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THE WORLD FINANCIAL SITUATION AND IMPLICATIONS FOR GATT

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1. You undoubtedly recall the turmoil on international commodity markets in the middle and late 1970s, which served as a somber background for the Tokyo Round of GATT negotiations of those years. But even those tumultuous commodity market conditions were subsequently dwarfed by the serious train of events on international financial markets since the early 1980s. This worrisome world financial situation adds a special sense of urgency to meaningfully addressing in the new Uruguay Round of GATT negotiations those trade policy issues which impede improving the financial health of the less developed countries (LDCs).

The Changing World Financial Scene

2. It is important to recognize that there have been some notable changes in the nature of the world economy since the

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1970s, some of which may not have been adequately recognized and fully understood at the time of the Tokyo Round negotiations. Fundamental changes in global financial and capital markets are merely one -- but nevertheless important -- aspect of the changes that have been occurring in the world economy since the last set of those multilateral trade negotiations which ended almost a decade ago. The volume of financial resources generated through new issues on these markets has grown to some US$ 250 billion by 1986, while the trading turnover is many times that, dwarfing even the total volume of world trade in goods and services. Both developed and developing countries have been major participants on these financial markets.

3. This rapid expansion of these markets has been accompanied by some fundamental changes in the international financial system. With the progressive deregulation of domestic financial markets of the major developed economies and their closer integration, there has also appeared a wide variety of innovative financial instruments to better permit financial institutions to intermediate on these markets. While to review many of these would be beyond the scope this short presentation, I think there are three fundamental changes of especial importance to the theme of our discussion:
(a) The movement from fixed to variable exchange rates for the major world currencies;

(b) The integration of international capital markets already alluded above; and

(c) The enormous rise in developing country debt.

4. The abandonment in the early 1970s of the Bretton Woods arrangements on fixed exchange rates represents a recognition of the importance of foreign exchange policy as a useful -- if potentially very abusive -- trade policy instrument for developed and developing countries alike. While there may be more than occasional complaints over the ensuing "huge" fluctuations and uncertainty in exchange rates for one foreign currency or another, it might be good to recall the turmoil on foreign currency markets which in the fifties and sixties typically preceded the often large and usually overdue devaluation of one currency or another. Moreover, in this new deregulated environment, market instruments such as futures and options contracts have been tailored in order to more efficiently hedge against such instability. In retrospect, it seems that politicians weren't much better in the good old days at setting the price of their country's money than they are at setting the price of their country's wheat today.
5. To the extent that we observe large movements in rates on foreign exchange markets nowadays, they are more likely owing to the inability of the authorities to insulate foreign currency markets from the imbalances arising from their domestic fiscal and monetary policy distortions. It is unrealistic in today's world of a globally integrated economy to attempt to return to the regime of fixed exchange rates established at the end of World War II; such a move would eliminate an important and very powerful policy instrument for spreading adjustments more broadly through an economy. Of course, further important refinements to this new system, such as moving away from the present bloc-floating currency arrangements to more generalized floating would be appropriate. Similarly, broader consultation and coordination of national economic policies such as sought through the recent Venice Summit are a sine qua non of this global economic interdependence.

6. The large volumes of funds traded daily on international financial and capital markets have grown to dwarf the magnitudes of actual international trade flows of goods and services. These financial markets grew rapidly and performed a remarkable intermediation role in the middle and late 1970s in recycling the so called petro-dollar surpluses from oil-exporting countries to cover the current account imbalances of other countries. Of course, these same financial markets
have in recent years served as the vehicle by which the U.S.
has financed its exaggerated domestic resource imbalances and
grew to become the country with the largest external debt in
the world.

7. During the middle and late 1970s these global capital
markets facilitated the large financial transfers to LDCs —
primarily in the form of syndicated commercial bank loans —
which subsequently formed the core of the international
debt problem which has afflicted so many of these countries
in the 1980’s. This debt was largely denominated in US
dollars, it was of shorter maturity than the custom with
multilateral lending instruments, and it carried variable
(i.e., floating) interest rates. The euphoria of the
seventies, with rising commodity prices, low or negative real
interest rates and rapid trade growth underpinned this rapid
expansion in developing country external debt. This rosy
perception of the future has been overtaken by a return to
the secular downward trend in real commodity prices,
historically high real interest rates, and slow growth in the
major OECD economies which has dampened market prospects for
many of these commodities.

8. The complexion of these global financial markets has
radically changed in the last several years. The spreading
inability of over-extended LDCs to fully service their
external debts to commercial banks has severely impacted the
sovereign debt market. Voluntarily syndicated sovereign debt operations for LDCs -- i.e., not part of a "rescue package", often assembled under the auspices of the Paris Club and with IMF/IBRD support -- have virtually disappeared on the part of commercial banks. The prospects for a resumption of new lending of this type by these banks, so long as presently outstanding loans are trading in the secondary interbank market at discounts of 30% to 80%, are not at all bright. For the time being, attention is rather focused, on debt-equity swaps, write-downs, provisioning of reserves, etc.

9. The magnitudes of outstanding debt are impressive. At the end of 1986, the total outstanding debt of the LDCs was estimated to be about US$ 1,035-billion, having grown by almost 60% since 1980 and even by 25% since the debt "crisis" really came to the forefront in 1982. Very clearly, during the past four years, the problem does not seem to have grown any smaller! About 45% of this external LDC debt is owed by merely thirteen highly indebted countries -- and nearly half of that merely by Mexico and Brazil. In some of these countries in this group -- and many of the smaller poorest countries -- debt service burdens will account for much of (or even more than) the likely future expansion in their production of goods and services. The further plight of the exceptionally poor sub-Saharan African countries, most of whose external debt already carries relatively concessional terms and conditions and is from official rather than
commercial sources, has recently occupied much of the
attention of the public.

