

INTERNATIONAL TRADE IN 1986 AND CURRENT PROSPECTS

First Assessment by the GATT Secretariat

The Report in Full

Geneva, March 1987

I. DEVELOPMENTS IN WORLD TRADE

In 1986, the volume of world merchandise trade is estimated to have expanded at the same 3½ per cent rate as in 1985. While this increase is well below the average rate of trade expansion during the 1960s and 1970s, it exceeds the average annual growth thus far in the 1980s by a full percentage point (Table 1).

TABLE 1. - GROWTH OF WORLD MERCHANDISE TRADE AND PRODUCTION, 1960-86
(Average annual percentage change in volume)

	1960-70	1970-80	1980-86	1985	1986
<u>EXPORTS</u>					
All merchandise	8½	5	2½	3½	3½
Agriculture	4	4½	1½	0	1
Mining	7	1½	-1	-1	7
Manufacturing	10½	7	4½	5½	3
<u>PRODUCTION</u>					
All merchandise	6	4	2	3	3
Agriculture	2½	2	2½	2	3
Mining	5½	2½	-1½	-½	5
Manufacturing	7½	4½	2½	4	2

Source: GATT Secretariat estimates.

World merchandise output is estimated to have also increased last year at the same rate as in 1985. As in the past, the growth in merchandise trade exceeded the increase in merchandise output, pointing to the ongoing specialization in the world economy, in particular in the area of manufactures.

For the first time in history, the dollar value of world merchandise trade passed the two thousand billion US dollar mark, reaching an estimated \$2,110 billion. The 10 per cent gain over 1985 represents the largest increase in value since the 21½ per cent gain recorded in 1980.

Any increase in the dollar value of world merchandise trade is the result of one or more of three effects: (i) a quantity effect, when the volume of world trade increases; (ii) a price effect, when the domestic currency prices of traded goods rise; and (iii) a valuation effect of a depreciation of the US dollar against other major currencies.¹ Of course, the three effects do not always move in the same direction. The increase in the dollar value of world merchandise trade last year, for example, appears to have been the result of just two of these effects, namely the increase in trade volume noted above and a depreciation of the dollar. The latter was the dominant factor.

The dollar's nominal effective exchange rate dropped by about 17 per cent in 1986 as compared to its average level in 1985, bringing the effective exchange rate back to a level close to that recorded in 1982.² The valuation effect of last year's depreciation boosted the dollar value of a substantial part of world merchandise trade including most of intra-West European trade, of trade between Japan and Western Europe and of the Eastern trading area's trade.

As regards the domestic currency "price effect", statistical information is still scarce. However, it is evident that the boost to the dollar value of world trade from the volume and exchange rate

¹The three effects obviously interact with one another, particularly beyond the short run. For example, a change in the exchange rate will affect firms' pricing and production decisions. As regards the "valuation effect", it should be stressed that - in the first instance - this is a purely mechanical effect. For example, the deutsche mark value of the Federal Republic of Germany's exports declined from DM 537 billion in 1985 to DM 526 billion in 1986, giving a 2 per cent decrease. When these figures are translated into dollars at the respective average annual deutsche mark/dollar exchange rates, the figures become \$184 billion and \$243 billion, giving a 32 per cent increase.

²The nominal effective exchange rate of the US dollar is a trade-weighted index of the bilateral exchange rates between the dollar and the currencies of the United States' trading partners (in standard estimates, only major trading partners are taken into account). To obtain the real effective exchange rate of the dollar, the nominal effective exchange rate is adjusted for differences in national inflation rates between the United States and those same trading partners.

changes was partially offset by declines in the domestic currency prices of exports from a number of trading nations in 1986. Those price declines reflected a variety of developments, including (i) attempts on the part of West European and Japanese producers to defend sales levels in North America (and in other areas whose currencies moved in parallel with the US dollar) by lowering export prices in terms of their respective domestic currencies; (ii) attempts on the part of heavily indebted countries to promote exports by way of attractive prices; (iii) a change in supply policies in a number of petroleum exporting countries; and (iv) an intensified fight over world markets in temperate-zone agricultural products, fuelled by the widespread use of production subsidies and export subsidies.

Trade by major product groups

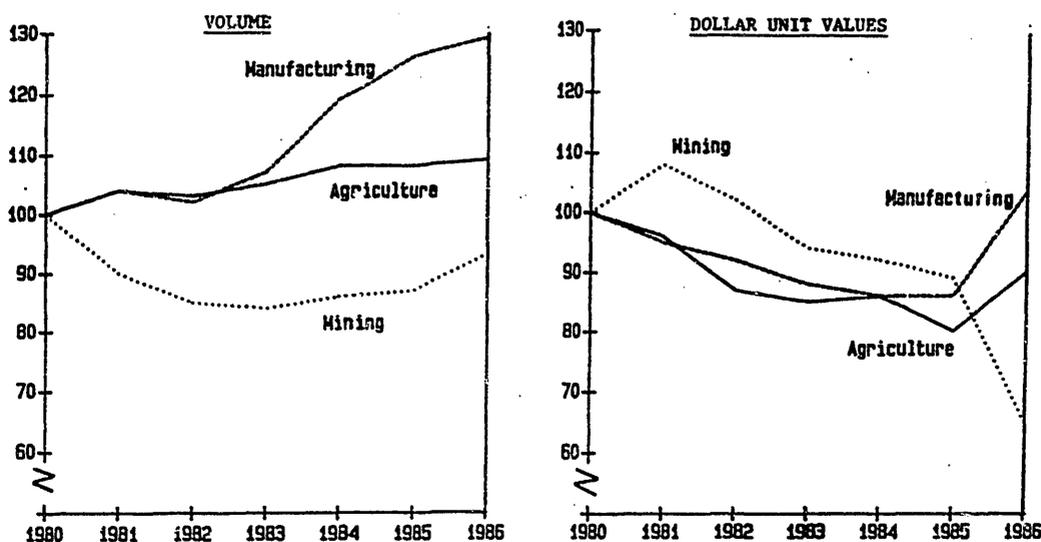
The sharp decline in world market petroleum prices, from about \$30 a barrel in November 1985 to a temporary low of around \$10 on the spot market in mid-1986, stimulated both consumption and stockbuilding and led to an estimated 9 per cent increase in the volume of trade in petroleum.¹ For mining products as a whole, there was a 7 per cent increase in the volume of trade last year (Table 1 and Chart 1).² It is necessary to go back to the recovery year 1976 to find an equivalent growth rate of trade in this product group.

The 1986 decline in the price of petroleum was the main factor behind the sharp drop of the dollar unit values of mining products shown in Chart 1. In contrast, the dollar unit values of trade in agriculture and manufacturing are estimated to have increased. These price movements reflect supply and demand developments, as well as valuation

¹Increased demand, coupled with production cutbacks, brought petroleum prices on the spot market back into the \$16-18 range in late 1986 and early 1987.

²The category "mining products" includes fuels, non-ferrous metals, metalliferous ores, and other crude minerals.

CHART 1 - WORLD MERCHANDISE EXPORTS BY MAJOR COMMODITY GROUP, 1980-86
(Index 1980 = 100)



Source: UN, and GATT Secretariat estimates.

effects of exchange rate changes.¹ As a result of these price developments in 1986, there was a strong shift in the terms of trade in favour of exporters of manufactures (and of agricultural products), and to the detriment of producers and exporters of minerals, in particular those of fuels.

In the agricultural area, trade growth in the 1980s has generally fallen short of output growth and this pattern continued in 1986, when the volume of trade increased by 1 per cent and output by 3 per cent. While this sluggish increase in export volume was only slightly below the annual average recorded thus far in the 1980s, it was well below the 4 per cent average annual growth in world trade in agricultural products during the two preceding decades.

