



THE OUTLOOK FOR DEVELOPMENT IN THE 1990S

UNIVERSITY OF GHANA
Outlook for development...



K. K. S. DADZIE

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*20th Aggrey-Fraser-Guggisberg Memorial Lectures
delivered at the University of Ghana, Legon
from 18th to 21st June, 1990*



GHANA UNIVERSITIES PRESS

ACCRA

1994

Published for
UNIVERSITY OF GHANA

by
Ghana Universities Press
P. O. Box 4219
Accra

© K. K. S. Dadzie, 1994

ISBN: 9964-3-0186-3

PRODUCED IN GHANA
Typeset by Frank Publishing Limited, Accra
Printed by Domak Press Limited, Accra

CONTENTS

<i>Preface</i>	ix
Lecture	
1. THE ENVIRONMENT FOR DEVELOPMENT: EXTERNAL CONDITIONS AND DOMESTIC POLICIES	1
Introduction	3
Problems of Adjustment	4
External Shocks, Adjustment and Macro- economic Disorder	8
Concluding Observation	10
2. DEVELOPMENT FINANCE BEYOND THE DEBT CRISIS	13
Introduction	15
The Inadequacy of Development Finance in the 1980s	15
Financing Development in the 1990s: Some Issues for Consideration	18
The Prospects for Increasing Official Flows	24
An Expanded Role for Private Flows	24
Concluding Observations	27
3. THE WORLD COMMODITY ECONOMY: COUNTERING INSTABILITY AND PROMOTING DIVERSIFICATION	29
Introduction	31
International Commodity Agreements and Other Arrangements for Producer-Consumer Co-operation	32
Diversification	37
International Support for Diversification	41
4. SYSTEMIC ISSUES IN TRADE, MONEY AND FINANCE AND EVOLVING ROLE OF UNCTAD	45
Introduction	47
International Trading System	48
International Monetary and Financial Framework	53
UNCTAD and the Evolution of International Economic Relations	56

PREFACE

Available evidence suggests that the overall international economic environment of the 1990s will not be a significant improvement on that of the 1980s and that it is likely to be influenced as much by trends inherited from the past as by the opportunities and challenges arising from the process of change in the world economy.

The past decade has seen an increased degree of interdependence within and among different groups of countries through trade, investment and technological innovation. This interdependence has been reinforced by closer financial linkages which, in turn, have increased the influence of international finance over trade. Meanwhile, the high geographical concentration of economic power has evolved towards a multipolar structure as dynamic new actors have emerged and established players have joined forces through the formation of regional economic groupings. The logic of economic interdependence has gained added force from the growing concern about ecological phenomena and about their potential for cumulative interaction with economic and social factors.

In addition to the growing integration of the world economy, the 1990s will also inherit a number of unresolved problems. One such problem is the persistence of imbalances in the world economy, particularly between the major developed market economies, and the coexistence of growth in the developed world and in some developing countries with stagnation or regression in large parts of the Third World. Another is the insufficiently fast movement towards an effective solution of the external debt problem. A third has to do with the persistence of low prices for the principal commodities exported by developing countries. And yet another relates to excessive rates of population growth in

some countries and skewed age distribution patterns in others.

Superimposed on these policy dilemmas are a number of incipient developments which, at least in the short-term, could make for uncertainty. Among these are: the easing of international political tension and progress towards disarmament; the greater integration of the Soviet Union and other countries of Eastern Europe into the world economy; the rapid evolution of trade in new products, especially services; and the increasing use of new financial instruments and techniques.

Just as no country or group of countries has remained untouched by the changes experienced in the 1980s, so is it that no country can, in the 1990s, achieve its economic and social objectives in isolation. In the highly interdependent and complex world I have described, the pursuit of the national interest requires policy makers to take into account a wider range of variables and considerations than before. For small countries, the constraints imposed by the external environment will influence the methods by which they pursue their national interest, if not their perception of that interest. For countries with a heavier weight in the world economy and whose policies, therefore, could ultimately rebound on themselves through their impact on trading partners, the national interest requires that account should increasingly be taken of the likely international consequences of domestic policies.

The conclusion to draw is that world economic stability and growth increasingly require national policies to be coordinated in order both to avoid inconsistencies among them and to ensure that they accord with global objectives. This calls for a corresponding development of international economic co-operation and for a systemic management of interdependence so as to achieve sustained global economic growth, development and trade.

In these circumstances, development can no longer be thought of as a purely national effort, but rather as a goal of common interest and an object of collective responsibility. Only thus can the vicious circle of stagnation that has gripped most of the developing world be broken. The success of the domestic policies of developing countries aimed at stability and development at a socially-desirable pace is crucially dependent not only on a substantial improvement in the external economic environment but also on the will of the international community deliberately to lend effective support to the development process. I shall discuss various aspects of this theme in the four lectures.

In the first lecture, I propose to examine the interaction between the external environment and domestic policies. In the second lecture, I shall discuss the prospects of development finance. The third lecture will address questions relating to the world commodity economy. Finally, in the fourth lecture, I shall consider some issues relating to the institutional framework of international economic relations and the role of UNCTAD in the development co-operation dialogue.

Geneva
June, 1990

K. K. S. DADZIE

Lecture 1

THE ENVIRONMENT FOR DEVELOPMENT: EXTERNAL CONDITIONS AND DOMESTIC POLICIES

Introduction

It is widely accepted that, taking initial conditions as **given**, the growth performance of a developing country **depends** primarily on its own policies, institutions and economic structure. Of these three factors, policies play a key role **since** they strongly influence the evolution of the other two. **Yet**, while there can be little doubt about the primary **importance** of domestic policies, the role of the external environment cannot be underestimated. Its influence stems from the dependence of developing countries on external **trade and finance**. This dependence is, of course, a manifestation of underdevelopment. For one thing, developing countries **rely** on imports to operate existing capacity and to expand it through new investment. For another, their ability to **generate** the foreign exchange needed through exports **depends** crucially on the state of world markets. Even when **world economic activity** is buoyant, export earnings tend to **fall short** of the level of imports which would permit a **socially-acceptable** level of activity and growth. External **financial transfers** are, therefore, needed to close the foreign **exchange gap**. They also allow investment to be raised above the level permitted by domestic resources alone, thereby **closing** the so-called savings gap. But the cost and availability of finance are themselves beyond the control of **developing countries**.

Thus, international trade and finance help reduce the constraints of domestic supply capabilities, investible **resources** and market size on economic growth and **development**. At the same time, they expose developing countries to **external shocks**. A country which is heavily dependent on imports of intermediate and capital goods will see its **production and growth** decline when foreign exchange availability is reduced because of a collapse in its export prices, **unless it** gains increased access to external finance. Similarly, a **rise in**

interest rates on external debt and/or a cutback in lending results in an increased share of export earnings being allocated to debt servicing rather than to imports. The country thus needs to adjust its balance of payments to changed external parameters. Policy re-orientation is called for when such changes are permanent. Even when they are transitory, however, countries often find it necessary to adjust because additional support from multilateral institutions does not always make up for the foreign exchange shortfall, and such support is conditional upon the implementation of certain policy measures.

Problems of Adjustment

In evaluating the likely effectiveness of payments adjustment, one would have to address two main questions: first, whether and to what extent the country can raise its export earnings or cut its imports without suffering a substantial loss of output, investment and growth and second, whether and to what extent declines in growth and investment would be transitory and reversible after a period of austerity, even though external conditions remained unfavourable.

Answers to these questions depend on the magnitude of external shocks, the extent of official external financial support, the level of industrial development reached, and domestic social and political institutions. When swings in external parameters are sizeable, the answer to the first question is usually negative. The answer to the second question also tends to be negative in countries lacking a large and flexible tradeable goods sector, and social and political institutions that facilitate burden-sharing among different economic sectors and social classes. In such circumstances, most developing countries would be unable to avoid loss of output and growth, and to reverse the decline through their own policy

efforts alone, so long as external conditions remained hostile.

This has, indeed, been the experience in the 1980s. Almost all developing countries suffered from a sharp decline in external resource transfers, owing, on the one hand, to worsened terms of trade and sharply-increased interest rates, and, on the other, to cuts in new lending. The cumulative cost of declines in the terms of trade reached 10 per cent of GDP, that is, about two years' growth in good times, and the entire output growth of the 1980s in a large number of countries.

Resource loss in debt-troubled countries through the decline in net financial transfers in the early 1980s was also considerable, amounting, on average, to almost 5 per cent of GDP. A number of countries turned from being net recipients to being net providers of financial resources. Most of the others, particularly in Africa, continued to be net recipients, but at much lower levels than before.

