeconomic level, of the "FDI follows trade" hypothesis that many authors have favoured, including: S.H. Hymer and R.E. Rowthorn, "Multinational Corporations and International Oligopoly: The Non-American Challenge", in C. Kindleberger (ed.), *The International Corporation* (Cambridge, MA: Harvard University Press, 1970); J.H. Dunning, "The Determinants of International Production", *Oxford Economic Papers,* Vol. 25, 1973; and G.C. Hufbauer, "The Multinational Corporation and Direct Investment", in P.B. Kenen (ed.), *International Trade and Finance* (Cambridge, MA.: Harvard University Press, 1975). In this context outsourcing through FDI implies a general loss of competitiveness, rather than loss of firm-specific advantage, as described in box 4.

14 See R.E. Rowthorn and J.R. Wells, *De-industrialization and Foreign Trade* (Cambridge University Press, 1987).

15 The figures in table 21 for the stock of FDI are cumulated annual outflows of FDI valued at historical cost. They do not include reinvested earnings of subsidiaries and foreign investment financed in the capital markets of the host or third countries; historical series including such data are not available for Japan.

16 The information in this paragraph is from MITI, *White Paper on International Trade 1994*, Tokyo, 1994.

17 UNCTAD, *World Investment Report, 1995, ...*, table II.3.

18 P. Harrod and R. Lall, *China: Reform and Development in 1992-93*, World Bank Discussion Paper, No. 215, Washington, D.C., 1993, p. 24.

19 See Tain-Jy Cheng, *Taiwan's SME Direct Investment in Southeast Asia*, Chung-Hua Institution for Economic Research, Taipei, 1995.

20 See *TDR 1986*, chap. IV, sect. C, and *TDR 1988*, Part One, chap. II, sect. C.

21 This practice among the Japanese exporters to lower (raise) profit margins whenever their competitiveness is declining (increasing) is reflected by the disparities in the amplitudes of variations in relative unit labour costs and relative export prices - see M. Durand, J. Simon and C. Webb, "OECD's Indicators of International Trade and Competitiveness", *OECD Economics Department Working Paper*, No. 120, 1992, p.12; and R.C. Marston, "Price Behaviour in Japanese and U.S. Manufacturing", *NBER Working Paper*, No. 3363, May 1990. Japanese exporters have been found to absorb as much as half of the real appreciation of the yen between 1985 and 1988 (*OECD Economic Surveys: Japan 1990-1991* (Paris: OECD, 1990), p. 56).

22 According to a study by OECD, the profitability of Japanese sales of automobiles in the United States market rose by 12 percentage points in the early 1980s as a consequence of voluntary export restraints *(Costs and Benefits of Protection* (Paris: OECD, 1985), p.17).

23 See *TDR 1987,* Part One, chap. D.1, and chap. II, sect. B.2.

24 *NRI Quarterly Economic Review*, Vol. 17, No. 4, November 1987, p. 18.

25 See *TDR 1989*, Part One, chap. III, sect. B.1, and *TDR 1990*, Part Two, chap. III, sect. B. According to the Economic Planning Agency of Japan, about 30 per cent of Japanese exports to the United States underwent some form of trade restriction in 1989; see *OECD Economic Surveys: Japan 1990-1991*, p. 131, table A2.

26 For a fuller discussion of these developments see *TDR 1991*, Part One, chap. III; and *TDR 1993*, Part Two, chap. IV.

27 H. Kohama and S. Urata, "The Impact of the Recent Yen Appreciation on the Japanese Economy", *The Developing Economies*, Vol. 24, No. 4, 1988; and K. Takeuchi, "Does Japanese Direct Foreign Investment Promote Japanese Imports from Developing Countries?" (Washington, D.C.: The World Bank, 1990), International Economics Department, *Working Paper WPS 458.*

28 For the recent surge in FDI by Taiwan Province of China see Chien-nan Wang, *Globalization, Regionalization and Taiwan's Economy*, Chung-Hua Institution for Economic Research, Taipei, 1994; and Tain-Jy Cheng, *op. cit.*.

29 See Y.H. Shin and You-Il Lee, "Korean Direct Investment in Southeast Asia", *Journal of Contemporary Asia*, Vol. 25, No. 2, 1995.

30 For a fuller analysis of the origin and effects of the debt deflation process in Japan and elsewhere see *TDR 1991*, Part Two, chap. II; *TDR 1992*, Part Two, chap. II; and *TDR 1993*, Part Two, chap. I.

31 In fact, the appreciation of the yen took place in two steps; first it rose to a parity of 100 to the dollar, where it stayed until early 1995, and then to 79 in the latter year before falling back again to around 100.

32 T. Klitgaard, "Coping with the Rising Yen: Japan's Recent Export Experience", *Current Issues in Economics and Finance* (Federal Reserve Bank of New York), Vol. 2, No. 1, January 1996.

33 According to a survey conducted by the Japan External Trade Organization (JETRO) in 1995 among 583 large companies on measures taken to cope with yen appreciation, more than 80 per cent had been cutting costs, 60 per cent developing high value-added products, and 40-50 per cent procuring finished or intermediate goods from abroad, half of which from overseas affiliates, particularly in Asia. Over one third had expanded production abroad, and another 40 per cent contemplated doing so, of which 51 per cent in China, 42 per cent in ASEAN-4, and 11 per cent in the United States. See JETRO, Japan External Trade Organization, *White Paper on International Trade, 1995 (Summary)*, Tokyo, July 1996 (http://www.jetro.go.jp).

34 These estimates distinguish three effects. The *export-inducing* effect arises from an increase in exports of capital goods and other products associated with a greater FDI outflow, largely as inputs into foreign production. The *export-substituting* effect is the substitution of previously exported goods by local production abroad. The *reverse-import effect* arises from supplying the Japanese market from foreign instead of domestic plants. There is also a secondary *import displacement effect* that occurs because reduced domestic production and exports lower the need for imports of raw materials. For a fuller discussion of these estimates see *TDR 1995*, Part Three, chap. II, sect. D.

35 See C.H. Kwan, "Asia's New Wave of Foreign Direct Investment", *Nomura Research Institute Quarterly,* Winter, Vol. 3, No. 4, 1994 (http://www.nri.co.jp).

36 Y. Takao and N. Nemoto, "Long-term Outlook: Japan's Economy in an Era of Structural Change", *ibid.,* Summer, Vol. 4, No. 2, 1995.

37 Takao and Nemoto, *op. cit*., chap. 2.

38 *NRI Quarterly Economic Review*, Vol. 25, No. 4, November 1995.

39 This is not to say that an ageing population presents no "financial" problems. Indeed, if the economic problem is not solved, the financial problem can be exacerbated.

40 For a fuller discussion of the role of the profits-investment nexus in East Asian industrialization see *TDR 1994*, Part Two, chap. I, sect. G; and Y. Akyüz and C. Gore, "The Investment-Profits Nexus in East Asian Industrialization", *World Development*, Vol. 24, No. 3, 1996.

41 In other words, Japan may enter a phase of what has been called "positive" de-industrialization, where employment in manufacturing is reduced either absolutely or relatively, but without creating unemployment because new jobs are forthcoming in services; see R.E. Rowthorn and J.R. Wells, *op. cit*.. Japan does not have to lose jobs in manufacturing in absolute terms if it can maintain an annual growth rate around 3 per cent; indeed, manufacturing employment rose by almost 14 per cent from 1980 to 1990, when the growth rate averaged about 4 per cent (table 29). Germany provides another example; in that country (the former Federal Republic) the share of manufacturing in total employment fell only slightly since the 1960s, but with the rise in overall unemployment since 1974 there has been a loss of jobs in manufacturing, where employment fell by some 10 per cent. Certainly, this could have been avoided if demand for labour had grown by 1 percentage point faster; GDP growth averaged almost 4.5 per cent during 1960-1973 and 2 per cent thereafter.

42 A recent proposal has identified 11 areas of business activity as new growth industries: housing; information and communication; energy; environment; health care and social services; new distribution network; culture and leisure; urban environment; international exchange; human resource training; and business support. See Y. Kimura, "Japan's New Growth Industries", *Nomura Research Institute Quarterly*, Spring 1995, Vol. 4, No. 1, 1995 (http://www.nri.co.jp).

Chapter II

EXPORTS, CAPITAL FORMATION AND GROWTH

A. Introduction

The debt crisis of the early 1980s triggered a critical reassessment of existing development strategies, as a result of which adjustment programmes in many developing countries turned away from more inward-oriented policy approaches. Over the course of the decade, the contrast in economic performance between the newly industrializing East Asian economies and most other developing countries was regarded as a confirmation of the growth potential of more outward-oriented approaches. The impetus given to the liberalization of world trade by the conclusion of the Uruguay Round has underpinned this general reorientation of development strategies.

Encouraging domestic firms to compete in international markets has consequently become a firmly established objective of policymakers in most developing countries. There is also a much greater recognition of the vital need in most developing countries to secure a rapid growth of exports in order to expand their industrial output, since they lack adequate capital goods and intermediate goods industries, and attempts to establish such industries in the earlier stages of development can give rise to serious inefficiencies. Moreover, defending inefficient domestic industries through high levels of protection is no longer seen as an appropriate response to competition from imports. However, the question of specific policy measures in support of more outward-oriented development strategies continues to provoke considerable disagreement.

Some analysts contend that rapid and complete liberalization is sufficient to accelerate development. Others, while fully acknowledging the central role of outward orientation and the importance of market forces, consider that there is a continuing need for government policies designed to shape market responses so as to maximize their contribution to development. A key issue determining the dynamics of outward orientation (or absence thereof) is the capacity to translate increased export revenues into investment in new lines of production and implement a consistent strategy of industrial upgrading.[1] The process of regional economic integration in East Asia discussed in the previous chapter already suggests that it was a mixture of policy intervention and market forces which ensured that rapid capital accumulation and technological progress were matched by an equally rapid pace of export growth and diversification.

This chapter discusses the links between exports, industrialization and economic growth in light of the East Asian experience. The next section examines the export-investment nexus as a crucial element in outward-oriented growth, and highlights some of the differences around common trends in the economies of East Asia. Sections C and D consider in more detail the evolution of exports in these economies, including important differences among them in terms of the diversification and upgrading of their export structure and

their penetration of northern markets. Section E identifies specific policy measures behind their successful export-investment nexus, including policies used to increase, diversify and upgrade exports.

B. The export-investment nexus

1. Why export?

Exports play a major role in industrialization and economic growth, but their role can be envisaged in a number of ways. In the mainstream analysis, the case for linking exports to industrialization and growth relates greater openness and competition in international markets to improved efficiency, which is expected to result not only from better resource allocation in the economy (allocative efficiency), but also, through the effects of competitive pressures, from better use of resources at the level of the firm (cost or X-efficiency).[2]

Another linkage between exports and growth is through market size. This was the essence of Adam Smith's assertion that the division of labour was limited by the extent of the market. In its most basic form, access to world markets provides a "vent for surplus" for developing countries, allowing them to take advantage of formerly underutilized land and labour to produce a larger volume of primary products, the surplus of which can be exported. Similarly, as industrialization progresses, firms can confront a range of technological and organizational constraints stemming from the fact that the minimum efficient scale of production far exceeds that required merely to meet the prevailing level of domestic demand. Exports help to overcome these constraints by allowing economies of scale at the firm level that can be secured from mass production techniques, as well as by providing a range of externalities arising at the industry level, including economies of specialization and agglomeration.[3] In addition, positive impulses from exports can emerge as a result of productivity-enhancing spillovers.[4] In all these respects, exporting manufactures may bring dynamic advantages, linked to faster economic growth through a virtuous circle of higher demand, greater investment and increased productivity growth.[5]

While much of the theoretical literature on the rationale for exports emphasizes efficiency gains and productivity increases, in practice perhaps the most important factor underlying an export drive in developing countries has been the need to overcome the balance of payments constraint. In building up their industrial capacity and competitive strength all newly industrializing countries must import a large volume of capital goods and intermediate goods. Thus, in an economy where investment is growing both in absolute terms and as a proportion of GDP, such imports will also need to grow faster than GDP and the financing of these imports may pose a serious constraint on the industrialization process if additional export revenue cannot be obtained.

The dependence of developing countries on foreign technologies embodied in imported capital goods is perhaps greater during the initial stages of industrialization. However, the need for large-scale imports of machinery and equipment continues throughout much of the industrialization process, especially when, as in East Asia, catching up is based on imitating technological leaders.[6] Even if domestic industries producing capital goods and intermediate inputs are gradually established to supply existing industries, as the economy moves up the technological ladder and establishes new industries and product lines, there will continue to be need for a considerable volume of imports of such goods. And the faster the pace of this upgrading and technological advance, the greater is the likely dependence thereon. Clearly, the speed at which a domestic capital goods industry is established, develops and becomes internationally competitive is critical in respect of the balance of payments constraint. Much also depends, *inter*

alia, on the size of the economy, since larger countries can more easily establish and develop capital goods industries on account of their large domestic market, which permits an efficient scale of production and associated economies.

In an economy without a significant capital goods industry, both investment and savings depend on exports. Investment does so to the extent that imports of capital goods require export earnings. But exports are not the only means of financing such imports; remittances from abroad or capital inflows, for example, are other sources of foreign exchange.[7] The dependence of savings on exports is much greater in such an economy. In the absence of exports, industry will have to rely on domestic demand to sell its output. When this output consists mainly of consumer goods, as is typically the case in a developing country, the only way to expand output is by increasing domestic consumption. But if output and income rise only to the extent that there is a rise in consumption, there cannot be any increase in savings.

True, capital goods imports needed for expanding capacity to produce consumer goods can be met for a time by inflows of foreign exchange from sources other than exports, as mentioned above. However, such an expansion cannot continue indefinitely, since before long it inevitably comes up against the balance of payments constraint. Clearly, while export growth is a necessary condition for domestic savings to rise, it is not a sufficient condition, since export earnings can also be used to import consumer goods or inputs for their production.

In sum, these considerations suggest that for growth to be sustained exports need to expand, thereby allowing domestic industry to operate at full capacity, or to expand it, without relying solely on domestic consumer demand. But since export expansion in turn depends on the creation of additional production capacity in industry, as well as on productivity growth, and hence on new investment, a sustainable growth process requires mutually reinforcing dynamic interactions among savings, exports and investment. Such a process will be characterized by continuously rising exports, domestic savings and investment, both in absolute terms and, during the greater part of the industrialization process, as a proportion of GDP. Initially, investment is likely to exceed domestic savings by a large margin, the difference being financed by net inflows of capital. However, over time, the external gap should narrow as exports and savings grow faster than investment.

2. Savings, investment and exports in East Asia

The evolution of investment, savings and exports in all the first-tier NIEs during the past three decades corresponds closely to the pattern of sustainable growth outlined above. During the 1950s gross national savings were less than 4 per cent of GDP in the Republic of Korea and less than 10 per cent in Taiwan Province of China, whereas the investment ratio was nearly three times as high as the national savings ratio in the former instance and almost twice as high in the latter (see table 31). Accordingly, during that period foreign savings financed two thirds of gross domestic investment in the Republic of Korea and 40 per cent in Taiwan Province of China. In both economies, investment rose rapidly in the 1960s and 1970s, and exceeded 30 per cent of GDP by the early 1980s. While the share of investment has since continued to rise in the Republic of Korea, it has declined quite sharply in Taiwan Province of China. Over the entire period 1951-1994, in both cases domestic savings rose much more rapidly than investment. They tripled in Taiwan Province of China, with the result that the economy became a net capital exporter. In the Republic of Korea, by the early 1990s the savings ratio had risen to more than 10 times the level in the 1950s, reaching over 30 per cent and closing the gap with investment. In both instances exports, too, expanded faster than investment. In Hong Kong and Singapore, savings have also risen much faster than investment, though the increase has been particularly rapid in Singapore.

Among the second-tier NIEs, the evolution of exports, savings and investment in Indonesia closely resembles that of the first-tier NIEs. The average annual share of investment in GDP tripled from the 1960s to the early 1990s, reducing the contribution of foreign savings to financing domestic investment from more than 50 per cent to around 10 per cent. The export share has closely tracked this rising share of investment. However, in all these respects Indonesia has yet to reach the levels achieved earlier by the first-tier NIEs. As in Indonesia, the sharp rise in the share of investment came later in Malaysia and Thailand than in the first-tier NIEs. But in contrast to Indonesia, it has in

Table 31

GROSS NATIONAL SAVINGS, GROSS DOMESTIC INVESTMENT AND EXPORTS IN THE ASIAN NIEs, 1951-1994

(Percentage of GDP)

	Republic of Korea			Taiwan Province of China			Hong Kong		Singapore		Indonesia			Malaysia			Thailand		
Period	*Savings*	*Investment*	*Exports*	*Savings*	*Investment*	*Exports*	*Savings*	*Investment*	*Savings*	*Investment*	*Savings*	*Investment*	*Exports*	*Savings*	*Investment*	*Exports*	*Savings*	*Investment*	*Exports*
1951-1960	3.3	10.0	2.0	9.8	16.3	9.6	9.2	9.1	...	11.4[a]	...	9.2[a]	13.6[a]	23.2[b]	15.3[a]	51.4[a]	15.3	13.5	18.3
1961-1970	13.7	20.0	9.1	19.7	21.9	20.4	20.6	20.6	14.9	22.3	4.9	10.4	9.7	21.5[c]	19.9	42.3	19.9	21.5	16.2
1971-1980	22.0	28.0	27.6	31.9	30.5	46.4	28.3	26.7	28.9	41.2	24.6	22.7	23.6	26.2	26.3	46.4	22.4	26.2	20.0
1981-1990	30.4	30.7	35.4	32.9	21.9	53.5	34.0	24.8	42.1	42.1	25.1	28.3	24.6	27.4	30.7	60.1	26.2	30.7	26.8
1991-1994	34.7	37.1	28.6	27.4	23.2	46.1	34.0	27.6	48.9	36.3	26.9	29.7	27.0	30.0	36.1	82.7	33.7	40.5	36.9

Source: UNCTAD secretariat calculations, based on national and international sources; and J. Riedel, "Economic Development in East Asia: Doing What Comes Naturally?", in H. Hughes (ed.), *Achieving Industrialization in East Asia* (Cambridge University Press, 1988), table 1.5.

Note: Exports include services.

a 1960 only.

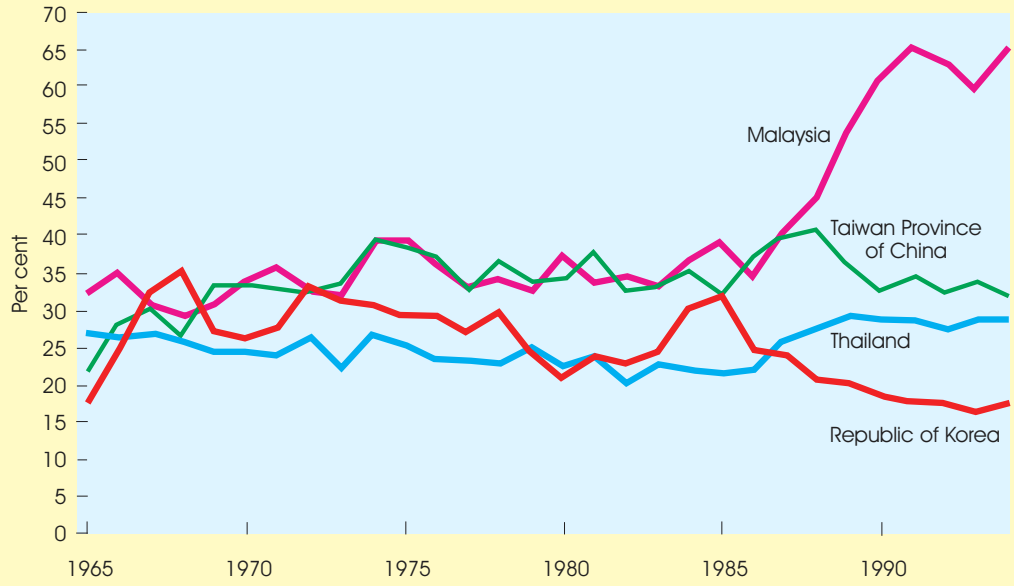
b Including Singapore, which became independent in 1965.

c 1965-1970.

Chart 4

IMPORTS OF CAPITAL GOODS IN SELECTED NIEs, 1965-1994

(Percentage of gross domestic investment)



Source: UNCTAD secretariat calculations, based on national accounts and United Nations, *Commodity Trade Statistics* tapes.

both countries caught up with - and in Thailand even surpassed - the first-tier NIEs. However, the gap between domestic savings and investment is still widening, raising the question of sustainability, which is discussed further below. In both countries, exports have generally kept pace with investment since the 1960s.

An important part of the increase in domestic savings in East Asian NIEs has come from corporate profits. Indeed, the role of corporate savings in general appears to be a distinguishing aspect of the development strategy in those countries. As discussed in greater detail in section E, Governments in East Asia used both the carrot and the stick in order to create and sustain a dynamic *investment-profits nexus*.[8] Equally important, policymakers have also been successful in building complementary links to the *export-investment nexus*. Expansion of exports enabled increased profits to be made without the need for domestic consumption to rise so as to keep up with the growth of production capacity, thereby allowing the savings rate to rise. Exports also provided the foreign exchange needed to expand productive capacity through imports of capital goods, thereby easing the balance of payments constraint which has held back industrialization efforts in many other developing countries.

The pattern of imports in the East Asian NIEs is broadly consistent with a sustainable export-investment nexus. All these economies have relied heavily on imported capital goods at crucial stages of their industrialization (see chart 4). In both Taiwan Province of China and the Republic of Korea imports of capital goods as a proportion of gross domestic investment rose until the mid-1970s, a period dominated by labour-intensive exports, followed by a sharp fall in the Republic of Korea and a more gentle one in Taiwan Province of China which coincided with the maturing of their domestic capital goods industries. A new wave of capital goods imports came in the early 1980s as these countries shifted their economic structures to a new generation of industrial activities, before the ratio fell again in the 1990s.

The pattern is less clear in the second-tier NIEs. In those countries, imported capital goods

were already important under import-substitution industrialization in the mid-1960s. However, as a proportion of domestic investment such imports were fairly stable until the mid-1980s, when these countries shifted to export-oriented manufacturing and started to import capital goods on a large scale. What is now important is whether in these countries, particularly Malaysia, domestic capital goods industries will be able to substitute for such imports at later stages in their catching-up process.

C. Structural changes in the pattern of East Asian exports

1. Export dynamics

In the earliest stages of economic development exports consist largely of primary commodities, including food products and raw materials, while imports comprise mainly manufactures, both capital goods and labour-intensive products. But where a country has become an established commodity exporter the obvious next step is to begin processing the commodities for export. Not only does diversification along these lines enable it to take advantage of the generally higher price elasticity of demand for and the less volatile prices of more processed products, but also it can provide additional demand for agricultural products, raise income levels and employment, and promote the development of an internal market. Moreover, the resulting increase in export earnings provides a potentially important source of foreign exchange earnings. Nevertheless, to the extent that diversification in this sector does offer early industrialization opportunities, export success will depend on appropriate industrial and technology policies (see the annex to this chapter).

In any case, the possibilities of accelerating development through deepening and diversification in the primary sector are limited.[9] For the vast majority of developing countries, sustained economic growth requires a shift in the structure of economic activity toward the production and export of manufactured goods. In most countries, import substitution allows manufacturing industries to be established initially for traditional labour-intensive products, which are the obvious candidates for the first generation of manufactured exports. But, by definition, developing countries have at this stage a limited capacity to transform resources because of a shortage of specialized industrial skills, lack of technical knowledge, scarcity of capital and narrow domestic markets. All these factors have a direct bearing not only on the range of manufacturing activities open to them, but also on their chances of success in international markets. Much thus depends critically on whether, and how fast, these limitations can be overcome; initial resource advantages can only be fully exploited if accompanied by rapid investment and attendant productivity growth.

As incomes increase and the domestic market begins to grow, rising labour costs and the entry of lower-cost producers progressively erode the export competitiveness of many labour-intensive manufactures. This can be offset, in part, by new investment and export opportunities in higher-level niches in traditional industries, such as textiles and clothing, created through improved design and marketing. However, a new set of challenges emerges around the upgrading of industrial activity so as to produce and export intermediate goods and capital goods as well as more sophisticated consumer goods. This move away from resource-dependent and labour-intensive activities towards more technology- and skill-intensive activities is well established, and because it coincides with a shift towards trading partners at a similar level of development, intra-industry trade takes a growing share of exports.

As discussed in greater detail in previous issues of *TDR*, it is not generally possible to rely on market forces alone to move economies through these various stages of industrialization and export orientation, on account of a number of market failures related to externalities, problems of coordination, imperfect and asymmetric information,

economies of scale, missing markets and imperfect competition. Since these factors impose themselves on the pace and direction of the industrialization process, the question of how best to manage this process gains in importance.[10]

Considerable policy effort is already required even at the initial stages of industrialization and export promotion, where competitiveness derives from abundant labour and natural resources. However, policy challenges increase considerably as the production process becomes more scale- and knowledge-intensive, since the technological and organizational capabilities required to compete internationally become more exacting, more difficult to master and more costly to acquire, and the investment climate becomes more uncertain.[11]

This process of building up these capabilities is particularly difficult in developing countries. Often, the learning requirements associated with a new generation of production techniques are more intangible, involving training and capability building at the firm level. However, firm-level capabilities do not develop in isolation but, in many industries, operate in a dense network of formal and informal relationships with suppliers, customers, competitors, consultants and technology research and educational establishments. Moreover, the international technology market in these industries is often oligopolistic and fragmented, and the leading suppliers possess considerable market power. In this context, the dangers of market failures, missing markets and other coordination bottlenecks can lead to a cumulative process of falling behind.[12]

In the early stages of development, FDI can contribute to development by creating employment, facilitating the transformation of natural resources into current revenue, and generating foreign exchange. The precise nature of its contribution will depend, of course, on how the current revenue and foreign exchange earnings are utilized. However, from a dynamic perspective the important issues concern the place of TNCs in the export-investment nexus as economies seek to upgrade.

Access to foreign technology is a critical part of upgrading in most developing countries. Other organizational assets located abroad, such as marketing and distributional skills, can also be important, particularly when an export-oriented strategy is being pursued. Access to these assets can be gained through a variety of channels, such as licensing and purchase of original equipment manufacture in the case of technology, and subcontracting in the case of distribution networks. However, the essential advantage of hosting FDI is that, in addition to capital, it brings a bundle of assets and capabilities which are already fully operational and so may allow a much more rapid entry into the international division of labour.

The advantage that this brings to host countries will depend, in part, on the degree of control that TNCs retain over their assets.[13] Such control may limit or totally prevent the development of an indigenous production and export capability. Whereas some assets of TNCs, such as skills, product design, and knowledge of international markets, can be captured in a variety of ways by domestic producers (e.g. through reverse engineering, the movement of employees and information gathering), the extent to which they spill over appears to be industry-specific.[14] Consequently, the choice of which industries or parts of industries to host is likely to be an important one for developing countries seeking to upgrade with the assistance of TNCs. Moreover, whether such spillovers can become the basis of a broader development depends upon the kinds of incentives made available as well as the relative bargaining power of TNCs and host-country Governments. This is particularly true for technological assets, where TNCs have strong economic reasons to keep innovative work centralized at home or in a few advanced countries and where government efforts to build domestic capacities can generate a potential conflict of interest with foreign producers.[15] For both these reasons, the way in which domestic policymakers manage FDI, including its function in the export-investment nexus, is likely to be critical in determining its contribution to longer-term development and growth.

Recent developments in technology and related changes in TNC strategy have complicated this relationship between FDI, exports and upgrading. In particular, in many industries it is becoming possible for TNCs to single out specific activities in the production chain according to skill, technology and capital intensity, match these activities to specific country advantages and locate and coordinate them through a network of interconnected affiliates in such a way as to enhance overall corporate profits. As a result, developing countries may be able to enter more easily the international division of labour by attracting the least skill- and technology-intensive parts of this TNC-centred production chain.

The extent to which this process has already progressed is a matter for further empirical research. More importantly, it seems likely that, with geographically dispersed production sites, the spillovers from hosting FDI are reduced because the package of technology and skills required at any one site is narrower and because cross-border backward and forward linkages are strengthened at the expense of domestic ones. Moreover, when only a small part of the production chain is involved, TNCs have a wider choice of potential sites, since these activities take on a more footloose character, thereby strengthening their bargaining position vis-à-vis the host country. Indeed, as suggested in a recent study, it is far less likely under these conditions that increased FDI flows to developing countries will automatically lead to the kind of technological upgrading necessary for industrialization and long-term economic growth.[16]

In the absence of policies promoting such upgrading and spillovers, heavy reliance on FDI may also result in serious payments problems. Even when FDI is in productive facilities requiring large imports of specialized semi-finished goods for domestic assembly using unskilled labour, with only very weak backward linkages with domestic suppliers, the additional net foreign exchange earnings generated may still be sufficient to cover the profit earned on the investment, so long as the bulk of the assembled goods are exported. If, however, too large a part is sold in the domestic market, they will be insufficient. In any case, to the extent that the economy has come to depend on such FDI, including the reinvestment of profits, to finance its current account deficit, whatever its origin, it will face the likelihood of a payments crisis. Without upgrading and the establishment of strong backward linkages with domestic suppliers, so as to raise the domestic value added content of exports in industries where foreign firms predominate, FDI will tend to remain footloose. In consequence, the flow of FDI, including the reinvestment of TNC profits, may dry up as the capital seeks low-cost locations elsewhere.

2. Exploiting initial advantages

Exports from the first-tier NIEs today consist mainly of manufactures. However, the Republic of Korea and Taiwan Province of China, unlike Singapore and Hong Kong, were essentially rural economies until the mid-1960s, with primary commodities constituting the bulk of their exports.[17] In the 1950s, both economies began to diversify away from crude agricultural and mineral exports to processed resource-based products; canned food from Taiwan Province of China, for example, found a large market in the United States, and the Republic of Korea moved from exports of iron ore to processed iron and steel, which by 1965 accounted for close to 8 per cent of its total exports.

The path followed by the East Asian countries in this early phase of their development resembled that of many other countries. Import substitution industries emerged in activities where local resources, including labour, could be quickly mobilized and where domestic demand could be generated. But for industrialization to proceed at a fast pace, it was essential to find export markets for domestically produced goods in order to alleviate the balance of payments constraint on investment.

