



IV

Convergence and Divergence in Developing Countries

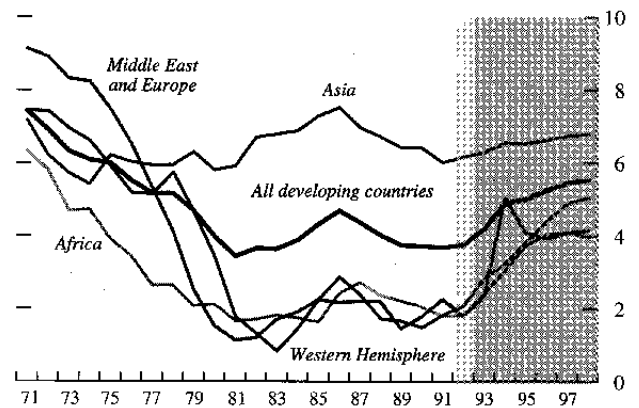
During the past two decades there have been wide disparities in the pace of economic growth among developing countries. Differences in the external environment account for some of these divergences, but domestic policies have been decisive. There is considerable evidence that macroeconomic stability and the removal of structural distortions boost growth by improving the incentives to save and invest, as well as the efficiency of investment. As more countries implement stabilization and structural reform policies, the medium-term prospects for the developing world appear brighter than they have been for some time.

Growth in Developing Countries

There have been significant variations in the growth performance of developing country regions since 1970, with growth in Asia notably higher than elsewhere (Table 9, Chart 20). These differences were especially marked during the 1980s, when per capita income increased at an average annual rate of nearly 5 percent in Asia but declined in other regions. There have also been significant variations within regions. In Africa, where growth was slowest in 1971–92, eight countries had average growth of 5 percent a year or higher.²⁶ Similarly, in Asia growth in the four newly industrializing economies and in China, Malaysia, and Thailand was spectacular during the past decade but was low in countries such as Myanmar, Nepal, and the Philippines. The group of “successfully adjusting countries” identified in the October 1992 *World Economic Outlook* (Chapter IV), which included countries from all regions, had above-average growth since the implementation of reform policies started in earnest in the early 1980s.

Countries have differed in the degree of persistence of above- and below-average growth over time because of changes both in policies and in the external environment. Although the East Asian countries and China have sustained very strong performances recently, growth has been much more unstable in the developing countries of the Middle

Chart 20. Developing Countries: Real GDP Growth¹
(Annual percent change)



¹Five-year centered moving average. Blue shaded area indicates staff projections.

²⁶Botswana, Cape Verde, Congo, The Gambia, Guinea-Bissau, Kenya, Mauritius, and Tunisia.

Table 9. Developing Countries: Growth Performance*(Annual percent change)*

	1971-92	1971-81	1982-92	1982-86	1987-92
All developing countries					
Real GDP	4.8	5.6	4.0	4.0	4.1
Real per capita GDP	2.4	3.1	1.7	1.5	1.8
By region					
Africa					
Real GDP	2.8	3.7	1.9	1.8	2.0
Real per capita GDP	—	0.9	-0.9	-1.1	-0.8
Asia					
Real GDP	6.3	5.9	6.7	6.9	6.6
Real per capita GDP	4.4	4.0	4.8	4.9	4.7
Middle East and Europe					
Real GDP	4.4	6.0	2.9	2.2	3.4
Real per capita GDP	1.0	2.6	-0.6	-1.2	—
Western Hemisphere					
Real GDP	3.7	5.9	1.6	1.6	1.6
Real per capita GDP	1.3	3.2	-0.5	-0.8	-0.2
By predominant export					
Fuel					
Real GDP	4.2	6.1	2.3	1.2	3.3
Real per capita GDP	1.1	2.8	-0.6	-2.0	0.6
Nonfuel					
Real GDP	5.1	5.5	4.7	5.0	4.4
Real per capita GDP	2.9	3.3	2.6	2.9	2.3
By financial criteria					
Net creditor					
Real GDP	5.1	6.7	3.5	1.5	5.2
Real per capita GDP	1.1	2.8	-0.5	-2.1	0.9
Net debtor					
Real GDP	4.8	5.5	4.1	4.2	4.0
Real per capita GDP	2.5	3.2	1.9	1.9	1.9
Successfully adjusting countries¹					
Real GDP	5.6	5.5	5.7	5.7	5.6
Real per capita GDP	3.5	3.4	3.7	3.5	3.8
Sustained adjustment					
Real GDP	6.5	6.5	6.4	6.3	6.5
Real per capita GDP	4.5	4.5	4.5	4.3	4.8
Recent adjustment					
Real GDP	3.9	3.6	4.1	4.5	3.8
Real per capita GDP	1.5	1.2	1.9	2.1	1.8

¹This group, identified in the October 1992 *World Economic Outlook* (Chapter IV), consists of 35 developing countries divided into two categories: sustained adjusters, consisting of countries that initiated stabilization policies and structural reforms (in five areas including financial, fiscal, trade, labor markets, and public sector enterprises) five or more years ago, and recent adjusters, consisting of countries that started adjustment and reform during the past three to four years.

East and Europe, where many countries have been affected by large changes in the terms of trade, drought, and civil conflict, and in Latin America, where most countries experienced sharp fluctuations associated with the debt crisis.²⁷ In Africa,

countries such as Botswana have maintained their impressive growth rates throughout the past two decades, while in others there have been marked variations in growth, in part because of terms of trade fluctuations and other exogenous shocks, particularly drought.

It is also worth noting that, for most developing countries, there is little evidence of catching up to living standards prevailing in industrial countries, in the sense that countries with relatively low initial per capita income did not grow faster than countries

²⁷The correlation between individual country average growth rates in the 1971-81 period and in the 1982-92 period were as follows: for all developing countries, 0.34; Africa, 0.31; Asia, 0.59; Middle East and Europe, 0.37; and Western Hemisphere, 0.21.

with higher incomes.²⁸ Catching up might have been expected for two reasons. First, higher potential returns to capital in the low-income countries, because of capital scarcity and lower capital-labor ratios, would attract international capital flows, leading to an increase in capital accumulation and growth. Second, because of the low-income countries' larger technological gap compared with the more affluent countries, productivity might have been expected to grow particularly rapidly. That many developing countries have not caught up underlines the role that policies to encourage the accumulation of physical and human capital play in the development process. Those countries that have pursued such policies, including some in Asia and Latin America, have grown rapidly, and some are in the process of catching up with standards of living in the industrial countries.

Changes in the external environment, especially in the terms of trade and world interest rates, certainly contributed to the divergent performance among the developing countries, particularly in many of the relatively undiversified primary commodity exporters (Table 10). But in most countries the effects of these factors on long-run performance have been limited compared with the role of domestic policies. Even when external shocks were significant—as in the case of oil importing countries in 1973–74 and 1979–80, or for exporters of oil and other primary commodities from the mid-1980s—the policy response to these shocks played a key role in determining growth performance. Where governments maintained macroeconomic stability and eliminated structural rigidities, countries were able to weather external shocks well and to return quickly to a high-growth path.

Saving, Investment, and Productivity

The fast-growing developing countries—defined as the top one-third of countries ranked by GDP growth during 1971–92—share a number of characteristics that contrast with the middle- and low-growth countries (Table 11). The high-growth countries had markedly higher saving rates, particularly during the 1980s, when saving rates were nearly double those of the low-growth countries; higher investment rates; more efficient investment as measured by incremental capital-output ratios; and a higher proportion of investment financed by

domestic saving. A large proportion of the foreign saving utilized by the high-growth countries was in the form of equity capital, including foreign direct investment and portfolio flows, rather than in the form of debt-generating capital flows.²⁹

Government policies played a key role in promoting growth, even though the direct involvement of government in the economy did not differ significantly across the three groups of countries. The ratio of government consumption expenditure to GDP was about the same in the three groups, although during the 1980s the ratio of public investment to GDP was markedly higher for the high-growth countries (with the ratio of private investment to GDP even higher). The most striking difference between groups of countries was in export performance—export growth of the high-growth countries was more than double that of the low-growth countries. The benefits of an outward-oriented strategy, which in part explain this export performance, are discussed extensively in Chapter VI, which shows that countries pursuing such policies had a significantly better overall performance.

The sharp differences in economic performance can be summarized by using a basic growth accounting framework. During the 1970s, trend or potential output growth in the high-growth countries was nearly three times as high as in the low-growth countries (Table 12).³⁰ Although the contribution of capital in the high-growth countries was twice that in the low-growth countries, the largest difference was in the contribution of total factor productivity, which can be interpreted broadly as an indicator of the efficiency of resource use. During 1971–91, for instance, productivity increases accounted for nearly one-fourth of the growth for the high-growth countries, around 15 percent for the middle-growth countries, and made no contribution for the low-growth countries. During the first half of the 1980s, all countries suffered a sharp decline in productivity, in part because of the dislocations caused by the sharp increase in oil prices in 1979–80, high international interest rates, and the debt crisis. But productivity growth remained positive for the high-growth countries in the early 1980s and then picked up substantially. For the low-growth countries, in contrast, there was a sharp drop in productivity in the early 1980s and further declines in the following five years.

²⁸See N.G. Mankiw, David Romer, and D.N. Weil, "A Contribution to the Empirics of Economic Growth," *Quarterly Journal of Economics*, Vol. 107 (May 1992), pp. 407–37; and Malcolm Knight, Norman Loayza, and Delano Villanueva, "Testing the Neoclassical Theory of Economic Growth: A Panel Data Approach," IMF Working Paper 92/106 (December 1992).

²⁹Korea is the main exception, where, until the 1970s, over a third of the investment was financed by foreign borrowing.

³⁰Potential GDP is approximated by a three-year moving average of real GDP. The contributions of capital and labor are derived by multiplying their respective growth rates by the estimated share of each factor in output. Total factor productivity is calculated as the residual after taking account of the contributions of capital and labor.

Table 10. Developing Countries: Export and Import Unit Values and Terms of Trade*(Annual percent change)*

	1971-92	1971-81	1982-92	1982-86	1987-92
All developing countries					
Export unit values	9.3	20.8	-1.1	-7.6	4.8
Import unit values	6.8	12.1	1.7	-1.7	4.6
Terms of trade	3.0	8.6	-2.4	-5.9	0.6
By region					
Africa					
Export unit values	9.0	21.3	-2.0	-7.5	2.9
Import unit values	6.9	12.1	2.0	-1.0	4.6
Terms of trade	2.3	8.7	-3.7	-6.4	-1.3
Asia					
Export unit values	6.9	12.6	1.5	-2.7	5.1
Import unit values	6.7	12.4	1.2	-2.5	4.4
Terms of trade	0.4	0.5	0.3	-0.4	0.9
Middle East and Europe					
Export unit values	11.4	29.5	-4.2	-14.7	5.5
Import unit values	6.7	11.7	2.0	-1.4	4.9
Terms of trade	5.0	16.9	-5.7	-13.6	1.3
Western Hemisphere					
Export unit values	7.5	17.0	-1.2	-6.0	3.0
Import unit values	6.8	12.2	1.7	-1.2	4.2
Terms of trade	1.2	5.0	-2.4	-4.1	-1.0
By predominant export					
Fuel					
Export unit values	10.9	28.9	-4.6	-14.9	4.9
Import unit values	6.4	10.5	2.4	0.5	4.1
Terms of trade	4.4	16.8	-6.7	-15.1	1.0
Nonfuel					
Export unit values	6.6	12.1	1.3	-2.0	4.2
Import unit values	6.9	12.9	1.2	-2.9	4.8
Terms of trade	-0.1	-0.5	0.4	1.1	-0.2
Successfully adjusting countries					
Export unit values	7.4	14.3	1.0	-4.2	5.3
Import unit values	6.7	12.2	1.5	-1.9	4.4
Terms of trade	0.9	2.3	-0.5	-2.5	1.2
Sustained adjustment					
Export unit values	6.9	12.4	1.6	-2.6	5.1
Import unit values	6.8	12.4	1.5	-1.8	4.2
Terms of trade	0.2	0.2	0.2	-1.0	1.2
Recent adjustment					
Export unit values	8.7	20.6	-1.9	-10.7	6.0
Import unit values	6.3	11.3	1.5	-2.5	4.9
Terms of trade	2.7	9.2	-3.5	-8.5	0.9

The achievements of the high-growth countries were attributable, in large part, to domestic policies that increased incentives to save, invest, and allocate capital and labor in the most efficient manner. Moreover, by reducing instability and uncertainty, the policies pursued by these countries encouraged innovation and the adoption of modern technology and enabled the private sector to respond speedily to market signals. The outward orientation of these policies, by increasing competition and exposing domestic producers to new products and ideas, further increased the efficiency of resource allocation.

Macroeconomic Stability

A stable macroeconomic environment is a prerequisite for high rates of investment and strong productivity growth. Such an environment is characterized by low and predictable inflation, stable and sustainable fiscal balances, low but positive real interest rates, a competitive and relatively stable real exchange rate, and a balance of payments that is perceived as viable. The beneficial effects of stability on growth can be readily illustrated by the recovery of economic growth in several countries in Latin

Table 11. Developing Countries: Characteristics of High-, Middle-, and Low-Growth Countries¹*(In percent a year or percent of GDP unless otherwise noted)*

	1971-92	1971-81	1982-92	1982-86	1987-92 ²
All developing countries					
Real GDP growth	5.0	5.7	4.2	4.2	4.2
Real per capita GDP growth	2.7	3.3	2.0	1.8	2.1
Total fixed investment	21.7	21.7	21.7	21.8	21.7
Public investment	12.1	11.9	12.4	11.8	13.0
Private investment	9.6	9.8	9.3	10.0	8.6
Total saving	22.6	23.1	22.1	21.3	23.0
Government final consumption	11.9	11.5	12.3	12.2	12.3
Export volume growth	6.9	6.8	7.0	5.7	8.0
Capital-output ratio ³	3.2	3.2	3.7	3.9	3.5
High growth					
Real GDP growth	7.0	7.1	6.9	6.9	7.0
Real per capita GDP growth	5.0	5.1	4.8	4.7	4.9
Total fixed investment	23.8	22.2	25.6	25.3	25.9
Public investment	11.8	10.8	12.8	11.9	13.8
Private investment	12.0	11.3	12.8	13.4	12.1
Total saving	27.3	26.5	28.1	26.5	29.6
Government final consumption	11.9	11.4	12.4	12.7	12.1
Export volume growth	9.1	8.8	9.4	7.6	10.9
Capital-output ratio	2.5	2.4	2.9	3.1	2.4
Middle growth					
Real GDP growth	4.1	5.3	2.8	2.8	2.9
Real per capita GDP growth	1.5	2.5	0.5	0.2	0.7
Total fixed investment	20.5	21.3	19.6	19.6	19.5
Public investment	12.7	12.9	12.6	12.1	13.1
Private investment	7.7	8.4	7.0	7.5	6.4
Total saving	20.0	20.9	19.0	18.2	19.7
Government final consumption	11.5	11.3	11.8	11.4	12.1
Export volume growth	5.8	6.0	5.7	4.6	6.6
Capital-output ratio	3.4	3.6	3.7	4.1	3.9
Low growth					
Real GDP growth	1.8	3.0	0.6	0.9	0.4
Real per capita GDP growth	-0.5	0.7	-1.6	-1.4	-1.8
Total fixed investment	19.6	21.7	17.4	18.8	15.9
Public investment	11.0	11.6	10.2	10.6	9.9
Private investment	8.7	10.1	7.1	8.2	6.0
Total saving	18.0	20.6	15.1	16.0	14.2
Government final consumption	13.2	12.9	13.5	13.7	13.3
Export volume growth	3.2	2.7	3.7	3.3	4.1
Capital-output ratio	4.9	4.6	6.6	6.0	5.1

¹Countries were divided into three groups on the basis of their rankings in GDP growth during 1971-92, with the "high-growth" group consisting of the top third, and so on. Data, for 90 countries accounting for over 95 percent of developing country GDP, are weighted averages, with weights based on 1981-84 PPP valuation of country GDPs.

²Data for investment, saving, and the capital-output ratio are through 1991.

³Incremental capital-output ratio, defined as the change in capital stock relative to the change in output.

America in recent years, where an upturn in growth was preceded by the restoration of budget discipline and the reduction of inflation. The fast-growing countries of East Asia have generally maintained low inflation rates and for the most part have avoided balance of payments crises. When these countries have experienced such crises—as in Korea in 1980—they have moved swiftly to correct the underlying causes.