These losses necessitated a substantial adjustment of trade volumes. In most cases, export volumes were raised considerably, but the scale of adjustment required made it impossible to avoid drastic import cuts. Indeed, the widespread co-existence of increased export volumes and reduced import volumes was unprecedented in the 1980s. Consequently, *per capita* domestic production either stagnated or declined, and in many countries the absolute level of real domestic output fell.

The upshot was that the volume of resources, both external and domestic, available for consumption and investment declined drastically in a large number of countries, exceeding 20 per cent in some cases. Although *per capita* consumption fell too, it was investment that bore the brunt of the adjustment. Domestic savings fell a little in many countries, but national savings, i.e. domestic savings less net factor payments abroad, declined sharply as interest payments escalated. This, together with the cut in bank lending,

was the main factor depressing the pace of capital accumulation.

This is not to deny that important differences exist among developing countries regarding growth and macroeconomic stability. It is true that almost every developing country suffering from persistent macroeconomic instability has not only incurred significant terms of trade and financial shocks but also experienced a drastic decline in growth. However, not every developing country that incurred such shocks has had the same experience regarding growth and macroeconomic stability. A small number of countries in East and South-East Asia successfully absorbed such shocks, and reversed the initial decline in economic activity, restoring a satisfactory rate of growth with price stability.

Differing policy approaches no doubt played an important role. However, it would be simplistic to explain the collapse of growth and persistent macroeconomic instability in a large number of developing countries solely in terms of the pathology of policy-making. For one thing, policy makers do not enjoy the same degree of autonomy and discretion everywhere; they are subject to social and political constraints that are closely related to institutional arrangements. Thus, for certain policies to be effectively applied, certain institutions and organizations would need to be reformed, and, in some cases, suppressed. But since such arrangements are deep-seated reflections of a country's history as well as political and cultural traditions, such changes may be difficult to undertake, and attempts to do so may prove disruptive.

For many developing countries, adjustment in the 1980s was determined by their ability to initiate export-led growth following an initial period of austerity to accommodate the external shocks: the expectation was that exports would generate the foreign exchange needed to raise imports, and that the consequent growth would provide additional domestic resources for consumption and investment. Experience

has shown that the scope for such a sequence of events varies across countries. Economies with a large tradeable goods sector, substantial industrial capacity and a production pattern similar to that of their major trading partners, find it easier to raise export earnings following a currency devaluation: they are able to do so without having to depress output and real wages significantly and without running a high risk of triggering a devaluation-price-wage-devaluation spiral. Moreover, if the overall rate of investment can be prevented from falling too much, the capacity to produce exports and import substitutes can be enlarged. Then, as export-led growth picks up, inflation can be reduced and real wages raised without eroding competitiveness. Such has been the performance of certain countries in East and South-East Asia.

The possibilities for this kind of adjustment, however, are limited in countries, like several on this continent, where the export sector is heavily concentrated on a few primary commodities. Even where the export structure is diversified and includes manufactured goods, but where the foreign trade sector is small, adjusting the trade balance may necessitate substantial cuts in imports, particularly of investment goods. Unless the initial rate of investment is very high, that will constrain the ability to generate exports and growth over time.

Thus, while most developing countries relied increasingly on currency depreciation to attain the required trade adjustment, for many of them, particularly those with a debt overhang, this proved destabilizing. Since the burden of adjustment fell primarily on investment, it became increasingly difficult to sustain export growth without repeated currency depreciations. At the same time, these measures triggered sharp changes in income distribution and subsequent efforts to recoup lost purchasing power by the worse-off income groups generated inflationary pressures. The resulting instability in domestic prices and in the real exchange

rate, in turn, were not helpful to exports.

External Shocks, Adjustment and Macroeconomic Disorder

While excessive currency depreciations and cuts in investment constituted the most important supply-side ingredients of the stagflation that has affected many countries, external shocks and the subsequent payments adjustment have also generated destabilizing influences on the demand side, by adding to budget deficits and monetary expansion. The reconciliation of different policy objectives has thus proved very difficult.

In many countries, demand pressures have been building up since the early 1980s in large part due to external shocks: the rise in international interest rates increased the interest bill on the public sector's external debts; and the collapse of commodity prices reduced both the revenues from export taxes as well as the direct export earnings of the public sector. Cutbacks in external lending also affected public sector finances. Many countries, therefore, have been able to adjust by cutting import volumes and/or raising exports only to find the imbalance in their external accounts transformed into a domestic monetary and financial imbalance.

Cuts in public sector investment and imports provided part of the foreign exchange needed by the public sector to compensate for the reduced financial transfers from abroad. However, as observed earlier, currency depreciation and trade policy liberalization, together with stagflation, worsened the fiscal balance. Currency depreciations in particular raised real government revenues from trade in countries where trade taxes have been an important source of revenue, but generally not enough to offset the revenue losses stemming from import cuts and commodity price declines. Moreover, reduced imports by the private sector and tariff reductions increased budget deficits, particularly where tariffs and other import charges were an important source of government reve-

nue. Depreciations also raised the cost of government expenditures, for instance, by increasing the real burden of interest payments abroad – in many countries, including both highly-indebted and low-income countries, the domestic currency value of interest payments in real terms rose by more than 40 per cent – and by raising the cost of public sector investment, which has a high import content. The evidence for a number of countries suggest that these effects taken together account for more than one-half of the average budget deficits incurred in recent years.

Fiscal adjustment in the 1980s has clearly taken place under extremely unfavourable circumstances. In general, it has involved spending cuts rather than revenue increases. In the few countries where revenues rose, it was largely due to increased prices of public sector goods and services, and sales of public assets. In most countries, tax revenues declined or stagnated, along with slower economic activity and faster inflation. While many governments found it very difficult to reduce the public-sector-borrowing requirement despite drastic cuts in spending, cutbacks in foreign borrowing forced them to shift the financing of deficits to domestic markets where the resulting higher interest rates added further to fiscal deficits. In some countries, these factors gave rise to an unprecedented pace of domestic debt accumulation.

Two findings emerge from these experiences. First, the budget deficits and monetary expansion of the 1980s were not the result of deliberate policies: they have followed rather than led inflation. Second, as was the case in the developed-market-economy countries during the 1970s, the persistence and acceleration of inflation reflected, in large measure, the increased difficulty of reconciling the income claims of different social and occupational groups. Orthodox policies of budget cuts and monetary restraint succeeded in reducing inflation only temporarily, and sharply increased unemployment. The resulting deterioration in income distri-

bution often exacerbated social tensions, often leading to even faster inflation.

An urgent need thus arises to restore monetary and financial stability and growth in many developing countries. To attain stability, it is essential for these countries to reduce reliance on currency depreciations and to strengthen public-sector finances through increased tax revenues. Both objectives, however, call for a revival of growth and, hence, for lifting investment from its current depressed level, particularly in basic infrastructure and in the tradeable goods industries. Three major elements would, therefore, need to be combined in order to restore growth and stability. First, it is necessary to eliminate the payments constraint on investment and growth through debt reduction. Second, increased policy efforts would be needed in developing countries to improve the size and allocation of domestic resources through reforms in the areas of trade, the financial sector, public enterprises and government finances. Reforms in these three areas must be internally consistent, include poverty alleviation measures, and focus on investment and economic growth as their final objectives. Lastly, an improved trading environment and, particularly, increased market access for developing countries would be essential for a growth-oriented payments adjustment. If there are serious shortcomings on any one of these fronts, efforts on the others are likely to be frustrated.

Concluding Observations

While these policy approaches are a necessary condition for the revival of growth and development, they are not sufficient for most African countries. A substantial infusion of new external resources through concessional flows would also be required in sub-Saharan Africa. Even such new resources cannot be expected to yield quick benefits in terms of increa-

sed export capacity. For one thing, part of any increase in external resource availabilities would be needed to mitigate poverty and malnutrition. For another, resources would need to be diverted to areas which do not immediately generate export capacity, such as physical and human infrastructure. Such infrastructure is necessary to provide an adequate basis for future industrialization, but its impact on non-traditional exports is inevitably slow. Furthermore, increased attention would need to be given to agriculture and other primary industries in order to accelerate primary import substitution, particularly in food. This will help essentially to reduce the import requirements of consumption, export and investment growth, but cannot be expected quickly to provide substantial balance-of-payments relief.

The domestic policy efforts of African countries – and indeed of many other developing countries – will, therefore, need to be supplemented throughout the new decade by increasing amounts of external resources, taking into account the need to speed up structural transformation and keep pace with population growth, as well as to compensate for any further adverse changes in the external environment.

Lecture 2

DEVELOPMENT FINANCE BEYOND THE DEBT CRISIS

Introduction

In the first lecture, I concluded that the revitalization of growth and development in many developing countries depends on their own efforts being supported by increasing amounts of external finance throughout the coming decade. The need for sustained financial support derives also from the perverse experience of the 1980s, whereby many developing countries became net exporters of financial resources. Today, I propose first to discuss the inadequacy of development finance in the 1980s and then, against this background, to assess various possibilities for increasing both the volume and the quality of development finance in the 1990s.