¹ For example, the dollar prices for some food items recovered from their depressed 1985 level. On the other hand, the appreciation of West European currencies vis-à-vis the US dollar, by itself, boosted the dollar unit value of intra-West European trade in agriculture for the purely "mechanical" reasons mentioned in footnote 1 on page 2. As regards manufacturing, the moderate inflation in the industrial countries, coupled with exporters' reactions to the exchange rate changes, suggest that the increase in the dollar unit value of manufactures stems largely from a valuation effect (note that the currencies of economies which account for a substantial part of world trade in manufactures have appreciated).

World trade in manufactures, traditionally the fastest growing of the three main product categories, increased by a mere 3 per cent in volume in 1986, down from 5½ per cent in 1985. Leaving aside the recession years 1958, 1975 and 1982, this was the poorest performance in three decades.

A variety of factors contributed to the weak performance of trade in manufactures, including a slowdown in economic growth in the industrial countries, from 3 per cent in 1985 to an estimated 2½ per cent in 1986. More importantly, the generally weak export markets for primary products had an adverse effect on foreign exchange earnings - and thus on the demand for imports of manufactures - in many countries.

Another factor in explaining the poor performance of trade in manufactures was the asymmetric response to the recent substantial changes in international price competitiveness among the major trading nations, resulting from changes in real effective exchange rates.¹ The volume growth of West European and Japanese exports was fairly quickly dampened by the real appreciation of their currencies. In contrast, export volume in the United States, and in some other countries whose currencies also depreciated in real terms, has only recently begun to respond to the stimulus stemming from their improved international price competitiveness (see below for additional details).²

¹Because differences in the rates of inflation among industrial countries remained limited, the West European currencies and the Japanese yen appreciated not only in nominal terms, but also in real terms. On average, the increase in consumer prices in the industrial countries declined from 4 per cent in 1985 to an estimated 2 per cent in 1986.

Most of the asymmetric response involved manufactured goods (as opposed to agricultural and mining products) because the countries whose currencies appreciated export principally manufactured goods.

²Trade restrictions on a wide range of goods - including textiles, clothing, steel, automobiles, and consumer electronics - continued to act as a serious drag on trade in manufactures, and new restrictions on, for example, machine tools and semi-conductors were introduced in 1986. (For a detailed listing of recent trade policy actions, see the GATT Secretariat document L/6087 of 28 November 1986.) However, trade barriers are not an important factor in explaining the sharp slowdown in the expansion of manufactures trade between 1985 and 1986.

Trade of the main country groups

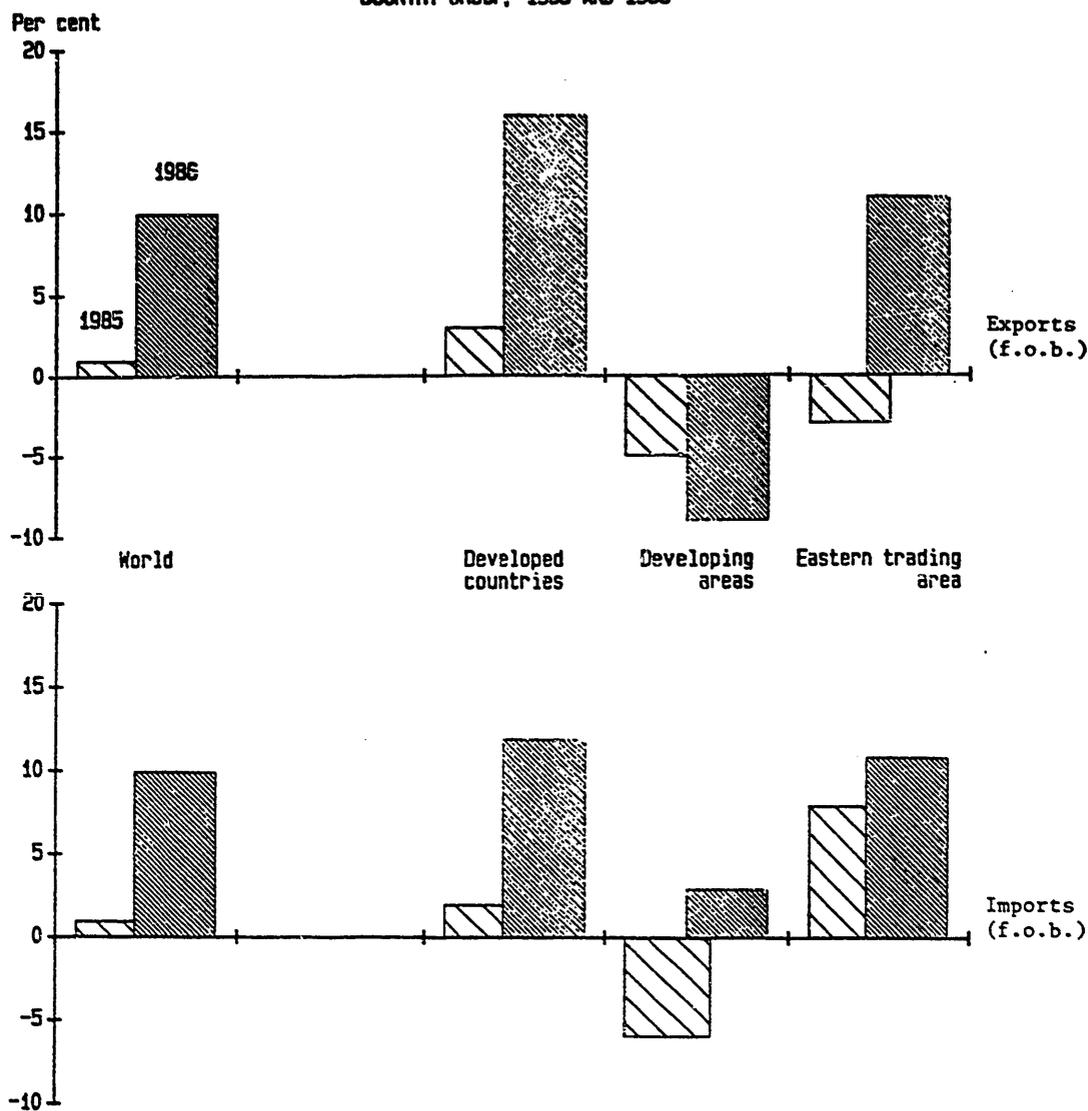
In 1986, the merchandise trade performance of the main country groups diverged sharply from developments in 1985. The dollar values of merchandise exports and merchandise imports recorded strong gains in the developed countries and, somewhat less, in the Eastern trading area (Chart 2). Because many developed countries, and the members of the Eastern trading area, experienced an appreciation of their currencies against the dollar, a substantial part of the increase in the value of their trade is a result of the valuation effect described above.¹

Exports of the developing areas declined significantly, while their imports increased moderately. Detailed statistics on trends in the developing areas' trade in specific products in 1986 are not yet available. However, it is possible to divide the changes in their total exports and imports into "fuels" and "other products".

Preliminary figures show that developing areas' exports and imports of non-fuel products increased more or less in line with the 10 per cent increase in the value of total world trade (their exports of manufactures were up 13 per cent in value terms). In spite of the volume increases, the value of their trade in fuels declined by about

¹Exchange rate developments also influenced the 1986 rankings of the world's twenty leading merchandise exporters and importers. As is evident from the Appendix Table, most of the West European countries on the list - that is countries whose trade is largely denominated in currencies which appreciated vis-à-vis the dollar - moved up in the ranking. For example, entirely as a result of the valuation effect, the Federal Republic of Germany replaced the United States as the world's largest exporter of merchandise. And if changes in rankings among West European countries are ignored, none of these countries had a lower ranking in 1986 than in 1985. In contrast, seven non-West European areas recorded declines in ranking on the export side (United States, Canada, USSR, Republic of Korea, Hong Kong, Saudi Arabia, Brazil), as did four areas on the import side (Japan, Republic of Korea, Singapore, Saudi Arabia).