One of the major reasons for macroeconomic instability in the developing countries has been large

fiscal deficits. These have been financed largely by lax monetary policies, with fairly direct effects on inflation. Even when budget deficits have been financed by running down foreign exchange reserves, the ensuing foreign exchange difficulties have invariably led to instability. In recent years, a substantial proportion of deficits in the middle-income developing countries have been financed by domestic borrowing, which has led to very high real interest rates that have further aggravated the fiscal

Table 12. Developing Countries: Contributions to the Growth of Trend Output¹*(Annual percent change)*

	1971-91	1971-81	1982-91	1982-86	1987-91
All developing countries					
Trend GDP	5.2	6.0	4.2	4.1	4.3
Capital contribution	2.5	3.1	2.0	2.3	1.7
Labor contribution	1.3	1.6	1.3	1.3	1.2
Total factor productivity	1.3	1.3	1.0	0.5	1.5
By region					
Africa					
Trend GDP	3.4	4.5	2.3	2.2	2.3
Capital contribution	1.9	2.9	1.0	1.6	0.5
Labor contribution	1.3	1.4	1.5	1.4	1.5
Total factor productivity	0.2	0.2	-0.2	-0.8	0.3
Asia					
Trend GDP	6.5	6.2	6.8	6.8	6.9
Capital contribution	2.8	2.9	2.9	2.9	2.8
Labor contribution	1.1	1.4	1.1	1.2	1.0
Total factor productivity	2.6	1.9	2.9	2.6	3.1
Middle East and Europe					
Trend GDP	5.0	6.5	3.3	3.5	3.1
Capital contribution	3.3	4.6	2.1	3.0	1.2
Labor contribution	1.6	1.9	1.6	1.7	1.5
Total factor productivity	—	—	-0.4	-1.2	0.3
Western Hemisphere					
Trend GDP	4.0	6.2	1.6	1.1	2.0
Capital contribution	1.9	3.0	1.0	1.2	0.7
Labor contribution	1.5	2.0	1.3	1.4	1.3
Total factor productivity	0.5	1.3	-0.7	-1.5	0.1
By growth					
High growth					
Trend GDP	7.2	7.5	6.8	6.7	6.9
Capital contribution	3.4	3.7	3.2	3.5	3.0
Labor contribution	1.3	1.6	1.2	1.3	1.1
Total factor productivity	2.5	2.2	2.3	1.9	2.8
Middle growth					
Trend GDP	4.2	5.5	2.9	2.6	3.2
Capital contribution	2.1	3.0	1.2	1.5	1.0
Labor contribution	1.5	1.8	1.3	1.4	1.3
Total factor productivity	0.7	0.7	0.3	-0.3	0.9
Low growth					
Trend GDP	2.2	3.4	0.8	1.0	0.6
Capital contribution	1.2	1.9	0.6	1.1	0.2
Labor contribution	0.9	1.0	1.1	1.0	1.1
Total factor productivity	—	0.4	-0.9	-1.1	-0.7

¹See footnote 1 to Table 11. Trend output is defined as a three-year moving average of real GDP.

position.³¹ In the late 1970s and early 1980s, external borrowing was often used to finance burgeoning fiscal deficits caused by high levels of public consumption or by public investments that failed to yield adequate returns. The resulting indebtedness and macroeconomic instability was compounded by capital flight.

The second major factor affecting macroeconomic stability is the exchange rate, which plays a dual role in economic policy. First, the stability of

the nominal exchange rate can be used as a monetary anchor to reduce and stabilize inflation. Second, an appropriate level of the real exchange rate is crucial to the development of the domestic economy through the effects the real exchange rate has on incentives to export and on the ability of domestic producers to compete. These two aspects have often clashed in the developing countries—especially when an initial peg was set at the wrong level—because governments, in order to keep domestic inflation in check, have attempted to stabilize the nominal exchange rate with the result that the real exchange rate appreciated, eventually leading to external payments difficulties.

³¹Pablo E. Guidotti and Manmohan S. Kumar, *Domestic Public Debt of Externally Indebted Countries*, Occasional Paper 80 (IMF, June 1991).

Macroeconomic instability reduces growth through several channels. First, by distorting price signals so that these no longer reflect underlying scarcities, it results in the misallocation of resources and reduced productivity. Second, macroeconomic instability increases uncertainty and reduces the rate of investment, as potential investors wait for uncertainty to dissipate before committing resources.³² Capital flight, which is likely to increase with macroeconomic instability, further reduces investment in the domestic economy. High and variable inflation, an important source of macroeconomic instability, further depresses investment, often by lowering real returns to saving. Large fiscal deficits may lead to the crowding out of private investment by raising real interest rates. High deficits, which result in rapid accumulation of public debt, may also signal higher taxes and lower public investment in the future.

The way that fiscal consolidation is undertaken has important implications for long-run growth. To reduce uncertainty, deficit reduction must be credible and sustainable. Increased taxes on income and investment may distort incentives and reduce growth. In many countries there is scope to reduce non-productive government spending, such as military expenditures. In general, reductions in public investment, including expenditures on human capital, will reduce long-run growth prospects. However, the net effect of public investment depends both on the extent to which it is complementary to private investment and on the form of taxation used to finance it.³³ Complementary and efficient public investment financed with consumption taxes is likely to lead to an increase in growth. In contrast, the effect of public investment is ambiguous when it is financed through taxes on income, profits, or capital.

As Table 13 illustrates, inflation and its variability and the variability of the real exchange rate have been considerably lower in high-growth countries than in other countries.³⁴ There has also been a tendency for high-growth countries to keep their deficits in check by maintaining expenditures and revenues relatively stable in relation to GDP.³⁵ For

instance, between 1971–81 and 1982–92, the ratio of central government expenditure to GDP was unchanged at around 26 percent for the high-growth countries, but it increased from 24 percent to 31 percent for the low-growth countries without any corresponding increase in revenues. In those countries where there were pressures on government revenues, expenditure cuts were distributed evenly across government consumption and investment.³⁶ In line with the relatively low fiscal deficits, the growth of broad money (adjusted for the growth in output) also tended to be lower. Many of the high-growth countries, including Indonesia, Malaysia, and Thailand, have undertaken substantial financial sector reforms that have allowed them to finance their deficits by market borrowing, and to some extent the need to service debt obligations may have imposed, in general, some discipline on the public sector.

Cross-country analysis suggests that an increase in the inflation rate by 10 percentage points a year reduces the growth of the capital stock by around 0.30 percentage point, and the rate of productivity growth by about 0.15 percentage point.³⁷ A sustained reduction in fiscal deficits of 1 percentage point of GDP is typically associated with an increase in growth of up to 0.25 percentage point. These large effects underscore the importance of macroeconomic stability, although the evidence indicates that some of the effects may be nonlinear. For instance, variations in inflation do not significantly affect growth as long as annual inflation is in single digits, but higher rates significantly reduce growth through adverse effects on capital accumulation and productivity.

Structural Distortions and Government Intervention

Although the above indicators of macroeconomic stability have a significant effect on growth, they

³²For a discussion of the relationship between macroeconomic stability and long-term growth, see Jacob A. Frenkel and Mohsin S. Khan, "Adjustment Policies and Economic Development," *American Journal of Agricultural Economics, Proceedings of the ASSA 1989 Winter Meeting* (August 1990).

³³Mohsin S. Khan and Manmohan S. Kumar, "Convergence, and Public and Private Investment," IMF Working Paper (forthcoming, 1993).

³⁴Inflation and its variability are highly correlated across countries, making it difficult to disentangle the effect on growth of the level of inflation from that of uncertainty about inflation.

³⁵Although fiscal deficits and growth may be expected to be endogenously determined over short periods and both may be influenced by external factors, over longer periods it is reason-

able to view deficits as being determined mainly by government policy. See, for instance, Stanley Fischer, "Growth, Macroeconomics, and Development," NBER Working Paper 3702 (Cambridge, Massachusetts: National Bureau of Economic Research, May 1991).

³⁶See "Fiscal Adjustment in Developing Countries," Annex V in the May 1992 *World Economic Outlook*.

³⁷These results are based on a sample of 50 developing countries over the period 1970–91. Given the cross-sectional nature of the analysis, these results should, of course, be regarded as illustrative, rather than indicating precise elasticities. See also Fischer, "Growth, Macroeconomics, and Development"; and José De Gregorio, "The Effects of Inflation on Economic Growth: Lessons from Latin America," *European Economic Review*, Vol. 36 (April 1992), pp. 417–25.

Table 13. Developing Countries: Indicators of Macroeconomic Stability¹
(Annual percent change unless otherwise noted)

	1971-92	1971-81	1982-92	1982-86	1987-92 ²
All developing countries					
Consumer prices	30.8	17.9	45.1	32.3	56.8
Consumer prices (median)	10.3	11.2	9.4	9.6	9.2
Variability of price inflation ³	127.7	14.6	156.7	27.5	170.1
Real effective exchange rate	-2.7	-0.9	-4.6	-6.8	-2.4
Variability of real effective exchange rate ³	12.8	8.7	14.3	10.0	13.8
Budget deficit (percent of GDP)	-3.9	-3.2	-4.6	-5.1	-4.2
Broad money	41.6	28.3	56.3	41.1	70.1
High growth					
Consumer prices	9.8	9.9	9.7	7.5	11.5
Consumer prices (median)	8.6	10.1	7.0	6.7	7.2
Variability of price inflation ³	8.0	7.2	4.9	3.1	4.7
Real effective exchange rate	-4.1	-2.3	-6.1	-7.9	-4.4
Variability of real effective exchange rate ³	9.4	7.8	9.5	8.4	9.3
Budget deficit (percent of GDP)	-2.6	-1.6	-3.6	-4.0	-3.3
Broad money	22.9	22.9	22.8	21.8	23.7
Middle growth					
Consumer prices	43.7	20.8	71.0	47.8	93.1
Consumer prices (median)	11.1	11.2	11.1	10.5	11.6
Variability of price inflation ³	154.8	16.3	184.5	19.5	199.2
Real effective exchange rate	-2.1	-0.4	-4.0	-5.7	-2.2
Variability of real effective exchange rate ³	12.3	8.7	13.9	10.3	12.4
Budget deficit (percent of GDP)	-4.6	-3.9	-5.3	-5.9	-4.7
Broad money	50.7	29.9	74.7	53.0	95.1
Low growth					
Consumer prices	60.0	34.7	90.0	68.5	110.1
Consumer prices (median)	12.2	12.2	12.2	11.9	12.4
Variability of price inflation ³	413.6	31.9	544.2	139.3	597.3
Real effective exchange rate	0.6	2.2	-1.2	-7.3	5.2
Variability of real effective exchange rate ³	29.0	12.1	36.4	15.1	39.0
Budget deficit (percent of GDP)	-5.4	-5.4	-5.4	-5.4	-5.3
Broad money	76.4	40.3	121.7	66.6	181.3

¹See footnote 1 to Table 11.

²Data for real effective exchange rates are through 1991.

³Variability is measured as the standard deviation of the variable.

explain only a part of the total cross-sectional variation in growth among countries. Structural policies also influence growth—as shown, for instance, by the evidence from the CFA franc zone in Africa, where many of the countries have grown slowly since the early 1970s despite relative macroeconomic stability, and from India, which grew steadily but moderately while pursuing cautious macroeconomic policies since the early 1950s. Such results may be the consequence of government interventions in the form of barriers to trade, subsidies, and exchange and interest rate controls that lead to price and trade distortions and reduce incentives to save and invest. In such an environment, resources will remain in low-productivity activities,

bottlenecks will become persistent, and growth will be impeded.³⁸

³⁸As noted in the October 1992 *World Economic Outlook*, in recent years many developing countries have undertaken major structural reforms that have improved the medium-term outlook considerably. In India, for instance, the process of reform initiated in mid-1991 has so far led to the dismantling of most industrial licensing, the opening up to the private sector of many industries previously reserved for the public sector, liberalization of foreign investment, the first stages of financial sector reform, and major trade liberalization. Price reforms have included the decontrol of many previously administered prices and increased flexibility in setting a number of important prices. Most recently, the dual exchange rate system has been unified, with the exchange rate now being determined through a system of managed floating.

Two indicators of price distortions are particularly noteworthy: the foreign exchange premium in the parallel (or black) market, and indices of trade intervention. The parallel market premium is an indicator of the distortions created by exchange restrictions and an overvalued currency. This situation encourages capital flight and distorts incentives—both for exporters, who tend to under-invoice exports, and for importers, who may over-invoice imports. The outflow of capital may thereby increase the scarcity of foreign exchange, which may induce governments to impose further restrictions on trade and capital flows.

Another area of distortion is in the financial sector. There is increasing evidence that government policies toward financial institutions have had an important effect on long-term growth. To encourage capital investment, governments often keep real interest rates artificially low and even negative for prolonged periods of time. This reduces incentives for domestic saving, encourages capital flight, and leads to misallocation of capital to nonproductive sectors. Similarly, when credit to particular sectors is subsidized, it often results in excessively capital-intensive projects. Policies that adversely affect the efficiency of financial intermediaries, including excessive restrictions on entry, hamper resource allocation and productivity growth.³⁹

Cross-sectional empirical evidence shows a clear link between structural distortions and growth performance. Countries with above-average growth have had relatively fewer trade restrictions and, as shown in Table 14, lower black market premiums. High-growth countries not only have had fewer distortions, but also have gradually reduced them over time.⁴⁰ The high-growth countries have tended to have positive but relatively low real interest rates, while the other two groups have had either large negative real interest rates or large positive real interest rates.⁴¹ High positive real interest rates were due, in part, to large fiscal deficits and may have reflected default risk premiums, while large negative real interest rates typically reflected interest rate controls coupled with high inflation. A composite index of distortions that combines the differ-

³⁹Empirical evidence suggests that financial development, proxied by the ratio of private sector bank credit to GDP, generally leads to improved growth performance through its effect on the efficiency of investment. See José De Gregorio and Pablo Guidotti, "Financial Development and Economic Growth," IMF Working Paper 92/101 (December 1992).

⁴⁰See Vinod Thomas and Yan Wang, "Government Policies and Productivity Growth: Is East Asia an Exception?" Working Paper, Office of the Vice President, East Asia and Pacific Region (Washington: World Bank, forthcoming, 1993).

⁴¹See October 1992 *World Economic Outlook*, Chapter IV, "The Experience of Successfully Adjusting Developing Countries."

Table 14. Developing Countries: Black Market Premiums and Growth

Average Annual Growth	Black Market Premiums ¹		
	Low	Medium	High
1971-81			
Less than 0 percent	9.1	—	11.1
0-2 percent	4.5	8.7	18.5
2-4 percent	13.6	26.1	40.7
4-6 percent	27.3	34.8	29.6
Greater than 6 percent	45.5	30.4	—
1982-86			
Less than 0 percent	9.1	17.4	29.6
0-2 percent	18.2	47.8	33.3
2-4 percent	27.3	21.7	11.1
4-6 percent	36.4	13.0	14.8
Greater than 6 percent	9.1	—	11.1
1971-86			
Less than 0 percent	—	—	3.7
0-2 percent	13.6	13.0	48.1
2-4 percent	27.3	30.4	29.6
4-6 percent	22.7	39.1	18.5
Greater than 6 percent	36.4	17.4	—
Total number of countries	22	23	27

¹The black market premium is measured as the difference between official and parallel market exchange rates. Countries for which data were available and that had a black market premium were ranked by the average level of premiums during 1971-83, with the "high" group representing roughly the top third and so on. Within each column, entries indicate the percentage of countries falling in the given growth range. For instance, the first entry shows that 9.1 percent of the countries with low premiums during 1971-81 had negative growth.

ent measures of distortions to provide one indicator again shows a clear difference between high-growth and low-growth countries.⁴²

It is often suggested that some types of direct intervention in industry, particularly the manipulation of financial incentives to favor certain sectors or firms, may be beneficial. Although there may be costs imposed by the distortions associated with these interventions, it is argued, there can be significant benefits in terms of structural transformation and positive external effects, especially in the early phases of development. In this regard the experience of East Asian countries is often emphasized. However, the experience of these countries also suggests that, while there were many instances in which government intervention was beneficial in facilitating the development of high-tech "strategic" industries and in the formation of managerial and technical expertise, policymakers in these countries

⁴²See Vinod Thomas and Yan Wang, "Government Policies and Productivity Growth."

Box 4. Economic Reforms, Growth, and Trade in China

The early stages of China's reforms, beginning in 1978, dealt chiefly with the agricultural and foreign trade sectors.¹ Rural reforms increased agricultural productivity sharply and released surplus labor to rural nonstate enterprises, many of which developed an external orientation. External reforms were designed both to boost exports and to encourage foreign direct investment and the adoption of new technology. The rules governing foreign investment were liberalized, and significant tax incentives were granted, initially in four special economic zones (SEZs) and later in other open economic zones.² Since 1978, China's complex exchange and trade system has been gradually liberalized. The role of the foreign trade plan was reduced, transactions were increasingly allowed at a market-oriented exchange rate, and the foreign trade corporations (FTCs) were decentralized, with most FTCs becoming responsible for their own economic performance by 1988. From the mid-1980s, market-oriented reform began to be applied to the urban industrial sectors, with particular emphasis on state-owned enterprises. These enterprises were gradually exposed to market forces, investment decisions were made more decentralized, and enterprises were allowed to retain profits and became liable for taxation. Simultaneous reform of the financial sector saw the breakup of the old monobank system and the growth of nonbank financial institutions.

¹See Michael W. Bell and Kalpana Kochhar, "China: An Evolving Market Economy—A Review of Reform Experience," IMF Working Paper 92/89 (November 1992).

²Open economic zones are areas that were opened up by the authorities to external trade and investment; these include mainly the SEZs, open coastal cities, and several other types of economic development zones.

