

The first chapter in full

from

INTERNATIONAL TRADE 1986/87

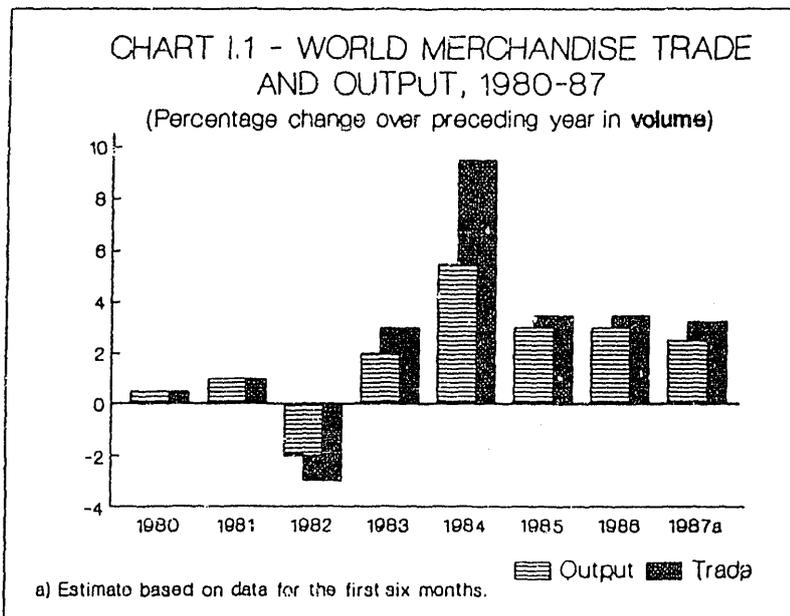
GATT

Geneva, SEPTEMBER 25, 1987

I. DEVELOPMENTS IN WORLD MERCHANDISE TRADE

TRADE VOLUME

The volume of world merchandise trade is estimated to have increased by 3½ per cent in 1986 (Chart I.1). This increase just matched the growth in 1985, and brought the volume of world merchandise trade to a new record level.¹ The index of world merchandise trade volume reached 195 last year, from a base of 100 in 1970, indicating that the volume of world merchandise trade has nearly doubled in the past sixteen years.



¹ Most statistics on merchandise trade flows are value figures, typically expressed in US dollars when the purpose is to aggregate or compare the trade of two or more countries. In some cases, it is also possible to estimate year-to-year changes in the volume of merchandise trade, by adjusting the value figures for estimated changes in dollar unit values. However, this is necessarily an imprecise process (especially during periods of large inflation differentials between the major countries, or when there are large changes in exchange rates or in the relative prices of major products), and the resulting volume estimates are useful primarily as a rough guide to year-to-year changes.

When both volume and value data are available, the decision as to which is the more relevant series depends on the issue being analysed. For example, the volume figures generally are a better guide to developments which influence levels of capacity utilization and employment, while the value figures are more relevant to financial considerations, for example in evaluating a country's debt servicing capacity.

The 3½ per cent estimate for the increase in the volume of world merchandise trade in 1986 is noticeably smaller than the 4.9 per cent estimate of the International Monetary Fund (the GATT and IMF estimates for the increase in 1985 are quite similar). The difference is due primarily to different estimates for the trade of the United States and countries in Eastern Europe (see Table I.2 below regarding differences in the US data).

The volume of world merchandise production expanded last year at the same 3 per cent rate as in 1985. In the past two years, the excess of trade growth over output growth has narrowed to half a percentage point. This margin had already fallen from 2½ percentage points in the 1960s to a 1 percentage point in the 1970s.

Preliminary information for the first half of 1987 indicates that world merchandise trade has been growing at close to the 3½ per cent rate recorded last year.

Trade by major product group

Table I.1 shows estimates of changes in the volume of trade in broad product categories.¹ Stimulated by the sharp drop in petroleum prices, the volume of petroleum trade increased by 8 per cent in 1986. Trade in other mining products was up an estimated 3 per cent in volume. Together, these two developments boosted the volume of trade in mining products by 7½ per cent, the largest one-year gain since 1973. Last year's increase brought the volume of trade in mining products back to the (pre-recession) 1981 level.

¹ As in the past, this Report deals with trade in merchandise - that is, trade in goods. However, a general indication of the relative importance of overall trade in services for selected countries is given in the Appendix Tables (not published with this Press Release). The available statistics on international services transactions have many shortcomings that make them far less comprehensive and reliable than data on merchandise trade. The United Nations Statistical Office, the International Monetary Fund, the OECD and other international organizations, as well as national bodies, are working to improve the methodology and practice of recording statistics on trade in services. Improving the basic source material is, however, a long-term exercise. Attempts are also being made to consolidate and re-organize existing information to provide a clearer picture in the short term of the value and structure of international services transactions.

TABLE I.1 - GROWTH OF THE VOLUME OF WORLD MERCHANDISE TRADE AND PRODUCTION
BY MAJOR PRODUCT GROUP, 1960-86
(Average annual percentage change)

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

Source: Secretariat estimates.

Up-to-date estimates of changes in the volume of world trade and output of agricultural products always present particular statistical problems. Therefore, the estimates for last year - that the volume of world trade in agricultural products declined by 1 per cent, while production increased by 1 per cent - should be considered very preliminary.

Manufactured goods account for the largest share of world merchandise trade (on a value basis, more than two-thirds). Trade in these products is also usually the fastest growing of the three categories. Last year, however, trade in manufactures yielded first place to mining products. The estimated 3 per cent increase in volume represented a considerable slowdown in the growth of trade in

manufactured goods from the previous year, and was well below the 4½ per cent average yearly gain thus far in the 1980s.¹

The slowdown of the growth of world trade in manufactures last year appears to have been the result of a variety of factors, including:

- There was an asymmetric response to the large movements in real effective exchange rates since March 1985. While production and export activity in countries whose currencies appreciated was dampened considerably in 1986, the export performance of the industrial countries whose exchange rates depreciated showed little or no improvement (Box I.1). The eight countries shown in the Box whose currencies appreciated in real effective terms accounted for 51 per cent of world exports of manufactured goods last year, while the three industrial countries whose currencies depreciated in real effective terms accounted for 19 per cent.

- The volume of imports of manufactures by the members of OPEC, which in 1985 accounted for 6 per cent of world imports of manufactures, fell by roughly one-fifth last year. This was part of the on-going adjustment to declining foreign exchange earnings, the most recent being the decline from \$155 billion in 1985 to \$118 billion in 1986 (in 1980, their total foreign exchange earnings were \$299 billion).

¹The slowdown in the volume growth of exports of manufactures is particularly noteworthy because it is not primarily the result of a slowdown in world economic activity. The growth of real gross domestic product for the industrial countries as a group declined by only half a percentage point (to 2½ per cent) in 1986. Among the industrial countries, a major slowdown in economic growth was recorded only in Australia and Japan, while Turkey and Iceland recorded a major acceleration in economic growth between 1985 and 1986. Among the developing areas, the differences in economic growth performance were again much wider than in the industrial countries. For example, the Republic of Korea recorded a 12 per cent increase of real GDP in 1986, after a 5 per cent gain in 1985; Mexico, in contrast, recorded a decline in real GDP of 3 per cent, following an increase of 2½ per cent in 1985.

BOX I.1. - REAL EFFECTIVE EXCHANGE RATES AND EXPORT VOLUMES OF SELECTED ECONOMIES, 1985-86

(Percentage change over preceding year)

Three exchange rate concepts are widely used, depending on the aim of measurement. The nominal exchange rate typically indicates the price of a foreign currency in terms of the domestic currency, for example 1.80 DM per US dollar. The nominal effective exchange rate is a trade-weighted index of the bilateral exchange rates between the domestic currency and the currencies of trading partners (in standard estimates, only major trading partners are taken into account). To obtain the real effective exchange rate, the nominal effective exchange rate is adjusted for differences in inflation rates between the domestic economy and those same trading partners. The latter is the most accurate measure of changes in a country's price competitiveness against its trading partners as a group.