CHART 2 - ANNUAL PERCENTAGE CHANGE IN VALUE OF TRADE BY MAIN COUNTRY GROUP, 1985 AND 1986



Source: GATT Secretariat estimates.

one-third for both exports and imports. Given that fuels are a much larger component of their exports than of their imports, this explains much (about four-fifths) of the swing from a surplus to a deficit in their merchandise trade account (Table 2).

TABLE 2. - VALUE OF WORLD MERCHANDISE TRADE BY AREA, 1985 AND 1986
(Billion dollars)

	Exports (f.o.b.)		Imports (f.o.b.)	
	1985	1986	1985	1986
<u>World</u>	<u>1 922</u>	<u>2 110</u>	<u>1 922</u>	<u>2 110</u>
Developed countries	1 275	1 480	1 312	1 465
Developing areas	441	400	408	420
Eastern trading area	206	230	202	225

Note: This table is constructed from a trade matrix in which, by definition, total exports equal total imports (f.o.b.-f.o.b.). However, in using these figures, it should be kept in mind that officially reported merchandise trade statistics often yield a fluctuating discrepancy between world exports and imports (ranging from \$5-30 billion, on a f.o.b.-f.o.b. basis, in the first half of the 1980s, or $\frac{1}{2}$ to $1\frac{1}{2}$ per cent of total trade).

Source: GATT Secretariat estimates.

Returning to the aggregate exports and imports of the three major country groups in 1986, it is possible to disaggregate their trade according to origin and destination (Appendix Chart 1). As regards last year's changes, noteworthy observations include:

- The dollar value of merchandise trade among developed countries, and of merchandise trade within the Eastern trading area, increased at about twice the rate estimated for overall world merchandise trade.
- At the other extreme, the dollar value of developed countries' imports from developing areas is estimated to have declined by about 11 per cent, due largely to the lower price of petroleum. There was also a significant decline in the developing areas' mutual trade.
- The Eastern trading area's merchandise imports from the developed countries and the developing areas did not change

BOX 1. - SHARES OF COUNTRY GROUPS IN WORLD MERCHANDISE TRADE,
1980, 1985 AND 1986
(Percentages)

<u>Importing area</u>	<u>Exporting area</u>	<u>1980</u>	<u>1985</u>	<u>1986</u>
Developed countries	Developed countries	45	50	54
	Developing areas	20	15	13
	Eastern trading area	3	3	3
Developing areas	Developed countries	15	13	13
	Developing areas	7	6	5
	Eastern trading area	2	2	2
Eastern trading area	Developed countries	3	3	3
	Developing areas	1	2	1
	Eastern trading area	4	6	6
		<u>100</u>	<u>100</u>	<u>100</u>

The above Table offers a convenient guide to the relative importance of each of the nine separate trade flows involving the developed countries, the developing areas and the Eastern trading area.

The share of each of the three groups of countries in world imports in a particular year is easily obtained by adding the three figures for the group in question. For example, in 1986, the respective shares in world imports were 70 per cent for the developed countries, 20 per cent for the developing area and 10 per cent for the Eastern trading area.

It is slightly more complicated to obtain their respective shares of world exports. For example, the developing areas' share of world exports in 1986 is obtained by adding the shares accounted for by their exports to the developed countries (13 per cent of world exports), their exports to one another (5 per cent), and their exports to the Eastern trading area (1 per cent), for a total share in world exports of 19 per cent.

Source: GATT Secretariat estimates.

much last year; in 1985, these imports had recorded the strongest increase among all regional trade flows depicted in Appendix Chart 1.¹

¹The changed performance is due primarily to developments in China's imports. In contrast to the sharp increase in 1985 (imports from OECD countries were up nearly 60 per cent), China's imports declined in 1986 (by about 10 per cent from OECD countries). After having stagnated in 1985, Eastern Europe's imports from the OECD countries increased by about 10 per cent last year.

As a result of the various changes, the share of the developed countries' mutual trade in the value of world trade reached 54 per cent, and their total share in world trade increased to 70 per cent. In contrast, the share of developing areas in world trade further declined, to 20 per cent on the import side and to 19 per cent on the export side; in 1980, after the second oil price shock, these shares stood at 24 and 28 per cent, respectively (Box 1).

It is important to note once again that trade flows expressed in dollars have to be interpreted with care. On the basis of available statistics, it is currently difficult to judge precisely to what extent the trade picture is clouded by valuation effects of the large 1986 movements in exchange rates.¹

It should also be recognized that, for each group of countries, the above figures represent aggregate developments only. Each group includes economies which are relatively specialized in exporting manufactured goods, economies in which primary commodities are the leading source of export earnings, and economies with a more or less balanced composition of exports. These differences are apparent in the trade developments in individual countries.

II. A CLOSER LOOK AT THREE DEVELOPMENTS IN 1986

Trade in primary products

One of the important features of world trade in the 1980s has been the generally depressed conditions in the world market for primary products. The value of world trade in crude petroleum has declined each year since 1981, first largely as a result of declining volume and then, last year, purely as a result of the sharp decline in the world market price. In the case of primary commodities other than crude petroleum, weak markets - including reactions to the appreciation of the dollar

¹It should be kept in mind that developments in the dollar value of trade are directly relevant to certain issues - for example, servicing international debts denominated in dollars.

during 1982-85 - combined to push prices to a level 23 per cent below the 1980 peak.¹

As a result of the dollar's sharp depreciation, this trend in the dollar prices of the non-fuel primary products may have bottomed out in 1986. The indices of dollar prices compiled by the UN and the UNCTAD each recorded increases in 1986; the IMF's index, in contrast, declined moderately.² When the prices are expressed in SDRs rather than dollars, however, all three indices indicate a further decline in 1986, ranging from 6 to 17 per cent (Table 3).

TABLE 3. - THE DEVELOPMENT OF PRICES OF NON-FUEL
PRIMARY COMMODITIES, 1985 AND 1986

(Annual percentage change)

	UN INDEX		UNCTAD INDEX		IMF INDEX	
	1985	1986	1985	1986	1985	1986
US dollars	-12.3	7.5	-10.7	5.3	-13	-3.8
SDRs	-11.3	-6.0	-9.7	-8.6	-12	-16.7

Source: UN, UNCTAD, IMF, and GATT Secretariat estimates.

¹ Because many primary commodities, including petroleum, are priced directly in dollars (rather than in the domestic currency of the exporting country), there is no valuation effect from a change in the dollar's exchange rate.

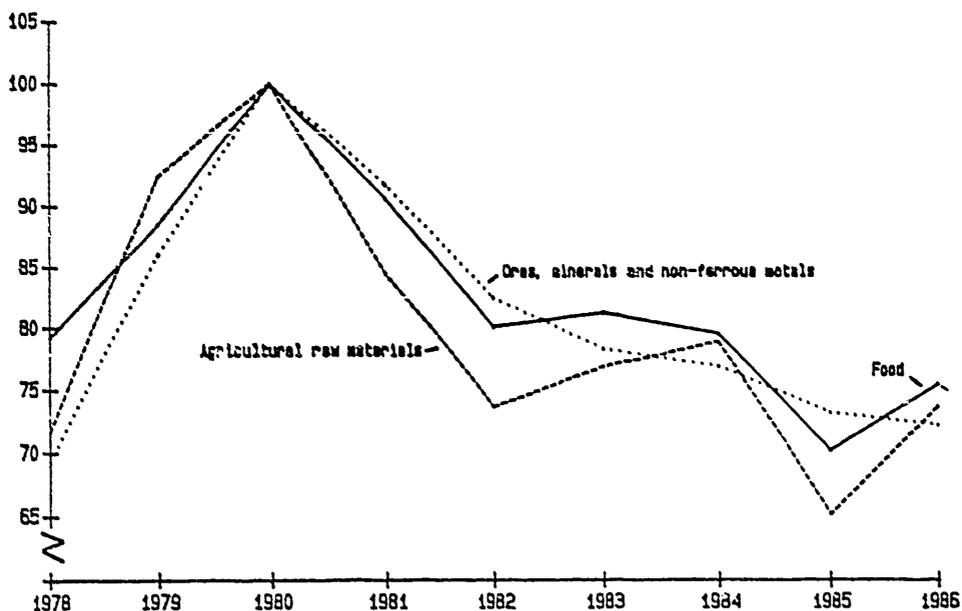
² The various indices differ in terms of commodity coverage, weighting pattern and their incorporation of spot prices vis-à-vis longer term contract prices. The UN index has a much wider coverage than the UNCTAD and IMF indices, and some of the items which showed a price increase in 1986, for example, dairy products, vegetables, citrus fruits and lumber, are not included in the IMF index. In addition, the latter index covers a smaller portion of the market for some items, such as beef. See United Nations (1987), "Methods Used in Compiling the United Nations Price Indexes for Basic Commodities in International Trade", Volume 1, ST/ESA/STAT/Ser.M/82; IMF (1987), International Financial Statistics, Volume XL, Number 1; and GATT (1987), "The International Markets for Meat".