The Inadequacy of Development Finance in the 1980s

In approaching the question of the financing of development, it is essential for one to bear in mind the radically-different role that is currently being played by international financial flows. Prior to the 1980s, international financial co-operation and the operation of international finance markets almost invariably produced a positive net transfer of resources from developed to developing countries. This meant that investment in the latter countries could proceed at a more rapid pace than would have been possible on the basis of domestic savings alone. There was wide agreement that this allowed the process of transformation and development in these economies to proceed faster than would have otherwise been the case.

Since the mid-1980s, however, international finance has played exactly the opposite role. Perhaps the most significant event of that decade was the sharp fall in net financial flows, accompanied by an unprecedented reversal of net financial transfers to many developing countries. By 1988, total net

resource flows to developing countries had shrunk in real terms to half of the record volume reached in 1981, from US\$182.7 billion to US\$93.5 billion.

In sub-Saharan Africa, net resource flows have risen in real terms since 1985 but not enough to offset a 30 per cent drop between 1982 and 1984. In 1988, total net flows still remained somewhat below the 1982 peak. While bilateral and multilateral donors stepped up their official development assistance to the region, there has been a virtual collapse of private lending. Overseas Development Agency (ODA) now represents about 70 per cent of total flows. Aggregate net transfers remained positive, albeit reduced. However, for a number of debt-distressed countries, they became significantly negative.

The debt crisis of the 1980s was a major factor in this unfavourable turn of events. Since 1983, rapidly-shrinking net financial flows together with persistently-high interest payments on external debt have led, as just indicated, to the emergence of a net transfer of financial resources from developing countries to the rest of the world. This transfer amounted to an estimated US\$36 billion in 1988. The bulk of this amount was accounted for by countries that could not afford to transfer resources abroad. The financing of this transfer required domestic investment to be compressed below the levels which would have been allowed by the domestic savings effort. For a few developing countries whose economies were growing rapidly and whose savings rates were already very high, this was not a serious problem; but for most debt-distressed countries, the reductions in investment imposed by the negative net resource transfer had a significant impact on their growth performance and on their capacity to adapt their productive structures to a changed external environment.

Another fundamental change in development finance was the sharp fall in private flows, and the attendant rise in

the share of official flows in total transfers. By 1988, the share of official flows of various kinds, including ODA, had grown to two-thirds, a proportion higher than that prevailing in the early 1960s, before the wave of heavy borrowing by developing countries from commercial banks. But this shift was entirely due to the collapse of private flows, rather than to the expansion of official finance. The debt crisis, in fact, led to a sharp contraction of export credits as well as of commercial bank lending. Foreign direct investment flows also declined as the climate for investment deteriorated. Consequently, official development assistance has remained the backbone of development finance, accounting for half of total net flows in 1988. Even so, concessional flows virtually stagnated in real terms during the 1980s.

The debt crisis also had adverse consequences for multilateral development finance. Some countries had no option but to build up arrears to the multilateral financing institutions because of their acute debt problems, with the result that they are now denied access to further borrowing from these institutions. A number of donors have applied the same policy to countries which have accumulated arrears on their bilateral debt. By the late 1980s, net transfers from the World Bank to all developing countries had turned negative, especially those to the highly-indebted middle-income countries (HICs). This disappointing development was compounded by a similar evolution in International Monetary Fund (IMF) disbursements. Over the period 1986–88, annual net disbursements from the IMF to the HICs were a negative US\$1.1 billion, reflecting difficulties encountered by major debtors in concluding arrangements with the IMF as well as repayments of large borrowing made during the early 1980s. However, the adverse impact of the debt crisis on financial flows was somewhat attenuated by the efforts made by the two institutions to raise additional funds particularly for debt-distressed sub-Saharan African countries.

The debt crisis explains other important features that characterized development finance during the 1980s, namely debt rescheduling and adjustment lending. The debt problem became so pervasive that debt rescheduling, once an isolated, one-off mechanism designed to overcome temporary liquidity difficulties, became an entrenched problem of solvency within the international financial system. During the period 1986–88, as many as 72 developing countries incurred external payments arrears or concluded official or private debt rescheduling agreements. However, the traditional rescheduling techniques which prevailed until 1988 tended only to postpone and, in most cases, to amplify the debt problem. Recent policy initiatives – the Toronto Agreement on official debt relief and the Brady Plan for commercial bank debt – reflect an awareness of this weakness. While they embody measures designed to reduce the stock of debt, the financial benefits that have accrued to developing countries so far have been modest.

Capital flight was an additional factor that adversely affected external resource availability – in the 1980s. This phenomenon is a manifestation of financial disorder which I addressed in my first lecture and is again intimately linked to the debt-servicing difficulties experienced by developing countries. Capital flight is thus unlikely to be reversed in significant measure until a durable solution to the debt crisis begins to be applied.

Financing Development in the 1990s: Some Issues for Consideration

With the debt problems of several developing countries as yet unresolved, there is a disturbing prospect that the current decade may turn out to be little better than the 1980s. At the same time, it is clear that the revitalization of the deve-

lopment process cannot await an end to the seemingly interminable search for a durable solution to the debt crisis. While recent improvements in Paris Club practices and the strengthened debt strategy initiated through the Brady Plan, have displayed considerable originality, strong doubts remain as to whether present approaches will yield the volume of debt and debt-service reduction necessary for a durable restoration of macroeconomic stability and growth.

For most of the developing countries, the financing of development must now look beyond the debt crisis. In this effort, particular importance attaches, first, to the need to increase very substantially both the volume and quality of official development finance, and second, to encouraging the contribution of private sources of non-debt capital to the financing of development. The potential contribution of private non-debt capital to the developing countries' development effort is far from being realized. Continuous attention needs to be directed towards improving the functioning of national financial and capital markets, as also towards putting in place and maintaining an appropriate set of incentives for domestic as well as foreign direct investment. However, these are essentially medium to long-term instruments. In the short-term, there is little alternative to continuing reliance on official sources of development finance.

The Prospects for Increasing Official Flows

The supply of external finance to developing countries — both official and private — will be influenced by the macroeconomic policies of industrial countries and by the co-ordination of such policies. With regard to official development finance, the outlook is particularly bleak. Both concessional and non-concessional flows face unfavourable prospects, although for different reasons. According to the most recent

OECD projections, ODA flows from all donors are expected to expand at an average annual rate of only about 2 per cent over the next few years. The global outcome is heavily dependent on the projected rapid increase in Japan's ODA and by the evolution of the US Aid Programme, which is expected to remain stable in nominal terms, at least in the near future.

Nevertheless, external aid flows will continue to be pivotal for a large number of poor developing countries, including the 41 countries in the least developed category, many of which are debt-distressed. The LDCs, the majority of which are located in Africa, are the weakest countries, with the least capacity for autonomous action, and private foreign investment cannot be expected to play a major role for some time. Projections of UNCTAD Secretariat indicate that the maintenance of recent trends in ODA flows and in the mobilization of domestic resources in the LDCs as a whole would result in the growth of their aggregate GDP by only 3 per cent per annum in the 1990s. This would barely exceed population growth.

In my view, a recovery scenario would require donors to double their present ODA to LDCs in the next five years and, as a longer-term endeavour, to aim at providing 0.20 per cent of their GNP as ODA to LDCs by the end of the 1990s. Moreover, to ensure complementarity between such international support and national macroeconomic policies, a new and more flexible approach to structural adjustment programmes (SAP) should be developed taking into account the specific circumstances of each country, and the performance criteria applied to these countries will need to be reviewed. Debt relief should be truly additional and should focus on debt reduction. The LDCs should be eligible for the whole range of Toronto options for official debt and these should be made more concessional for these countries. Concessional relief should also be extended to multilateral debt, through, for instance, refinancing and interest subsidy arrangements

and to commercial bank debt through the provision of adequate resources to support debt reduction and the greater involvement of creditor governments.

The broad retrenchment in the supply of funds from market-related sources inevitably focused attention on the role that multilateral financial institutions (MFIs) could play in financing adjustment and growth, especially in debt-distressed countries. However, the prospects for increasing multilateral concessional assistance to developing countries in the 1990s do not look encouraging. The amount recently agreed upon for the ninth IDA replenishment in the World Bank implies no increase in real terms over the resources of IDA-8. Yet, the worsened debt crisis, commodity price declines and the urgent need for further adjustment have considerably raised recipients' requirements. At the same time, stagnant IDA resources have to accommodate the needs of newly-eligible major countries such as Nigeria, and possibly Angola. Under this scenario, it is difficult to envisage how the financial needs of sub-Saharan Africa will be met. The World Bank has recently estimated that for that region to grow at 5 per cent annually in the 1990s, ODA flows would have to expand at 4 per cent a year in real terms.