What distinguished the Republic of Korea and Taiwan Province of China from other developing countries was the pace at which export growth of labour-intensive manufactures was achieved, especially in textiles and clothing, as had earlier been the case in Hong Kong, and in wood and paper products. According to estimates of the UNCTAD secretariat, in both economies labour-intensive exports as a share of their domestic production rose steadily and rapidly from the mid-1960s, reaching 60 per cent in the early 1980s, and soon accounted for the bulk of exports, although in the Taiwanese case resource-intensive manufactures remained important. In line with this expansion of low-skill, labour-intensive output, the share of primary commodities in total exports fell rapidly in both economies - to 18 per cent in 1975 in the Republic of Korea and 20 per cent in Taiwan Province of China.

The second-tier NIEs, by contrast, have had the advantage of much richer natural-resource endowments. They had much less need to rely on low-skill, labour-intensive sectors, since they were able to meet their foreign exchange requirements from their exports of primary commodities. Such exports still account for almost one third of total export earnings (other than fuels). There was initially considerable scope to accelerate growth through diversification and increased processing of natural-resource-based products. In Malaysia indigenous, agriculture-based technologies have been developed in a comprehensive manner with a

view to reducing the share of unprocessed primary products in total exports. There has been successful diversification into palm-oil, rubber and cocoa processing, as well as wood and paper. Indonesia has succeeded in moving from the export of wood and paper raw materials to the export of wood and paper manufactures.

Beginning in the early 1970s, the second-tier NIEs also developed those export-oriented manufacturing industries where lower labour costs gave them a competitive edge. While the development of traditional low-skill, labour-intensive industries played a relatively minor role in Malaysia - which in this respect resembled Singapore - both Indonesia and Thailand followed the path taken earlier by the Republic of Korea, Taiwan Province of China and Hong Kong, with textiles, clothing and footwear becoming the most important manufactured exports. However, in Indonesia the process only began in the 1980s, when the domestic textiles, clothing and footwear industries turned their attention to export markets. By 1994, the share of such exports in total non-oil export revenue had reached 25 per cent in Indonesia and 20 per cent in Thailand. However, in both countries, the development of these sectors was considerably slower than in the first-tier NIEs, and shares in total export earnings after 20 years of industrialization were only about half of what they had been in the Republic of Korea and Taiwan Province of China by the mid-1970s. The reason for the considerably slower expansion of these sectors in the second-tier NIEs was not only the remaining large export potential in primary commodities, including food, but also the fact that their later start coincided with a period of heightened international competition in these sectors.

Nevertheless, the reduction of the second-tier NIEs' reliance on exports of non-oil primary commodities, though less rapid than in the Republic of Korea and Taiwan Province of China, has been considerably faster than in most other developing countries. For example, the share of non-oil primary commodities in total exports of three large Latin American economies taken together (Argentina, Chile and Colombia) fell from 95 per cent in the mid-1960s to around 70 per cent by the early 1990s (see table 32). Over the same period, the share in second-tier NIEs came down from more than 96 per cent to less than one third. Initially, this substantial fall in the share resulted mainly from the rise of exports of low-skill, labour-intensive and resource-based manufactures. To judge by the declining share of exports based on an initial resource advantage (i.e. non-oil primary commodities and low-skill, labour-intensive and resource-based manufactures), the performance of the second-tier NIEs is considerably better than the average for the five major Latin American economies distinguished in the table. However, such goods still account for more than half of their total export earnings, whereas the first-tier NIEs have become much less dependent on cheap labour as a result of the emphasis placed on capital formation as well as on technology and skill acquisition in more advanced sectors.

3. Industrial upgrading and dynamic comparative advantage

The sustained rise in exports in the first-tier NIEs would not have been possible had these economies relied only on initial comparative advantages. Such advantages, especially those related to labour-intensive industries, were unlikely to persist, as wages tended to rise with economic development. That is why export expansion in the textiles and clothing industries in the Republic of Korea, Taiwan Province of China and Hong Kong levelled off, while it took off in Indonesia and Thailand. The first-tier NIEs consequently needed to establish a comparative advantage in different activities.

They have indeed been particularly successful in upgrading their structure of manufacturing output towards scale- and skill-intensive activities. By the second half of the 1980s, the share of these activities in total manufacturing output had surpassed that of resource- and labour-intensive activities. The rising share of these scale- and skill-intensive goods in total manufacturing exports (although initially lagging behind their share of total output) also began to accelerate rapidly from the mid-1970s. These goods now comprise the majority of manufactured exports. Likewise, the first-tier NIEs have gained substantial shares in the world markets for ships and boats, iron and steel, plastic products, radio and television sets, watches, cycles and, above all, automatic data processing equipment. Upgrading has been slower in the second-tier NIEs. However, beginning in the early 1980s, the process has gained pace.

A more detailed analysis of the links between industrial upgrading and exports, based on a clas-

Table 32

PRIMARY COMMODITIES AND LABOUR-INTENSIVE AND RESOURCE-BASED EXPORTS AS A SHARE OF TOTAL NON-OIL EXPORTS OF SELECTED DEVELOPING COUNTRIES AND REGIONS, 1965-1994

	First-tier NIEs (2 countries)[a]	*Second-tier NIEs*	*Latin America (3 countries)*[b]	*Brazil*	*Mexico*
Primary commodities[c]					
1965	51.4	96.6	94.6	92.3	84.3
1975	18.4	87.5	81.6	74.0	64.8
1985	7.2	67.6	84.0	52.8	33.9
1994	6.1	31.4	69.5	43.9	13.1
Primary commodities[c] ***plus resource-based and low-skill labour-intensive goods***[d]					
1965	86.5	97.7	96.6	94.2	89.2
1975	69.4	93.2	87.7	83.4	75.0
1985	47.6	82.9	89.6	64.1	44.7
1994	31.6	59.0	82.0	58.1	22.8

Source: UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.
a Republic of Korea and Taiwan Province of China.
b Argentina, Chile and Colombia.
c Excluding petroleum and including non-ferrous metals (SITC 68).
d Wood and paper products; non-metallic mineral products; textiles and clothing (including footwear); and toys and sports equipment.

sification of exports into five broad categories, reveals a number of interesting features (tables 33 and 34). The classification takes into account the mix of different skill, technology, capital and scale requirements at the final product stage. Group I comprises primary commodities, including processed food. Group II covers labour-intensive and resource-based industries with a low skill, technology and capital content, or where use can be made of indigenous skills and technology acquired through earlier handicraft production (textiles, clothing and footwear; toys and sports equipment; wood and paper products; and non-metallic mineral products). Group III comprises sectors with a low-to-medium level of skill, technology, capital and scale requirements (iron and steel; fabricated metal products; transport equipment other than motor vehicles and aircraft; and sanitary and plumbing equipment). Group IV consists of sectors with a medium-to-high level requirement in respect of the four criteria (rubber and plastic products; non-electrical machinery; electrical machinery; and road motor vehicles). Finally, in group V there are the sectors which in general are most demanding in the terms described (chemical and pharmaceutical products; computers and office equipment; communication equipment and semiconductors; aircraft and associated equipment; and scientific instruments, watches and photographic equipment).

To be sure, skill requirements do not always increase in proportion to capital intensity, the most obvious example being motor vehicles. Moreover, as already noted, slicing of the production chain by TNCs has made it possible to single out technically and geographically low-skill, labour-intensive intermediate stages in the production of goods which are otherwise highly technology- and capital-intensive. Such intra-firm divisions of labour

appear to have been playing an important role in the recent wave of industrialization of the second-tier NIEs and other developing countries; examples are industries such as automobiles and electronics in Mexico.[18] Nevertheless, there is a general tendency for skill, technology and capital requirements to rise together. Indeed, complementarities among these factors are at the core of the upgrading process.

Tables 33 and 34 reveal a number of similarities of industrial upgrading among the East Asian NIEs, as well as important differences between the first- and the second-tier ones, and within each of these two groups. The evolution of the export structure of the first-tier NIEs exhibits a clear pattern of sequenced upgrading, from primary commodities in the Republic of Korea and Taiwan Province of China and from entrepôt activity in Hong Kong, and particularly Singapore (group I), through increasingly more advanced stages of industrialization to goods which require the highest level of skill and technology. The second-tier NIEs reveal a less systematic pattern of upgrading as well as larger differences among each other than in the first tier.

Clothing, textiles and footwear remained the main pillar of export success in the Republic of Korea and Taiwan Province of China during the phase of most rapid export expansion, their share in total exports rising until the mid-1970s. But soon after entering world markets in group IV products, the first-tier NIEs were also able to expand group III exports. The increasing share of these sectors in total exports continued until 1985, but was much more rapid in Taiwan Province of China and the Republic of Korea than in the other two economies. In the Republic of Korea, the increase was due in the first instance to fast growth of heavy industry, particularly shipbuilding and iron and steel, whereas Taiwan Province of China went through a phase of less rapid, but still relatively fast, growth of "lighter" industries, such as fabricated metal products and non-motor vehicles. Growth in the latter products was sustained well into the 1990s, whereas in the Republic of Korea exports of ships and boats and other group III products rapidly declined in importance as a share of total exports after 1985. In both cases, the development of these sectors was closely linked to their diminishing dependence on imported capital goods noted above.

Already in the late 1960s, when exports of the technologically less advanced sectors (groups III and IV) were still rising, the first-tier NIEs also succeeded in expanding exports of goods requiring higher levels of skill and technology, such as machinery (especially electrical machinery) and goods incorporating what has come to be labelled "high-technology", such as computer equipment, semiconductors and telecommunications equipment. In 1994 group IV and V exports accounted for more than half of the total export earnings of the first-tier NIEs. In Latin America, only Mexico had reached by that time a similar share; in the four other major economies (Brazil, Argentina, Chile and Colombia) it averaged less than one quarter.

A vital prerequisite for this success was a process of systematically nurturing new generations of industries with a greater potential for innovation and long-term productivity growth. A decisive element was the use of selective industrial policies, designed to encourage investment in new industries where competitive advantages had to be created in human capital and technology (see section E below). A notable example of these policies is the Korean automobile industry. Today the Republic of Korea stands out as the first country after Japan that has become competitive worldwide in this sector. It took 30 years of production for the domestic market under import protection, but accompanied by constant acquisition of new skills and technology, to reach this point. The share of this industry in total exports rose from close to zero in 1975 to 2.2 per cent by 1985, and since then has tripled.

As already noted, upgrading in the second-tier NIEs has been slower. However, differences in the pattern and sequence of upgrading between the first and second-tier NIEs are perhaps more important. As can be seen from table 34, there has been relatively little export-oriented development in group III sectors in the second-tier NIEs, which even today contribute importantly to foreign exchange earnings in the Republic of Korea and Taiwan Province of China. By contrast, in Malaysia and Thailand, since the early 1980s there has been a sharp increase of exports in the upper segments of manufacturing, namely electrical machinery and electronics, while Indonesia has made progress in these same sectors in recent years. Apart from chemicals, these countries exported virtually no group V products in the mid-1960s. Although some advances were made by Thailand, and even more so by Malaysia, during the 1970s and early 1980s in exports of electrical machinery

Table 33

COMMODITY STRUCTURE OF EXPORTS FROM FIRST-TIER NIEs, 1965-1994

(Percentage of total non-oil exports)

	Republic of Korea				Taiwan Province of China				Singapore				Hong Kong			
Commodity group	1965	1975	1985	1994	1965	1975	1985	1994	1965	1975	1985	1994	1965	1975	1985	1994
Group I	*42.8*	*17.7*	*5.9*	*5.3*	*60.0*	*19.0*	*8.6*	*7.0*	*61.1*	*36.9*	*23.3*	*8.6*	*7.5*	*3.2*	*4.0*	*5.0*
Food	17.5	14.1	4.4	2.8	53.0	16.6	6.2	4.0	21.2	11.8	7.6	4.8	4.7	1.9	2.1	2.9
Other primary commodities	25.3	3.6	1.5	2.5	7.0	2.4	2.4	3.0	39.9	25.1	15.7	3.8	2.8	1.3	1.9	2.1
Group II	*43.8*	*53.3*	*36.3*	*25.2*	*26.3*	*48.7*	*44.4*	*25.7*	*12.6*	*12.4*	*10.6*	*6.1*	*74.4*	*69.0*	*56.4*	*48.4*
Wood & paper products	11.1	5.6	0.7	1.1	7.3	5.2	2.9	1.7	1.3	3.1	2.4	1.0	0.5	0.3	0.6	1.5
Textiles, cloth., footwear	30.9	43.9	32.1	22.7	15.8	38.9	32.6	19.4	9.1	7.8	6.5	4.0	64.2	60.4	46.7	44.8
Non-metallic mineral products	1.7	2.3	1.2	0.7	2.6	1.1	2.3	1.2	1.9	1.1	0.9	0.7	0.9	0.8	0.5	0.7
Toys and sports equipment	0.1	1.5	2.3	0.7	0.6	3.5	6.6	3.4	0.3	0.4	0.8	0.4	8.8	7.5	8.6	1.4
Group III	*9.1*	*11.0*	*30.8*	*14.7*	*4.2*	*6.1*	*11.1*	*9.6*	*5.4*	*8.6*	*4.8*	*3.9*	*7.7*	*4.4*	*3.6*	*2.7*
Iron and steel	7.7	4.9	6.4	5.4	2.6	1.9	2.1	1.9	2.3	2.6	1.4	0.9	0.9	0.1	0.1	0.2
Fabricated metal products	1.3	2.6	5.2	2.8	1.2	2.7	5.4	6.1	2.5	2.0	1.7	1.3	3.6	2.9	2.5	2.3
Ships and boats	0.0	3.0	17.9	5.6	0.0	0.4	0.6	0.5	0.1	3.8	1.4	1.1	0.5	0.3	0.1	0.0
Other[a]	0.1	0.6	1.3	1.0	0.4	1.1	3.0	1.0	0.5	0.2	0.3	0.6	2.6	1.2	0.9	0.2
Group IV	*3.0*	*10.9*	*13.4*	*35.3*	*3.1*	*11.7*	*19.0*	*29.2*	*13.7*	*24.8*	*29.4*	*32.7*	*4.7*	*9.5*	*12.9*	*18.2*
Rubber and plastic products	0.7	3.7	2.0	2.2	0.3	3.1	4.1	3.9	0.8	0.6	0.8	1.1	1.0	2.8	2.3	1.8
Non-electrical machinery	1.5	0.7	2.0	5.7	1.4	2.8	4.5	8.2	4.6	8.6	8.6	7.5	0.6	0.6	1.6	3.3
Electrical machinery	0.3	6.4	7.2	20.8	1.4	5.1	9.1	15.1	1.8	13.2	19.0	23.4	3.1	6.1	9.0	13.1
Road motor vehicles	0.6	0.1	2.2	6.6	0.0	0.7	1.3	2.0	6.5	2.4	1.0	0.7	0.0	0.0	0.0	0.0
Group V	*1.4*	*7.2*	*13.5*	*19.5*	*6.4*	*14.4*	*17.0*	*28.5*	*7.4*	*17.4*	*31.9*	*48.7*	*5.8*	*13.9*	*23.1*	*25.8*
Chemicals and pharmaceuticals	0.2	1.6	3.6	7.1	4.9	2.0	2.9	6.1	5.7	6.0	8.7	6.9	1.3	0.9	1.1	4.0
Computer and office equipment	0.0	1.0	2.1	4.0	0.0	1.6	4.5	13.5	0.3	2.6	9.3	27.6	0.0	1.7	5.7	7.1
Communication equipment[b]	0.9	3.0	5.7	6.7	1.3	9.0	7.7	6.6	0.5	4.9	8.6	10.4	3.6	7.0	6.9	4.5
Other[c]	0.3	1.7	2.1	1.7	0.1	1.8	1.9	2.3	0.9	4.0	5.3	3.8	0.9	4.3	9.4	10.2

Source: UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.

a Transport equipment other than road motor vehicles, ships and aircraft; and sanitary and plumbing products.

b Telecommunications and sound recording and reproducing apparatus and equipment; and semiconductors.

c Aircraft and associated equipment; and scientific instruments, including watches and photo equipment.

Table 34

COMMODITY STRUCTURE OF EXPORTS FROM SECOND-TIER NIEs, 1965-1994

(Percentage of total non-oil exports)

	Indonesia				*Malaysia*				*Thailand*			
Commodity group	1967	1975	1985	1994	1965	1975	1985	1994	1965	1975	1985	1994
Group I	*96.7*	*95.8*	*75.9*	*42.0*	*94.8*	*81.0*	*63.6*	*23.6*	*98.0*	*85.7*	*63.3*	*28.7*
Food	27.0	22.7	14.6	11.7	6.9	7.7	6.1	3.6	55.2	64.0	47.4	22.7
Other primary commodities	69.7	73.1	61.3	30.3	87.9	73.3	57.5	20.0	42.8	21.7	15.9	6.0
Group II	*0.2*	*0.4*	*16.4*	*43.6*	*1.5*	*5.6*	*7.0*	*12.0*	*1.6*	*11.1*	*22.5*	*27.1*
Wood and paper products	0.0	0.1	10.0	17.3	0.7	2.6	1.5	4.1	0.1	1.3	1.3	1.1
Textiles, clothing, footwear	0.2	0.3	6.1	24.7	0.5	2.7	4.5	6.2	0.5	6.6	16.7	20.4
Non-metallic mineral products	0.0	0.0	0.4	1.0	0.3	0.3	0.5	1.1	1.0	3.2	4.2	4.0
Toys and sports equipment	0.0	0.0	0.0	0.6	0.0	0.0	0.4	0.7	0.0	0.0	0.3	1.6
Group III	*0.1*	*0.3*	*0.4*	*3.0*	*0.3*	*0.8*	*2.2*	*3.0*	*0.1*	*0.8*	*1.7*	*3.3*
Iron and steel	0.0	0.0	0.3	1.0	0.1	0.2	0.5	0.8	0.0	0.3	1.0	0.7
Fabricated metal products	0.1	0.2	0.0	1.1	0.2	0.4	0.5	1.1	0.1	0.5	0.6	1.5
Ships and boats	0.0	0.1	0.0	0.2	0.0	0.1	1.2	0.6	0.0	0.0	0.0	0.2
Other[a]	0.0	0.0	0.0	0.7	0.0	0.1	0.1	0.5	0.0	0.0	0.1	0.9
Group IV	*2.5*	*1.4*	*1.0*	*3.9*	*2.3*	*5.7*	*20.7*	*29.8*	*0.1*	*1.6*	*9.6*	*20.7*
Rubber and plastic products	0.0	0.0	0.1	0.9	0.5	0.7	0.6	1.3	0.0	0.4	1.3	2.8
Non-electrical machinery	2.5	0.8	0.2	0.6	0.7	1.6	2.1	3.6	0.0	0.2	1.8	3.7
Electrical machinery	0.0	0.6	0.8	2.1	0.2	3.1	17.9	24.5	0.1	1.0	6.3	12.7
Road motor vehicles	0.0	0.0	0.0	0.4	1.0	0.4	0.2	0.4	0.0	0.0	0.2	1.5
Group V	*0.5*	*2.1*	*6.3*	*7.5*	*1.2*	*6.9*	*6.5*	*31.6*	*0.1*	*0.9*	*3.0*	*20.2*
Chemicals and pharmaceuticals	0.5	1.4	5.9	3.2	1.1	1.0	1.6	3.1	0.1	0.6	1.4	3.0
Computer and office equipment	0.0	0.0	0.0	0.9	0.0	0.9	0.2	10.0	0.0	0.0	0.8	9.5
Communication equipment[b]	0.0	0.1	0.0	2.5	0.0	0.6	3.3	13.8	0.0	0.1	0.1	4.2
Other[c]	0.0	0.6	0.4	0.9	0.1	4.4	1.4	4.7	0.0	0.2	0.7	3.5

Source: UNCTAD secretariat calculations based, on United Nations *Commodity Trade Statistics* tapes.

a Transport equipment other than road motor vehicles, ships and aircraft; and sanitary and plumbing products.

b Telecommunications and sound recording and reproducing apparatus and equipment; and semiconductors.

c Aircraft and associated equipment; and scientific instruments, including watches and photo equipment.

Table 35

SELECTED EAST ASIAN NIEs: RELATION OF IMPORTS TO EXPORTS IN THE ELECTRONICS SECTOR, 1994

	Republic of Korea	Taiwan Province of China	Singapore	Indonesia	Malaysia	Thailand
Exports of electronics products[a] ($ million)						
All electronics products	11 630	14 681	34 262	1 665	14 768	6 387
of which:						
Automatic data processing equipment	3 395	9 090	21 878	193	4 726	3 680
Communication equipment[b]	8 234	5 591	12 385	1 473	10 042	2 707
Share of finished goods in exports[a] (per cent)						
All electronics products	80.4	60.0	67.1	80.2	65.3	64.8
of which:						
Automatic data processing equipment	82.5	54.9	66.6	49.9	30.9	57.5
Communication equipment[b]	79.6	68.4	76.4	84.1	81.5	74.8
Imports of parts as a percentage of exports of finished goods						
All electronics products	18.7	12.6	32.7	26.7	38.5	60.1
of which:						
Automatic data processing equipment	24.3	8.5	28.9	33.2	95.4	79.4
Communication equipment[b]	16.3	17.8	39.3	26.2	28.4	40.0
Imports of parts as a percentage of total exports[a]						
All electronics products	15.0	7.5	21.9	21.4	25.2	39.0
of which:						
Automatic data processing equipment	20.0	4.7	19.4	16.6	29.5	45.7
Communication equipment[b]	13.0	12.2	26.5	22.0	23.1	29.9

Source: UNCTAD secretariat calculations, based on United Nations *Commodity Trade Statistics* tapes.

a I.e. exports of both finished goods and parts.

b Telecommunications and sound recording and reproducing apparatus and equipment; and semiconductors.

and of semiconductors and telecommunications equipment, it was not until the second half of the 1980s that exports from this group surged. By 1994 computer equipment, semiconductors and telecommunications equipment, together with scientific instruments, represented some 19 per cent of the exports of Thailand and more than 28 per cent of those of Malaysia, proportions which were much higher than in the Republic of Korea, Taiwan Province of China and Hong Kong.

While the first-tier NIEs have thus achieved a relatively diversified export structure, there appears to have emerged a largely dual structure in the second-tier ones, with exports bunched at the upper and lower ends of the skill and technology range. However, the figures for total exports in higher segments from the second-tier NIEs hide a large import content. For example, imports of parts of automatic data processing equipment in 1994 were close to 80 per cent of the export value of

finished products in Thailand and more than 95 per cent in Malaysia, compared to less than 30 per cent in the Republic of Korea and Singapore (the latter country being the leading East Asian exporter in this sector) and only around 8.5 per cent in Taiwan Province of China (see table 35). In Malaysia the majority of such exports again consisted of parts; finished products were only around 30 per cent of total exports of the sector. The corresponding figures for the first-tier NIEs vary from 54.9 per cent (Taiwan Province of China) to 82.5 per cent (Republic of Korea). It is thus possible that in the second-tier NIEs a larger proportion of imported parts is processed for export as parts, rather than as finished products. However, even in terms of the ratio of imported parts to total exports of parts and finished products, the import content of exports appears to be considerably higher in Malaysia and Thailand than in the Republic of Korea and Taiwan Province of China.

The ratio of imported parts to exported finished products in the second-tier NIEs is considerably smaller for telecommunications equipment than for computers. In the Republic of Korea and Taiwan Province of China, the corresponding ratios in 1980 for telecommunications equipment were already lower than they now are in the second-tier NIEs. Again, the ratio of imports of parts to total exports of parts and finished products is considerably higher in the latter countries than in the former. These figures suggest that in Malaysia and, to a lesser extent, Thailand a large share of exports in these sectors consists of intermediate products that are reexported after processing, so that the "high-tech" character of exports may often be primarily a reflection of that of the imported inputs.

What appears to be a jump from the lower skill and technology range to the upper range in exports from Malaysia and Thailand consequently reflects, to a large extent, an increasing division of labour among East Asian countries whereby the second-tier NIEs assume the less demanding and more labour-intensive assembly stages. This high-skill export structure arises primarily from the success of the second-tier NIEs in attracting affiliates of foreign firms rather than from use of existing domestic capacities and capabilities in these sectors. In this context, and as discussed in greater detail in the previous chapter, the idea of a "recycled comparative advantage" which marries domestic cost advantages with the technology and skills of TNCs does not necessarily have the same implications for the host country as for the foreign firms involved.

Table 36

FDI IN MANUFACTURING: RANKING OF HOST COUNTRIES

Host country[a]	Year	*Share of foreign affiliates (Per cent)*
Singapore	1988	53.0
Thailand	1986	48.6
Philippines	1987	40.8
Malaysia	1986	40.5
Brazil	1987	34.2
Republic of Korea	1986	21.5
Hong Kong	1987	17.3
Uruguay	1987	13.6
Peru	1988	11.8
Sri Lanka	1987	11.7
Japan	1986	2.2

Source: M. Wilkins, "Multinational Corporations: An Historical Account", paper for UNU/WIDER Conference on Transnational Corporations and the Global Economy, held at King's College, Cambridge, United Kingdom, 21-23 September 1995.

a Ranked by foreign affiliates' share of total sales in the domestic market for manufactures (for latest available year).

4. Foreign direct investment, exports and upgrading

The East Asian NIEs have, in general, been particularly successful in attracting FDI so as to compensate for specific deficiencies in domestic technological and organizational skills. In part, their success reflects an early willingness to host FDI. But probably the single most important factor in attracting FDI has been the sustained rates of rapid economic growth in these economies. However, in East Asia FDI has been more consistently export-oriented than in other developing regions.[19]

Within the region there is nevertheless a remarkable diversity of experience with FDI. As can be seen from table 36, foreign affiliates accounted

Table 37

RATIO OF FDI INFLOWS TO GROSS FIXED CAPITAL FORMATION IN SELECTED EAST ASIAN COUNTRIES, 1971-1993

(Percentage)

Country	*1971-1980*	*1981-1990*	*1991-1993*
Japan	0.1	0.1	0.1
Hong Kong	5.1	9.9	5.7
Republic of Korea	1.2	0.9	0.5
Singapore	15.8	26.2	37.4
Taiwan Province of China	1.3	2.6	2.6
Indonesia	3.5	1.5	4.5
Malaysia	13.6	11.3	24.6
Philippines	1.0	3.8	4.6
Thailand	2.3	4.8	5.0
China	0.0	1.5	10.4

Source: UNCTAD data base.

for 40-50 per cent of domestic sales of manufactures in Singapore and ASEAN-4 in the late 1980s, whereas for the Republic of Korea and Hong Kong the proportions were around 21 per cent and 17 per cent, respectively.[20] The figures in table 37 on shares of FDI in gross domestic capital formation show a similar pattern of reliance on FDI.

Broad aggregates such as those just considered do not necessarily provide a true measure of the importance of FDI in the industrialization process. In the Republic of Korea, for example, foreign affiliates accounted for a quarter of all manufactured exports, which is a much greater proportion than their shares in GDP or gross capital formation. In the key electrical machinery and electronics sectors, the share of foreign affiliates was around 70 per cent.[21] Thus, although development in the Republic of Korea and Taiwan Province of China relied mainly on domestic firms, an important role was, and still is, played by FDI in certain sectors. This reflects the fact that these countries were extremely selective and restrictive in their policy towards FDI. Following the lead of Japan, they have shown a clear overall preference for promoting indigenous enterprises and enhancing domestic technological capabilities.[22] Even when successful upgrading took place in the presence of FDI, as in the electronics industry, it has been judged by the extent to which moves into design and product development gradually reduced dependence on TNCs.[23] In many respects, the policy pursued was similar to that for domestic investment, where neither narrow corporate interests nor the spontaneity of market forces were left alone to guide the investment process.

The two most important hosts to FDI among the first-tier NIEs are Singapore and Hong Kong. However, there are important differences between the two in the contribution of FDI to development. Although Singapore has not nurtured domestic private firms to compete with TNCs, it has targeted specific industries for promotion, particularly where knowledge is an important input, and used TNC-controlled assets in efforts to upgrade.[24] The sizeable presence of TNCs in Hong Kong, particularly in manufacturing for export, followed from an early but essentially passive reliance on FDI to build a low-skill industrial base. However, FDI has contributed little to upgrading and industrial deepening, and has been much more footloose than in the other NIEs. Deindustrialization has been particularly rapid since the mid-1980s and in recent years manufacturing exports have stagnated or even declined.

Economic development in East Asia has become steadily more dependent on FDI, as was demonstrated in the previous chapter (see also tables 36 and 37). In Japan the share of foreign affiliates in manufacturing sales in the late 1980s was negligible. It was much higher in Hong Kong and the Republic of Korea, and still higher in the second-tier NIEs. This, with some qualifications, can also be seen from the figures on capital formation. Even so, apart from Malaysia, FDI still accounts for a relatively small share of total investment amongst second-tier NIEs.

The second-tier NIEs have been more willing to allow in wholly-owned foreign subsidiaries and have taken a somewhat less restrictive approach towards FDI. More liberal foreign investment laws were introduced, or their implementation accelerated, in the second half of the 1980s, a period which coincided with sharp shifts in the competitive position of firms in both Japan and the first-tier NIEs. As discussed in the previous chapter, the most strik-

ing development has been the mushrooming of FDI from the first-tier NIEs, which between them now have more direct investment in ASEAN-4 than does Japan.

Although Malaysia and Thailand, through their heavy reliance on FDI, have succeeded in high-technology exports, which in large part combine low-skill assembly activities with high-technology imported parts, both countries have yet to develop a diversified manufacturing base. In particular, their early orientation towards electronics contrasts with the slow development of most capital goods industries, such as iron and steel, non-electrical machinery, metal products and transport equipment. The continued heavy reliance on imports of both capital and intermediate goods suggests that the second-tier NIEs still have to embark on the kind of upgrading process in the medium technology sectors pursued earlier by the first-tier ones. Many of the elements of the technological infrastructure needed to allow domestic firms to compete in this middle range of exports are still missing.[25] These countries also have yet to put in place a well-developed local supplier network, incipient clusters of high-technology activities and an adequately trained workforce; nor do they have any significant industrial R&D, either within the enterprise system or in the public sector. Indeed, figures on R&D expenditure are particularly revealing; the second-tier NIEs are on this criterion still relatively poor performers among developing countries (devoting under 0.25 per cent of GNP to this purpose), falling considerably behind the first-tier NIEs.[26] Consequently, in the electronics sector in Malaysia, for example, the process of upgrading has been slow. In the absence of strong backward and forward linkages local firms continue to concentrate on the supply of secondary materials and services such as packaging and transportation.[27]

The evolution of industrial output and exports in the second-tier NIEs and their increasing reliance on FDI is currently raising concerns about an economic structure with insufficient technological and supply linkages between the TNC-dominated export sectors and the domestic economy. The predominance of simple assembly and finishing operations and the low level of technological capabilities have given rise to the fear that China, India, Viet Nam and other Asian countries with relatively low wage levels could eliminate these sources of growth momentum, unless measures are introduced to deepen the domestic industrial base and improve the quality of the labour force, management and infrastructure. The fact that in Malaysia and Thailand wage pressures can only be mitigated by large-scale immigration suggests that these economies may be having difficulty in achieving the necessary upgrading.[28]

As discussed above, without upgrading and raising the domestic value-added content of exports in industries dominated by foreign firms, FDI would tend to remain footloose and the economy would be highly vulnerable to interruptions of capital inflows. Concerns over such a possibility have been growing in Thailand, and even more in Malaysia, in view of their large current account deficits.