Price trends since 1978 for three main categories of non-fuel primary products are shown in Chart 3. While prices of food and agricultural raw materials recovered in 1986 - after falling by about one-third during 1980-85 - the prices of ores, minerals and non-ferrous metals continued to decline.¹

Trends in the prices of primary products since 1980, coupled with the increased exports of manufactured goods from the developing areas, have caused a major shift in the product composition of the developing areas' exports (Chart 4). In 1986, for the first time, the developing areas earned more foreign exchange selling manufactured goods than

CHART 3 - U.S. DOLLAR PRICES OF NON-FUEL PRIMARY COMMODITIES,
1978-86

(1980 = 100)

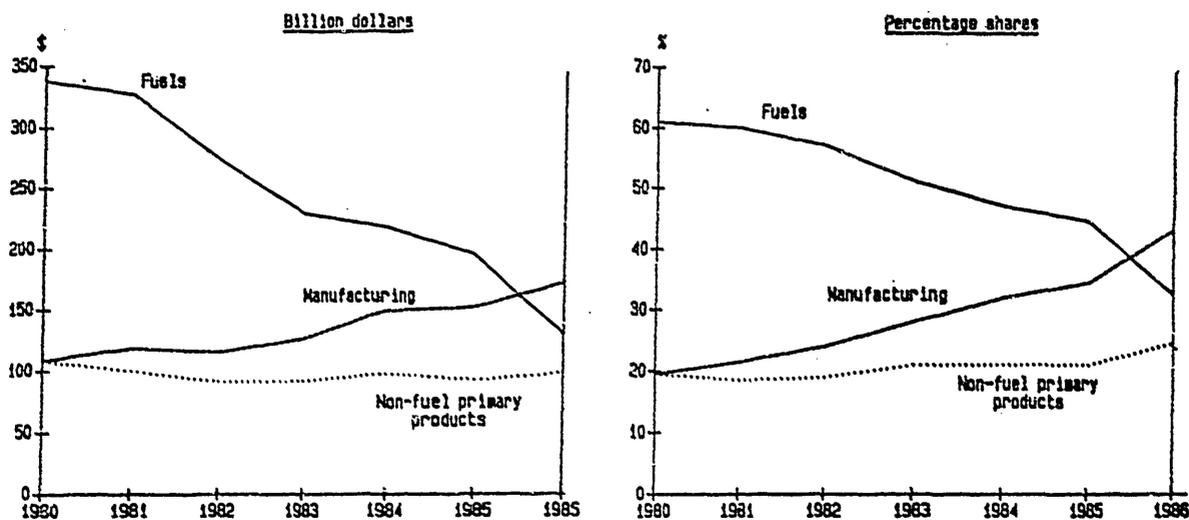


Source: UN, and GATT Secretariat estimates.

¹Data on the average annual prices of the ten leading products in the food price index indicate that five of the products recorded price gains in 1986 ranging from 16 to 47 per cent (in ascending order: fish, oilseed cake, beef, coffee and sugar); the other five products (milk, maize, rice, wheat and soya beans) recorded price declines of 3½ to 9 per cent. It should be noted that coffee prices began declining in the latter part of 1986, and dropped sharply in early March of this year.

The IMF index, which indicates a fall in the price of food, shows changes in direction similar to those reported by the UN for agricultural raw materials and for ores, minerals and non-ferrous metals.

CHART 4 - DEVELOPING AREAS' EXPORTS, 1980-86



Source: UN, and GATT Secretariat estimates.

selling either fuels or non-fuel primary products (approximately \$170 billion, versus \$130 billion and \$100 billion, respectively). The 13 per cent increase in the value of their manufactured exports indicates that the volume of manufactured exports from developing countries in 1986 increased at a rate well above that for the volume of total world trade in manufactures.

Discussions of the repercussions of depressed prices for primary products are often limited to the impact on the foreign exchange earnings of the developing areas. While this is to be expected, given the continued importance of these products in the total exports of many developing areas, two points should be kept in mind:

- The developing areas, as a group, are also important importers of these products. Even after the sharp decline in petroleum prices, primary products accounted for more than one-quarter of their total merchandise imports in 1986.¹

¹Fuels accounted for 10 per cent of the developing areas' imports in 1986 (down from 16 per cent in 1985). Non-fuel primary products have ranged from 16-18 per cent of their total imports since 1980 (this range is not very different from the 18½ to 24½ per cent share of non-fuel primary products in their exports over the same period).

- Primary products are important sources of foreign exchange earnings for a number of industrial countries. For example, in 1985 (the year before the sharp drop in petroleum prices) primary products together accounted for between 25 per cent and 80 per cent of the total merchandise exports of twelve OECD countries (in ascending order: The Netherlands, Portugal, Spain, Ireland, Canada, Turkey, Denmark, Greece, Norway, New Zealand, Australia and Iceland).

Trade developments in the indebted countries

Preliminary figures indicate that 1986 was again a difficult year for the trade of most of the sixteen indebted countries whose trade performance the Secretariat has been following since 1982. A comparison with the figures for 1985 reveals that their combined merchandise trade surplus fell by more than half - from \$29 billion to an estimated \$13 billion - as a result of sharply lower export earnings and virtually unchanged imports. Relative to 1981 (the last year before the emergence of the debt crisis) the combined imports of the sixteen countries in 1986 were down more than 25 per cent, while their exports were off nearly 10 per cent.

Only five of the sixteen countries managed to increase their exports, despite the 10 per cent increase in the value of total world merchandise trade in 1986 (Table 4). Of those five, the Republic of Korea and Thailand had the strongest export expansion, based on a rapid growth of manufactured exports.

Given developments in the petroleum market, it was to be expected that the five countries for which petroleum is an important source of foreign exchange (Egypt, Indonesia, Mexico, Nigeria and Venezuela) would report a poor export performance in 1986. But the sharp decline in the price of petroleum cannot explain the fact that four other members of the group (Argentina, Brazil, Peru and Turkey) also experienced a decline in the dollar value of their exports. For these four countries, the main explanation seems to be that a strong expansion of domestic demand reduced supplies available for export.

TABLE 4. - TRADE ADJUSTMENT IN SIXTEEN
INDEBTED COUNTRIES, 1986

<u>Export and import expansion</u>		<u>Export expansion and import contraction</u>	
Chile	Thailand	Philippines	
Colombia			
Korea, Rep. of			
<u>Export and import contraction</u>		<u>Export contraction and import expansion</u>	
Brazil ^a	Morocco ^b	Argentina ^a	Turkey ^a
Egypt ^a	Nigeria ^a	Indonesia ^a	Venezuela ^a
Mexico ^a		Peru ^a	Yugoslavia ^{a b}

^aIndicates an increased merchandise trade deficit, or a reduced surplus. All other countries in the table experienced a reduced merchandise trade deficit or an increased surplus.

^bPreliminary figures indicate that the declines in export value were very minor.