It is clear that if the multilateral financial institutions are to meet the challenges of the 1990s, they will have to be provided with adequate resources. The recently-agreed 50 per cent increase in the resources of the IMF is a step in the right direction — though it is 50 per cent below what the Fund management had originally sought three years ago and well below what most of its members would have supported. The Managing Director of the IMF himself had warned that a quota increase as low as 50 per cent could force the Fund to increase its borrowing. This rather timid response to a dramatic situation already appears to be inadequate. Not only have the financial needs of developing countries grown over the past three years but Eastern European countries have now

emerged as legitimate claimants on the resources of the MFIs. In short, the question of providing the MFIs with adequate resources has not been resolved and, in the meantime, other channels will have to be explored.

Several practical possibilities exist for further strengthening the resources of the IMF and World Bank. First, it may be useful to examine the possibility of increasing the resources of the Fund's Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) using not only voluntary contributions but also the proceeds from the sale of the IMF's stock of gold. Such resources could also be used to assist poorer countries experiencing difficulties in meeting current repayments to MFIs, and who now risk suspension under the terms of the new quota agreement. Additional resources would also be required to enable the MFIs to engage in more meaningful debt reduction programmes — a precondition for a return to sustained growth in the heavily-indebted countries. Second, the question of an SDR increase should be given renewed consideration. The previous objection that an increase in SDRs would add to inflationary pressures in the world economy is no longer credible in the present period of controlled inflation and steady growth in developed market-economy countries. Furthermore, the liquidity problems of developing countries are likely to become more acute as they seek to adjust to lower trade barriers in the wake of the Uruguay Round. Third, the time has come for the World Bank to give greater weight in its operations than has been the case for the past several years to its traditional role of financing development projects in developing countries. At 30 per cent, its current level of commitments for SPAs appears too high, especially at a time when project financing from other sources has virtually dried up. New emphasis on environmental protection and the role of the private sector raises the likelihood of a trade-off in the allocation of exist-

ing resources between environmental protection and project development, as also between the public and private sectors. The resource requirements of the economies of Eastern Europe currently under reform could be substantial in both respects. Additional resources would have to be mobilized by the IBRD and IFC in order to avoid a diversion of resources to Eastern Europe at the expense of developing countries; such additional resources would also help to ensure that environmental considerations do not impose additional costs on developing countries.

In addition, the role that official institutions play in helping to mobilize funds available in private capital markets requires strengthening. The World Bank and regional development banks were established, among other objectives, to mediate between private capital markets and developing countries. The rationale, broadly speaking, was that without such intermediation funds from private markets would not flow to developing countries in the volume that was both possible and desirable, and would not carry the terms, conditions and other necessary characteristics of development finance. The recent experience of developing countries in seeking direct access to private markets validates this underlying rationale, and suggests the need for an expanded role for official intermediation.

Some recent developments are of particular interest in this regard. In order to meet the need to channel additional finance to Eastern Europe, for example, governments are well on the way to establishing the proposed European bank for reconstruction and development. The main purpose of this bank would be precisely to undertake intermediation between private capital markets and ultimate borrowers. It is indeed the case that private capital is unlikely to flow in sufficient volume to countries that are heavily indebted and whose current economic performance is mediocre or even poor, even when those countries are undertaking vigorous

efforts at adjustment and reform. This is just as true for countries in say Latin America, as it is for countries in Eastern Europe. This underlines the importance of enhancing the capacity of international financial institutions across the board to engage in financial intermediation.

Mention should also be made of individual national efforts to intermediate funds flowing through private capital markets. Some of the mechanisms recently put in place in Japan, for example, are worthy of note. Japanese attempts to recycle funds to developing countries rely extensively on hybrid flows i.e., joint financing arranged by the government in collaboration with the private sector. In these arrangements, private institutions raise funding while public institutions serve as intermediaries to reduce the risk of channelling funds for investment projects in developing countries. Government resources are used mainly to provide some form of appropriate guarantee and, particularly in the case of low-income countries, to provide an interest subsidy. This Japanese recycling technique has proven to be an effective instrument which other surplus countries, especially the Federal Republic of Germany, might usefully adapt.

Finally, the ending of the Cold War, which is unfolding hand in hand with the process of reform in Eastern Europe, promises to open opportunities for drastically scaling down military expenditures. The so-called peace dividend should make it possible for some important donor countries, such as the USA, to better meet their own social and other needs as well as to support the process of economic transformation in both Eastern European and developing countries. The translation into reality of this once-in-a-lifetime opportunity calls for statesmanship of the highest order.

An Expanded Role for Private Flows

In the 1960s and 1970s, concern over ownership and control

of capital encouraged a misplaced emphasis on general obligation borrowing by developing countries where the borrower retained maximum risks as well as rewards. Since the onset of the debt crisis, the prevailing policy view has been that the role of equity and quasi-equity finance should be expanded, both to redress the imbalance between debt-creating and non-debt-creating flows and to compensate in part for the sharp decline in commercial bank lending. Encouraged by international financial institutions and bilateral donors, many developing countries have made great efforts to attract foreign direct investment flows through the liberalization of investment regimes, the introduction of new incentives and the setting up of schemes aimed at the conversion of debt into equity. Despite this improved receptivity, however, the results have been meagre. Although FDI flows have recovered in the last few years from the trough registered in 1985, by 1988 their volume in real terms was about half the peak level of 1981. The recovery was largely concentrated in Asian countries with low external debt profiles and in a few Latin American countries under the impetus of major debt-equity swap programmes. Nevertheless, the evolution of new techniques such as joint ventures, production and profit-sharing arrangements, licencing agreements etc., has opened up new possibilities for FDI.

Portfolio investment in equities is another valuable source of non-debt-creating finance that remains largely underutilized by developing countries. At the end of 1989, the pool of institutional and other funds held by institutions in the main markets of the United States of America, Europe and Japan was estimated at about US\$7.5 trillion and was growing at about 15 per cent a year. However, the flow of portfolio investment to developing countries is insignificant and concentrated mainly on a few markets in Asia. The limited number of existing capital markets and restricted trading activity in developing countries would have to be rapidly ex-

panded if they were to succeed in attracting a modest proportion of these rapidly-growing portfolio resources. While the potential for growth is enormous, the further development of equity markets in developing countries requires a combination of measures ranging from the relaxation of barriers to market entry and related regulatory provisions, to financial and technical assistance to support the opening of new markets and to strengthen existing ones. IFC's emerging Markets Fund established in 1986 has played a pioneering role in this respect. However, some observers feel that this role should be expanded by increasing IFC's investments in domestic financial institutions in developing countries and enlarging its technical assistance role funded by transfers from the World Bank. Similarly, the decision by Commonwealth Finance Ministers in September 1989 to establish a Commonwealth Equity Fund will further strengthen the flow of investment resources to developing countries and provide developing countries with an additional incentive to establish new or modernize existing capital markets.

Likewise, the use of asset-backed financing techniques such as commodity-linked bonds, where returns are related to the commodity's price, hold out interesting possibilities for commodity-dependent developing countries. Though asset-backed financing techniques using commodities may be in their infancy, the principle is not new. Commodities such as petroleum, precious metals, minerals, etc. that generate a flow of income can be used to back the issue of long-term government securities, the repayment of which is directly related to their current market value. This implies additional effort to improve commodity-price risk management. In 1989, the World Bank initiated a technical development programme to assist developing countries in using international financial markets for commodity finance and risk management. The time may also be ripe to expand the role of non-resource project financing in which risks and responsibilities

are shared with foreign investors by linking borrowing to a related enterprise or project without a general guarantee.

Concluding Observations

Financing development in the 1990s will depend not only on the flow of external resources but also on developing countries' ability to increase their export earnings substantially. At a time when attention is focused on ways of reducing their burden of external debt, it is well to recall that, in real terms, the prices of the principal commodity exports of developing countries have fallen by 20 per cent and earnings by one-third since the early 1980s. As a result, developing countries have lost over US\$120 billion in real export earnings from commodities, not counting petroleum — a sum that would, if it had materialized, have made a considerable difference to their need for external assistance and their development performance. This is, therefore, another area which calls for new and bolder initiatives by the international community in the 1990s.

One of the main obstacles to increasing developing countries' exports relates to market access. Tariff levels in the developed market-economy countries continue to be higher on products of interest to developing countries than on other imports, and tariff escalation in step with the degree of processing also remains a handicap. The most serious impediment to market access, however, has been the proliferation of non-tariff barriers, which currently affect almost 30 per cent of the exports of developing countries to the developed market economies. In sectors of particular export interest to developing countries (especially textiles, clothing and steel), the proportion of affected trade has ranged between one half and three quarters. This background clearly points to the importance of achieving a balanced outcome to the Uruguay

Round which fully accommodates the priorities and objectives of the developing countries.

