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THE CURRENT ECONOMIC SITUATION

1. It is still too early to say anything definite about developments last year in many of the key variables of the international economy. Only indications of the likely orders of magnitude can be derived from the partial returns available. The need for timeliness in economic information must be set off against its desirable precision.

World trade

2. Preliminary figures suggest that there was zero growth (or perhaps a small decline) in the volume of world trade in 1981. Excluding exports of fuels, which declined by nearly 10 per cent, world trade grew by about 3 per cent, matching the gain recorded in 1980.

3. The dollar unit values of world exports are estimated to have declined by roughly 3 per cent in 1981, the rise of domestic prices of goods entering world trade being more than offset by the strong appreciation of the US dollar. Combined with the stagnant volume figure, this means that the dollar value of world trade declined in 1981 - the first such year-over-year decline since 1958.¹

4. As compared with the corresponding period of 1980, world export unit values of fuels increased by 12 per cent in the first nine months of 1981, while those of non-fuel primary products fell by 6 per cent. The decline was much more pronounced for unit values of exports by developing countries (11 per cent) than for exports from developed countries (3 per cent). Export unit values of manufactures exported by developed countries declined by 6 per cent in dollar terms.

5. Exports from the industrial countries expanded modestly in volume terms (2-3 per cent), in spite of sluggish growth of their mutual trade. Export performance among the industrial countries differed widely, from a decline of about 5 per cent in Australia to a 11 per cent gain in Japan. US exports declined by about 2-3 per cent in 1981 after a strong expansion in 1980 (+10 per cent). The exports of the EC grew by about 2 per cent. Despite an increase in United States imports of some 3 per cent, the volume of imports into the industrial countries as a group declined by an estimated 3 per cent in 1981. The terms of trade of the United States and Japan improved in 1981, as the estimated dollar unit values of their exports increased by more than import unit values; Western Europe's terms of trade, in contrast, worsened as dollar export unit values declined substantially more than those of imports.

¹In volume terms 1975 was a worse year for world trade than 1981; this is not apparent from the value figures because the change in unit values was very different in the two years (they increased in 1975 and declined in 1981). In 1975 the volume of total trade declined 1 per cent and the volume of trade excluding fuels declined 0.5 per cent.

6. Continuing gains in energy conservation, together with sluggish growth in the industrial countries, were the major causes behind a decline of about 18 per cent in the volume of OPEC's exports. Oil export prices tended to decline after mid-1981, with the result that total export earnings fell by an estimated 7-9 per cent. Large declines in export earnings experienced by Iraq and Iran (about 50 per cent), and by Nigeria and Libya (about 30 per cent) contrast with Saudi Arabia's export expansion of around 10 per cent in value terms. The OPEC countries remained the world's most dynamic import market in 1981, with imports growing by some 15-20 per cent in dollar value.

7. The value of exports by other developing countries is provisionally estimated to have increased by some 3-4 per cent in 1981, with a somewhat faster expansion in volume terms. Much of the increase derived from exports to the OPEC countries and to the USSR. Exports from developing countries to Western Europe declined. Only a few countries in Latin America and Asia (for example, Argentina, Brazil, Mexico, Korea and Pakistan) managed significantly to expand their export earnings. Imports by developing countries other than OPEC are estimated to have expanded in 1981 by about 5 per cent in value terms.

8. The growth of Eastern Trading Area's foreign trade slowed down markedly in 1981. Eastern Europe's trade declined slightly in dollar value, mainly due to developments in Poland, whose exports declined by 15 per cent in value and imports by 13 per cent. Data for the first nine months of 1981 also show a decline in the dollar value of Czechoslovakia's trade and of imports into Romania, as well as a stagnation of Hungary's trade. Imports from the industrial countries into Eastern Europe show a particularly pronounced decline.

9. In contrast to Eastern Europe, the Soviet Union's foreign trade expanded markedly in 1981, especially on the import side. During the first nine months of the year imports from developed market economies rose in dollar terms by 11 per cent over the year earlier level, while those from developing countries (excluding Cuba) were up by nearly one half, the increases in volume being even more pronounced. In value terms imports from Argentina more than doubled, making it the Soviet Union's leading non-CMEA supplier, followed by F.R. Germany. Imports from Brazil trebled and those from India rose by more than one half.

10. China's foreign trade also expanded at a relatively fast rate, with the dollar value of imports and exports estimated to have increased by 20 per cent and 15 per cent, respectively.