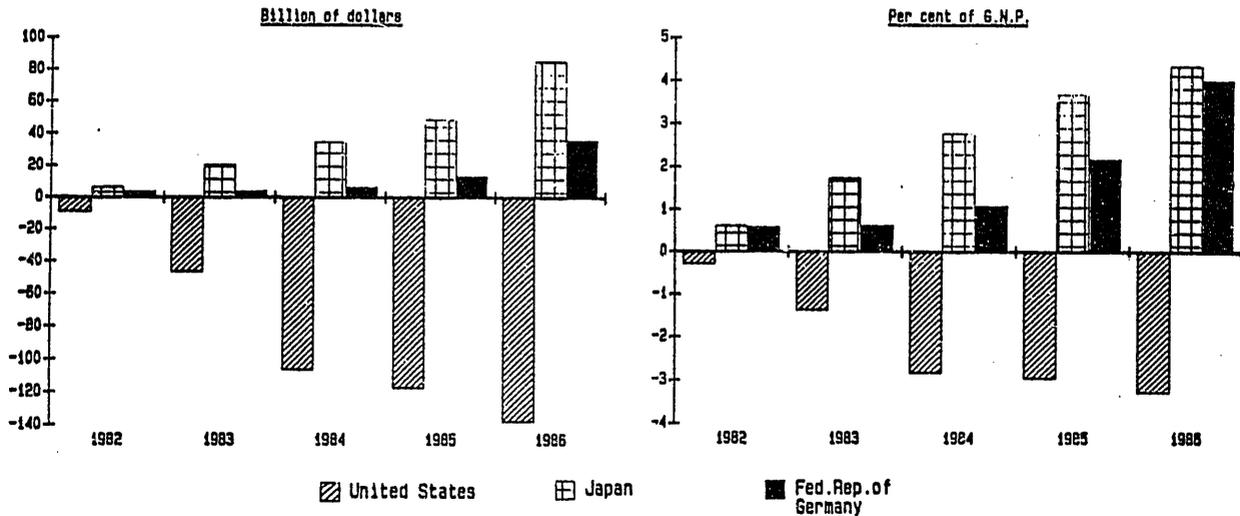
Source: GATT Secretariat estimates.

Trade imbalances in the three leading traders

The historically large current account imbalances of the world's three largest trading nations - the United States, the Federal Republic of Germany, and Japan - continued to increase in 1986. This holds both for the dollar value of the imbalances and for the imbalances expressed as a share of the respective gross national products (Chart 5). Thus the predictions that these trade and current account imbalances would be reduced by the major realignment of exchange rates that began two years ago have yet to be borne out. At least four possible explanations have been put forward to explain the apparent absence of the expected effects.

First, there is scattered evidence that the initial impact of the declining exchange rate was muffled by the response of some exporters in countries with appreciating currencies, who reduced their domestic

CHART 5 - EVOLUTION OF CURRENT ACCOUNT IMBALANCES OF THE UNITED STATES,
THE FEDERAL REPUBLIC OF GERMANY, AND JAPAN



Source: National Statistics and GATT Secretariat estimates.

currency prices in order to protect overseas market shares.¹ The ability (and willingness) of producers to sustain below average profits (or even losses) is limited, however, and it is likely that this effect has been declining in importance. In any case, it hardly qualifies as an explanation of the increase in the trade imbalances in 1986.

Second, there is the argument that the dollar's exchange rate has declined less than is indicated by the standard estimates, which show a decline in the dollar's nominal effective exchange rate of 25 to 30 per cent between March 1985 and December 1986. New measurements have yielded estimates of the dollar's depreciation anywhere from two-thirds to one-tenth of that indicated by the standard measures.² However, when these new estimates are adjusted for differences in inflation between

¹ See, for example, the OECD Economic Outlook, May 1986, pp. 57-63.

² The standard estimates are those prepared by the Federal Reserve Board, Morgan Guaranty Trust, the US Treasury and the International Monetary Fund. The new estimates include selected developing countries as US trade partners, and use more recent and sometimes conceptually different trade weights. See, for example, the international edition of Business Week, 6 October 1986, and the international edition of Fortune, 10 November 1986.

the United States and its trading partners - as they must be in the present context - the diagnosis of the standard estimates is largely restored: the competitive position of producers in the United States has improved markedly since early 1985.¹

Third, there is the view that the length of the so-called "J-curve" effect - according to which the current account deficit in a country with a depreciating currency initially worsens because (i) import prices rise quickly but import volume declines only slowly, and (ii) both export volume and export prices rise only slowly - is particularly long this time. However, as is evident from the figures in Box 2, not only did the volume of imports into the United States fail to decline slowly, they actually recorded a sharp increase in 1986.

Fourth, there is the argument that the realignment of exchange rates has not reduced the current account imbalances because the exchange rate changes have not had a significant influence on the macroeconomic factors which underlie the current account imbalances. Or, to put it slightly differently, the current account imbalances did not decline because the exchange rate changes were not backed-up by the needed changes in macroeconomic policies. It is this explanation that carries the most weight.

The macroeconomic roots of a current account imbalance can be illustrated by the example of the United States. In 1982, when the Federal government began borrowing heavily to finance its growing budget deficits, the level of savings by domestic residents (that is, household savings plus retained profits of firms) was still sufficient to finance both the desired level of domestic investment by United States firms and the government budget deficit. More or less the same situation held in 1983. But during the strong economic recovery in 1984 business investment by domestic firms increased very sharply (and by much more

¹IMF Survey, 9 February 1987. For a discussion of the methodology of estimating nominal and effective exchange rates, see Trade Relations Under Flexible Exchange Rates, GATT Studies in International Trade No. 8, 1980, pp. 61-68.

than their retained profits), and in 1985 and 1986 personal savings declined (from 4.5 per cent of GNP in 1984 to 3.6 and 2.7 per cent, respectively); meanwhile, the government budget deficit increased from 2.7 per cent of GNP in 1984 to 3.4 per cent in 1985 and 1986.

As private savings were not sufficient to meet the financing needs of both domestic investors and the government, the United States began borrowing savings from the rest of the world to cover the gap. Looking at the account books for the United States economy, it is apparent that the inflow of foreign savings (a surplus on international capital flows) was matched by a deficit on the current account. The borrowed savings allowed United States residents to buy more goods and services from foreigners than they sold to foreigners.

Against this background, the figures in Box 2 showing a strong growth in the volume of imports into the United States, despite the dollar's depreciation, are less puzzling. The low savings rate (which means a strong consumption demand) and the relatively strong investment demand, together with government spending in excess of tax revenue, are all contributing to a level of expenditure in excess of competitively produced output in the United States. The result is a continued strong demand for imports to make up the difference.

An obvious question to ask is why this "extra" demand is spilling over onto imports rather than being satisfied by domestic production, when - as in the United States at the present time - the unemployment rate and figures on factory capacity utilization rates seem to suggest that idle resources are available. The answer is that the simultaneous existence of unemployment and a current account deficit points strongly to the conclusion that the current capabilities of the idle workers and underutilized factories do not match the pattern of current demand for

BOX 2. - TRENDS IN THE VOLUME OF TRADE IN THE UNITED STATES,
JAPAN AND THE FEDERAL REPUBLIC OF GERMANY, 1985-86

(Percentage change over corresponding
period in previous year)

	United States		Japan		Germany, Fed. Rep.	
	X	M	X	M	X	M
1985	2.1	5.3	4.4	0.4	5.9	4.2
1986 ^a	4.1	13.5	-1.3	12.5	1.4	6.3
1986 Q ₁	0.5	13.0	-0.2	3.6	-0.8	2.8
Q ₂	0.0	11.6	-1.0	16.8	4.6	12.1
Q ₃	6.7	18.4	-0.3	18.7	0.7	3.7
Q ₄	9.4	10.6	-4.1	14.4	1.1	6.7

^aThe figures for 1986 are affected by unusually large shipments of non-monetary gold, in particular in the case of Japan and the United States. For example, it is estimated that the import figure for Japan excluding gold is about 9 per cent, rather than 12.5 per cent.