D. Upgrading and international competitiveness

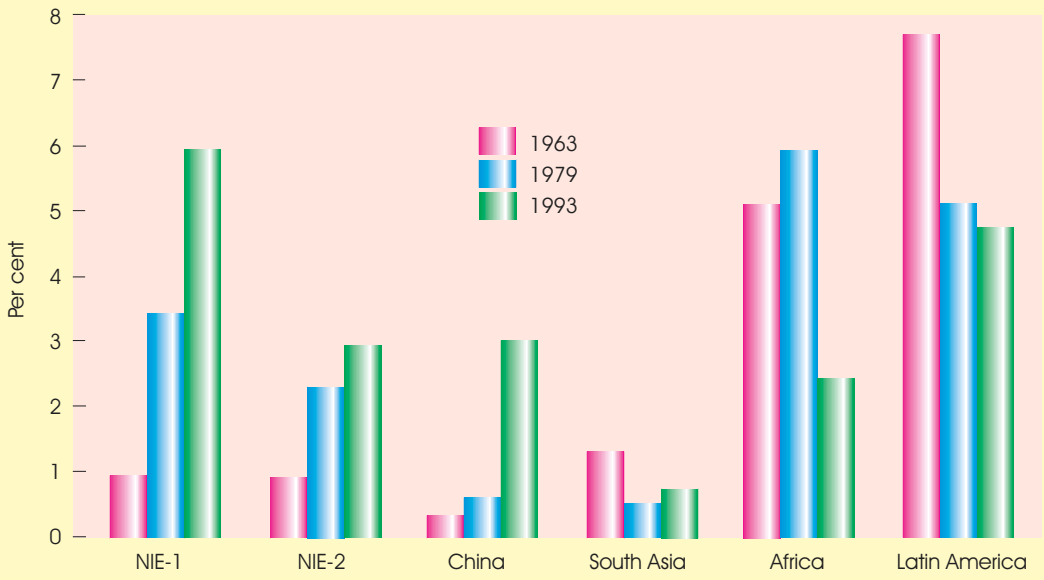
For most developing countries, entering and adapting to markets in the more advanced countries is crucial for establishing competitive industries and for successful upgrading. In this respect, both the first-tier and the second-tier NIEs have performed much more successfully than most other developing countries over the past three decades. While their shares in total OECD imports rose steadily from 1963 to 1993, those of all other developing regions have fallen (chart 5). The situation since 1979 has become even more dramatic: from 1979 to 1993 their combined share rose from 5.7 per cent to 8.8 per cent, whereas for Latin America the share declined further, from 5.1 per cent to 4.7 per cent.

A more detailed analysis, based on data of ECLAC's Comparative Analysis of Nations (CAN)

Chart 5

SHARES OF SELECTED REGIONS AND COUNTRIES IN TOTAL IMPORTS OF OECD COUNTRIES, 1963, 1979 AND 1993

(Percentage)



Source: ECLAC, Comparative Analysis of Nations data base.
Note: "NIE-1" comprises Hong Kong, Republic of Korea, Singapore and Taiwan Province of China.
"NIE-2" comprises Indonesia, Malaysia and Thailand.
"South Asia" comprises India and Pakistan.
"Africa" includes South Africa.

system,[29] indicates that the East Asian economies have been singularly successful in increasing their exports of products that are growing in importance in international trade. In 1990 about three quarters of their exports were in goods for which the share in total OECD imports had been expanding over the previous three decades. In contrast, the proportion for Latin America was only 38 per cent, and only 24 per cent if Mexico is excluded. There was, however, some difference between the first-tier and second-tier NIEs: 85 per cent of exports from the former were in expanding areas of trade, but less than 70 per cent from the latter, and under 40 per cent from Indonesia alone. Indeed, as is suggested by the figures in table 38, the second-tier NIEs, in this respect, resemble more closely non-Asian NIEs, such as Mexico, Tunisia, Morocco and Turkey. Moreover, while in the Republic of Korea and Taiwan Province of China greater competitiveness in such dynamic products is based primarily on indigenous capacity, in other Asian NIEs, as well as in Mexico, greater penetration[30] of OECD markets in these products is to a much larger degree a reflection of their participation in the international division of labour through TNCs.

Success in entering expanding areas of international trade may have resulted from a fortuitous endowment structure at the start of their export boom. In fact, in the early 1960s, the first-tier NIEs - with the exception of Hong Kong - were no better placed in what were to be the future growth markets than other developing countries. The Republic of Korea, for example, had only 21 per cent of its exports in these products in 1963, while Taiwan Province of China and Singapore had less than 10 per cent.

A more detailed analysis of export dynamics, focusing on 20 product groups (at the three-digit

Table 38

SECTORAL ORIENTATION OF EXPORTS OF SELECTED DEVELOPING COUNTRIES IN 1990

(Share in total exports of exports in fast-growing OECD import sectors[a])

Country		Country	
Hong Kong	91.0	Mexico	61.2
Taiwan Province of China	83.9	Tunisia	57.9
Singapore	83.3	Morocco	49.8
Republic of Korea	82.0	Turkey	49.4
		Brazil	35.5
Thailand	66.7	Argentina	20.9
Malaysia	60.8	Colombia	16.0
Indonesia	39.5	Chile	12.3

Source: ECLAC, Comparative Analysis of Nations data base.

a A fast-growing OECD import sector is defined as one in which imports into OECD countries as a proportion of total OECD imports rose from 1963 to 1990.

SITC level) which had the most rapidly rising shares of OECD imports in 1963-1990 confirms these broad tendencies.[31] The first-tier and the second-tier NIEs have, in general, been more successful than other developing countries in moving into these products. The contrast with the Latin American region is particularly striking. In 1963 Latin America accounted for 15 per cent of all OECD imports in what were then the 20 leading product groups (i.e. had the greatest share in 1963 OECD imports), or for 60 per cent of all developing country exports of these products.[32] However, Latin America has not adapted to the change in import structure of the advanced economies. Its share in 1993 of the 20 most dynamic products stood at only 2.5 per cent of total OECD imports of such goods, and only 16 per cent of total developing country exports. Over the same period, East Asia's share rose from under 1 per cent to 10 per cent, and accounted for 64 per cent of total developing country exports by the end of the period.

Another way of looking at the matter is to compare the structure of exports in 1963 and 1990. Taking the 20 leading product groups in the earlier year, it is clear that they comprised mainly resource-based and low-skill goods. The overlap of this group of products with the most dynamic products (i.e. those listed in note 31 above) is small, involving only four product groups. A comparison with the export structure in 1990 shows that the East Asian NIEs have successfully moved away from the group of leading products in 1963, while Latin America has remained with the older pattern of trade that limited the opportunities to establish a virtuous export-investment-growth nexus.

From this perspective, differences between the first-tier and the second-tier East Asian NIEs are also brought into sharper focus. In terms of both their penetration of OECD markets in these 20 dynamic products and their share in total exports to those markets, the second-tier NIEs lagged slightly behind the first-tier ones in 1963, with both groups of countries being of marginal importance, like other developing regions.[33] By 1993, the second-tier NIEs had overtaken other developing regions, but the gap between them and the first-tier NIEs had widened considerably. The widening of the gap was most marked in the period up to the late 1970s, and has since narrowed (especially since the early 1980s, when the second-tier NIEs made significant gains). As already noted, this jump is closely associated with rapid flows of FDI into the second-tier NIEs during the 1980s. Nevertheless, these figures broadly confirm that the kind of upgrading needed to maintain their catching-up process still lies ahead for these economies.

International trade can expand for different reasons and with vastly different implications for the longer-term growth of national economies. In particular, trade liberalization in otherwise fairly sluggish markets is likely to stimulate imports in OECD countries, but it has very different implications for long-term growth than import expansion due to strong growth of domestic demand. In this respect it is useful to consider the income elasticity of demand for the most dynamic products. On the basis of available data, imports of goods in most of the 20 product groups studied above (i.e. those that were the most dynamic in the last three decades) appear to be income-elastic in OECD countries, the principal exception being aircraft and associated equipment, for which the market is rather specialized. Interestingly, a number of traditional low-skill exports, such as textiles and toys, show a relatively high income elasticity. However, many of the products involved are in high-technology sectors; from 1963 to 1993, high-tech imports into OECD countries grew by over 180 per cent, compared to only 40 per cent for medium-technology goods and a decline of 12 per cent for low-technology goods.

Although these figures must be interpreted with caution in view of the heterogeneity of products which fall under these broad classifications, it would appear that the East Asian economies have been far more successful than other developing economies in entering markets for products with high income elasticities of demand. While 9 of the 10 leading exports from the first-tier NIEs to OECD in 1993 were income-elastic, there were only 2 in Latin America. However, there is a significant difference between the first-tier and second-tier NIEs. For Thailand, 5 of the 10 leading exports to OECD markets, accounting for 18 per cent of export earnings, were income-elastic, and for Malaysia there were only 3 (although they accounted for over 26 per cent of total exports). For both the Republic of Korea and Taiwan Province of China there were 8 such products, accounting for over 36 per cent and 41 per cent of exports, respectively.

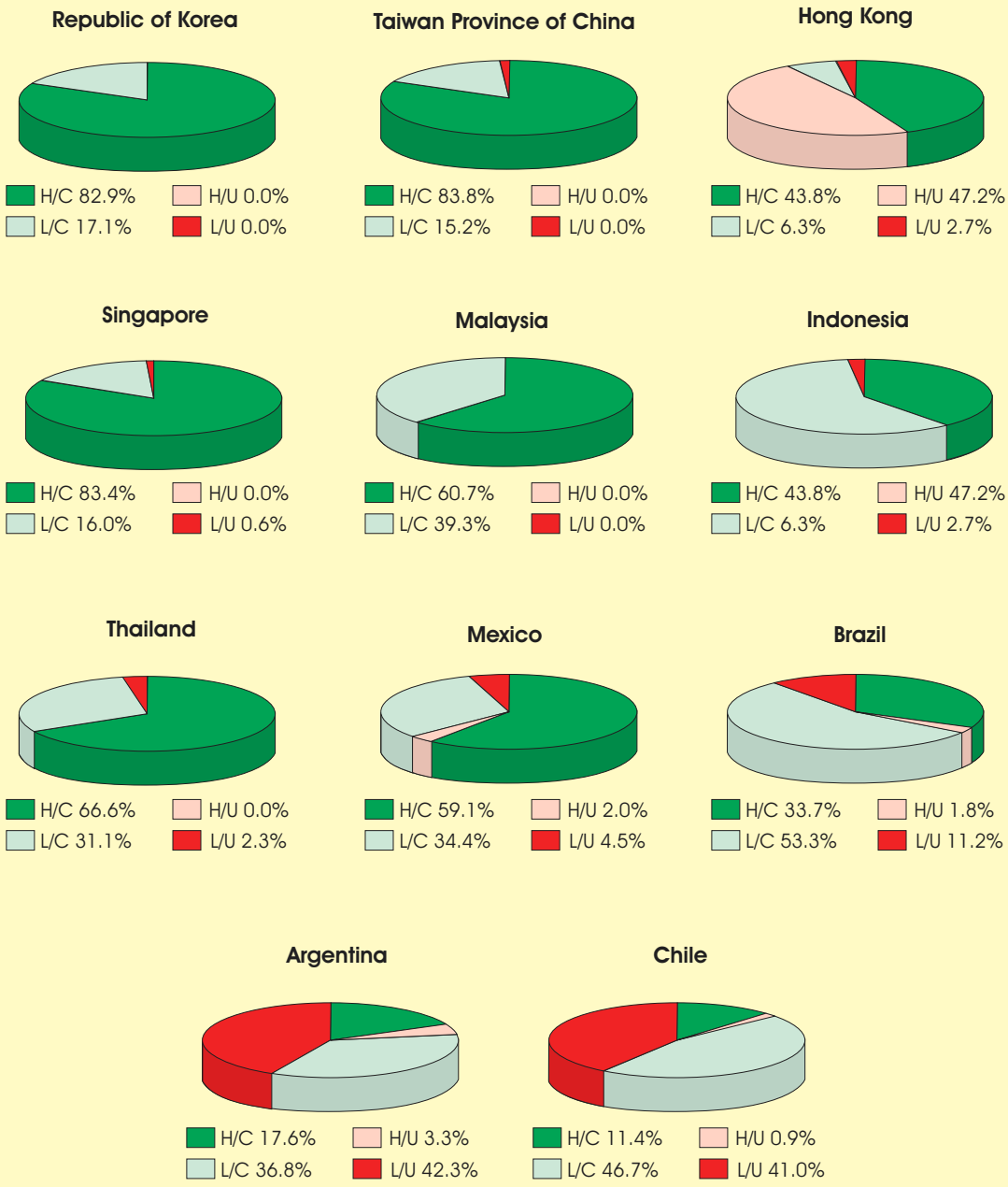
It is possible to combine market dynamics with changes in market penetration in determining a country's position in international trade. A dynamic/competitive position is one where a country's share is rising in a market for a dynamic product, and a dynamic/uncompetitive position is one where it is falling. Similarly, a country's share may be rising or falling in markets for less dynamic or declining products. Certainly, a country has various positions in different markets and products. One which is constantly upgrading and gaining market shares in dynamic products is likely to have low or falling shares in less dynamic or declining products. If it loses share in the latter products without gaining elsewhere, it is certainly being marginalized in international trade. In contrast, a country gaining shares in the less dynamic or declining products may see its exports lose steam over time if it fails to move into more dynamic ones. Finally, as noted in chapter I above, a maturing, post-industrial economy can be expected to lose shares in dynamic markets.

As noted above, a large proportion of exports of the East Asian NIEs is concentrated in fast-growing dynamic products (see table 38). An examination in terms of the 20 most dynamic products shows that, with the exception of Hong Kong, all Asian NIEs increased their shares of OECD markets during 1963-1990 in almost all these products. The dynamic/competitive position of the first-tier NIEs is particularly striking if these 20 products are further divided into two categories, "highly dynamic" and "less dynamic", according to the growth rates in OECD import markets. Hong Kong has been losing its market share in almost half of the highly dynamic products it exports, in which it had earlier built a strong market presence, indicating that it has been falling behind the other first-tier NIEs in upgrading (see chart 6). The second-tier NIEs have a closer balance between highly dynamic and less dynamic products; in particular, Indonesia has been enlarging its market shares more in the latter than in highly dynamic products. As already noted, the apparent success of Malaysia and, to a lesser extent, Thailand in raising their market shares in highly dynamic goods is linked to their participation in the new production strategies of TNCs.

The contrast with Latin America is striking. Not only is the share of Latin America in the 20 products smaller than that of East Asia, but also two thirds of exports are in less dynamic products. Interestingly, Chile, a successful export-oriented Latin American economy over the past decade, does not resemble the second-tier East Asian NIEs, with which it is often compared. More than four fifths of its exports are in less dynamic products, in about one half of which its competitiveness has been increasing while in the other half it has been decreasing. Chile thus appears to have been restructuring its exports within the more sluggish

Chart 6

DYNAMISM AND COMPETITIVENESS OF EXPORTS FROM SELECTED ASIAN AND LATIN AMERICAN DEVELOPING COUNTRIES, 1990



Source: ECLAC, Comparative Analysis of Nations data base.
Note: H/C: highly dynamic/competitive position (rising market share for highly dynamic products);
L/C: less dynamic/competitive position (rising market share for less dynamic products);
H/U: highly dynamic/uncompetitive position (falling market share for highly dynamic products);
L/U: less dynamic/uncompetitive position (falling market share for less dynamic products).
For further explanation see text.

sectors, rather than upgrading in favour of more dynamic products. The situation is much the same for Argentina, whereas Mexico and Brazil have been gaining market shares in both less dynamic and highly dynamic products. The export structure in these two countries, particularly Mexico, is much closer to that of the second-tier NIEs than in Chile and Argentina.

E. Export-oriented development strategies in the East Asian NIEs[34]

The economic transformation of East Asia has not been a spontaneous process. It cannot be explained by a peculiarly favourable set of initial conditions in these countries, nor has it been driven solely, or even mainly, by market incentives and disciplines. Rather, Governments in all countries of the region have pursued policies aimed at restructuring the market in ways that reduce the uncertainty surrounding the achievement of specific development goals.[35] These policies have been designed to address not only market failures, but also a number of problems stemming from the organization of industry (particularly in relation to scale economies and the supply of entrepreneurial capabilities), the structure of public institutions (particularly in relation to the provision of public goods) and rent-seeking behaviour. At the core of East Asian success lies a set of institutions which keep policymakers connected to business while still enabling Governments to propose and implement appropriate measures directed at tackling a series of interrelated institutional and structural obstacles that can seriously hold back the process of investment, technological progress and exporting in a late-industrializing country.[36]

1. Investment policies

East Asian Governments have successfully guaranteed certain basic conditions for capital accumulation by creating a pro-investment macroeconomic environment. "Pro-investment" is a better description of East Asian macroeconomic policies than "stable" or "low-inflationary", because countries in the region have experienced, often for prolonged periods, large fiscal and current account deficits, financial repression and inflationary pressures. However, while policymakers have used monetary and fiscal measures to boost investor confidence they have also avoided extreme policy shifts, with all that such shifts imply for volatility and uncertainty that could damage confidence.

Measures to stimulate investment have also included a number of incentives designed more specifically to boost profits above their free-market levels.[37] These measures fall into two broad categories. First, in all these countries, a range of fiscal instruments, including tax exemptions and special depreciation allowances, have been used to augment corporate profits and encourage their retention in order to accelerate capital accumulation. Such fiscal measures were pioneered in Japan during the 1950s, were used extensively in the early stages of labour-intensive manufacturing in Taiwan Province of China, following the Statute for Encouragement of Investment introduced in 1960, and were employed with considerable success in the Republic of Korea to promote capital-intensive industries during the 1970s. Fiscal incentives were also introduced at an early stage in the second-tier NIEs. Malaysia's 1958 Pioneer Industrial Ordinance offered various tax incentives, and similar measures were introduced by Thailand's Board of Investment, established following passage of the Investment Promotion Act of 1959. Singapore, which became independent in 1965, has used an extensive array of fiscal incentives in efforts to promote investment in a range of industries with "pioneer status".[38]

Second, a combination of selective trade, financial and competition policies has been used to create "rents" which, by increasing profits, enhance the potential for corporate investment. In all the East Asian NIEs, with the exception of Hong Kong, protection, along with restrictions on competition

among domestic enterprises, has been an important source of rent for infant industries.[39] The degree and duration of protection have varied significantly among countries and sectors. In general, the first-tier NIEs appear to have been more selective in their use of such measures, while the second-tier ones followed, in their early stages of growth, a more conventional strategy of import substitution.

Controls on interest rates and direct allocation of credit have been a further type of instrument used for augmenting profits. Although such measures have been among the most successful in accelerating capital formation, the extent of their use and their impact varied considerably among countries according to the structure of domestic financial systems. The measures were used with particular success in Japan during the 1950s and 1960s through an "indirect finance method" whereby credit was mainly allocated by private sector financial institutions under government guidance. A similar arrangement between large conglomerates and a limited number of private banks privileged by the Government has been resorted to in Thailand.[40] In the Republic of Korea, directed credits were used to favour large domestic conglomerates in priority sectors, albeit under state control following the nationalization of the banking sector in 1961. State-directed credits were also used, with rather more mixed results, in Indonesia during the 1970s and 1980s.[41] Taiwan Province of China and Malaysia have been more cautious in using these measures, although in both cases sectors with large public enterprises have received preferential treatment, including direct allocations from the government budget.[42]

While these measures enhanced the role of corporate savings in capital accumulation, policymakers in East Asian NIEs did not believe that channelling resources into the hands of potential investors was enough. There was no guarantee that corporations would use them for productive investment, or that all the investments made would in the long run sustain rapid productivity growth. There was always the possibility that the resources would be used simply to increase luxury consumption. Consequently, East Asian Governments have severely restricted consumption of luxury goods, both directly through, for example, control of imports and of domestic production of like goods, and indirectly through high taxation and restrictions on consumer credit. They also tried to eliminate speculative investment opportunities by restricting capital flows during the initial stages of development.[43]

This mixture of incentives and disciplinary measures has created and sustained a dynamic investment-profits nexus in all the East Asian NIEs; high profits have enhanced the capacity of firms to invest, which in turn has increased profits by enhancing both rates of capacity utilization and the pace of productivity growth. However, an important difference between the first-tier and second-tier NIEs lies in the sectoral bias of policies supporting the investment-profits nexus. In the first-tier NIEs policies focused from an early date on manufacturing, initially in low-skill industries but shifting to more sophisticated industries as the economies matured. In contrast, the potential contribution of natural resource rents to economic growth in South-East Asia led policymakers to concentrate on strengthening the profit-investment nexus in the primary sector, while efforts to accelerate and deepen the investment process in import substitution industries were delayed or else implemented on a largely ad hoc basis.

2. Trade and industrial policies

Given the relative paucity of natural resources in the first-tier NIEs, it was evident that efforts to promote export industries would have to concentrate on labour-intensive manufactures, which enjoyed the advantage of relatively cheap, unskilled labour. However, the manufacturing sector was far from being competitive in foreign markets in terms of both price and quality, and during the 1950s Governments promoted exports through a variety of subsidies, including tariff rebates, tax exemptions, preferential export credits and export credit insurance. Although these measures produced mixed results, and indeed the export drive somewhat faltered in the Republic of Korea and Taiwan Province of China in the late 1950s and early 1960s, they provided the foundations for a reinforcement of such policies from the early 1960s, when measures to raise profits and investment also facilitated a more systematic promotion of manufactured exports.[44] Moreover, Governments were also obliged to exercise considerable discipline over business, in order to meet export targets, through tax penalties, withdrawal of import licences and reduced access to credit.

However, what distinguishes the role of government policies in the export-investment nexus in

East Asia, particularly in the first-tier NIEs, is not so much the concern to fully exploit gains from labour-intensive manufactures, but rather an anticipation of the future difficulties that these industries would face, including rising wages, limits to productivity growth, and constraints on demand expansion in export markets. Overcoming these difficulties required gradually and purposefully nurturing a new generation of industries, with greater potential for innovation, productivity growth and export dynamism. East Asian Governments have encouraged investment in a number of such industries at each stage of development, whenever they were deemed suitable for promotion, given existing technological and managerial capabilities.[45]

In addition to promoting investment, Governments, particularly in the first-tier NIEs, actively encouraged the establishment of a domestic capital goods industry. Measures applied included reinstituting import restrictions, rolling back tax exemptions on the import of certain intermediate and capital goods and granting higher investment tax credits to businesses purchasing domestically produced machinery. In addition, a policy was pursued of building up a technological capacity at the national, industry and even firm level. In the first-tier NIEs, tax and other incentives for enterprise training were complemented by a more detailed national training programme which placed greater emphasis on technical subjects at higher levels of education and on greater industry involvement in vocational training schemes. Measures to facilitate local R&D, including direct financial subsidies, particularly where projects were large and risky, have also been extensively used. In both the Republic of Korea and Taiwan Province of China, as well as more recently in the second-tier NIEs, regional policy has also been used to support technological upgrading and the diversification of industrial structure through, for example, science parks and special industrial estates.[46]

Concerned that investors might not adopt a sufficiently long-term perspective in upgrading industry, Governments throughout East Asia have assumed a more direct involvement in the investment process; among other measures, they have encouraged mergers and restricted entry into specific industries, promoted cartels for specific purposes such as standardization, specialization and exports, and undertaken direct public investment in industry. In some countries, notably in Japan and the Republic of Korea, these objectives have been pursued by powerful economic bureaucracies working in close collaboration with large domestic conglomerates. In Taiwan Province of China, Indonesia and Malaysia similar efforts at coordination have been pursued, but in the context of a large state industrial sector. However, coordination has not meant less competition. Market rivalry has often been intense and in most cases incentives to raise profits have been closely linked to performance standards.[47]

As industries built up technological and managerial capabilities and became internationally competitive, protection and other forms of support were gradually withdrawn. The range of incentives and disciplines was redesigned to push firms in these industries into the international market as the new generation of exporters which would earn the foreign exchange necessary for the import of capital goods needed by the succeeding generation of infant industries. As a result of this process, at any given time the East Asian economies have contained a spectrum of protectionist measures and export incentives for industries at varying degrees of maturity - a phenomenon which is often misleadingly described as a "neutral incentive regime". Hence there was not the conventional dichotomy between an import substitution strategy and export promotion strategy, as both were integral parts of a single strategy which aimed to accelerate investment and productivity growth in the long run and enhance the pace of innovation.[48]

Although this process of upgrading has been an ubiquitous one in East Asia, it has proceeded at a different pace and with differing degrees of success in individual countries. The economies of Hong Kong and Singapore were too small to support a wide range of scale-intensive heavy industries, and the scope for industrial policies was correspondingly much more limited. The pace of upgrading has nevertheless been much more rapid in Singapore than in Hong Kong, in large part because the former used a variety of market-supplementing policies to build up managerial and technological capabilities in support of its shift to high technology activities.[49] Despite the use of more detailed industrial policies in support of upgrading in Taiwan Province of China and the Republic of Korea, there are also instructive differences between the two. In particular, the absence of large domestic firms in the former economy, primarily due to political factors, has led industrial policymakers to concentrate their upgrading efforts on small- and medium-sized enterprises, on

the one hand, and state enterprises on the other, to an extent not found in the Republic of Korea. These differences are clearly reflected in their different export structures discussed above.

Moreover, it is important to recognize that mistakes were made in this process. However, policymakers were able to learn from these mistakes in subsequent efforts at upgrading. In the Republic of Korea, for example, upgrading in the textile industry in the late 1970s was hampered by policy measures which were biased against new entrants to the industry, particularly SMEs. Steps to correct these mistakes were taken in the late 1980s, enabling the textile industry to gain competitiveness in higher market niches thereafter. The experience acquired in this respect also proved of value in upgrading the electronics industry.[50]

In the second-tier NIEs, export diversification of primary products has received strong policy support through investment incentives and the funding of research in resource-based sectors.[51] However, although lagging behind the first-tier NIEs, their recent switch from primary exports suggests that they, too, have been using industrial policy to promote manufacturing exports beyond what market signals dictated. This switch began in Malaysia following adoption of the 1968 Investment Incentives Act but was pursued more systematically from the mid-1980s, when more generous incentives were given for manufacturing investments and exports.[52] In Thailand it began in the 1970s, when fiscal incentives and credit allocation measures were switched to the promotion of manufactured exports. In Indonesia it was delayed until the mid-1980s, when its traditional exports suffered from the oil price shock; exchange rate policy was then used as a major instrument.[53] However, in all these countries, and as discussed in more detail in the previous chapter, regional influences from Japan and the first-tier NIEs also played a very important role in the subsequent growth of manufactured exports, from the mid-1980s onwards.

Recently, the second-tier NIEs have switched to more selective industrial policies aimed at diversifying their output and developing a capital goods sector. Especially since 1988, Malaysia has made concerted efforts to move into higher value-added activities by deepening local supply linkages, revising its incentive schemes to encourage high-technology exports and strengthening the human resource base, including through training and R&D. Indonesia's efforts at upgrading have concentrated on the steel and aircraft industries. The results, particularly in aircraft, have been impressive; the state-owned aircraft producer has made considerable progress in achieving technological competence and broadening the skill base, and has shown remarkable ability to develop close business relationships with the world's leading aircraft producers, particularly through subcontracting. The rising share of scale-intensive exports is a clear result of these policies. However, the cost of these projects has been very high and the backward and forward linkages necessary for a more widely based and sustained development have yet to emerge; more recently, policymakers have identified a broader range of industries through which to pursue the upgrading process. Although Thailand has been the least aggressive of the three countries in pursuing industrial upgrading, efforts have been renewed since the late 1970s to strengthen the capital goods sector, including through increased protection. Moreover, industrial policy has become more firm- and industry-specific and involves greater conditionality. This switch has also coincided with efforts to improve the coordination of regional, industrial and investment policies that are reflected, for example, in the Eastern Seaboard Project.[54]

The challenge of industrial upgrading in the second-tier NIEs has led them in a policy direction pursued earlier in the first-tier. The measures used have provoked considerable debate about whether the beneficiary industries are strategically linked with the rest of the economy and are ones which can significantly advance industrialization efforts. Despite flaws in these policies, there can be little doubt that the extent of structural transformation achieved is well beyond what was possible by exclusive reliance on market forces and private initiatives. However, the measures have not been designed and implemented in the context of a broad-based industrial strategy or through a tailored institutional structure of the kind found in the first-tier NIEs, and there is still uncertainty about the future course of upgrading in these economies.

3. Foreign direct investment and technology policies

Major new industries, particularly in export sectors, cannot be easily - and sometimes not at all - established and developed without some form of technological and other help from companies in the advanced industrial countries. However, there are

different ways in which such help can be extended. Moreover, without appropriate measures to strengthen the domestic technological base, access to foreign technology is unlikely by itself to sustain rapid economic growth.

As discussed in greater detail in *TDR 1994*, both the Republic of Korea and Taiwan Province of China consciously chose to tap foreign capital in ways other than through FDI, a choice which also implied resort to other forms of technology transfer. Reverse engineering of imported goods, technology licensing and original equipment manufacture were all extensively used in the context of a strategy to support indigenous skills and technology development. Managerial and technical assistance from Japanese companies also played an important role. For instance, in the Republic of Korea a subcontracting relationship between Hyundai Heavy Industries and the Kawasaki Shipbuilding Company was accompanied by the supply of proven designs and the training of engineers and technicians both on site and in Japan. Similarly, Nippon Steel acted as an engineering consultant at a crucial stage in the development of POSCO, the state-owned steel producer. In both industries the country established world-class industries within the space of a decade.[55] Without such assistance, the task of catching-up would certainly have been far more difficult. However, in all such cases, the Government provided public information services as well as direct support to indigenous firms dealing with foreign firms exerting considerable market power in the area of technology transfer.

In the Republic of Korea where government measures to upgrade were focused on strengthening domestic capabilities, restrictions on FDI were commonly used to protect domestic conglomerates (*chaebols*). However, where it was permitted, FDI did play an important role, in particular as a source of foreign exchange in export processing zones; and the mere threat that it might be permitted in a particular sector was enough to discipline domestic producers. When FDI was allowed in, domestic content agreements and technology screening were extensively used, with full government support.[56] Similar measures were often also used in Taiwan Province of China, where, although the space between SMEs and the state sector left more room for TNC involvement, and so for a more flexible policy towards FDI, a list of industries where foreign investment was prohibited lasted until the late 1980s.