Domestic economic activity

11. The GDP of industrial countries as a group is estimated to have increased by perhaps 1 per cent in 1981, more or less the same rate of growth as in the preceding year. Industrial production, which stagnated in 1980, increased marginally in 1981, although it was declining again in the last quarter of the year.

12. In North America, a slight decline in GNP in 1980 was followed in 1981 by a recovery of about 2 per cent, despite a new contraction in the second half of the year. The recovery of industrial production, which started in the last quarter of 1980, came to an end in the third quarter of 1981; as a result, the level of industrial production recorded in 1981 was still somewhat below that of 1979. In Japan, the rise of GDP slowed down moderately from 4 per cent in 1980 to about 3¹/₂ per cent in 1981. In contrast to most other industrial countries, Japan's

domestic demand increased markedly less than GDP. The combined GDP of Western Europe, which had increased by $1\frac{1}{2}$ per cent in 1980, fell by about $1\frac{1}{2}$ per cent in 1981. In the EC countries, the rise of GDP was somewhat less pronounced in 1980, and its fall more pronounced in 1981, than in the other European countries. Industrial production in Western Europe, which stagnated in 1980, dropped an estimated 3 per cent in 1981.

13. Fragmentary information suggests that economic activity was generally sluggish in the developing countries which are not members of OPEC. Their aggregate GDP growth, which remained around the 4 to 5 per cent level in 1980, may have slowed to 3 per cent in 1981; if this estimate is confirmed by more complete data, the 1981 growth rate will be the lowest since 1955. It appears that the poor performance was concentrated in mining and manufacturing, while agricultural production expanded at the historically average rate. As usual, results varied enormously between individual countries: while actual declines in GDP are reported for Argentina and Brazil, the Mexican economy was booming at some 8 per cent and the Korean economy resumed a healthy growth rate.

14. Available indications suggest that for the Eastern Trading Area as a whole the expansion of aggregate production continued to slow down in 1981. There were, however, significant differences between Eastern Europe, the Soviet Union and China. In Eastern Europe, following two years of sluggish growth (2 per cent in 1979 and 1 per cent in 1980) overall production declined slightly in 1981, mainly as a result of the 15 per cent fall in Poland. Industrial production in the Soviet Union expanded by about 3 per cent in 1981, slightly less than in the preceding year. Agricultural output was again considerably below planned levels. In China the combined production of industry and agriculture increased in 1981 by 3 per cent. In line with the planned new pattern of development, favouring the expansion of the consumer goods sector, light industry production increased by 12 per cent whereas heavy industry's output declined by 5 per cent.