With one major exception, the trends in the volume of trade have begun to move in a direction consistent with the exchange rate realignment. The volume of US exports expanded faster in 1986 than in 1985, as a result of particularly strong growth in the third and fourth quarters. In Japan in 1986, export growth turned negative and there was a very strong growth in the volume of imports, while in the Federal Republic of Germany the volume of exports increased in 1986 at only one-quarter the 1985 rate, and the rate of growth of imports was one and a half times as strong as in 1985. The puzzling figures are those in the import column for the United States, which indicate that the volume of imports into the United States increased at a much faster rate in 1986 than in 1985. For a possible explanation, see main text.

The volume data on United States merchandise trade shown above are taken from national account statistics (Bureau of Economic Analysis) which continue to differ markedly from the volume data provided by the Bureau of the Census. For example, the Bureau of the Census reports a small decline in United States export volume last year. However, data from both sources show a recovery in export growth in the second half of 1986. Both sources also agree that there was high import growth (above 10 per cent for the year as a whole) in 1986, with some acceleration in the second half.

Source: National statistics and GATT Secretariat estimates.

goods and services. This could suggest that adjustment is being slowed down, for example, by a lack of managerial innovation and rigidities or inadequacies in training, mobility and wage structures.¹

Viewed in these terms, a successful effort to get a substantial and lasting reduction in the United States trade deficit must, one way or another, lead to some combination of three developments. These are: higher savings by domestic residents, lower domestic investment (which would mean fewer jobs and slower economic growth), and a smaller Federal budget deficit.

This raises the question of the impact of the depreciation of the dollar. To begin with, the depreciation will lead to upward pressure on the price level. It will also redistribute income to the export and import-competing sectors, and if their savings behaviour differs from that of the rest of the economy, the national savings rate will change. The pattern - and perhaps the overall level - of investment may also be affected.

This being said, it is still true that an exchange rate change can have a noticeable impact on the current account balance only if it has a noticeable impact on the difference between national savings on the one hand and, on the other, the demand for savings on the part of domestic

¹ It is not easy to predict the overall impact on the current account deficit of an increase in structural flexibility. There would be an increase in production in the United States, but total consumption would also increase because income would be higher. Some fraction of the additional income would be saved, and that would act to reduce the shortfall of domestic savings. However, if the improved working of the economy stimulated investment, the increase in investment would offset part (perhaps all) of the increase in savings. The impact via the Federal budget deficit is more straightforward - income tax revenue would increase and transfer payments to unemployed workers and their families would decline. The resulting decline in the budget deficit would act to reduce the current account deficit. In a different vein, it is clear that lower unemployment and increased capacity utilization would reduce the extent to which the current account deficit stimulated protectionist pressures.

investors and the government borrowing to finance its budget deficit. As of now, there is little empirical support for the claim that a depreciation of the dollar - by itself - would have such an impact.¹

It would be wrong, of course, to oversell the link between private savings, investment, and the government budget balance on the one hand and, on the other, the current account balance. Other factors obviously are at work, and no one should expect, for example, that cuts in the budget deficit will produce dollar-for-dollar reductions in the current account deficit.² But it is equally true that there is little in economic theory or experience to justify claims that significant reductions in the United States' current account deficit are possible without a significant realignment of the relationships between private savings, investment and the government budget deficit.

¹Exchange rate changes may also lead to changes in policies. The inflationary pressures associated with a strong depreciation may lead to a tightening of monetary and fiscal policies. A tighter monetary policy may curb investment and raise savings, while a tighter fiscal policy would reduce the government budget deficit, and thus the government's borrowing requirement. And in a country whose currency has appreciated strongly, the dampening effect on industries producing for export or competing against the now cheaper imports will generate domestic support for more expansionary macroeconomic policies.

²Included among these other factors are economic developments abroad. In particular, it has been suggested that an acceleration of economic growth in the Federal Republic of Germany and Japan by one or two percentage points would boost United States exports, because of increased demand for United States goods and services (i) from the two countries, and (ii) from third countries whose economies would be stimulated by accelerated economic expansion in the Federal Republic of Germany and Japan. However, while such a development could make a positive contribution to the general economic climate, it would contribute only modestly to reducing the United States current account deficit. That is, under the assumption that an acceleration of economic growth in the Federal Republic of Germany and Japan would result in a one percentage point extra growth of the world economy outside the United States, this would have only a very limited impact on the United States current account deficit for two reasons: first, any plausible increase in United States exports would be small in relation to the deficit (for example, if the foreigners' income elasticity of demand for United States exports is three, the increase in exports would be in the range of \$10-\$12 billion, compared to a 1986 current account deficit of \$140 billion); second, any acceleration of United States exports would stimulate the domestic economy which, in turn, would induce higher imports into the United States.

The considerations outlined above help to explain why it is likely that an increase in United States trade barriers would have little or no impact on the current account deficit. There is no reason to believe that increased trade barriers could noticeably increase savings (people would simply switch to other products, including products which the United States currently exports), reduce investment or noticeably lower the Federal budget deficit.¹ The basic cause - some combination of insufficient domestic savings and an excessive budget deficit - would remain.

Finally, this discussion highlights the extent to which current international issues interact with one another. An increase in the savings rate in the United States, or a major reduction in the budget deficit, could be expected not only to defuse protectionist pressures by reducing the United States current account deficit, but also to ease the debt crisis by bringing about lower (than otherwise) interest rates. The IMF has estimated that each 1 percentage point decline in interest rates reduces the developing countries' net interest payments by \$3½ billion.²

¹It is sometimes argued that an increase in import barriers which brings increased revenue to the government will reduce the current account deficit via its impact on the government budget deficit. In effect, the higher trade barriers are being advocated as a fiscal measure - that is, as a tax increase, similar to an increase in the tax on gasoline or liquor. But even on this basis, it is a poor policy. To begin with, while it causes the prices of both imports and domestically produced close substitutes to rise, the government collects revenue only on the imported versions. Second, because surcharges and other kinds of balance-of-payments-related trade barriers generally exempt many products (and sometimes some countries), the amount of additional revenue is likely to be relatively minor in relation to the budget deficit. Finally, experience suggests that it is not safe to assume that the level of government expenditure is independent of the level of tax revenue.

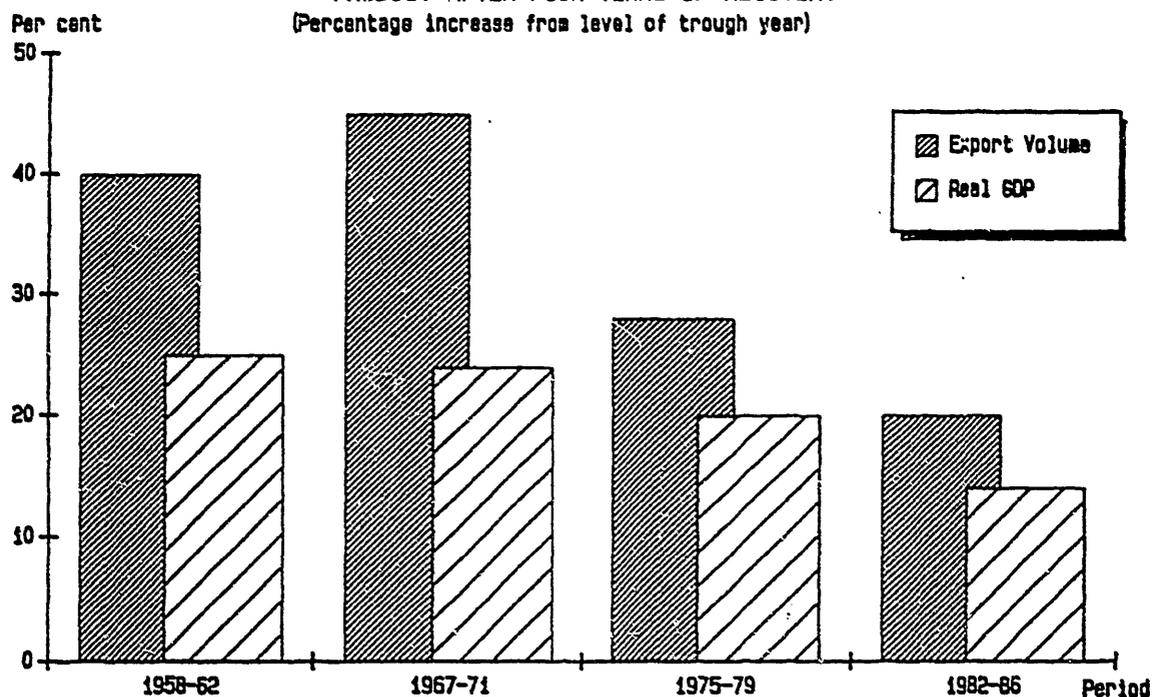
²IMF, World Economic Outlook, October 1986, p.15.