In both economies successful upgrading has, over the past decade, allowed a more liberal approach to FDI, in line with their higher levels of industrialization and the emergence of their own TNCs. In Singapore, which had a weak tradition of local entrepreneurship but a thriving, outward-looking entrepôt activity, export-oriented industrialization relied heavily on TNCs. However, policy subsequently targeted specific manufacturing and service activities, through a variety of incentives and the provision of training facilities and publicly funded R&D institutions, with the aim of attracting the right kind of TNC participation. In sharp contrast to policy in all three of these economies is the laissez-faire approach to FDI adopted by Hong Kong, which, as discussed above, has also been the least successful of the East Asian NIEs in upgrading. However, while Hong Kong continues to grow and prosper, it is doubtful whether it is an example for other developing countries to follow:

> In view of the exceptional initial circumstances of the territory, *laissez faire* would not by itself be sufficient to lead to the Hong Kong-kind of industrial or export development in typical developing countries. Furthermore, the lack of industrial deepening and the massive deindustrialization over time follow directly from its absence of industrial policy, and in the absence of a gigantic and thriving hinterland to service a similar policy would be deemed undesirable in other developing economies. In brief, the case does not conclusively establish a general case for fully liberal policies on trade or FDI.[57]

To date, the approach to FDI in the second-tier NIEs appears to have been closer to that of Hong Kong than the other first-tier NIEs, although recently the difference seems to have been narrowing. Export-oriented FDI was attracted from an early date into the primary sector, but efforts to draw it into manufacturing began only in the 1970s; they were intensified in the 1980s, with a series of fiscal incentives, relaxed ownership requirements and remittance laws and the establishment of export processing zones.[58] These measures, combined with strong regional dynamics, have generated the export growth discussed earlier in this chapter. However, only limited use has been made of other measures to gain access to foreign technology, and more dynamic industrial policies to establish stronger domestic industries have lagged, in part due to complex domestic political factors. In re-

cent years, partly as a response to concerns about such heavy reliance on FDI, more targeted measures have begun to be pursued that conform more to those adopted in the first-tier NIEs, including the use of local content agreements, more selective incentives to attract higher value-added activities and greater efforts to capture FDI spillovers in the areas of training and R&D.

F. Some policy lessons

Given the variety of experience in East Asia, it would be misleading to draw over-simplified conclusions and lessons for other countries. None the less, the structural changes underpinning these experiences are broadly familiar from over two centuries of industrial development. What distinguishes these economies from earlier industrialization is the very rapid pace of change which has been sustained over several decades.

Certainly, the tendency in recent years to polarize the development challenge into a series of opposing choices - State versus market, outward- versus inward-oriented development, investment-led versus export-led growth - finds little justification in this experience. Most of these economies have pursued an export-oriented strategy combined with varying degrees of domestic protection, and they have done so for familiar reasons - in particular, to meet the balance of payments constraint which in many other developing countries has throttled rapid economic growth. But in addition, upgrading export structures in line with shifts in competitiveness has been an integral part of broader efforts to deepen industrial and technological capabilities.

The world market has been one important source of discipline over this process. However, successful upgrading has not been the spontaneous outcome of market forces. Rather, from the discussion in this and the previous chapter, it is possible to conclude that rapid economic growth involved a mix of economic policies to accelerate and coordinate investment and promote exports. These policies were designed and implemented in a variety of ways, so as to accommodate different levels of economic development, different resource endowments and different macroeconomic circumstances.

Even in the initial stages of industrialization, where export opportunities were in low-skill manufactures, low wages and existing factor proportions were not seen as the basis for sustained growth. Rather, enhancing productivity was an integral part of export promotion at this stage. However, in view of the balance of payments constraint and the limits on exporting manufactures embodying low levels of skill, a sophisticated infant industry programme was implemented relatively early in the industrialization process so as to begin building up capacity and know-how in sectors producing more skill-intensive consumer goods, capital goods and intermediate goods. Differences in the design and implementation of these programmes explain much of the variation in economic performance, particularly between the first-tier NIEs and second tier. In some cases, as in Singapore, particular emphasis was placed on human capital, while in others, as in Taiwan Province of China and Malaysia, the state sector played a central coordinating role; in yet other economies the State nurtured large private firms, often closely allied with the financial sector, as in the Republic of Korea and Thailand, so as to better pursue efforts to upgrade and diversify industrial output and exports. Because these new industries were destined to become the next generation of export industries, trade policy also began to be more entwined with technology and industrial policies. In East Asia this involved the timely shift in the incentive structure towards export promotion through changes in tariff policy and the linking of fiscal and credit support to export targets. In the most successful cases, liberalization measures have been sequenced so as to gradually increase the pressure from international markets to improve productive efficiency and product quality.

Because new skills and technology are embodied in new capital equipment, all such

programmes have gone hand-in-hand with a rapid pace of investment. However, policies in East Asia have evolved, with the growing sophistication of industrial activity becoming increasingly conditional on specific performance criteria in such areas as training and R&D. Over the longer term in the most successful cases, a denser network of private and public institutions responsible for the management of technological and organizational upgrading at all levels of society has evolved.

Efforts to strengthen domestic entrepreneurial and technological capacities have not evolved in isolation; using foreign technology has been an essential part of the catching-up process. The role of capital goods imports at crucial stages in the industrialization process has been important in all East Asian economies, but FDI has also been used successfully, so as to complement their domestic sources of growth by compensating for deficiencies in technology and in organizational skills. However, the role of FDI in the export-investment nexus proved to be a complex one. The extent of reliance on it varied considerably among countries and, because the assumption of automatic spillovers from foreign affiliates was rejected, a strategic approach, linking FDI to a wider national development strategy, particularly in relation to exporting and upgrading, has been followed. In this respect, the approach adopted towards domestic firms, involving a mixture of incentives and controls, was extended to foreign affiliates. None the less, the success of the larger first-tier NIEs in reducing their dependence on foreign capital in line with the successful upgrading of domestic capabilities distinguishes them from the experience so far of the second tier.

At the core of these successful development experiences lies a series of institutional ties and more informal individual networks that connect the public and private sectors, allowing information to flow between business and Government without compromising the ability of policymakers to propose and implement development goals even when they did not coincide with a narrow business interest. The term "developmental State" has been coined to describe the set of government institutions, capabilities and policies which have been responsible for this aspect of East Asian growth. However, competent government institutions did not construct an effective system of government-business relations without comparable private counterparts. In general, strengthening the domestic entrepreneurial class through raising profits and providing a series of incentives and controls to channel those profits into new investment projects, in particular those that were export-oriented and stood to benefit from official and officially assisted export promotion measures, have been essential elements in the development process in East Asia. ■

Notes

1 See *TDR 1992*, Part Three, chap. I, and G. Helleiner, *Trade, Trade Policy and Industrialization Reconsidered* (Helsinki: UNU/WIDER, Oct. 1995), World Development Studies, No. 6. For lessons that can be drawn from an earlier generation of, mainly European, late industrializers at the end of the last century, see P. Bairoch and R. Kozul-Wright, "Globalization myths: Some historical reflections on integration, industrialization and growth in the world economy", *UNCTAD Discussion Paper, No. 113* (Geneva, March 1996).

2 See, for example, J. Bhagwati, "Free trade: old and new challenges", *The Economic Journal*, Vol. 104, March 1994.

3 See J. A. Ocampo, "New Theories of International Trade and Trade Policy in Developing Countries", in M. Agosin and D. Tussie (eds.), *Trade and Growth: New Dilemmas in Trade Policy* (London: Macmillan, 1993).

4 On the links between trade and technological progress see G. Grossman and E. Helpman, *Innovation and Growth in the Global Economy* (Cambridge: MIT Press, 1991); World Bank, *World Development Report 1991: The Challenge of Development* (New York: Oxford University Press for The World Bank, 1991), chap. 5; D. Keesing and S. Lall, "Marketing Manufactured Exports from Developing Countries: Learning Sequences and Public Sup-

port", in G. Helleiner (ed.), *Trade Policy, Industrialization and Development: New Perspectives* (Oxford: Clarendon Press, 1992). Although traditional scale economies are an important element of an outward-oriented development strategy, evidence both on their presence and on the link between exports and productivity growth is not conclusive. See the various country studies in G. Helleiner (ed.), *Trade Policy and Industrialization in Turbulent Times* (London: Routledge, 1994).

5 This notion of a virtuous circle linked to manufacturing exports is closely associated with the work of the late Lord Kaldor. See N. Kaldor, "The Role of Increasing Returns, Technical Progress and Cumulative Causation in the Theory of International Trade and Economic Growth" in F. Targetti and A.P. Thirlwall (eds.), *The Essential Kaldor* (London: Duckworth, 1989).

6 See C. Freeman, "Interdependence of Technological Change with Growth of Trade and GNP", in M. Nissanke and A. Hewitt (eds.), *Economic Crisis in Developing Countries* (London and New York: Pinter, 1993).

7 There is indeed considerable evidence to show that the role of exports in financing imports is an important one, albeit one that varies significantly over time due to the availability of foreign exchange from other sources. See H.S. Esfahani, "Exports, imports and economic growth in semi-industrialized countries, *Journal of Development Economics*, Vol. 35, No. 1, 1991; H.G. Fung, B. Sawhney, W.C. Lo and P. Xiang, "Exports, imports and industrial production: evidence from advanced and newly industrializing countries", *International Economic Journal*, Vol. 8, No. 4, Winter 1994.

8 For sectoral savings see P. Honohan and I. Atiyas, "Intersectoral Financial Flows in Developing Countries", World Bank, *PPR Working Paper*, No. 164, March 1989. For further discussion of the investment-profits nexus see *TDR 1994*, Part Two, chap. I, sect. G.; Y. Akyüz and C. Gore, "The investment-profits nexus in East Asian industrialization", *World Development*, Vol. 24, No. 3, March 1996; A. Singh, "Savings, Investment and the Corporation in the East Asian Miracle", Study No. 9 prepared for the UNCTAD project on "East Asian Development: Lessons for a New Global Environment", sponsored by the Government of Japan (Geneva: United Nations, March 1996).

9 See D. McCarthy, L. Taylor and C. Talatti, "Trade Patterns in Developing Countries, 1964-1982", in P. Bardham, A. Fishlow and J. Behrman (eds.), *International Trade, Investment, Macropolicies and History: Essays in Memory of Carlos F. Diaz-Alejandro* (Amsterdam: North Holland, 1987); A. Maizels, "Commodity market trends and instabilities: Policy options for developing countries", *UNCTAD Review 1994* (United Nations publication, Sales No. E.94.II.D.19).

10 See *TDR 1991*, Part Two, chap. III; *TDR 1992*, Part Three, chap. I; and *TDR 1994*, Part Two, chap. I. The question of how best to manage this process provides the starting point for a "new" trade theory; see P. Krugman (ed.), *Strategic Trade Policy and the New International Economics* (Cambridge: MIT Press, 1986). Despite the adjective, the origins of this approach can be traced back to Adam Smith, Joseph Schumpeter, Allyn Young, Gunnar Myrdal and Nicholas Kaldor. On the relationship between the "old" and the "new" theories see J. Stiglitz "Comments on 'Toward a counter-revolution in development theory' by Paul Krugman", in *Proceedings of the World Bank Annual Conference on Development Economics 1991* (Washington, D.C.: The World Bank, 1992).

11 See J. Fagerberg, "Why Growth Rates Differ", in G. Dosi *et al.* (eds.), *Technical Change and Economic Theory* (London: Pinter, 1988); C. Freeman, *op. cit.*; S. Lall, " The Creation of Comparative Advantage: The Role of Industrial Policy" in Irfan ul Haque *et al.*, *Trade, Technology and International Competitiveness* (Washington, D.C.: The World Bank, 1995).

12 For an elaboration of these points, see UNCTAD, *Science and Technology in the New Global Environment: Implications for Developing Countries* (United Nations publication, Sales No. E.95.II.D.14) and I. ul Haque, *et al., op. cit.*

13 See UNCTAD, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9), p.229.

14 The research on FDI spillovers is surprisingly thin. For a recent survey see M. Blomström and A. Kokko, "Multinational Corporations and Spillovers", *CEPR Discussion Paper*, No.1365, London, April 1996.

15 See UNCTAD, *Science and Technology in the New Global Environment: .....*, p.22.

16 S. Ostry and M. Gestrin, "Foreign direct investment, technology transfer and the innovation-network model", *Transnational Corporations*, Vol. 2, No. 3, Dec. 1993.

17 Primary commodities accounted for 80 per cent of total exports in the Republic of Korea in 1955, the principal items being silk, rice, tungsten and iron ore. In Taiwan Province of China they accounted for nearly 90 per cent, the staple exports being sugar and rice.

18 See M. Mortimore, *Transforming Sitting Ducks into Flying Geese: The Mexican Automobile Industry*, No. 26 in the ECLAC series *Desarrollo productivo*, Santiago, Chile, 1995.

19 See A. Estache and J. Morisset, "Foreign investment and exports: correlation or causality? Evidence from over 70 LDCs" (Washington, D.C.: The World Bank and IFC, 1995), mimeo (first draft).

20 It is necessary to treat these figures with caution, since they refer to affiliates which often are joint ventures and so may include a large domestic contribution. For instance, according to some estimates, in 1986 foreign affiliates employed 11.4 per cent of

all manufacturing workers in Taiwan Province of China, but if the numbers are weighted by equity holdings, the share falls to 6.5 per cent. See Chi Schive and Jenn-Hwa Tu, "Foreign Firms and Structural Change in Taiwan", in E.D. Ramstetter (ed.), *Direct Foreign Investment in Asia's Developing Economies and Structural Change in the Asia-Pacific Region* (Boulder: Westview Press, 1991), table 6.6.

21 See C.H. Lee and E.D. Ramstetter "Direct Investment and Structural Change in Korean Manufacturing" in E.D. Ramstetter (ed.), *op. cit.*, p. 124, table 5.8.

22 For a detailed discussion of the measures adopted in the Republic of Korea during its first stages of industrial development see *White Paper on Foreign Investment* (Seoul: Economic Planning Board, 1981). On differences between the Republic of Korea and Taiwan Province of China in the approach to FDI, see S. Lall, "Industrial strategy and policies on foreign direct investment in East Asia", *Transnational Corporations*, Vol. 4, No. 3, Dec. 1995.

23 See UNCTAD, *World Investment Report 1995* ...., chap. V, sect. B.2(b).

24 S. Lall, *op. cit.*, pp.12-14.

25 For the Malaysian case, see R. Rasiah, *Foreign Capital and Industrialization in Malaysia* (London: Macmillan, 1995).

26 See UNCTAD, *Science and Technology in the New Global Environment: .....*, table 2.

27 See the ESCAP contribution, "Comparative Analysis of Development of the Export-oriented Electronics Goods Sector in Selected Countries of the ESCAP region", in UNCTAD, *Expansion of Trading Opportunities to the Year 2000 for Asia-Pacific Developing Countries: Implications of the Uruguay Round and Adaptation of Export Strategies* (United Nations publication, Sales No. GV.E.96.0.7).

28 For a recent discussion of this issue see "Vital and vulnerable", *Far Eastern Economic Review*, 23 May 1996.

29 The CAN system contains data for 239 product groups at the three-digit level of SITC, as from 1963, for the trade of 88 countries with OECD countries. The system provides various measures of competitiveness in OECD import markets. For a description of the system see ECLAC, *CAN*: *Analisis de la Competitividad de los Paises, Version 2.0* (LC/G.1863), Santiago, May 1995.

30 Throughout this section "market penetration" is used to indicate the share of a given product in imports of that product by OECD countries.

31 These 20 product groups (and their SITC/Rev.2 code) were: medicinal and pharmaceutical products (541); polymerization and copolymerization products (583); paper and paperboard (641); internal combustion piston engines and parts thereof (713); non-electric parts and accessories of machinery (749); automatic data processing machines and units thereof (752); parts and accessories of office machines and automatic data processing machines (759); telecommunications equipment other than television and radio-broadcast receivers and gramophones, and parts and accessories for telecommunications and sound recording and reproducing apparatus and equipment (764); thermionic, cold cathode and photo cathode valves and tubes, etc. (776); electrical machinery and apparatus (778); passenger motor cars and other passenger vehicles (781); parts and accessories of motor vehicles (784); aircraft and associated equipment and parts thereof (792); furniture and parts thereof (821); outer garments, women's, girls' and infants' textile fabrics (843); outer garments and other articles, knitted or crocheted (845); footwear (851); measuring, checking, analysing and controlling instruments and apparatus (874); baby carriages, toys, games and sporting goods (894); special transactions and commodities not classified, according to kind (931).

32 The 20 leading product groups (excluding fuels) in 1963 (and their SITC/Rev.2 code) were: meat and edible meat offals (011); wheat and meslin (041); fruits and nuts (057); sugar and honey (061); coffee and coffee substitutes (071); alcoholic beverages (112); wood products, simply worked (248); pulp and waste paper (251); cotton (263); wool and other animal hair (268); iron ore and concentrates (281); ores and concentrates of base metals (287); paper and paper board (641); textile yarn (651); iron and steel bars, rods, etc. (673); universals, plates and sheets of iron and steel (674); copper (682); passenger motor vehicles (781); parts and accessories of motor vehicles (784); and special transactions and commodities not classified according to kind (931).

These product groups accounted for 30 per cent of all OECD imports in 1963, whereas the dynamic groups listed in note 31 accounted for 35 per cent of all OECD imports in 1993. It is interesting to note that the 1963 list contains 12 groups that consist of primary commodities, whereas the 1993 list does not contain any such groups.

33 In terms of market penetration of these 20 leading product groups, the first-tier NIEs accounted for 0.05 per cent of OECD imports, the-second tier for 0.03 per cent and Latin America for 0.4 per cent. In terms of their share of total exports to OECD they accounted for 2.1 per cent, 0.6 per cent and 1 per cent, respectively.

34 For a more detailed discussion of some of the issues considered in this section see *TDR 1994*, Part Two, chap. I.

35 On Japan as a model in this respect see D.I. Okimoto, *Between MITI and the Market* (Palo Alto: Stanford University Press, 1989).

36 See Irfan ul Haque *et al.*, *op. cit.*. The question of institutional reform is addressed in greater detail in a number of papers prepared for the UNCTAD Conference on "East Asian Development: Lessons for a New Global Environment" referred to in note 8. See, in particular, the papers by A. Singh, "Sav-

ings, Investment and the Corporation in the East Asian Miracle"; K.S. Jomo, "Lessons from Growth and Structural Change in the Second-tier South-East Asian Newly Industrializing Countries"; and T-J. Cheng, S. Haggard and D. Kang, "Institutions, Economic Policy and Growth in the Republic of Korea and Taiwan Province of China".

37 The discussion which follows generally refers to measures to stimulate overall investment, regardless of source. Countries have also provided incentives specifically to FDI. There is little evidence, however, that these incentives have had any major impact on the investment decisions of TNCs.

38 See V. Tanzi and P. Shome, "The Role of Taxation in the Development of East Asian Economies", in T. Oto and A. O. Krueger (eds.), *The Political Economy of Tax Reform* (Chicago, Ill: Chicago University Press, 1992).

39 As with many other related policies, Japan was the first to pursue such measures. See K. Yamamura, "*Caveat Emptor*: The Industrial Policy of Japan" in P. Krugman (ed.), *Strategic Trade Policy and the New International Economics* (Cambridge, Mass: MIT Press, 1986).

40 See M. Rock, "Thai industrial policy: How irrelevant was it to export success?", *Journal of International Development*, Vol. 7, No. 5, 1995.

41 See A. MacIntyre, "The Politics of Finance in Indonesia: Command, Confusion and Competition", in S. Haggard *et al.* (eds.), *The Politics of Finance in Developing Countries* (Ithaca, NY: Cornell University Press, 1993); S. Sen, "Growth Centres in South-East Asia in the Era of Globalization", a forthcoming UNCTAD *Discussion Paper*.

42 See D. Rodrik, "Getting intervention right: How South Korea and Taiwan grew rich", *Economic Policy*, No. 20, April 1995; S. Sen, *op. cit.*

43 See Ha-Joon Chang, *The Political Economy of Industrial Policy* (Basingstoke: Macmillan, 1994) and Yung Chul Park and Chi-Young Song, "Managing Capital Flows: The Experiences of Korea, Thailand, Malaysia and Indonesia", in UNCTAD, *International Monetary and Financial Issues for the 1990s. Research Papers for the Group of Twenty-four*, Vol. VIII (forthcoming).

44 In the Republic of Korea in the early 1960s, for example, a series of institutional reforms were introduced, such as establishment of the Korea Trade Promotion Corporation, a monthly export promotion conference and the export-targeting system. See S. Haggard *et al.*, "Policy Reform in Korea", in R.H. Bates and A.O. Krueger (eds.), *Political and Economic Interactions in Economic Policy Reform: Evidence From Eight Countries* (Oxford: Blackwell, 1993).

45 This type of intervention has been obscured by arguments about the effectiveness of industrial policy in countries at a more advanced stage of development. Unlike developed countries, most developing countries do not initially operate at the technological frontier of international best practice. Consequently, promoting industrial development has not involved "picking winners" in an uncertain technological race based on innovation. For a more detailed account and review of the extensive literature on the experience of the first-tier NIEs in coordinating new investment initiatives, see *TDR 1994*, Part Two, chap. I.

46 S. Lall, "The Creation of Comparative Advantage: The Role of Industrial Policy" in I. ul Haque *et al.*, *op. cit.*; and the papers on the Republic of Korea by Linsu Kim and on Taiwan Province of China by Chi-Ming Hou and San Gee in R. Nelson (ed.), *National Innovation Systems: A Comparative Analysis* (New York: Oxford University Press, 1993).

47 See A. Singh, "The causes of fast economic growth in East Asia", *UNCTAD Review 1995* (United Nations publication, Sales No. E.95.II.D.23).

48 See M. Kagami, *The Voice of East Asia: Development Implications for Latin America* (Tokyo: Institute of Developing Economies, 1995); and L. K. Mytelka, "Learning, Innovation and Industrial Policy: Some Lessons from Korea", in M. Storper, G. Thomadakis, and H. Tsipouri (eds.), *Industrial Policies for Latecomers* (London: Routledge, forthcoming in 1997).

49 See S. Lall, "Creating comparative advantage: country experiences, in I. ul Haque *et al., op. cit.*

50 See L. Mytelka, *op. cit.*

51 See the report by the UNCTAD secretariat, "Analysis of National Experiences in Horizontal and Vertical Diversification, including the Possibilities for Crop Substitution: Malaysia" (UNCTAD/COM/73), Geneva, December 1995; J. Mayer, "Learning sequences and structural diversification in developing countries", *Journal of Development Studies* (forthcoming).

52 See S. Lall, "Malaysia: Industrial success and the role of government ", *Journal of International Development*, Vol. 7, No. 5, 1995; R. Rasiah, *op. cit.*

53 See Y. van der Meulen Rodgers, "Indonesia's macroeconomic and trade performance", *The Journal of Developing Areas*, Vol. 30, No. 2, Jan. 1996; H. Hill, "Indonesia: from `chronic dropout' to `miracle'?", *Journal of International Development*, Vol. 7, No. 5, 1995.

54 The various policies described in this paragraph are set out in more detail in the relevant country studies contained in Part III of UNCTAD, *Expansion of Trading Opportunities to the Year 2000 for Asia-Pacific Developing Countries: National Strategies and Institutional Frameworks for Export Expansion* (New York: United Nations, 1995).

55 For an elaboration see A.H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989), chaps. 11 and 12.

56 For a description of this policy up to the early 1980s, see Economic Planning Board, White Paper on Foreign Investment (*Oegoogin Tooja Baesuh*) (Seoul: Government of Korea, 1981).

57 S. Lall, "Industrial strategy and policies on foreign direct investment in East Asia", *Transnational Corporations*, Vol. 4, No. 3, Dec. 1995, p.12.

58 In Malaysia, for example, for companies which export more than 80 per cent of production, there is no requirement for local equity participation, but that requirement increases as the export share falls.

Annex to chapter II

NATURAL RESOURCES, PROCESSING AND EXPORT DIVERSIFICATION

Differences among countries in natural resources and the quality of the labour force raise the question of to what extent these factors can explain the varying success of developing countries in diversifying their exports; and to the extent that they do so, should strengthening the human resource base, rather than trade and industrial policies, be the main concern of development policy in developing countries that are well endowed with natural resources?

The results of a cross-section regression for 80 developed and developing countries of the composition of their exports on their human capital and natural resources suggest that these variables are important in determining the composition of their trade.[1] In particular, being rich in natural resources and having a poor human-resource base appears to be detrimental to export diversification away from unprocessed commodities. But evidence on the link between processing and diversification in the primary sector and trade policy is not conclusive. Nevertheless, a possible conclusion from these findings is that economies that are well endowed with natural resources, rather than viewing this endowment as an obstacle to industrialization, should try to manage better the export proceeds it procures them and, where possible, engage in semi-processing for export by strengthening their stock of human capital and liberalizing trade. This is sometimes seen as replicating the experience of the second-tier East Asian NIEs.[2]

However, because a combination of rich natural resources and a well developed human resource base does not automatically lead to export diversification, the specific policy measures needed to facilitate diversification merit more careful attention. A comparison of East Asian and Latin American experiences - regions with comparable human resources - with export diversification in a number of areas can illustrate this point.

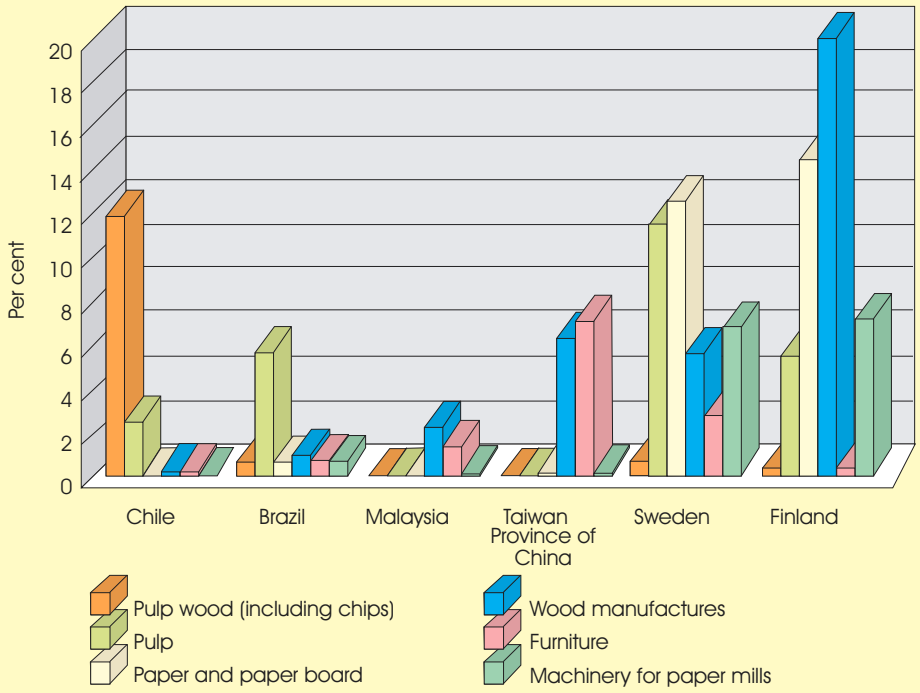
Part A of chart A-1 shows the differences in export structure in timber-related industries among a group of countries in each of these two regions that have important timber-related exports. The industries included involve activities (product groups) with varying degrees of processing, from pulpwood and chips, through pulp, paper and paper board, and wood manufactures to furniture, as well as the related industry of machinery for paper mills. Longer-run market prospects and productivity growth vary directly with the degree of processing involved in these activities. The chart shows, for each exporting country, its percentage share, for each of the product groups, in OECD imports. It can be seen that, while Chile's exports to OECD are almost entirely concentrated at the lower end of processing (pulpwood, especially chips, and some pulp) and those of Brazil on pulp, Malaysian forestry exports consist entirely of plywood and furniture. Taiwan Province of China has an export structure similar to Malaysia, although its exports, in contrast to the other countries considered, are based almost entirely on imported timber. The chart also shows the export structure of two temperate zone timber producers (Finland and Sweden), which is highly diversified in favour of more processed products.