At the national level, the mobilization of domestic savings, the maintenance of sound macroeconomic policies and the fostering of an attractive investment climate are all areas for policy action, the need for which cannot be over-emphasized. In these as in other areas, developing countries must themselves take appropriate action in fulfilment of their primary responsibility for their own development. The optimal utilization of limited financial resources must receive closer attention by policy-makers.

In conclusion, let me say that though the financing of development in the 1990s presents formidable challenges for the international community, and the developing countries in particular, meeting these challenges is not beyond the realm of possibility. It should not be forgotten that, in today's interdependent world, all countries stand to benefit from a revitalization of growth and development in the developing countries.

Lecture 3

THE WORLD COMMODITY ECONOMY: COUNTERING INSTABILITY AND PROMOTING DIVERSIFICATION

Introduction

One of the main distinguishing features of developing countries is their high degree of dependence on foreign technologies, expertise and markets. For the many developing countries which rely on a few commodities for most of their export earnings, this amounts to an unacceptable vulnerability to factors beyond their control. In the current external environment, generally unfavourable for development and holding out little promise of improvement, particularly in so far as external financial flows are concerned, it is more than ever necessary for them to devise measures to counter this vulnerability, especially through the diversification of commodity-dependent economies.

In the period 1982-1986, 50 out of 84 developing countries depended on one or two commodities for over half of their export earnings. Twenty-eight out of 41 African countries were in this position. Particularly important for Africa were petroleum, coffee, cocoa and cotton; four countries depend for over half of their export earnings on coffee alone, and one on cocoa. For such countries, the outlook for development in the 1990s clearly depends on the outlook for the commodity economy and, more so, on the prospects for diversification.

The dependence on a limited number of commodities is dangerous for several reasons. First, commodity production is often highly volatile, depending on factors like weather conditions or input shortages due to a lack of foreign exchange, which are hard to control. Second, world market prices fluctuate strongly. There is rarely a balance between supply and demand: whereas demand is relatively stable, supply tends to vary significantly in the short run. To give some examples, during the period 1980-1989, sugar prices varied, on average, 89 per cent a year from their trend. Rice prices varied 28 per cent, aluminium prices 33 per cent, and cocoa prices 14 per

cent. To indicate what this means: for the period 1980–1987, commodity export earnings made up one-fifth of total gross domestic production of sub-Saharan Africa. A 10 per cent reduction in these earnings, then – and the data mentioned earlier on commodity dependence indicate this is well within the range of probability – would reduce the GDP growth rate by about two percentage points.

High commodity dependence also causes a large variability of export earnings as well as of government and personal incomes. This makes government planning very difficult, endangers import capacity, thus causing hardships for local industry, and undermines the economic stability of developing countries. And economic instability gives rise to social and political problems.

The international community, recognizing these characteristics and problems of commodity markets and developing countries, has been actively seeking to ameliorate the situation for a long time: first, through various instruments involving consumer-producer co-operation including International Commodity Agreements to reduce the instability of world market commodity prices and to improve the functioning of commodity markets; second, through the provision of compensatory finance partially to cover export earnings shortfalls; third, and more fundamental, by promoting the diversification of the export structure of developing countries. These then are the two themes I would like to develop in this lecture.

International Commodity Agreements and other Arrangements for Producer-Consumer Co-operation

International commodity agreements are a means of improving the functioning of commodity markets. When the adjustment process towards a balance of supply and demand is deficient or slow for a commodity, and thus creates high costs to

producers and consumers, a commodity agreement can reduce the costs involved in such an adjustment. This can be done through at least two different kinds of activities. First, action can be taken to increase the stability of world market prices by negotiating a price stabilization agreement based on export quotas, a buffer stock, or a combination of the two. Examples of such commodity agreements have been those for sugar, coffee, cocoa, tin and natural rubber. These agreements have, for shorter or longer periods, dampened price movements on international markets, and have thus been, and can continue to be, depending on the circumstances of each case, of importance to producers and consumers of these commodities.

Price stabilizing commodity agreements with effective economic provisions are, however, difficult to negotiate and to implement. Both consumers and producers have to feel committed; such commitment is often not present. If countries perceive their short-term national interest to be different from the objectives of an agreement, they often choose to pursue these short-term interests, frequently to their own long-term detriment. Unfortunately, producers often perceive an interest in a commodity agreement when prices are falling, and prefer to depend on the market when prices are rising. For consumers, the opposite is true. It is, therefore, no surprise that consumer disagreements over price ranges or size of stocks and/or quotas are frequent. Supply management by producers, and as necessary with the co-operation of consumers, could open up far-reaching possibilities especially in times of oversupply. If supply could thus be brought into better balance with demand, the prices of many primary products could be improved, and production and exports more effectively rationalized. However, for several important commodities, the large number of countries involved in exporting makes this difficult. Recently, interest in supply management among commodity-exporting developing countries has been

revived, and some progress in this direction may be possible in the future.

For commodity agreements with buffer stock arrangements, the First Account of the Common Fund for Commodities, when it becomes operational, can be of assistance as a source of supplementary financing. The Common Fund, as a whole, has recently entered into force, but only its Second Account, which is designed to support commodity developmental activities, is set to begin operations. It is to be hoped that, despite changing circumstances, both Accounts will be enabled to play a useful role in the future. Unfortunately, there is at the moment only one commodity agreement with functioning price provisions, that for natural rubber. The economic provisions of both the Cocoa Agreement and the Coffee Agreement, which are of great importance for Africa, have ceased to be operational in the recent past.

In the case of cocoa, the price range to be defended by the buffer stock has proved to be a major difficulty. Despite semi-automatic adjustment mechanisms to adapt the price range to changing market conditions, disagreement on this question resulted in the virtual collapse of the latest Cocoa Agreement in early 1988. With the buffer stock almost full, it was not possible to reach agreement on the introduction of supplementary measures, while cocoa producers outside the Agreement continued to make considerable sales. Between the start of 1988 and 1990, cocoa prices fell by almost one-half. Since then, however, considerable progress towards international co-operation has been made. At a session of the International Cocoa Council last March, it was decided to extend the Agreement for a period of two years, without economic provisions but effectively freezing the buffer stock. Moreover, Malaysia attended meetings of the cocoa producers' group in the Cocoa Council and has announced that it is joining the Cocoa Producers' Alliance. Since the March agreement, cocoa prices have risen by one-

third.

For coffee, an international commodity agreement has in the past effectively reduced market instability and maintained price levels through the use of an export quota scheme, rather than through buffer stocking. However, the difficulties experienced in reaching a satisfactory distribution of quotas and the dissatisfaction of consumers with the existence of a two-tier market (permitting non-members to make purchases at a considerable discount) and with the effect of quotas on the availability of different grades of coffee, led to the collapse of the Agreement in July 1989. After the suspension of export quotas, prices dropped by 40 per cent within a few months. There have been several initiatives undertaken to revive producer-consumer co-operation on coffee and it is to be hoped that the coffee agreement can be renegotiated in the near future. UNCTAD, for its part, is committed to promoting this objective.

The second important activity which commodity agreements can undertake but which can also be pursued in the context of other forms of producer-consumer co-operation, is the improvement of market transparency through exchange of information on markets and policies, and the carrying out of research on structural and technological change, competition with synthetics and substitutes, new end-uses, environmental issues and trends in capital investment. A related activity is the monitoring and review of market developments and prospects including the effects of domestic policies affecting production and pricing. Likewise, considerable potential exists for the elaboration, in the context of producer-consumer co-operation, of programmes and projects in such areas as research and development, productivity improvement, market promotion and vertical and horizontal diversification. The Second Account of the Common Fund for Commodities, once it is fully operational, can make funds available to commodity bodies in support of such programmes and projects.

Two Commodity Agreements which concentrate on these activities have been negotiated in the framework of UNCTAD during the last few years, i.e., those for jute and jute products and for tropical timber. For several minerals, more informal groups, with an emphasis on the exchange of information and statistics, are operative, some of which are within the UNCTAD framework. These activities can help to increase the benefits developing countries reap from their export activities.

Price stabilizing commodity agreements are not, of course, feasible for all commodities, and besides they only act on international prices; they do not necessarily stabilize the foreign exchange earnings of commodity-exporting countries. To reach this goal, we must have recourse to another mechanism, namely compensatory financing. Most compensatory finance is provided through a facility in the International Monetary Fund. However, its effects have been limited. Funds are made available on market-related terms, with a relatively-short period for reimbursement, and only to countries either with no balance-of-payments problems other than the shortfall, or to those with such problems who agree with the Fund on the adjustment measures to be undertaken. IMF conditions are often rather stringent, and have become more so in the 1980s. As an indication, in 1989 only three countries made a drawing under the compensatory financing component of the facility, whereas in the late 1970s and early 1980s up to 20 drawings a year were made.

