PROSPECTS FOR INTERNATIONAL TRADE

Main Conclusions of GATT Study for 1981-1982 Published

Developments in the world economy over the past eighteen months, and prospects for the future, are analyzed each year in the GATT secretariat report International Trade. This press release reproduces the complete text of the first chapter of the latest report, International Trade 1981/82. The full report will be published shortly. The report is based on information available to mid-August 1982.

The first section reviews the latest data on world trade, production and other aspects of the world economy during 1981 and the first half of 1982. In the second section the focus shifts to the issues confronting policy makers as they search for ways to pull the economy out of what is, in most respects, the worst economic situation since the 1930s. The analysis calls attention to the danger which protectionism poses for indebted countries and firms, and thus for the international financial system itself.

1. MAIN DEVELOPMENTS IN 1981/82

Despite considerable progress in the difficult fight against inflation, 1981 was another disappointing year for the world economy. World production increased marginally, as less-than-normal increases in agriculture and manufacturing were largely offset by a decline in world production of minerals, mainly petroleum. A similar pattern was evident in the volume of world trade; where moderate increases in the export of agricultural and manufactured products were offset by a decline in mineral (again mainly petroleum) exports, resulting in an overall stagnation. No improvement in these trends has become evident so far in 1982.

International Trade 1981/82 will be available in October, in English, French and Spanish language editions, and may be ordered from the GATT secretariat or through book sellers at a price of 30 Swiss francs.
Production, employment, price levels and exchange rates

Following a recovery in 1976, growth in the volume of world production has been slowing down continuously. In 1981, the increase was about 1 per cent. This was the fourth worst performance in the post-war period, after 1958 and 1975 when world production declined, and 1954 when it stagnated.

<table>
<thead>
<tr>
<th>TABLE 1. - GROWTH OF WORLD PRODUCTION, 1963-1981</th>
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<tbody>
<tr>
<td>(Average annual rate of change in volume, percentages)</td>
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<tr>
<td>All commodities 6 3 2 2 2 7 6 3 1 1</td>
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<tr>
<td>Agriculture 2 2 1 3 2 2 2 1 2</td>
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<tr>
<td>Mining 5 1 2 -1 6 5 1 -1 3 -2 -3</td>
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<tr>
<td>Manufacturing 7 3 3 -1 8 5 4 5 1 1</td>
</tr>
</tbody>
</table>

Note: For sources and methods, see Appendix to GATT, International Trade 1981/82.

The slowdown in the growth of aggregate world production last year was due to a fall of nearly 7 per cent in the production of petroleum, following a decline of 4 per cent in 1980. The growth of world manufacturing production, at 1 per cent, was as slow as in the preceding year. Only agricultural production showed an improvement, with a growth of 2½ per cent in 1981. As regards the main areas, aggregate growth in the industrial countries remained, at 1 per cent, unchanged from the preceding year. In the traditional oil-exporting developing countries, production is estimated to have declined substantially due to the fall in output of petroleum. In both the oil-importing developing countries and the Eastern trading area, aggregate production growth is estimated to have slowed down to less than 2 per cent, the lowest rate in the post-war period. In the case of the oil-importing developing countries this implied, also for the first time in this period, a decline in output per capita.

While employment contracted further in Western Europe in 1981, especially in the EC, there were modest gains in North America and in Japan. In the course of 1982, however, the latter areas joined Western Europe's declining employment trend. The average rate of unemployment in the industrial countries increased from about 6 per cent in 1980 to some 7 per cent in 1981; by the second quarter of 1982 it exceeded 8 per cent. Judging from the increase in recorded unemployment in

1In this section, production refers to the combined output of agriculture, mining and manufacturing, that is, it excludes services and construction.

2Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates and Venezuela.

3The Eastern trading area comprises Eastern Europe, USSR and centrally planned countries in Asia.
manufacturing, the overall unemployment level in the developing countries also appears to have increased.

The rate of increase in consumer prices in the industrial countries slowed down from 13 per cent in 1980 to 10½ per cent in 1981, the deceleration being somewhat more pronounced in the United States than in the EC. The slowdown of inflation has been particularly marked since the last quarter of 1981. Estimates for the second quarter of 1982 for seven leading industrial countries1, indicate that consumer prices were up 8.1 per cent over their level in the second quarter of 1981.

In 1981, the most notable change in exchange rates was the strong appreciation of the US dollar. For the year as a whole, its trade-weighted exchange rate appreciated by 12½ per cent. Following a modest decline against most currencies near the end of the year, there was a further appreciation during the first half of 1982. Although on average the yen appreciated as much as the dollar in 1981, it has been depreciating since the second quarter of that year. The trade-weighted average depreciation of the majority of European currencies in 1981 was in the range of 7 to 10 per cent, with somewhat smaller percentages for the pound sterling and the Swiss franc.

World trade

In volume terms, world trade in 1981 followed a pattern similar to that of the preceding year. Trade in manufactures increased by about 4¼ per cent, followed by an estimated 3 per cent increase in the volume of trade in agricultural products. The gains in these two categories were offset by a decline in trade in mineral products, notably a 15 per cent decline in exports of crude and refined petroleum. As a result, the volume of total world trade is estimated to have stagnated in 1981.2

<table>
<thead>
<tr>
<th>Table 2. - Growth of World Exports, 1963-1981</th>
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<tr>
<td>(Average annual rate of change in volume, percentages)</td>
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<td>Total</td>
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<td>5</td>
<td>9</td>
<td>2</td>
<td>9</td>
<td>7</td>
<td>3</td>
<td>3</td>
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<tr>
<td>Agricultural products</td>
<td>4</td>
<td>4½</td>
<td>-3½</td>
<td>5</td>
<td>9</td>
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<td>9</td>
<td>7</td>
<td>3</td>
<td>3</td>
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<tr>
<td>Minerals*</td>
<td>7</td>
<td>-2¼</td>
<td>-2½</td>
<td>-7½</td>
<td>4½</td>
<td>2</td>
<td>1¼</td>
<td>5</td>
<td>-8</td>
<td>-12</td>
</tr>
<tr>
<td>Manufactures</td>
<td>11</td>
<td>5</td>
<td>8½</td>
<td>-4½</td>
<td>13</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>4½</td>
<td>4½</td>
</tr>
</tbody>
</table>

*Including fuels and non-ferrous metals.