Export structures are similar for iron-related industries (iron ore and concentrates, iron and steel,

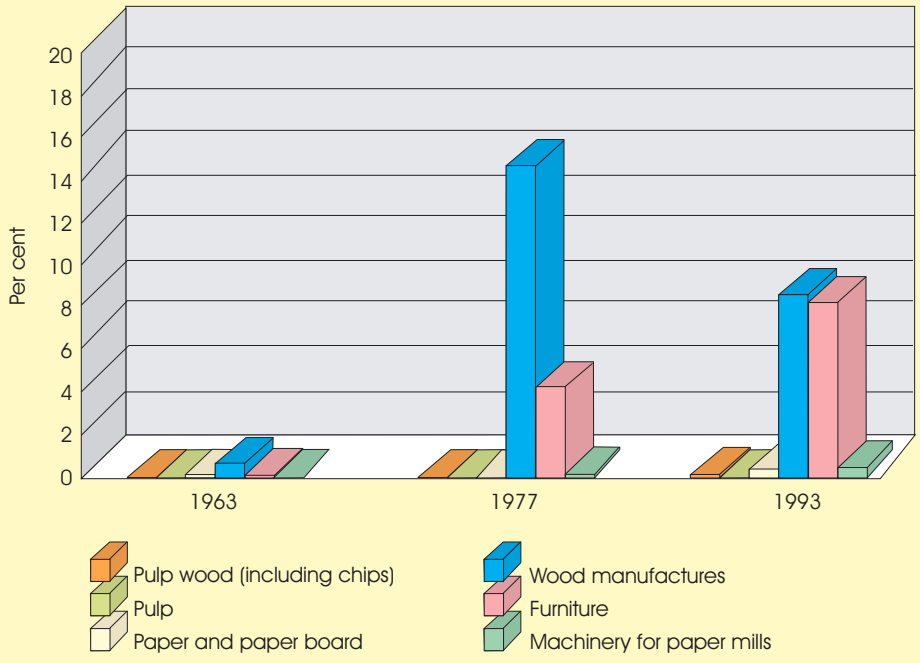
Chart A-1

EXPORT DIVERSIFICATION IN SELECTED COUNTRIES IN TIMBER-RELATED INDUSTRIES

A. Share in OECD imports of timber-related products, 1993
(Per cent)



B. Combined share of Malaysia and Taiwan Province of China in OECD imports of timber-related products, a comparison of 1963, 1977 and 1993
(Per cent)

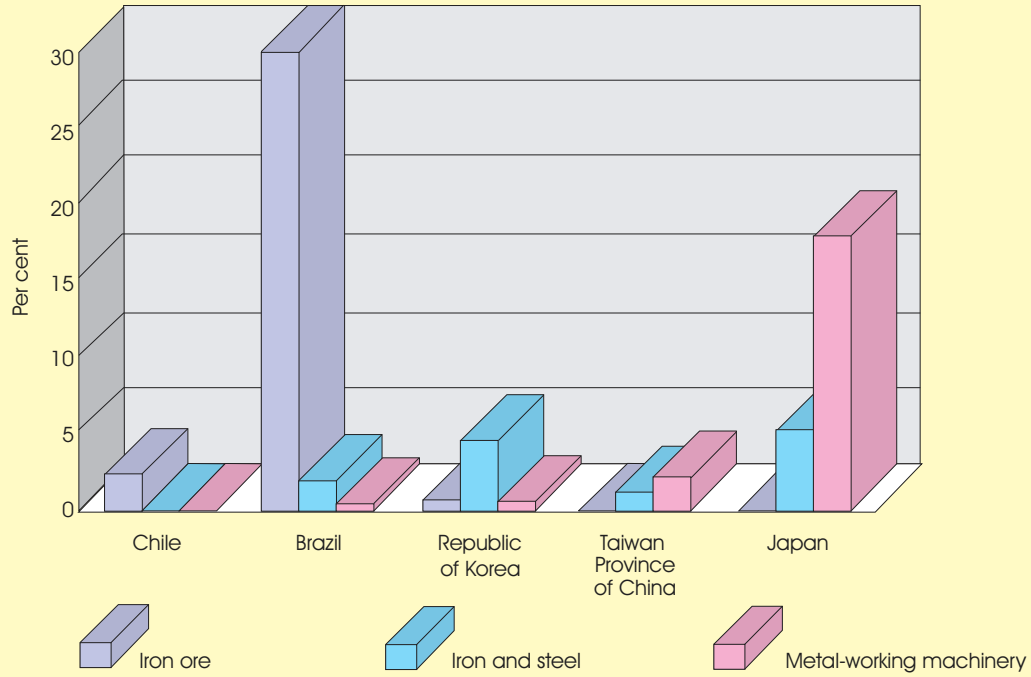


Source: ECLAC, Comparative Analysis of Nations data base.

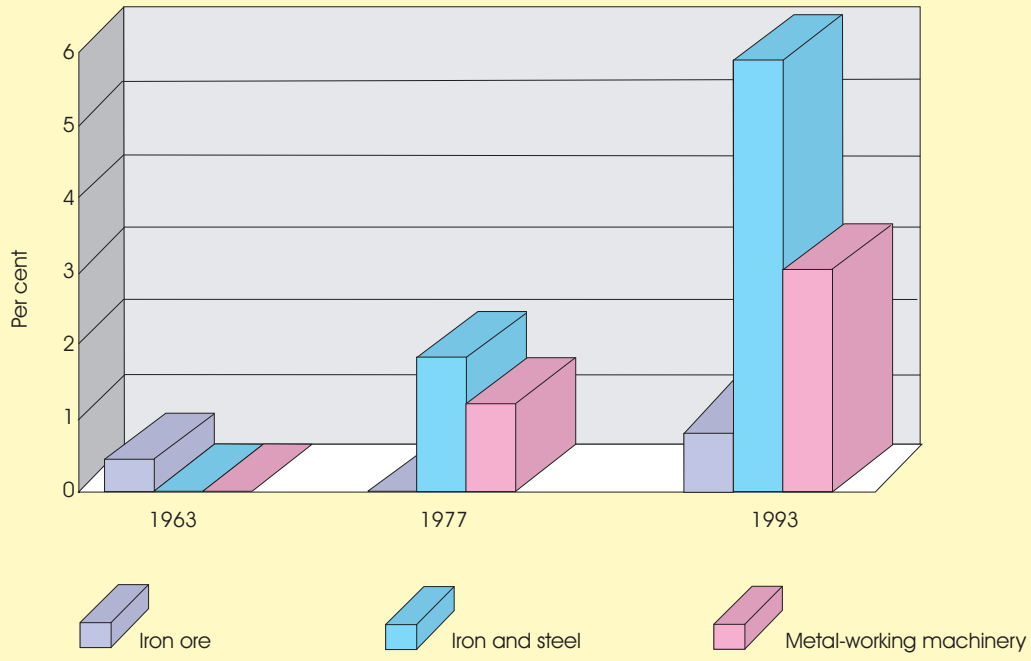
Chart A-2

EXPORT DIVERSIFICATION IN SELECTED COUNTRIES IN IRON-RELATED INDUSTRIES

A. Share in OECD imports of iron-related products, 1993
(Per cent)



B. Combined share of the Republic of Korea and Taiwan Province of China in OECD imports of iron-related products, a comparison of 1963, 1977 and 1993
(Per cent)



Source: ECLAC, Comparative Analysis of Nations data base.

and metal-working machinery), with again significant differences between the East Asian and the Latin American countries (see part A of chart A-2). These differences obviously cannot be explained in terms of human capital. Rather, the advantage of East Asian economies was gradually built up over time through a process of industrial upgrading. Part B of chart A-2 illustrates how the export structure in the Republic of Korea and Taiwan Province of China, taken together, has changed since 1963 as a result of this upgrading.

To explain these differences in export diversification, it is necessary to examine the nature of technological progress in these sectors. In particular, the technology required for natural-resource-based development is often determined by specific local production conditions. Under these circumstances a case can be made for R&D policies that take full account of the concerns of local producers. Moreover, the close link between technology and skill formation also means that training at the enterprise level is likely to be important. Consequently, export diversification requires appropriate technology and training policies so as to improve the technological, managerial and organizational capacities of domestic producers; technology transfer from developed countries may be a complement to, but rarely a substitute for, these efforts.

An example where indigenous primary sector research-based technologies have been developed is Malaysia, in particular in palm-oil and cocoa production but also in timber-related processing activities. Two characteristics of Malaysia's strategy are worthy of note: R&D has often been financed by specific taxes or duties on production and/or exports; and there has been close public-private cooperation in terms of both the funding and the organization of R&D activities.[3] For the timber industry, these efforts have been complemented by export promotion policies as well as by restrictions on log exports. As regards the iron and steel industries of the Republic of Korea and Taiwan Province of China, industrial policies have been instrumental in the upgrading process, including technical assistance in the use of imported technology, R&D to promote technological and managerial upgrading, and labour training schemes. In both economies close collaboration between the private and public sectors seems to have been a critical element.[4] Perhaps just as telling, the recent success of Chile in diversifying its agricultural exports has also involved a more interventionist type of industrial policy than was extended to its timber and metal-based sectors[5]. ■

Notes

1 See J. Mayer, "Is having a rich natural-resource endowment detrimental to export diversification?" (UNCTAD/COM/RDS/5), Geneva, April 1996.

2 See, for example, *Global Economic Prospects and the Developing Countries, 1996* (Washington, D.C., The World Bank, 1996), chap. 4.

3 See UNCTAD, "Analysis of national experiences ...." (UNCTAD/COM/73).

4 On the upgrading of iron and steel in the Republic of Korea see A. Amsden, *Asia's Next Giant* ...; on Taiwan Province of China see R. Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, N.J.: Princeton University Press, 1990).

5 See World Bank, *op. cit.*, p.54.

Chapter III

RESPONDING TO THE NEW GLOBAL ENVIRONMENT

A. Introduction

The East Asian experience examined in the two previous chapters offers some interesting lessons on how poor economies dependent on natural resources can make an effective transition to labour-intensive manufacturing, and then to more complex manufacturing industries essential for the attainment of high standards of living. Export orientation has played an important role in this process. In their early stages of industrialization, the first-tier NIEs of the region depended crucially on rapid growth of exports of labour-intensive manufactures to major industrial countries. This allowed them to make full use of their relatively abundant unskilled and semi-skilled labour, and to move to skill- and capital-intensive sectors without the balance-of-payments constraint on capital accumulation and technology transfer. Implementation of such an export-oriented development strategy required considerable government intervention in the context of a long-term industrial strategy.

However, it is often argued that the East Asian experience cannot easily be replicated by other developing countries because of changes that have taken place in the global trading environment. Such arguments generally take two forms. The first is the fallacy of composition argument.[1] This argument maintains that the export success of East Asian countries has been predicated on the failure of other developing countries to compete effectively in the markets of industrialized countries, where the bulk of their exports were directed. With increased emphasis on export-led growth, the question arises of whether a simultaneous export push by a great number of developing countries, including in particular those with large economies, could lead to success for all. On its own, a small developing country can substantially increase its exports to industrialized countries without flooding the market and seriously reducing world prices of the products concerned. However, this may not be true for developing countries as a whole. If all developing countries become successful exporters of labour-intensive manufactures, there is the risk that the terms of trade will decline to such an extent that the benefits of any increased volume of exports may be more than offset by losses due to lower export prices; i.e. risk of "immiserizing growth", to use the term coined by Bhagwati many years ago.[2] Some studies have even suggested that a decline in the terms of trade is already taking place, without, however, having yet reached the point of immiserizing growth.

Two additional features are pointed to in support of this thesis. The first is that growth in the developed world has slowed down considerably during the past two decades. Whereas the economies of OECD countries grew at an annual rate of almost 5 per cent during 1960-1973, in the past two decades growth has averaged 2.5 per cent. The second is that many labour-intensive industries have already been phased out in the developed

countries as East Asian NIEs have successfully penetrated these markets. Further penetration of these markets may be resisted in view of their growing labour market problems, including widespread unemployment and low wages for unskilled labour.

The second argument against the replicability of the East Asian export success is more straightforward and relates to national policy autonomy. It is often argued that the intensification of multilateral trade disciplines and the extension of their scope as a result of the Uruguay Round prohibit the use of some key policy tools to support and protect industries that were central to the export success of these countries. On this view, the only viable option is to actively and fully integrate into the global economy, rather than try to pursue a more selective strategy along East Asian lines.

This chapter addresses these issues. There can be little doubt that the global economy has been going through significant changes, some of which may pose difficulties for replicating the successful experience of East Asian NIEs. A proper understanding of possible new constraints is indispensable for avoiding pitfalls in the outward-oriented development strategy that is now being adopted by many developing countries. However, this does not mean that the East Asian experience of export-oriented industrialization has no relevance. The very same changes in the global trading environment also offer new opportunities, which were not open to the first-tier NIEs in their initial stages of industrialization. Developing countries today are less dependent on trade with the developed market-economy countries[3] than were the East Asian NIEs by virtue of the fact that the very success of the latter has opened new trading opportunities for other developing countries. More generally, as discussed in chapter I, the increased diversity in their extent of industrialization provides much greater scope for expanding trade among developing countries, providing the potential for a mutually reinforcing process of industrialization along "flying geese" lines. Again, partly because of a more rapid dissemination of technology and greater flexibility and divisibility of production processes, the opportunities to diversify and upgrade are considerably greater today than they were for the first-tier NIEs.

Furthermore, many developing countries differ significantly from the first-tier NIEs in the size of their economies and resource endowments, and these differences themselves call for a different approach to determining how much they need to depend on exports, what kind of industries to promote and what markets to target. As already noted, such differences exist both between the first- and second-tier NIEs and among the first-tier NIEs themselves. For instance, while the initial export industries have generally tended to be labour-intensive, there have been considerable differences in the product composition of such exports. Again, there are considerable differences among the first-tier NIEs in their degree of export orientation.

Together, these factors suggest that there is considerable scope for developing countries to formulate export-oriented industrialization strategies along the lines of East Asian NIEs without necessarily having the same degree of export orientation, exporting the same products, developing the same industries with the same speed or in the same sequence, or targeting the same markets abroad. However, avoiding potential pitfalls in formulating and implementing an export strategy requires constant monitoring of developments in markets for various manufactured products, projecting the possible evolution of global supply and demand, and paying close attention to the trade policies of the major trading countries. For many developing countries this may not be an easy task because of lack of information and resources. It may thus be worthwhile to explore the possibility of establishing, in an international body such as UNCTAD, a marketing-*cum*-information service (such as exists at the national level in Japan and the Republic of Korea - JETRO and KOTRA), to help developing countries formulate their export strategies so as to minimize the risk of fallacy of composition in labour-intensive manufacturing.

Similarly, while the Uruguay Round obligations reduce policy autonomy in developing countries, they also bring new opportunities. The discipline that the new multilateral trading system imposes on the industrial countries means improved security of market access for the exports of developing countries. Such security is vital for the latter if they are to avoid the fallacy of composition and immiserizing growth in their attempts to achieve export-oriented industrialization. Furthermore, strengthened multilateral disciplines can also encourage a more effective use of policy instruments in developing countries themselves, thereby helping to reduce some of the possible inefficiencies and waste associated with policy intervention.

B. Replicating the East Asian export-oriented industrialization process

1. What is meant by replication?

As discussed in previous chapters, the industrialization of East Asia has involved a dynamic interaction of manufactured exports with capital formation and growth whereby export ratios rose along with per capita income. However, this was not a linear process, and the growth of manufactured exports varied over time relative to that of GDP. During the early stages, exports of manufactures were negligible and primary goods accounted for the bulk of exports. Following the successful import-substitution phase, which was particularly short in the first-tier NIEs, labour-intensive manufacturing exports shot up, growing much faster than income. Over time, however, as the share of exports in GDP rose, export expansion slowed down. In the Republic of Korea, for instance, from the mid-1960s to the late 1970s the annual growth of manufactured exports was about twice that of GDP, but in the 1980s exports rose only moderately faster than GDP. The same also holds for Taiwan Province of China. It follows that the replication of the experience of the first-tier NIEs does not necessarily imply that developing countries at different levels of industrialization must have an equivalent export performance.

Moreover, there are considerable differences among the first-tier NIEs with respect to their manufactured exports in relation to GDP. Currently the proportion (excluding re-exports) is around 24 per cent in the Republic of Korea and Hong Kong, 36 per cent in Taiwan Province of China, and 70 per cent in Singapore. Indeed, the evidence clearly shows that the relation between per capita income and the share of manufactured exports in GDP is not linear; that is, two countries at similar levels of per capita income will have different ratios of manufacturing exports to GDP depending on a number of other factors. One such factor is natural resource endowment. As already discussed, the second-tier NIEs have taken much longer to move from resource-based products to labour-intensive manufacturing because of their abundant natural resources. This is likely to be the case for many other developing countries too, including in particular for those LDCs that are rich in natural resources, where priority in export promotion is accorded to diversification into resource-based products.

Another factor influencing export-orientation is population. Experience shows that trade orientation is in general inversely correlated with the size of the country; of two countries with the same per capita income, the country with the larger population can be expected to have smaller trade ratios (i.e. exports per capita or in relation to GDP). As already noted, since the division of labour is limited by the extent of the market, less populous countries need to rely on external markets to ensure an efficient scale of production and benefit from economies of scale. China and India, for example, do not need and will never achieve the same per capita exports or imports as the first-tier NIEs. The degree of export orientation that the latter achieved was attainable (and necessary) because the economies are all relatively small, with a combined population of only 74 million. It is thus not much larger than the population of Guangdong Province of China (around 65 million), and well below that of Indonesia (around 184 million) or the Chang Jian Delta around Shanghai (some 125 million). China alone has a population of 1.2 billion, and developing countries well over 4 billion.

The replication of East Asian industrialization thus implies different degrees of export-orientation in manufactures for different developing countries with different levels of per capita income, industrialization and resource endowment and varying sizes of population.[4] Poor countries will have a low level of manufactured exports relative to GDP, no matter what kind of trade strategy they follow, but those without adequate natural resources would need to raise their export ratio rapidly in order to lift growth while

those rich in natural resources would take much longer to do so. Major exporters of manufactures outside East Asia (such as Brazil, Mexico and Turkey)[5] would need to attain a relatively fast expansion of exports of manufactures in order to be able to sustain a growth of GDP similar to that of East Asian countries, but they do not need the kind of export growth that the first-tier NIEs achieved in their early stages of industrialization. Again, countries such as China and India can be expected to have much smaller per capita exports and export/GDP ratios than the first-tier NIEs because of both the size of their populations and their per capita income levels. Although in recent years in these two countries, and in particular China, exports have grown much faster than GDP, the initial momentum cannot be expected to continue for long and the differential can be expected to diminish over the coming years.

The question of replicability is often posed in terms of expansion of exports to the North. The South needs to export to the North primarily in order to purchase capital and intermediate goods and to gain access to technology. While the first-tier NIEs depended almost entirely on the North in this respect, this need no longer be the case for today's NIEs because a number of them in East Asia have already established domestic capital goods industries, as have also some other middle-income countries. Similarly, while the North constituted the single most important market for manufactured consumer goods exports of the first-tier NIEs during the past decades, this is no longer true for the developing countries today. Although the markets in the South are still small compared to the North, they are growing much faster. In other words, there is considerable scope for increased trade among developing countries. This trade is likely to be hierarchical, with more advanced countries, notably the first-tier NIEs, exporting capital-intensive and skill-intensive products to less advanced ones in return for products with a high resource or unskilled labour content. The outcome will be a "flying geese" pattern of the type discussed in chapter I above. While the overall pattern and speed of the formation is greatly influenced by the growth and openness of markets in the North, developing countries can also provide considerable autonomous impetus to each other in the process of export-oriented industrialization.

Finally, while many developing countries would have to rely on exports of resource- or labour-intensive manufactures, some, including the non-East Asian major exporters of manufactures, second-tier NIEs and China, have capabilities to upgrade and move to more diversified products. For such products, market opportunities in the North are certainly much greater than for labour-intensive manufactures. These countries, particularly the large ones, can also move into some capital goods industries at earlier stages of development than were able to the first-tier NIEs. To the extent that the more advanced developing countries can produce the capital goods needed by the less advanced ones, the reliance by the South as a whole on exports to the North will be diminished.

2. Recent trends in the terms of trade for manufactures

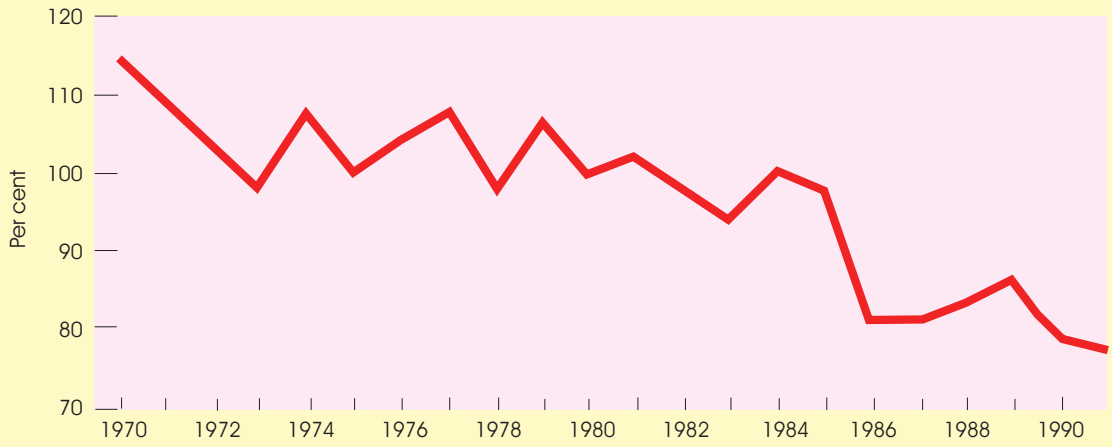
Since the celebrated works of Prebisch and Singer[6] it has been frequently argued that the terms of trade between primary products and manufactures are on a downward trend. Developing countries wishing to boost their export earnings should, therefore, diversify away from primary products into manufactures, for which income and price elasticities in the advanced economies are relatively high.

Such a diversification has to a considerable extent taken place, and the composition of exports of developing countries has undergone a rapid transformation since the early 1980s. In 1980 exports of commodities (excluding fuel) from developing to developed countries exceeded those of manufactures. As a result of rapid expansion of manufactured exports, by the early 1990s the latter were three times the value of exports of commodities. While this rapid increase in the share of manufactured exports has been partly due to the increase in the prices of manufactured exports of developing countries relative to commodities, much of it was the result of volume changes.

However, recent empirical work has suggested that this expansion of manufactured exports from developing countries has also been associated with a downward trend in their terms of trade. According to a recent estimate based on a time-series regression of the ratio of unit values of manufactured exports from developing and developed countries, over the period 1970-1987, prices of manufactured exports of developing countries fell by an average of 1.0 per cent per annum relative

Chart 7

RATIO OF DEVELOPING COUNTRIES' EXPORT PRICES OF MANUFACTURES TO DEVELOPED COUNTRIES' EXPORT PRICES OF MACHINERY AND TRANSPORT EQUIPMENT AND SERVICES, 1970-1991



Source: Reproduced from P. Minford, J. Riley and E. Nowell, 'The Elixir of Growth: Trade, Non-traded Goods and Development', *CEPR Discussion Paper,* No. 1165, London, May 1995 (figure 6).

to those of developed countries.[7] Yet, because the volume of manufactures exported by developing countries rose rapidly, there was an average annual increase of 10 per cent in their income terms of trade.

It has been suggested that this result is biased by the inclusion in the definition of manufactured products used in the estimates (namely, that of the United Nations in its index of unit values of manufactured exports) of non-ferrous metals.[8] These are not normally considered as manufactures in the analysis of trade, because their value-added component is small and variations in their price mainly reflect the behaviour of prices of metalliferous ores. Indeed, if non-ferrous metals are excluded, there is no deterioration in the manufacturing terms of trade of developing countries over the period in question. However, closer examination reveals that while the two series (with and without non-ferrous metals) behave very differently prior to 1975, their movements are virtually identical thereafter. Thus, from 1975 onwards it makes no difference to the outcome whether or not these metals are included in the calculations.[9] This conclusion supported by research based on the use of an alternative export price series for developed countries; namely, export prices of machinery and equipment, and services.[10] This latter measure (see chart 7) indeed indicates a somewhat larger deterioration in the terms of trade of developing countries than the first measure.

These results, however, do not provide an adequate test of the Prebisch-Singer thesis as it applies to manufactures, because they are based on aggregate data for manufactured exports from all developing countries, including both labour- and technology-intensive products, which, according to this thesis, should be subject to different price dynamics.[11] A more recent study attempts to provide an additional empirical test of the deterioration thesis by analysing trends in the manufacturing terms of trade of the various developing regions in their trade with developed countries.[12] These estimates are based on EUROSTAT unit value series for 1979-1994 for trade of the European Union with five groups of countries: least developed countries (LDCs), ACP, Latin American and Mediterranean Basin countries and East Asian NIEs (see table 39).

Table 39

MANUFACTURING TERMS OF TRADE BETWEEN DEVELOPING COUNTRIES AND THE EUROPEAN UNION, 1979-1994

(Percentage change per annum)

	All developing countries[a]	of which:				
		LDCs	ACP	Latin America	Mediterran. Basin[b]	East Asia[c]
Unit value of:						
EU imports	2.0	-1.3	-0.1	1.3	2.1	2.9
EU exports	4.2	4.4	4.6	4.9	4.4	4.1
Terms of trade of developing countries[a]						
Net barter terms of trade	-2.2	-5.7	-4.7	-3.6	-2.3	-1.2
Income terms of trade	5.5	..	0.4	1.0	4.1	6.8

Source: A. Maizels, T.B. Palaskas and T. Crowe, "The Prebisch-Singer Hypothesis Revisited", in D. Sapsford and J.R. Chen (eds.), *Development Economics and Policy: Essays in Honour of Sir Hans Singer* (London: Macmillan, forthcoming).

a Excluding China.

b Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, Tunisia, Turkey and former Yugoslavia.

c Including also Brunei Darussalam and Macao.

According to this study, while the manufacturing net barter terms of trade (NBTT) of developing countries as a whole with EU declined at an average rate of 2.2 per cent per annum from 1979 to 1994, the increase in export volume was more than enough to offset the price decline, so that the income terms of trade rose strongly. However, there are significant differences among developing countries. The decline in NBTT was largest for LDCs, followed by ACP, Latin American and Mediterranean countries, while it was significantly smaller for the East Asian NIEs. Income terms of trade rose for all groups of countries for which data are available. However, the increase was considerably smaller for the ACP and Latin American countries, where much of the gains from growth of export volumes were wiped out by the deterioration in NBTT. By contrast, in the Mediterranean countries, and even much more in East Asian NIEs, where growth of export volumes was higher and NBTT deterioration lower, the increases in income terms of trade were much greater.

As can be seen from table 39, the main reason for the different rates of decline in NBTT among these groups of countries was differences in the unit values of their exports to EU rather than in the unit values of their imports. The authors explain these differences in terms of the technology intensity of exports of manufactures:

> ... while for the NICs and ASEAN countries there was a deterioration but at a modest rate of little more than 1 per cent per annum. This is in sharp contrast with relatively high rates of deterioration of the NBTT of the least developed and ACP countries, the two groups with almost certainly the lowest proportion of technology-intensive manufactures and the greatest proportion of unskilled or semi-skilled labour-intensive exports. The Latin American region and the countries of the Mediterranean Basin are intermediate between these two extremes as regards the rate of deterioration in their NBTT and very probably also as regards their general level of scientific and technological development.

This conclusion is largely in accordance with the discussions in the previous chapter. An addi-

tional reason for the relatively sharp decline in the terms of trade of LDCs, ACP and Latin American countries is the debt crisis. For instance, as discussed in *TDR 1995*, export growth in most of Latin America during the 1980s was driven by the distress caused by the debt crisis. Sharp drops in real wages in manufacturing that were associated with rising exports most probably contributed to declines in the terms of trade by allowing export prices of these products to be reduced without affecting profitability.[13]

Within East Asia it could also be expected that there would be considerable variation between the first- and second-tier NIEs with respect to the movements in their manufacturing terms of trade with the developed countries since the skill intensity of their exports differs considerably. Information in this regard by country is limited. However, according to one study, while for the Republic of Korea the manufacturing terms of trade moved favourably during the 1980s, the movement was "slightly adverse" for Indonesia.[14]

Thus, there is evidence that the relative price of manufactured exports from developing countries has fallen during the past two decades alongside the rapid expansion of their volume. However, there appears to be much variation by product category with significant declines for resource- and labour-intensive exports, but little evidence of a downward trend for more skill- and technology-intensive goods.

To what extent the behaviour of the manufacturing terms of trade of developing countries reflects global productivity and price trends is not easy to determine. As discussed in greater detail in *TDR 1995,* although the findings of a number of studies suggested that world prices of skill-intensive goods have fallen over the past decade or so relative to those of labour-intensive goods, this result appears to be quite sensitive to the products chosen as well as the way in which the skill content of goods is measured. On the other hand, while the evidence suggested a faster productivity growth for skill-intensive manufacturing, it was concluded that the findings for both Europe and the United States that prices of both high-skill and low-skill manufactures had fallen relative to prices of those embodying a medium level of skills could not rule out the predicted price effect of import competition from the South.[15] This conclusion is consistent with the independent evidence on manufacturing terms of trade of developing countries examined above.

3. Labour-intensive exports and fallacy of composition

The above findings suggest that either income and price elasticities for the type of manufactures which most developing countries currently export are low or that demand for these exports is constrained by protection in the advanced economies. They also raise the possibility that the prices of labour-intensive manufactured exports could come under significant pressure if supply increases much faster as a result of a widespread attempt to replicate the successful experience of first-tier NIEs.

The question of fallacy of composition with respect to labour-intensive manufactures can be highlighted by examining the case of clothing, which has been the major labour-intensive export item from East Asia. Despite their rapid growth, imports of clothing from developing countries still account for only one third of apparent consumption (gross production plus net imports) of clothing in the North (see table 40). Most clothing expenditure is thus still on domestically produced goods. Under the Multi-Fibre Arrangement (MFA), to be phased out by January 2005, domestic clothing producers in most Northern economies enjoy protection against imports from developing countries. As a result, the output of clothing in some important instances has remained roughly constant over the past 20 years (chart 8), although employment has fallen everywhere because of rising labour productivity. Whilst protection has served to stabilize or contain the fall in domestic output, demand for clothing in these countries has been rising, and a widening gap has emerged between output and expenditure, which has been filled by imports from developing countries.

What would the situation have been like in the absence of protection? Some indication is provided by the example of Sweden, which has virtually eliminated protection for the clothing industry. Over the past 30 years, the output of clothing has dropped by 90 per cent in Sweden. This suggests that under free trade, the production of clothing and similar labour-intensive goods would fall dramatically in most advanced countries, although perhaps not as much as in Sweden, where an egalitarian wages policy has meant very high labour costs for the producers of such goods.

The Agreement on Textiles and Clothing concluded in the Uruguay Round provides for the

Table 40

PROSPECTS FOR CLOTHING EXPORTS FROM THE SOUTH TO THE NORTH[a]

(Billions of dollars)

	1993 (actual)	*Post-MFA[b]*
Apparent consumption in the North	258.0	355.2
Production in the North	160.3	64.1
Northern imports from developing countries[c]	88.8	264.6
First-tier NIEs	22.7	..
ASEAN-4	11.5	..
China	24.8	..
India	3.4	..
Other	26.4	..
Other external imports[d]	8.9	26.5

Source: UNCTAD secretariat calculations based on UNIDO data and United Nations *Commodity Trade Statistics* tapes.

a Canada, EU, Japan and United States only.

b Projections for 2006 (in constant 1993 prices), based on the assumptions described in the text.

c Derived from data (f.o.b.) of the exporting countries, including re-exports via Hong Kong.

d Mainly from the transition economies.

phasing out of the MFA, leading to the "integration" of this sector into GATT at the end of a 10-year transition period, when the same rules will apply to trade in textiles and clothing as to trade in other goods. The figures in table 40 show that there may be considerable scope for developing countries to increase their exports of clothing to the North if the Uruguay Round obligations are implemented as envisaged. In the table it is assumed that consumption of domestically produced clothing in the North will fall by 60 per cent by the end of the transition period. It is also assumed that expenditure in the North on clothing will grow by 3.25 per cent per annum during this period.[16] Thus, developing country exporters are assumed to enjoy the twin gain of increased access to expanding markets in the North and reduced output by their northern rivals. The result of these assumptions is a 200 per cent increase in their clothing exports to the North. Assuming that the MFA is phased out steadily during the 10-year period, this gives an average of about 12 per cent growth per annum in the clothing exports for all developing countries taken together. These figures are obviously very crude and their purpose is purely illustrative. Even so, they do indicate the orders of magnitude involved and the potential for developing countries to increase their exports of clothing provided that they are no longer faced by protectionism. Should growth in the North be faster, these opportunities would certainly be greater.