A surge in inflation in the late 1980s led to a two-year hiatus in reform, but the process began to regain momentum in the course of 1991, with a further sharp quickening in 1992. Significant liberalization in the trade and exchange systems in 1991 was followed in 1992 by steps toward an integrated foreign exchange market. There has also been an extension of liberalization to new inland regions, reinforcing their growth potential. Foreign participation in new areas of economic activity (notably in the tertiary sector) was allowed in 1992, and steps were taken toward adopting international standards and practices in areas such as accounting, copyright law, and patent protection. Domestic reforms, which have included a major liberalization of prices and a sharp reduction in mandatory planning, have also focused on the enterprise sector, where the policy objectives include the elimination of price distortions and soft budget constraints. The social security and housing systems are being overhauled to ensure an adequate social safety net. The prospects for reform in the financial sector are being bolstered by promoting money markets and interbank markets, while trading in enterprise shares is growing rapidly on the stock exchanges.

Domestic and external reforms in China have played a complementary role, leading to a dramatic increase in growth (see table). The domestic reforms contributed to a sharp increase in savings and investment, with the investment-GDP ratio rising to 34 percent in the 1980s and an increasing amount being directed to the fast-growing manufacturing sector.³

³See World Bank, *China: Between Plan and Market*, World Bank Country Study (Washington, 1990).

were not always successful in their attempts to pick the winners.⁴³

In Korea, for example, the government actively intervened in the early process of industrialization and pursued an export-oriented strategy, but the extent to which the interventions successfully favored particular sectors is subject to considerable debate. Some maintain that the motivation for the interven-

⁴³Note that, in contrast to the debate about government intervention in industry, there is a consensus that land reforms in countries such as Korea and China have been extremely important in laying the foundations for spectacular growth performance. These reforms, by improving incentives, sharply increased growth of output and productivity in agriculture and freed up resources for industrial development. Lack of agricultural reforms in countries such as the Philippines has been a serious impediment to structural transformation and sustained growth.

tions, including tax and tariff exemptions and subsidized credits, was to maintain rough neutrality between incentives provided to different sectors and that the interventions did not result in large price distortions.⁴⁴ Together with competitive labor markets and Korea's comparative advantage in labor-intensive manufacturing activities, the interventions led to a rapid expansion of labor-intensive exports. Others have suggested that such interventions, especially the heavy and chemical industry promotion drive in the mid-1970s, promoted industries that were subsequently able to compete in world markets but at the expense of other sectors. The degree of distortion is difficult to assess. What

⁴⁴Anne O. Krueger, "Asian Trade and Growth Lessons," *American Economic Review, Papers and Proceedings*, Vol. 80 (May 1990), pp. 108-12.

China: Exports and Growth*(Annual average, in percent)*

	1978-82	1982-86	1986-90	1990-92
Growth of real GDP	7.0	11.9	7.5	10.3
Growth of export volume	16.1	6.5	13.2	12.7
Share in world exports	1.0	1.4	1.8	2.1

The external reforms have been accompanied by a dramatic expansion in foreign direct investment, a major part of it coming from Hong Kong and Taiwan Province of China, and by a rapid growth in exports. The opening up of the economy contributed to the acceleration in growth because the development of many key manufacturing industries hinged on imports of technologically advanced machinery and equipment, and export earnings were an important source of financing for these imports.⁴

Exports increased more than sixfold between 1978 and 1991, China's share in world exports more than doubled, and its rank among world exporters advanced from thirty-second to thirteenth. Regional trade also boomed, as the share of China's total exports going to other Asian countries rose from 39 percent in 1985 to 57 percent in 1991. One of the largest and fastest-growing export categories, referred to as "products exported after inward processing," reflects processing in the open economic zones and involves enterprises set up and operated primarily by investors

⁴See Nicholas R. Lardy, *Foreign Trade and Economic Reform in China, 1978-1990* (Cambridge and New York: Cambridge University Press, 1992).

from Hong Kong and Taiwan.⁵ In contrast to the rest of the Chinese economy, whose exports are dominated by basic manufactures and primary products, exports from these zones largely consist of machinery and electronics and textiles and garments. The growth of these exports illustrates the importance of economic liberalization and foreign investment in the zones in the development of the Chinese economy through the 1980s. The share of inward processing industries in China's total exports and imports increased sharply toward the end of the decade, rising from 8½ percent and 4½ percent, respectively, in 1985 to 17 percent and 16 percent in 1990. The open economic zones have been a major recipient of foreign direct investment, new technologies, managerial skills, and labor training. Many foreign investors, particularly those from countries with labor shortages, are attracted by the relatively low wages.

The marked rise in economic activity in 1991-92, however, has led to a renewed risk of overheating that, if not contained, could lead to macroeconomic instability and could jeopardize the reform process. A key to containing fiscal and monetary pressure would be an improved performance by the state enterprise sector, whose losses were compensated by budgetary subsidies, amounting to 2½ percent of GNP in the past, and bank credit of a similar magnitude. Sustained domestic demand restraint should help the Chinese economy to achieve a soft landing from its current very high rates of expansion while maintaining a sound external position. Greater efforts to preserve macroeconomic stability will ensure that the full benefits of China's trade reforms will be realized.

⁵See Adi Brender, "China's Foreign Trade Behavior in the 1980s: An Empirical Analysis," IMF Working Paper 92/5 (January 1992).

is not disputed is that the heavy and chemical industry drive culminated in serious macroeconomic imbalances in the early 1980s, which led to a marked shift in these policies and reforms. There is also some evidence that tariffs and subsidized credit may have had negative effects on labor productivity and technological progress in some of the favored sectors, although tax incentives had a strong positive effect.⁴⁵ The negative relationship between trade protection and productivity growth highlights the difficulties in targeting the right industries and the inefficiencies that can arise from reduced competition.

In Thailand, the push for capital-intensive, large-scale, import-substituting industries in the 1970s

⁴⁵Jong-Wha Lee, "Government Intervention and Productivity Growth in Korean Manufacturing Industries," IMF Working Paper (forthcoming, 1993).

also had mixed results. These policies contributed to macroeconomic imbalances, but they also helped to develop infrastructure, as well as technical and managerial structures, that were essential for the subsequent expansion in the 1980s. In Indonesia, sectoral policies entailing public investment in infrastructure and agricultural services were successful in promoting agricultural development, but interventions in the industrial and financial sectors did not always yield the desired results.

In Singapore, industrial policy, through fiscal incentives and direct government investment in firms, was relatively successful. The promoted industries were more broadly defined than the specific industries targeted in other countries such as Korea. Moreover, the incentives affected the sectoral composition of investment and output only to a limited extent. Given the large share of foreign direct investment in total investment, the selection of indus-

tries was ultimately made by multinational firms on the basis of their own assessment of profitability. As regards direct investment, the so-called government-linked companies in Singapore, in contrast to state-owned companies in other countries, were run on a commercial basis, and the government did not interfere with business decisions or provide subsidies to nonprofitable companies.

In general, although selective industrial policies have left a mark on East Asian development, they did not play a consistently positive role. These policies varied greatly in intensity across countries and over time, as well as in the extent to which they achieved their objectives. Where government interventions succeeded, it was in the context of a stable macroeconomic environment and an outward-oriented trade strategy, and the interventions sought to complement the market rather than replace it.⁴⁶ (See Box 4 on reforms in China.)

Institutions and Human Capital

The experience of high-growth countries underscores the importance of strong institutions, especially those responsible for macroeconomic policy formulation and implementation. In many fast-growing countries, the viability and credibility of these institutions were reinforced by strong social support for growth, which, in turn, was nurtured by the wide distribution of the fruits of growth. For instance, in addition to strong economic growth performance, East Asian countries have made outstanding progress, compared with other developing countries, in reducing absolute and relative poverty.

Education and the formation of human capital are necessary to build institutions and raise productivity growth. Investment in education leads to the acquisition of skills that improve efficiency through the better use of existing technologies. Education also helps technological progress by shortening the "imitation" lag between the development and use of new technologies.⁴⁷ Technological progress, in turn, speeds up the accumulation of human capital through positive externalities and learning by doing. Indeed, one of the main obstacles preventing

⁴⁶Cross-sectional evidence also supports the view that, even where high rates of investment in particular sectors (such as machinery and equipment) yield high increases in productivity, the benefits are likely to be low unless policy interventions are market conforming. See Bradford J. De Long and Lawrence H. Summers, "Equipment Investment and Economic Growth," *Quarterly Journal of Economics*, Vol. 106 (May 1991), pp. 445-502.

⁴⁷R.E. Lucas, Jr., "On the Mechanics of Economic Development," *Journal of Monetary Economics*, Vol. 22 (July 1988), pp. 3-42.

the poorest developing countries from catching up in living standards is the lack of investment in human capital, not just a shortage of physical capital.

In this regard also, the experience of East Asian countries—with some of the highest per capita expenditures on education—is instructive. Unlike in many other developing countries, these expenditures, incurred substantially by private households, were used to acquire primary and secondary education and vocational skills. The sharp increase in literacy in these countries surpassed the increase in most other countries. For instance, both Korea and India had a literacy rate of roughly 30 percent in the mid-1950s; by 1991 Korea's literacy rate had increased to over 95 percent, while India's had increased to only about 45 percent. Between 1960 and 1991, college enrollment in Korea increased fourteenfold, far surpassing the increase elsewhere and making it second only to the United States in the number of students as a share of the total population.

The cross-sectional evidence suggests that growth in productivity as well as the accumulation of physical capital are strongly correlated with the level of human capital. For instance, the level of secondary school enrollment, which may be interpreted as a proxy for the stock of human capital, is strongly correlated with subsequent growth.⁴⁸

Medium-Term Prospects

The medium-term prospects for developing countries are encouraging, perhaps more so than they have been in decades. This assessment is based primarily on the fact that increasing numbers of countries are pursuing policies to achieve macroeconomic stability and the reduction of structural distortions.⁴⁹ On the assumption that these efforts continue and, in particular, that developing countries with IMF-supported adjustment programs implement the policies underlying the programs, output is projected to grow at an average rate of 5³/₄ percent in 1995-98—considerably faster than in 1982-92—while growth performances across different regions would tend to converge (Table 15).⁵⁰ Much of this improvement can be traced to a

⁴⁸See Robert J. Barro, "Economic Growth in a Cross-Section of Countries," *Quarterly Journal of Economics*, Vol. 106 (May 1991), pp. 407-43.

⁴⁹These include countries such as Argentina, China, Egypt, India, Kenya, Malawi, Mexico, Tanzania, Tunisia, and Uganda; the structural reforms undertaken by these countries were examined in the October 1992 *World Economic Outlook* (Chapter IV).

⁵⁰A detailed assessment of the medium-term outlook for developing countries is provided in Annex II.

marked pickup in the countries that had previously been experiencing debt-servicing difficulties.

Real output growth in *Asia* is projected to average 7 percent in 1995–98, fueled in part by continued increases in intraregional trade, further modernization of financial systems, and increases in infrastructure investment. In the *Western Hemisphere*, major reforms in the areas of trade, foreign investment, and financial and labor markets, together with the declining debt overhang, are projected to boost growth markedly in the medium term. As in other regions, the medium-term outlook depends crucially on the assumption that the region continues to ensure macroeconomic stability and to sustain the momentum of reform.

For the developing countries in the *Middle East and Europe*, medium-term growth is expected to average around 4 $\frac{1}{4}$ percent, somewhat higher than in the recent past. Several countries are likely to benefit from improvements in both the rate and efficiency of investment, owing to significant financial sector liberalization and exchange market reforms. Moreover, several countries have embarked on fiscal consolidation programs that will enhance the credibility of government policies, improve financial stability, and spur economic growth. For the oil exporting countries in the region, there are considerable uncertainties about the medium-term balance between global supply and demand for petroleum (Box 5).

Although growth in *Africa* is projected to increase somewhat in the medium term, these projections are subject to a wider margin of uncertainty than for other regions. Despite considerable progress in some countries, many obstacles to stronger growth remain to be tackled, including inadequate infrastructure, weak administrative capacity, rigidities stemming from official controls, poorly designed tax and expenditure policies, and social and political instability. Comprehensive policy initiatives, such as those associated with the IMF's SAF and ESAF arrangements (with complementary assistance from the World Bank), are being implemented to create the conditions for sustained growth and progress toward external viability. Continuing weakness in commodity prices and serious debt problems in several countries, however, may hamper these efforts. To change prospects decisively, reform policies would have to be accompanied by political stability, institution building, greater investment in education, and increased financial and technical assistance.

Previous issues of the *World Economic Outlook* have emphasized the risks to the projections for the

Table 15. Developing Countries: Growth and Investment

(Annual percent change and percent of GDP)

	1982–87	1988–92	1993–94	1995–98
All developing countries				
Real GDP	4.4	4.7	5.1	5.9
Investment ratio	24.1	25.8	26.7	27.6
Africa				
Real GDP	1.8	2.4	3.3	4.4
Investment ratio	22.2	20.9	22.2	23.5
Asia				
Real GDP	7.3	6.8	6.6	7.0
Investment ratio	28.3	30.9	30.7	30.9
Middle East and Europe				
Real GDP	3.0	4.0	4.4	4.4
Investment ratio	22.7	19.9	20.6	21.0
Western Hemisphere				
Real GDP	1.8	1.6	2.5	4.8
Investment ratio	19.0	20.7	22.4	24.6

developing countries if the assumed policies are not implemented. The possible consequences of policy slippages in countries with IMF programs are examined in Annex II, where it is assumed that fiscal imbalances would persist and that structural reforms are not implemented as steadfastly as assumed in the baseline projections. The consequences of policy slippages would, of course, depend on the number of countries affected, on the degree of slippage, and on the impact on capital flows.

Nevertheless, the policy-slippage scenario suggests that average inflation in 1995–98 would be about 30 percentage points higher than in the baseline case, with a particularly sharp rise in the Western Hemisphere and in the most heavily indebted countries. Investment ratios would be somewhat lower than the baseline, and total factor productivity growth in 1995–98 would fall from 3 percent to 1 $\frac{1}{2}$ percent for the net debtor countries. The annual average growth of potential output would fall from 4 $\frac{3}{4}$ percent to about 3 $\frac{1}{4}$ percent for the program countries as a group, and actual growth would decline at least as much. Although growth in the developing countries would still be 5 percent a year in the medium term, relatively large divergences would persist between the stronger performers and those experiencing policy slippages.

Box 5. Oil Demand and Supply in the Medium Term

Global oil *demand* is expected to grow by an average of about 1¼ percent a year until 1995, and by about 1 percent a year between 1995 and 2000.¹ A key determinant of world oil demand in the medium term will be GDP growth and energy policies in the major industrial countries. Total demand for oil by industrial countries reached a peak of 42.2 million barrels a day (mbd) in 1978, fell significantly in the early 1980s, and then picked up with the sharp decline in oil prices in 1985 (see chart on oil prices). In the medium term, demand growth is likely to be lower if excise taxes on fuels are increased to reduce oil imports, to increase government revenues, or to curb carbon emissions. Even without tax increases, the oil intensity of output is expected to fall in the medium term. The share of oil in electric power generation, for example, was 15 percent in 1990, but is expected to drop to 12½ percent by 2005.

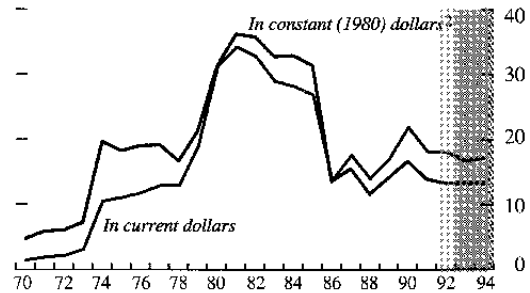
In the former Soviet Union, oil demand has been falling sharply with the collapse of economic activity. Oil demand is likely to increase as output grows in the medium term, but the energy intensity of output is expected to decline as subsidies are removed and energy is used more efficiently. In developing countries such as India, in contrast, stronger economic growth is likely to increase the demand for oil in the medium term, and the oil intensity of output is expected to rise in response to buoyant population growth, urbanization, and industrialization. Although China is currently a small net exporter of oil—production and consumption in 1991 were 2.8 and 2.5 mbd, respectively—the likelihood of continued high output growth implies that China will be a net importer of oil in the medium term. Given China's large population, there is a potential for a substantial increase in oil demand, which could have a major influence on world oil prices.

The share of non-OPEC output in total world oil

¹The projections discussed in this box are from *Energy Policies of IEA Countries: 1991 Review* (Paris: OECD and International Energy Agency, 1992), *OECD Economic Outlook* (Paris, December 1992), and staff projections based on oil industry forecasts. The economic assumptions underlying these projections are broadly consistent with the medium-term projections discussed in Annex II.

World Crude Oil Prices¹

(In U.S. dollars a barrel)



Sources: *Petroleum Market Intelligence* (New York), other oil industry sources, and Commodities Division of the IMF Research Department.

¹Data from 1984 are the unweighted average spot market prices of U.K. Brent, Dubai, and Alaska North Slope crude oil, representing light, medium, and heavier crude oil, respectively, in three different regions. Estimated average prices for earlier years are broadly comparable with the data after 1984. Blue shaded area indicates staff projections.