	Real effective exchange rate		Export volume	
	1985	1986	1985	1986
Japan	-1	22	4½	-1½
Switzerland	-2	10	8	3½
Germany, Fed. Rep.	-1	9	6	1½
Netherlands	-1	7	4½	2½
Austria	0	4½	9½	-1
France	3½	4½	2½	-1
Italy	-1	4½	7½	2
Belgium	-½	½	3½	8
Sweden	1	0	3	3
Canada	-3½	-4½	4	4
United Kingdom	3	-4½	7	4
Taiwan	-2½	-6	5½	25
Hong Kong	4	-9	6	15
United States	4	-13½	-2	-1
Korea, Rep. of	-7½	-15	7½	13

Evidence from leading exporters of manufactures indicates an asymmetric response to the large movements in real effective exchange rates in 1986. There was a marked decline in the growth of total export volume, or even a change from growth to decline in export volume, in the economies which experienced a real appreciation of their exchange rates, with Belgium being the only exception. In contrast, the export stimulating effect of a real depreciation is evident only in the export performance of the developing areas. In the case of the industrial countries, real depreciations did not improve export performance (United Kingdom, Canada), or only slightly lowered the rate of decline of export volume (United States). It remains to be seen whether the full response to the stimulus from currency depreciation is only delayed or whether there exist also supply bottlenecks or non-tariff trade barriers which could be playing a role.

Basically the same asymmetric response to the movements in real effective exchange rates is observable on the import side. In particular, stimulated by real effective exchange rate appreciation, the growth of import volume accelerated in Japan, Switzerland, the Federal Republic of Germany, France and Belgium last year. However, an acceleration of the growth of import volume was also recorded in Canada, the United Kingdom, Taiwan, Hong Kong, the United States and the Republic of Korea despite the dampening effect on import volume of a real effective depreciation. In these cases, the changes in relative prices which favoured domestically produced import-substitutes and non-tradeable goods appear to have been out-weighted by a relatively strong expansion of domestic demand, including demand for imports.

[Note: The above economies are the fifteen leading market-economy exporters of manufactures for which relevant data were available, ranked according to the exchange rate changes in 1986. The data on changes in real effective exchange rates are calculated on the basis of indices published by the Morgan Guaranty Trust Company in World Financial Markets. Positive figures indicate real appreciations and negative figures real depreciations. The figures for the percentage change in export volume for the United States are Bureau of the Census figures, and are not the same as the figures published by the Bureau of Economic Analysis; see Table I.2 below.]

- The volume of imports of manufactures into the developing areas which are not members of OPEC declined by an estimated 2 per cent in 1986 (these imports currently represent about 15 per cent of world imports of manufactured goods). The import capacity of many non-petroleum primary commodity producers, including in particular many least developed countries, continued to suffer from falling or low commodity prices in 1986 and thus a shortage of hard currency earnings. For some of the heavily indebted developing countries, a fall in foreign exchange earnings coincided with increasing debt service obligations.

Turning to the first half of 1987, the US dollar, and a number of currencies pegged to it, have continued to depreciate against many West European currencies and the yen in the first half of 1987.¹ To the extent that this latest change in exchange rates was subject to the same asymmetric response noted earlier, it would help explain the sluggish performance of manufactured exports from Japan and the Federal Republic of Germany in the first half of 1987. (Table I.2).

At the same time, petroleum prices have been fluctuating about a rising trend, and in early September stood at around \$18 per barrel. There are also signs that the post-1979 price decline for a number of non-fuel primary commodities is bottoming out - indeed, for some of these commodities, major price increases have been recorded recently.² These particular developments are likely to improve economic conditions in developing areas whose foreign exchange earnings are heavily dependent on exports of primary commodities, and thus could stimulate their imports of manufactures.

¹The average real effective exchange rates of the dollar, the yen and the deutsche mark during the period May through July 1987 (the latest three months for which estimates are available), relative to their average levels for 1986 as a whole, were as follows: the dollar was down 7½ per cent; the yen was up 3½ per cent; and the deutsche mark was up 4 per cent.

²See Chapter II (not published with this Press Release).

Trends in the three leading trading nations

Estimates of trends in the volume of merchandise trade indicate that, along with the large movements in exchange rates since early 1985, major trade adjustments have been taking place in Japan and the Federal Republic of Germany (Table I.2). Between 1985 and 1986, the growth in the volume of imports increased in both countries (especially in Japan), and export growth either slowed (Federal Republic of Germany) or turned negative (Japan).

The situation in the United States, where the dollar's depreciation was expected to stimulate exports and restrain import demand, was more mixed in 1986. Both sets of official figures in Table I.2 suggest that the volume of exports from the United States responded modestly to the stimulus from the improved position of US producers vis-a-vis foreign competitors.¹ However, they also suggest that the growth in the volume of imports into the United States accelerated rather than declined last year.

Estimates of the corresponding volume figures for the three countries in the first half of 1987 also show a somewhat mixed situation. The United States' trade performance has moved more into line with expectations, as the growth in import volume declined from the 1986 level and the growth in the volume of exports picked up (very strongly, if subsequent data confirm the preliminary estimates for the second quarter).

The marginal increase in the United States merchandise trade deficit in the first half of 1987 relative to the first half of 1986 (\$77 billion versus \$76 billion) - despite the trends in export and import volume - results mainly from the fact that in 1986 the value of US exports was about 40 per cent smaller than the value of imports. In this situation, the favourable volume changes were too small to prevent a further increase in the dollar value of the deficit.

¹As is evident from the figures in Table I.2, estimates of changes in the volume of United States merchandise exports and imports continue to differ according to the source used. Apart from differences in product coverage, in the dates at which transactions are recorded, and in the index formulas and base years used, the BEA series relies less heavily on estimates of unit values in the course of converting value estimates into volume estimates. Because they are available on a more disaggregated basis, this Report uses the trade figures published by the Bureau of the Census.

TABLE I.2 - MERCHANDISE TRADE VOLUME IN THE UNITED STATES,
JAPAN AND THE FEDERAL REPUBLIC OF GERMANY, 1985-1987
(Percentage change over corresponding period of previous year)

	United States				Japan		Germany, Fed. Rep.		
	Exports		Imports		Exports	Imports	Exports	Imports	
	<u>BC</u>	<u>BEA</u>	<u>BC</u>	<u>BEA</u>					
1985	-1.8	2.1	8.7	5.3	4.4	0.4	5.9	4.2	
1986	-1.0	4.4	10.6	13.5	-1.3	12.5	1.3	6.1	
1986	Q1	-3.8	0.5	13.1	13.0	-0.2	3.6	2.3	5.3
	Q2	-3.5	0.0	7.7	12.2	-1.0	16.7	1.9	9.5
	Q3	0.8	6.7	13.9	18.3	-0.2	18.6	0.4	3.5
	Q4	5.1	10.5	8.6	10.5	-4.1	14.4	0.1	5.7
1987	Q1	3.3	9.8	-0.6	9.0	0	8.1	-1.7	2.3
	Q2	15.0e	13.9	3.5e	3.9	-3.9	3.6	1.8	4.3

Note: U.S. Department of Commerce: BC = Bureau of the Census.
BEA = Bureau of Economic Analysis. An "e" indicates
Secretariat estimate. The quarterly BEA figures for the United
States and the quarterly figures for the Federal Republic of
Germany are seasonally adjusted.