An average growth of 12 per cent per annum in clothing exports is lower certainly than that achieved by the first-tier NIEs in their earlier stages of their labour-intensive manufacturing export drive. However, as discussed above, not all countries have reached the point of being able to launch a massive export expansion in labour-intensive manufactures; nor do countries at relatively higher levels of industrialization need to rely on such exports to the same degree. Similarly, the first-tier NIEs have already began moving out of such labour-intensive manufacturing, which should create room for other developing countries in the northern markets as well as in their own domestic markets.

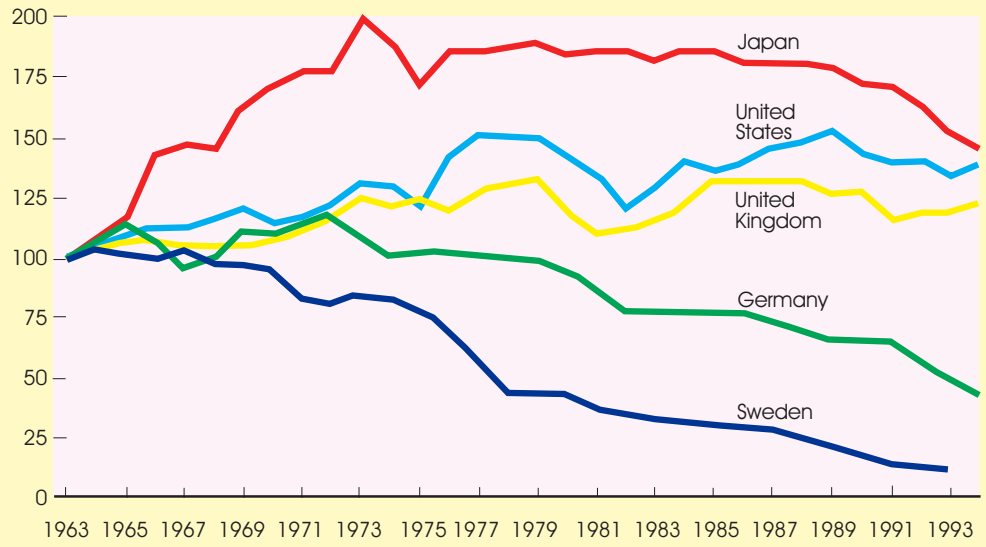
There can be little doubt that some large countries, such as China and India, are among those that are likely to constitute the next generation of (third-tier) NIEs with considerable advantage in labour-intensive manufacturing. Exports of these countries to the North are relatively small compared to the potential market there.[17] Thus, even if these countries could increase their clothing exports by 20 per cent per annum, their combined exports would reach only $175 billion at the end of 10 years, about one-half the estimated market size of the North. This would still leave considerable room for other developing countries to increase their clothing exports to the North (and to the first-tier NIEs) without flooding the markets.

There is thus considerable scope for a new generation of NIEs to expand their exports of clothing to northern markets over the next decade or so without facing a supply-induced terms-of-trade deterioration, provided that protectionist barriers in the North are dismantled. Opening of the northern markets can also be expected to slow or halt the downward trend in the manufacturing terms of trade of countries exporting mainly labour-inten-

Chart 8

PRODUCTION OF CLOTHING IN SELECTED INDUSTRIAL COUNTRIES, 1960-1994

(Index numbers, 1963 = 100)



Source: UNIDO data base.

sive products. However, such high export growth rates cannot be maintained simultaneously by a large number of countries. Nor could they be maintained indefinitely; for once the market protected by MFA is fully penetrated by southern producers, it will no longer be possible for the South to increase exports faster than the rate of growth of demand in the North (i.e. around 3 per cent per annum).

The above discussion implies that if southern producers were enabled to enter northern markets in products where there is still substantial local production, they would not necessarily encounter the fallacy of composition problem. Under these conditions exports from the South would be highly substitutable for the northern products, and no matter how much the South has already exported, the price elasticity of demand in the North for the exports of developing countries as a whole would remain high. Thus, no matter how much the South exported to the North, only a modest reduction in prices would be required to achieve a further substantial increase in exports.[18]

However, when southern exports of manufactures expand considerably in products in which there is no significant production in the North and for which demand there is growing slowly due to slow income growth and/or a low income elasticity, the fallacy of composition would be a much more likely result. This can be illustrated with the help of the North-South trade model of UNCTAD cited in note 18. The model is used to simulate the effects of increased exports of labour-intensive manufactures by the South on the terms of trade and incomes. It is assumed that North and South are completely specialized in the skill- and labour-intensive manufactures respectively, so that southern exporters do not compete with the northern producers, that wages are fully flexible in the North and that full employment always prevails. The simulations are carried out by increasing the size (population and employment) of the South by 20 per cent compared to the baseline while keeping the size of the North unchanged. This is equivalent to increasing the supply of labour-intensive exports faster than demand. The result is to lower their prices relative to the prices of north-

Table 41

SIMULATION OF TRADE AND INCOME EFFECTS OF EXPANSION OF LABOUR-INTENSIVE EXPORTS BY THE SOUTH

(Percentage change due to a 20 per cent increase in the size of the South[a])

NORTH	
Real wages (unskilled)	8.1
Real wages (skilled)	7.2
Manufacturing employment	-6.9
Export volume (good 1)	-31.5
Per capita income	4.2
SOUTH	
Terms of trade	-63.2
Real wages (unskilled)	-2.9
Real wages (skilled)	-8.9
Export volume (good 2)	86.7
Per capita income	-7.8

Source: Calculations by the UNCTAD secretariat. For the simulation model used see *TDR 1995*, Annex I to Part Three.

a I.e. an increase of 20 per cent in population and employment.

ern manufactures, with the extent of the decline depending on their substitutability with skill-intensive manufactures.

The results are summarized in table 41. Export volumes from the South increase by more than 80 per cent, but the terms of trade for their manufactures drop to less than one half of their previous level. Thus, real export earnings of the South (i.e. in terms of the imports they can procure from the North) fall considerably. Similarly, aggregate national income rises much less than population, and hence per capita income declines. In the North real wages of both unskilled and skilled workers are higher when the South is larger. However, since the model assumes balanced trade between the South and the North, and since the purchasing power of exports of the South declines, the volume of northern exports to the South also declines. Consequently, manufacturing employment as a proportion of the total labour force (and employment) falls in the North.

There can be little doubt that results obtained from such simulations are highly sensitive to the assumptions made with respect to consumption substitution elasticities; with a higher elasticity of substitution, the terms of trade would certainly fall less, and would probably be more than compensated by volume increases. However, these results show that any widespread attempt to increase exports of labour-intensive, low-elasticity manufactures to northern markets may lead to a collapse in their terms of trade with the North. The danger of immizerisation is widely recognized in the case of primary products, but it is no less for labour-intensive manufactures.

4. Diversification and market penetration

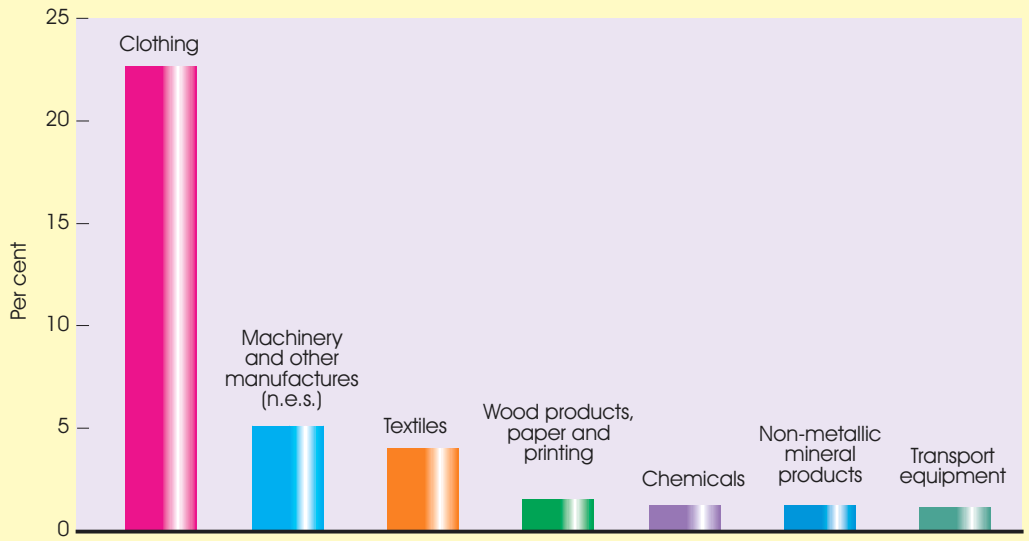
While fallacy of composition and immiserizing growth are potential dangers for the exporters of labour-intensive manufactures, they are by no means inevitable since there is considerable scope to move to other manufactured exports. A number of manufactures exported by developing countries to the North are produced in much larger quantities in the latter countries; for example, their imports from the South of machinery, wood products, paper and printing materials, chemicals and transport equipment account for only a very small proportion of apparent consumption (see chart 9), even though for some of these products southern exports have been growing very fast, particularly from the first-tier NIEs. Consequently, if a number of relatively large and more advanced developing countries could upgrade and diversify their exports into these products through appropriate industrial policies, the danger could be avoided of an unfavourable turn of the terms of trade through a simultaneous export expansion in labour-intensive manufactures.

Even if demand for manufactures grows only slowly in the North because of slow income growth, southern producers could still expand such skill-intensive exports by replacing northern producers. However, this could entail serious dislocations in the North, and a smooth adjustment would depend on the overall macroeconomic conditions, including their growth and unemployment rates. If adjustment in the North is rendered difficult by sluggish growth and high unemployment, protectionist pressures could mount.

In sum, replicability of the East Asian experience in this sense depends very much on the

Chart 9

IMPORTS OF MANUFACTURES, BY PRODUCT GROUP, FROM DEVELOPING COUNTRIES AS A PERCENTAGE OF APPARENT CONSUMPTION IN THE NORTH, 1990-1991



Source: UNCTAD, *Handbook of International Trade and Development Statistics 1994*.

success of industrial policies in the South in upgrading and diversifying, and on the success of macroeconomic policies in the North in accelerating growth and reducing unemployment.

In table 42 the consequences are explored for the North of a simultaneous expansion of exports of manufactures by developing countries on the basis of alternative scenarios. In the low growth scenarios, northern demand for manufactures is assumed to grow by 2.5 per cent per annum in real terms over the next decade - i.e. in line with the trend growth rate of the major industrial countries. In the high growth scenario, demand in the North is assumed to grow by 4 per cent per annum. In projecting market penetration by developing countries in the North within the next 10 years on the basis of two alternative scenarios, an estimate is first made for import penetration for 1996.

In both scenarios the growth of manufacturing exports of the first-tier NIEs is assumed to keep pace with the increase in demand in the North. This is a reasonable assumption, given that their exports of manufactures to the North have increased by around 4 per cent per annum since the beginning of the decade. Certainly, this is a considerably lower rate than that achieved during the 1970s and 1980s, but it is consistent with their tendency to supply the northern markets increasingly through FDI, and to expand manufacturing exports to developing countries. In scenario I, it is assumed that ASEAN-4 and China will also maintain the recent growth rates of their manufacturing exports to the North during the next 10 years, at 20 per cent per annum. Other developing countries, on the other hand, including large countries such as India, are assumed to double their export growth rates to the North immediately, maintaining them at 20 per cent per annum. Thus, scenario I assumes that, while the recent pace of manufacturing exports of the East Asian developing countries (first-tier NIEs, ASEAN-4 and China) to the North will continue, other developing countries will significantly increase their rate of export expansion.[19]

For a number of reasons the increases in market penetration projected in scenario I can be considered to be much higher than is implied by the replication of the East Asian export performance. First, as noted above, many developing countries have not yet reached the stage of indus-

Table 42

IMPORT PENETRATION BY DEVELOPING COUNTRIES OF THE NORTHERN[a] MARKET FOR MANUFACTURES SINCE 1990 AND PROJECTIONS FOR 2006

(Percentage)[b]

Year	*Northern imports of manufactures[c] from*				
	All developing countries	of which:			
		First-tier NIEs	*ASEAN-4*	*China*	*Other developing countries*
			1990-1996		
1990	3.9	1.8	0.4	0.5	1.2
1991	4.1	1.8	0.5	0.6	1.2
1992	4.5	1.8	0.6	0.8	1.3
1993	5.1	1.8	0.8	1.0	1.5
1996[d]	6.6	1.9	1.2	1.7	1.8
			Projections for 2006		
Low growth in the North					
Scenario I	20.7	1.9	4.8	6.8	7.2
Scenario II	14.1	1.9	3.1	4.4	4.7
High growth in the North					
Scenario I	18.1	1.9	4.1	5.9	6.2
Scenario II	12.5	1.9	2.7	3.8	4.1

Source: See table 40.

a Canada, EU, Japan and United States only.

b Imports of manufactures (SITC 5-8, less 67 and 68) as a percentage of apparent consumption (gross output plus net imports).

c Derived from data (f.o.b.) of the exporting countries, including re-exports via Hong Kong.

d Forecast.

trialization needed to launch a massive expansion of manufactured exports. Second, this projection does not take into account the recent trend in the growth of South-South trade relative to that between North and South. Finally, as discussed above, large countries such as China and India do not need and cannot be expected to maintain such high export growth rates for a long period.[20] Scenario II takes these considerations into account and assumes a growth rate of 15 per cent per annum for the export of manufactures from ASEAN-4, China and other developing countries to the North over the next 10 years.

The results in both scenarios have some common features that are independent of how fast the North grows. In all cases, at the end of the 10 years import penetration in the North by ASEAN-4 will exceed that of the first-tier NIEs, but their per capita exports will still be smaller; the population of ASEAN-4 is about 4.5 times that of the first-tier NIEs, while their manufactured exports to the North are higher by 1.5-2.5 times, depending on the scenario. China will catch up with ASEAN-4 in import penetration in the North, but again its per capita exports will be considerably lower. Similarly, although market penetration by the remaining developing countries will rise at the same rate as for ASEAN-4 and China, average per capita exports for those countries will be considerably less than, and about one-half of, respectively, that of those two regions.

To achieve the average degree of penetration of northern markets envisaged in these scenarios, the South would need to make massive inroads into many sectors at present dominated by northern producers and simultaneously to replace northern producers in sectors such as clothing and household electrical goods, where they still retain a significant presence. However, not all developing countries can be expected to perform equally well in all these areas. For a number of countries, particularly the second-tier NIEs and China, a rapid shift to technology- and skill-intensive products would be necessary to maintain a relatively high rate of growth of manufactured exports. In countries at earlier stages of industrialization, much of the expansion can be expected to take place in traditional labour-intensive manufacturing, replacing exports by more advanced developing countries. In both cases success will continue to depend, as in the East Asian NIEs, on government policy in animating the investment-export nexus.

What does this imply for the North? Taking the low-growth scenario II, the rate of market penetration roughly doubles from an estimated 6.6 per cent in 1996. Such increases are not unprecedented, although in the past they were from relatively low levels (generally under 1 per cent). For instance, import penetration by the developing countries tripled from 1970 to 1980, and then doubled over the following 10 years. Italian and Japanese penetration in the (then) EEC market of six and in the United States showed similar increases during the 1960s and 1970s.[21] Total southern exports, 10 years from now, amounting to 14 per cent of apparent consumption of manufactures in the North, will correspond to less than 6 per cent of northern GDP. In terms of employment, they affect about 3.5 per cent of the total labour force. Moreover, the counterpart to massive imports of manufactured goods from the South would be the export of other types of manufactured goods, particularly capital goods, together with modern services, thereby creating new jobs.

However, such a development would still have major implications for the economic structure of the North, necessitating considerable restructuring of industries and redeployment of labour. Jobs created by increased exports to the South are not always in the same sectors as those lost as a result of increased imports; nor are they necessarily of the same quality. Shortages may occur for skilled labour while the overall demand for unskilled workers will decline as a result of labour-intensive imports from the South. The feasibility of such a structural adjustment in the North would depend to a large extent on macroeconomic circumstances. As discussed in *TDR 1995*, in an expansionary environment, with high investment and rising output in the North, there would be plenty of new jobs available to replace those destroyed by increased southern penetration in certain sectors, and the structural changes involved could be absorbed fairly smoothly. As may be seen from a comparison of the low- and high-growth scenarios in table 4, faster growth in the North would also imply lower import penetration for any given rate of export expansion by the South. These were indeed the conditions prevailing in the 1960s, when rapid penetration by Japan and Italy in the European and United States markets was not associated with serious labour market problems and protectionist pressures.

Conversely, with the depressed demand conditions and growing labour market problems which have characterized the North over the past 20 years, the scale of import penetration envisaged here could cause serious problems of adjustment, and might trigger an intensification of protectionist pressures. As discussed in greater detail in *TDR 1995*, unless the twin problems of high unemployment and low wages in the North are tackled, additional hurdles to maintaining present trends towards more open markets could emerge. Thus, whether or not a large number of developing countries can simultaneously replicate the successful export-oriented industrialization experience of the first-tier NIEs will depend very much on the evolution of the global trading system, and particularly on maintaining open markets in the North.

There can be little doubt that if the size of and access to northern markets do not increase rapidly, prospects for developing countries to achieve rapid export-oriented industrialization will be limited. However, with the rapid industrialization already achieved by a number of East Asian countries and other major exporters of manufactures, and the associated increase in South-South trade, the dependence of growth in the South on the North has weakened considerably. Moreover, should the South as a whole find it difficult to raise imports from the North because of the balance-of-payments constraint, it could cut imports unrelated to capital accumulation and growth. The more consumer goods the South imports from the North, the more goods it needs to export, and if that is not possible because of economic conditions and trade policies in the North, the higher imports for consumption

can only be at the expense of imports for investment. However, unlike most capital goods, most of the consumer goods produced in the North are also produced in the South. Hence it is possible for the South to maintain rising imports of capital goods from the North by increasing its output of mutual trade in consumer goods. In other words, greater South-South cooperation in trade could help overcome the problems associated with inadequate growth of and access to markets in the North.

C. Export promotion after the Uruguay Round

The conclusion of the Uruguay Round and the establishment of the World Trade Organization (WTO) have cast a new light over the experience of East Asia. In many respects the international disciplines consolidate the export-oriented approach adopted by East Asia. But, at the same time, there is concern that the selective promotion of exports pursued by those countries will no longer be a permissible option.

Certainly, the new trading regime under the WTO has reduced the scope for general forms of tariff protection, many trade-related subsidies and performance standards and lax enforcement of intellectual property rights. However, much of the current discussion tends to highlight extremes: on the one hand, it emphasizes the constraints of WTO obligations, while on the other it tends to exaggerate their impact in narrowing the scope for policy options. Policy-makers need to make an objective analysis of the options which remain open to other developing countries for emulating the experience of the East Asian economies.

The Uruguay Round has clearly opened up new export opportunities for developing countries and improved their security of market access, thereby improving on the conditions faced by many East Asian NIEs during their early stages of industrialization. Although the tariff reductions made in some low-skill industries, such as textiles and clothing, that are critical to developing countries were relatively small, the elimination of non-tariff barriers and voluntary export restraints provides some offset. However, the danger of new forms of protectionism in these industries cannot be ruled out. Moreover, while the restrictions built into the various Agreements shorten the time available to policy-makers to enhance the organizational and technological assets of their domestic firms, the disciplines they introduce will help to make for a more purposive and focused pattern of industrial policy in the time allowed, encourage the better provision of traditional public goods needed to compete internationally as well as widen the scope of policies to include measures which can strengthen domestic savings and investment.

Certainly the kind of lengthy protection - which for the automobile industry in the Republic of Korea, for example, lasted three decades - used to promote industrial upgrading in the first-tier NIEs will no longer be possible. However, with respect to infant industry protection, it should be noted that none of the East Asian NIEs ever had resort to the "infant industry" provisions of section C of GATT article XVIII. Section B of that article allows developing countries to apply quantitative restrictions for balance-of-payments reasons. Although the understanding relating to this article strongly discourages resort to quantitative measures and provides for stricter multilateral surveillance, it remains a possibility for developing countries. Moreover, to the extent that tariff rates remain unbound or are bound at levels above currently applied rates, they can be increased to protect "infant industries".

The Agreement on Subsidies and Countervailing Measures defines "subsidies" for the fist time, tightens the disciplines on subsidies, and extends them to all WTO members. It also contains the most important provisions on differential and more favourable treatment, some of which are not subject to any precise limits. For example, the least developed countries, together

with 20 other countries with GDP per capita of less than $1,000, are exempt from the prohibition of export subsidies so long as they retain this status, and are also exempt from thresholds based on shares of world markets for products benefiting from export subsidies. Although specific subsidies (i.e. those limited to certain enterprises and not granted on the basis of objective criteria) are "actionable", remedies may be applied against actionable subsidies of developing countries only if injury to the domestic industry of another member, serious prejudice to its interests or nullification of concessions can be demonstrated. In addition, there are a set of non-actionable subsidies, including those which are intended to promote basic research, agriculture, and regional development. The last of these played a particularly important role in the first-tier NIEs in supporting efforts at technological development and industrial diversification, including through science parks and special industrial estates. Similar efforts to link infrastructure investment to technological upgrading will remain possible under the current Agreement.

Strictly speaking, the TRIMs Agreement did not modify GATT obligations but simply identified with greater clarity those investment measures which were incompatible with GATT articles. These include local content requirements (which can still be applied by countries invoking article XVIII.B), but leave a wide range of measures untouched. For example, export performance requirements are still permitted (but if they involve payments to exporters, they fall under the disciplines on export subsidies). However, while Governments in East Asia did exact formal agreements from both domestic and foreign firms in these areas, it should be noted that many of the arrangements were of a more informal nature and were mediated through such practices as "administrative guidance" which can act as a powerful constraint over business behaviour. These areas of institution building and reform are critical to strengthening development prospects in many developing countries and to a large extent lie outside WTO jurisdiction.

The General Agreement on Trade in Services involves binding commitments on market access and national treatment only when these have been specifically negotiated on a sectoral and subsectoral basis and included in the schedules of commitments. Most of these commitments relate to investment (i.e. "commercial presence"), and market access for foreign service suppliers can be made conditional on access to networks and technology. Perhaps the most dramatic extension of the multilateral trading system was through the TRIPs Agreement, which establishes the basic intellectual property norms of WIPO as multilateral trade obligations. Certain key policy tools, such as compulsory licensing, are still permitted, but are confined to exceptional cases. However, the real impact of the TRIPs Agreement's will only become evident with the experience of implementation.

In sum, while the WTO multilateral Agreements have reduced the scope of policy options, policy measures comparable to those employed by the East Asian NIEs can still be applied, particularly by the least developed countries. It is also worth noting that in two key sectors, agriculture and textiles, there is still room for selective government intervention by developing countries. Moreover, many of the policies to establish a dynamic profit-investment nexus will not be affected and might be brought into sharper focus. Given that these measures have a considerable influence on exports by promoting technological upgrading, resort to such measures will become increasingly important for developing countries. However, it has to be recognized that many of the important challenges, in such areas as FDI and the transfer of technology, lie ahead.

Lastly and importantly, the WTO Agreement may facilitate efforts by developing countries to strengthen trade and FDI among themselves. Regional integration has been of growing importance in East Asia, in particular through the growing trade and FDI links between the first- and second-tier NIEs. As discussed in the previous chapter, this has not been the outcome of unregulated market forces but very much the outcome of the interaction of industrial policies. More recently, growth triangles in South-East Asia have widened the search for economies of proximity and agglomeration, and more formal regional ties through ASEAN are beginning to receive greater attention. Whether similar arrangements elsewhere would represent obstacles to global integration appears to be a less important question than whether they could stimulate the kind of regional growth pattern that was established in East Asia. In this context, the fact that regional trade and FDI flows have led to closer integration among developing countries does suggest that the kinds of policies that encouraged these links need to be carefully considered by other developing countries as a possible means of intensifying South-South cooperation. ■

Notes

1 This argument was pioneered by W. Cline, "Can the East Asian Model of Development be Generalized?", *World Development*, Vol. 10, No. 2, Feb. 1982. See also R. Faini, F. Clavijo and A. Senhadji-Semlabl, "The Fallacy of Composition Argument: Does Demand Matter for LDC Manufactured Exports?", *CEPR Discussion Paper* No. 499, London, December 1990.

2 Jagdish Bhagwati, "Immiserizing Growth: A Geometrical Note", *The Review of Economic Studies*, Vol. XXV(3), June 1958.

3 The terms "developed market-economy countries" and "North" are used interchangeably in this chapter. It should be noted that the countries composed by this group (see the Explanatory Notes) include certain countries that are industrially less advanced than some of the East Asian NIEs.

4 It is not easy to determine norms for the degree of export orientation needed at each level of income and population to replicate the East Asian export performance. An attempt to do so has been made through a cross-country regression of export/GDP ratios on population and per capita income, but problems of estimation are involved on account of large differences of size among countries. For a similar attempt and the problems involved, see also Cline, *op. cit.*

5 Developing countries that are major exporters of manufactures comprise: Brazil, Hong Kong, Malaysia, Mexico, Republic of Korea, Singapore, Taiwan Province of China, Thailand, Turkey and the former constituent republics of Yugoslavia.

6 R. Prebisch, *The Economic Development of Latin America and its Principal Problems* (E/CN.12/89/Rev.1.), United Nations publication, E.1950.II.G.2, New York, 1950; H.W. Singer, 'The Distribution of Gains Between Investing and Borrowing Countries'; *The American Economic Review*, Vol. 40, No. 2, May 1950.

7 P. Sarkar and H. W. Singer, "Manufactured Exports of Developing Countries and their Terms of Trade since 1965", *World Development*, Vol. 19, No. 4, April 1991.

8 P. Athukorala, "Manufactured Exports from Developing Countries and their Terms of Trade: A Re-examination of the Sarkar-Singer Results", *Ibid.*, Vol. 21, No. 10, October 1993.

9 On the basis of the United Nations index the regression analysis reveals that the relative price of developing country manufactured exports fell by 0.48 per cent a year during 1975-1993. If non-ferrous metals are excluded, the decline is 0.46 per cent. This is partly because the relative price of non-ferrous metals varied less after 1975, and partly because their relative importance in total manufactured exports from developing countries declined. Whilst in 1970 non-ferrous metals accounted for one quarter of such exports, their share had fallen to 12 per cent by 1975 and is now around 4 per cent. Consequently trends based on regression analysis are dominated by the effects of an unusually large fall in the relative price of non-ferrous metals in the early 1970s, when these metals were of great importance in developing country exports.

10 See P. Minford, J. Riley and E. Nowell, 'The Elixir of Growth: Trade, Non-traded Goods and Development', *CEPR Discussion Paper* No.1165, London, May 1995.

11 H. Singer, "The Distribution of Gains Revisited", in A. Cairncross and M. Puri (eds.), *The Strategy of International Development* (MacMillan, 1975).

12 Estimates of A. Maizels, T.B. Palaskas and T. Crowe, "The Prebisch-Singer Hypothesis Revisited", in D. Sapsford and J.R. Chen (eds.), *Development Economics and Policy: Essays in Honour of Sir Hans Singer* (London: Macmillan, forthcoming).

13 See *TDR 1995*, table 34.

14 H.A.C. Prasad, "Bilateral Terms of Trade of Selected Countries from the South with the North and the South", *UNCTAD Discussion Paper*, No. 110, January 1996, pp. 25 and 33. See also S. Sen, "Growth Centres in South-East Asia in the Era of Globalization", *UNCTAD Discussion Paper*, No. 117, July 1996, for a discussion of the terms of trade of Indonesia and Malaysia.

15 See *TDR 1995*, Part Three, chap. III, introductory paragraph to sect. C.

16 This assumption is in conformity with the income elasticity of demand for these goods in the G-7 countries (estimated at about 1.3 for the G-7 countries for the period 1981-1992) and their trend growth rate of 2.5 per cent. It should be noted that for lack of data, the initial year of the calculations in table 40 does not coincide with the date of entry into force of the Uruguay Round Agreements. Since the purpose is to illustrate rather than to project, no adjustment has been made to account for this difference.

17 The figure in table 40 for exports from China to the North of $24.8 billion is based on imports (c.i.f.) from China as reported by the countries concerned. It is greater than the figure for exports reported by

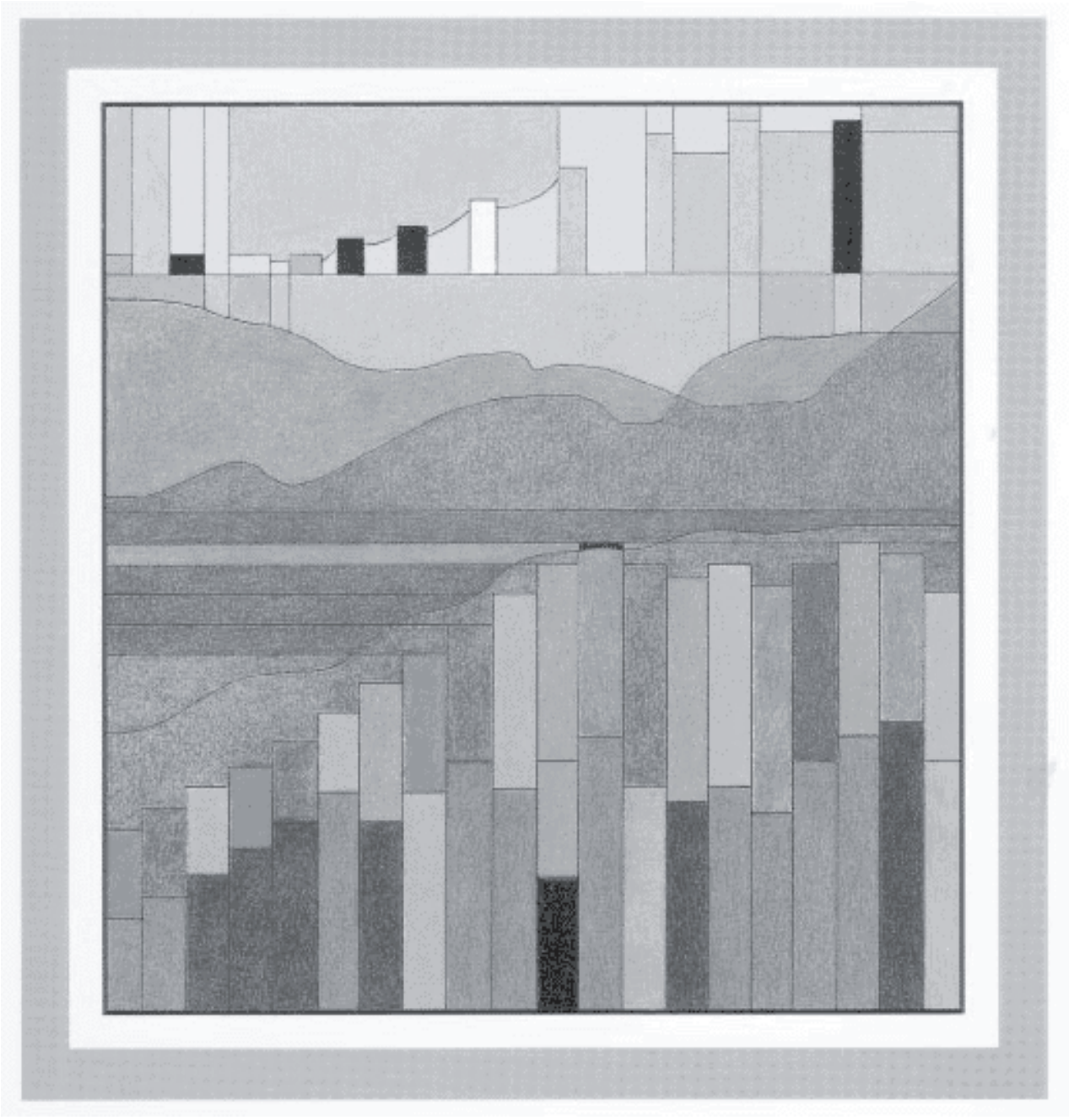
China because it includes goods exported to and reexported from Hong Kong.