²Crude oil prices deflated by the export price of manufactures of industrial countries.

supply has declined steadily since 1985 (see chart on oil supply), in part because of the decline in oil prices and the higher cost of production compared with the OPEC countries. Non-OPEC output is expected to peak in 1997 at around 43 mbd. In the short run, U.S. oil output will decline as a result of the slump in drilling activity since 1986, and in the medium term as resources are depleted. North Sea oil production is likely to rise in the short run but to decline after the late 1990s, while oil output could increase in Canada (from the Hibernia oil field and the Beaufort Sea). In Latin America, Mexico appears to have significant oil reserves, but the extent to which they can be exploited will depend on investment and foreign capital. In the non-OPEC Middle East, Yemen, Oman, and Syria are

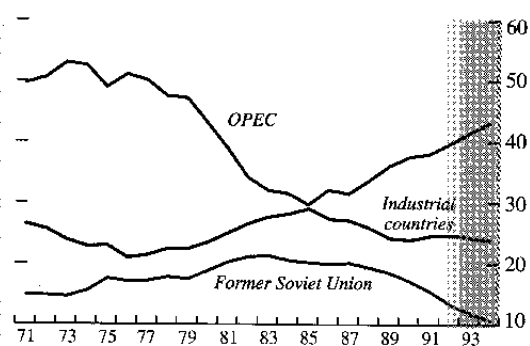
each capable of producing up to about 1 mbd. Non-OPEC oil production elsewhere in Asia and Africa is expected to stagnate, although China may have some undiscovered reserves in its northwest region, which is being opened to foreign exploration, and oil production in India could increase as a result of changed government policies in the oil sector. Oil output in countries of the former Soviet Union has fallen since the late 1980s and is expected to fall further until the mid-1990s. A recovery of oil output in the former Soviet Union—which is the major uncertainty with regard to the medium-term outlook for non-OPEC oil production—will depend on the resolution of political and economic uncertainties, substantial inflows of direct foreign investment, and introduction of better technology and improved management.

The share of OPEC in world oil supply—which fell following the two oil price increases in the 1970s—has been increasing since mid-1980, and this trend is expected to continue. OPEC production is likely to increase about 6 percent in 1993 and 1994, with most of the increase coming from countries in the Middle East. Over the medium to long term, Saudi Arabia, Kuwait, the Islamic Republic of Iran, Iraq, and the United Arab Emirates—countries in the region with the greatest reserves of oil—are expected to dominate world supply. OPEC production in 1992 is estimated to have been 26.6 mbd, but estimates of capacity for 1997–98 range from 31 mbd to 36 mbd, with Saudi Arabia accounting for about 11 mbd, the Islamic Republic of Iran about 5 mbd, and the United Arab Emirates and Kuwait about 3 mbd each. Oil output in Iraq could be as high as 5 mbd. Among the other members of OPEC, Venezuela is expected to increase capacity to about 3.5 mbd in the medium term.

In the short run, oil prices will largely be determined by the ability of OPEC countries to influence supply. Prices may fall with the return of Iraq to the international oil market unless production is reduced in other countries. Although constant real oil prices in the medium term are assumed in the IMF medium-term projections, there is the possibility of substantial downward pressure on oil prices from lower oil demand growth—reflecting increased energy efficiency, environmental policies, and higher energy taxes—combined with possible increased production capacity

Share in World Oil Supply¹

(In percent)



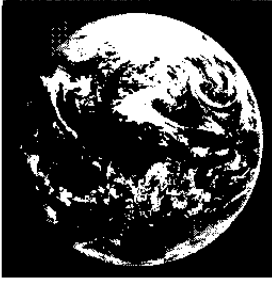
Source: International Energy Agency (IEA).

¹Blue shaded area indicates IEA projections, which are based on economic projections that are broadly comparable with the *World Economic Outlook* medium-term projections; see *Energy Policies of IEA Countries: 1991 Review* (Paris: OECD and IEA, 1992).

among major OPEC countries (to 35 mbd, for example). This downward pressure may be partially offset by higher oil demand growth if prices remain low or if OPEC is better able to control production as its total share in world supply increases.

A sustained fall in the price of oil of 10 percent, stemming from a rise in production, would have a positive, but small, impact on oil importing countries as a whole. There would, however, be substantial adverse effects on countries where oil production accounts for a large share of GDP, because the increase in oil output would not offset the fall in prices, owing to inelastic oil demand. Real income would therefore fall, which would tend to reduce domestic absorption and output in the non-oil sector.²

²Work is in progress to include the net creditor countries, many of whom are oil exporters, in a new version of the IMF's Net Debtor Developing Country Model used to prepare alternative scenarios.



V

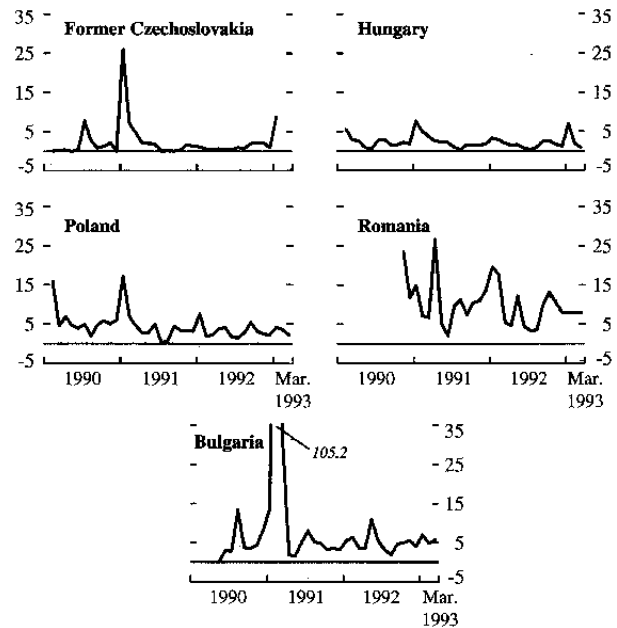
Economic Stability and Transformation in Countries in Transition

The countries in transition—the former centrally planned economies of central Europe, the former Soviet Union, and Mongolia—have adopted, or are in the process of adopting, economic reforms on an unprecedented scale. These countries are now in different stages of the transition to market economies, with central Europe broadly more advanced, having started earlier. Some of the countries in transition—notably the former Czech and Slovak Federal Republic, Estonia, Hungary, Latvia, and Poland—have made significant progress in macroeconomic stabilization. Most, however, still face difficult fiscal problems stemming from the web of soft budget constraints and state subsidies, increases in outlays for social benefits and structural reform, or reductions in revenues because of output declines and administrative difficulties. Containing inflationary pressures will require tight control of government budgets and of credit creation, while reductions in subsidies, hard budget constraints on enterprises, and further privatization will be required if firms are to respond fully to market forces. Both macroeconomic stability and structural change are crucial to ensuring sustainable increases in living standards in the years ahead.

Economic Transformation in Central Europe

Among the transforming countries of central Europe, the former Czechoslovakia, Hungary, and Poland have made the greatest progress in macroeconomic stabilization and structural reform. In these countries, output has begun to recover, and inflationary pressures have been relatively contained (Chart 21). As the reforms already in place begin to take hold, and assuming that further reforms are carried out as planned and that inflation is contained, real output growth is expected to rise during the rest of the decade. Bulgaria and Romania have also begun to implement many important structural reforms, although both countries have been less successful in macroeconomic stabilization. Reform is still in its very early stages in Albania. Civil conflict in most of the former Yugoslavia has resulted in hyperinflation and widespread economic disruption, although Slovenia, which has been insulated from the conflict, is an exception,

Chart 21. Central European Countries in Transition: Inflation
(Monthly percent change in the consumer price index)



and output declines appear to have come to an end in Croatia.

Bulgaria and Romania began their reform efforts from a more difficult starting position and a harsher external environment than other central European countries, and these factors, rather than a weaker initial commitment to reform, explain their relatively weak economic performance. Both countries were dependent on primary goods imported from the former Soviet Union and were disproportionately affected by the collapse of trade among members of the Council for Mutual Economic Assistance (CMEA). Bulgaria inherited a large overhang of debt contracted under the previous regime, and a lack of progress toward an agreement with its commercial creditors on a comprehensive debt- and debt-service reduction package has undermined its trade performance. In Romania, the accelerated repayment of debt under the Ceausescu regime left the country with an impoverished population and an obsolete capital stock. The flow of foreign official financial assistance to both countries has been considerably less than that to other central European countries. Nevertheless, the sharp declines in output in the past few years appear to be coming to an end, and growth is expected to pick up gradually over the medium term. Inflation has proved difficult to control in both countries, but the implementation of appropriate reforms as planned should lead to a moderation of price pressures in 1993 and beyond.

A disturbing development in most of the central European countries in 1992 has been the emergence or continuation of considerable strains on government budgets. Although fiscal deficits in 1992 were the equivalent of 2 percent of GDP in Romania and 11 percent of GDP in Bulgaria, these figures understate the underlying imbalances because of temporary revenues from unsustainable inflation and, in the case of Bulgaria, debt-service arrears. Deficits were 8½ percent of GDP in Hungary and 7¼ percent of GDP in Poland in 1992 (Table 16). A key feature of these budgetary pressures has been the dramatic decline of tax revenue in most countries (Table 17), in large part because of the steep drop in output, which has cut tax revenue on turnover and business profits. Business tax revenue was also adversely affected by the collapse of institutional arrangements whereby the government had direct access to state enterprises. Some transitory factors have also reduced revenue. The introduction of new taxes, such as VATs, are important reforms, but there have been difficulties in implementation that have led to revenue shortfalls. An important part of the fall in tax revenue has also been a consequence of progress in the structural adjustment process. Profit taxes have fallen as an increasing share of activity has moved to the emerging private sector, which has proved difficult to tax owing to inade-

**Table 16. Countries in Transition:
Government Budget Balances**

(In percent of GDP)

	1990	1991	1992
Central Europe			
Albania	-15.4	-30.2	-20.2
Bulgaria	-12.6	-14.8	-11.0
Former Czechoslovakia	0.1	-2.0	-3.0
Hungary	-0.8	-3.2	-8.4
Poland	0.5	-5.9	-7.2
Romania	0.1	-1.0	-1.9
Former Yugoslavia	-0.7	-2.7	-10.3
Former U.S.S.R.			
Armenia ¹	...	-1.9	-32.2
Azerbaijan	...	2.6	-4.2
Belarus	...	1.2	-4.8
Estonia	...	4.6	1.7
Georgia	...	-3.5	-35.1
Kazakhstan ¹	...	-7.9	-5.6
Kyrgyzstan ¹	...	4.8	-14.7
Latvia	...	6.3	-1.5
Lithuania	...	2.8	2.2
Moldova ¹	...	—	-7.8
Russian Federation ²	...	-16.4	-22.6
Tajikistan ¹	...	3.4	...
Turkmenistan ¹	...	4.0	...
Ukraine	...	-15.8	-36.8
Uzbekistan ¹	...	-5.5	-12.0
Other			
Mongolia	-14.0	-10.5	-9.9

¹General government, excluding special funds.

²Includes import subsidies.

quate administrative machinery, while at the same time the profits of state enterprises have collapsed. Bank profitability also fell as banks made provisions for potential losses from the bankruptcy of their debtors, particularly in Hungary. Finally, payroll taxes have fallen as excess labor has been shed by enterprises and, in Hungary and Poland, as substantial payment arrears have built up.⁵¹

The sudden and pronounced fall in government revenue has not been matched by an equal drop in public spending, notwithstanding the substantial cuts in subsidies that have already been implemented in almost all countries. Moreover, as the adjustment process proceeds, new pressures on expenditures will arise. Before economic reform, social benefits were provided not only by the government sector but also, to a large extent, by state enterprises. A successful transformation of these enterprises will shift greater responsibility for these functions onto governments, particularly in the case of unemployment insurance, which was not needed under central planning because there was no overt unemployment.

⁵¹In Poland, the wage tax was eliminated in January 1992, when the personal income tax came into effect.

**Table 17. Central European Countries in Transition:
Tax Revenue During the Transition***(In percent of GDP)*

	1988	1989	1990	1991	1992
Albania	...	44.2	42.2	27.5	17.8
Bulgaria	47.4	48.3	42.4	36.8	30.8
Former Czechoslovakia	51.7	53.1	54.8	45.5	44.4
Hungary	54.0	48.2	48.7	46.4	44.5
Poland	40.2	37.0	43.8	35.3	...
Romania	29.9	33.2	35.7	31.8	33.9

Source: Vito Tanzi, "Fiscal Policy and the Economic Restructuring of Economies in Transition," IMF Working Paper 93/22 (March 1993).

The close relationship between economic transformation and government budgets has important macroeconomic implications. Large and rising budget deficits will crowd out private investment, may result in a deterioration in current accounts, and could lead to accelerating inflation, thereby threatening macroeconomic stability. Preventing this will require new taxes that are suited to market economies, a broadening of the tax base, improved tax administration, and further reductions in subsidies. It will also be necessary to contain expenditures, even as the composition is shifted from subsidies to social transfers and outlays needed to support structural adjustment. Although the inflation risks are clear, larger deficits might be sustainable in the transition period if they can be financed by private saving, as occurred in Hungary, or by external resources. To the extent that these sources of financing are not available, it is particularly important to prevent deficits from increasing to levels where they ultimately result in higher inflation.

To relieve the growing demands on the budget for financial support of loss-making state enterprises, as well as to complete the transition to a market economy, almost all countries in the region have launched ambitious privatization programs as a key part of their reform strategy, although progress has generally been slower than anticipated. In the former Czechoslovakia, shares of state enterprises privatized in the first wave of vouchers (which employ about one-fifth of the work force) will be distributed by end-March 1993. The dissolution of Czechoslovakia (Box 6), however, has delayed the second wave of vouchers, originally scheduled for early 1993.⁵² In Hungary, about one-fifth of the enterprises owned by the state at end-1990 have since been privatized. In Poland, about a fourth of all state enterprises have been privatized, and ownership transformation is an integral part of the enterprise restructuring program. The Romanian

⁵²See the box on voucher privatization in the former Czech and Slovak Federal Republic in the October 1992 *World Economic Outlook*, Box 2, pp. 50-51.

government began the free distribution of certificates of ownership in 1992, allowing the population to participate in five Private Ownership Funds that have been allocated 30 percent of the shares of state enterprises; the remaining 70 percent, now in the hands of the State Ownership Fund, are to be offered for sale over the next seven years. In Bulgaria, 60 percent of the shares of each state-owned enterprise are to be auctioned to the public, with the remaining 40 percent to be distributed to employees and enterprise social security funds. Large companies have already been broken up in preparation for the auctions, which are scheduled to begin in early 1993. In both Bulgaria and Romania, however, actual sales of enterprises are likely to be delayed.

The experience with privatization has so far been encouraging. The growing private sector is contributing to a pickup in economic activity, although much private sector growth is accounted for by newly created, as opposed to privatized, firms. Moreover, unemployment has risen less than had been earlier feared, although in some countries this may be because enterprise restructuring is still in its early stages. The privatization of large industrial enterprises, while now under way in some countries, is proceeding slowly, in part because governments wish to avoid the rise in unemployment that would probably result.

Stabilization, Inter-Enterprise Arrears, and Structural Change in the Former Soviet Union

Output has declined sharply in the former Soviet Union in the past two years, and it is expected to fall further in 1993; inflation has risen rapidly and is likely to remain quite high in 1993 as well. But if macroeconomic stability can be achieved, and if the economic reform programs are followed through, most of the countries in the former Soviet Union could experience sharply falling inflation during 1993 and an economic turnaround as early as the middle of the decade.

The most pressing challenge now facing almost all of the successor states of the former Soviet Union is to reduce inflation and establish macroeconomic stability. The widespread liberalization of prices in these countries at the beginning of 1992 resulted in a large increase in the price level throughout the former Soviet Union, as had been the case in the wake of the earlier liberalizations in central Europe (Chart 22).⁵³ In most of the former Soviet Union, however, price liberalization was incomplete, and prices of several products—energy, public utilities, and rent—remained directly controlled, while extensive subsidies, trade distortions, and other indirect methods kept other prices well below world levels. The price of natural gas, for example, was only 5–10 percent of the world price in early 1993; although oil prices were raised substantially during 1992, they had reached only about one-fourth of the world price by February 1993. In contrast, prices in the Baltic countries, including energy prices, have virtually all been liberalized.

The price level in most of the former Soviet Union jumped sharply in January 1992 as a result of price deregulation. In contrast to the experience in central Europe, however, inflation fell only temporarily during mid-1992, and then rose sharply to rates of about 20 percent a month, or in excess of 1,000 percent a year. In Russia, inflation soared in the last quarter of the year to about 25 percent a month (or nearly 1,500 percent at an annual rate), raising fears of hyperinflation. High inflation, and the expectation that it will continue or worsen, has contributed to capital flight and to a sharp decline in the value of the ruble, which fell from 135 to the U.S. dollar in July 1992 to about 740 to the dollar in early April 1993.

A major factor behind the inflationary pressure has been the excessive credit expansion by the central banks—including, since July 1992, the Central Bank of Russia—to state enterprises. In addition, the Central Bank of Russia has expanded credits to other central banks in the ruble area on a large scale, even though such credits were in principle to have been limited after July 1992. Other factors include the explosion of inter-enterprise arrears and chaotic monetary relations in the ruble area (both of which are discussed below). Increases in energy prices have also been reflected in the general price indexes, although this represents only a once-off effect as prices are brought up to world levels.

