"ADJUSTMENT, TRADE AND GROWTH IN DEVELOPED AND DEVELOPING COUNTRIES"

Adjustment, Trade and Growth in Developed and Developing Countries is published today by the GATT secretariat as a staff paper in the series "GATT Studies in International Trade".

The major problems and difficulties experienced by national economies and the world economy turn out, in the end, to be essentially political, the authors of this new GATT study suggest. They see little reason for pessimism about growth prospects at the purely economic level, even if one takes full account of the recent discouraging performance of the industrial economies. "The difficulty", they conclude, "lies at the political level. It is not so much a difficulty of knowing what the appropriate policies should be, as one of disentangling national economies from policies known to be wrong."

"The fact is", says the study, "that inflation, unemployment, payments imbalances and all the other problems high on the agenda of economic policymakers are the results of policies. They are the consequences of what


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governments decided to do several months or years ago. This is indeed the one hopeful aspect of the present situation because, if our difficulties are man-made, they can be resolved and reversed by analysis, learning and persuasion."

This study carries further the line of analysis of an earlier GATT staff paper in the same series, Trade Liberalization, Protectionism and Interdependence, by the same three authors, published in November 1977. But whereas the earlier study examined the general issue of protection and liberalization, this essay focusses on more specific problems and obstacles in the area of adjustment and trade, and provides where possible statistics on the magnitude of various developments. The authors also develop further the two main themes of their earlier study: first, the importance of international trade as a source of economic growth; second, that protectionism is a short-run but ultimately self-defeating alternative to adjustment, which is a necessary condition of economic growth.

The study consists of an introduction, two chapters, and a concluding section. The first chapter surveys the long-term as well as the more recent changes in the growth and trade of developing countries classified into several characteristic groups. The second chapter deals with the trade structure and economic activity of the developed countries, and explores specific problems which these economies are facing in adjusting to continuous change in both national and international political-economic conditions.

The authors of this study, Richard Blackhurst, Nicolas Marian and Jan Tumlir, are senior economists of the GATT secretariat.

The aim of the series GATT Studies in International Trade is to make publicly available the results of some of the work undertaken by the staff of the GATT secretariat. They are published on the initiative of the secretariat. The views expressed are those of the authors alone and do not necessarily reflect the views of Contracting Parties to the General Agreement on Tariffs and Trade or of the secretariat of GATT. The purpose of the studies is to contribute to the discussion and understanding of current issues in the field of international trade.

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The following is a brief guide to the contents of the study:

Introduction

Identifying the main obstacles to economic adjustment is a necessary precondition of formulating more successful growth policies. In current public discussion one can detect a growing fear of economic stagnation, and
also a fear of economic disruption by imports, especially imports from developing countries. Together, these two fears propel the spread of protectionism. But ultimately they are mutually exclusive, since stagnation is the absence of change, and disruption results from change which is excessive or too rapid. The assumptions on which economic policy is based have to be defensible in the light of economic theory. If they are not, the policy is unlikely to attain its objectives. Unwillingness to review these policy assumptions will lead to increasingly irrational collective attitudes.

Chapter 1: The impact on world trade patterns of industrialization in developing countries

The study notes that the most significant shift in the product pattern of world trade has been the continuous rise in the share of manufactures and fuels, and the steady decline in the share of other primary products. As manufactured goods become an increasingly important part of the exports of developing countries, the decline of the share of these countries in world trade can be expected to be stopped or reversed, assuming there are no new policy-imposed obstacles.

Developing countries have been much more important as buyers than as suppliers of manufactured goods. The growth of developing country imports since 1955 has been positively related to the purchasing power of their exports. Even if in a few sectors some developing countries were able to reap the benefits of international specialization over the past fifteen years, in most manufacturing branches the foreign-trade induced economies of scale in developing countries appear to be still at an early stage.

The study notes that during the decade ending in 1973, the increase in the developing countries' purchases of manufactured goods from the industrial countries was more than double the increase in their exports of manufactures to the industrial countries. Recently, this trend has been even more pronounced. The demand from developing countries for manufactures was less affected by the 1973-76 recession than the demand from industrial countries, and this made a substantial contribution to the expansion of world trade during the recession. "This development illustrates the important counter-cyclical or support rôle which developing countries can play during economic downturns in industrial countries."

The authors say it is worth remembering that the developing countries' share in the total manufactured imports of industrial countries was only 7½ per cent in 1976. A proper assessment of the adjustment problem faced by developed countries due to imports from developing countries must take into account ratios of import penetration to domestic consumption.
Chapter II: The situation in the developed countries

The industrial economies remain bedevilled by inadequate growth, unusually high unemployment and inflation. This is increasingly difficult to explain in terms of deficiency of aggregate demand. After three years of consumption-led recovery, investment in plant and equipment remains very weak.

This chapter begins with a brief discussion of the main pressures for change in the industrial economies. Adjustment to these pressures requires new investment. Since not only an objective need but also technical opportunities for investment exist, the question is what prevents them from being translated into effective investment opportunities. The authors conclude that the weakness of investment is to be explained by an increased level of uncertainty coinciding with a decline in (or an inadequate recovery of) the rate of return on industrial capital. Inflation is seen to be the major factor in both developments.

Uncertainty and other obstacles to investment

Several kinds of inflation-generated uncertainty are distinguished. An investment decision depends on the estimate of future relative prices of the inputs and outputs of the contemplated enterprise. However, not only does the variability of the average price level increase with the inflation rate, but so does the variability of individual prices around the average price level. Thus, at high rates of inflation, the prices relevant for the prospective investor become even less predictable and many investment projects must be postponed for this reason.