There are also other, smaller-commodity-related schemes: the Stabex facility, created as part of the EEC-ACP Lomé Convention, the EEC scheme for non-ACP least developed countries, and the comparable programme recently introduced by Switzerland. These supply financing in the form of grants for shortfalls in earnings from specific agricultural commodities exported to the EEC and Switzerland, and contribute to easing the commodity instability problem because

the funds are used in the sector suffering from the shortfall or for diversification. Within UNCTAD, the Committee on Commodities is to review existing compensatory financing mechanisms and their implications for the development of developing countries at its November 1990 session.

Diversification

Let me now turn to the subject of diversification. As I said earlier, price stabilization and compensatory finance can mitigate the negative effects of the commodity export dependence of developing countries, but they cannot solve the problem. This objective can only be attained through diversification. Affected countries need to develop new export products, stimulate the processing of commodities before exporting them, and increase their participation in, and returns from, the marketing and distribution of their exports.

Export diversification is an essential part of economic development. It is no coincidence that the five least developed countries which had a per capita growth of over six percent during the 1980s all now depend on non-traditional exports as the main source of foreign exchange earnings. These countries have begun to find a special niche in the international economy; other countries deserve support to discover as well how they can diversify their economies so as to achieve higher economic growth.

The international community has long recognized the crucial role of diversification. So far, however, the record of developing countries in the area of export diversification has been meagre. Over the period 1967–1986, two-thirds of the developing countries showed either little change or even an increase in their dependence on one or two commodities. In sub-Saharan Africa, only four countries showed a reduced dependence on their major export commodities and alas, two

of these did so because of large setbacks in production.

Nevertheless, the scope for diversification is large. For instance, developing countries account for almost all world exports of cocoa; but their share in world exports of processed cocoa products is only 26 per cent, and their share in the export of chocolate a mere 5 per cent. Over three quarters of bauxite traded on the world market comes from developing countries; their share in world exports of aluminium, however, is less than a quarter.

Many possibilities exist also for increasing the participation of developing-country firms in the marketing of their export products. At present, for many commodities this profitable activity is almost exclusively in the hands of transnational enterprises. Because such firms tend to control distribution networks, increased involvement by the producer countries in marketing will not be easy, but possibilities do exist. These need to be supported through exchanges of experiences among developing countries on policies and measures to encourage marketing activities, and through appropriate human resource development and increased market transparency.

Broadening the gamut of exported commodities is another option. Here, however, some caution is necessary. For many countries, new products are likely to be the traditional exports for other countries. For most traditional commodity exports of developing countries, the elasticity of demand is quite low, and larger volumes entering world markets are likely to depress prices. Even if one country gains, others might lose. While non-traditional commodities, like fresh vegetables, tropical fruits or cut flowers offer somewhat better prospects, markets for them are small compared to those for, say, coffee or cocoa; they are also highly product differentiated and spatially segmented and will quickly be saturated if many developing countries start exporting the same products.

Diversification, especially in terms of new products or the provision of marketing services, does not usually happen spontaneously. Active, supportive intervention by governments, foreign aid donors and the international community is necessary. A concerted effort by all parties involved is needed, as a whole set of conditions has to be met in order to make the diversification process viable.

Of course, not all countries have the same possibilities. Some are better endowed with raw materials than others. Some are landlocked, others have easier access to the world market. Some have large populations with a reasonable per capita income, for others the absorption capacity of the local market is far smaller and unlikely to provide a base for diversified outputs. But all countries have the possibility to stimulate diversification, be it on their own or within a regional framework. In this context there are several crucial elements which need to be considered. First, governments should identify diversification opportunities, including those with export potential, and design appropriate supportive policies. Moreover, information on export-oriented diversification possibilities should be transmitted to the private sector, especially the local small-scale entrepreneurs who do not have easy access to information on export markets.

Second, governments have a responsibility for providing the basic infrastructure necessary for the diversification of the economy. This includes not only the construction and maintenance of roads, ports, storage facilities, irrigation works, etc. but also telecommunication facilities. Especially when exports are to be diversified or when increased participation in marketing is envisaged, the existence of a good telecommunications network linked with overseas markets is indispensable. Experience in different countries shows that a deficient infrastructure has a negative impact on diversification, hindering both the introduction of non-traditional products and the processing of commodities. Macroeconomic and

incentive policies, including getting the prices right and liberalizing market structures, which have received much attention during the last few years are indeed important. However, without these other infrastructural elements, they alone are not sufficient.

Third, human resource development is crucial. Entrepreneurs need a whole set of managerial, technical and marketing skills to function well; moreover, an adequate level of general education of the labour force is necessary. Since external markets are becoming increasingly competitive with stiff requirements in terms of quality standards and promoting product differentiation, increasing marketing skills is of extreme importance.

Fourth, the existence of highly competitive markets implies an emphasis on up-to-date research and development. This, along with the need to adapt technologies to local conditions implies support for institutions and local universities to undertake these tasks.

Fifth, governments have to tackle the problem of access to credit by entrepreneurs, especially those in small-scale industries. Small entrepreneurs in developing countries have always had problems in obtaining credit, and this situation is now compounded in many countries by the credit ceilings imposed by the International Monetary Fund. A way has to be found around this problem, otherwise a take-off of local industry is very unlikely. The supply of credit lines and loans to local development banks for onlending is being used as part of the solution, but the conditions these banks impose are often discouraging for small scale entrepreneurs. New actions in this area are already underway, even though their scope is as yet limited: the International Finance Corporation and the African Development Bank, for instance, have recently started programmes to support local entrepreneurs. The operation of facilities such as the Centre for the Development of Industry, which is part of the framework of EEC-

ACP co-operation and geared to small scale projects, is another interesting approach.

International Support for Diversification

Increased support actions by the international community are also necessary. Specifically, the markets of industrial countries have to be made more accessible to developing countries' products, and world commodity markets made more transparent. Action is needed in the areas of tariffs, non-tariff barriers, restrictive business practices, and the access of developing countries to the necessary market information, as well as to information that would facilitate investment decisions and to training facilities in a wide range of areas.

Trade restrictions are an important barrier to trade for many agricultural products; many developed countries use these to protect their own agricultural production and their local industries. It is also significant that tariffs in developed countries escalate with the degree of processing embodied in imports from developing countries. For instance, the tariff applied by the European Community for imports under the Generalized System of Preferences is 6.5 per cent for raw coffee, the tariff on ground coffee 12 per cent; and while there is no tariff on cocoa beans, there is a tariff of 11 per cent on cocoa paste. This tariff escalation, of course, makes local processing in developing countries before export less attractive.

ACP countries currently face relatively low tariffs compared to non-ACP countries in the EEC under the Lomé Convention. On the other hand, their exports are considerably affected by non-tariff measures, such as quantitative restrictions, internal taxes, voluntary export restraints, seasonal tariffs and health and sanitary requirements. Experience

shows that market access conditions are generally important. It also shows that a few developing countries have succeeded in diversifying exports despite high market barriers, whereas many others, facing the same, and in some cases lower barriers, have not. The determinants of such differential growth and development experiences among developing countries have been explored in my first lecture.

Restrictive business practices, used by enterprises to strengthen their position in a given market, are quite common in international trade, especially trade in commodities. For instance, sugarcane exporters have found themselves obliged to deliver to a single group of firms around 90 per cent of the cane sugar which they were permitted to sell in the European Community. Another example: the practice of aggressive brand-name promoting in the developed countries' markets for chocolate by a few large enterprises has made new entry into these markets almost prohibitively expensive.

Developing countries have few independent sources of information on markets. For most commodity markets, this information is in the hands of the large trading companies. This reduces the bargaining power countries have when confronted with these trading companies, and moreover makes it very difficult for them to penetrate markets by themselves. The usual solution is to enter into a joint venture with the foreign partner handling the export marketing. However, improvement of information flows in an accessible and usable form at a reasonable cost is an area where international co-operation can be helpful.

The international community should also be involved in making sure that adequate financial resources are available for diversification purposes, including multilateral, bilateral and private sources of funds. Only a small percentage of multilateral funds has actually been devoted to diversification projects over the last decade, and so a more focussed effort

is needed in this direction, particularly for countries which remain highly dependent on the export of a few primary commodities.

International assistance can also be crucial in the formulation of diversification programmes. This would include assistance in assessing the potential of the commodity sector in terms of resource endowments and domestic demand, its interaction with other sectors, institutional requirements, incentives and support requirements of the main economic agents, as well as external factors, such as world market prospects.