Another important underlying source of inflation pressure has been the monetization of the large budget deficits that have opened up in many of the states of the former Soviet Union (see Table 16). In

Russia, the general government budget deficit for 1992 was over 20 percent of GDP, and in Ukraine the situation appears even worse, with the deficit rising to over 30 percent of GDP in 1992. In contrast, budgets were in surplus, or small deficit, positions in the Baltic countries, and inflation has been contained.⁵⁴

The budget deficits in most of the former Soviet Union have resulted from both revenue shortfalls and excessive expenditures. As in central Europe, the decline in output associated with economic transformation has reduced revenues from turnover, profit, and wage taxes. Moreover, although new forms of taxation that are more suited to a market economy, such as the VAT, have been introduced, they are not yet fully functioning. On the expenditure side, a major problem is subsidies to money-losing state enterprises. In Russia, explicit transfers, including large import subsidies, amounted to over 20 percent of GDP in the first nine months of 1992. Implicit credit subsidies have taken the form of soft loans from the Central Bank of Russia and credit that has been allocated at highly negative real interest rates. In addition, the policy of holding domestic energy prices well below world levels amounts to a large subsidy to energy users.

A key symptom of, and contributor to, these macroeconomic imbalances has been the explosive growth of inter-enterprise arrears, particularly in Russia, where they grew from 48 billion rubles at the beginning of 1992 to over 3 trillion rubles—70 percent of GDP and twice the value of domestic credit—by mid-1992. Arrears are a feature of alleconomies, in that enterprises extend limited credit to others by not immediately requiring payment due, thereby facilitating commercial relations by relaxing the need for cash on hand in transactions between firms.⁵⁵ However, the scale and growth of arrears in the former Soviet Union go well beyond what would be warranted by normal commercial relations. Moreover, in contrast to practice in market economies, enterprises in the former Soviet Union have allowed huge arrears to build up with firms that are almost certainly not creditworthy, at least according to normal commercial criteria.

Perhaps the major reason that firms extend credit through arrears is that a failure to do so would disrupt supplies or shipments of inputs needed for production, resulting in closure. Normally, a creditworthy firm could fill the gap through the banking system. In the former Soviet Union, however, the financial system is still underdeveloped. In any

⁵³In late 1992, the Russian government announced the reimposition of price controls on a wide range of goods, although these controls were never implemented.

⁵⁴In Estonia, the operation of the currency board precludes the monetization of deficits. See Box 3 in the October 1992 *World Economic Outlook*, pp. 52–53.

⁵⁵The term “arrears” is sometimes restricted to credit that is extended involuntarily. This distinction is not applied here.

Box 6. Economic Arrangements for the Czech-Slovak Breakup

Within weeks of the June 1992 general elections in what was then the Czech and Slovak Federal Republic, it was clear that coexistence of the two emerging governments was impossible, and it was agreed that the country would divide into two independent republics on January 1, 1993. In the economic sphere, preparations for the breakup focused on the division of common assets and liabilities between the Czech Republic and the Slovak Republic and on trade, fiscal, monetary, and exchange relations.

The major common assets and liabilities to be divided were held by the central bank, the foreign trade bank, the federal government (government debt, the army, embassies, and the like), and certain enterprises owned by the federal government. The basic principles governing the division were, in order of priority, the "territorial principle" (an item belongs to the republic in which it is located) and a relatively uncontroversial split of two for one in favor of the Czech Republic (roughly reflecting its larger population). In most cases these two criteria were applied sequentially, with little conceptual difficulty. In the case of the central bank, however, a split of bank reserves and other items according to the two basic principles created a mismatch between the assets and liabilities of the two new central banks. This was resolved by the creation of a claim by one central bank on the other, the terms of which are still subject to negotiation.

Assets and liabilities abroad presented special problems. There was concern that the former Czechoslovakia's considerable credits outstanding to other countries might become less collectible if there were two creditors rather than one. Accordingly, it was decided to retain the former foreign trade bank as an intermediary to manage these assets. In the case of

external debt, most of the former Czechoslovakia's creditors, who had to be consulted on the division of the debts, accepted the two-for-one rule, although a few are still insisting on joint and several liability. The former Czechoslovakia's quota in, and liabilities to, the IMF were divided in a ratio of 2.29 to 1, determined in accordance with IMF rules for quota calculation.

The Czech and Slovak economies were closely intertwined, with interrepublic exports estimated to have been equivalent to about one-third of the former Czechoslovakia's exports to the rest of the world, and with considerable labor migration between the two republics. For these reasons, a customs union was established, under which the two countries would share a common tariff vis-à-vis the rest of the world, undertake not to erect trade barriers against each other, and consult informally about wage policies.¹ Capital and labor would be free to move between the two countries. However, disruptions to trade during the initial months following the separation have been greater than envisaged. If this situation continues, it would have highly adverse impacts on both countries.

Fiscal relations during the post-communist federal period were characterized by annual negotiations on the allocation of revenues and expenditures between the federal and republic budgets. Upon division of the country, each republic became responsible for its own revenues and expenditures. As a result, firms are

¹A catch-all clause allows the imposition of trade barriers if "increased imports damage or threaten to damage the market of [a] contracting party" (from Article 22 of the Treaty Establishing a Customs Union between the Czech Republic and the Slovak Republic).

case, it would be difficult for a bank (or another firm) to determine an enterprise's creditworthiness because of the rudimentary accounting system, the absence of a market to evaluate assets, the presence of soft budget constraints, and the possibility of a government bailout. It would also be difficult to untangle the vast inter-enterprise arrears themselves. Another benefit of arrears to firms arises from the fact that, in a holdover from central planning, enterprise profit taxes are assessed on the basis of financial transactions registered through the banking system. Arrears delay registration and, given the high inflation, greatly reduce the real value of tax payments, contributing to the government's revenue shortage and further increasing the need for inflationary deficit financing.

The possibility that unpaid arrears could force an enterprise into bankruptcy is mitigated by two factors. First, the pervasiveness of soft budget constraints on firms has led to the expectation that either the debtor or, if necessary, the creditor will

be bailed out by the state. The second mitigating factor stems from the use of "noncash" rubles (bank accounts) for inter-enterprise payments and "cash" rubles for wages. For most enterprises, the immediate threat to their continued operation had been the shortage of cash rubles, not a shortage of noncash rubles; because inter-enterprise arrears are settled in noncash rubles, nonpayment may not have much affected the short-term viability of these firms.

The massive buildup of inter-enterprise arrears in the first half of 1992 risked destabilizing the economy as the implied credit expansion and tax avoidance intensified inflationary pressures. At the microeconomic level, arrears also made it difficult to judge the creditworthiness of enterprises, a prerequisite to allocating credit on market principles. In mid-1992, the Central Bank of Russia put in place a mechanism to net out the arrears by establishing special accounts with the central bank reflecting each firm's arrears. This operation was

required to register separately as taxpayers in each republic in which they have a presence. The VAT, which replaced the turnover tax on January 1, 1993, is paid to the republic in which an item is consumed. Consideration was given to a clearinghouse system for interrepublic trade, but it was decided that such trade would be treated like other foreign trade. Tax competition is to be avoided by informal understandings that the major tax rates would remain the same in the two republics, an arrangement that should also ease enforcement.

The most difficult issues arose in the context of monetary relations. It was decided that the two new countries would—at least initially—share a single currency, with coordination between the two central banks managed by a committee comprising three members from each republic. In principle, this monetary union was to last at least six months but could be terminated early if international reserves fell to less than one month's worth of imports, if bank deposits in one republic fell by more than 5 percent, if the fiscal deficit of one republic exceeded 10 percent of revenues, or if there was deadlock in the interrepublic monetary committee. In the event, there was considerable speculation about an early dissolution and a subsequent devaluation of one or both currencies, spurred by the explicitly temporary nature of the monetary union. The drain on foreign reserves that had begun in late 1992 continued, and the monetary union was terminated on February 8, 1993.

The introduction of the new currencies—stamped versions of the old Czechoslovak koruna—proceeded smoothly. Banks ceased transactions with non-residents on February 3, 1993. In the period February 4–8, resident individuals were able to convert 4,000

koruny in cash (about a month's average wage) into stamped notes; larger sums were paid with a delay. Firms exchanged their holdings during February 8–10, although large deposits were subject to checking against receipt records, in an attempt to prevent money laundering. All deposits were automatically converted, and all foreign individuals and firms were able to convert cash freely on presentation of proof that they had acquired it legally.

The authorities of both countries saw the quick introduction of a bilateral payments arrangement as the best means of minimizing uncertainty and the consequent disruption of trade in the short term. Accordingly, two basic mechanisms were put in place for settlement of new transactions: individuals may purchase a limited amount of cash and an unlimited amount of traveler's checks in the other republic's currency at a floating exchange rate; and commercial transactions—with the exception of re-exports, which must be paid for in convertible currencies—go through clearing accounts at the two central banks, under which balances above ECU 130 million are to be settled monthly. Except for tourist transactions, the official rates for the two currencies are fixed against the same basket and at the same level as the former Czechoslovak koruna, although the exchange rates under the Czech-Slovak clearing arrangement can differ by up to 5 percent from the official rates. In response to an emerging bilateral trade imbalance, in early March the Slovak koruna was devalued by 5 percent against the ECU under the clearing arrangement, and the Czech koruna was revalued by 2 percent. Effective in early May, the Czech Republic announced a reduction in the number of currencies in the basket for the Czech koruna.

completed by the end of the year, and net arrears, which were monetized, were only about 10 percent of GDP or 7 percent of bank credit to enterprises outstanding at end-November.⁵⁶ But the incentives that gave rise to the buildup of inter-enterprise arrears largely remain (except that enterprises are no longer short of cash rubles), and the monetization of the residual net position may have raised expectations of a future subsidy if arrears again expand. The limited information available suggests that arrears may be building up again in early 1993, but at a slower rate than a year earlier.

Despite loose monetary and fiscal policy and the expansion of credit through inter-enterprise arrears, output continues to fall sharply in the former Soviet Union as industry is restructured and CMEA trade has collapsed. To some extent, the measured output

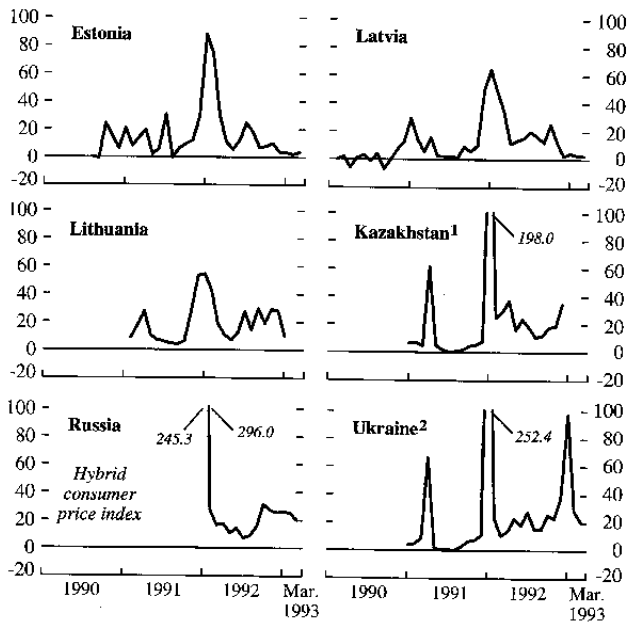
drop reflects poor underlying data, which over-represent the declining industrial sectors and do not fully capture the growth of small, consumer-oriented activities, many of which are in the informal sector. Moreover, liberalization has resulted in large changes in relative prices, making comparisons of real output indices over time unreliable. These indices also overstate the fall in living standards because they do not account for the sharp reduction in the physical shortages of consumer goods that had characterized centrally planned economies.

The decline in output has been particularly sharp in the industrial sector. In the small service sector, which is largely private and informal, there is substantial evidence that production has been rising. The shift in the composition of output reflects to a large extent the unwinding of distortions under central planning, which favored heavy industry at the expense of the production and distribution of consumer goods. This reallocation of resources is far

⁵⁶Outstanding tax liabilities were cleared as part of this process. Because the government charged no interest on these liabilities, real revenue was reduced by the delay in payments.

Chart 22. Selected Countries of the Former Soviet Union: Inflation

(Monthly percent change in the consumer price index unless otherwise noted)



¹Retail price index.

²Hybrid consumer price index before January 1993.

from complete in most of the former Soviet Union because large industrial concerns are still being propped up by state subsidies. In Belarus, Russia, and Ukraine, the need to convert huge military industries, which has hardly begun, will make this reallocation even more difficult. In this context, it will be vital for the governments of the former Soviet Union to adopt market-oriented policies conducive to the expansion of those activities that will eventually replace the declining industrial sector.

Comprehensive structural initiatives are now under way to promote a flexible and dynamic market economy, although much remains to be done. Most countries of the former Soviet Union and Mongolia have begun to put commercial legislation in place, including property, bankruptcy, and antimonopoly laws. But the application of this legal framework has been uneven. Property rights are still inadequate and unclear, with the result that investment and production decisions have been delayed. Monopoly laws have not been enforced—no monopolies have been broken up—and the trade regime is still too distorted to provide much of a check on monopoly power.

Privatization has also begun in most countries of the former Soviet Union and in Mongolia. In Russia, this process has been proceeding on several fronts.⁵⁷ In July 1991, the privatization of small enterprises was placed in the hands of local authorities, although progress has been slow. In July 1992, large and medium-size firms were slated for privatization. They were to be transformed into corporations issuing equities that would be purchased first by workers and managers using vouchers, then by the public using vouchers, and eventually by the public using cash. The distribution of vouchers began on October 1, 1992; by the end of the year almost all vouchers had been distributed, and nearly 700 large enterprises and nearly 900 medium-size enterprises had been turned into corporations. In early December, shares began to be sold to the public for vouchers. At the same time, there has been privatization of residential property (about 8 percent of apartments were privatized in 1992) and existing legislation permits privatization of agricultural land. Privatization in some of the other states is moving more slowly than in Russia. In Ukraine, for example, the privatization law passed in July 1992 set ambitious targets, but very little has yet been accomplished. In Mongolia, however, the transfer of ownership under the 1991 voucher privatization schemes is nearing completion, and almost three-quarters of the herds have been privatized.

⁵⁷Quasi-privatization has been under way since 1987, when control of firms devolved to enterprise managers and some of them were able to transfer ownership of resources to themselves or to their business partners.

Monetary Arrangements and the Adoption of New Currencies

The task of economic transformation in central Europe and the former Soviet Union has been compounded by the disintegration of existing political unions into independent countries. The most spectacular example, of course, is the former Soviet Union, which split into 15 sovereign countries in 1991. The former Czechoslovakia separated into the Czech Republic and the Slovak Republic on January 1, 1993 (see Box 6), and the former Yugoslavia has split into five independent states.

The sudden creation of so many new states has greatly complicated the international aspects of the transition to market economies. Trade, monetary, and exchange arrangements, which used to be internal matters, now have to be restructured. For trade, the possibilities range from a fully integrated single market to segregated markets with tariff and non-tariff barriers. The range of possible monetary and exchange arrangements extends from a common currency area at one extreme to a system of independent currencies with mutually floating exchange rates at the other.

The preservation of unified currency areas in the former Soviet Union, the former Czechoslovakia, and the former Yugoslavia might, in principle, have preserved the gains from a single currency, which are well known and significant.⁵⁸ The costs, from an individual country's perspective, are that the responsibility for the conduct of monetary policy for the region as a whole rests with a central monetary authority—over which any country may have little, if any, influence—and that the exchange rate is precluded as a policy instrument. Preserving monetary union would also require explicit consideration of the institutions of monetary policy, the decision-making mechanisms, and a fair distribution of the seigniorage created at the union level.

Many of the newly independent countries have established their own currencies or plan to do so (Box 7). Thus, a common currency area appears to be only a transitional arrangement. A number of countries, including the Baltic states, Slovenia, and Croatia, started to withdraw from their monetary

unions as soon as the required institutions were in place. Even as a transitional solution, monetary union has proven to be difficult among former member countries. In the case of the former Czechoslovakia, monetary union was intended to last at least six months after the dissolution of the federation but broke down in less than two months.

In the former Soviet Union the problem of maintaining a monetary union has been compounded by the fact that the institutions that had existed when the Soviet Union was formally dissolved no longer reflected the characteristics of a monetary union. The Gosbank was replaced at the end of 1991 by a decentralized banking system in which the main branch of Gosbank in each of the former republics was transformed into a more or less independent central bank. The Central Bank of Russia had the sole power to issue ruble currency. Nevertheless, the other central banks could extend credit to their governments and to domestic enterprises by creating bank reserves, drawing on credit lines at the Central Bank of Russia, and in many cases (for example, Ukraine) issuing coupons. They were also able to set interest rates charged on central bank credit independently and to determine reserve requirements imposed on commercial bank deposit liabilities.

In the absence of arrangements to control monetary expansion in the ruble area, the efforts by the central banks of Russia and some of the other countries of the former Soviet Union to pursue a restrained monetary policy after price liberalization in early 1992 were ineffective. Central banks in other countries in the ruble area adopted expansionary credit policies, increasing their share of seigniorage and exporting inflationary pressures to other states in the region. Part of this expansion was financed by borrowing from the Central Bank of Russia, which provided automatic financing of interstate payment imbalances through the correspondent accounts of other central banks in the former Soviet Union. As a result, the net credit balance of the Central Bank of Russia vis-à-vis the other states expanded rapidly. In an attempt to regain control, the Central Bank of Russia centralized the processing of interstate payments in its Moscow branch and introduced restrictions on payment orders, although doing so further disrupted interstate trade. Inflationary pressures in the ruble area were reinforced when the Central Bank of Russia itself, in the second half of 1992, reversed its policy of restrained domestic credit expansion in order to meet the growing financing requirement of the government and to increase lending to Russian commercial banks.