The figures for Japan continue to indicate a decline in export volume, but also a slowing down in the growth of import volume in the first half of this year. However, the slowdown in the growth of import volume is the result of wide fluctuations in imports of gold. If gold is excluded from the trade figures, the increase in merchandise imports into Japan in the first half of this year is 10 per cent above the corresponding period of the previous year (for 1986 as a whole, the increase in import volume, excluding gold, is estimated to have been 9 per cent, rather than the 12.5 per cent shown in Table I.2).

In the case of the Federal Republic of Germany, import and export performance weakened in the first quarter of this year. As the level of overall economic activity picked-up in the second quarter (in part as a result of a modest recovery in the volume of exports) the growth in import volume also picked-up.

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DEVELOPMENTS IN TRADE VALUE

The value of world merchandise trade increased by an estimated 10 per cent in 1986 to \$2,120 billion, also a new record level (Table I.3). This increase is the net result of three effects, two of which pushed in an upward direction and one in a downward direction: (i) the 3½ per cent increase in world merchandise trade volume noted above; (ii) an estimated 16 per cent increase in trade value due to the valuation effect stemming from the depreciation of the US dollar against other major currencies, and (iii) an estimated 8½ per cent decline in national currency prices of internationally traded goods.¹

Various factors contributed to the decline in national currency prices of merchandise entering world markets last year. Many exporters located in countries whose currencies appreciated against the US dollar (and against other currencies pegged to the dollar) rationalized costs and profit margins in an attempt to remain competitive abroad. Another factor was the sharp decline in petroleum prices, from an average of about \$27 per barrel in 1985 to an average of \$15 in 1986.

Value of trade by product group

As regards trade by major product group, the dollar value of exports of agricultural products expanded somewhat more rapidly than world merchandise trade on average (Table I.3). This development reflects the fact that the 1 per cent decline in the volume of world trade in agricultural products noted above was more than offset by an

¹Although it is possible to decompose the net change in trade value into a quantity effect, a valuation effect and a price effect, it should be kept in mind that the effects are not independent - that is, they interact - particularly beyond the short-run. As regards the valuation effect it is important to note that in the first instance it is a purely "mechanical" effect. It is defined as the difference between (i) the sum of countries' exports translated into US dollars at the 1986 average exchange rate and (ii) the sum of countries' exports translated into dollars at the preceding year's average exchange rate, expressed as a percentage of the latter. The estimated 16 per cent valuation effect in 1986 is only a rough estimate, based on calculations involving the twenty leading exporting countries (which currently account for about three-quarters of world merchandise trade).

estimated 12½ per cent increase in the dollar unit value of world exports of agricultural products.¹

TABLE I.3 - VALUE OF WORLD MERCHANDISE EXPORTS BY
MAJOR PRODUCT GROUP, 1985 AND 1986
(Billion dollars and percentage change)

	Billion dollars		Percentage change over preceding year	
	1985	1986	1985	1986
Agriculture	267	298	-4½	11½
Fuels	359	272	-5	-24½
Mining, excl. fuels	70	73	-5	4
Manufacturing	1 190	1 430	4½	20
<u>All merchandise</u> ^a	1 925	2 120	1	10

^aIncludes products and merchandise transactions not elsewhere specified.

In 1986 the dollar value of trade in fuels declined for the fifth year in a row, as the strong 7½ per cent increase in the volume of trade was more than offset by the much larger 30 per cent decline in dollar unit values. Exports of non-fuel mining products, in contrast, were up last year, but the 4 per cent increase was less than one-half the increase in the dollar value of total merchandise trade.

¹See Chapter II for an analysis of trade developments in agriculture (not published with this Press Release).

TABLE I.4. - PERFORMANCE OF SELECTED MERCHANDISE TRADE FLOWS AS COMPARED
TO THE PERFORMANCE OF TOTAL WORLD MERCHANDISE TRADE, 1986

(Percentage change in value over 1985)

<u>Performed better than total world trade</u>			
			Clothing 27
			Other consumer goods 26½
			Road motor vehicles 24½
			Machinery for specialized industries 23
Developed countries'	Western Europe's		Other semi-manufactures 22½
total exports	total exports	21½	Household appliances 21½
			Textiles 21½
	Asia's total exports	13½	Office and tele-communications equipment 21
			Chemicals 16½
			Other machinery and transport equipment 16
<u>Performed about the same as total world trade</u>			
			Food 12½
Eastern trading area's	Eastern Europe and the		Raw materials 9
total exports ^a	USSR's total exports	9	Non-ferrous metals 8
<u>Performed worse than total world trade</u>			
	North America's total		
	exports	½	Iron and steel 6
Developing areas'	Latin America's total		Ores and minerals ½
total exports	exports	-12½	Fuels -24½
	Africa's total exports	-17½	
	Middle East's total		
	exports	-19½	

^aThe Eastern trading area is composed of the East European countries, the USSR, China and other centrally planned economies in Asia.

Source: Secretariat estimates.

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Despite the modest increase in volume, the dollar value of world exports of manufactures increased by an estimated 20 per cent last year (Table I.3). As may be seen in Table I.4, clothing, other consumer goods (a group which includes such items as footwear, furniture, and printed matters), road motor vehicles and machinery for specialized industries were among the fastest growing product groups last year in value terms. Trade in four other categories of manufactures, ranging from other semi-manufactures (such as paper and rubber) to office and tele-communications equipment increased twice as rapidly as total merchandise trade. Among manufactured products, only trade in iron and steel had a rate of growth below that of total trade.

Regional trade developments

Turning to developments in the three major areas of the world economy, it is apparent from Chart I.2 and Table I.5 that the industrial countries as a group recorded a strong increase in merchandise trade last year, while the Eastern trading area reported gains in line with the increase for world trade as a whole. In both instances, the dollar values of the merchandise trade were strongly inflated by the appreciation of a large number of currencies against the dollar.

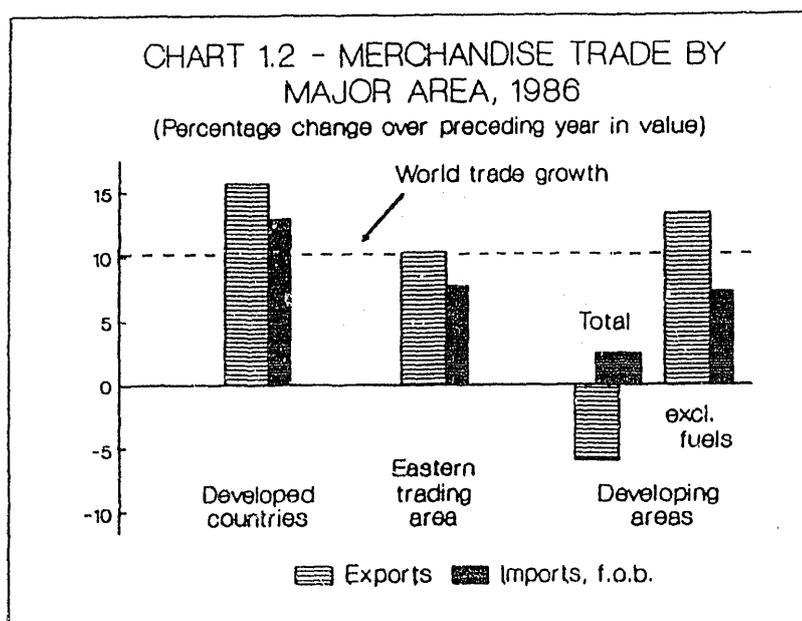


TABLE I.5 - WORLD MERCHANDISE TRADE BY MAJOR AREAS, 1985 and 1986
(Billion dollars)

	<u>EXPORTS (f.o.b.)</u>		<u>IMPORTS (f.o.b.)</u>	
	1985	1986	1985	1986
Developed countries	1 275	1 475	1 310	1 480
Developing areas (excl. fuels)	440 (240)	415 (275)	410 (340)	420 (365)
Eastern trading area	210	230	205	220
<u>World</u>	<u>1 925</u>	<u>2 120</u>	<u>1 925</u>	<u>2 120</u>

The dollar value of total merchandise exports of the developing areas fell by about 6 per cent in 1986, while their merchandise imports increased moderately. If fuels are excluded (they accounted for about one-third of the developing areas' total merchandise exports last year), the picture changes considerably, with exports up nearly 15 per cent and imports up more than 7 per cent.