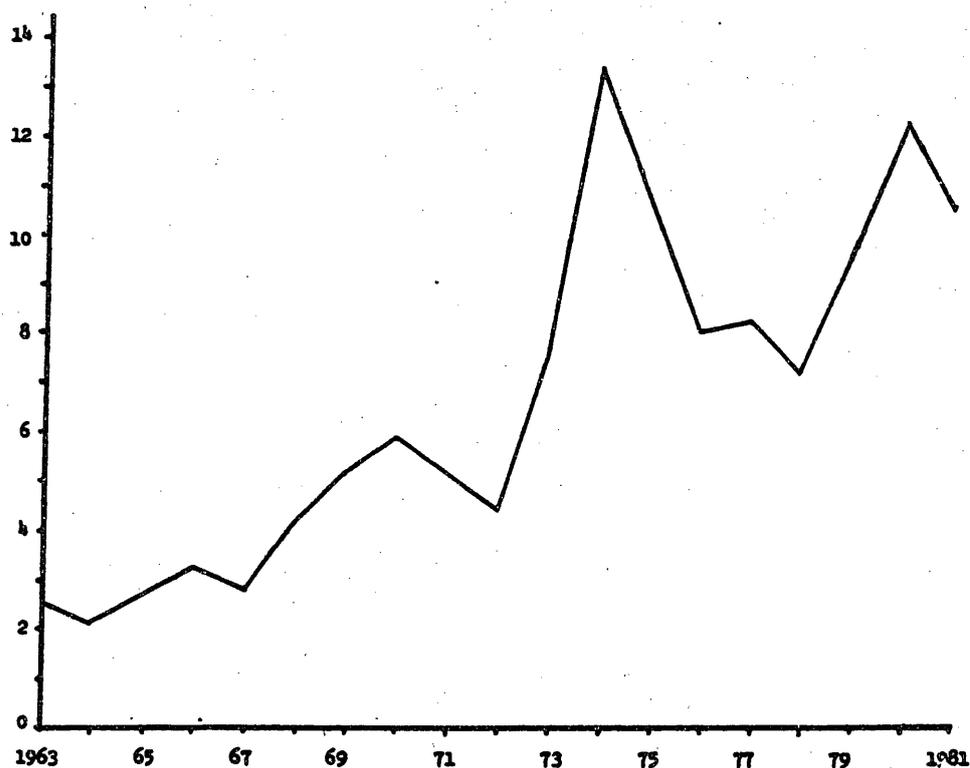
Unemployment

15. Unemployment rates continued to be affected by the interaction of increases in the labour force and the slow growth of output. In Western Europe the unemployment rate rose at an accelerating pace throughout 1980 and 1981. In North America, where unemployment had been declining since 1975, a sharp rise was recorded in the first half of 1980; the unemployment rate remained at this new level, or slightly below it, until September 1981, when it started to increase rapidly again. The average unemployment rate for the industrial countries as a group exceeded 7 per cent at the end of 1981, compared with a figure somewhat above 5 per cent at the peak of the 1975 recession.

Inflation

16. The increase in consumer prices in the industrial countries combined accelerated from 8 per cent in 1978 to 10 per cent in 1979 and 13 per cent in 1980. In the second half of 1980, the rate of increase began slowing down, and for 1981 the inflation rate is estimated to have been about $10\frac{1}{2}$ per cent. In the second half of 1981, the annual rate of inflation was slightly below 10 per cent. The deceleration was more pronounced in the United States (from $13\frac{1}{2}$ per cent in 1980 to about 10 per cent in 1981), than in the EC (from $12\frac{1}{2}$ per cent in 1980 to about 11 per cent in 1981). For the area as a whole, the rise in producers prices in the manufacturing sector showed a somewhat sharper slow down, from $14\frac{1}{2}$ per cent in 1980 to 10 per cent in 1981.

CHART I. — CONSUMER PRICES IN THE MAJOR INDUSTRIAL COUNTRIES^a
(Percentage changes from previous year)



^a United States, Canada, Japan, France, Federal Republic of Germany, Italy and the United Kingdom.

Sources: OECD, *Economic Outlook*; national statistics.

17. Chart I is an up-dated version of a chart which appeared in International Trade 1980/81. Our projection for the 1981 inflation rate, as indicated in the earlier version of the chart, was somewhat too optimistic. As the figures in the chart indicate, the fight to bring inflation under control is making progress. At the same time, it is clear that the return to a reasonable price stability has only begun, and that the most recent decline in the rate of inflation is proceeding less rapidly than the descent from the preceding peak in 1973. In the developing countries, where the average inflation is roughly estimated to have been in the 35 per cent range in 1981, the descent has hardly begun.

Current account balances and international capital flows

18. The largest changes in estimated current account balances between 1980 and 1981 occurred in the aggregate balances of the industrial countries and OPEC.¹ The deficit (including official transfers) of the industrial countries declined by more than a half, from about \$75 billion to an estimated \$35 billion, while the OPEC surplus fell by nearly one-half, from \$110 billion to \$60 billion. The deficit of the other developing countries, in contrast, is estimated to have

¹The current account figures are taken from the Economic Outlook, (OECD) December 1981.

increased by about \$8 billion (to \$68 billion). An important note of caution regarding these figures is in order, however. Between 1980 and 1981 the already very large "errors and omissions" figure associated with these estimates nearly doubled, from \$25 to \$45 billion. Thus the figures for the four areas indicate only the direction of change.

19. Looking to the future, one of the most important factors to influence the pattern of international payments is the expectation of a decline in the OPEC current account surplus. Some financial market analysts estimate that the OPEC countries as a group may be net borrowers on the international capital market before the middle of the decade (in this connection, it should be added that analysts have not been notably successful in their past efforts to forecast the OPEC current account balance). If the anticipated decline does occur, it would set in motion a number of adjustments. Many of the oil-importing countries would find their current account deficits reduced and the rapid growth of imports into the OPEC area could be expected to slow down; furthermore, to the extent that a reduced surplus led to a lower level of world saving, the global level of (real) interest rates would, other things constant, receive an upward impetus.