Within UNCTAD, the international community has been devoting serious attention to these matters. Intensive inter-governmental dialogue has been under way on issues and areas for international co-operation in the field of diversification, including processing, marketing and distribution. In addition, the UNCTAD secretariat has been actively engaged in collecting, analyzing and identifying gaps in existing technical assistance for diversification; in executing technical co-operation projects in such areas as support to developing countries in the context of the Uruguay Round of trade negotiations; in providing support for enhancing commercialization policies of developing countries' products; and in developing an international programme of assistance to increase local processing in developing countries.

While diversification decisions are primarily the responsibility of developing countries themselves, the international community does have the obligation to assist in the process both by making the trading environment as fair and open as possible, and by ensuring access to the necessary complementary components of finance, information and technical assistance. This conclusion leads to the broader question of the need for appropriate systemic arrangements designed to reflect and accommodate the new realities of the world economy and the changing needs of the weaker countries.

Lecture 4

SYSTEMIC ISSUES IN TRADE, MONEY AND FINANCE AND EVOLVING ROLE OF UNCTAD

Introduction

In this last lecture, I would like to address some issues relating to the institutional framework of international economic relations and the role of UNCTAD in the development co-operation dialogue.

In response to the development crisis of the 1980s, most developing countries have undertaken a substantial reappraisal of their development strategies and policies. This has led to an increased awareness of the limitations of centralized planning systems and of over-reliance on import-substitution-based industrialization. Many of these countries are now pursuing far-reaching macroeconomic policy reforms designed to promote both price stability and a viable external balance, to improve the flexibility of their economies and to achieve greater responsiveness to changes in the external environment. Trade policy reforms are also being widely introduced, involving a combination of reductions in non-tariff import barriers and in the level, as well as in the dispersion of tariffs, currency devaluation, and heavier reliance on the exchange rate as a balance of payments equilibrating mechanism.

These efforts will, however, have little chance of success without a conducive external environment, in particular a supportive regime governing international trade, monetary and financial relations. The influence of the external environment stems, of course, from the mainly one-sided dependence of developing countries on the developed world for external trade and finance. This dependence, which is itself a manifestation of underdevelopment, persists in the context of growing interlinkages among national economies generally through trade, investment, technology and financial flows.

Such interlinkages have given rise to growing interdependence within the world economy and have enhanced the potential for the transmission of both expansionary and con-

tractionary influences across the world economy. In effect, interdependence is serving increasingly as a vehicle for the transmission of impulses: either in a positive sense towards broad-based growth and development, or negatively towards serious imbalances, wider instability, and stagnation or regression in the developing world. For these reasons, the functioning of the international trading, monetary and financial systems has become an important factor affecting the health of the world economy and the aspirations of the developing world.

How the interlinkages among different economies and the interrelationships between problems and policies in the areas of trade, money, finance and development are managed and, in that context, how the institutional framework of international economic relations evolves in the period ahead will greatly influence the outlook for development in the 1990s and beyond. It is in this perspective that the present lecture will focus on some basic aspects of the functioning of the international trading, monetary and financial systems.

The need to improve the functioning of the international trading, monetary and financial systems is now widely recognized. While approaches to this objective differ very widely, their viability depends on the extent to which they meet the number of requirements. They must be directly supportive of the efforts of the developing countries to carry out adjustments and corrections in their economies conducive to an adequate tempo of growth. They must be supportive also of the efforts of the developed market economies and other countries in transition to achieve better macro-economic management and structural adjustment. And they must provide for the equitable participation of all countries in the relevant decision-making processes.

International Trading System

As regards the trading system, three sets of issues need to be

addressed. The first concerns the inherent limitations of the existing system in dealing with a wide range of trade policy issues and trade relations between developed and developing countries. The second set has to do with certain adverse tendencies in the operation of the system. And the third concerns developments which are outside the field of trade policy but affect the functioning of the trading system.

The inherent limitations of the trading system stem partly from the priorities that were built into the Bretton Woods system for international economic co-operation established in the wake of the Second World War. That system was envisaged as a pattern of mutually-supportive institutional arrangements involving the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD); and a trading system which was to be administered by a comprehensive International Trade Organization (ITO). In the conception of these institutional arrangements, the primary concern was to prevent a repetition of the economic problems experienced by the industrialized countries during the inter-war period. These arrangements thus reflected, in the main, the viewpoints and priorities of the industrialized countries. Most developing countries, not having yet attained independence, had little say in the matter. Consequently, development did not figure as a major objective in the design of these arrangements.

The limitations of the trading system also derive from the failure of the planned International Trade Organization to materialize; in the event, only the commercial chapter of the Havana Charter for the ITO came into effect, leading to the establishment of GATT as an interim arrangement. In consequence, issues covered by the Havana Charter but which remained outside the purview of the GATT, particularly commodity price stabilization, economic development measures, restrictive business practices and macroeconomic policies, have been pursued within United Nations forums,

notably UNCTAD, and in the OECD among developed market economy countries. Nevertheless, the exclusion of these areas of trade relations from the mutual rights and obligations of the trading system has remained an important limitation of the trading system.

Since the establishment of the GATT, attempts have naturally been made to make the multilateral trading system more consistent with the needs of developing countries. These include the incorporation of a provision into the General Agreement in 1957 to permit developing countries to take protective action, including quantitative restrictions for infant industry and balance of payment purposes; the establishment of the generalized system of preferences (GSP), negotiated in UNCTAD and perhaps the most important manifestation of the international consensus of the 1960s and 1970s on these matters: namely that trade policy action should be taken by the industrialized countries to promote the growth and development of the developing countries; the incorporation of Part IV on "Trade and Development" into GATT, signifying the acceptance of the principle that developed countries did not expect reciprocity from developing countries in trade negotiations. However, these measures in favour of developing countries are either non-contractual or are heavily qualified, and the derogations permitted to developing countries are generally subject to strict surveillance.

Thus, the GATT-based trading system has, from its inception, embodied some fundamental inadequacies. What is more, its evolution has been characterized by a steady erosion of certain of its basic principles, in particular the MFN principle. Also prominent over the past decade have been increased tendencies towards managed trade, a gradual retreat from multilateralism in favour of regional, bilateral and unilateral approaches and an increasing reliance on the exercise of economic weight rather than the observance of

agreed rules of international trade policy. In addition, there has been a strong trend towards the increased use of non-tariff protective trade measures of a discretionary character. These measures, which according to the initiating countries, are designed to shield domestic producers from external shocks, either fall outside the jurisdiction of the GATT or involve derogations from GATT rules, as in the case of the Multifibre Arrangement (MFA).

Over the years the tariff-based trade liberalization process has, of course, been actively pursued, but it has been concentrated in sectors characterized by a horizontal division of labour among developed market-economy countries. The escalation of tariff rates in step with the degree of processing has persisted, and the liberalization process has encountered strong resistance in certain sectors, notably agriculture, textiles, clothing, footwear and other leather goods – sectors in which developing countries have a distinct comparative advantage. Some observers have suggested that lack of participation by developing countries in trade negotiations on the basis of reciprocity has been the main reason for the exclusion from the trade liberalization process of sectors in which they have a particular interest. Others have argued, however, that the interests of transnational corporations (TNCs) have played a dominant role in this process; as a result, liberalization has been concentrated in areas of interest to them, and has tended to promote their freedom of action, particularly as such intra-firm trade is not governed by GATT rules.

The evolution and operation of the trade regime has also been influenced by developments outside the field of trade policy, especially shifts in macroeconomic objectives in developed market-economy countries and the breakdown of the Bretton Woods system of fixed exchange rates. Since the late 1970s, the preoccupations of many developed market-economy countries have given less weight to promoting growth and employment than to controlling inflation. At the

same time, the fear of unemployment in particular sectors has remained an important factor in trade policy and has been a major impulse behind recent protectionist initiatives in these countries. Finally, sharp movements in real effective exchange rates and large currency misalignments, which also weaken the effectiveness of tariffs as a protective mechanism, have contributed to the prevalence of managed trade and the proliferation of non-tariff protectionist measures.

Proposals have recently been advanced by some developed countries for the establishment of an international trade organization. The stated objective of such proposals is to provide a stronger institutional basis to the GATT, to consolidate and integrate the results of the Uruguay Round, in particular in new areas, to reduce the risks of unilateral enforcement procedures (such as are contained in Article 301 of the US Trade Law) and to evolve comprehensive multilateral dispute settlement procedures for all relevant multilateral instruments.