Exports of fuels from developing areas in 1986 were \$59 billion below the 1985 level, a decline of 30 per cent.¹ In this connection, it should be noted that only a limited number of developing countries depend heavily on fuel exports for their foreign exchange earnings, and that of these only a few have large populations and low per capita incomes. For the many developing areas which are net fuel importers, lower fuel prices are a benefit.

¹The decline in world market petroleum prices has also had a noticeable impact on the export earnings of other countries, notably Norway, the United Kingdom and the USSR. In Norway's case, it was particularly serious because export earnings from fuels account for nearly 20 per cent of national income - a ratio higher than that of Mexico or Indonesia.

The developing areas' dollar earnings from exports of non-fuel primary commodities, currently one-quarter of their total export earnings, increased last year by an estimated 8 per cent. However, the dollar value of exports of these commodities from developing areas was still 5 per cent below the 1980 level, a development which is particularly worrying in view of the fact that many of the least developed countries are still highly dependent on exports of non-fuel primary commodities.¹

Although the 17 per cent increase in the dollar value of the developing areas' exports of manufactures in 1986 was somewhat below the 20 per cent increase for the world as a whole, it helped to raise the share of manufactures in their total merchandise exports to 40 per cent, as against 19 per cent in 1980. The result was that for the first time ever, they earned more foreign exchange from exports of manufactures than from exports of agricultural products or mining products. It is true that this doubling of the share of manufactures in their total exports is explained in part by the absolute decline in earnings from fuels. But it also reflects a rapid growth of the dollar value of manufactured exports - at an average annual rate of 8 per cent between 1980 and 1986, that is, almost twice the 4½ per cent growth rate for total world exports of manufactures.

As is well known, a small number of exporters account for most of the exports of manufactures from developing areas. However, thus far in the 1980s the rapid trade expansion has not been limited to the five leading exporters and, in consequence, a growing number of developing areas are becoming significant exporters of manufactures (Table I.6).

More detailed data reveal a high degree of variation in trade developments in the seven regional groups. As is apparent from the figures in Table I.4, only two regions - Western Europe and Asia - recorded relatively strong export growth in 1986. In contrast, the dollar value of exports from North America, Latin America, Africa and the Middle East declined last year, the latter three trade flows

¹IMF figures on the "real" prices of non-fuel primary commodities exported by developing countries (that is, dollar prices deflated by an index of export unit values for manufactures of developed countries), show a 30 per cent decline between 1980 and 1986, bringing the index to its lowest level since the 1930s. See World Economic Outlook, April 1987, p.94. However, since the beginning of 1987, a number of prices for non-fuel primary commodities, including cotton and wool, have been increasing significantly.

TABLE I.6 - EXPORTS OF MANUFACTURES OF SELECTED ECONOMIES,
1979-81 AND 1984-86

(Annual averages)

	Billion dollars		Average annual percentage change between 1979-81 and 1984-86
	1979-81	1984-86	
Indonesia	0.5	2.3	35½
Turkey	1.1	4.4	32
Mexico	4.3	10.1	18½
Malaysia	2.2	4.2 ^a	15½
Brazil	7.4	14.8	15
Thailand	1.5	2.9	14
Saudi Arabia	0.4	0.7 ^a	13
Taiwan	17.1	30.5	12½
Korea, Rep. of	16.0	28.7	12½
Morocco	0.6	1.0	10½
Singapore	8.5	12.4	8
Pakistan	1.3	1.9	8
Hong Kong	12.5	17.2	6½
Tunisia	0.7	0.9	5
Philippines	2.0	2.5 ^a	5
Yugoslavia	6.6	8.2	4½
Israel	4.3	5.3	4½
Bangladesh	0.5	0.6 ^a	4
India	4.4	4.7 ^a	1½
Colombia	0.7	0.6	-3
Argentina	1.8	1.5	-3½
Peru	0.5	0.4	-4½
Uruguay	0.4	0.3	-4½
Kuwait	2.1	1.1	-12
Jamaica	0.6	0.3	-13

^a1984-85.

Note: The developing areas are ranked in descending order of the average annual percentage change of exports of manufactures between 1979-81 and 1984-86. The figures exclude exports and re-exports of gold. The data for Mexico include estimates for exports of manufactures from Maquiladoras.

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reflecting mainly the sharp decline in the value of fuel exports. Once again, in interpreting these (and other figures in Table I.4) it should be kept in mind that some of the data are strongly affected by the valuation effects of the movements in exchange rates. For example, in terms of ECUs, exports of West European countries declined 5½ per cent last year, compared with a 21½ per cent gain in dollar terms.

Trade developments in indebted countries

Last year's modest 2 per cent increase in the value of merchandise imports into fifteen heavily indebted countries, to \$85 billion, was the first increase since 1981.¹ It was accompanied by a 15 per cent decline, to \$100 billion, in their combined export earnings. The result was a decline of more than one-half in their merchandise trade surplus, from \$34 billion in 1985 to \$15 billion last year.

This rather gloomy picture for the fifteen countries as a group conceals a relatively good trade performance in two countries (Chile and Uruguay). They managed to increase their merchandise trade surplus in the course of export and import expanding adjustment (Table I.7).²

¹This group of fifteen countries, defined by the International Monetary Fund, differs as follows from the group of sixteen indebted countries discussed in previous issues of this Report: it excludes Egypt, Indonesia, the Republic of Korea, Thailand and Turkey, and it includes Bolivia, Côte d'Ivoire, Ecuador and Uruguay.

²In Chile's case, about half of the increase in exports involved food products (farm and fishery); exports of wood-pulp were also up sharply. The main markets for the increased exports were Spain, the Federal Republic of Germany, Argentina and Brazil. In the case of Uruguay, large gains were recorded in earnings from meat and other traditional exports such as leather and wool. In 1986, the most buoyant markets for Uruguay's exports were Argentina, Brazil and the EC.

It should be noted that if the fifteen countries are classified according to the four categories in Table I.7 for each of the years 1982 through 1986, it is apparent that on average eleven of the fifteen countries change categories each year. One factor behind the year-to-year changes is the valuation effect of changes in the dollar's exchange rate. The valuation effect varies from country to country, depending on (among other things) whether the country's currency is pegged to the dollar, and whether its main export products are priced directly in dollars.

Among the other thirteen countries, four recorded an increase in the dollar value of exports in 1986 (Colombia, Côte d'Ivoire, Morocco, and the Philippines). For the remaining nine countries, weak markets for primary commodities is one explanation behind their disappointing export performance last year. In addition, expanding domestic demand affected the merchandise trade balance in some countries, not only by boosting imports but also by increasing domestic absorption of the country's exportable goods.

TABLE I.7 - TRADE ADJUSTMENTS IN FIFTEEN HEAVILY INDEBTED COUNTRIES, 1986

<u>Export and import expansion</u>	<u>Export expansion and import contraction</u>
Chile, Côte d'Ivoire ^a , Uruguay	Colombia, Morocco, Philippines,
<u>Export and import contraction</u>	<u>Export contraction and import expansion</u>
Mexico ^a , Nigeria ^a , Yugoslavia	Argentina ^a , Bolivia ^a , Brazil ^a , Ecuador ^a , Peru ^a , Venezuela ^a

^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.