Note: For sources and methods, see Appendix to International Trade 1981/82.

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

2 Thus 1981 is the fourth post-war year in which the volume of world trade failed to expand; the other years are 1952 (down by 2 per cent), 1958 (by 1 per cent) and 1975 (by 3 per cent).
The volume of exports from the industrial countries rose by 2 per cent in 1981, while their imports declined by 3½ per cent. In contrast, the volume of imports by the traditional oil-exporting developing countries expanded by more than 20 per cent, while their exports declined by 15 per cent. Available data suggest that in the other developing countries, export volume increased somewhat faster than import volume in 1981.

On a value basis, world trade is estimated to have totalled nearly $2,000 billion in 1981, 1 per cent less than in 1980. This decline, which contrasts with the increase of more than 20 per cent in the preceding year and a yearly average increase of 20 per cent between 1970 and 1979, is mainly due to a decline in unit values expressed in dollars, which in turn reflects primarily the appreciation of the dollar. Dollar unit values of world exports declined by an estimated 1 per cent in 1981, whereas they had increased by 19 per cent in 1980 and by 14 per cent on average per year between 1970 and 1979.

**World market price developments**

With the advent of generalized floating among the major currencies, a question arose as to whether trade flows should be measured in some unit other than dollars. The only alternative was the SDR (that is, a particular basket of currencies), but its use as an international unit of account has never gained wide acceptance. There are several reasons for this. One is that most international debts are denominated in dollars, which means that analysis of the debt servicing capacity of a country's foreign exchange earnings is easier if those earnings are expressed in dollars. Another is that the bulk of international reserves is still held in dollars or dollar-denominated assets. The most important reason, however, is the fact that measuring trade flows in SDRs would do little to eliminate the problems involved in using dollars. At best, the use of the SDR would dampen fluctuations in the value of trade, but it would not facilitate the process of estimating changes in the volume of trade. It is true that if trade flows are expressed in SDRs the value of trade in 1981 shows an increase of 9½ per cent, compared with a 1 per cent decline in the dollar value. But if at some future date the dollar depreciated sharply against the SDR, the statistics could show a decline in the SDR value of world trade at a time when its dollar value increased. In short, there is no unit of account which could give a fully satisfactory measure of changes in the value of international trade flows in a period of fluctuating exchange rates.

Changes in dollar export unit values of the kind experienced since the early 1970s are a composite of changes in: (i) the domestic prices of goods entering international trade from all sources, including the United States; (ii) the export prices of non-United States goods which are fixed directly in US dollars (this is the case for certain primary commodities, among which petroleum is the most important), and (iii) the exchange rate of the US dollar. Since the early 1970s, high rates of domestic inflation, together with sharp increases in the price of petroleum in some years, have often been accentuated by the depreciation of the US dollar. In 1981, in contrast, there was a

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1 This was the first year-over-year decline in the value of world trade since 1958.
deceleration in the rate of domestic inflation in a number of countries, and export prices of primary products fixed in US dollars either increased less rapidly than in the preceding year (world export prices of petroleum increased by 10 per cent in 1981 as against an increase of 74 per cent in 1980) or declined. In addition, the appreciation of the US dollar in 1981 was so strong that it offset the (reduced) effects of the other two factors on the prices of traded goods.

Estimating year-to-year changes in dollar export unit values, under these circumstances, has become very difficult. Since the estimates of changes in the volume of trade are obtained by adjusting the value of trade for changes in unit values (which serve as a substitute for prices), the reduced reliability of the unit value estimates has, in turn, reduced the accuracy of the volume estimates, perhaps substantially.1

Dollar export unit values of manufactured products, the largest category in world trade, are estimated to have declined by 4½ per cent in 1981, following an increase of 11 per cent in 1980. This change essentially reflects the depreciation of Western European currencies against the US dollar. Dollar export unit values of European exports of manufactures declined by 11 per cent in 1981, while they increased by 12 per cent in the United States and 6 per cent in Japan. Export prices of non-fuel primary commodities declined by about 7 per cent in 1981, after an increase of 14 per cent in the preceding year. Relative to the prices of manufactures and fuels, the prices of non-fuel primary products were at their lowest level since the mid-1960s. The fall in dollar export prices of primary products exported by developing countries averaged 13 per cent, while the prices of those exported by the developed countries declined by 5 per cent. This reflects the different commodity composition of primary exports from the two areas.2 During the first half of 1982, export prices of non-fuel primary commodities continued to decline, the fall in comparison with the corresponding period of 1981 being again more pronounced for developing countries (about 14 per cent) than for the developed countries (about 6 per cent).

The main factors behind the general decline in world export prices of primary commodities in 1981 and the first half of 1982 include the continuing weakness of demand, especially in industrial countries, the rundown of stocks in the consuming countries (partly due to high interest rates), and the ample supplies of a number of important agricultural products due to abundant harvests. These price-depressing elements were only to a minor extent offset by strong import demand, especially for foodstuffs, in non-traditional markets such as the Soviet Union.

1 For a more detailed discussion of the statistical problems involved, see International Trade 1976/77, pp. 183-84.

2 For example, the steepest price declines were in sugar (40 per cent), rubber (25 per cent), coffee, cocoa and copper (roughly 20 per cent), coconut oil (18 per cent), tin (15 per cent), tea and iron ore (8 per cent). All these products are much more important in the exports of the developing than of the developed countries.
Elements of strength

It is of some significance to note that for the two growing categories of world trade, most of the additional import demand came from outside the industrial areas.

In the case of manufactured exports, 45 per cent of the overall increase in volume is accounted for by the growth of exports from the industrial countries to the traditional oil-exporting developing countries, and a further 15 per cent by industrial countries' exports to other developing countries (Table 3). In addition, expansion of trade among developing countries, accounting for 10 per cent of the overall increase, was the next largest contribution. Developing countries also continued to expand the volume of their exports of manufactures more rapidly than the world average. In 1981, their exports of manufactures to developed countries accounted for about 10 per cent of the increment in the volume of world exports of manufactures. In contrast, the mutual trade of industrial countries, which together account for some two-thirds of world production and more than 80 per cent of world trade, contributed only 5 per cent of the overall increase.

| TABLE 3. - CONTRIBUTION OF THE MAIN FLOWS TO THE OVERALL INCREASE IN TRADE IN MANUFACTURES BETWEEN 1979 AND 1981 |
| (Percentages\(^{a}\)) |
| 1980 | 1981 |
| 1979 | 1980 |
| --- | --- | --- | --- |
| Increase in the volume of world trade | 100 | 100 |
| of which: | | | |
| Intra-industrial countries | 20 | 5 |
| Exports of industrial countries to traditional oil-exporting developing countries | 20 | 45 |
| Exports of industrial countries to other developing countries | 30 | 15 |
| Exports of developing countries to industrial countries | 5 | 10 |
| Intra-developing countries | 10 | 10 |

\(^{a}\)Based on values at 1979 prices.

Sources: Appendix Table A24, International Trade 1981/82; UN, Monthly Bulletin of Statistics; national statistics.
Statistical difficulties preclude an equally detailed analysis of the geographical distribution of changes in the volume of trade in agricultural products. Nonetheless, it can be seen from Table 4 that the entire increase in this category of trade in 1981 was accounted for by an expansion of exports to non-industrial markets. In particular, food imports by the developing countries (among which the traditional oil-exporting developing countries have been the most rapidly expanding) and by the Eastern trading area, have increased rapidly in recent years. The value increases in 1981 imply an even greater growth in volume, given that the dollar prices of foodstuffs in world trade have declined.

### Table 4. - Imports of Foodstuffs by Main Areas, 1979-1981

<table>
<thead>
<tr>
<th>Destination</th>
<th>1979 (Billion dollars)</th>
<th>Percentage change over previous year</th>
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</thead>
<tbody>
<tr>
<td>Industrial countries</td>
<td>127</td>
<td>+7</td>
</tr>
<tr>
<td>Developing countries</td>
<td>44</td>
<td>+29</td>
</tr>
<tr>
<td>Eastern trading area</td>
<td>22</td>
<td>+25</td>
</tr>
</tbody>
</table>

Source: Calculated from world export matrix (Appendix Table A24, International Trade 1981/82).

It is noteworthy that in the case of both manufacturing and agriculture, world trade continued to expand despite the very slow growth of output. This is particularly pronounced for manufactures. In 1980 and 1981, world exports expanded by 4.5 per cent in volume, while world production of manufactures increased by an estimated 1 per cent in both years. This pattern reflects mainly the relation of production and trade in the industrial countries which account for the bulk of both, but the same pattern is observable in the developing countries as well.

As regards the distribution of trade by major areas, shown in Table 5, there were only relatively minor changes on the export side. The industrial countries retained their leading position, with 61 per cent of the total, the traditional oil-exporting developing countries and the other developing countries accounting for around 14 per cent each. On the import side, the share of industrial countries declined from 66 per cent in 1980 to 64 per cent in 1981, while the shares of world imports accounted for by the developing countries and the Eastern trading area increased.
(Percentage shares in world exports (X) and imports (M))

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<tbody>
<tr>
<td>Industrial areas</td>
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<td></td>
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<tr>
<td></td>
<td>64</td>
<td>68</td>
<td>63</td>
<td>65</td>
<td>63\frac{1}{2}</td>
<td>61</td>
<td></td>
</tr>
<tr>
<td></td>
<td>M</td>
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<td>69\frac{1}{2}</td>
<td>66\frac{1}{2}</td>
<td>65\frac{1}{2}</td>
<td>67</td>
<td>66</td>
</tr>
<tr>
<td>Traditional oil-exporting developing countries</td>
<td>X</td>
<td>6</td>
<td>7\frac{1}{2}</td>
<td>13\frac{1}{2}</td>
<td>11</td>
<td>13</td>
<td>15</td>
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<tr>
<td></td>
<td>M</td>
<td>3</td>
<td>3\frac{1}{2}</td>
<td>6\frac{1}{2}</td>
<td>7\frac{1}{2}</td>
<td>6</td>
<td>6\frac{1}{2}</td>
</tr>
<tr>
<td>Other developing countries</td>
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<td>14\frac{1}{2}</td>
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<td>12</td>
<td>12</td>
<td>13</td>
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<td>M</td>
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<td>Eastern trading area</td>
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<td>9\frac{1}{2}</td>
<td>9\frac{1}{2}</td>
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<td>M</td>
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<td>9\frac{1}{2}</td>
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<td>8\frac{1}{2}</td>
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Source: Calculated from world export matrix (Appendix Table A3, International Trade 1981/82).

Merchandise trade balances

The combined trade deficit of the industrial countries (in f.o.b. terms) declined by roughly one-half, to $50 billion, in 1981. This decline resulted entirely from movements in volume, the terms of trade for the industrial countries as a group having shown no change. Within the group, the improvement in the terms of trade of the United States and Japan in 1981 was offset by a decline for Western Europe.

The combined trade surplus of the traditional oil-exporting developing countries declined by an estimated $50 billion to $120 billion in 1981. In volume terms, there was a substantial decline in exports and a further large increase in imports. The terms of trade continued to improve (by 15 per cent), though less rapidly than in the preceding two years.

The trade deficit of the other developing countries continued to rise, but at a slower pace than in the preceding two years, reaching a level in excess of $80 billion. This resulted primarily from a further deterioration in the terms of trade, for the third consecutive year. Although the rise in export volume was smaller than in 1981, it slightly exceeded that of imports.

In Eastern Europe, the trade deficit was considerably reduced, mainly as a result of the drop in imports from outside the area, due to balance-of-payments constraints. In the Soviet Union, however, imports grew faster than exports, causing the trade surplus to decline. China's exports continued to increase strongly while imports stagnated, so that the trade deficit of 1980 was replaced by a surplus in 1981. For the Eastern trading area as a whole, the trade surplus more than doubled.

Current account balances

Current account surpluses and deficits around the world should in principle sum to zero, but in practice there is an inevitable statistical discrepancy between the two aggregates. Whereas this
discrepancy used to be relatively small, since the early 1970s it has become so large that year-to-year changes in current account balances indicate, at best, only the probable direction of the true change. With this in mind, it is plausible to conclude from the data in Table 6 that between 1980 and 1981 the aggregate current account of the industrial countries moved from deficit into approximate balance, while the surplus of the traditional oil-exporting developing countries declined by about one-half; as for the other developing countries, the figures suggest that their aggregate current account deficit may have increased further, to around $85 billion. Recent figures point to a further sharp decline in the surplus of the traditional oil-exporting developing countries in 1982, but how the offsetting change is being divided among the current account balances of the oil-importing countries is still unclear.


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<td>15</td>
<td>-4</td>
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<td>30</td>
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<td>-45</td>
<td>-10</td>
<td>10</td>
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<td>Traditional oil-exporting developing countries</td>
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<td>30</td>
<td>40</td>
<td>31</td>
<td>6</td>
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<td>-24</td>
<td>-20</td>
<td>-30</td>
<td>-48</td>
<td>-70</td>
<td>-85</td>
<td>-85</td>
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a Excluding official transfers.
b Projections.

Sources: OECD, Economic Outlook; IMF, International Financial Statistics.

Production and trade in 1982

Manufacturing production in the industrial countries was declining in the first half of 1982. Data from developing countries are incomplete, but in several of the leading exporters of manufactures, industrial production has been stagnating or declining since the middle of 1981. In the Eastern trading area there was a further slowdown in the growth of manufacturing production. In trade, the volume of exports by the industrial countries has levelled off since the second half of 1981; there was a further sharp decline in their imports of petroleum, while imports of other products showed some increase. Corresponding to these import trends, the growth of exports by the leading exporters of manufactures among the developing countries has continued to slow down.

Footnote:
1 For example, the estimated discrepancy for 1981 is $45 billion (OECD, Economic Outlook, July 1982, p. 55), a figure which is very large when compared with the figures for 1981 in Table 4. For a recent discussion of this issue see "The World Current Account Discrepancy", OECD, Occasional Studies, June 1982.
Faced with large current account deficits and growing debt-service charges, numerous developing countries, both exporters of manufactures and those which export mainly primary commodities, are known to be introducing policies to dampen domestic demand and curtail imports. Thus the elements of strength, discussed on pp. 6-7, which sustained the level of world trade in 1981, appear to be fading in 1982.

2. CURRENT PROBLEMS IN ECONOMIC POLICY

In deciding to hold their annual November meeting at the ministerial level for the first time since 1973, the CONTRACTING PARTIES indicated their intention to carry out a thorough analysis of the issues confronting the trading system. It seems therefore opportune to attempt to provide in the following discussion a broad analytical picture of the general economic context in which trade policy operates, so that its shortcomings, problems and potential for contributing to a recovery can receive as comprehensive and balanced an assessment as possible.

The difficulty of the undertaking should be obvious, even though we are able to draw on the line of analysis developed in these pages over the years. There is no single, simple cause or explanation of the difficulty the world economy is experiencing - if there were one, it would have been already grasped and corrected, and the economic outlook would be more promising. There are, instead, many factors and they interact in numerous - often circular and cumulative - causative chains.

A good place to begin is with the least disputed fact: in all the major industrial countries, the proportion of non-residential investment in GNP has declined substantially since 1973. It is therefore possible to say that the weakness of investment is the proximate cause of the slow growth and high unemployment. Another way of stating this is to say that the decline in economic growth reflects an inadequate pace of adjustment to changes in technology, relative factor supplies and comparative advantage. It is even possible to speak of an accumulated backlog of adjustments which burdens the national economies and stifles their growth. The backlog itself is growing, as evidenced by the rising unemployment and the growing demand for protection and subsidies.

The level of investment is determined by its expected returns in relation to present costs. It is a distinctive feature of the present situation that economic conditions a few years hence have become less predictable than usual; thus the prospective yields of any investment project are more difficult to calculate or, what is the same thing, must be discounted by a higher risk factor. At the same time, the presently high costs of investment - dominated as they are by the cost of capital, or the interest rate - also reflect increased uncertainty about the future. Regardless of the particular theories of interest rate determination which different economists may hold, or the particular explanations they may devise to explain what exactly drove the interest rates to their recent and present levels, they all agree that the rise of interest rates signals an increase in uncertainty about, or a decrease in the predictability of, the future.
On this background, it appears convenient to discuss the adverse investment climate under two broad headings. The first comprises the causes of the general weakness of the incentives to invest; that is, the various elements of increased risk and uncertainty, or the diminished predictability of economic conditions in the future, when the currently contemplated investment projects would come into operation. The second refers to considerations, motives and incentives which distort the composition of the investment, leading firms astray from efficient paths of adjustment.

It should be recognized that the distinction is to some extent arbitrary or even incomplete. The two categories of conditions are obviously not unrelated to each other; the general weakness of incentives to invest is partly due to distortions in their pattern and vice versa. Thus the same condition may appear in both contexts. The distinction is, nonetheless, useful in sorting out the factors at work.

The General Investment Climate

The most general cause of the weakness of investment is the increased economic uncertainty. Though it is pervasive and composed of many elements shading into each other, its main forms can be identified. The least tractable as far as reasonable foresight can reach is the uncertainty, persisting since 1973/74, about future availability and prices of energy. Since energy enters into all economic activities, this uncertainty impinges on all investment decisions. The most that policy can do in such a situation is to create propitious conditions for energy saving, substitution, and the development of additional sources of supply.

Equally potent, though more amenable to policy, is the uncertainty generated by inflation. It affects business planning in two distinct ways. Business decisions are based primarily on information conveyed by changes in relative prices. Inflation introduces severe irregularities into relative price behaviour and thus impairs the information function of the price system. (The word "uncertainty" is synonymous with "inadequate information"). The second form of uncertainty generated by inflation concerns the future course of the price level. It represents, for example, the most widely given explanation of the present high level of interest rates. The unpredictability of price level behaviour, however, makes not only the future economic environment uncertain and difficult to predict, but also the political one.

Another type of uncertainty arises from international economic relations. Because inflation in different national economies is proceeding at different and varying rates, uncertainty about future exchange rates is inevitable. More serious is the diminishing security of access to foreign markets. Measures taken to limit particular imports and/or subsidize exports have made it increasingly risky to plan new lines of production the profitability of which would depend on a part of output being exported and/or on the availability of materials and other inputs at world market prices.

Finally, a distinct type of uncertainty has become important in the last year or so - uncertainty felt within and emanating from the financial system. A perceived deterioration in the quality of bank assets and corporate balance sheets has given rise to a growing preoccupation with two distinct but mutually reinforcing risks: the country risk and the company risk, the latter relating to both industrial and financial corporations. The causes of the system's perceived current weakness are analyzed in greater detail below.

No doubt there are other sources of uncertainty besides the four we have identified. It is by now sufficiently obvious that any increase in uncertainty, whatever its source, has far-reaching effects not only on the level, but also on the pattern of productive investment. Investments with short pay-off periods will be preferred to investments which pay for themselves only in the long term; and investments which would be on the margin of acceptable risk in more normal times will not be undertaken at all when the general level of uncertainty rises.

This provides an important part of the explanation for the puzzling decline in the rate of productivity growth in recent years. Relatively large contributions to productivity growth are made by "greenfield" plants - wholly new installations in which the production process has been fundamentally redesigned for optimal economic use of the latest technology available. Such projects imply a relatively high proportion of (long-lived) plant in total fixed investment, which high levels of uncertainty simply make too risky. The same conditions reduce the relative proportion of investment in new products and new technologies; yet the whole history of modern industrial development testifies to the fact that these purely innovative but highly risky investments make the largest contribution to productivity growth.

Distortion of Investment Plans

Structural adjustment consists of the expansion of more efficient industries and the simultaneous contraction of those which have been adversely affected by technological change, shifts in demand or changes in comparative advantage. In addition to the increased uncertainty, there are numerous domestic rigidities which limit firms' ability to respond to the changing economic environment. Even worse, the incentives facing firms which are under pressure to adjust often pull in the opposite direction, having been designed to slow down the adjustment process.

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Thus, in addition to the difficulties caused by high interest rates and the other consequences of uncertainty, labour market rigidities have brought about a declining long-term trend in rates of return on capital, insufficient matching of supply of and demand for particular skills and, closely related, insufficient inter-industry movement of the labour force. Excessively high levels of longer-term unemployment are the result.

More open trade policies would have made for much more flexibility in this respect. In other words, there is little doubt that uncertainty caused by protection against imports, in the form of trade barriers and/or subsidies of one kind or another, is among the most important factors causing the backlog of adjustment.

The harmful effects of protectionist policies, which in the first instance merely slow down adjustment and economic growth in the protecting countries themselves, extend well beyond their borders. For example, import restrictions in the industrial countries affect the allocation of investment in, and future growth prospects of, the developing countries. In view of the disappointing experience with development strategies based on import substitution, there is little doubt that the promise of development lies in outward-looking strategies. However, the current commercial policy environment seriously impedes development efforts along these lines. When quantitative restrictions are applied to those exports which developing countries can produce most efficiently, their pattern of investment is distorted. As a result, less employment, income and foreign exchange is obtained per unit of capital than would be attainable in a liberal trade system with protection limited to MFN tariffs only.

Subsidies have not only been an important cause of the growing adjustment backlog in many industrial countries, but at the present time are rapidly becoming the main source of political friction among them. Economics has traditionally considered subsidies to be an alternative to protective measures imposed at the border, but in the last decade we have seen them increasingly combined with traditional forms of protection. This is easily explained. Industries which export a significant part of their output have been receiving additional protection in their home markets. Since such protection provides scope for, or validates recent, increases in production costs, some form of subsidy often becomes necessary if the industry is to maintain at least the absolute volume of its export sales. When subsidies given for such purposes are added to measures designed to protect domestic market shares, the scope for international conflict is greatly enlarged. Needless to say, subsidization also clashes with most governments' recognized need to bring their budget deficits under control.

The practice of subsidization very often ties resources into activities which offer little hope of expansion and innovation; and the non-availability of these resources in turn increases the production costs, and thus reduces the comparative advantage, of industries which

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could expand. The waste of resources involved when firms, which could not sell their output in open competition, are enabled by subsidies to go on producing, is reminiscent of the old anti-recession "remedy" of digging holes and filling them up again.

Last but not least, industrial cartels can be a highly effective, if only temporary obstacle to adjustment. These are price-raising and market-sharing agreements, national and international, among firms in particular industries, especially common in industries experiencing excess capacity. Compared to competition, however, cartels are an inefficient instrument for reducing excess capacity. Since their central purpose is to raise prices, which can be done only by reducing output, it would be more correct to say that they increase excess capacity. Moreover, as was noted in an earlier GATT study, cartelization reduces

"the pressure for productivity and profit-increasing investment ... [S]ome cartel agreements explicitly stipulate that participating firms should not increase capacity for a given period, so as not to aggravate the problem of excess capacity. Normally, productivity increasing investment adds to output capacity, so that if additions to the latter are prohibited the scope for raising productivity is also reduced. Meanwhile, in the developing countries investment in these industries continues ... with the result that when the cartel arrangement eventually expires [the participants'] share of the world market is likely to shrink even further."

In the case of intermediate goods, it should also be noted that when a cartel succeeds temporarily, it makes adjustment more difficult for the users of its product. Where the number of firms exceeds a certain (usually quite low) minimum, cartel agreements are nearly impossible to maintain without the backing of public authority. It is for good reasons that most forms of trade-restrictive cartel agreements are illegal not only in the United States but also, except for coal and steel, in the European Community.

It may also be noted that these various obstacles to adjustment ultimately represent different forms of income redistribution. At the production level, the redistribution is from the actually or potentially more productive groups in the economy to the less productive ones. While such a redistribution is often defended on equity grounds, it is open to the fundamental objection that it not only reduces the "pie to be divided", but also minimizes the opportunities for upward mobility of both existing workers and their children, thereby trapping large numbers of people at their current position on the income ladder. At the consumption level, protection is overtly biased against low income groups because it is the cheap, mass-produced consumer goods that are most often the target for protectionist measures.

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1Adjustment, Trade and Growth in Developed and Developing Countries, GATT Studies in International Trade, No.6, September 1978, p.50.
Digression: a Tax on Imports is a Tax on Exports

The motivation for these incentive-distorting policies merits additional reflection. They testify to the persistence of mercantilist habits of thought and a less than complete understanding of the effects of protection on the protected economy. The seven major trade negotiations held under the auspices of the GATT indicate that most governments have understood the benefits of trade liberalization: export expansion and import expansion have come to be seen as two sides of the same coin. Yet a certain amount of ambivalence has always remained. Reallocation of resources is considered a cost, hence liberalization and tariff reduction a concession. In the multilateral liberalizations, each country believed that it had sacrificed something and had benefitted only from the sacrifices of others. No matter how useful this conception might have been in practice, it obscures the fact that the protecting country harms its own economy first of all, and in particular that any action which restricts a country's imports will also restrict its exports. This proposition was firmly established in economic theory by the end of the nineteenth century.

Commercial policy practice has never absorbed this theoretical insight, which only the most recent empirical research is forcing it to acknowledge. It was brought to the forefront of attention in three stages. The degree of protection was traditionally measured by the extent to which it allowed domestic prices of the protected goods to exceed their world market prices. An important advance in understanding was achieved by the development, some seventeen years ago, of the concept of effective protection, with its emphasis on (i) the need to take into account the impact of import restrictions on the prices of inputs as well as final products, and (ii) the consequent fact that the degree of protection is properly measured by its effect on value added (selling price less the cost of material inputs) rather than on the selling price alone. Among other things, this approach highlighted a point that businessmen and trade negotiators had known all along, namely that an import restriction on an input used by an export industry is a tax on exports.

The analytical potential of this approach was limited, however, since its underlying assumptions become unrealistic when we try to study the impact of simultaneous changes in protection affecting several industries. This gap has now been filled by the recent development of a framework for estimating the net protective effect of a country's entire set of import restrictions. In effect, this method is the general equilibrium counterpart to the analysis of the effective rate of protection. Space limitation precludes a detailed explanation, but the broad outline is as follows.

Domestic production is divided into three classes: goods which compete with imports, goods sold domestically as well as exported, and non-tradeable or purely home-market goods. Imposing protection raises the prices of imports and, with a lag, import-competing goods relative to the other two classes. While the traditional analysis stopped at this point, the new approach pursues the adjustments set in motion by this change in relative prices: consumers shift part of their expenditure away from the now more expensive imports to import substitutes, home goods and exportables; and the increase in the price of import-substitutes increases profits, inducing firms in that sector to expand by bidding labour and capital away from the industries producing home goods and exportables. Both effects cause the price of home goods to rise; the more ready consumers are to substitute home goods for importables, and the closer labour and capital from the home goods sector match the needs of the expanding import-competing firms, the higher will be the increase in the price of home goods. The same pressures affect the export sector, but world market competition prevents prices of exportable products from rising. Their domestic prices thus decline relative to those of other categories of products.

In essence what happens is that the import duties lead to an increase in the general level of money wages. Higher prices in the sectors producing import-substitutes and home goods allow the higher wages to be passed on to consumers, whereas firms in the export sector are squeezed, having little or no scope for raising prices. The resulting decline in profits makes it difficult for the export sector to hold onto all the factors of production it was employing, with the result that most of the expansion of the import-competing sector is at the expense of the export sector. Any employment gains in the sector producing import-substitutes are thus offset by losses on the export side, with resources throughout the economy used at a lower level of efficiency, and national income reduced.

The increase in the price of import-competing goods relative to home goods measures the degree of true protection, while the rise in the price of home goods relative to exportables measures the amount of the original import tax which has been shifted onto the export sector. Analysis of the actual experience of a number of countries suggests that on average, some two-thirds of the import duty is shifted onto the export sector in the form of a "tax".

In principle, the existence of widespread unemployment of labour and capital should dampen the increases in wages and prices following an increase in protection. This could perhaps occur in a situation of "Keynesian" unemployment, caused by a shortfall in aggregate demand. The experience of stagflation in recent years makes it clear, however, that widespread unemployment of a structural nature is not an effective restraint on wage and price increases.

Several conclusions follow from the fact that a substantial part of the burden of a country's import restrictions is shifted, in the form of a tax, onto the export sector. It explains, first of all, the observed

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1Empirical estimates of the shift factor for individual countries range from about 0.5 to around 0.9; see references in footnote 1 on p. 15 above.
fact that protection does not increase total employment. More important, it shows that there can be no protection for the economy at large. Protection which enables some industries to maintain a larger scale of operations than would otherwise be possible is "paid for" by unintended and undesired shrinkage of other industries. In fact, many industries which receive nominal protection are actually taxed by the protective system. The dividing line between those which are penalized and those which receive some true protection is determined by the amount of the average duty that is shifted onto exports. For example, if two-thirds is shifted, any industry whose level of protection is less than two-thirds of the national average is actually penalized. Such industries obviously would benefit from a linear reduction in trade barriers. Finally, since the relations analyzed here are fully symmetrical, it also follows from this analysis that the grant of an export subsidy sets into motion adjustments that transform a part of it into an import subsidy.

In the light of this analysis, it is unsurprising that there are so few expanding industries to provide higher-productivity employment opportunities for the labour force locked in import-competing industries needing ever higher levels of protection.

The Mirror Image

In economics as well as in matters of policy, there is a traditional specialization between the "real" and the financial sides of the economy. With respect to certain problems, however, such as the general economic difficulty we are discussing, it is necessary to bring the two sides together. Changes on the "real" side of the economy—that is, in the composition of its production facilities, in the profitability and size of particular enterprises and whole industries and sectors—produce corresponding changes in the financial system. The production and the financial structures reflect each other.

The counterpart of the growing backlog of adjustments in the real economy has been a weakening of the financial system, to which we now turn. The strength or weakness of the financial system refers to the quality of the assets held by the institutions (firms) in the financial sector. These assets are composed mainly of the debts of individuals, firms and public entities. The "quality" of such assets refers to the probability that they will be serviced and repaid on time. The expression "deteriorating quality of the assets of the financial system" refers to the fact that the real value of part of the outstanding debt is now below the nominal value at which this debt is carried on the balance sheets of banks and other financial intermediaries. This development can be traced to the impact of the disinflation on debtors whose financial condition was already weakened by chronic inflation and the growing structural maladjustments.

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2The impact of inflation (interacting with the tax system) on firms' financial health is discussed in GATT Study No. 6, op.cit, p.47, and in Press Release, GATT/1285, op.cit., p.15.
Many of the current problems can be traced to the fact that the 1970s saw a large and rapid increase in international indebtedness. In response to calls to recycle the "unspendable surplus" of the oil-exporting countries, all forms of debt increased, but particularly (a) commercially contracted debt (as against intergovernmental loans and other forms of official economic assistance), (b) medium and short-term as against long-term debt, and (c) debt contracted in the form of export credit. For the oil-importing developing countries as a group, current estimates indicate a foreign indebtedness in excess of $500 billion, to which some $80-$90 billion of estimated indebtedness of Eastern Europe should be added. For a time, the burden of the growing debt was lightened by very low or negative real interest rates, but that inherently temporary "benefit" is no longer available. To this must be added the depressing effect of current economic stagnation in industrial countries on both the prices and export volumes of many primary products of key interest to the indebted developing countries.

A difficulty for the financial system is posed by the fact that a significant, though not precisely determinable, proportion of the additional indebtedness incurred in the 1970s represents what is best called "deadweight debt" – that is, debt to which there correspond no additional production facilities from which to service it. In effect, there was considerable borrowing not for investment but to maintain current consumption levels in the face of a sharp adverse shift in the terms of trade.

Perhaps even more important is the fact that the rate of return on many of the investment projects which this credit expansion helped to finance is well below the original expectations. The main cause has already been suggested. When protectionism in the industrial countries cuts off, or makes uncertain, investment projects in industries whose international comparative advantage is greatest, only second-best projects are left to finance. They will in turn often be even less profitable than expected because, as the disappointing experience with import substituting strategies has shown, when a country cannot fully exploit its comparative advantage through exporting, import demand tends to outrun its export earnings, and the resulting need for macroeconomic restraint prevents the industrial projects coming on stream from operating at full capacity. We now see that the recycling of current account surpluses to deficit countries can be carried out in a financially sound way only if the borrowers are guaranteed secure access to their main overseas markets.1

It would be a mistake, however, to assume that only the uncertain foreign debts are causing the weakness of the financial system. It is impossible to know how many of the "purely domestic" transactions, and the loans financing them, are related to foreign trade in one way or another, and thus are also exposed to foreign risk. More important, again, is the fact that loans to firms whose failure to adjust is, for the time being, backed by public policy are also far from fully secure.

1 In fact, this was understood already at the time. See, for example, T. Rybczynski, ed., The Economics of the Oil Crisis, (Macmillan Press for the Trade Policy Research Centre, London)), 1976. This issue was also discussed in International Trade 1976/77, p.23.
Protection against imports seldom increases efficiency in the protected industry, and the maintenance - let alone the periodically necessary raising - of the protective barriers can never be taken for granted. Industries viable only by virtue of public subsidies are an increasingly poor banking risk, in view of the question of how long governments themselves, desperately grappling with runaway budget deficits and rising costs of borrowing, can afford to subsidize them. Similarly, industries whose sales revenue depends on price-raising cartel arrangements are poor banking risks in view of the cartels' vulnerability to legal action.

The Pain of Disinflation

A gradual decline in inflation rates would eventually, by improving the information conveyed by relative price changes as well as the predictability of future price level movements, make a more efficient investment process possible and thus facilitate the correction of the adjustment backlog in the production structure. In the meantime, however, the process of disinflation aggravates the economic and social distress, and increases the tensions in the financial structure.

The pain of disinflation is best explained as a disappointment of past expectations. Contracts were concluded in anticipation of a continuing or even rising inflation, and now the rate of general price rise is declining. In many instances the miscalculation will affect only the distribution of gains and losses among the parties involved, but if the miscalculation is so substantial that the contract cannot be met, then both sides will suffer. If a wage increase was granted in the expectation of a corresponding increase in the price of output, and the latter does not materialize, the firm will suffer losses and workers will be laid off.

These are serious problems, but there is no painless or indeed feasible alternative to pursuing the disinflation process until price level stability is restored. Moreover the responsibility for arresting inflation rests with national governments, and there is a risk that the unpromising search for an international agreement on the speed with which inflation should be cut back may distract them from that responsibility. The stakes are too high to accept such a risk. An inspection of Chart I reveals that the four successive troughs in the jagged inflation line between 1964 and 1978 traced an exponentially rising curve. Although current estimates of the 1982 inflation rate suggest that this pattern is about to be broken, the 1982 figure is still above the previous trough and more than double the average inflation rate in the 1960s. It is not pleasant to contemplate what another resurgence of inflation, confirming a long-term exponential trend, would do to public confidence and to the governments' ability to control economic events.

The Real Danger

The words "trade war" now appear almost daily in the headlines. This danger should not be over-dramatized. Memories of the 1930s, and the enormous stake which most countries have in a continued flow of goods and services should rule out a sudden, large-scale breakdown in trade relations. The gradual but continuing accumulation of restrictions on international trade of course poses a threat to the
multilateral trading system which we must not underestimate, but the more immediate danger may be that it will trigger a severe disturbance in the already troubled international financial system.

CHART I

CONSUMER PRICES AND UNEMPLOYMENT IN THE MAJOR INDUSTRIAL COUNTRIES*, 1963-1982

This danger was demonstrated in the decade of the Great Depression. Not even today can full agreement be said to exist on all points of the economic history of that unhappy period. The standard explanation has emphasized the central role of the absolute decline (by one-third) in the United States money supply. However, at that stage the collapse of confidence was already far advanced. More recent discussion has identified two factors which can explain how the process started. Firstly, there had been, in the 1920s, a sudden large increase in international indebtedness, most of which was "deadweight debt" in the sense defined earlier (inter-Allied war debt and German reparations). Secondly, diplomatic efforts of that decade had not succeeded in establishing an institutionalized international order capable of preventing a rapid deterioration in the conditions of international trade.

The more recent explanations emphasize that the international financial crisis occurred after the United States Congress passed the highly restrictive Smoot-Hawley Tariff Act in June 1930. The long Congressional deliberations on the Act were followed anxiously by other governments, and when it was signed into law, commercial retaliation by a number of countries followed promptly. As trade declined, a growing proportion of the debts of businesses depending on export trade, and of
foreign debts, became uncollectible. Thus it is not surprising that the United States banking crisis began with runs on banks in the agricultural exporting districts in the South-East and Mid-West of the country.

It is often argued that a shortage of international liquidity leads to protectionism. This brief review of recent history suggests, however, that the danger inherent in the present situation is just the reverse - that protectionism could cause an international liquidity shortage, one severe enough to produce a series of insolvencies. In particular, when anti-inflation policies are pursued in conjunction with increasingly restrictive commercial policies, and with domestic economic policies which tend to inhibit market adjustment, it must be admitted that a high degree of deflationary danger exists.

Tactics and Strategy

It is understandable that in a highly uncertain world, every government will demand considerable latitude for short-term policies with which to face unforeseen contingencies. But if they are to be effective, such improvised short-term policies - the tactics - must be guided by a long-term view of the state of the world economy as well as the national economy. In fact, only in such a "strategic" view can the nature of any unforeseen contingency be properly understood and an effective way of dealing with it improvised. The fact that economic life unfolds in what appears as a continuous series of contingencies cannot justify a continuing reliance on ad hoc expedients, especially when the economic situation is getting steadily worse rather than better. Yet we are still witnessing a proliferation of new "solutions" to the growing number of short-run policy problems, defended by the promise of particular results but without basis in either theory or historical experience. A strategy based on general principles, not a series of short-run tactics, is needed to lead the world economy out of its present impasse. Such a strategy must rest on many considerations of the kind outlined in the preceding pages, such as

- the need for overall flexibility in the economic system as a necessary condition for high and sustained levels of employment and income growth,

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1Allan Meltzer observes that the explanation he has presented "assigns a large role to the Hawley-Smoot tariff and subsequent tariff retaliation in explaining why the 1929 recession did not follow the path of previous monetary contractions but became the Great Depression. A principal reason for the importance given to the Hawley-Smoot tariff and to retaliation is that the magnitude of the increase in duties and the subsequent fall in imports of semi-finished goods and exports of food is very large. ... Given the size of the decline in food exports and in agricultural prices, it is not surprising that many of the US banks that failed in 1930 and in 1931 were in agricultural regions." In "Monetary and Other Explanations of the Start of the Great Depression", Journal of Monetary Economics, November 1976, pp.460-61.
- the danger implied by even a temporary resurgence of inflation,
- the danger to the international financial and trading systems in the proliferation of restrictive border measures and subsidies to uncompetitive industries, and
- the danger posed to the rule of law by the temptation to let cartels solve industrial problems.

Conclusion

Taking stock of the present situation, we see two main problems, a macro- and a micro-economic one. On the first one, inflation, there has been some encouraging progress, though it is still too early to speak of its solution being in sight. The micro-economic problem — the backlog of adjustments in the main economies and the corresponding weakness of the international financial system — continues to grow unabated.

The two problems complicate and aggravate each other but are essentially distinct, each tractable in its own right. The main purpose of the preceding analysis has been to show that to talk of them as posing a "dilemma" for governments, each of the problems standing in the way of solving the other, would be decidedly exaggerated.

To say that without arresting inflation stable growth cannot be restored is not to advocate a line of policy but to describe a general agreement. Disinflation does, in its early phases, exert a dampening influence on the level of economic activity, but as it proceeds and becomes convincing, the progress itself may be expected to generate expansionary forces, to create incentives for new and more efficiently planned investments. Signs of an incipient upswing when inflation rates were brought to low levels were apparent in some European countries in 1978, before the second round of oil price increases.

But a return to price stability will not, in itself, arrest the growth of the micro-economic problem, which clearly cannot go on growing forever. There is, therefore, a need to reinforce the positive, investment-strengthening effects of declining inflation and interest rates by clearing the way for structural adjustment to proceed without further distortions. This would require a reversal of current protectionist trends, a renewal of the sustained liberalization effort that characterized the earlier postwar decades, and a phasing out of the distorting incentives created by internal policies.

The long digression on the shifting incidence of import taxes was intended to show that not even a unilateral liberalization should be expected to have a net depressive impact on the economy as a whole. Not merely the unprotected industries, but all those receiving protection at less than a certain level, are actually penalized in the present situation. Thus a general liberalization would stimulate them to expand, with the export industries receiving a particularly strong stimulus, since they would also benefit from the reductions in foreign trade restrictions. Being a credible reaffirmation of the rules, such a
policy would signal the return to a more stable and predictable economic environment in which investments could be planned with more assurance. The process of investment-led recovery would offer the financial institutions an opportunity to increase the proportion of good quality loans in their portfolios and to phase out the bad paper accumulated in the period of blocked adjustment. This would offer a real prospect of restoring confidence by dispelling the uncertainty and pessimism characterizing contemporary economies.