The shortage of currency and the blockage of the interrepublican settlement system have led to a de facto dissolution of the ruble area. Ruble deposits earned in one state cannot be used to make

⁵⁸In the former Soviet Union, production is regionally specialized, suggesting that a currency union could reduce transaction costs. Yet specialization also exposes different regions to specialized economic shocks, suggesting that flexible exchange rates could help macroeconomic adjustment. In any case, this pattern of production is to some extent a result of central planning, and it may not survive the transition to a market economy. For a discussion of monetary unions, see Paul R. Masson and Mark Taylor, "Issues in the Operation of Monetary Unions and Common Currency Areas," in *Policy Issues in the Evolving International Monetary System*, edited by Morris Goldstein, Peter Isard, Paul R. Masson, and Mark P. Taylor, Occasional Paper 96 (IMF, June 1992), pp. 37–72.

Box 7. Currency Arrangements in the Countries in Transition

	Currency	Exchange Rate Regime	Convertibility ¹
Central Europe			
Albania	Lek	Floating	Current account convertibility
Bosnia	Bosnian dinar	Floating	Current account convertibility
Bulgaria	Lev	Floating	Current account convertibility
Croatia	Croatian dinar	Managed float	Current account convertibility
Czech Republic	Czech koruna, created February 8, 1993	Pegged to basket of five currencies (U.S. dollar, deutsche mark, Austrian schilling, Swiss franc, and French franc)	Current account convertibility
Former Soc. Fed. Republic of Yugoslavia	Dinar	Floating	
Hungary	Forint	Adjustable peg to basket (50 percent U.S. dollars, 50 percent ECU)	Current account convertibility
Former Yugoslav Republic of Macedonia	Macedonian dinar	Floating	
Poland	Zloty	Crawling peg to basket of five currencies (U.S. dollar, deutsche mark, pound sterling, French franc, and Swiss franc)	Current account convertibility
Romania	Leu	Managed float with currency rationing	Current account convertibility
Slovak Republic	Slovak koruna, created February 8, 1993	Pegged to basket of five currencies (U.S. dollar, deutsche mark, Austrian schilling, Swiss franc, and French franc)	Current account convertibility
Slovenia	Tofar	Floating	Current account convertibility
Mongolia			
Mongolia	Tugrik	Uniform fixed rate (150 tugrik = \$1) and parallel market	Theoretical current account convertibility, but transactions difficult owing to poorly functioning international payments system and large external commercial and capital arrears
Former Soviet Union			
Armenia	Ruble	Same as Russia	Same as Russia
Azerbaijan	Ruble and coupons (the manat) for cash transactions (10 rubles = 1 manat); Planning to replace ruble in early 1993	For ruble, same as Russia	Same as Russia

payments in the other states and are now being exchanged at exchange rates differing from parity. A number of countries have issued coupons to relieve shortages of ruble currency and, in some cases, in order to delay price adjustments. Where these coupons have been declared sole legal tender for some transactions, excess ruble balances have flowed into neighboring countries, thereby prompting them to

impose export restrictions and to introduce their own coupons.

New currencies are being introduced in the former Soviet Union. In mid-1992, Estonia introduced the kroon and pegged it to the deutsche mark in the context of a currency board arrangement. One month later, the Latvian ruble was declared sole legal tender in Latvia and was allowed to float in

	Currency	Exchange Rate Regime	Convertibility ¹
Former Soviet Union (continued)			
Belarus	Ruble, and a coupon (the rubel) for cash transactions (10 rubles = 1 rubel)	Floating unified exchange rate for current transactions (980 rubles to \$1 as of early April 1993)	Limited convertibility between rubles and rubels; current account convertibility
Estonia	Kroon replaced the ruble in June 1992	Fixed to the deutsche mark under a currency board (8 kroon = DM1)	Current account convertibility, partial capital account convertibility
Georgia	Ruble; has decided in principle to introduce own currency, but no date set	Same as Russia	Same as Russia
Kazakhstan	Ruble; may introduce own currency	Same as Russia	Same as Russia
Kyrgyzstan	Ruble; may introduce own currency in 1993	Same as Russia	Same as Russia
Latvia	Latvian ruble introduced in May 1992; sole legal tender since July 1992	Floating rate (170 Latvian rubles = \$1)	Current convertibility, partial capital account convertibility
Lithuania	Talonas replaced ruble in October 1992; talonas may be replaced by litas in 1993	Floating rate (425 talonas = \$1)	Current account convertibility, partial capital account convertibility
Moldova	Ruble; parallel coupons have circulated since mid-1992; introduction of own currency (the leu) approved by parliament in January 1993	Same as Russia	Same as Russia
Russia	Ruble	Floating (740 rubles = \$1 in early April 1993); with broadly unified exchange rate except for certain bilateral payments	Current account convertibility for residents; restrictions on capital account transactions
Tajikistan	Ruble; may introduce own currency	Same as Russia	Same as Russia
Turkmenistan	Ruble; own currency, the manat, to be introduced	Same as Russia	Same as Russia
Ukraine	Karbovanets introduced as parallel currency (cash transactions only) in January 1992 and replaced the ruble in November 1992; may replace karbovanets with hryvnia	Floating (in early April 1993, 3,000 karbovanets = \$1)	Current account but not capital account convertibility; current account convertibility compromised by poorly functioning markets
Uzbekistan	Ruble	Same as Russia	Same as Russia

¹For many countries with de facto current account convertibility, there continue to be certain restrictions under the transitional arrangements of Article XIV of the IMF's Articles of Agreement.

foreign exchange markets. More recently, Lithuania and Ukraine withdrew from the ruble area and declared their already-circulating coupons to be the sole legal tender. Similar moves have been announced by other countries, including Moldova and Azerbaijan.

An orderly withdrawal from a common currency structure is likely to be less disruptive than remain-

ing in a dysfunctional monetary union. Independent currencies will encourage the development of interstate credit arrangements among commercial banks and enterprises that are separate from official monetary arrangements and settlement mechanism. Independent currencies also will facilitate the conclusion of interrepublican credit arrangements by separating them from monetary arrangements

Box 8. The Systemic Transformation Facility

The Executive Board of the International Monetary Fund on April 23, 1993 approved the establishment of the systemic transformation facility (STF), to provide financial assistance to members experiencing balance of payments difficulties arising from severe disruptions in their traditional trade and payments arrangements due to a shift from significant reliance on trading at nonmarket prices to multilateral market-based trade. These disruptions would be manifested by a sharp fall in export receipts, a substantial permanent increase in net import costs—particularly for energy products—or a combination of the two. Eligible members are expected to include countries of the former Soviet Union and most former CMEA members. Substantial additional financial support from other sources over a sustained period would also be needed by members that make use of the new facility.

The use of the new facility is open to members that are willing to cooperate in an effort to find appropriate solutions to their balance of payments problems—including countries that are at an early stage of the transition process and are as yet unable to formulate a program that could be supported by the IMF under its other facilities and policies. For these countries, the use of the STF would be on the basis of appropriate prior actions and a written policy statement, laying out the member's economic objectives, projections, and the macroeconomic and structural policy measures to be implemented over the following twelve months. The statement would also indicate the member's intention to move as soon as possible to adopt a program that could be supported under an upper credit tranche stand-by, extended, or enhanced structural adjustment facility (ESAF) arrangement.¹

Convincing actions to stabilize monetary conditions would be a prior action in cases where inflation has been unacceptably high or is accelerating. Early structural measures, such as the liberalization of trade and prices, would be needed as appropriate. Structural reforms would also focus on putting in place the basic institutions of economic management in a market system, and would generally be more comprehensive than under credit tranche arrangements. The member would be expected to put in place a quarterly

¹See the IMF's 1992 *Annual Report*, Box 6, pp. 50-51, for a description of the facilities through which the IMF provides financial support to its members.

financial program as soon as possible, and in any event before a second purchase could be made under the facility (see below). The member country would be expected to agree not to tighten exchange or trade restrictions or to introduce new restrictions or multiple currency practices. It would also agree to cooperate with its trading partners in seeking constructive solutions to common problems.

It is anticipated that countries that have already had IMF arrangements would generally make use of the new facility in parallel with such arrangements. Thus, the approval of a new arrangement or the completion of a review under an existing arrangement would satisfy the requirements of the STF.

Access would be for up to 50 percent of IMF quota, provided in two equal purchases. The first purchase would be available on approval, while the second purchase would follow a review by the IMF (normally about six months after the first purchase) to determine whether there are satisfactory policy performance, continued cooperation, sufficient movement toward an upper credit tranche arrangement, and progress in mobilizing external financing. For members making use of the STF in conjunction with an upper credit tranche stand-by, extended, or ESAF arrangement, the second purchase could become available within two months, upon the approval of such an arrangement or the completion of a review.

The rate of charge is the same as for other uses of the IMF's general resources (currently just below 6 percent a year), and repayment terms of 4½ to 10 years are the same as IMF financing under the extended Fund facility. The new facility is temporary, and will be in effect through the end of 1994. However, the second disbursement may be completed by the end of 1995, provided that the first disbursement is made by the end of 1994.

There are precedents for the creation of temporary financing facilities in the IMF. In December 1990 the compensatory and contingency financing facility (CCFF) was modified to include a petroleum import financing component in the context of the Middle East crisis. Earlier, in 1974 and 1975, the IMF had created two oil facilities, to deal with temporary financing problems related to sharp oil price increases among oil importing developing countries. Both facilities, as well as the CCFF modification, have been discontinued.

and settlement systems. Perhaps most important in the context of the former Soviet Union, independent currencies should permit greater monetary discipline than has seemed possible to date. A national currency, however, does not in itself guarantee low inflation; macroeconomic reforms and monetary restraint are required.

Momentum for Reform

In the past three years, the former Czechoslovakia, Hungary, and Poland have implemented fundamental structural reforms while following monetary and fiscal policies that have maintained a relatively stable macroeconomic environment.

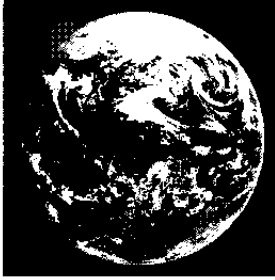
Bulgaria and Romania have put in place some of the necessary legislative framework and have begun to implement reforms, but there has not yet been sufficient time to judge the course of reform. Although there has been considerable debate about the merits of policies that have often been described as “shock therapy” (versus a more gradual reform process), several of these economies now appear to be on the path of economic recovery. Despite this success, much remains to be done. Further progress is needed in the areas of commercial law, property rights, competition policy, fiscal reform, and financial sector reform. The most important task, however, is to complete the privatization of the vast state sector. Privatizing the large enterprises will require the closure of some of them and the sharp contraction of others, which is likely to lead to substantial dislocations and increased unemployment. There is, however, little alternative. The subsidization of inefficient producers cannot be continued indefinitely, and delaying privatization only retards the emergence of efficient producers. Until privatization is substantially complete, it will be necessary to enforce hard budget constraints on remaining state-owned enterprises in order to ensure that they operate as efficiently as possible, and to reduce budgetary pressures.

The countries of the former Soviet Union have put in place reforms broadly similar to those of central Europe. However, they are well behind the pace set in central Europe because of a more difficult starting position, the need to convert or close down military production, and civil strife in many states. Moreover, most of the countries of the former Soviet Union—with the notable exception of the Baltic states—have followed loose fiscal and monetary policies, which have not succeeded in preventing substantial declines in output but have resulted in

widespread macroeconomic instability that is undermining their fragile economies. Indeed, the risk of hyperinflation is now the major threat to continued reform in the former Soviet Union. High and accelerating inflation has already caused massive capital flight and, if unchecked, will eventually destroy the price system and make further economic reform virtually impossible. Controlling inflation will require, above all, an end to central bank financing of the losses of state enterprises and an end to monetization of budget deficits. Both would be promoted by further progress on privatization, financial sector restructuring, and the rationalization of government support to enterprises with the aim of making all subsidies transparent, conditional, smaller over time, and consistent with macroeconomic objectives.

Despite the difficulties faced to date, there is a continued determination in the vast majority of cases to press ahead with needed structural and macroeconomic reforms. All the countries in transition, however, face the risk that this enthusiasm will flag as output declines and unemployment mounts, especially because the reforms to come—particularly the privatization and possible closure of large industrial enterprises—are likely to be costlier to implement than those already undertaken. The international community can play a vital role in supporting reform efforts through financial and technical assistance—including the IMF’s new systemic transformation facility (Box 8)⁵⁹—and, as discussed in the next chapter, by fully liberalizing trade with the countries in transition.

⁵⁹The STF is in addition to other facilities of the IMF and other international organizations and to bilateral assistance to the countries in transition.



VI

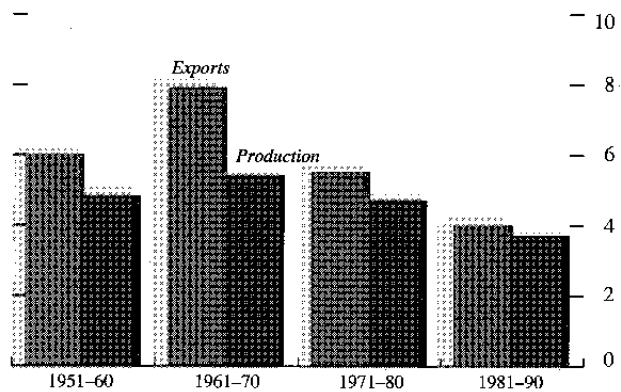
Trade as an Engine of Growth

The dismantling of trade barriers among the industrial countries in the 1950s and 1960s contributed to a period of unprecedented world economic growth (Chart 23). In the 1970s and the 1980s, an increasing number of developing countries adopted outward-looking trade policies as part of a strategy of structural economic reform. Those countries that have succeeded in implementing these reforms have experienced a significant and durable improvement in economic performance. Most recently, the countries in transition in central Europe have liberalized their previously distorted trading regimes as an essential element of the process of transformation to market-based economies, and some progress has been made in several countries of the former Soviet Union. Trade in both industrial and developing countries has tended to become more regionalized, in part because of regional trade arrangements, which are discussed in detail in Annex III.

The outward-oriented strategies of many developing countries and the economies in transition contrast with the increasingly negative attitudes toward free trade in the very same countries that drew the largest benefits from earlier efforts at trade liberalization. The re-emergence of large external imbalances and rising levels of unemployment in the industrial countries have contributed to heightened protectionist pressures and have spurred a large and growing interest in managed trade and in strategic trade theories (Box 9). At the same time, the Uruguay Round remains deadlocked, and there is widespread resort to countervailing and antidumping measures and to "voluntary" export restraint agreements.⁶⁰ A reversal of these developments is essential to improve the economic climate and to provide new impetus to world growth during the period ahead.

⁶⁰For detailed analyses of trade policy developments in the 1980s, see Shailendra J. Anjaria, Naheed Kirmani, and Arne B. Petersen, *Trade Policy Issues and Developments*, Occasional Paper 38 (IMF, July 1985); and Margaret Kelly and Anne Kenny McGuirk, *Issues and Developments in International Trade Policy*, World Economic and Financial Survey (IMF, August 1992).

Chart 23. World Exports and Production of Goods¹
(Annual percent change)



Source: General Agreement on Tariffs and Trade, *International Trade*, several issues.

¹Agriculture, mining, and manufacturing.

Box 9. New Theories of Growth and Trade

Recent developments in *growth theory* have emphasized the potential growth-enhancing roles of physical and human capital accumulation and research and development, as well as the possibility of increasing returns to scale at the aggregate level.¹ This literature contrasts with traditional growth models, in which capital accumulation raises the *level* of output but not its long-term *growth rate*. In traditional growth models, policies that stimulate saving and investment raise output growth only temporarily because each addition to the capital stock is assumed to generate diminishing amounts of extra output.² The new growth theories assume either that investment does not have such diminishing returns or that some of the extra output is used in activities that directly increase the rate of technical change and economic growth.

The new growth theories predict that structural reforms such as trade liberalization could permanently increase economic growth under some circumstances. Lowering barriers to trade, for example, could affect economic growth through several mechanisms.³ First, closer economic links increase the transmission of technology, thereby reducing the duplication of research and development activities. Because knowledge is a public good, its accumulation increases the rate of technical progress. Second, the international integration of sectors characterized by increasing returns to scale raises output without requiring more inputs. Third, the opening of trade reduces price distortions, reallocating resources across sectors and increasing economic efficiency. The first two effects unambiguously raise economic growth; the third raises growth to the extent that greater efficiency frees resources for research and development, but it could also lower growth if the change in relative prices causes resources to shift out of research and development.

Recent developments in *trade theory*, by contrast, have focused on economies of scale at the firm or

industry level and on market imperfections that generate excess economic profits. In principle, trade barriers could be used to shift these oligopolistic profits from foreign to domestic producers.⁴ Alternatively, economies of scale at the industry level may provide strategic advantage to the country that first provides protection in order to establish an industry ahead of its trade partners. Although these theories have been used to support policies of government intervention in international trade, the key characteristic of such policies is that one country gains at the expense of its trading partners. Beggar-thy-neighbor policies will not promote worldwide growth; instead, they will reduce growth by misallocating resources and by provoking retaliation and a shrinkage of world trade.