The moderate world economic growth in 1987 has not made it any easier for the indebted countries to achieve the twin targets of improving living standards and maintaining debt service. The recent strengthening of petroleum prices has helped some indebted countries but, at the same time, it has increased the burden on others which are net importers of petroleum. In contrast, the bottoming out of non-fuel primary commodity prices has brought more general relief. Indeed, in some of the heavily indebted countries, for example the Philippines, economic growth appears to have picked up this year.

OUTLOOK

Currently available forecasts for the year 1987 generally predict rates of growth of real gross domestic product of around 2½ per cent in the industrial countries and 3½ per cent in the developing areas. This would match the 1986 performance. For the world economy as a whole, this translates into a continued rate of economic growth of just under 3 per cent in 1987. At the present time, no major pick-up in economic growth is anticipated for 1988.

Statistics for the first half of 1987 point to an increase in the volume of merchandise trade close to 3½ per cent for the year as a whole. This upward revision in the earlier 2½ per cent estimate for 1987 (GATT Press Release GATT/1409, 23 March 1987) is the result of the strong export performance of the United States, certain developing economies in Asia, and Western Europe thus far this year. No major change in the growth rate of trade is currently foreseen for 1988.

II. MEDIUM-TERM DEVELOPMENTS IN MANUFACTURES TRADE

During the three decades from 1950 to 1980, trade in manufactured goods was much more dynamic than trade in agricultural or mineral products. In volume terms, manufactures trade was twelve times larger in 1980 than it was in 1950, whereas trade in mining and agricultural products was "only" five times and three and a half times larger, respectively. In value terms, the sharp increases in petroleum prices gave mining trade a big boost in the 1970s, but the gain vis-à-vis manufactures was only temporary.

By 1981 trade in manufactures was once again consistently out-performing trade in mining products in terms of the annual change in dollar value. Table I.8 indicates the average annual increase during the years 1980-86 in the dollar value of world trade in the sixteen

product groups presented regularly in the Appendix tables of this Report (not published with this Press Release). As is apparent, all ten product groups which out-performed the growth of world trade on average between 1980 and 1986 involve manufactured goods, and only one group of manufactures - iron and steel - is in the below average category.¹

At the beginning of the 1980s, the share of the industrial countries in world exports of the high growth products was distinctly higher than their share in world exports of all merchandise. By the same token, the developing areas, and to some degree also the Eastern trading area, tended to export products which turned out to perform worse during the 1980s than world merchandise trade on average.

However, in the course of the past six years a number of developing areas have proved capable of adapting to changing market conditions. Thus far in the 1980s, as in the 1970s, the developing areas as a group have been restructuring their exports more rapidly than either the developed countries or the Eastern trading area (Appendix I). As a result, between 1980 and 1986 the share of the developing areas in world trade in the fast growing products - that is, in the ten product groups in the upper part of Table I.8 - increased from 10 to 12 per cent.

¹The percentage change in the value for each product group in Table I.8 is a composite of changes in five elements: changes in trade volume, prices, product quality, product mix and exchange rates. For example, the dollar value of trade in road motor vehicles may have increased (i) because the volume of trade in road motor vehicles has increased, (ii) because domestic market prices for road motor vehicles of a given quality have increased, (iii) because world demand has shifted from less expensive to more expensive versions of particular products (for example, from compact to medium size automobiles), (iv) because there was a change in product mix across types of vehicles, for example from motorbikes to passenger cars, or (v) because of valuation effects of exchange rate changes. There is, of course, no need for all five elements to be changing in the same direction, even when the change in the dollar value of a product group is large. For example, exports of many categories of advanced electronic products have been rising rapidly in value at the same time as per unit prices were declining sharply.

Exchange rate changes between 1985 and 1986 appear to have been of minor importance in determining which product groups grew at an above average rate in the period since 1980. This is suggested by the fact that the ranking of product groups for the period 1980-85 looks quite similar to the one shown in Table I.8, except for the fact that during the 1980-85 period trade in other semi-manufactures and machinery for specialized industry performed slightly worse than world merchandise trade on average.

TABLE I.8 - WORLD MERCHANDISE EXPORTS BY PRODUCT GROUP,
1980-1986

(Percentage shares and average annual percentage change in value)

Share in world merchandise exports 1986	Product group	Average annual percentage change 1980-86
5.7	Office and telecommunication equipment	12½
9.2	Road motor vehicles	7½
2.9	Clothing	7½
3.2	Household appliances	6
5.5	Other consumer goods (furniture, leather goods, etc.)	5½
11.9	Other machinery and transport equipment	4
9.0	Chemicals	3½
3.1	Textiles	3
8.7	Machinery for specialized industry	2½
4.9	Other semi-manufactures (manuf. of wood, paper and rubber)	2
	World merchandise exports	1
10.7	Food	0
3.5	Iron and steel	-½
3.4	Raw materials (crude rubber, wood, etc.)	-1
1.6	Ores and minerals	-4
1.9	Non-ferrous metals	-4½
12.7	Fuels	-9

Along with these developments, the pattern of merchandise trade between the developing areas and the developed countries has been changing. More and more of this trade is taking the form of exchanges within product groups.¹ For example, the figures in Box I.2 indicate that:

¹As is noted below, trade between the developing areas and the industrial countries in thirteen of the sixteen product groups in Box I.2 has become more balanced over time. At the same time, the merchandise trade balance (f.o.b.-f.o.b.) of the developing areas with the industrial countries has changed from a surplus of \$300 million in 1970 to surpluses of \$103 billion in 1980 and \$10 billion in 1986. It should be kept in mind that these surpluses must be related to the dollar value of the underlying trade flows. On this basis (that is, as a share of exports plus imports, divided by two), the corresponding figures for 1970, 1980 and 1986 are ½, 30, and 3½ per cent, respectively.

- The two-way trade in household appliances has become much more balanced; in 1986 (in contrast with 1970 and 1980) exports of these products by the developing areas to the developed countries were larger than the exports of the developed countries to the developing areas.
- Trade in several other product groups, such as textiles and office and communication equipment, is becoming more balanced, but the exports from the developed countries to the developing areas continue to exceed the exports from developing areas to the developed countries.
- The developing areas' shares of the two-way trade in raw materials, non-ferrous metals, and ores and minerals continued to exceed the shares of the developed areas, but to a much smaller degree than in 1970 and 1980.
- Trade in clothing is becoming less balanced, as exports from the developing areas to the developed countries increase relative to their imports of clothing from the developed countries. The same is true of trade in food (which includes beverages and tobacco), and in products grouped under other consumer goods, between 1980 and 1986.
- In 1986, the developing areas accounted for the larger share of the two-way trade in eight product groups: in three of those product groups (clothing, food, and other consumer goods) they have been increasing their shares, while in the other five (household appliances, raw materials, non-ferrous metals, ores and minerals, and fuels) the two-way trade is becoming more balanced.
- In all eight of the product groups in which the share of the developed countries in two-way trade was larger in 1986 than the share of the developing areas, the trend is toward more

BOX I.2 - GROWING IMPORTANCE OF TRADE WITHIN PRODUCT GROUPS IN THE TRADE OF THE DEVELOPING AREAS WITH THE DEVELOPED COUNTRIES

For all product groups except food, clothing and other consumer goods, the dollar values of exports and imports in the trade of the developing areas with the developed countries have become more balanced over time. This development is evident from the indices presented below. For each of the sixteen product groups shown in the Table, the figures are calculated by taking the absolute amount of net trade of the developing areas with the developed countries (that is exports minus imports ignoring the question of whether it is a trade surplus or a trade deficit) as a percentage of gross trade (that is exports plus imports), and adjusting it so that it becomes 100 if the dollar value of imports of an individual category precisely matches the dollar value of exports of that category (all figures on an f.o.b. basis). It becomes zero if there are only exports or only imports.