18 For a model built on such assumptions see W. Martin, "The Fallacy of Composition and Developing Country Exports of Manufactures", *World Economy*, Vol. 16, 1993. Similar results were obtained from the simulations of a North-South trade model in *TDR 1995* which showed that the opening up of trade between the South (exporting labour-intensive goods) and the North (exporting skill-intensive goods) resulted in considerable gains for the South as well as the North; see *TDR 1995*, annex I to Part Three. For a more detailed explanation of the model used, see R. Rowthorn, "A simulation model of North-South trade", *UNCTAD Review 1995* (United Nations publication, Sales No. E.95.II.D.23).

19 These assumed rates of expansion are in terms of current values. In calculating the increases in market penetration in table 42 the real growth rates of demand for manufactures have accordingly been adjusted for price increases, assumed to be 2 per cent per annum, in line with the recent behaviour of the United States consumer price index (excluding services).

20 In China, for instance, exports have recently grown at more than double the planned GDP growth rate of 8 per cent for the next five years (see Part One, chap. I).

21 *TDR 1995*, tables 30 and 32.



Annex

MACROECONOMIC MANAGEMENT, FINANCIAL GOVERNANCE, AND DEVELOPMENT: SELECTED POLICY ISSUES

A. Introduction

Amongst the topics of the agreed annotations to the provisional agenda for UNCTAD IX was the consideration of national and international policies needed to enable full advantage to be taken of the opportunities for growth and development offered by the new global context while minimizing the risks of new imbalances and instabilities, including those in international financial markets. Greater integration of financial markets has increased the amounts and categories of financing potentially available to entities throughout the world economy. However, so far only a small minority of entities have actually achieved access to this financing. Moreover, the capital movements which have accompanied financial globalization have been associated with greater instability, and it has been frequently shown how greater financial openness can restrict autonomy in macroeconomic management. These features of financial globalization have been recurring themes of recent issues of the *TDR*, which have monitored the effects of, and policy responses to, increased financial inflows into certain developing countries resulting from their progressive integration into the global network of financial markets,[1] and have reviewed major features of the legal framework of international financial liberalization as well as selected policy proposals aimed at the achievement of a more stable international financial system.[2] The observations concerning these subjects which follow are based largely on papers presented and subsequent discussion at the conference, *Capital Flows in Economic Development*, organized by the Global Interdependence Division of UNCTAD in cooperation with the Jerome Levy Institute of Bard College on 7-9 March 1996 at Blithewood, the home of the Institute on the campus of Bard College in Annandale-on-Hudson, New York.

B. Floating exchange rates and the liberalization of international capital movements

The abandonment of fixed exchange rates by major OECD countries at the beginning of the 1970s was widely believed at the time to lead to a system in which countries would have considerable autonomy in the pursuit of appropriate national macroeconomic policies, while exchange rates themselves would gravitate towards levels set by purchasing power parities. However, the out-

come proved to be different. Under the new regime of floating exchange rates the international financial system has been subject to instability in currency and other financial markets, and has been notable for levels of exchange rates which have obstinately diverged for long periods from those corresponding to economic fundamentals.

Currency volatility under the new regime has tended to fluctuate, with periods of increased volatility being interspersed with periods of calm. There have also been shorter episodes of exceptional instability in international financial markets, outstanding recent examples being the disruptions of the Exchange Rate Mechanism of the European Monetary System in 1992 and 1993. The effects on developing countries of the resulting instability take place through several channels. A large part of both their exports and their imports, as well as of their debt service obligations, are denominated in major currencies. Owing to mismatching of the denomination of external receipts and outflows their balance-of-payments positions are generally sensitive to relative movements in the values of different currencies and to changes in major interest rates. Moreover, increases in debt-service obligations resulting from higher interest rates often coincide with weakening export prospects, also closely related to dearer money. More recently, as the scale of foreign investment in the financial markets of certain developing countries has increased, these markets have become directly vulnerable to large shifts in sentiment among international investors. An early example of the possible effects of such vulnerability was provided by the collapse of the stock market in Hong Kong during the crash of October 1987,[3] and a more recent one by Mexico's financial crisis of late 1994 and early 1995, which not only led to a collapse of the exchange rate of the peso and of the value of other Mexican financial assets but also had spillover effects on other emerging financial markets.

Unsound economic policies can contribute to global financial instability. However, a recurrent lesson of recent experience of such instability is its frequently tenuous or non-existent connection to fundamentals such as countries' relative price levels, microeconomic performance and the stance of their macroeconomic policies. This appears to reflect the lack of a systematic relation between these fundamentals and the indicators used by actors in financial markets to guide their decisions as to holdings of different currencies. For example, much evidence suggests that many of these actors extensively use trading rules that rely on extrapolation of past movements and that are thus capable of perpetuating and accentuating movements of exchange rates frequently divorced from fundamentals.[4] Such behaviour by traders also probably helps to explain the failure of economic models to account for short- and medium-term variations in major exchange rates in terms of variables such as money supplies, real incomes, interest and inflation rates, and balances on current account.[5]

C. Problems for developed and developing countries due to financial instability

Concern over international financial instability reflects the pervasive economic effects of fluctuations in capital flows and exchange rates on the prices of goods, services and financial assets, and is related to a number of different issues. The most important of these issues for policymakers is misalignment of exchange rates. Misalignment results from movements of exchange rates which are extended in time and should be distinguished from short-term currency volatility. The term denotes exchange rates which, at reasonably full employment for the economy in question, are inconsistent with a sustainable external payments position as determined by the balance on current account and the longer-term propensity to attract or export capital. Misalignment is capable of distorting resource allocation through its impact on relative prices, of exerting perverse effects on activity, employment and the price level, and of generating protectionist pressures. In economies

with relatively small financial markets - for example, those of developing countries - misalignment due to large capital inflows is also frequently accompanied by booms in asset prices, the sequel to which is likely to be collapse when the capital flows eventually undergo a reversal.

Difficulties can also result from short-term volatility of exchange rates. The severity of these difficulties varies with the extent to which firms and other economic agents possess skills of financial risk management and have access to different instruments designed for this purpose. For large financial firms, as well as for non-financial firms with well-developed treasury-management functions, the hedging of fluctuations in exchange rates and other financial variables can be highly effective. Such hedging comprises long-established techniques such as the matching of assets and liabilities denominated in different currencies, price adjustments and invoicing practices, geographical diversification of operations, the timing of payments and receipts of foreign exchange, and the use of instruments such as forward, futures and options contracts designed to provide protection against exchange- and interest-rate fluctuations.[6] Although the expansion of markets for hedging instruments in recent years has facilitated the use of such techniques, it is not possible to achieve complete protection against financial volatility by these means. This impossibility is partly due to gaps in the coverage of hedging instruments (an example being the lack of forward and futures contracts for many currencies and maturities) and partly to the problems posed for current techniques of financial risk management by fluctuations in volatility itself outside specified ranges.[7] Moreover for many firms and economic agents, especially those of developing countries, access to these techniques remains restricted or highly expensive, and fluctuations in volatility itself can be expected to be a source of still greater difficulties for them.

Evidence on the adverse effects of currency volatility on international trade and other economic activities is somewhat fragmentary. There is none the less widespread belief that short-term currency volatility abbreviates time horizons for investment decisions, raises transactions costs and, through its close relation to volatility of asset prices and interest rates, increases wealth holders' preferences for liquid as opposed to longer-term financial instruments.[8]

D. International regimes and the scope for policy

National policy responses to the threat of exchange-rate misalignment posed by unstable international capital flows are of several kinds, and are not mutually exclusive since different kinds of measures may be used to reinforce each other. One response is official intervention in the currency markets in the form of purchases and sales of foreign exchange.[9] If there are persistent capital outflows, such a policy on its own will eventually lead to the exhaustion of a country's exchange reserves and credit lines. In the case of capital inflows official intervention causes an increase in the country's money supply unless its effects are sterilized. However, as is documented from the experience of selected developing countries in section E below, such sterilization usually entails some loss of control over domestic monetary policy and may lead to rises in interest rates and unwanted increases in government indebtedness. The response to capital flows may also include fiscal tightening, but such action is frequently open to the objection that in consequence exogenous developments in international financial markets are being permitted to override national objectives regarding fiscal balance and public expenditure. Faced with the problems associated with handling the effects of capital flows solely through some combination of intervention in exchange markets and fiscal measures, countries may have recourse to actions aimed more specifically at the capital movements themselves. Some of the measures under this heading are in the form of taxes or tax-like restrictions which exercise their effect on capital transactions by increasing their costs and thus reducing their profitability. Other restrictions involve more direct limits on capital transactions.

Both categories of restriction have been extensively used by developed and developing countries to control outflows and inflows during the postwar period.[10] However, in recent years OECD countries have become increasingly subject to self-imposed restraints regarding the use of such restrictions, embodied in the international legal regimes for capital transactions.

The only global regime applying to international monetary movements is that of IMF. But the most important obligations in its Articles of Agreement relate to current transactions and not capital movements. These are set out in Article VIII (which prescribes the obligation not to impose restrictions on payments and transfers for current international transactions without the Fund's approval) and in Article XIV (which specifies transitional arrangements for countries not yet willing to accept the obligations of Article VIII). Concerning international capital movements, Article IV contains, among the general obligations of IMF members regarding exchange arrangements, the statement that one of the monetary system's essential purposes is the provision of a framework facilitating the exchange of capital among countries.[11] In more specific references to capital movements in Article VI, section 3 provides for the exercise by member countries of such controls as are necessary to regulate international capital movements so long as they do not restrict payments for current transactions. Section 1 of the same Article gives the Fund the authority to prevent the use of its resources to finance a large or sustained capital outflow.

Developed countries, however, are subject to obligations under the OECD Code of Liberalization of Capital Movements and (in the case of members of EU) under the EEC Council's 1988 Directive on capital movements and the Maastricht Treaty. The OECD Code classifies the great majority of capital movements into two Lists, A and B, to the former of which more stringent liberalization obligations apply. For much of the period of the Code's existence List A consisted principally of operations judged to have fairly close links to international trade in goods and services and to longer-term investment, while List B included operations in short-term financial instruments. But recently the scope of operations included in List A was extended to some hitherto covered by List B, and a number of previously uncovered money-market operations were added to List B.

The 1988 EEC Directive on capital movements forbids restrictions on those between residents of member countries subject only to provisos concerning the control of short-term movements during periods of financial strain and certain measures necessary for the functioning of tax and administrative systems and for prudential supervision. Under the Directive member countries are also committed to endeavour to attain the same degree of liberalization of capital movements with third countries as with each other. The provisions of the 1988 Directive are reinforced by the pertinent articles of the Maastricht Treaty applying to the second stage of economic and monetary union, which began in 1994. Once the third stage of this union starts, the imposition of controls over short-term capital movements during periods of financial strain for single-currency countries will continue to be permitted only with regard to non-EU countries.

Under current international legal regimes developing countries, on the other hand, have considerable latitude regarding controls over international capital movements. Some of them have none the less undertaken obligations in this area as part of Treaties of Friendship, Commerce and Navigation or of regional agreements involving limited numbers of countries such as the North American Free Trade Agreement (NAFTA). Moreover, such obligations may well become more common as the number and country coverage of regional agreements expand.

E. The international financial markets and developing countries: access and challenges to macroeconomic management

Notable features of the rise in private external financing for developing countries and economies in transition in the 1990s have been its concentration on a small number of recipients and the varying character of the flows and of national policy responses to them. Both features have implications for the shape of an appropriate international financial regime and for international

economic policy more generally. The extreme unevenness of the distribution of external financing from private sources, which for several developing countries is associated with tight restrictions on, or the virtual absence of, access to such financing, means that there remains an indispensable and substantial role in the provision of development financing to be played by the official sector.

The variety of responses to increased capital inflows reflects divergences in the policy objectives and the perceived effectiveness of policy instruments in recipient countries. Such divergences point to the need for an international financial regime with rules that are sufficiently flexible to accommodate a broad gamut of policy measures on the part of developing countries and economies in transition regarding the capital account of the balance of payments.

The concentration of financial flows applies to all the major categories of financing from international capital markets. In recent years more than three quarters of external bond issues by developing countries and economies in transition have been accounted for by four borrowers in Latin America and five in Asia. More than 60 per cent of the value of syndicated international bank lending has gone to six Asian borrowers.[12] High levels of concentration, again involving countries which were also the main recipients of categories of financing already mentioned, have also characterized international equity issues, medium-term Euronote facilities and issues of Eurocommercial paper. Thus the great majority of developing countries have not shared in the increase in financing from the international financial markets of the 1990s. For example, little money from this source has been raised in securitized form by countries in sub-Saharan Africa, and net international bank lending to this region has been widely negative (although a recent analysis of the figures suggests that this unfavourable picture may be due in part to deficiencies of countries' reporting systems for balance-of-payments statistics).[13]

The breakdown of external financing by major categories has varied even among the main recipients, as discussed in more detail above (chapter II, section B). For example, FDI as a share of new capital flows amounted to 70 per cent for Singapore in the period 1991-1994, while for the Republic of Korea the corresponding figure was less than 10 per cent. Generally, bank lending was a relatively less important source of external financing for Latin American than for Asian countries, while a number of Asian countries received relatively little financing in the form of international bonds and international equity issues.

Furthermore, there have been marked differences in the relation of these capital inflows to major macroeconomic variables and economic performance in recipient countries, their effects being determined by, *inter alia*, the size and composition of the inflows, exchange controls and regulations governing inward and outward financial operations, and the economic policies of the countries themselves. Thus in some countries, particularly certain Asian ones, the inflows were associated with increases in domestic savings and investment, whilst in others they were a substitute for, rather than a complement to, domestic savings, in consequence contributing much less to economic performance. In several of the recipients an important effect of the inflows has been to increase the fragility of the domestic banking system. Banks have been tempted by the availability of external financing at a low cost to finance local-currency operations from this source, including the acquisition of illiquid assets. The consequence has been the mismatching of currencies and maturities, the potentially destabilizing effects of which have been particularly important in countries lacking effective systems of prudential regulation.

Few of the major recipient countries adopted a largely or completely non-interventionist stance towards financial inflows. But considerable differences have none the less characterized the measures taken to ward off misalignment and other potentially adverse effects.[14]

There has been widespread recourse by recipient countries to intervention in foreign-exchange markets to prevent currency appreciation. However, where capital inflows were large relative to current-account deficits, such intervention created serious conflicts with domestic monetary policy objectives.

When intervention was not sterilized, there resulted rapid increases in money supply which threatened loss of control of monetary policy. Very rarely did the increases reduce interest rates, discourage capital inflows and ease the upward pressure on the currency. Fiscal tightening has been recommended as a way of solving the problems arising from non-sterilized intervention. This

would be achieved, first, by restraining domestic absorption, and secondly, by generating a budget surplus to absorb the excess supply of foreign exchange, which could be used to reduce foreign-currency public debt. However, fiscal policy has often lacked the flexibility required. Furthermore, the scope for generating fiscal surpluses without undermining the efforts to develop human and physical infrastructure has generally been limited. Thus, very few countries have been willing to subordinate the goals of their fiscal policies to the offsetting of the impact of external capital flows.

Sterilization of intervention in foreign-exchange markets to offset its impact on money supply and prices through sales of interest-bearing government paper, on the other hand, increases interest rates, thus accelerating capital inflows. Indeed, the high-yield short-term government debt issued as part of the sterilization policy has itself often become a source of attraction for additional capital inflows. Paradoxically, in many cases a deterioration in the fiscal position has also resulted, since the rate of interest earned on the increased exchange reserves thus required was almost always below that paid on short-term government debt. These quasi-fiscal deficits also were themselves a source of increases in money supply in countries where intervention was sufficiently large and interest differentials were substantial.

Other methods of sterilization have also been used, including restrictions on domestic credit expansion through increases in statutory reserve requirements, window guidance and direct controls, and increases in discount rates. Some countries have also used central bank swaps, selling foreign currency to domestic financial institutions that are required to invest it abroad with the implicit guarantee that the central bank would make good any losses due to interest-rate differentials or exchange-rate adjustments. However, such methods have typically provided only temporary relief and, by creating losses and pushing up interest rates, have often aggravated the problem to which they were a response.

The problems associated with sterilized intervention have led to other policy responses to large capital inflows. For example, import liberalization has been tried as a way of absorbing the excess supply of foreign exchange. But such liberalization can result in increased import dependence or higher imports of consumption goods. The loss of government revenue due to the tariff reductions associated with import liberalization can also contribute to fiscal imbalance.

An approach without such adverse side-effects has been the adoption of more flexible exchange-rate policies. The avoidance of rules for official intervention and of advance announcement of devaluations, the widening of currency bands, and the linking of the currency to a basket of currencies rather than a single benchmark currency can increase the effectiveness of monetary policy and slow capital inflows by introducing uncertainty regarding movements of the exchange rate. But this approach involves the risk of sacrificing the benefits sought from exchange-rate stability.

There has also been increasingly widespread recourse to more direct controls over capital inflows, but with considerable variation among countries in the extent to which such controls were integrated into overall balance-of-payments policy as opposed to constituting an ad hoc response to the problems caused by the inflows. For example, some countries, notably the Republic of Korea, geared controls to the state of their current account: when the current account deteriorated, restrictions on capital outflows were tightened, while those on inflows were loosened, and vice versa when the current account recorded a surplus and the currency came under upward pressure. The main strategic consideration in this approach has been maintaining competitiveness irrespective of whether the current account was in surplus or deficit. Capital flows have not been allowed to govern the exchange rate and the current-account balance, but rather developments in the latter have dictated the way in which capital controls were implemented. Restrictions have been maintained on holding and issuing foreign-currency assets in the domestic market, so that shifts between domestic and foreign assets have been more likely to involve cross-border transactions. This has greatly facilitated the regulation of capital flows. Other countries, in both Latin America and Asia, have also regulated capital flows successfully but their approach has been somewhat different. They have resorted to regulation of inflows or deregulation of outflows (or both) only after capital inflows had already started to undermine competitiveness or to widen the current-account deficit (or both), or when intervention in the foreign-exchange market had already proved problematic for the reasons already described. Consequently, these countries have experienced greater instability of capital flows, current-account balances and exchange rates.

The measures used by developing countries to control capital inflows have included both the taxes and tax-like restrictions and the other, more direct, limits on capital transactions mentioned in section D above. The measures have often differentiated between FDI and portfolio investment, and between categories of capital transaction.

One of the more successful instruments of control, which is designed to close the arbitrage gap between returns on foreign and domestic assets, has been non-interest-bearing reserve requirements for inflows. Variable reserve requirements have been applied when setting the reserve requirement at a single level which did not undermine long-term investment proved ineffective in checking short-term capital inflows. In such cases the reserve ratio varied inversely with the maturity of the investment. Reserve requirements discourage capital inflows by reducing their net effective rate of return, thus having an effect much like a levy on foreign-exchange transactions. These reserve requirements were a policy tool independent of normal prudential regulations. Some Latin American countries have also actually imposed taxes on selected capital inflows.

Risk-adjusted capital requirements have been applied to banks' and institutional investors' acquisition of assets abroad. Foreign-currency deposits, foreign-currency borrowing and interbank credits have been included in defining the base for statutory reserve and liquidity requirements. In countries which have successfully managed capital inflows, regulations designed to reduce the currency mismatch between assets and liabilities and to restrict open positions in foreign exchange have typically been a permanent feature of the financial system. A number of quantitative restrictions have also been deployed, including restrictions on issues of external bonds and American Depository Receipts (ADRs) in the form of specification of minimum issue sizes and credit rating for the issuers, the prohibition of sales of money-market instruments such as Treasury bills to non-residents, bans on commercial banks' swaps unrelated to trade, and quantitative limits on offshore borrowing by public enterprises and commercial banks and on forward transactions with non-residents.

Experience so far suggests that successful management of capital flows depends on combining in a flexible and pragmatic manner the tools of macroeconomic policy with regulations designed to reduce the volatility of such flows by deterring interest-rate arbitrage, limiting destabilizing speculation, and avoiding bubbles in asset prices and exchange rates. While macroeconomic policies characterized by consistency and by fiscal and monetary discipline have been essential prerequisites for the management of capital flows, such policies needed to be accompanied by other measures, directly affecting the capital account.

F. Other global policy actions

1. Introduction

As explained in section D above, OECD countries have now accepted obligations under the OECD Code of Liberalization of Capital Movements and the regime of the EU which substantially restrict their freedom to use capital controls. Nevertheless, there is continuing discussion in these countries concerning international policy actions consistent with these constraints which would have the aim of producing more orderly financial markets and of avoiding crises due to volatile capital movements as well as handling such crises when they occur. The actions proposed include financial integration, macroeconomic policies aimed at economic convergence, an international lender-of-last-resort facility, arrangements for preventing difficult balance-of-payments situations from developing into full-blown financial crises, new techniques of official intervention in the currency markets, improved prudential supervision of firms engaged in international financing, and various tax and regulatory measures directed at the reduction of international financial instability.[15] The policy

actions which are discussed in this section are mostly directed in the first instance at financial instability and volatile international capital movements among OECD countries. But they also take account of developments due to the integration of financial markets and its consequences for developing countries. Moreover, the benefits of more orderly financial markets generally would also extend to developing countries.

2. Monetary union and financial integration

One way to avoid the problems caused by the effects on exchange rates of volatile international capital movements is to introduce a single currency. Monetary union is not a realistic prospect at a global level but is envisaged for EU countries under the Maastricht Treaty. The attainment of monetary union is generally believed to require the convergence of potential members with respect to key economic criteria - involving for EU the stability of exchange rates, a specified permissible deviation of interest rates from a benchmark, and the avoidance of excessive government debt and deficits. However, rules such as those embodied in the Maastricht Treaty are inherently deflationary by virtue of their requirement that countries with excessive deficits should retrench without corresponding obligations regarding more expansionary monetary policies or the adoption of more expansionary fiscal policies by countries capable of doing so, while still meeting the Treaty's fiscal criteria.[16] Moreover, the discussion of the behaviour of exchange rates in section B above points to doubts that progressive convergence regarding economic fundamentals will ensure achievement of the required stability of exchange rates in the presence of freedom of capital movements.

Political agreement on the introduction of a single currency is not the only approach to financial integration. An alternative, which might be described as "bottom upwards", in contrast to the "top downwards" instrument of a single currency, would rely on profit incentives at the level of banks and other financial institutions for the achievement of a continuous and orderly process of external-payments adjustment.[17] All restrictions would be removed on the use of currencies of member countries, thus making them legal tender throughout the financially integrated region. Banks would thus offer deposits in any of the region's currencies, and could consequently be expected to hold foreign-currency deposits as part of their primary reserves and short-term foreign currency assets among their secondary reserves. An external payments imbalance in any part of the region, whether caused by flows on current or capital account, would then require banks in the deficit area to sell foreign-currency assets, increasing domestic deposits of banks in the surplus area and decreasing them in the deficit area. The interest-rate differentials which could be expected to result from these actions by banks would then move in favour of the deficit area so that banks in the surplus area would be attracted by the resulting higher yields to expand their holdings of the deficit area's assets, thus automatically generating increased demand for its currency.

3. Policies for macroeconomic convergence

Macroeconomic policies designed to lead to convergence with regard to fundamental variables such as inflation, interest rates and fiscal deficits are often put forward as the key element of a strategy aimed at achieving greater international financial stability. A major difficulty with this approach would be that of obtaining international agreement covering the United States, EU countries (both those eventually entering the monetary union and those staying outside), Japan and other countries on the required levels of these fundamentals and on the measures necessary to attain them. Furthermore, and perhaps more fundamentally, the evidence discussed above in section B casts doubts on whether currency markets and international capital flows are closely connected to economic fundamentals as presupposed by this approach. Indeed, experience suggests that the theories underlying advocacy of convergence with regard to such fundamentals have little or no relation to indicators widely used by actors in financial markets to guide their decisions concerning their holdings of different currencies.

4. An international lender of last resort

National central banks typically are called upon to provide support to financial institutions facing temporary liquidity shortages in order to prevent them

from growing into more generalized insolvencies. An analogous institution at the international level is lacking, although volatile international capital movements are now capable of subjecting entire economies to severe strain (often in situations where such movements cannot easily be justified on the basis of the economies' fundamentals). An international lender of last resort would require large financial resources and access to all major currencies.

A role with several features of an international lender of last resort was originally envisaged for IMF as part of the postwar international financial system. However, this role was to apply only to current-account transactions, and its extension to capital transactions would require reinterpretation of Article VI (described above in section D). Current proposals for a Short-Term Financing Facility (STFF) are designed to allow IMF to play a more active role as lender of last resort to developing, and possibly other, countries.[18] Resources under this Facility might be available for rapid disbursement to offset the impact on countries' external payments of capital outflows due to changes in market sentiment and speculative pressures which do not reflect economic fundamentals. In such situations the Facility would contribute to the avoidance of excessive currency depreciations and deflation, and would reduce the risk of default on external obligations.

The case for such a facility was dramatized by the recent Mexican crisis. Establishing it would require decisions concerning issues such as country coverage, the procedures for disbursement of funds, the conditions associated with drawing rights, the level of access in relation to IMF quotas, the maturity of loans, and the amount of the facility's financial resources and the modalities of raising them. The size of any such facility presents a particularly difficult problem, since the financial support mobilized for countries during recent currency crises has frequently amounted to large multiples of existing IMF quotas. Some of the problems which would have to be confronted are indicated by the difficulties being experienced over the implementation of the initiative of the Group of Ten to increase the resources of the General Arrangements to Borrow, which provide a line of credit to IMF. Under this initiative the group of countries which would make available resources for this line of credit would be expanded, but there have been disagreements over the association of the new countries involved in the decision-making process regarding the use of these resources.

Tighter surveillance of countries' policies and performance could be expected to accompany the establishment of a STFF. Moreover, it would be reasonable to expect, as a complement to the provision of an international lender-of-last-resort facility, pressures for various types of action which might contribute to more orderly international financial markets.[19] One proposal frequently put forward in this context, concerning policies for macroeconomic convergence, was mentioned above. The two which immediately follow were partly or wholly inspired by the policy debate in the aftermath of the Mexican crisis, whereas those taken up subsequently are proposals of longer standing.

5. More orderly arrangements for handling emergent external payments problems

The Mexican financial crisis has led to a revival of discussion of formal arrangements for the handling of external debt and payments problems which would be less ad hoc than current ones, and less likely to generate controversy concerning appropriate international policy responses. Such arrangements would be intended, *inter alia*, to prevent incipient problems in a debtor country from developing into full-blown crises marked by the collapse of the exchange rate and economic activity and a threat to its banking system as well as possible spillover effects on other countries' financial markets.

One of the more fully articulated proposals[20] for this purpose would have the following principal elements: a signalling role for IMF under which in appropriate circumstances the Fund would indicate to a debtor country its approval of a temporary suspension of debt-service payments, subsequently also disclosing its action to the financial markets in order to help in the avoidance of a panic; the creation of a representative bondholders' committee, which would minimize uncertainty as to the terms of authority in negotiations on the restructuring of debts in the form of external bonds; a mediation and conciliation service designed to speed negotiations between the debtor and the bondholders' council; changes in bond covenants designed to permit a majority of creditors to alter the terms in the interest of the speedy settlement of debt restructurings, thus preventing small minorities from holding up the progress of negotiations; and an arbitral tribunal to which dissident credi-

tors could have eventual recourse - an arrangement which, it is hoped, would make contractual innovations regarding bond covenants more palatable. The role of IMF under this proposal would be closely related to that envisaged for it in the event of the establishment of a STFF. Solutions to the problems of countries imposing temporary standstills on debt-service payments would be found primarily through negotiations with creditors. But IMF would be provided with additional resources which would be available for rapid disbursement in situations where the stability of the debtor's banking system was threatened, there was a danger of contagion in the form of the spread of instability to other emerging financial markets, or the run on the debtor country had a self-fulfilling character unconnected to weak fundamentals.

The proposal's contribution to more orderly financial markets would depend on whether an IMF-approved standstill on debt-service payments preceding recourse to more orderly arrangements for working out a debtor's problems would prevent a run by investors. The authors believe that in the case of Mexico in late 1994 approval by the Fund of a suspension of debt-service payments on *tesobonos* and *cetes* would have helped to contain the crisis by halting the run on Mexican assets, thus eliminating the need to bail out private investors with public funds, though not necessarily avoiding many of the other adverse developments such as the spillover effects on other financial markets.[21] In their view, however, the policy response to the Mexican crisis is extremely unlikely to be repeated, and their proposal would contribute to reducing the instability associated with future crises, since it would be known in advance that massive rescue packages would no longer be forthcoming. Doubts regarding their proposal concern the difficulty of anticipating both the dynamics of international financial crises and creditors' responses.

6. International standards of prudential supervision

At the national level the regulatory framework for financial systems includes not only a lender-of-last-resort facility and orderly arrangements for handling insolvencies but also prudential supervision of financial firms. Recent years have witnessed efforts to develop an international regime of prudential supervision which would cover the rapidly expanding cross-border operations of such firms.