In any case, governments have not been very successful in picking winners—determining which industries to support—because this depends on details of production technology and market structure about which governments typically know little. Moreover, if specific industries are “winners” because of market imperfections, trade policies should not aim to exploit these imperfections; rather, structural policies should seek to correct them by increasing competition and by encouraging new entrants. Protecting the wrong industries, providing the wrong degree of protection, or accepting market imperfections reduces living standards, even from the narrow perspective of one country. The few studies that have investigated initiatives potentially consistent with the recommendations of the new trade theory—in the automobile, semiconductor, and commercial aircraft sectors⁵—suggest that even the unilateral gains have been modest at best. Perhaps the most important consideration, however, is that a policy of granting selective protection would almost certainly open the door to calls for more widespread intervention, diverting resources to socially unproductive, rent-seeking activity.

¹See Paul M. Romer, “Crazy Explanations for the Productivity Slowdown,” *NBER Macroeconomics Annual* (Cambridge, Massachusetts: National Bureau of Economic Research, 1987), pp. 163–210; Xavier Sala-i-Martin, “Lecture Notes on Economic Growth (I): Introduction to the Literature and Neoclassical Models,” NBER Working Paper 3563 (Cambridge, Massachusetts: National Bureau of Economic Research, December 1990); and Elhanan Helpman, “Endogenous Macroeconomic Growth Theory,” *European Economic Review*, Vol. 36 (April 1992), pp. 237–67.

²This is a consequence of the assumption of constant returns to scale to all inputs—usually labor and capital—at the aggregate level, and hence diminishing returns to capital.

³Paul M. Romer and Luis A. Rivera-Batiz, “International Trade with Endogenous Technological Change,” *European Economic Review*, Vol. 35 (May 1991), pp. 971–1004.

⁴See Robert E. Baldwin, “Are Economists’ Traditional Trade Policy Views Still Valid?” *Journal of Economic Literature*, Vol. 30 (June 1992), pp. 804–29; and Paul R. Krugman, “Is Free Trade Passé?” *Journal of Economic Perspectives*, Vol. 1 (Fall 1987), pp. 131–44.

⁵See, respectively, Avinash K. Dixit, “Optimal Trade and Industrial Policy for the Automobile Industry,” and Richard E. Baldwin and Paul R. Krugman, “Market Access and International Competition: A Simulation Study of 16K Random Access Memories,” both in *Empirical Methods for International Trade*, edited by Robert C. Feenstra (Cambridge, Massachusetts: MIT Press, 1988); and Richard E. Baldwin and Paul R. Krugman, “Industrial Policy and International Competition in Wide-Bodied Jet Aircraft,” *Trade Policy Issues and Empirical Analysis*, edited by Robert E. Baldwin (Chicago: University of Chicago Press, 1988).

Table 18. Industrial Countries: Export Volume*(Annual percent change)*

	1951-60	1961-70	1971-80	1981-90
All industrial countries¹	6.7	8.7	6.4	4.3
Major industrial countries	6.8	8.7	6.5	4.2
United States	5.0	5.9	7.0	2.9
Japan	15.9 ²	17.9	9.7	5.1
Germany	14.7	9.3	5.4	4.5
France	7.3	8.6	7.1	3.7
Italy	11.9	12.8	6.1	4.4
United Kingdom	1.7	4.7	4.8	4.1
Canada	4.1	9.7	4.4	5.7
Other industrial countries				
Spain	7.9 ³	11.1	11.4	6.1
Netherlands	10.1	9.3	6.3	4.1
Belgium	5.7 ²	10.1	5.6	4.1
Denmark	6.9	7.1	5.4	4.0
Greece	9.9 ²	10.6	11.6	3.1
Portugal	...	...	...	12.3 ⁴
Ireland	5.5	7.6	8.3	8.8
Sweden	5.3	8.7	4.3	3.9
Switzerland	8.1	8.3	4.7	3.9
Austria	12.0	9.5	7.1	6.4
Finland	8.2	7.2	5.0	2.3
Norway	5.4	8.7	7.2	4.2
Australia	0.8	8.4	4.3	5.2
New Zealand	2.8	4.2	3.5	3.3

Source: IMF, *International Financial Statistics*.¹Aggregate excludes Portugal for 1951-60, 1961-70, and 1971-80.²1952-60.³1954-60.⁴1984-90.

Trade and Growth in Industrial Countries

From 1950 to the early 1970s the industrial economies experienced unusually high productivity and real output growth, both by historical standards and by comparison with the two decades that followed.⁶¹ Trade also grew rapidly as the industrial economies became more closely integrated (Table 18). Those economies that recorded high rates of output growth also tended to experience large increases in trade growth. The links between trade and economic growth are complex and run in both directions, and this extraordinary performance must therefore be attributed to several factors. In particular, the reconstruction from World War II and reductions in the cost of transportation and communication fostered both growth and international trade.

The key policy initiatives, however, were the cuts in tariffs and nontariff barriers from the very

high levels of the interwar period, and a widespread move toward currency convertibility for current account transactions. Successive rounds of multi-lateral trade negotiations reduced average tariffs for manufactured goods among industrial countries from about 40 percent in the late 1940s to as low as 5 percent after the Tokyo Round in 1979. These cuts were front-loaded, in the sense that particularly large reductions took place in the Geneva Round in 1947 and the Annecy Round in 1949. By 1961, after the Dillon Round, the average tariff for manufactured imports into the United States was only one-fifth of its prewar level, or just over 10 percent.⁶²

Since the early 1970s, trend productivity and output growth have slowed significantly in the industrial countries, as has the growth of trade. The large tariff reductions undertaken during the 1950s may have had their main impact in the 1950s and 1960s and, therefore, provided less impetus to trade and

⁶¹See Angus Maddison, *The World Economy in the 20th Century* (Paris: OECD, 1989), for extensive evidence on long-term growth trends in industrial economies.

⁶²For a discussion of the GATT process see J.M. Finger, "Trade Liberalization: A Public Choice Perspective," in *Challenges to a Liberal International Economic Order*, edited by Ryan C. Amacher, Gottfried Haberler, and Thomas D. Willett (Washington: American Enterprise Institute for Public Policy Research, 1979).

Table 19. Industrial and Developing Countries: Export Volume Growth
(In percent)

	Average Annual Change		Cumulative Change	
	Industrial countries	Non-oil developing countries	Industrial countries	Non-oil developing countries
1961-65	7.2	4.7	41.6	25.7
1966-70	9.7	5.7	58.8	31.8
1971-75	6.2	1.0	35.2	5.2
1976-80	6.5	10.4	37.0	63.9
1981-85	3.4	7.1	18.0	41.0
1986-90	5.3	8.9	29.7	53.2
1961-75	7.7	3.8	204.2	74.3
1976-90	5.1	8.8	109.6	254.1
1961-90	6.4	6.3	537.5	517.1

Source: United Nations, *Monthly Bulletin of Statistics*.

growth in the period that followed.⁶³ The rise in nontariff barriers in the 1970s and 1980s may also have played a part. Moreover, the output share of services, many of which are nontradable or are subject to trade barriers, has increased at the expense of manufactures. In contrast, even closer economic integration was fostered within Europe by the development of the European Community. Recent studies suggest that European integration has continued to contribute to productivity growth during the past two decades, although the impact has diminished over time, and that the single market project will further boost growth during the 1990s (see Annex III).⁶⁴

The multilateral trade system has served the industrial economies well by greatly reducing barriers to trade in manufactured goods and by promoting a period of virtually unprecedented economic growth. Recently, however, these gains have been threatened by the resurgence of nontariff barriers, such as voluntary export restraints, quotas, import licensing, and state support for industry. If these nontariff barriers can be reduced and a return to tariff protection avoided, the achievements of the past four decades will be secured. Further growth through trade, however, now requires the expansion of free trade principles to include the agricultural,

textile, and service sectors, and to encompass all trade with the developing countries and the countries in transition.

Outward-Oriented Growth Strategies in Developing Countries

As discussed in Chapter IV, an increasing number of developing countries have adopted outward-oriented economic policies. A basic feature of an outward-oriented strategy is that trade and industrial policies do not discriminate between production for the domestic market and exports, or between purchases of domestic and foreign goods. This approach explains the successful export performance and increased pace of economic development of many developing countries. From 1960 to 1990, exports of non-oil developing countries increased more than five times, broadly similar to the increase observed in industrial country exports (Table 19). In contrast to the industrial countries, the developing countries have registered the strongest growth in export volume since the mid-1970s. In value terms, however, the non-oil developing countries' share of world exports changed little, because volume changes were offset by shifts in the terms of trade.⁶⁵

The expansion of trade by the developing countries was accompanied by an increased importance of trade and direct foreign investment among them. The share of developing country nonfuel exports going to other developing countries rose from 19 percent in 1960 to 26 percent in 1975 and then

⁶³See Charles Adams, Paul R. Fenton, and Flemming Larsen, "Potential Output in Major Industrial Countries," *Staff Studies for the World Economic Outlook* (IMF, August 1987), pp. 1-38.

⁶⁴See Richard Baldwin, "The Growth Effects of 1992," *Economic Policy*, Vol. 4 (October 1989), pp. 247-81; David T. Coe and Thomas Krueger, "Why Is Unemployment So High at Full Capacity? The Persistence of Unemployment, the Natural Rate, and Potential Output in the Federal Republic of Germany," IMF Working Paper 90/101 (October 1990); and David T. Coe and Reza Moghadam, "Capital and Trade as Engines of Growth in France: An Application of Johansen's Cointegration Methodology," IMF Working Paper 93/11 (February 1993).

⁶⁵The terms of trade of the developing countries for their nonfuel exports rose by 11 percent between 1960 and 1975 but then declined by 20 percent between 1975 and 1990, leaving these countries' share of world exports unchanged at slightly more than one-fifth.

Table 20. Developing Countries: Destination and Source of Exports
(In percent of total)

	1960	1965	1970	1975	1980	1985	1990
<i>All exports</i>							
Destination							
Developing countries	21.8	21.5	21.3	23.0	26.5	29.5	33.0
Industrial countries	78.2	78.5	78.7	77.0	73.5	70.5	67.0
Source							
Asia	28.9	23.4	27.9	23.1	25.1	43.0	55.8
China	...	...	2.7	2.7	3.2	5.7	7.9
NIEs ¹	7.3	5.4	11.7	10.5	13.5	23.8	32.8
Middle East	18.3	19.1	26.3	45.0	40.1	22.8	19.9
Africa	19.3	20.6	15.3	11.0	16.7	13.6	10.6
Latin America	34.3	35.9	30.5	20.8	17.5	20.7	15.7
<i>Nonfuel exports</i>							
Destination							
Developing countries	18.8	20.1	21.3	26.0	29.7	27.2	35.3
Industrial countries	81.2	79.9	78.7	74.0	70.3	72.8	64.7
Source							
Asia	33.8	35.0	35.1	43.0	54.5	55.4	70.9
Middle East	7.1	4.0	4.2	5.4	4.9	6.7	4.9
Africa	29.1	24.2	22.8	15.6	9.8	7.9	4.5
Latin America	29.8	33.1	36.7	34.6	26.3	29.3	16.8

Source: United Nations, *Monthly Bulletin of Statistics*; and IMF, *Direction of Trade Statistics*.

¹Four newly industrializing economies. Data before 1970 exclude Singapore; data for 1970–80 include estimates for Taiwan Province of China.

jumped to 35 percent in 1990 (Table 20). This increase reflected higher demand growth in developing countries than in the industrial countries and a sharp increase in intraregional distribution of labor and direct investment among the developing countries, especially in Asia. The decreased dependence on industrial country export markets, together with the adoption of appropriate macroeconomic policies in many developing countries, has contributed to the resilience of growth in the developing countries during the recent downturn in the industrial countries.

The composition of developing countries' exports has also changed substantially. Their exports of manufactures increased twentyfold from 1960 to 1990, and the share of manufactured goods in total nonfuel exports of the developing countries rose from 15 percent to 68 percent (Chart 24). By comparison, nonfuel primary exports only doubled over this period. The shift toward manufactures was spurred by weak demand and deteriorating terms of trade for commodities, but the main factor was the rapid integration of many developing countries into the world trading system in the 1970s and 1980s. The growing importance of developing countries in world trade has, however, largely been concentrated in Asia, where output growth has also been the highest. The share of all exports of developing countries originating in the developing countries of Asia rose from 29 percent in 1960 to 56 percent in

1990, and the share of nonfuel exports expanded even faster (see Table 20).

The outward-oriented strategy—lowering trade barriers, removing disincentives to exports, and implementing currency convertibility—pursued by many, but by no means all, countries has promoted more efficient use of resources, the gains from which go well beyond those suggested by standard analyses of resource allocation and economies of scale. Dismantling the administrative systems associated with import licenses, selective credit policies, and foreign exchange controls redirects the energies of entrepreneurs away from unproductive rent-seeking activities toward the production of marketable goods. Because exporting firms have a clear incentive to keep up with modern technology and to improve management, they benefit from the transfer of technology and from the exposure to foreign know-how. The outward-oriented strategy also encourages the adoption of sustainable and prudent macroeconomic policies to ensure a stable domestic environment that safeguards external competitiveness and encourages domestic saving. Taken together, these benefits of liberalized trade raise the returns to productive investment, including foreign direct investment, which reduces reliance on debt-creating capital inflows.

The benefits of an outward-oriented strategy in terms of macroeconomic performance are clear

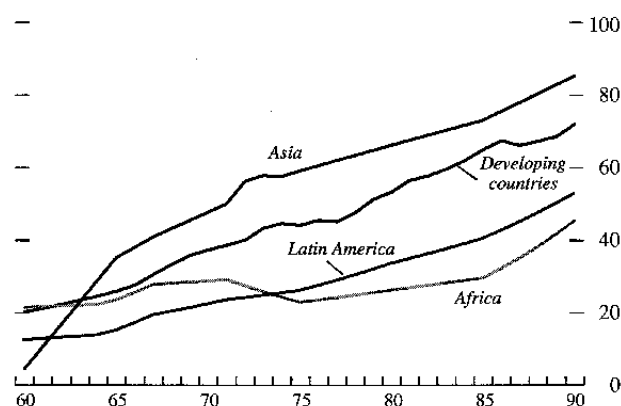
(Table 21).⁶⁶ The performance of the outward-oriented economies has been clearly superior to that of the inward-oriented economies, where tariff and nontariff barriers have been high and there has been a bias against exports in favor of import substitution. Although not all differences can be fully attributed to trade policy, growth rates of GDP per capita show a descending pattern from the strongly outward-oriented to the strongly inward-oriented economies; similar marked differences are seen in saving and investment rates; the variation in incremental capital-output ratios, which may reflect efficiency in the use of capital, suggests that investments have been more productive in the outward-oriented economies; and differences in the growth of total factor productivity, which measures the efficiency of both capital and labor inputs, also testify to the benefits of outward-oriented strategies.

Importance of Trade for Countries in Transition

Nowhere are the costs of rigid trade restrictions and isolation from the competitive forces of world markets more apparent than in the former centrally planned economies. Decades of central planning, including managed trade, resulted in unproductive investments and an obsolete capital stock. In recognition of the need to restructure their economies, the countries of central Europe have made early liberalization of the trade and exchange system a major component of their efforts to adopt market principles. Fundamental reforms have been undertaken in Hungary, the former Czechoslovakia, Poland, Bulgaria, and Romania to eliminate state monopolies on foreign trade operations, reduce quantitative import restrictions, and modify the structure of tariffs. All these countries have also unified their exchange rates and established current account (but not capital account) convertibility. More limited reforms have been carried out in the countries of the former Soviet Union and, at the same time, trade and payments relations within the former Soviet Union have deteriorated sharply. Although some of these countries have begun to liberalize their trade and payments systems, trade continues to be distorted by export restrictions,

⁶⁶Table 21 extends the analysis of 40 developing countries contained in the World Bank's *World Development Report 1987*, Chapter 5 (New York: Oxford University Press, 1987), from which the classification of countries for the period 1973–85 is taken. This classification was extended to cover the 1985–92 period using IMF data. The analysis here is complementary to the one presented in the October 1992 *World Economic Outlook* (Chapter IV), which examined the role of structural reforms, including trade liberalization, in the successfully adjusting developing countries.

Chart 24. Developing Countries: Share of Manufactured Goods in Nonfuel Exports
(In percent)



Source: United Nations, *Monthly Bulletin of Statistics*.