For example, in 1986 the developing areas exported chemicals worth \$6.9 billion to the developed countries and imported chemicals worth \$32.9 billion from them. The amount of net trade in chemicals was thus \$26 billion and gross trade was \$39.8 billion. Net trade as a percentage of gross trade was 65 per cent. The index represents the difference between that percentage and 100, notably 35. Thus an increase over time in the percentages in the Table indicates that trade in the particular product category is becoming more balanced (net trade is becoming proportionately smaller) - a sign that countries are specializing more within the particular product category.

PRODUCT GROUP	1970	1980	1986
Textiles	66	85	94
Household appliances	35	68	92*
Raw materials	52*	71*	91*
Non-ferrous metals	35*	71*	84*
Office and telecommunication equipment	22	68	84
Other semi-manufactures	55	61	84
Food	63*	97*	79*
Other consumer goods	95*	99	68*
Ores and minerals	24*	39*	57*
Iron and steel	19	21	49
Other machinery and transport equipment	12	22	45
Chemicals	17	28	35
Road motor vehicles	2	5	29
Clothing	47*	30*	17*
Machinery for specialized industries	2	6	17
Fuels	8*	5*	13*

* Indicates a situation in which the dollar value of exports from developing areas to developed countries was larger than the dollar value of exports from developed countries to developing areas.

balanced two-way flows (textiles, office and tele-communication equipment, other semi-manufactures, iron and steel, other machinery and transport equipment, chemicals, road motor vehicles, and machinery for specialized industries).

Three of the more important conclusions to emerge from this brief review of medium-term trends in world trade in manufactured goods are:

- Even during periods of slow growth in total world trade, world market demand for some products will be growing rapidly.
- The faster growing products are likely to be manufactured goods.
- Within the category of manufactures, the fast growing products span the full range of possible comparative advantage, from labour intensive to capital and technology intensive.

This analysis shows that even in periods of slow growth, there are opportunities for countries to spur economic growth by diversifying into exports of manufactures. Of course, the faster the rate of economic growth world-wide, the greater will be the gains to each country from increased participation in the world market. This brings us to the question of what is needed for the world economy to improve its economic performance in recent years.

III. CURRENT POLICY ISSUES

There is little doubt that the world economy is currently falling short of its productive potential. The widely expected pick-up in economic activity failed to occur last year (Box I.3), and the growth of world output and trade remain well below the average annual gains recorded in the turbulent 1970s (4 and 5 per cent, respectively). Despite some improvements, the number of unemployed workers remains high

in many industrial countries, particularly in Western Europe, not to speak of the problem of persistent and widespread unemployment in many parts of the developing world. And, as was noted above, current forecasts see no major pick-up in either output growth or trade growth in 1988.¹

An important element in recent trends in output and trade is the weakness of business investment in plant and equipment. According to IMF figures, the annual increase in business investment (excluding stockbuilding) in industrial countries declined, in real terms, from 6.5 per cent in 1985 to 0.4 per cent in 1986; the forecast for this year is for a modest 1.6 per cent increase.² The seriousness of this slowdown is compounded by the results of recent studies which suggest that the efficiency of investment has declined in recent years.³

¹The trends in output growth and trade growth are obviously interdependent. For example, it is evident that the recent weakness in world economic growth has been translated into weaker import demand around the world. At the same time, the weakness of demand for countries' exports has been a factor in the weakness of their economic growth.

²The IMF figures are taken from the World Economic Outlook, April 1987, p. 35. Related figures from the OECD for the seven Summit countries tell a similar story. In 1985, business investment in plant and equipment accounted for 1.1 percentage points in an overall GDP growth rate of 3 per cent; last year, the contribution was 0.2 percentage points to a 2.5 increase in GDP, and the forecast for this year is a zero contribution to GDP growth of 2.25 per cent (the average contribution in the 1970s was just under 0.5 percentage points). The OECD figures are taken from the June 1987 Economic Outlook (p. 6). The IMF is moderately optimistic about 1988, forecasting a 3.3 per cent increase in business investment in the industrial countries. Similarly, the OECD forecast for 1988 is that business investment in the seven Summit countries will contribute $\frac{1}{2}$ a percentage point to a GDP growth rate of 2 $\frac{1}{2}$ per cent.

³See, for example, C. Adams, P.R. Fenton, and F. Larsen, "Potential Output in Major Industrial Countries", IMF Staff Studies for the World Economic Outlook, August 1987.

BOX I.3 - SOMETHING WENT WRONG

The relatively weak growth of world trade and output is particularly disappointing against the background of the widespread optimism that prevailed at the beginning of 1986. A variety of economic trends and developments were pointing toward a pick-up in world economic growth and world trade. Investment opportunities were expanding as a result of the rapid pace of technological innovation, efforts to increase structural flexibility were getting started in a number of countries, and substantial progress in combating inflation was evident in the industrial countries and in several developing countries. More immediate favourable developments were also evident, in particular a decline in nominal interest rates, adjustments in exchange rates toward levels perceived to be more in line with underlying fundamentals, and a sharp drop in the world market price of petroleum. In the trade area, preparations for a major new round of negotiations opened up the prospects for long-term improvements in the multilateral trading system.

Even though these general conditions have, for the most part, continued to hold, the expectations of faster economic growth clearly have been disappointed. It is evident that the general optimism which characterized the economic outlook at the beginning of 1986 overlooked or failed to anticipate certain factors which have impeded the expected acceleration of world economic growth and trade.

There are good reasons for believing that part of the explanation for the recent disappointing performance of investment, output and trade can be traced to an asymmetric response to the changes in two key "prices" - the sharp decline in world market petroleum prices, and the major realignment of exchange rates that began in March 1985. There is little doubt, for example, that the first phase of the adjustment to lower petroleum prices has been dominated by its impact on petroleum exporting countries, as well as on petroleum-related industries and energy-producing regions within individual countries, whose economic prospects were hurt by the lower prices. Cut-backs in expenditures by adversely affected producers were expected, of course. What was not expected was the magnitude of the cut-backs indicated by the available statistics. In addition, the boost to expenditure on other goods and services - as consumers and firms found their energy bills reduced - was weaker than had been anticipated.

Turning to exchange rates, the figures in Box I.1 at the beginning of this Report indicate that producers who were affected by the major movements in exchange rates that have been taking place since March of 1985 also reacted in different ways, according to whether they were hurt

or helped by the change in exchange rates. The dampening effect on export activities in the countries whose currencies appreciated has been quite pronounced, while the volume of exports from the industrial countries with depreciating currencies either increased modestly or actually declined.

One explanation for this behaviour is that producers who benefit from an exchange rate change generally can afford a more cautious or leisurely approach to adjustment than can the producers who are squeezed by it. Moreover, to the extent that exchange rates in the preceding period had caused firms to abandon certain markets or transfer some of their production activities overseas, the adjustment to the new pattern of exchange rates involves more than a simple decision to step-up production for export. Building up export markets often involves tangible and intangible investments in marketing and servicing facilities in foreign markets, as well as time-consuming expansion of productive capacity.

The pace and pattern of adjustment is being affected not only by the normal delays, but also by uncertainties about the future levels of both petroleum prices and exchange rates.¹ Following the low of about \$10 a barrel in mid-1986, petroleum prices first recovered to around \$20 a barrel. More recently, the outlook for prices has become more uncertain as markets struggled to interpret developments with conflicting implications for the future evolution of petroleum prices. As for the key exchange rates, future trends are very difficult to predict (see below).