III. PROSPECTS

Last year was the fourth year of recovery from the 1982 recession. The growth of world trade and output has been weaker, however, than during the first four years of the recoveries from each of the three preceding troughs in world economic activity.¹ Indeed, there has been a tendency for each successive recovery to be weaker and shorter than the preceding one (Chart 6 and Appendix Chart 2).

Obviously, the future of the current recovery of the world economy cannot be charted by mechanically extrapolating past patterns. However, it would be a mistake to ignore (i) the likelihood that an important factor behind the tendency for recoveries to become weaker and shorter has been a growing mismatch between adjustment needs and adjustment capacity in the world economy, and (ii) that the inadequate pace of

CHART 6 - COMPARING THE STRENGTH OF RECOVERY PERIODS: WORLD EXPORT VOLUME AND WORLD REAL GROSS DOMESTIC PRODUCT AFTER FOUR YEARS OF RECOVERY
(Percentage increase from level of trough year)



Source: GATT Secretariat estimates.

¹The trough years are identified on the basis of developments in real gross domestic product. The 1967 trough took the form of a pronounced slowdown of world economic activity; world real GDP continued to grow at a 3½ per cent rate, with recessionary developments being pronounced in Western Europe and in some developing areas. In the three other trough years, in contrast, world real gross domestic product either stagnated (1958, 1975) or declined marginally (1982).

adjustment is the result of market rigidities which are to an important extent the result of trade barriers and subsidization.

Forecasts that were available late last year from a range of public and private institutions predicted that the world's real GDP would increase by about 3 per cent in 1987. Moreover, the great majority of forecasts pointed to remarkably balanced economic growth among the major country groupings:

- For the developed countries as a group, real gross domestic product is expected to increase by a little less than the rate predicted for the world economy on average. Among the major countries of this area, the rates of economic growth are expected to differ by not more than one percentage point.
- The developing areas as a group are expected to expand at about the same speed as the world economy on average. The predicted differences in growth performance range from $4\frac{1}{2}$ per cent for Asia, $3\frac{1}{2}$ per cent for heavily indebted Latin America to stagnation in the Middle East. The spectrum of economic growth among individual economies of the developing area is likely to be much wider, however.
- The Eastern trading area is expected to grow at the same $3\frac{1}{2}$ per cent rate as in 1986, that is somewhat more rapidly than the world economy as a whole.

In the light of recent developments, it seems likely that these forecasts indicate the upper rather than the lower bound of probable economic growth in 1987. More specifically, aside from the longer-term structural rigidities noted above, four major risks for the development of the world economy have recently become the focus of increased attention:

- Some West European countries and Japan have still to overcome fully the difficulties in adjusting their pattern of production and employment to the large changes in real exchange rates. In fact, growth forecasts for 1987 have been recently revised downward in a number of countries.

- In certain other countries, including in particular the United States, there is a risk of a sizeable increase in the inflation rate under the combined impact of a rapid expansion of the money supply and exchange rate depreciation. Such a development could worsen the business climate by increasing uncertainty and pushing up interest rates which, in turn, would adversely affect world trade.
- There are renewed concerns regarding debt management, both at the international level and at the level of private financial and non-financial firms in some countries. Adverse repercussions for the growth of world output and trade could develop rapidly if prolonged strains in that area had a major impact on confidence in financial markets.
- Finally, there is the danger that a continuation of the large current account deficit in the United States could trigger a tit-for-tat escalation of protection, leading to a massive shrinking of markets worldwide.

On the other hand, there is evidence that the export performance of the United States has improved and there is reason to believe that it will continue to do so. It also bears emphasis that, while difficulties remain, the countries whose currencies appreciated in real effective terms have already made substantial progress in adjusting to the new constellation of exchange rates. Similarly, petroleum-exporting countries have had time to adjust to the lower price of petroleum. Meanwhile, that lower price continues to be a stimulus to consumer demand in petroleum-importing countries.

With these points in mind, and in the absence of any dramatic change, the volume of world trade is likely to expand by about 2½ per cent in 1987.

APPENDIX TABLE - LEADING EXPORTERS AND IMPORTERS IN WORLD MERCHANDISE TRADE,
1985 AND 1986
(Percentages)

Exports (f.o.b.)					Imports (c.i.f.)				
Rank			Share in world exports		Rank			Share in world imports	
1986	1985		1986	1985	1986	1985		1986	1985
1	2	Germany, Fed. Rep.	11.5	9.6	1	1	United States	17.8	18.1
2	1	United States	10.3	11.1	2	2	Germany, Fed. Rep.	8.7	7.9
3	3	Japan	10.0	9.2	3	5	France	5.9	5.4
4	5	France	5.9	5.3	4	4	United Kingdom	5.8	5.4
5	4	United Kingdom	5.0	5.3	5	3	Japan	5.8	6.5
6	8	Italy	4.6	4.1	6	6	Italy	4.5	4.6
7	6	Canada	4.3	4.7	7	7	USSR ^a	4.1	4.1
8	7	USSR	4.1	4.5	8	8	Canada	3.9	4.1
9	9	Netherlands	3.8	3.6	9	9	Netherlands	3.4	3.3
10	10	Belgium-Luxembourg	3.3	2.8	10	10	Belgium-Luxembourg	3.1	2.8
11	11	Taiwan	1.9	1.6	11	11	China	2.0	2.1
12	17	Switzerland	1.8	1.4	12	13	Switzerland	1.9	1.5
13	12	Sweden	1.7	1.6	13	15	Hong Kong	1.6	1.5
14	13	Korea, Rep. of	1.7	1.6	14	14	Spain	1.6	1.5
15	14	Hong Kong	1.7	1.6	15	16	Sweden	1.5	1.4
16	16	China	1.5	1.4	16	12	Korea, Rep. of	1.5	1.6
17	20	Spain	1.3	1.3	17	20	German Dem. Rep. ^a	1.3	1.2
18	19	German Dem. Rep.	1.3	1.3	18	21	Austria	1.2	1.0
19	15	Saudi Arabia	1.2	1.4	19	19	Australia	1.2	1.3
20	27	Austria	1.1	0.9	20	17	Singapore	1.2	1.3
		<u>Total</u>	<u>78.0</u>	<u>74.3</u>			<u>Total</u>	<u>78.0</u>	<u>76.6</u>