20. A second important factor in the international financial situation is the foreign indebtedness of the developing and the East European countries. Estimates of the gross foreign indebtedness of the developing countries to commercial and public lenders combined show the debt of OPEC members increasing from \$78 billion at the end of 1980 to \$94 billion at the end of 1981; the comparable figures for other developing countries are \$378 billion and \$430 billion, respectively. The level of new borrowing from commercial sources by developing countries which are not members of OPEC is estimated to have increased from \$26 billion in 1980 to \$37 billion in 1981; new borrowing by OPEC members in 1981 totalled an estimated \$12 billion, virtually unchanged from the two preceding years.

21. The net foreign debt of the East European countries (excluding the USSR) is estimated to have been \$57 billion at the end of 1980, with Poland accounting for approximately \$24 billion of the total. New borrowings from commercial sources apparently were very limited in 1981 (about \$1.5 billion for the area as a whole, compared with \$3 billion and \$7¹/₂ billion in the two preceding years).

22. The reduced borrowing is due in large part to the current account difficulties recently experienced by the East European countries in their trade with developed market economies - difficulties stemming primarily from (i) the slow rise in their export earnings, due to a variety of factors on both the supply and the demand side; (ii) the deterioration in their terms of trade resulting primarily from the sharp rise of energy prices in world markets; and (iii) the growing payments of interest and amortization resulting from the large debts contracted in earlier years, a problem aggravated by the strong rise in interest rates in 1981. In Poland already in 1980 the debt service to Western countries was almost as large as total exports to the creditor countries.

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¹ Figures on foreign indebtedness and borrowing have been taken from the following sources: Economic Bulletin for Europe (E.C.E.), vol. 33, 1981; World Financial Markets (Morgan Guaranty Trust Company), December 1981; Development co-operation (OECD), 1981 Review. The cautionary note concerning the accuracy of the current account estimates applies fully to these estimates.

23. These summary results explain the sombre tone of business news throughout the past year. Since last fall, however, readers of business pages must have been struck by a pronounced increase in the frequency of headlines reporting trade conflicts and crisis meetings, and raising doubts about the viability of the international trade system as a whole. It is important to think of the effect this general tone exerts on the investment decisions of business.

24. The role of inflationary expectations is now generally accepted as one of the crucial factors in monetary theory and policy. It is logical to consider economic expectations in other directions - expectations as to aggregate demand, access to markets abroad, and as to policies affecting the adjustment of industrial structures - to have equally important effects on actual economic developments. Businesses operate on the basis of plans they have made for the future; thus all economic change has to be first imagined and expected by someone. There is little room for improvisation in business decisions. Even small and medium size corporations have to plan in relatively long time horizons - at least five years for relatively routine improvements in the production process (for that is, roughly, the average depreciation period for machinery) and up to twenty years for major changes in production strategy (such as are called for in major restructuring of troubled industries).

25. Events of recent months show clearly that protectionist tendencies, far from being stemmed, are still on the increase. Import-limiting measures are generally defended by the intention to provide certain industries in need of more or less extensive readjustment with a firmer framework of expectations on the basis of which their corrective investments may be decided. There are, however, serious reasons to doubt the effectiveness of this approach.

26. First, the protective systems which have been built for particular industries in recent years are themselves not stable but continuously improvised. Admittedly they may temporarily increase the profits of the beneficiary industries - albeit only at the cost of the potentially most dynamic firms in them, as well as at the cost of other industries and final consumers. They are, however, inherently incapable of providing the kind of stability of expectations that is needed for planning and carrying out the long-term investments required for basic readjustment of an ailing industry.

27. Second, and more important, a world economy in which a number of improvised protection systems tailored to the needs of particular industries are in effect does not operate as a coherent market. In consequence, the information on relative price and demand trends, which is essential for the planning of viable industrial adjustment, is simply not available. Relations between industries are known to be distorted and only wild guesses can be made as to what these relations would be in more normal conditions with less protection. Businesses invest mostly other people's money, and no responsible firm can commit long-term funds on a wild guess. Thus both productivity and profitability remain depressed for lack of long-term investment, and the resulting economic malaise strengthens the demand for the impossible - namely, for more secure protection. Thus also the level of uncertainty continues rising.

28. A leading government official was recently quoted in the press as saying that protectionism is no longer a possibility but a probability. Industrial firms, most of them at least partly dependent on foreign markets, are asking before they invest what the state of the world economy may be in three or five years' time if the present trade policy trends continue. This should also be a matter of concern to those responsible for national economic policies.