It is difficult to say whether the majority of the negative effects of the changes in petroleum prices and exchange rates are now behind us. Some signs point in that direction, for example, the apparent speed with

¹An important development with implications for adjustment to changes in exchange rates is the internationalization of many production and marketing processes - for example through greater reliance on foreign sourcing, direct foreign investment and cooperative agreements with foreign firms. Among other things, the impact of exchange rate changes on decisions concerning production or the sourcing of inputs is likely to vary more among firms than in the past.

which Japanese industry is adjusting to the stronger yen.¹ If so, the world economy could be at or near the point where the expansionary effects of these price changes will finally begin to dominate the negative effects.

Even if this turns out to be the case, however, the boost to the growth rates of output and trade is likely to be modest. Moreover, there are other continuing sources of concern, including the third world debt problem, the twin deficits of the United States, the behaviour of exchange rates, and the risk of an escalation of protectionist trade policies.

The impact of these factors on the growth of output and trade is two-fold. To varying degrees, each of the four is having a direct negative impact, as when debt service problems reduce growth and import demand in the heavily indebted countries. They are also indirectly depressing worldwide growth rates through their impact on the level of uncertainty facing firms and entrepreneurs considering investments in plant and equipment. By substantially increasing the amount of uncertainty surrounding the future evolution of key prices and markets they are reducing the overall level - and efficiency - of business investment, which in turn reduces the growth of world output and trade.²

¹See, for example, the article entitled "Now for the Next Miracle" in the Financial Times of August 26, 1987.

²It is sometimes argued that investment in plant and equipment has been weak because capacity utilization rates have been relatively low in many industries. The main problem with this explanation is the difficulty of distinguishing between idle physical capacity and idle economically efficient capacity. Even in the steel industry, which is widely regarded as suffering from over-capacity, there may be a shortage of plant and equipment capable of producing steel in an economically efficient way (in other words, in a better investment environment, investment in new plant and equipment would occur side by side with the scrapping of economically obsolete plant and equipment). More generally, given the potential for new production technologies, new products, shifts in consumer tastes and changes in international competitiveness to render existing plant and equipment economically obsolete, the "surplus capacity" argument - at least at the casual level at which it is usually made - is not convincing as an explanation for the weak investment. For a discussion of the main problems involved in measuring capacity utilization rates, see, for example, G.L. Perry, "Capacity in Manufacturing", and the accompanying discussion, Brookings Papers on Economic Activity, 3, 1973.

Debt and trade

In 1986 the dollar value of merchandise imports into the fifteen heavily indebted countries discussed earlier in this Report was more than 40 per cent below the 1981 level.¹ Between the same two years, the dollar value of total world trade increased nearly 8 per cent. Imports into the fifteen countries accounted for 6½ per cent of world imports in 1981, an amount roughly equal to the imports of the number three importer in the world that year, namely Japan. By 1986 their share had fallen to 4 per cent.

The main impact of the severe cut-back in imports has been, of course, on living standards and investment in the indebted countries.² But there have also been repercussions on their trading partners. In particular, with much of the debt servicing difficulties concentrated in Latin America, there has been a pronounced impact on jobs and profits in the United States' export industries.³

For the heavily indebted countries to pull themselves out of the current situation, an increase in the amount of resources available to them for reviving both their rate of economic growth and their import demand is essential. It is encouraging, therefore, that moves are underway to ease the plight of the poorest countries, whose debts are

¹The need to make debt-service payments was, of course, not the only factor behind the decline in imports. Depressed primary commodity earnings were also a factor in the way-below-average import performance of the heavily indebted countries. However, the importance of the latter factor should not be exaggerated. A comparison of figures for 1981 and 1986 reveals that the \$60 billion decline in the value of imports of the fifteen heavily indebted countries was double the \$30 billion decline in their earnings from exports of primary commodities.

²The IMF estimates that investment in the heavily indebted countries declined from 24½ per cent of GDP in 1980 to less than 17 per cent in 1986 (World Economic Outlook, April 1987, p.22). This has worrying implications, not only for future economic growth, and thus for future debt servicing capabilities, but also for job creation in a number of countries with high population and labour force growth rates.

³One study, for example, estimated that financial restraints on Latin America's ability to import cost the United States nearly 400,000 jobs during 1982 and 1983. See S. Dhar, "US Trade with Latin America: Consequences of Financing Constraints", Federal Reserve Bank of New York Quarterly Review, Autumn 1983.

owed mostly to developed country governments. Proposals include lowering interest rates on existing debt, extending grace periods and repayment schedules, and significantly increasing the resources available under the IMF's Structural Adjustment Facility.

But for many developing countries, including most of the ones that owe the bulk of their debt to commercial banks, recent developments have not been encouraging. Measured in current dollars, international banking lending to developing countries as a group has declined steadily from \$52 billion in 1981 to \$5 billion in 1986; over the same period, export credits fell from \$18.4 billion to \$2 billion. It is true that the flow of official development finance to developing countries increased from \$49 billion in 1985 to \$56.6 billion last year, but all the increase resulted from a valuation effect stemming from the dollar's depreciation; without the valuation effect, it would have declined 4 per cent from the 1985 level.¹

At the same time, the sharp slowdown in lending did not bring about a decline in the ratio of external debt to exports of goods and services in the heavily indebted countries. Between 1982 and 1985 (the latest year for which data are available for all fifteen countries), that ratio increased in thirteen of the fifteen countries. Nor did the decline in interest rates prevent an increase in the ratio debt service payments to exports of goods and services in eight of the fifteen countries between 1982 and 1985.² Coupled with the slow economic growth in the industrial countries and interest rates that are creeping upward again, the immediate prospects are not encouraging for many of the heavily indebted countries.

¹These figures, and those in the preceding sentence, are taken from Financing and External Debt of Developing Countries: 1986 Survey, OECD, 1987, p. 34.

²The statements in this paragraph are based on data in the 1987 edition of the World Bank's World Debt Tables.

The debt problem has had a further spillover effect on developing countries which do not currently have serious debt service problems. There has been a sharp decline in the flow of financial resources to all developing countries. Many of these countries are running large current account deficits and the reduced availability of foreign capital could affect their ability to maintain current import levels of consumer and investment goods.¹

Despite the attention given to the debt problem over the past five years, it is still very much with us. The debt strategies followed thus far have prevented a banking crisis. But that is not enough to judge them a success. In future efforts to deal with the problem it is important to focus both on adjustments in the patterns of production and trade in the creditor and debtor countries within the framework of open markets, and on the resources available to the indebted countries for stimulating investment and economic growth.

As long as the debt problem remains as severe as it is, it will remain a factor holding back the recovery of the world economy - both directly via reduced imports into the heavily indebted countries, and indirectly through the impact of the resulting uncertainty on investment in the indebted countries and in their trading partners. It is thus a problem for everyone, and not just for the debtors and their creditor banks and governments.

The United States' twin deficits

For the past two years it has been widely expected that the sizeable depreciation of the dollar would play a central rôle in bringing about a large reduction in the United States current account deficit. As was noted above, there have in fact been some encouraging developments thus far in 1987 in the trends in the volume of United States merchandise exports and imports. However, when measured in

¹The importance of developing countries as markets for manufactured goods produced in the industrial countries is frequently underestimated. In 1981, North America sold more manufactured goods to the developing countries than to Western Europe and Japan combined, and Western Europe sold more manufactured goods to the developing countries than to North America and Japan combined; in that same year Japan's exports of manufactured goods was divided equally between developing countries on the one hand, and North America plus Western Europe on the other.

dollars, the merchandise trade deficit and the current account deficit have widened rather than declined. Since it is the latter which catch the most attention - in part because they are available first - there is a growing frustration with the failure of the dollar's depreciation to deliver the promised reductions in the current account deficit. And that growing frustration is proving to be an increasingly powerful source of protectionist rhetoric and protectionist demands in the United States.