Table 21. Developing Countries: Trade Orientation and Economic Performance
(Annual percent change unless otherwise noted)

	1974-85	1986-92
Total		
Real GDP growth	4.1	3.8
Real per capita GDP growth	1.7	1.5
Total savings (percent of GDP)	18.1	18.1
Total fixed investment (percent of GDP)	20.6	18.9
Capital-output ratio	1.5	2.3
Total factor productivity	0.8	1.4
Strongly outward-oriented		
Real GDP growth	8.0	7.5
Real per capita GDP growth	6.1	5.9
Total savings (percent of GDP)	30.3	34.0
Total fixed investment (percent of GDP)	30.1	28.8
Capital-output ratio	1.3	1.4
Total factor productivity	2.6	3.8
Moderately outward-oriented		
Real GDP growth	4.3	4.8
Real per capita GDP growth	2.2	2.5
Total savings (percent of GDP)	18.6	17.9
Total fixed investment (percent of GDP)	22.4	18.3
Capital-output ratio	1.2	2.1
Total factor productivity	0.9	2.4
Moderately inward-oriented		
Real GDP growth	4.4	2.4
Real per capita GDP growth	1.8	-0.1
Total savings (percent of GDP)	18.1	15.8
Total fixed investment (percent of GDP)	20.5	17.9
Capital-output ratio	1.3	2.4
Total factor productivity	1.3	0.3
Strongly inward-oriented		
Real GDP growth	2.3	2.5
Real per capita GDP growth	-0.3	-0.1
Total savings (percent of GDP)	13.7	10.9
Total fixed investment (percent of GDP)	16.3	14.1
Capital-output ratio	2.0	2.8
Total factor productivity	-0.4	0.3

Note: Developing countries are classified into four categories according to the orientation of their trade strategy during the past two decades: (1) strongly outward-oriented, where trade controls are either nonexistent or very low; (2) moderately outward-oriented, where the average rate of effective protection for the home market is relatively low and the range of effective protection rates relatively narrow; (3) moderately inward-oriented, where the overall incentive structure favors production for the domestic market; and (4) strongly inward-oriented, where the overall incentive structure strongly favors production for the domestic market.

price controls, lack of currency convertibility, settlement problems, Russia's "centralized exports" scheme, and other impediments.

The collapse of central planning was accompanied by a sharp decline in trade among the former members of the CMEA. Within central Europe, this

decline has been especially severe for Romania and Bulgaria, although there has also been a significant drop in trade among Poland, Hungary, and the former Czechoslovakia. The contraction of trade between central Europe and the former Soviet Union has been even more pronounced, with recent estimates suggesting a cumulative decline of 60-70 percent in 1990-92.⁶⁷ The causes of this steep fall—the breakdown of the command system, the switch to world market pricing, and the change in the CMEA settlement system—are well known and have been discussed in previous issues of the *World Economic Outlook*. The recent worsening of the disruptions in production and interregional economic relations in the former Soviet Union has been aggravated by reductions in the supply of energy and raw materials for export, which have in turn depressed demand for imports from central Europe.

A significant amount of CMEA trade had been an artifact of the planning system, and the reorientation of trade has been a necessary prerequisite to ending the artificial isolation of these economies from world markets. New patterns of trade, involving closer integration with market economies, are already emerging, and estimates point to increases in export volumes in 1992 of between 10 and 20 percent for Hungary, Poland, the former Czechoslovakia, and Bulgaria. This performance is remarkable against the background of depressed domestic demand in the industrial countries, and it demonstrates the importance of reduced trade barriers and the ability of firms in the central European countries to respond to new opportunities. In contrast, exports from Romania and Albania have continued to decline, in part because of severe input shortages.

The liberalization of international trade and the early exposure to world markets have played a key role in those economies of central Europe that have made the most progress. Trade liberalization has helped to establish a rational set of relative prices and has introduced competition in monopolistic sectors. Access to imports from industrial countries has provided much-needed investment goods, although foreign direct investment has lagged behind initial expectations. Export earnings have eased financing constraints, and the expansion of exports has also been an important factor in attracting foreign investment.

Much of the expansion of trade has been with the EC, in part because of the improved access to EC markets for some central European countries resulting from the bilateral Association Agreements (also called Europe Agreements) between the EC and

⁶⁷Economic Commission for Europe, *Economic Bulletin for Europe*, Vol. 44, Table 2.1.1 (November 1992).

Bulgaria, the former Czechoslovakia, Hungary, and Poland.⁶⁸ These agreements envisage the eventual elimination of trade barriers on many goods, although separate provisions deal with textiles, steel, and agricultural products. For these goods, the lowering of trade barriers will be more gradual, and safeguard clauses and antidumping measures have been retained by the EC. The EC Commission has recently begun to explore a free trade agreement with Russia. The former Czechoslovakia, Poland, and Romania signed free trade agreements with the European Free Trade Association (EFTA) in 1992, while negotiations between Hungary and EFTA are still taking place. Central European countries that had been GATT members are in the process of negotiating the same obligations and advantages accorded to market economies.

A sustained effort by the industrial countries to open their markets to imports from the countries in transition will be crucial to the success and speed of the economic transformation now under way. The recent antidumping measures imposed by the EC and the United States are, therefore, a matter of concern.⁶⁹ Such measures also increase the risk that trade barriers will be raised in the reforming countries. As domestic demand in these countries picks up, trade imbalances may appear, and it will be necessary to resist protectionist pressures. Although closer economic relations with the market economies will be important, trade opportunities within the region of the former CMEA—including those between central Europe and the former Soviet Union—should not be neglected, and the bilateral preferences granted by the EC and EFTA should not be allowed to unduly divert trade from former CMEA partners. The recent agreement between Poland, Hungary, the Czech Republic, and the Slovak Republic to establish a free trade zone by the end of the decade is an important step in this regard.

Extensions of the GATT Process

The sweeping reductions in trade barriers in the past four decades under the auspices of the GATT have left the important agricultural, textile, and ser-

vice sectors largely outside the system of multilateral, nondiscriminatory agreements on tariffs. Moreover, protection of intellectual property varies considerably from country to country. The Uruguay Round has sought to broaden the multilateral trade liberalization process by including these areas, although the sensitive issues raised in relation to these sectors have made the negotiations difficult.

Most industrial countries have put in place complex policies to protect agriculture, the economic impact of which has been quantified by the OECD and others in calculations of producer subsidy equivalents (PSEs), a standardized measure of the degree of agricultural protection. By this measure, support for agriculture is considerable, with an average subsidy of roughly 45 percent of the domestic price, or the equivalent of \$170 billion annually during 1990–91 (Table 22). In contrast, there is relatively little protection for agriculture in many developing countries.⁷⁰ Although PSEs are not widely available for developing countries, estimates by the U.S. Department of Agriculture for a small group of large developing countries—Argentina, Brazil, China, India, and Mexico—indicate levels of protection in 1985–88 that are generally low, typically less than 3 percent of the domestic price for most agricultural products.

The economic effects of the high levels of agricultural protection characteristic of the industrial countries are twofold. First, these policies distort production, employment, and consumption, thereby lowering real incomes. According to one estimate, eliminating agricultural support in the OECD countries from levels prevailing in 1988 would raise real incomes in the region by \$72 billion in 1988 dollars (or by 1 percent of GDP in the OECD).⁷¹ Second, despite a shift in patterns of trade and production toward manufactured goods, many developing countries—especially those in the Western Hemisphere and Africa—remain dependent on agriculture. Liberalizing agricultural trade would, therefore, substantially increase the welfare of the developing world, although there is concern that higher world food prices would raise import costs. Multilateral liberalization would have a much larger impact in this region than would a reduction of agricultural support by the developing countries

⁶⁸These agreements, which cover a broad range of economic relations between the contracting parties, were signed at the end of 1991 and contain trade provisions that entered into force in March 1992 except for Bulgaria, which signed its agreement in March 1993. The arrangements provide for a move to free trade between the EC and each of the contracting countries, with tariffs and quotas for a number of goods being eliminated immediately and a timetable covering the next ten years being established for other products.

⁶⁹In 1992 the EC imposed antidumping duties on steel products from Hungary, Poland, the former Czechoslovakia, and Croatia. In early 1993, the United States imposed preliminary antidumping duties on steel imports from Poland and Romania.

⁷⁰See Anne O. Krueger, Maurice Schiff, and Antonio Valdés, "Agricultural Incentives in Developing Countries: Measuring the Effect of Sectoral and Economywide Policies," *World Bank Economic Review*, Vol. 2 (September 1988), pp. 255–71.

⁷¹John P. Martin, Jean-Marc Burniaux, François Delorme, Ian Lienert, and Dominique van der Mensbrugge, "Economy-wide Effects of Agricultural Policies in OECD Countries: Simulation Results with WALRAS," in *OECD Economic Studies*, Vol. 13 (Paris: OECD, 1989–90). Although a 1 percent gain seems small, it is worth recalling that agriculture accounts for only 3 percent of output.

Table 22. Industrial Countries: Agricultural Producer Subsidy Equivalents¹

	1979-86	1987	1988	1989	1990 ²	1991 ³
Australia	1.1 12	1.2 11	1.2 10	1.3 10	1.7 15	1.4 15
Austria	1.1 33	2.2 48	2.2 48	1.8 41	2.7 50	2.6 52
Canada	4.2 32	6.6 49	6.1 42	5.5 36	7.1 45	7.7 45
European Community	39.8 37	71.5 49	69.1 46	60.0 41	86.3 49	83.6 49
Finland	2.3 58	3.7 71	3.9 72	4.2 69	5.3 72	4.5 71
Japan	21.5 65	35.0 76	36.5 74	33.3 70	29.8 66	31.5 66
New Zealand	0.7 25	0.3 14	0.2 7	0.2 5	0.2 5	0.1 4
Norway	1.7 71	2.5 74	2.6 75	2.5 73	3.2 76	3.0 77
Sweden	1.6 44	2.6 57	2.5 52	2.7 52	3.4 61	2.7 59
Switzerland	2.6 68	4.5 79	4.8 78	4.2 73	5.3 80	5.2 80
United States	30.6 28	44.2 40	36.9 34	32.2 28	35.3 29	34.7 30
OECD	107.2 37	174.3 49	166.0 45	147.9 40	180.2 45	177.0 45

Sources: OECD, *Agricultural Policies, Markets and Trade: Monitoring and Outlook* (Paris, several issues).

¹For each country, the first row is the producer subsidy equivalent (PSE) in billions of U.S. dollars. The second row is the PSE expressed as a percentage of the value of agricultural production, inclusive of the PSE.

²Estimate.

³Preliminary.

alone, in view of the relatively high levels of protection in the industrial countries.⁷²

Managed trade of textiles and clothing was broadened significantly with the negotiation of the first Multifiber Arrangement (MFA) in 1974. The MFA is a web of bilateral agreements establishing country-specific import quotas that, contrary to the principles established by the GATT for other traded goods, discriminate extensively among countries. As in the case of agriculture, it is the developing countries that have the most to gain from a liberalization of textile trade, although some countries now benefit from the system of preferential agreements. The industrial countries would also benefit from lower prices and the rationalization of resources. Proposals currently under discussion

envisage phasing out the MFA in the course of ten years, although in view of the inconclusiveness of the Uruguay Round it was decided to extend the current arrangement to end-1993.

International trade in services, although less distorted than agricultural and textile trade, is now under discussion in the Uruguay Round. In particular, it is proposed that an agreement on trade in services incorporate most favored nation treatment. Services trade raises issues that are distinct from those in trade in goods, largely because trade in services often does not require the cross-border shipment of a product, but rather movement of service providers or receivers. As a result, the barriers to trade have not mainly been tariffs, but regulations and an array of nontariff barriers. Although some regulations may not be intended to discriminate against foreign providers, they nevertheless hinder trade. Other barriers, however, are specifically designed to restrict international competition in services.

The subtle nature of these restrictions has complicated efforts to liberalize trade in services. The problems are compounded by a divergence of views

⁷²Rod Tyers and Kym Andersen, *Disarray in World Food Markets: A Quantitative Assessment* (Cambridge and New York: Cambridge University Press, 1992); and Barry Krissoff, John Sullivan, and John Wainio, "Developing Countries in an Open Economy: The Case of Agriculture," in *Agricultural Trade Liberalization: Implications for Developing Countries*, edited by Ian Goldin and Odin Knudsen (Paris: OECD Development Centre, 1990).

between industrial and developing countries about what should be included in the definition of services. In general, developing countries prefer to limit the negotiations to cross-border movements of services and to factors of production specifically necessary for the provision of such services. Industrial countries argue, in contrast, that this would leave out services that require foreign direct investment and the right of establishment in the recipient country, which are important to compete effectively with domestic service providers. Initial commitments on services are still to be undertaken by Uruguay Round participants, so the outcome is still far from settled. The objective of integrating services into the GATT is, nevertheless, a positive development.

Another area that is now receiving attention is intellectual property. Without legal protection, the producers of inventions may lose royalties, which could undermine the incentive to carry out research. As trade in the products of research has grown, and as the importance of research and development in the growth process has become more widely recognized (see Box 9), the international extension of patent and copyright protection has taken on greater importance. In this case, as with other services, there is a conflict between the interests of the industrial, or "technology-exporting" countries, which seek relatively high levels of protection for intellectual property rights, and the developing, or "technology-importing" countries, which are concerned that too much protection could give rise to excessive monopoly power, leading to higher prices for certain goods.

The outcome of the Uruguay Round remains in considerable doubt because the major trading powers—the United States, the EC, and Japan—as well as other participants have yet to come to full agreement. It now appears likely, however, that in many respects the Round will achieve less than had originally been hoped. The agreement on agriculture, for example, seems likely to fall far short of the goal of trade liberalization. Nevertheless, as was the case with manufactured goods after World War II, bringing agricultural and service trade into the GATT process would result in a formal, multilateral mechanism that might permit further reductions in trade distortions over time.

Trade Liberalization as a Strategy for World Growth

Although the links between trade and growth are complex, empirical evidence indicates a close relationship.⁷³ An important way in which lower

barriers to trade and access to world markets raise incomes is by promoting productive activity, increasing competition, stimulating foreign and domestic investment, and facilitating the exploitation of economies of scale and the transmission of technology and best-practice techniques. These mechanisms yield more than just "static" gains; they also promote dynamism by encouraging firms to adjust rapidly to changing circumstances in order to remain efficient and technologically competitive. Although specific enterprises or industries might suffer, at least initially, when exposed to world competition, all countries benefit from trade liberalization as they exploit more fully their comparative advantages. For these reasons, the mercantilist metaphors of "trade wars" and "sporting competitions," with the implication that a country either loses or wins, are inappropriate. Similarly, the elevation of bilateral trade balances to the status of policy goals is misguided. Trade is not a zero-sum game; trade liberalization benefits all countries.

Despite the significant benefits in terms of economic growth that the rapid expansion of trade has brought to many countries, further advances now seem threatened, and there is a risk that the recent increases in trade barriers will accelerate. It has proved difficult to extend the multilateral, non-discriminatory trade rules that have been negotiated for trade in manufactured goods under the GATT to other sectors, such as agriculture, textiles, and services. The industrial countries have increasingly resorted to countervailing and antidumping duties and to nontariff barriers. This has gone hand in hand with a focus on bilateral trade balances—sometimes even in specific sectors—and a heightened interest in managed trade, often in the context of regional trading blocs (see Annex III).

These developments have emerged against a backdrop of macroeconomic imbalances, including persistent current account imbalances, recessions or periods of slow growth, and historically high unemployment in Europe. In the near term, larger surpluses in Japan and larger deficits in the United States and Europe—in the latter case accompanied by increased unemployment—risk leading to still greater pressures to restrict trade.

In contrast to the significant trade liberalizations undertaken by many developing countries, tariffs and quantitative restrictions abound in others. These countries, which have much to gain from world trade, have a growing responsibility to open their markets further, both to each other and to the industrial countries. Those developing countries with sizable, sustained surpluses need to be aware

⁷³For econometric evidence on the relation between trade restrictions and growth, see Malcolm Knight, Norman Loayza, and Delano Villanueva, "Testing the Neoclassical Theory of

Economic Growth: A Panel Data Approach," IMF Working Paper 92/106 (December 1992).

of the reactions these can produce in their trading partners and need to implement both structural and macroeconomic policies to reduce these imbalances.

The multilateral trading system is particularly critical for the countries in transition. Granting access to their markets is probably the single most important way that the industrial countries can help to ensure that the countries in transition successfully manage the difficult process of restructuring and transformation. Impeding access to world markets could have severe consequences for these countries and for the rest of the world, at a minimum hindering the transition process, leading directly to a need for potentially much larger amounts of direct financial aid for both stabilization and structural reform.

It is crucial that the Uruguay Round of multilateral trade negotiations be successfully concluded. This would confirm and reinforce the long-standing commitment to the principles of free and nondiscriminatory trade. By further reducing trade barriers and by extending the GATT process to non-manufactures, completion of the Round would also raise economic prosperity. Although quantitative estimates of the gains are necessarily uncertain, recent studies suggest that completing even the partial

liberalization now envisaged would raise annual world real income permanently by \$120 billion to \$200 billion.⁷⁴ The failure of the Round, in contrast, could roll back gains already made—notably reforms to dispute settlement—as well as raise pressures for protectionism and discourage the growing movement toward liberalization in the developing countries. The macroeconomic imbalances that could give rise to protectionism must also be addressed, in many cases by reducing excessive government budget deficits and raising national saving. By demonstrating the willingness of the major industrial countries to cooperate in solving common problems, such efforts would bolster confidence and provide a new spur to activity, in both the industrial and developing countries, and would provide an environment conducive to successful economic restructuring in the countries in transition.

⁷⁴See Ian Goldin and Dominique van der Mensbrugge, "Trade Liberalization: What's at Stake," OECD Development Centre Policy Brief No. 5 (Paris: OECD, 1992); and Trien T. Nguyen, Carlo Perroni, and Randall M. Wigle, "The Value of a Uruguay Round Success," *World Economy*, Vol. 14 (December 1991), pp. 359-74. The second study estimates the benefit of more complete liberalization to be twice that from partial liberalization.