The existence of such proposals is a reminder of the incompleteness of institutional arrangements for dealing with problems of international trade. It would, indeed, be welcome if the international community, through the United Nations, were to agree, in a new wave of commitment to multilateralism, to work towards an international trade organization which would be comprehensive in subject coverage, universal in membership, based on agreed objectives and norms of behaviour, responsive to the interests of all its members, equitable in decision-making and organically linked to related institutional arrangements in the areas of money and finance. It is to be hoped that this ambitious aim will be kept firmly in view in current discussions and that the possible establishment of new institutional mechanisms in the area of trade will be seen not in relation to the specific negotiating process of the Uruguay Round but in this wider perspective.

International Monetary and Financial Framework

An efficient and equitable trading system would need to be underpinned by a stable and supportive international monetary and financial system. Over the past two decades, however, the effectiveness of the international monetary and financial system in providing stable conditions for world trade has weakened significantly. The unfavourable environment for developing countries with regard to the external financing of development, which I addressed in my second lecture, together with inadequacies in the functioning of the international monetary and financial system itself has impeded the adjustment efforts of many developing countries and has been a constraint on the growth potential of these countries. Thus, from the perspective of growth and development in the 1990s, an urgent need arises for the international community to tackle more vigorously a number of basic interrelated issues concerning the functioning of the international financial and monetary system.

The first set of issues has to do with the external financing needs of developing countries. These have already been examined in my second lecture. In the present context, one point to emphasize is that the experience of the 1980s has underlined the severe limitations of an approach which relies heavily on private commercial flows. The need for stronger efforts by developing countries to mobilize domestic savings and to create favourable conditions for foreign investment is self-evident. But external flows will continue to be pivotal for a large number of these countries. In order to help ensure that such flows are available on appropriate terms and conditions, the international financial institutions will have to assume a much larger role, direct and indirect, in meeting the requirements for development finance and they will need to be provided with substantial new resources.

Another potentially-important source of capital for developing countries could be the surplus developed coun-

tries. In addition to their own bilateral recycling mechanisms, these surplus countries could channel resources through the multilateral financial institutions for the purpose of facilitating debt and debt service reduction, and for enabling developing countries to attain higher import and investment levels. This could also help reduce persistent trade imbalances among developed countries without depressing the world economy.

Where international monetary stability is concerned, it used to be argued that the replacement of fixed exchange rates by a floating exchange rate regime would facilitate a more efficient adjustment process by permitting small but frequent adjustment exchange rates. In practice, however, the floating rate regime has displayed a great deal of volatility and unpredictability and this has been a factor in strengthening protectionist trends. Moreover, an exchange rate regime which is subject to wide fluctuations has proved difficult to reconcile with a tariff-based trading system.

A major objective of development co-operation in the period ahead should, therefore, be to evolve a symmetrical and equitable adjustment process that promotes economic growth, development and trade expansion at the highest sustainable levels consistent with price stability. At the global level, this objective entails, among other things, an exchange rate regime which, while flexible, is capable of promoting international monetary stability; symmetry in the treatment of deficit, surplus and reserve currency countries so that the burden of adjustment is equitably shared; and effective macroeconomic policy co-ordination.

The proper functioning of the international trade and payments system also requires that international liquidity grows in line with the requirements of an expanding world economy. The experience of the 1980s has demonstrated that international lending and private capital flows cannot be relied upon to compensate for current account disequilibria;

nor can the commercial banking system be relied upon to create international liquidity in line with the requirements of non-inflationary growth and development. Consequently, the central role of the IMF in the creation and distribution of international liquidity again assumes topical importance. The time is ripe for reconsidering the possibility of a new allocation of special drawing rights: the earlier objection that this would add to inflationary pressures in the world economy is no longer credible in the present period of strong anti-inflationary policies in developed market-economy countries. In present conditions of extreme liquidity shortage for many developing countries, an issue of SDRs would make a major contribution to reconstituting their reserves. Continuing efforts would also have to be made towards establishing the role of SDRs as the principal reserve asset of the international monetary system. Looking farther into the future, it has been suggested that in view of the growing integration of the world economy, the evolution of the IMF in the direction of a genuine international central bank may be desirable for the effective functioning of the international trade and payments system.

So far as macroeconomic policy co-ordination is concerned, an encouraging feature of the 1970s was the recognition that the effectiveness of policy actions taken in one of the interrelated spheres of money, finance, trade and development was often influenced by, or dependent on, policy actions taken in other areas. There is greater awareness also of the degree to which signals generated in increasingly integrated markets can engender major and unintended shifts in the world economy. In recent years, policy co-ordination has been pursued mainly among major developed market economies and has focused on external disequilibria affecting their own economies. Furthermore, the IMF has been authorized to monitor and evaluate the macroeconomic policies of these countries on the basis of quantitative indica-

tors related to growth, employment, inflation, investment, external reserves, etc. Even so, forms of co-ordination have not emerged which adequately address the fundamental concerns of the rest of the world. The conclusion follows that these efforts should be extended to cover the harmonization of international policies in the interrelated fields of commodities, trade, money, finance and development, as well as national and regional economic policies in so far as they have a major impact on the world economy.

Effective policy co-ordination requires agreement on certain goals and on policy actions needed when outcomes differ from the agreed goals. Objectives, including desirable rates of growth of domestic demand as well as exchange rates and current account balances need to be consistent across the countries concerned. Such co-ordination would also need to take into account the implications for small economies which are open to influences from abroad, and would in any event call for considerable flexibility based on extensive consultations. In the same context, multilateral surveillance would also have to be strengthened to include assessment of policies affecting trade, capital flows, external adjustment and the functioning of the international monetary system.

UNCTAD and the Evolution of International Economic Relations

The establishment of UNCTAD in 1964 was a formal recognition of the need for a universal forum for intergovernmental deliberations and negotiations on issues related to trade and development, in the context of multilateral co-operation. It was also the expression of a growing concern that there was no single institution responsible for formulating and implementing international policy in the field of trade comparable to the IMF and the World Bank in the respective fields of

international monetary relations and development finance.

Since its inception, UNCTAD has played a major role in the evolution of the development co-operation dialogue. Its main thrust has focused first on the formulation of policy measures within the existing institutional framework that would lend support to the development process and second on the search for improvements in the structures and arrangements underpinning international economic relations so as to make them more supportive of macroeconomic management, structural adjustment and development. Through its inter-governmental machinery, UNCTAD has provided a framework for the negotiation of important policy advances and agreements, and a forum for intergovernmental deliberation, the outcomes of which have provided impetus for action in other international institutions responding to the needs of the developing countries and to the requirements of development co-operation.

The role of UNCTAD has, of course, evolved under the guidance of successful sessions of the Conference. The consensus embodied in the Final Act of the last Conference, UNCTAD VII, embodies constructive and significant advances in areas such as debt, commodities, international trade and action in favour of the least developed countries. The Final Act also continues to provide a valid framework for the formulation of specific policy measures. One important component of this framework was the recognition that if both national and international policies were growth-oriented and mutually-reinforcing, the interdependence of national economies and the interrelationships of different areas of economic policy would — in contrast to recent experience — become a vehicle for transmitting and cumulating positive impulses. A second component is the broad understanding that all countries, collectively and individually, are responsible for taking action, in accordance with their respective capacities and weights in the world economy, to accelerate

and sustain development and to improve the health and stability of the world economy. Third, the Conference witnessed a more open discussion than hitherto in UNCTAD of the interaction between the external economic environment and the domestic policies and structural characteristics of developing countries. There was also a better acknowledgement of the respective contributions of the public and private sectors to development. Finally, the Conference proceedings expressed a strong concern to make the international monetary, financial and trading systems more supportive of growth development, and international trade.

These elements have been reinforced by the Declaration adopted in October 1989 by the Trade and Development Board on the occasion of UNCTAD's twenty-fifth anniversary. The Declaration affirms that the main substantive challenge facing UNCTAD in the 1990s is to bring fresh thinking to bear on long-standing problems and new areas of concern, with a view to promoting innovating policy measures. UNCTAD, according to the Declaration, should do so taking full account of the interdependence of economies and of policy areas, of long-term structural changes in the world economy, as well as of the need for a more supportive and predictable international economic environment for trade and development, particularly of developing countries. It should also continue to pay special attention to economic problems faced in common by developing countries, notably in expanding and diversifying their production base and their trade in goods and services including their mutual trade, reducing commodity dependence, building financial, technological and transport capacities, coping with the debt burden and its consequences, adverse trends in resource flows, and undertaking adjustment programmes oriented to growth and development.

If UNCTAD is to continue to make the innovative substantive contributions expected of it to multilateral co-opera-

tion in all these areas, member States, in co-operation with the Secretariat, need to give full effect to their commitment, expressed in the Declaration, not only to the objectives of UNCTAD but also their pledge, individually and collectively, to rise to the challenges just mentioned and to make UNCTAD a more effective instrument of international co-operation for trade, growth and development, particularly of developing countries.



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