What these protectionist demands ignore is the fact that there is nothing in economic theory or experience to support the view that higher trade barriers in the United States would produce a lasting reduction in the current account deficit. While professional opinion among economists differs on the question of the extent to which exchange rate depreciation can substitute for reduced budget deficits, opinion is virtually unanimous regarding the ineffectiveness of higher trade barriers in reducing a current account deficit. Thus, a major increase in protectionism in the United States would not only fail to produce a lasting reduction in the trade and current account deficits, but would also invite large-scale retaliation by other countries and a subsequent loss of export markets for everyone.

Since there is a direct connection between the fiscal deficit and the current account deficit, there is a very good chance that substantial progress in reducing the current account deficit can be achieved if the targets for further cuts in the budget deficit are realized.¹ It is encouraging that estimates of the Federal budget deficit for the current fiscal year ending September 30th show a decline of nearly \$65 billion, from \$221 billion in the previous fiscal year to \$157 billion this year.

¹For an analysis of the factors influencing the United States current account deficit, see pages 15-22 of GATT Press Release GATT/1409, 23 March 1987. There is the argument that the real depreciation of the dollar boosts profits in the tradeable goods sector, causing retained profits (business savings) to rise. However, account must also be taken of (i) the likelihood that the opposite effects are taking place in the non-traded goods sector, and (ii) that any increase in business investment due to higher profits would offset the extent to which higher business savings would reduce the current account deficit.

Ultimately, the question is not whether the twin deficits will be substantially reduced, but how, when and with what repercussions on the United States' economy and the rest of the world economy.

There is also the closely related question of how far policy changes in other countries could ease the transition to lower United States deficits, while maintaining non-inflationary growth in the world economy. Meanwhile, the uncertainty and debate over the answers to these questions are affecting firms' willingness to invest in plant and equipment, and this is likely to be one of the more important elements clouding the prospects for a pick-up in world economic growth and world trade.

Exchange rates and trade

The behaviour of exchange rates is affecting the economic outlook in two closely related ways. There is the uncertainty regarding future changes in exchange rates.¹ Second, there is the concern about the extent to which exchange rates can distort international competition.

The main worry of producers and traders in the current environment is the large number of apparently extraneous factors which impinge on the exchange rates between the major currencies. These have caused not only large short-run fluctuations, but also more persistent deviations from levels that would equate the purchasing power of the different currencies.

It is not difficult to predict the impact on firms and entrepreneurs contemplating investments in plant and equipment - and, through the impact on investment, on world output and trade - of a widespread perception that the relative values of national currencies are not reflecting each country's true competitiveness.¹ Longer-term deviations in exchange rates, as well as large short-term fluctuations,

¹In an article in a recent issue of the International Edition of Fortune magazine, two prominent economists argue that the dollar has fallen too far, while other prominent economists are quoted as saying it has not fallen far enough. See "Fortune Forecast: Is the Dollar Too High - or Too Low?" in the May 11, 1987 issue.

are particularly serious for investment decisions in export and import-competing industries. The distortions and "noise" they create make it harder to interpret the price signals emanating from the world market, which are the primary source of information about emerging surpluses and shortages in the world economy, as well as of information about changes in international competitiveness.

A perception that the exchange rate system is not functioning properly can have an equally corroding effect on political support for relatively open and liberal trade policies. In some instances there is the mistaken assumption that more restrictive trade policies can somehow help a country cope with the adverse effects of exchange rate movements. More often, however, it seems to reflect more an attitude of "Why worry so much about trade policies when exchange rates are already distorting the situation so badly?" This is just one of many examples of the interdependence of policies, and of the way in which problems in one area can have serious consequences for other policy areas.

THE ROLE OF A STRENGTHENED TRADING SYSTEM

Protectionist pressures always increase during periods of slow economic growth. In the present situation, these pressures are being reinforced by the difficulties noted above in other policy areas. The consequence has been an increased tendency to view imports as threatening and export markets as difficult and uncertain.

Because repercussions of policy actions transcend national boundaries, they have to be judged in an international rather than a purely national context. By distorting the competitive environment, protectionist trade policies are weakening world economic growth - both directly through their impact on the level and pattern of world trade,

and indirectly through an increase in investment-inhibiting uncertainty, especially as regards trade-related investment.¹ In the recent past, such actions and threats in the trade field have also produced very sharp reactions in financial and foreign exchange markets around the world.²

As this Report has shown, these policy interactions have become more and more pronounced. There is a more important rôle than ever for a framework of rules and disciplines that reduces the uncertainty surrounding future trade policies and ensures that policy decisions taken at the national level take into account the repercussions on other countries.

In the trade field, the framework is provided by the General Agreement on Tariffs and Trade. The decision to launch the Uruguay Round with its emphasis on improving the trading rules and disciplines - especially those affecting conditions of competition - demonstrates the importance governments attach to strengthening this multilateral framework or guiding national trade policy making.

Launching the new round of negotiations did not, of course, put an end to protectionist pressures and trade frictions. To contain the pressures and frictions which inevitably will arise in the course of the negotiations, the Punta del Este Declaration includes a standstill agreement and provides for a surveillance mechanism to monitor compliance with that commitment.

¹ A survey of trade policy developments for the period October 1985-September 1986 is available in GATT documents L/6025 and L/6087, which may be obtained from the GATT Secretariat.

² On March 31, 1987 the front page headline in the Financial Times read "World Markets Fall as Trade Tensions Mount" while in the International Herald Tribune the front page headline was "Trade Fears Jolt World Financial Markets".

Safeguarding current levels of trade liberalization is essential, but by itself not enough. Disappointing rates of growth in world output and trade, the new stresses and strains which are affecting the economic and trading environment, as well as the state of trade policies, highlight the need for an improved and extended framework for the conduct of international trade. The Uruguay Round offers a unique opportunity to provide the international community with a trading system that can function effectively for the rest of this century and beyond.

MORE

APPENDIX I. - SPEED OF CHANGE IN MERCHANDISE EXPORT STRUCTURES BY
MAJOR AREA, 1970-1986

(Average annual percentage point change in share per product group)

	Total merchandise exports		Merchandise exports excluding fuels	
	1970-80	1980-86	1970-80	1980-86
Developed countries	0.08	0.17	0.02	0.16
Developing areas	0.38	0.54	0.26	0.26
Eastern trading area	0.21	0.08	0.09	0.10

The speed of structural change can be measured in a variety of ways. The concept used for the calculations presented above involved five steps.

First, merchandise exports of the developed countries were divided into seventeen product groups (the product groups shown in Table I.8). Second, the percentage share of each of these product groups in total merchandise exports of the developed countries were calculated for the years 1980 and 1986. Third, for each product group the absolute difference between the 1986 share and the 1980 share was calculated, that is ignoring the fact whether it was a decrease in share or an increase in share. Fourth, all absolute differences were summed up and then divided by 17 in order to arrive at the average percentage change in share per product group over the whole period 1980 to 1986. The final step was to divide this result by six, that is the number of years between 1980 and 1986, so as to arrive at the average annual percentage point change in share per product group. The corresponding calculations were then made for the period 1970-80 and for merchandise exports of the developing areas and of the Eastern trading area.

For example, the figure 0.38 for developing areas in the first column means that, between 1970 and 1980 the share of the "typical" product group in total exports of the developing areas changed annually by about four-tenth of one percentage point.

In view of the massive changes in the share of fuels in world merchandise exports corresponding calculations were made for merchandise exports excluding fuels, that is on the basis of sixteen product groups.

The calculations indicate, among other things, (a) that the speed of structural change was higher in the developing areas in both periods shown in the Table, and (b) that there was a large increase in the pace of structural change in the developed countries in the 1980s relative to the 1970s.