International initiatives to improve the prudential supervision of banks with such operations date from the 1970s, and were a response to the awareness of regulatory authorities in countries with large financial centres that a major banking default could have a destabilizing effect that extended beyond the jurisdiction in which it took place. The main sources of these initiatives have been the Basle Committee on Banking Supervision and the Bank for International Settlements (BIS).[22] The early work of the Basle Committee was concerned with strengthening the standards of prudential supervision of international banks and improving international supervisory cooperation, better internal controls for banks' international credit risks and internationally uniform standards for the capital set aside for banks' credit risks. More recently the Basle Committee's attention has been turned to capital requirements for market risks, namely risks due to changes in the prices of different components of banks' trading books. Other bodies associated with BIS have focused on reducing the risks of payments and settlement systems, the development of statistics for the global market for foreign exchange and closely related financial instruments, and supervisory and accounting standards for financial conglomerates. These initiatives can be expected to contribute to greater financial strength and improved risk management for international banks.

The effects of these initiatives are not limited to members of the Basle Committee and BIS. Standards promulgated by the Basle Committee are accepted in many other countries. This process will be reinforced by the insistence of many countries during the negotiations on financial services in WTO on inclusion of observance of these standards by regulators in banks' home countries among conditions for the granting of market access. However, the main focus of international supervisory initiatives has been default risk. Better internal controls and improved allocation of capital to banks' different activities may reduce, but will not eliminate, their involvement in speculation. Moreover, the remit of banking supervisors in many countries does not include non-bank securities firms (whose supervisory bodies are represented in other multilateral organizations, such as the International Organization of Securities Commissions (IOSCO)), let alone the increasing number of non-financial institutions which now take large positions in the international financial markets. The activities of these non-bank participants in the markets are widely believed to be major sources of recent international financial volatility.

7. Capital requirements and restraining currency speculation

Suggestions have been put forward for more direct use of prudential regulation regarding banks' capital as an instrument for restraining currency speculation. The primary function of banks' capital is to absorb losses which might otherwise threaten their continued operation. But if the size of balance-sheet positions permitted under banking regulations is linked to the capital supporting them, such requirements can also restrict the scale of banks' involvement in particular activities. Accordingly, it has been proposed that an internationally agreed surcharge should be imposed on capital requirements for banks' open positions in foreign exchange so as to increase the costs to them of currency speculation.[23] The agreement would have to extend to all financial centres to prevent its frustration by the flight of currency trading to jurisdictions where the surcharge did not apply.

A major problem to which such a surcharge on a permanent basis would give rise is that it would be at variance with the approach to managing market risks embodied in the procedures for determining capital requirements for such risks adopted by the Basle Committee at the beginning of 1996.[24] Under these procedures, which are intended to serve as the basis for regulations which will be implemented by the end of 1997, banks will be permitted to use proprietary risk-management systems to measure market risks. The core of these procedures is the setting of a bank's capital charge on the basis of a measure generated by its in-house model of the value at risk of its trading book, that is to say of the maximum loss on the trading book expected during some period at a specified level of confidence. Some allowance for offsetting correlation effects between broad categories of risk (interest rates, exchange rates, equity and commodity prices) will be permitted, so that the market risk associated with foreign exchange positions will not be segregated. Use of an alternative method for calculating capital requirements, which does segregate positions in foreign exchange and precious metals, is also possible, but widespread use by banks of proprietary models to generate their capital requirements will mean that estimation of these requirements will not be carried out on a uniform basis. Thus, while the imposition of capital charges as a measure to restrain currency speculation remains a policy option, such action would now be at variance with the approach to managing market risks embodied in the 1996 guidelines of the Basle Committee. Recourse to such charges seems more likely as part of an emergency policy response to a crisis in the foreign-exchange markets than as a measure imposed on a more permanent basis (in spite of the likelihood that their effectiveness will often be limited in such circumstances).

8. New methods of intervention in foreign-exchange markets

Recent financial innovations designed to facilitate risk management have furnished new opportunities not only for private-sector participants in international financial markets but also for monetary authorities. There is a long tradition of intervention by central banks not only in the spot but also in the forward foreign-exchange market. Creation of forward markets as a vehicle for intervention was urged by Keynes during the interwar period. In view of the relationship of forward premiums to international interest-rate differentials, Keynes proposed intervention in the forward market by the central bank as a way of influencing capital flows without changing official interest rates. The possibility of defending the spot exchange rate in this way at no immediate cost to official reserves has been extensively analysed in the literature,[25] and such intervention played an important part in the defence of sterling in the 1960s. Forward exchange contracts are a form of derivative instrument, so that unsurprisingly the recent proliferation of derivatives has been accompanied by proposals for the use by central banks of the new instruments for the purpose of hedging their foreign exchange reserves and of intervention in the foreign exchange market.

For example, the former Director of the Group of Thirty has proposed that central banks purchase far-out-of-the-money put options on their currencies as a technique for defending the exchange rate against the effects of large speculative outflows.[26] The technique would have relatively low costs since the out-of-the-money options would have low premiums. In the event of downward pressure on the currency, the options could be exercized, thereby providing additional reserves to limit the depreciation. The reserves could also be used to sterilize the funds used to exercize the put contract.

There are many other potential uses of options for official intervention in the foreign-

exchange markets. For example, the sale of covered calls on foreign currency could also be used as part of the defence of an upper limit for a country's exchange rate. Likewise, in order to prevent an undesired currency appreciation due to excessive capital inflows, the central bank might write put options on a foreign currency. The Hannoun Report even raised the possibility that by writing currency options and thus reducing option premiums central banks might also reduce implied volatility, thus producing a desired signalling effect helping to counter disorder in the foreign-exchange market.[27] However, the ultimate result of such intervention is not clear, since changes in prices due to reduced implied volatility would have an additional effect on the delta hedging of options positions by dealers.[28]

Derivative products clearly provide banks with additional instruments for intervening in foreign-exchange markets, but two caveats are in order. Firstly, not only must a market for options in the currency exist (a condition which is likely to require the existence of a futures market, as most options are written on futures contracts), but also, if intervention via options is to provide an effective alternative to that in the forward market, the market for options should be reasonably liquid. Secondly, a central bank might have to confront criticism, similar to that which it faces if it fails to defend its currency through intervention in the forward market, that it has provided the counterpart of speculators' profitable forward sales. Where the recourse to put options is a means of defence against capital outflows the criticism might take the form that the central bank was speculating against its own currency and, if its initiative were successful, that it had generated profits for banks in exchange for instruments which had expired unused.

9. Taxation of foreign-exchange transactions

In recent debate on ways to control instability in the international financial markets there has been much discussion of the idea of taxing foreign-exchange transactions, originally proposed by James Tobin in the 1970s.[29] Such a tax, which has also attracted interest as a potential source of revenue for various internationally agreed purposes, presents a series of difficult, though not necessarily insuperable, practical problems. Decisions would be necessary concerning the locations at which the tax would be imposed, the level of the tax, and the coverage of instruments.

The question of location has been subjected to a thorough discussion by Kenen in a recent volume on different aspects of the Tobin tax.[30] Kenen plumps for the location or locations at which the deal is made in preference to the site or sites at which the deal is booked (which would not be identical if booking is done at the head offices of the overseas branches of the dealers' banks) or to the country in which settlement takes place (when settlement, for example, involves the transfer of sums between banks' correspondents). One difficulty frequently raised in connection with the Tobin tax is the possibility that some financial centres would refuse to impose it, with the consequence, as in the analogous case of a surcharge on banks' capital requirements discussed in the preceding sub-section, that these centres would attract large amounts of additional currency trading from other locations. Kenen also suggests a possible solution to this problem, namely the taxing of transactions with tax-free trading sites at a punitive rate. But, as he admits, while this could act as a strong disincentive to the migration of currency trading to smaller financial centres, it would not be an effective response to the refusal of a major financial centre already used by many traders (say, London) to join the scheme.

Decisions on the level and coverage of the tax cannot be divorced from consideration of its likely effects. Yet conclusions as to these effects are still speculative. Proponents of the tax have noted the way in which the expansion of currency trading has been accompanied by increased exchange-rate volatility. Thus, if the tax succeeds in reducing the volume of trading, so the argument continues, it should also reduce volatility.[31] There is indeed evidence that low percentage taxes or charges can have significant effects on both the levels and the character of financial transactions. To take one recent example, the fee of 10 basis points imposed by the Federal Reserve on daylight overdrafts in April 1994 reduced their amount by 40 per cent in the subsequent six months.[32] Another example is given in analysis of the stock market crash of October 1987 in the publication, *The Quality of Markets Report*, which attributed the limited role of programme trading in London at that time partly to tax and stamp duty.[33] More mundanely it should also be recalled that mutual funds sometimes impose exit fees on shareholders which vary inversely

with the holding period.[34] These charges act as a disincentive to herd selling by shareholders (though the consequent impact on the funds' investment managers is only indirect).

Quantitative research on the relation between trading volume and volatility is to be found mainly in studies of stock markets, which have investigated such subjects as the influence of the absence of trading on the volatility of daily returns on stocks[35] and the effects on stock markets of the introduction of transaction taxes or of increases in transaction costs. Two studies under the latter heading are of special interest in the context of the Tobin tax. The first[36] shows that the introduction of transaction taxes in the Swedish stock market caused an increase in volatility, and that daily volatility was greatest when the tax was at its highest level. The second[37] concerns the effects on volatility of the elimination in May 1975 of the New York Stock Exchange's 193-year-old system of fixed commission rates, and the results confirm the lack of an inverse relation between the level of transaction charges and volatility. Although the conclusions of these studies are not directly applicable to the foreign-exchange market, they should give pause to advocates of transaction taxes for restraining volatility in that area.

The difficulties of forecasting the effect of the introduction of a Tobin tax are enhanced by the complexity of the techniques through which traders now take positions in the foreign-exchange market. These positions often involve combinations of transactions, including recourse to derivatives. As a result, currency volatility depends on trading behaviour in a number of different, though closely related, markets. To be effective, a transaction tax should thus presumably apply to all these markets. But owing to this multiplicity of markets, forecasting the effects of a transaction tax becomes correspondingly harder.

A tax with the required comprehensiveness with regard to coverage of instruments and transactions would entail the solution of several awkward and sometimes novel problems of tax design. Spot and forward foreign-exchange transactions seem relatively straightforward: the tax could be assessed at a percentage rate of the transactions' value. Since foreign-exchange swaps, which combine simultaneous spot and forward transactions, are typically priced in the market as a single transaction, they might be treated in the same way for the purpose of the tax, being assessed on the same basis as simple spot or forward deals. But this does not exhaust the problems of tax design for these transactions since, for example, the timing of the tax obligation must still be decided. Currency futures might also be taxed at a percentage rate on the notional value of the contract. In this case the tax, if imposed when the contract is initiated, would have an effect on cash flow similar to an increase in the initial margin.[38] For currency swaps[39] the transaction tax might be imposed on the streams of netted payments[40] and on exchanges of principal, since these payments seem to correspond most naturally to the actual foreign-exchange transactions associated with such swaps.

Designing a transaction tax for currency options is likely to be particularly difficult. One solution might be to tax them only when they are exercised. However, this would leave untaxed options positions settled through offsetting in the options market (i.e. in the form of sales of contracts by longs or buyers, and purchases by shorts or sellers), and could be expected to enhance the attractiveness of currency options in comparison with other transactions as an instrument for hedging and portfolio management as well as for currency speculation. Stiglitz has proposed taking an option's strike price as the base for the transaction tax.[41] Puts and calls would then be taxed at 50 per cent of the rate applying to other foreign-exchange transactions, the rationale being that the pay-off to a long position in a call combined with a short position in a put at a time near the maturity of the contracts is approximately equivalent to the pay-off on an investment in the underlying asset.[42] But this equivalence applies when the exercise price of the option is equal to the price of the underlying asset and thus does not hold in all circumstances. Nevertheless, the idea may point towards a fruitful approach to tax design for currency options, namely the breaking-down of options positions into equivalent combinations of other contracts for which the design of transaction taxes is easier.

10. Alternatives to the Tobin Tax

A number of alternatives to Tobin's proposal have been advanced with similar objectives. These are framed to avoid problems such as those due to the difficulty of defining what is and what is not a foreign-exchange transaction. Dornbusch, for example, has proposed taxing all cross-border

payments.[43] While this approach has the virtue of simplicity, it would not eliminate all forms of evasion, since it would not be applicable to back-to-back transactions.[44] Moreover, since it adds to the costs of a wider variety of transactions than the Tobin tax, there is a risk that the proposal would meet with correspondingly stronger political resistance. The proposal is also open to the objection that the tax would be borne disproportionately by current, rather than capital, transactions.

An alternative to taxing foreign-exchange transactions for the purpose of reducing currency speculation, and one which might naturally occur to many economists, would be to tax the short-term profits of currency trading at a punitive rate.[45] Such a tax might be regarded as an instrument designed to achieve objectives analogous to those sought for stock trading from the 100 per cent tax on short-term gains proposed by the famous United States investor, Warren Buffet.[46] An internationally agreed tax of this kind would have to raise the taxation of short-term profits from currency trading to a uniform level if it were not simply to lead to the transfer of foreign-exchange business to lightly taxed jurisdictions.[47] Putting such a tax in place would seem a tall order, but the problems involved are none the less worth a somewhat closer examination.

Profits from trading, including that in currencies, are generally already subject to taxation, so that the base for an internationally agreed tax could be readily identified. But pre-existing tax systems would pose difficulties to the design of a supplementary international tax. These systems vary considerably among countries and, in respect of the newer instruments through which foreign-exchange positions can be taken, are often underdeveloped.[48] Moreover, in several countries the systems incorporate concepts inconsistent with the across-the-board approach on which an internationally agreed tax on trading profits would presumably have to be based.

For example, in many countries the tax treatment of profits associated with positions in currency futures and currency swaps depends on whether they are held for the purpose of hedging or speculation, the distinction frequently being related to the corresponding accounting treatment.[49] Since the objective of taxing short-term profits on foreign-exchange trading would be precisely to restrain speculation, there might seem to be an argument for incorporating the same distinction in the internationally agreed tax. However, achieving agreement on this subject, as on many other technical aspects of such a tax, could be expected to be, if anything, still more difficult than on the practicalities of a transaction tax.

11. Concluding remarks

Discussion of ways to bring greater stability to international financial markets has so far proved inconclusive. Those emphasizing the need for policies to achieve the "right" levels of fundamentals appear to ignore the frequently tenuous connection between fundamentals and the decisions of participants in the foreign-exchange market. Those who put forward measures directed at the processes associated with transactions have to confront the difficulty of delimiting the foreign-exchange market and dealing with the wide-ranging effects of rapid financial innovation.

For some financial markets their institutional structures make possible the imposition of rules designed to keep speculation within bounds and to prevent excessively large short-term movements of prices. These rules include daily price limits, circuit breakers under which trading is halted if prices fall by specified amounts, and position limits restricting the number of contracts which a speculator may hold. However, the global nature of the foreign-exchange market and the multiple channels linking it to the markets for other financial assets seem to rule out the application to it of such measures.[50] In consequence, there have been calls for the establishment of a central clearinghouse for foreign-exchange transactions, but technical, financial, organizational and political impediments make the idea seem utopian.

Financial innovation has in recent years produced an environment in which not only have there been large changes in the elements of financial markets that are the subject of tax and regulatory measures but also the traditional conceptual framework for classifying these elements has lost some of its relevance. Of special importance in the latter connection is the way in which derivative instruments have eliminated any sharp distinction between long- and short-term investments, with the result that the traditional association of an investment's maturity with its degree of permanence no longer holds as it once did. Derivatives now make it possible to construct synthetic equivalents of

long-term investments through the combination of such instruments with positions in short-term assets. As a result, there is a risk that the benefits of any reduction of speculation due to increased transaction charges (following, say, introduction of a Tobin tax) might be offset by the costs of disrupting arbitrage processes and what are now normal methods of managing cross-border financial risks. Moreover, international agreement on the imposition of increased transaction charges would have to be reached in circumstances in which those responsible for national frameworks of taxation and regulation are struggling to adapt them to what one famous analyst of financial markets has called "the new financial world".[51]

However, the difficulties of international action to control financial instability should not divert attention from the possible adverse economic consequences of such instability. Concern over financial instability tends to peak in the aftermath of periods of disorder in the currency markets, progressively subsiding as calm returns. It is possible to conceive a future in which periods of disorder would become less frequent and their effects less pervasive. For example, monetary union may be successfully introduced in the EU, its coverage being progressively extended to more member States, while improved risk management and tighter control of open foreign-exchange positions within financial firms could easily reduce their involvement in speculation. But even this optimistic scenario would leave important parts of the foreign-exchange markets open to the influence of speculative forces, and more pessimistic scenarios can also be envisaged. If the misalignments and volatility which are associated with foreign-exchange instability persist, they are capable of threatening countries' trading relations and more generally of posing a challenge to greater coherence in global economic policy making, a goal now publicly endorsed by Governments.[52] ■

Notes

1 Notably *TDR 1992*, Part Two, chap. I and annex II; *TDR 1993*, Part One, chap. III, and Part Two, chap. III; *TDR 1994*, Part One, chap. III; and *TDR 1995*, Part One, chap. II.

2 See *TDR 1990*, Part Two, chap. I, and *TDR 1994*, Part Two, annex to chap. II.

3 See the survey of the views of international investors concerning the stock exchange of Hong Kong undertaken as part of the aftermath of the crash of October 1987 and described in Securities Review Committee, *The Operation and Regulation of the Hong Kong Securities Industry : Report of the Securities Review Committee* (Hong Kong, 1988), appendix 9.

4 See, for example, M.R. Rosenberg, *Currency Forecasting: a Guide to Fundamental and Technical Models of Exchange Rate Determination* (Chicago, etc.: Irwin, 1996), pp. 337 and 379. A more radical critique of the very idea of identifiable fundamentals as determinants of market outcomes has been put forward by one of the best-known actors in the global currency markets, George Soros. According to this critique, market participants' understanding of such outcomes is necessarily imperfect but none the less serves as the basis for their decisions, which determine subsequent outcomes. This theory (which Soros dubs "reflexity") "connects facts to perceptions and perceptions to facts in a shoelace pattern, [yielding] a `shoelace' theory of history". It can easily be visualized that in the foreign exchange markets such interactions are capable of generating cumulative movements in currency prices. G. Soros, *The Alchemy of Finance: Reading the Mind of the Market* (London: Weidenfeld and Nicholson, 1988), chaps. 1 and 3.

5 See, for example, J.A. Frankel and A.K. Rose, "A survey of empirical research on nominal exchange rates", *NBER Working Paper No. 4865*, 1994.

6 For a fuller non-technical account of the techniques of financial risk management see D. Ross, I. Clark and S. Taiyeb, *International Treasury Management* (New York: New York Institute of Finance Corp., 1987), chaps. 3 and 4. Case studies of the management of currency risk can be found in G.J. Millman, *The Floating Battlefield: Corporate Strategies in the Currency Wars* (New York: AMACOM, 1990).

7 It should also be noted that financial and competitive risks may be interdependent. This point can be illustrated with an example from Ross, Clark and Taiyeb (*op. cit.*, p. 7). Consider a hypothetical company which imports wine from country B into country A. Unlike its main competitors, it covers its requirements for B's currency early in a particular year in the forward market. However, during the year there is a depreciation of the spot rate for B's currency of about 25 per cent. If the costs of the hypothetical company were locked in at the forward rate prevailing early in the year, while its competitors were in a position to sell at prices up to 25 per cent lower, the company might be in danger of being forced out of business. Recently developed risk-management instruments have facilitated the task of extricating companies from situations of this kind. For example, break-forward contracts can now be purchased, providing customers at an additional cost the option of reversing forward contracts if the spot exchange rate reaches a certain level.

8 For surveys of estimates of the effects of fluctuations in exchange rates on international trade see section B of the study by the UNCTAD secretariat, "The exchange-rate system", in *Compendium of Selected Studies on International Monetary and Financial Issues for the Developing Countries* (UNCTAD/ST/MFD/4), United Nations publication, Sales No. E.87.II.D.3, and *Exchange Rate Volatility and World Trade*, IMF Occasional Paper No. 28 (Washington, D.C.: IMF, 1984), chaps. IV-VI. The somewhat inconclusive nature of these empirical estimates should not be a source of surprise, according to a the former chairman of the United States Federal Reserve System, Paul Volcker, since "in a world in which so many things are happening at once, it is hard to pin down the effects of any one factor. But the logic of the situation suggests to me that, over a long period of time, the costs in economic efficiency must be substantial." P. Volcker and T. Gyohten, *Changing Fortunes: the World's Money and the Threat to American Leadership* (New York: Times Books, 1992), pp. 292-293.

9 Official intervention in foreign-exchange markets may also be used to restrain shorter-term currency volatility (see below, section F).

10 Such restrictions by developing countries in response to recent capital inflows are discussed in the next section.

11 As part of its surveillance function over exchange arrangements IMF is frequently supportive of varying degrees of liberalization of capital transactions by member countries. See P.J. Quirk, O. Evans *et al.*, *Capital Account Convertibility: Review of Experience and Implications for IMF Policies*, IMF Occasional Paper 131 (Washington, D.C.: IMF, October 1995), pp. 5-7 and 22-24.

12 For the concentration of the distribution of external financing in 1995 see chap. II, sect. A above.

13 See L. Kasekende, D. Kitabire and M. Martin, "Capital inflows and macroeconomic policy in sub-Saharan Africa", paper presented at the conference, *Global Capital Flows in Economic Development*, p. 7.

14 The discussion which follows makes extensive use of G. Le Fort and C. Budnevich, "Capital account regulations and macroeconomic policy: two Latin American experiences", and Y.C. Park and C.-Y. Song, "Managing foreign capital flows: the experiences of Korea, Thailand, Malaysia and Indonesia", papers presented at the conference, *Global Capital Flows in Economic Development*.

15 This list of proposed global policy actions is by no means comprehensive, limited as it is principally to ideas raised at the conference, *Capital Flows in Economic Development*.

16 See *TDR, 1993*, Part Two, chap. I, sect. C.

17 An approach of this kind has been suggested as a solution of the problems of financial instability between the United States, Japan and EU by Toyoo Gyohten (in *Changing Fortunes* ..., pp. 309-310). The mechanics of external payments adjustment under such an approach were fleshed out by James Ingram in a series of publications of the 1960s and 1970s, which are digested in L.B. Yeager, *International Monetary Relations: Theory, History, and Policy*, 2nd edition (New York, etc.: Harper and Row, 1976), pp. 634-636.

18 Concerning this proposal see J. Williamson, "A New Facility for the IMF?", *International Monetary and Financial Issues for the 1990s*, *Research Papers for the Group of Twenty-Four*, Vol. VII (United Nations publication, Sales No. E.96.II.D.2).

19 Concerning elements of an improved system of governance for the international monetary system see E.V.K. Fitzgerald, "Intervention versus regulation: the role of the IMF in crisis prevention and management", paper presented at the conference, *Global Capital Flows in Economic Development*, reproduced as UNCTAD *Discussion Paper No. 115*.

20 B. Eichengreen, R. Portes *et al.*, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (London: Centre for Economic Policy Research, September 1995), chap. 5, which served as the basis for a presentation by Eichengreen at the conference, *Capital Flows in Economic Development*.

21 The reference of Eichengreen and Portes to suspension of debt-service payments on domestically issued short-term debt instruments of the Mexican Government in this context points to the blurring of traditional distinctions regarding foreign and internal debt that has resulted from the global integration of financial markets.

22 Concerning the work of the Basle Committee see, for example, *TDR 1992*, Part Two, annex I, and *TDR 1995*, Part Two, chap. III, sect. D.

23 For a discussion of this proposal see *TDR 1994*, Part Two, annex to chap. II, sect. D.5.

24 The proposal for a capital surcharge was consistent with the approach to the measurement of market risks due to positions in foreign exchange for the purpose of setting banks' capital requirements set out in Basle Committee on Banking Supervision, *The Supervisory*

Treatment of Market Risks. Consultative Proposal by the Basle Committee on Banking Supervision (Basle, April 1993). However, this proposal encountered strong criticism from banks (as described in *TDR 1995*, Part Two, chap. III, sect. D.3) and its approach was subsequently replaced by that set out in the Committee's *Amendment to the Capital Accord to Incorporate Market Risks* (Basle, January 1996).

25 The *locus classicus* of historical information on forward exchange markets is the work of Paul Einzig, in particular his two books, *The Theory of Forward Exchange* (London: Macmillan, 1937) and *A Dynamic Theory of Forward Exchange* (London: Macmillan, 1961).

26 C.R. Taylor, *Options and Currency Intervention* (London: Centre for the Study of Financial Innovation, October 1995). A put grants its buyer the right (without obligation) to sell an asset at a pre-set price (the strike price) to the seller or writer of the option.

27 Bank for International Settlements, *Macroeconomic and Monetary Policy Issues Raised by the Growth of Derivatives Markets*, Report prepared by a working group (chaired by Hervé Hannoun, Banque de France) established by the Euro-currency Standing Committee of the central banks of the Group of Ten countries (Basle, November 1994), pp. 49-50.

28 The delta of a derivative instrument is defined as the rate of change of its price with respect to the price of the underlying asset. A delta-neutral position is one in which an investor's gain from a change in the price of the underlying asset is offset by a corresponding loss from the change in the price of the derivative instrument (and vice versa). This concept can be generalized to an entire portfolio consisting of several assets and derivative instruments, and is the basis of the portfolio strategy denoted as delta hedging.

29 J. Tobin, "A proposal for international monetary reform", *The Eastern Economic Journal*, July/October 1978. In explication of his proposal at various times Tobin himself has put greater emphasis on the increased autonomy for national interest-rate policies that would result from the tax than on consequent reduction of exchange-rate volatility.

30 P.B. Kenen, "The Feasibility of Taxing Foreign-exchange Transactions", in M. Haq, I. Kaul and I. Grunberg (eds.), *The Tobin Tax: Coping with Financial Volatility* (Oxford, etc.: Oxford University Press, 1996).

31 See, for example, D. Felix, "Financial Globalization versus Free Trade: The Case for the Tobin Tax", *UNCTAD Discussion Paper No. 108*, sect. 3B and annex, which served as the basis for a presentation by the author at the conference, *Capital Flows in Economic Development*. Felix's assertion that the Tobin tax could be expected to reduce currency volatility is related to his belief that such volatility reflects the impact of speculation, and that speculation is carried out mainly through short-term transactions, which are those for which profitability would be most reduced by such a tax (*ibid.*, p. 39).

32 H.R. Richards, "Daylight overdraft fees and the Federal Reserve's payment system risk policy", *Federal Reserve Bulletin*, December 1995, p. 1071.

33 "The International Stock Exchange of Great Britain", *The Quality of Markets Report*, Winter 1987/1988 (at p. 333, as reprinted in R.W. Kamphuis, R.C. Kormendi, and J.W.H. Watson (eds.), *Black Monday and the Future of Financial Markets* (Homewood, Ill.: Dow Jones-Irwin, 1989).

34 J.C. Bogle, *Bogle on Mutual Funds. New Perspectives for the Intelligent Investor* (Burr Ridge, Ill.: Irwin Professional Publishing, 1994), pp. 193-194.

35 For a summary of such studies see W.F. Sharpe and G.J. Alexander, *Investments*, fourth edition (Englewood Cliffs, N.J.: Prentice-Hall, 1990), chap. 15, appendix A.2.2.

36 S.R. Umlauf, "Transaction taxes and the behaviour of the Swedish stock market", *Journal of Financial Economics*, vol. 33, No. 2, 1993.

37 C.M. Jones and P.J. Seguin, "Transactions costs and price volatility: evidence from commission deregulation" (mimeo.), 1996.

38 Initial margin consists of the sum in the form of money and securities posted by buyers and sellers of futures upon initiation of contracts. The sum is typically in the range of 5-15 per cent of the price specified in the contract, the precise proportion being related to the contract's volatility.

39 Currency swaps (which are to be distinguished from the foreign-exchange swaps mentioned above) involve the exchange of series of payments denominated in different currencies. Under currency swaps, unlike interest-rate swaps, which entail the exchange of payments denominated in the same currency, the payments typically include both interest and the underlying principal.

40 Netting refers to the practice of setting off payment obligations between two counterparties so that only a single net payment is made to settle the residual obligation.

41 J.E. Stiglitz, "Using tax policy to curb speculative short-term trading", *Journal of Financial Services Research*, 3:1989, p. 14.

42 For puts see footnote 26. A call grants the purchaser the right (but without obligation) to buy an asset at a pre-set price (the strike price) from its seller or writer.

43 R. Dornbusch, "Cross-border Payments Taxes and Alternative Capital Account Regimes", paper prepared for the Group of 24, 1995 (to be published in UNCTAD, *International Monetary and Financial Issues for the 1990s*, *Research Papers for the Group of Twenty-Four,* Vol. VIII).

44 Back-to-back transactions can be illustrated by the example of an arrangement under which one company lends in its national currency to another company or to another company's subsidiary in return for an offsetting loan in the national currency of the borrower for itself or one of its subsidiaries. Such an arrangement enables the avoidance of cross-border payments in connection with the loans.

45 Melitz has proposed a 100 per cent levy on foreign-exchange profits on positions held for less than one year (with no corresponding tax deduction for losses). J. Melitz, "Comment on the Tobin tax", presented at the conference, *Globalization of Markets: Theoretical and Empirical Challenges and Prospects for Advances in Research*, sponsored by CIDEI, Università di Roma "La Sapienza", 27-28 October 1994 (CIDEI Working Paper).

46 Under Buffet's proposal all gains from the sale of stocks or derivatives securities held for less than a year would be subject to the 100 per cent tax. The proposal could be expected to lead to a drastic reduction in the trading of options and index futures. Concerning Buffet's proposal see L. Lowenstein, *What's Wrong with Wall Street? Short-Term Gain and the Absentee Shareholder* (Reading, Mass., etc.: Addison-Wesley, 1988), pp. 86-87 and 200-208.

47 As in the case of the surcharge on banks' capital requirements (section F.7) and the Tobin tax (section F.9), countries wishing to attract the business of currency trading would have an incentive to remain outside the agreement.

48 Ernst & Young, *International Bank Taxation*, 2nd edition (London: Euromoney Publications, 1993).

49 See, for example, the discussion of the taxation of banks' profits in the chapters on Belgium (by J. Buelens and W. Vandenberghe) and France (by N. Dejean) in Ernst & Young, *op. cit.*

50 The following characterization of the foreign-exchange market in a book by a currency trader brings out well relevant features in this context: "... the foreign-exchange market was never incorporated or chartered to perform any specific functions. To this day it has no headquarters and no official bureaucracy. The centers of this market remain diversified, and to a large degree its operations are improvisational. Essentially, there are as many foreign-exchange operations as there are computer display terminals and telephone hookups." A.J. Krieger, *The Money Bazaar: Inside the Trillion-Dollar World of Currency Trading* (New York: Times Books, 1992), pp.210-211.

51 H. Kaufman, *Interest Rates, the Markets, and the New Financial World* (New York: Times Books, 1986).

52 For example, in the Ministerial Declaration adopted at the conclusion of the Uruguay Round, in December 1993, on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking.