Division of Research
School of Business Administration

December 1987

**THE IMPACT OF CHANGES IN THE WORLD ECONOMY
ON DEVELOPING COUNTRIES**

Working Paper #545

Linda Y.C. Lim
The University of Michigan

December 1987

Revised version of a paper prepared for the Symposium on "Cooperation for International Development: U.S. Policy and Programs for the 1990s, Symposium I: Setting the Agenda", Center for Advanced Study of International Development, Michigan State University, East Lansing, Michigan, June 1-2, 1987. To be published by MSU.

Introduction

Developing countries are deeply affected by changes in the international economic environment. But this does not mean that what happens in these countries depends only or even mainly on what happens in the world economy. Internal changes in developing countries are also important, and they both influence and are affected by international changes in the world economy. My task in this paper, however, is one-sided: to consider only how changes in the world economy might affect developing countries in the 1990s. I will discuss not what will happen, but rather what will affect what will happen in these countries in the next decade, concentrating on a broad overall prospective rather than on detailed numerical forecasts.

Before doing so, it is necessary to note that the developing countries themselves are a heterogeneous group, including at the extremes both very poor, stagnant, agrarian countries in Africa and relatively high-income, high-growth, newly-industrialized countries (NICs) in Asia. Different types of countries will be differentially affected by the various anticipated changes in the world economy, and will have a differential capacity to deal with these changes. At the same time, the developed countries which currently dominate the world economy are themselves diversified: among the First World countries, Western Europe, the United States and Japan face somewhat different economic problems and prospects and will exert varying influences on the world economy and on developing countries in the next decade. Changes in the world economy themselves involve both market forces and government polices in both the developed and developing countries which are ever-changing and difficult to predict even in the short run. This complex matrix -- even without considering internal changes in individual developing countries -- should be borne in mind when reading this essay.

I. Macroeconomic Developments

I.1 The Industrial Economies

Because of their generally heavy dependence on external trade, developing countries' growth is directly related to the growth of world output and trade. This in turn depends on what happens in the industrial countries, which account for nearly three-quarters of world trade. If the industrial countries can solve their current domestic macroeconomic and external imbalance problems, the prospects for world economic growth and trade are improved.

For example, a fall in the U.S. budget deficit will lower interest rates, thus alleviating developing countries' external debt burden. It will also at least partially reverse the diversion of international capital flows to the U.S., encouraging more foreign investment in the developing countries. If the decline in the U.S. budget deficit includes decreased farm export subsidies, the market for developing countries' agricultural exports will expand. A fall in the U.S. trade deficit will reduce protectionist pressures in the U.S., thereby

----

1. Developing countries need not be hurt by the fall in the U.S. trade deficit itself if this is achieved by increased U.S. exports, rather than reduced imports; even if U.S. imports fall, they are more likely to involve reduced imports from other developed countries whose currencies have appreciated, than reduced imports from developing countries whose currencies have mostly depreciated against the dollar.

promoting trade growth.[1] Reorientation of the Japanese and West German economies from export-led to domestic market-oriented growth, and opening of the Japanese, South Korean and Taiwan markets, will also boost world growth and world trade, increasing these countries' imports from developing countries.

Restoration of internal and external balance in the industrial countries and some of the NICs will have a favorable impact on world trade by stabilizing exchange rates. Currency shifts and interest rate changes themselves affect foreign investment, which has recently been declining from the U.S. and increasing from Japan as a result of the weak dollar and strong yen, a situation likely to continue into the 1990s. Foreign aid which comes from industrial countries' government budgets is obviously affected by how much and how government expenditures are cut (e.g. in the U.S.) or increased (e.g. in Japan and West Germany), and by the state of donor countries' external reserves. Thus Japan, which has surplus external reserves, is increasing its aid to developing countries, while the U.S. is likely to continue reducing its foreign aid contributions until its twin deficits decline.

If the industrial countries do not solve their internal and external balance problems, then the world is likely to be plagued with higher interest rates, slower growth of output and trade, and worsening protectionist barriers, and the developing countries will be worse off. It is probably safe to suggest that some kind of muddling along will take place, and that world growth will be restored, but not necessarily at the high levels of the 1960s and 1970s. The IMF's October 1987 projection (before the October 19 Wall Street crash) is that industrial countries' output will grow by about 2.9% in the medium term (through

1991), with developing countries growing at a higher rate of around 4.8% a year.[2]

I.2 World Trade

Between 1980 and 1986, world trade grew by 18% in volume terms but by only 6% in (dollar) value terms. In volume terms, mining exports declined, while agricultural exports increased by about 8%, and manufactured exports grew by nearly 30%. Since most developing countries are predominantly exporters of mineral and agricultural products, they have been hurt by this relative performance. Their share of world exports by dollar value declined from 33.6%% in 1980 to 24.6% in 1986, while their share of world imports declined from 28.7% in 1980 to 25.2% in 1986.[3] In 1980, the industrial countries bought 29% of their imports from developing countries, and 66% from each other; in 1986 the industrial countries bought only 19% of their imports from developing countries, and 77% from each other.[4]

----

2. International Monetary Fund, World Economic Outlook October 1987, Washington, D.C., 1987.

3. IMF, Direction of Trade Statistics Yearbook, 1987, cited in IMF Survey, July 27, 1987, p. 226.

4. Provisional estimates by GATT, provided in The Economist, April 4, 1987, p. 104.

As world trade shifts increasingly away from merchandise items, especially raw materials -- in which developing countries arguably have a market comparative advantage -- towards manufactures and, especially, services[5] -- in which developing countries are unlikely to have a comparative advantage -- their share of world trade is likely to decline further. The exception is the export of manufactures. Developing countries' share of world trade in manufactured goods rose from 7% in the mid-1970s to 12.5% in 1985. In 1986 the value of their manufactured exports grew by 13%, and for the first time they earned more foreign exchange selling manufactured exports than fuels or non-fuel primary products.[6] Because of the sharp decline in primary commodity prices between 1980 and 1986, developing countries' terms of trade declined during those years, and despite a current price recovery, future prospects for commodity trade performance remain dull.

This slower growth and changing pattern of world trade has a differential impact on developing countries. The majority which rely heavily on primary commodity exports have suffered severely from slowly-growing volumes and low and declining prices, and this is likely to continue. But those developing countries which rely heavily on the export of manufactures are prospering. Most prominent here are the Asian NICs, but export manufacturing success is not

----

5. Between 1970 and 1985 the share of invisibles in world exports rose from 29% to 32%, while that of merchandise exports fell from 71% to 67.8%. Within the invisibles account, the share of investment income (accruing mostly to industrial countries) rose from 7% to 13% of all current-account earnings, while that of transport and travel fell, and those of transfers (workers' remittances and government grants -- important to many developing countries) and other invisibles (including financial services, consultancy and royalties) were unchanged. IMF data cited in The Economist, March 14, 1987, p. 98.

6. GATT report cited in IMF Survey, April 6, 1987, p. 109.

limited to them alone. Manufactures now account for more than half the foreign exchange earnings of large middle-income agrarian countries like the Philippines and Thailand, and are second only to oil as a foreign exchange earner for Mexico and Malaysia. Manufactured exports are also increasingly important to the balance of payments in a range of other, very diverse, developing countries.

Increased protectionism in industrial countries is a major threat to developing countries' export, output and income growth. Exports from developing countries are already subject to more trade barriers in industrial countries than exports from other industrial countries. Agricultural products are both very heavily subsidized, and more heavily protected than manufactures, in the industrial countries. Manufactured goods exported by developing countries (e.g. textiles, footwear) are also subject to more protection in the industrial countries than manufactured goods predominantly exported by other industrial countries.[7] Over time, both protection and subsidies have increased, especially on agricultural products. Trade preferences for developing countries (mainly GSP) exist, but they remain limited and subject to ever-more-stringent eligibility criteria, including progressive graduation. As developing countries themselves have moved towards more liberal exchange and trade regimes in recent years, developed countries have moved in the opposite direction.[8] This could deter further trade liberalization in the developing countries, by fuelling nationalistic sentiments and bolstering the position of (mostly elite) interest groups in these countries who benefit from and favor continued domestic market

----

7. For a brief survey of industrial country protection and its impact on developing country exports, see World Bank, World Development Report 1985, pp. 37-41.

8. IMF Survey, July 27, 1987.

protection.

Developing countries have a strong interest in several outcomes of the current 8th round of GATT negotiations, which will set the stage for international trade relations in the 1990s. Together with industrial country agricultural exporters like the U.S., developing countries are pushing for liberalization of agricultural trade, and the reduction or removal of agricultural production and export subsidies in developed countries like Japan and the European Community. At the same time, a large bloc of developing countries, led by India and Brazil, is opposed to the liberalization of trade in services favored by the industrial countries, fearing that their own underdeveloped domestic service sectors will be unable to compete with industrial country enterprises in a free trade environment. Developing countries are also concerned that discussions on such issues as "safeguards", "intellectual property rights" and "graduation" from eligibility for trade preferences, could jeopardise their future trade prospects.

In addition to multilateral trade policy issues, many special bilateral relationships exist between developing countries and industrial countries. For example, "free trade areas" have been mooted between the U.S. and developing countries like Mexico and the ASEAN group, but for political reasons they are unlikely to be fully enacted. The U.S. already has its politically-inspired and economically-limited "Caribbean Basin Initiative", meant to free trade and capital flows with Caribbean countries, while the European Community gives special trade preferences to its former "ACP" (Africa, the Caribbean and the Pacific) colonies under the Lome Convention. The U.S. has also been using its GSP program benefits and threats of selective trade restrictions to force trade policy changes in the Asian NICs -- including pressuring them to open their domestic markets to U.S. goods and capital, to respect intellectual property and labor rights, and to revalue their currencies. The U.S. has also imposed "voluntary export restraints" on certain products from South Korea and Brazil, and is currently penalizing Brazil for closing its domestic market to U.S. computer software exports. Some developing countries -- e.g. Vietnam, Nicaragua, South Africa -- are subject to various forms of economic sanctions, including trade boycotts, by the U.S.. If the GATT talks are successful, the importance of bilateral policies should decline.

The alternative to a more liberal world trading environment supervised by GATT is some system of "managed trade". While much would depend on its specific details, if such a system is implemented (which seems politically unlikely), it is likely to be to the detriment of the developing countries, since in a free market environment, and assuming the appropriate domestic conditions and policies, their competitiveness is likely to increase with time in both agricultural and manufactured goods markets. Any system of "managed trade" is also likely to be managed by, and in the interests of, the largest and most powerful trading nations i.e. by the major industrial countries. Small, poor developing countries -- and the smaller industrial countries as well -- are unlikely to be included, since large numbers make efficient management difficult if not impossible. Proposals for "managed trade" have, not surprisingly, emanated mainly from the major trading nations whose international competitiveness and dominance of the world economy is being challenged by the industrialization of developing countries. The goal of most of these proposals is essentially to slow down or pre-empt market-induced changes which would involve a transfer of production and income from the industrial to the developing countries.

Finally, in terms of geography, the future is likely to see an even greater shift of world trade flows from the Atlantic to the Pacific ocean, including trade among the U.S., Canada, Japan, China, other Asian countries, and Mexico. This is an ongoing response to demographic and economic shifts, with the "center of gravity" of the world economy increasingly shifting towards the populous and dynamic economies of the Asia-Pacific region. If Japan opens its domestic market, it will become an increasingly important export market for developing countries the world over, particularly in Asia. Africa, on the other hand, is likely to remain geographically marginal to the main loci of world trade.

I.3 Currency Shifts

The biggest change in the world economy since 1985 has been the change in exchange rates between the currencies of the major industrial countries, with the U.S. dollar depreciating by about 45% against the Japanese yen and the West German mark, and by a smaller fraction against other Western European currencies. The appreciation of the dollar earlier in the 1980s resulted in currency over-valuation, balance-of-payments and external debt problems in the many developing countries which pegged their currencies to the dollar. Many have since disengaged their currencies from the dollar, thereby effectively devaluing, while those which remain tied to the dollar have depreciated with it. For example, between October 1983 and November 1986, the currencies of eight African nations depreciated by between 57% and 98% against the dollar[9]; between February 1985 and September 1986, the Mexican peso depreciated by 270% against the dollar[10]; and in August 1986 Indonesia devalued its currency by 45% against the dollar. The oil-exporting Middle Eastern countries' currencies have stayed on par with or about 10% below the dollar[11], while, under pressure from the U.S., the currencies of South Korea and Taiwan have appreciated by 10% and 40% respectively against the dollar.

The majority of developing countries, whose currencies have depreciated with or against the dollar, are now more competitive in export markets, particularly in Japan and Western Europe. This has not necessarily translated into increased export earnings, however, since the West German economy has been stagnating, non-tariff barriers in Japan reduce the price-sensitivity of its imports, and demand for primary commodities in any case remains mostly stagnant and relatively price-inelastic. For many countries, export receipts have in fact declined with the terms of trade, while import bills have increased, limiting the improved competitiveness of exports which are dependent on imported inputs. Depreciating currencies also increase the domestic budgetary burden of external debt repayment, fuel domestic inflation, and reduce domestic real incomes, especially in very open economies. While the gains from currency depreciation are often only gradually realized, the costs are usually immediately felt, posing both political and economic problems for the governments concerned.

----

9. <u>The Economist</u>, November 1, 1986, p. 65.

10. Ibid., October 11, 1986, p. 79.

11. Ibid., February 21, 1987, p. 69.

But depreciation also makes investment cheaper for foreigners, and could encourage an inflow of foreign capital if other conditions are right. For example, the massive and ongoing peso depreciation in Mexico has attracted U.S. and especially Japanese investment in its export-oriented border industries. At the same time, currency appreciation resulting in declining export competitiveness has led Taiwan and South Korea to relocate some of their simpler export industries to neighboring developing countries like Thailand and the Philippines. It has also led Japan to relocate some of its manufacturing production to the Asian NICs, ASEAN and Mexico, countries which because of the strong yen are now undercutting Japanese products in third-country markets and the Japanese home market as well.

In general, while some developing countries have benefitted from recent world currency shifts, others have not. But all will stand to gain if wild fluctuations in exchange rates can be eliminated from the international monetary system, allowing for more rational long-term calculations of production possibilities, less frequent shifts in competitiveness, and less unpredictable balance of payments impacts.

I.4 Third World Debt

The ballooning external debt of developing countries and their inability to pay it has occupied center stage in concerns about development in the 1980s. Around 1983, debt service payments began to exceed new borrowing, resulting in a net outflow of capital from the developing to the industrial countries. About half of the total outflow is principal repayment, and the rest interest. Overborrowing in the 1970s, high real interest rates in the 1980s, and wasteful and inefficient use of borrowed funds, are to blame. Aggravated by the commodity price slump and terms of trade decline of the 1980s, debt service ratios increased, amounting to 47% of Brazil's and 50% of Mexico's (the two largest developing country debtors) export receipts in 1986, and as much as 70% of Argentina's.[12] The major debtor nations are middle and upper-middle income countries in Asia and Latin America which were able to borrow readily from commercial banks in the 1970s and early 1980s. The poorer African countries are mostly indebted to international development agencies and foreign governments.

The debt crisis is the major constraint on developing countries' growth in the 1980s, since large debt service burdens limit their ability to import items they need for growth. Trade surpluses are required to pay for the debt repayments, but these have been difficult to earn given falling commodity prices -- until the 1987 price recovery -- and rising protectionism in industrial countries. Since Mexico's debt crisis in 1982, debt renegotiations have been ongoing on a country-by-country basis, and have involved a combination of measures -- including refinancing with new loans, rescheduling of debt payments, lower interest rates, debt-equity swaps and other new financial instruments, the Morgan Guaranty Mexican debt-bond swap, and domestic fiscal and monetary reforms in debtor nations. The results of these efforts have been mixed at best. Many debtor countries in Latin America and Africa have suspended or otherwise unilaterally limited interest as well as principal payments on their external debt, while Asian debtor nations, most of them much poorer than the Latin American countries, have continued to service their external debt and even to repay some principal. Major creditor banks have recognized that defaults on

----

12. The Economist, March 7, 1987.

some loans are probably inevitable. Default is particularly likely in the poorest countries, mostly in Africa, which have no way in which they could possibly repay their accumulated debts. There has been a partial shift away from IMF-type austerity programs, but "growing out of the problem" has not been successful either, especially given the weak long-term world market prospects for commodity prices, and the reluctance of most foreigners to loan to or invest in Third World debtor nations.

In the meantime, many developing countries are responding to their debt problems by liberalizing trade policies (to promote domestic efficiency and exports), privatizing state-owned enterprises (to reduce the burden of government budget subsidies)[13], removing restrictions on foreign investment and welcoming it more enthusiastically than has been the rule before (to obtain the foreign capital necessary for growth and debt repayment). All these policies face nationalistic objections, since they involve what many developing countries have become accustomed to viewing and abhorring as increased "dependence" on the industrial countries, though it will likely be different more in kind than in degree from their present dependence on foreign commercial banks.

The issues raised by the debt-equity swaps pioneered by Chile suggest the complexity of the situation. A swap simultaneously relieves host governments of some debt; minimizes the creditor bank's loss on a dubious loan; provides foreign (or local) investors with cheap local currency; and injects new private

----

13. Note that in most countries privatization is unlikely to proceed very far or fast because of political and economic constraints, including a lack of local private capital and managerial expertise, vested bureaucratic interests, and fear of dependence on foreign capital and minority ethnic business groups.

capital into the economy; it may also attract back some domestic flight capital. The problems are that creditor banks may not want to take the loss; investors may not want to invest or expand in such problem-ridden economies; nationalistic governments do not want to increase foreign ownership of their economies (a major reason why they preferred external debt to foreign investment in the 1970s); private investments may be merely subsidized, not increased, resulting in resource misallocation, and will eventually generate outward payments again (if the investors are foreign); foreign investors may merely take over existing local enterprises, not create new production; the increase in the local money supply may be inflationary; and "roundtripping" may occur (i.e. if returning domestic flight capital is swapped cheaply into pesos only to be exchanged back into dollars on the black market). For all these reasons, while debt-equity swaps may be expected to grow, they are unlikely to account for a major proportion of current debt.

I.5 Foreign Investment and Aid

Because of the debt crisis -- the resultant unwillingness of creditors to lend, and inability of debtors to absorb and service, more debt -- developing countries' external financing declined from $160 billion in 1981 to $68 billion in 1986, with the share of net private lending dropping from 57% of the total in 1981 to only 4% in 1986. The share of direct investment correspondingly increased, from 12% in 1981 to 19% in 1986.[14] The U.S. remains the largest source of new foreign investment in developing countries, accounting for nearly

----

14. IMF data, cited in The Economist, May 9, 1987, p. 100.

half their stock of foreign investment, but it has been losing ground to Japan in recent years. Investments in commodities have declined in recent years, while those in manufactures have increased. Five countries -- Brazil, Mexico, Singapore, South Africa and Malaysia -- account for almost half of the total stock of foreign investment in developing countries in 1986.[15]. The ASEAN countries -- Singapore, Malaysia, Thailand, the Philippines and Indonesia -- increased their share of total foreign investment in developing countries from a third in 1974 to more than 40% in 1984,[16] with 40% of the ASEAN total going to Singapore alone. In contrast, there has been divestment in most of Africa.

Because of their heavy debt burdens and severely reduced capacity to borrow, many developing countries have become more welcoming to foreign investment in recent years -- relaxing domestic ownership requirements, liberalizing trade, reducing bureaucratic regulations, and offering new fiscal incentives. Export-oriented investments are particularly sought after, because of their ability to earn foreign exchange that would alleviate the debt burden and permit continued growth. So far, in most countries these attempts to lure new foreign investment have not been very successful. Domestic political and economic conditions, including debt problems, remain discouraging in many countries, while internationally, the U.S. stock and bond markets and fears of protectionism continue to divert and attract capital from the developing countries. The decline in the dollar has slowed, and in a few cases begun reversing, the moves offshore which U.S. industry undertook to survive the strong dollar in the first half of the 1980s. There has recently been some

----

15. Ibid., June 20, 1987, p. 71.

16. Ibid., October 25, 1986, p. 72.

corresponding increase in offshore investment in developing countries by Japanese and German firms whose home currencies have strengthened. But these, like new U.S. investments, tend to be concentrated in relatively few developing countries -- primarily Mexico (which is attracting Japanese as well as U.S. manufacturing investment because of its much-depreciated currency and proximity to the U.S.) and the Asian NICs (which are attracting both Japanese and U.S. investment because of their accumulated skills and infrastructure as well as lower costs). Some Japanese and Asian NIC investment is also going to lower-wage Southeast Asian countries like Thailand and the Philippines.

Beyond these few countries, most foreign investment by industrial countries continues to go mainly to other industrial countries, often because of fears of being shut out of their markets by protectionism. Japan, for example, has for some years been investing more in North America and Western Europe than in its traditional Asian locations, such that by 1986, Japan's cumulative investments in the U.S. accounted for 30.2% of its worldwide foreign investments, followed by Asia (23.3%), Latin America (18.7%) and Europe (13.2%).[17] Japanese investments in Asian developing countries will increase, especially with the announcement of a new Japanese government Asian Industries Development (AID) plan to support private sector export promotion in China, Malaysia, Thailand, Indonesia and the Philippines, by providing financial, technical and market assistance to export manufacturing enterprises in these countries, and improving their access to the Japanese market. But the share of these countries in Japan's overseas investments will continue to decline.

----

17. Ministry of Finance, Tokyo, data cited in Asiaweek, June 7, 1987, p. 59.

In the long run, the amount of foreign investment going to developing countries will depend on what happens to trade patterns and policies, currency shifts, interest rates, and the prospects for commodity, manufactured and service exports from the developing countries, as well as their internal economic and investment policies. Unless these underlying conditions change significantly, and favorably, foreign investment flows to developing countries are unlikely to increase dramatically. However, a significant increase may be expected in overseas investments by the Latin American and Asian NICs and their so-called "Third World multinationals". Brazil and Hong Kong are already among the world's top 15 providers of direct investment abroad[18], while both Taiwan and Singapore, rich in external reserves, are encouraging overseas investments by domestic firms. Taiwan and South Korea are also relocating some of their labor-intensive industries abroad, in order to avoid trade restrictions directed at them, and in response to appreciating currencies and rising domestic wages.

As private lending has fallen precipitously, official loans and grants have risen from 31% of developing countries' external finance in 1981 to 77% in 1986, although in nominal terms this was only a small absolute increase.[19] In real terms, industrial country government aid to developing countries has been declining, and for political and budgetary reasons this situation is unlikely to be reversed soon, with the exception of an increase in Japan's overseas development assistance. For example, in May 1987, Japan announced that it would provide $20 billion of its foreign exchange earnings to debtor nations through a combination of untied export credits, increased contributions to multilateral

----

18. The Economist, June 20, 1987, p. 71.

19. The Economist, May 9, 1987, p. 100.

development banks, and loans jointly financed by government and private institutions. The Japanese government will also double its official aid to Asian developing countries which trade heavily with Japan, to $8 billion a year by 1990.[20] While there is plenty of evidence to suggest that the net benefit to developing countries of Japanese aid may be limited by the many business strings typically attached to it[21], the increased importance of Japan as an aid donor provides a sign of hope in an otherwise rather bleak foreign aid picture. Japanese aid will not only help to make up for declining real aid to developing countries from the U.S.; it may also stimulate more aid from the U.S. if the latter recognizes, as Japan clearly does, the importance of aid as an instrument that can open up foreign markets for donor country businesses.

The problem is that relating aid to potential markets will mean a concentration of aid in the more prosperous and promising developing countries, mostly in Asia and Latin America, which can deliver such a market, and a corresponding neglect of aid to the poorest and least developed countries, most of them in Africa. Yet it is these poorest countries which need official assistance the most, on both humanitarian and developmental grounds, since they are the least likely to attract commercial lending and direct private investment. Aid to these countries -- particularly if invested in infrastructure and human resource development -- is necessary to enhance their attractiveness to and absorptive capacity for foreign private (equity or loan) capital which would not otherwise be forthcoming.

----

20. Wall Street Journal, May 22, 1987.

21. See, for example, Business Week, December 1, 1986, p. 47.

II. Microeconomic Developments

II.1 World Trade in Commodities

At the end of 1986, the world price of food and industrial raw materials weighted by developing countries' exports had declined in real terms by close to 30% since 1980, and by nearly 50% since 1954. Developing countries' raw material exports could then buy only half the volume of manufactured imports that they did in 1974.[22] But commodity prices have been rising since early 1987. Despite this -- and for well-known reasons to do with low income-elasticity of demand and high price-elasticity of supply -- structural conditions in world commodity markets are not favorable to developing country exports in the long run. With conservation, technological substitution and taste changes in industrial countries reducing demand, and price responsiveness and technological innovation in developing countries increasing supply, relative prices have fluctuated around a declining trend over time. Interestingly, the more market-oriented that developing countries have become -- the more they have dismantled agricultural marketing controls and removed policy distortions -- the greater is the risk of periodic over-supply and price collapses which may eventually discourage some market participation. In theory, price and income fluctuations can be managed on the national or international level -- e.g. by hedging, buffer stock and crop insurance schemes, and international commodity

----

22. UNCTAD data, cited in The Economist, November 22, 1986, p. 107.

agreements -- but in practice these have not worked out well and there is no indication that they are more likely to in future.

The major problem today is not periodic but rather chronic over-supply which does discourage production, especially in food crops. The chief cause is agricultural protection and farm subsidies in the industrial countries -- Japan, Western Europe and the U.S. -- which preserve a small but politically powerful and high-cost farm sector in these countries at the expense of their own consumers (and hence of industrial growth elsewhere in these economies), and especially of vast numbers of impoverished Third World farmers who are or could be much more competitive in producing and exporting the same or substitutable crops at true market prices or scarcity values. The prospects for the continuation of this phenomenon of costly and regressive farm subsidies in developed countries are uncertain, though the budget and hence political burden that they pose could very rapidly become intolerable in these countries.

Technological innovation also makes possible continuously increasing agricultural productivity in both industrial and developing countries. In food production, the spread of "green revolution" technology in Asia and Latin America, together with the liberalization of agricultural policy in developing countries[23], has turned such giants as India and China from food-deficit into self-sufficient or food-surplus countries which export their surpluses to world markets in which they were major buyers just a few years before -- although the Asia-wide drought and resultant shortages and high prices of food in 1987 show how much this success is still hostage to the vagaries of the weather. Still,

----

23. This involves returns to market pricing, private enterprise and market distribution systems, and improved government agricultural management.

technology has enabled even Saudi Arabia to grow twice as much wheat as it needs in the desert, and it may soon bring about a "green revolution" in Africa as well, despite serious ecological, political, infrastructural and organizational constraints in that continent. Worldwide overproduction of food crops results in low food prices, farm incomes and export receipts, and increased farm indebtedness and government budget deficits. It also discourages food production in the developing countries, thereby threatening the adequacy of future food supplies, increasing migration and unemployment.

Farmers in many developing countries have already diversified their market production, including export production, into higher-value foodstuffs and non-food crops -- in Southeast Asia, Central America and the Caribbean, to tropical (and even temperate) fruits, vegetables, flowers and seafood, as well as marijuana, heroin and cocaine. Thailand, the Philippines, and even the socialist countries of Burma and Vietnam, have increased their shrimp exports to Japan, with the aid of technology and capital imported from Taiwan. New crops grown in the highlands include strawberries for local hotels and the tourist trade, and potatoes for McDonald's french fries in the big cities. Meat production is expanding, mainly for home consumption. These countries are also capitalizing on the growth of the gourmet or exotic foods market in Japan and Western countries, while some are benefitting from agricultural problems in competing developed countries e.g. Brazil and some Central American countries have been taking over Florida's share of the orange juice market following many years of frost damage and citrus canker disease in Florida.[24]

----

24. The Economist, February 14, 1987, p. 60.

While such diversification is admirable, its long-term success is by no means guaranteed. Import restrictions in the industrial countries remain a problem -- for example, protective quotas have been imposed on Costa Rica's successful export of cut flowers to the U.S.; Florida orange juice growers have filed an anti-dumping suit against Brazil; and Japan still bans the import of bananas from the Philippines during the harvest season for domestic fruits. Japanese health inspection standards remain a major non-tariff barrier for tropical food exports from other Asian countries. There is also the ever-present threat of over-supply, despite higher price and income elasticities of demand for the new foods. Innovative Asian or Latin American marketeers who develop a market for a new exotic food in the U.S., for example, often find their market quickly usurped by other developing country and even U.S. suppliers. Exporting non-grain food crops also often involves greater dependence of developing country farmers on industrial country multinationals which either operate plantations themselves or enter into contract relationships with independent farmers, to supply them with various inputs and credit in return for processing, packaging and marketing their crop abroad. While there are obvious benefits, many people argue that the relationship with multinationals also involves potential costs -- including the risks of increased indebtedness for small farmers, vulnerability to price and other market manipulations by monopsonistic global firms with operations in many different competing countries, and the pre-empting by foreign firms of higher-value stages of production which, if undertaken by independent local firms, would increase the share of domestic value-added in the world price.

Market prospects for some non-food agricultural products are not as bleak as they are for food products. Despite a long-term downward trend, prices of non-food agricultural products have now recovered from their 1986 trough and are back at 1980 levels. A growing consumer preference for cotton, for example, is increasing demand and prices for this crop. In rubber, Malaysia has developed epoxidized natural rubber (ENR), a natural rubber composite soon to be introduced which outperforms synthetic rubber and could replace it in family car tyres. This could as much as double the world market for natural rubber, of which Malaysia is the largest producer. But there is already a growing world shortage of rubber, due to acreage cutbacks during long years of low and declining prices, and supplies are not easily replenished due to the crop's long gestation period (seven years). Malaysia is also intensively researching new processes and uses for palm oil, of which it is also the world's largest producer. But palm and other edible tropical oil exports from developing countries are threatened by a recent consumer campaign in the U.S. against the use of saturated fats in processed foods, and by the imminent development of a no-calorie synthetic fat substitute. There is also the constant threat of over-supply, compounded by the ease with which technological innovators may be imitated by other countries. For Malaysia, the largest supplier of non-food agricultural products among developing countries, domestic cost pressures from rising wages and acute labor shortages on plantations make it particularly vulnerable to intensifying competition from lower-cost neighbors.

Of all the commodities exported by developing countries, metals are probably most vulnerable to declining demand from technological conservation, substitution, and the development of new composite materials. The amount of metals used per unit of manufacturing output has been falling fast.[25] Frequent price fluctuations are one factor encouraging consumers to switch from metals to non-metallic manufactured substances such as various plastics, supply of which is more readily controlled and prices of which are therefore more stable. Metal producers also have to cope with over-supply, exacerbated by structural changes and government policy interventions. For example, country-by-country nationalization of the operations of large oligopolistic multinationals which used to carefully control world supply and prices to maximize industry profits has resulted in a more competitive supply situation, with each individual country or producer (often state mining enterprises) acting as a price taker and seeking to maximize output for maximum national revenues -- leading to worldwide over-supply and falling prices. Producer cartel attempts to raise prices have also resulted in increased output from non-members, including new entrants, thereby undercutting the cartel price through over-supply. Thus Malaysia's attempt to push up the price of tin caused it to fall instead by nearly 60% between 1979 and 1986.

Current world excess capacity in metals production is likely to decline over time as the closure of old mines and smelters, e.g. for copper and aluminium, in developed countries like the U.S. shift supply more towards the developing countries, where technological advancements in exploration and mining are making it increasingly possible to extract metals from previously difficult locations. But despite recent price increases, the generally dismal world

----

25. For example, between 1979 and 1985, while manufacturing output rose an average of 2.1% a year, world consumption of aluminium remained static, and world copper usage fell due to the increasing use of fibre optics rather than copper wire in telecommunications. The Economist, April 18, 1987, p. 65.

market prospects for metals is a serious concern because many of the poorest developing countries derive most of their foreign exchange earnings from a single metal e.g. copper in Zaire and Zambia, and diversification is difficult.

The price of oil, the leading fuel exported by developing countries, was raised dramatically by OPEC, the oil cartel, beginning in 1973. After the "second oil shock" in 1981, oil prices slumped equally dramatically to about one-third their peak values by 1986. OPEC's success in raising the price of oil encouraged conservation and substitution on the demand side, and increased production by non-OPEC members on the supply side, reducing OPEC's share of the world oil market and exerting downward presure on the price. OPEC's failure to maintain cohesion among its members resulted in weakening observance of cartel quotas and undercutting of the cartel price, especially by Iran and Iraq, who have needed their oil earnings to finance their protracted war with each other.

The oil price decline resulted in huge revenue losses for oil-exporting developing countries, and increased debt service ratios for the heavily indebted nations like Mexico, Indonesia and Nigeria. A heavy structural dependence on imports permitted by many years of plentiful oil revenues, and heavy external borrowing for domestic industrialization based on assumptions of continued abundant oil earnings, resulted in severe balance of payments problems. In response, many of these countries have devalued or depreciated their currencies and are attempting to diversify into non-oil exports, including agricultural commodities and manufactures. Unaccustomed capital constraints, generally weak world markets, and limited domestic skills, are making this difficult. Meanwhile, oil-importing developing countries enjoyed import savings and improved trade balances.

The oil price partly recovered in 1987, and the general belief is that the recent reduction in production capacity will result in oil shortages and high prices again in the 1990s. While this will help improve the situation for the oil-exporting countries, it will add to the burden of oil-importing countries, as it did in the 1970s. But the huge payments surpluses and external borrowing which characterized the 1970s are unlikely to recur, in part because of the weakening of OPEC and the continued entry of new producers. Natural gas supplies, which are concentrated in oil-exporting countries, especially in the Middle East, but are also found in countries without oil, will continue to decline in the industrial countries and increase in the developing countries in the 1990s.

II.2 World Trade in Manufactures

Against the generally gloomy picture in commodities, manufactured exports are a bright spot. Developing countries which have specialized in the export of manufactures -- mainly the Asian and Latin American NICs -- continue to prosper handsomely and to make increasing inroads into industrial country markets for an ever-widening range of products. The lesser developed countries which have followed suit have almost all succeeded to some extent, at least in increasing the quantum and proportion of foreign exchange earnings which are derived from manufactured exports. They include a range of very different countries, from large, populous and poor countries like China, India and Bangladesh, to medium-sized, middle-income countries like Turkey, Thailand and the Philippines, and small, resource-poor island nations like Mauritius and the Dominican

Republic. In almost all of these countries, manufacturing for export has become the fastest-growing sector of the economy, although especially for the larger countries it typically remains small relative to agriculture and manufacturing for the domestic market. In relative terms its contribution to the balance of payments is typically much greater than its contribution to total output or employment.

Developing countries have been increasing their share of both world industrial output and world manufactured exports since 1970. While light, labor-intensive manufactures such as textiles, clothing, footwear, fashion accesories, toys and sporting goods remain the most typical and widespread exports,[26] the range has increased to include more capital-intensive goods such a steel, chemicals, glass, petroleum products, transport equipment (cars, ships and even planes), machinery and machine tools, electrical and electronic products, and professional and scientific equipment. Many of these latter industries are set up or evolve to serve both domestic and foreign markets, allowing developing countries to enjoy the scale economies that would not be possible if they were limited only to their own small domestic markets.

Despite the fact that manufacturing for export now has a long (more than 30 years) and fairly widespread history of success in a variety of developing countries, and still enjoys faster-growing, less wildly-fluctuating markets and more favorable terms of trade than commodity exports, pessimism about its long-run prospects has been common since the 1970s and persists today despite

----

26. For example, textile products account for over 25% of all developing country manufactured exports to industrial countries, and 10% of all developing country exports.

the contradicting evidence. This largely reflects the political unpopularity of export manufacturing in industrial countries (which have been losing their world market shares in specific industries) and even in some of the developing countries themselves (where domestic vested interests often oppose the liberal economic policies which must accompany export manufacturing). Here I will briefly examine the reasons related to the international economic environment which are usually given for this pessimism, and consider their validity.

Technological advancement is often considered to be disadvantageous to developing countries exporting manufactures, since it generally proceeds in a labor-saving direction. Thus it has long been predicted that automation in industries like textiles and electronics will result in comparative advantage shifting back to the industrial countries. In fact, high costs and risks have considerably slowed the diffusion of automated technology in industrial countries, while short product cycles, intense competitive cost pressures and market trends towards individually differentiated products have extended the life of labor-intensive processes in high-tech and fad industries like computer equipment, fashion garments and toys.

Even automated technologies frequently include intrinsically labor-intensive processes or require some relatively labor-intensive inputs which are best produced in low-wage developing countries. There they may attract the location of complementary capital-intensive processes, to benefit from economies of vertical integration and just-in-time delivery. "Deskilling" as a consequence of automation may also make more production processes feasible in developing countries, since machine operation substitutes for the operator skill which they lack. These countries are also more likely to be able to offer the "flexible" labor willing to perform the round-the-clock shift-work necessary for the quick attainment of maximum volumes and rapid depreciation of expensive capital-intensive equipment.

More generally, advances in transport, communications, computers and information technology have shrunk the world so that geographical distance is no longer a major handicap as it can be offset by good infrastructure which many developing countries, especially the NICs, have developed. These countries have further expanded their technological capacity so that they increasingly possess relatively cheap supplies of skilled and experienced as well as unskilled labor. Some of the Asian NICs are now even in the position of offering cheap capital or direct capital assistance to capital-intensive, high-tech companies, as well as providing training or training subsidies to upgrade workers' skills. Where technological change is rapid, developing countries can also benefit from the advantage of latecomers to industrialization in that they may immediately implement the latest technology without waiting for older equipment to be depreciated.

Another common cause for pessimism about the future prospects of export manufacturing in developing countries relates, as with commodities, to the fear of worldwide over-supply. It has frequently been argued that as more and more developing countries are lured into manufacturing for the world market, competition among them will lead to over-production, excess capacity and falling prices. The entry of China and India into the market is particularly feared. In fact, nothing like this has yet happened, for many reasons.

Demand for manufactured goods is more price- and income-elastic than that for commodities, and has been growing more rapidly than income in industrial countries and in the world as a whole. Developing countries still account for a relatively small proportion of industrial country imports of manufactures, and for an even smaller proportion (less than 10%) of industrial country consumption of manufactures, most of it concentrated in only a few industries like garments and footwear. From this small base, the scope for further market penetration, including displacement of huge ready markets, is enormous, not including the accelerating growth of developing country markets themselves. Thus exports of manufactures from developing countries can grow more rapidly than demand for manufactures, which is itself still growing more rapidly than income.[27]

The entry of more developing countries into particular export manufacturing industries -- usually textiles and garments -- does not necessarily hurt older producers, who have the option of diversifying and are often keen to move up the industrial ladder anyway. Indeed, the spread of export manufacturing to more recent entrants among developing countries is often initiated from the more-established NICs, which have been moving labor-intensive processes to lower-wage countries while moving into more sophisticated products and processes themselves. As incomes and costs rise in the NICs and they open their own domestic markets, more opportunities arise for the developing countries to supply them with cheap manufactures. At the same time, the NICs remain much more attractive than the developing countries to multinationals relocating production from industrial countries, because of their superior skills, efficiency and supporting industries.

----

27. For example, in 1986 world trade in manufactures rose by only 3% in volume terms, one of the worst performances in three decades, according to GATT, though still higher than total output growth, yet the value of developing country manufactured exports grew by 13% in the same year. <u>IMF Survey</u>, April 6, 1987, p. 109.

Not all developing countries presently want to or can embark on export manufacturing on a large enough scale to "flood" world markets in particular product lines. Many of the countries beginning export manufacturing are very small and have limited domestic capacity e.g. the Caribbean islands and Mauritius. The larger countries like China and India remain primarily domestic market-oriented, and are interested in exporting manufactures mainly to earn the foreign exchange necessary to invest in their potentially huge domestic markets. They are unlikely to end up as "export platforms" only, and bring with their increased supply also their increased demand for manufactures on the world market. Most of the low-wage countries also remain relatively inefficient, such that they do not pose a major competitive threat to more established exporters, while their policy-making elites still tend to favor import protection for domestic market monopolies, and a low-waged, underemployed labor force, over the more democratic impacts (lower consumer costs, higher employment) of export manufacturing.

In short, domestic supply-side limitations in developing countries themselves remain a greater constraint to the expansion of manufacturing for export than world market demand prospects, which remain good for those countries which do succeed in establishing export manufacturing industries. If these supply-side limitations are eased by political changes in the future, then concerns about excess capacity may become more valid, but even so this would depend on the relative rate of growth of demand.

The major demand-side constraint is imposed not by the world market, but rather by protectionist trade policy in the industrial countries, which already discriminates against developing countries -- most notably through the

Multi-Fibre Arrangement (MFA) which regulates world trade in textiles and textile products outside of GATT rules. There has also been a growing use of voluntary export restraints and other non-tariff barriers against specific products from individual countries. Protectionism is certainly a major problem, but it is also a complex phenomenon, and complete pessimism about its spread and its effects may not be warranted.

For one thing, protectionism against some countries benefits others, and helps to spread export manufacturing among more countries. Examples include textile quotas against Hong Kong, and voluntary export restraints and other import restrictions against Japan, South Korea and Taiwan -- all of which have shifted trade opportunities to other developing countries. Protectionism also remains less severe against developing country manufactured exports than against their agricultural exports to industrial countries,[28] and this is likely to continue. There is a much larger number and wider range of manufactures; it takes time to identify import damage and to undertake the formal procedures and political lobbying necessary to obtain import protection -- during which time many of the import-impacted companies may be forced to shut down or move out; rural-based farm sectors often have disproportionate political clout compared with urban-based industries in developed countries (particularly Japan); unity is more difficult to achieve in manufacturing, where national companies may be highly competitive with and distrustful of one another, and capital and labor may have different interests e.g. capital can meet import competition from developing countries by relocating to those countries, but labor, which is often

----

28. For example, in 1983, 29% of developing countries' agricultural exports to industrial countries were affected by non-tariff barriers, while the ratio for manufactured exports was 18%.

weakly organized, cannot; protection against industrial inputs will be opposed by industrial consumers of those inputs, pitting capital in one sector against capital in another; there is usually a dominant preference for free trade among policy-making elites in industrial countries which are free-enterprise market economies; governments are sometimes hesitant to take policy actions which raise the prices of manufactured goods to consumers; GATT regulates international trade in manufactures, but not in agricultural commodities. Those developing countries whose manufactured exports benefit multinationals in the industrial countries also have a powerful ally against protectionism in their export markets.

Protectionism can, within limits, be adjusted to. For example, it encourages the affected countries to diversify their export markets and their industrial production, shifting from protected to unprotected products, and upgrading into more sophisticated, newer industries which tend to have growing markets and to be less inclined towards protectionism. Import tariffs or surcharges can be a stimulus to cost reduction to remain competitive, while quotas can be filled with higher-value products or avoided by shifting to products not covered by them, as has been the case under the MFA. Protectionism is also generally ineffective in improving the competitiveness and viability of protected industrial country industries. And though developing countries have so far been too weak to retaliate against discriminatory trade restrictions, their capacity to do so is growing with the size and purchasing power of their domestic markets.

Thus, while protectionism remains the major threat to developing countries' continued export of manufactures, this is not sufficient to completely condemn the prospects for such exports in the future. Protectionism has not so far undermined the growth of its major country targets -- Japan and the Asian NICs -- and is itself not a market parameter, but a policy variable which can be changed, since it encounters some resistance within the industrial countries themselves.

Recent developments in the world economy have in fact improved the immediate prospects for expanded export manufacturing in developing countries. They include the appreciation of the yen, European and Asian NIC currencies, and the depreciation of most developing country currencies even against the dollar. This has increased the competitiveness of developing countries' manufactured exports against exports from these established countries in world markets. It has also encouraged the relocation of export-oriented manufacturing industry from the industrial and newly-industrialized countries to the developing countries. Export manufacturing is booming especially in Southeast Asia and Mexico. If adjustment of the major industrial economies and Asian NICs to the changing world environment proceeds as desired i.e. with stimulation of the Japanese and West German economies, and the opening of the Japanese, South Korean and Taiwanese domestic markets to more foreign imports, the demand for the developing countries' manufactured exports will increase even further.

II.3 World Trade in Services

In addition to commodities and manufactures, developing countries' exports of services are also affected by the world environment. Workers' remittances to many Asian countries have declined sharply since the early 1980s due to the slump in oil prices and in Middle East construction and other economic activity relying heavily on imported labor. Even with the recovery of the oil price, the completion of major infrastructural construction projects in the Middle East makes substantial rehiring of foreign workers unlikely. Elsewhere, slow growth and high unemployment in Western Europe has slowed the flow of migrant workers from the Mediterranean, while the passage of a new immigration bill in the U.S. which penalizes employers for employing illegal foreign workers will reduce and perhaps even reverse the flow of Mexican migrant labor. There has also been some retrenchment of foreign workers from neighboring black African nations in South Africa as a result of that country's economic woes. On the other hand, government-controlled labor exports are becoming increasingly common for China and Vietnam, while workers from Thailand and the Philippines are increasingly finding work -- often illegally -- in the booming, labor-short economies of the Asian NICs.

Tourism earnings have remained relatively stable on the whole, and very much dependent on supply-side conditions, especially political conditions, in individual countries. Countries with depreciated currencies should become more competitive, and an increase in visitors from Japan and Western Europe may be expected because of their stronger currencies. There are regional variations. For example, tourism has declined in the Middle East and North Africa because of concerns about terrorism, but increased in the Caribbean, which is fortunately situated close to the U.S.. In the longer run, the prospects for increased foreign exchange receipts from tourism are not particularly bright, especially for the many developing countries which lack local attractions and/or are remotely situated relative to the richer countries from which most tourists hail. This is the case, for example, for Africa (with the exception of Kenya), where the AIDS threat poses a further problem for tourism (as it does also, though to a lesser extent, in Thailand). Tourism is partly dependent on income growth in the industrial countries, is competitive among developing countries (and between developing and industrial countries), and tends to favor the more developed of these countries because of its relative capital-intensity and need for expensive infrastructural support. Tourism in China, for example, is limited not by demand but by domestic capacity. In general, except for small island nations with few other resources, tourism is not likely to be a growth market for developing country exports.