"Second, there is the problem of predicting the government's policy reaction to an increasing, or persistently high rate of inflation. A fiscal-monetary tightening will affect future capacity-utilization rates; price controls might create a profit squeeze just when the project would come on stream; trade controls might affect both the prices of the project's inputs and its export chances."

These uncertainties may reinforce each other in a vicious circle. The risk premia which have to be added to investment calculations have to increase more than proportionately to the economic life of the contemplated project. In this way, inflation not only depresses, but also biases the pattern of investment towards projects with short pay-off periods. This is especially worrisome because an economy's response to pressures for structural adjustment usually involves long-term investments. The central task now confronting governments, the study says, is to dispel the excessive level of uncertainty by achieving a lasting reduction in inflation to the level of 1955-65.
Concern about the instability of international economic relationships is the second major source of investment-inhibiting uncertainty. The driving force behind the post-war performance came from outward looking long-term investments, made possible by the stability brought to the world trading system by the international institutions created in the post-war period. Developments in recent years have tended to undermine this stability at an accelerating pace. An increase in protectionist pressures to levels not seen since the Great Depression, a multiplication of products whose allegedly unique situation requires making exceptions to long-established rules governing domestic and international trade, growing disregard of the non-discrimination principle and a variety of other protectionist developments have all contributed to a marked increase in uncertainty surrounding future market access.

The study points out that cartelization of an industry also reduces investment incentives. It harms both the rest of the economy and the industry's own efficient members. By setting aside market forces, the normal allocative mechanism is distorted and resources are trapped in less productive uses.

Recent developments both in the United States and in Western Europe offer evidence of inadequate occupational and geographic mobility. While unemployment remains high by post-war standards, there are reports of emerging labour shortages in a variety of occupations.

The authors note that "artificially narrow wage differentials distort the pattern of skills in the economy by reducing the incentive to acquire skills through apprenticeship, technical school or college ... High marginal tax rates on personal income have a similar disincentive effect on skill acquisition, particularly during periods of rapid inflation when people are pushed into higher brackets. Trade restrictions in the developed countries contribute to artificially narrow wage differentials by simultaneously permitting higher-then-otherwise wages in the low-skill, inefficient industries, and depressing wages in the more efficient high-skill industries."

From the viewpoint of the economy as a whole, the authors say, complete stability - with industries maintaining their relative shares and individuals attached permanently to existing jobs - is not only impossible but actually unwanted. "People do make mistakes in choosing jobs, and the social order must keep open - indeed, must continuously improve - the possibility of correcting such mistakes. Moreover, most parents hope that their children will follow careers which are an improvement, in terms of satisfaction and earnings, on their own."
The study says that the effect of increased imports on domestic job displacement is typically quite small relative to other factors such as labour-saving innovations; a long-term decline in the demand for a good or service; annual net additions to the labour force; voluntary quits for the purpose of increasing earnings or job satisfaction; and business recessions. The study examines several likely motivations behind this misplaced emphasis on import restrictions as a device for protecting employment. Among these factors are: (1) lack of familiarity with the relevant statistics. The authors say it would not be surprising to discover that a majority of the public in the developed countries have a highly exaggerated view of the relative importance of imports as a source of job displacement. (2) Whatever their net results, trade restrictions appear faster and more effective than policies directed at other sources of employment problems. This appearance is deceptive. Any restriction on imports must have a depressing effect on employment in the export sector because the less we buy from the rest of the world, the less they buy from us (regardless of whether or not they explicitly retaliate). This is still not widely appreciated among the general public nor, more surprisingly, among export industries. (3) Attacking imports not only generates little domestic opposition, but is often quite popular.

Conclusion

Following are some of the points made in the summing-up:

"As long as three quarters of the world population remain poor, it is idle - or perhaps the luxury of the idle - to speak of limits to growth closing in, and of growth impulses being exhausted. The poverty of the vast majority of the world's population indicates not merely the world's need for economic growth but, more directly and importantly, the world's growth potential."

If neither population and natural resources, nor technology represent limits on growth in any fundamental sense, then all the economic difficulties of the present - comprised in the inflation-unemployment syndrome - are essentially transitional, the study suggests. They are problems of multiple adjustment and adaptation, not only to imports from developing countries but also to changing rates of population and labour force growth, and to the consequent change in the age structure of population, which will in turn influence the patterns of domestic demand and the savings ratio. To say that these problems are essentially transitional is not to minimize their difficulty. But at the moment the main danger seems to lie in the opposite direction of overestimating them.

The authors add that "it would be a mistake to view the adjustment to imports from developing countries as a distinct issue, additional to and complicating the elimination of the other distortions and uncertainties"
which are inhibiting recovery. All these problems have one and the same solution, which consists of making the structure of production in industrial economies more flexible."

The study concludes by saying that 'demand stabilization policies presuppose an economy in which competition ensures, through changing relative prices, a flexible adaptation of supply to changes in the pattern of demand ... The tendency for market relations to ossify is constant and requires a constant policy effort to counter it. Elements of rigidity are being introduced by the actions of private firms and groups as well as by government policy measures aimed at particular structural objectives. It is the gradual deterioration of the allocative mechanism that has been reducing the effectiveness of macroeconomic policy. One can imagine an ultimate degree of rigidity through which macroeconomic policy would be wholly frustrated. Protectionist policies, especially those directed against the developing countries, are both a manifestation and a cause of this rigidity."

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