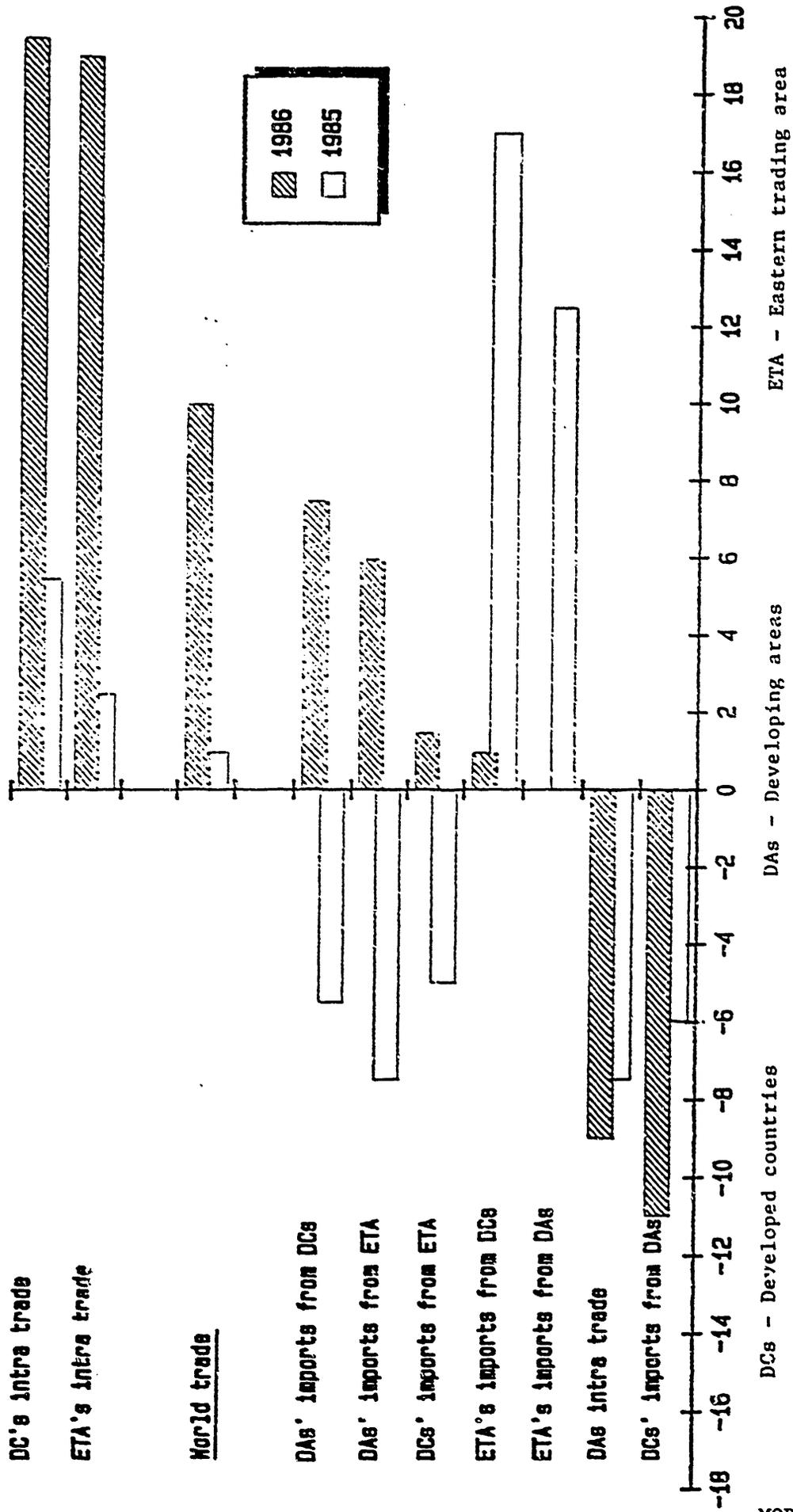
^aImports f.o.o.

Note: In most instances the data refer to "general trade", that is, the import data include imports for re-export, and the export data include those re-exports.

Source: IMF, International Financial Statistics, and GATT Secretariat estimates.

APPENDIX CHART 1 -- THE PATTERN OF WORLD MERCHANDISE TRADE,
1985 AND 1986

(Percentage change over preceding year in value)

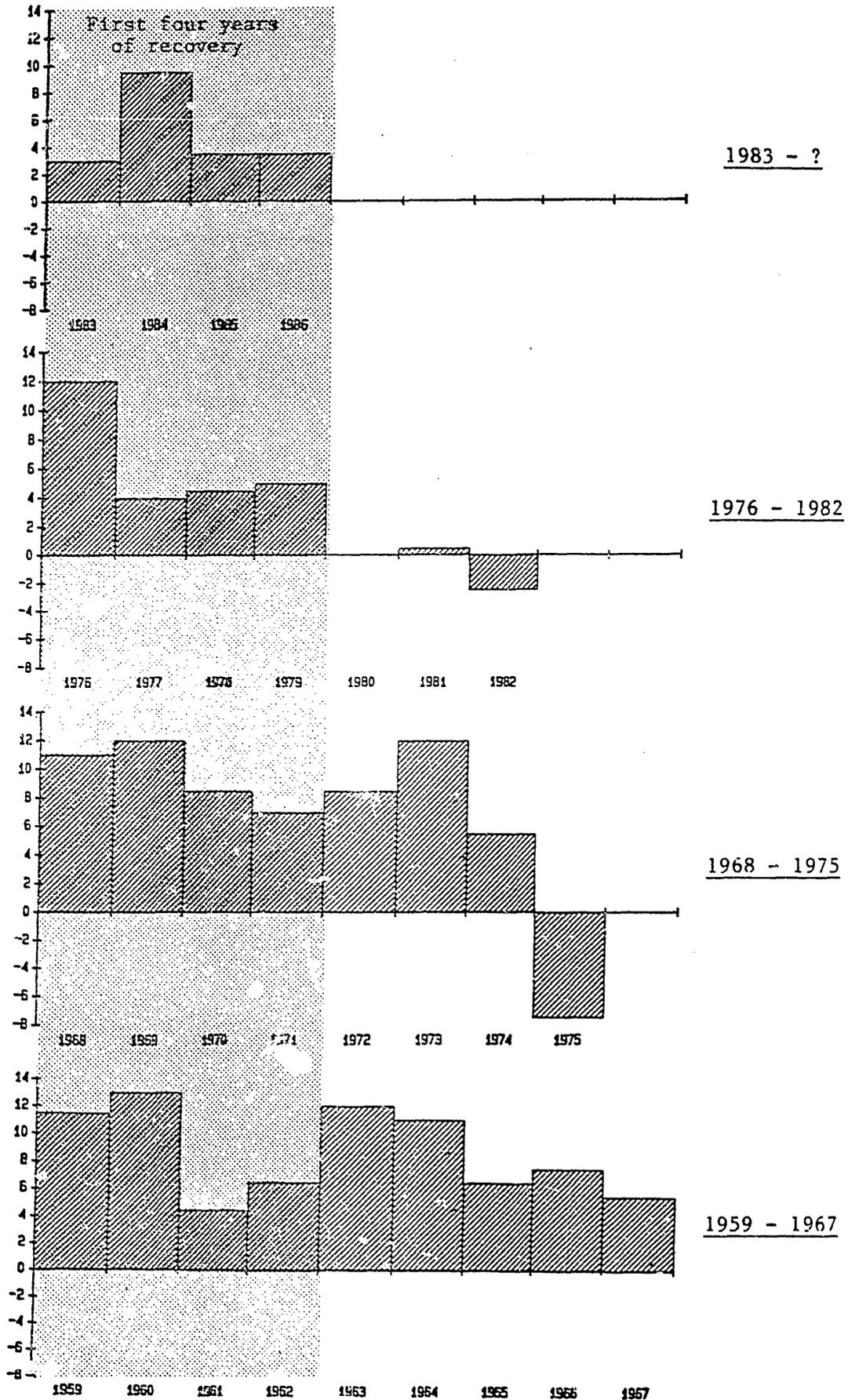


Source: GATT Secretariat estimates.

MORE

APPENDIX CHART 2 - THE PATTERN OF WORLD TRADE GROWTH
DURING SUCCESSIVE TRADE CYCLES, 1959 - 86

(Annual percentage change in world export volume)



Source: GATT Secretariat estimates.