Few developing countries are involved in exports of transportation services, which tend to be dominated by the industrial countries, are regulated by international or regional cartels, and often subject to protectionist restrictions in the industrial countries. Several developing countries are involved in shipping, but this is a competitive sector which suffers from world excess capacity. In general, transportation is a very capital-intensive sector which few developing countries can enter successfully. The exceptions here are once again the Asian NICs and their neighboring Southeast Asian countries, which run highly-successful international airlines that have been out-competing older industrial country airlines with a combination of more modern fleets, better service, and lower fares (resulting in part from lower labor costs). There is also scope for some developing countries to develop roles as regional transportation and communications centers, as Singapore, already the busiest sea-port in the world, already is for Southeast Asia. Some of the small South Pacific Islands are trying to develop as naval bases for superpower military fleets in that ocean.

Two service exports which have been increasing their share of world trade are investment income, and consultancy services including financial, technical and business services. These are areas which the industrial countries have traditionally dominated and are seeking liberalization of in the current GATT round. Most developing countries run deficits in these services which could worsen if liberalization does in fact occur. However there are prospects for at least some countries increasing their exports of these services. The Asian NICs, for example, have been increasing their overseas investments and can expect to receive increased investment income in the future. They are also becoming important sellers of technology to lesser-developed countries, for whom their technology is arguably more "appropriate" in terms of scale, sophistication and costs.

Hong Kong and Singapore are struggling to become world financial centers but their prospects here are limited by small domestic economies (which for Hong Kong could change with its incorporation into China after 1997) and intense worldwide competition resulting in a potential over-supply of such services. For example, in the Asia-Pacific region, which is expected to experience a boom in demand for financial services, the two city-states are likely to be overshadowed by both Tokyo and Sydney. However both are likely to retain a regional role, as are the Cayman Islands and other Caribbean offshore financial centers and tax havens, and Turkey. South Pacific countries like Vanuatu are also attempting to develop as tax havens and offshore financial centers, but are likely to be less successful because of their small size and remote geographical location.

Low wages combined with improved education in some developing countries are increasing their ability to export manual and "brain" services, aided by technological advancements in communications and information technology. At the low end, Barbados and South Korea already perform labor-intensive data-entry and processing operations for U.S. multinationals, while at the high end, computer scientists and engineers in the Asian NICs and India are beginning to perform skill-intensive research and design functions and software development for high-tech multinationals in the industrial countries. This comparative advantage is likely to grow, and protectionism is much more difficult and unlikely in these "brain services" than it is in manufacturing.

In general, because of domestic skill and infrastructural constraints, only a few developing countries and NICs, mainly in Asia, are likely to develop significant service exports in the next decade, and these exports will remain small relative to their commodity and manufacturing exports.

Conclusion

For a long time it has been fashionable -- especially among non-economists and in the developing countries themselves -- to view the international economy as essentially unfavorable to the developing countries, and even as a constraint on their development and a major cause of the inequality which exists between developing and developed countries, and within the developing countries themselves. Participation of developing countries in the world economy has thus been denigrated.

This is puzzling, because the historical evidence is so completely different. Firstly, those developing countries which are most integrated into the world economy -- say, the Asian NICs and to a lesser extent the countries of

Southeast Asia -- and which are the most export-oriented and the most dependent on the world market, are also the most successful by any indicator of development -- output and employment growth, income distribution, real and relative wage growth, mass living standards, and social indicators such as health status, educational attainment, infant mortality, female labor force participation, and so on. Those developing countries which are most marginal and least integrated into the world economy -- say, in sub-Saharan Africa -- have been the least successful on all counts. Within Southeast Asia, the contrast between the outward-oriented ASEAN countries and their socialist neighbors (Burma, Vietnam, Laos and Kampuchea -- which have similar colonial histories and resource endowments) is particularly striking, although the difference in domestic economic systems may have more to do with this since the socialist countries are as if not more externally dependent than the capitalist ASEAN countries.

Secondly, those opposed to integration in the world economy often posit self-sufficiency as a desirable alternate goal. But all the developed countries are heavily integrated into the world economy, with the smaller developed countries of Western Europe especially being much more export-oriented than even South Korea and Taiwan. Self-sufficiency even in a large rich country like the U.S. has been decreasing rather than increasing through time, and as self-sufficiency has declined, incomes and living standards even in the U.S. have risen. For both developed and developing countries, as participation in the world economy increases, so does domestic income, including incomes of farmers and of the urban working-class. This partly explains the eagerness of many socialist developing countries -- including China and Vietnam -- to expand their participation in the world economy, in their case as a means to building socialism. Furthermore, only those developing countries which heavily participate in the world economy, especially in export manufacturing, have any hope of narrowing the income gap with industrial countries, and even overtaking some of them.

Thirdly, no country -- not even the U.S. or, at the other extreme, China -- has the <u>option</u> of not participating in the world economy. This is particularly true of developing countries simply because they are small, poor and not industrialized, and therefore do not, and in many cases never can, make all of their own needs, including basic subsistence needs. The relevant question really is the <u>terms</u> under which developing countries participate in the world economy -- what they sell, what they buy, under what rules, and affected by what policies. Even where the world economy is likely to be unfavorable for some developing countries -- especially the poorest of them, mostly in Africa -- this does not imply that they should not participate in it, since non-participation is likely to be even worse (as the example of Burma's long period of virtual autarky suggests).

In this paper I have outlined the features of the changing world economy which will affect developing countries in the 1990s. They include macroeconomic developments in the industrial countries, world trade patterns and policies, currency shifts, and international capital flows, including foreign investment, aid and Third World debt. These developments are, of course, inter-related, and difficult to predict with any certainty, given their dependence on political as well as market forces. My conclusion is an evasive one: that the world economy will "muddle through" without major calamities or boons for the developing countries. At the microeconomic level, I have suggested that the world market prospects for developing countries' commodity exports are likely to continue to be fairly poor and unstable in the 1990s, despite current and occasional price booms in particular commodities. Market prospects for manufactured exports are much better, though hardly excellent, with prospects for service exports lying somewhere in between. All these markets will be heavily conditioned by decisions on international trading rules, and by government policies in both the developed and developing countries. Because of different indigenous conditions, individual developing countries will have differing capacities to take advantage of favorable market prospects and to avoid or manage unfavorable ones, leading to greater differentiation among them.

If both the macroeconomic and microeconomic developments are favorable -- and they are linked -- many developing countries will be able to grow out of their current debt problems, and to attract more external capital resources -- both investment and loans -- to finance their development. Official development assistance will become less necessary, though arguably more readily available, given healthier budgets and trade balances in the developed countries. On the other hand, if developments in the world economy are unfavorable, debt problems and slow growth will persist and official development assistance will become more necessary, though probably less available. With the increasing importance of Japan as a key player in a more decentralized world economy, and as a major trading partner, creditor and foreign investor in developing countries, the role of official and private external finance in these countries' development may be set to undergo a subtle change, something that the U.S. must decide how to respond to in the 1990s. In particular, it must confront and consider the striking difference between the currently favored political goals of U.S. foreign aid, which direct it largely to countries of "strategic foreign policy interest", and the more economically self-interested aid linked to the donor's international business interests, which is more characteristic of Japan.