The World Food Economy

10. It is not our intention to drag before you this gloomy
portrait for the purpose of pleading for special treatment of
the agricultural sector in the LDCs. To the contrary, we
should recognize some important elements of success in the
global food system and the role played therein by LDC
agriculture. It is no exaggeration to state that never in the
recorded history of the world has such a large proportion of
the world's population been as adequately nourished as it is
in the 1980s. In a recently released report by the World Bank
-- Poverty and Hunger -- we note the remarkable growth of
world food production in the past forty years, even
surpassing an unprecedented increase in world population.

11. But it is not just a question of food production
matching or outpacing food consumption. Because of the
increasing efficiency -- albeit some might claim at a
spasmodic pace -- of world food markets, nations need no
longer pursue the will o' the wisp of strict food self-
sufficiency through national autarky in order to achieve an
adequate level and reliability of food supplies. Rather,
through a closer participation in world markets -- for
agricultural commodities as well as other goods and services
-- developing and developed countries may both pursue
resource allocation strategies which permit following a more rapid and economically efficient growth path.

12. We do not mention these notable accomplishments of the global food economy with the intention of lulling you into a sense of complacency. The nutritional situation continues to be worrisome in some parts of the world. A commonly cited case is that of sub-Saharan Africa, where in 1982-3 the index of per capita food production was 12 per cent below the already exiguous average level for 1969-71. While the short-term situation in this Region may have marginally improved in the last year, we should expect to continue to face serious food production, demographic/human resource and natural resource management problems in the area for some time to come. On the other hand, it would be entirely inappropriate to hold the world food system responsible for those instances in which political authorities have themselves actively and intentionally prevented people at nutritional risk from feeding themselves; time and again, for example, we have seen governmental action tending to disrupt civil life and normal market operations, and/or preventing legitimate relief operations from going into action -- occasionally for political, religious or ethnic reasons.

A Growing Appreciation of the Policy Errors of the Past

13. With the growing articulation or "globalization" of both financial and commodity markets, we are increasingly
appreciating how really futile it is to attempt to isolate or insulate domestic economic policies from external forces. Whether it be questions of fiscal policy, monetary and credit market conditions, or a government's commodity price interventions or production controls, domestic circumstances will spill over into the international arena -- often with a vengeance! The effects may show up in both the magnitudes and directions of the flows of commodities and the principal price -- the exchange rate -- which translates the domestic terms of trade into their international equivalent.

14. Unfortunately, at the same time that the LDCs have been encouraged -- and even compelled by the chain of events -- to more closely articulate their agricultural economies with global markets, it appears that the OECD countries have increasingly sought to raise protectionist barriers around their producers, driving broad wedges between domestic and world market prices. This has often involved shifting the resultant production surpluses -- in increasing volumes and at increasing costs through export subsidization -- unto export markets, too frequently with little or no regard for the resulting turmoil on these markets. This has at times been accompanied by additional restrictions on their imports of LDC agricultural commodities. Official food donations have occasionally been mismanaged so as to cause further turmoil on the recipient countries domestic agricultural markets. There have resulted huge reversals in market posture, as
former importers have become important exporters of, for example, cereals, beef and sugar. The budgetary costs and economic inefficiencies arising from such market distortions have been pointed to on numerous occasions, such as the World Bank’s World Development Report published last year, in a recent USDA report measuring government intervention in the agricultural sectors of various countries, or in a series of studies recently released by the OECD.

15. The costs to the OECD countries of implementing these programs are so impressive as to merit citing a few examples:

(a) U.S. farm support spending reached nearly US$27 billion in 1986, a contribution of almost $700 from each non-farm family in the nation. Programs such as that for sugar which report no net federal budgetary outlay involved further heavy consumer costs.

(b) Direct subsidy costs of the EEC’s Common Agricultural Policy stood at about the same level: adding to that the increased consumer costs of agricultural commodities, the total farm subsidy amounted to about $40 billion or about $900 from every nonfarm family in the Common Market.
16. Additional impressive figures have been given of the costs of these programs, burgeoning commodity stocks, and the related distortions in product and factor markets. The degree of overcommitment of resources to the agricultural sector in the OECD countries persists. Given the magnitude of these program costs, one is frankly puzzled that consumers in the OECD countries have not sought to more energetically dispute the continuation of these programs. A fundamental step would be to refocus these domestic farm programs away from production incentives and towards targeted income support and assistance to redeploy human, natural and financial resources towards efficient non-farm production activities. Thus the price support measures currently in place would have to go, while the rundown of current large stocks would have to be phased over a reasonable time period in order not to introduce further turmoil unto the commodity markets in question.

17. It is not just a question of the farm policies of many of the developed countries, which have so often sought to wrap up their producers in a cocoon of stable prices and
guaranteed markets. We must also lament the pernicious effects of a now fortunately progressively discredited policy framework typically applied by the LDCs in the past. The principal components of that framework included, for example:

(a) Overvalued exchange rates which artificially maintained staple foods relatively cheap;

(b) State agencies which imported foods and made them available domestically at subsidized prices in spite of the impact on budget deficits;

(c) State export marketing boards which taxed farm exports; and

(d) Inadequate research and extension services which discouraged private investment in farming.

Such approaches were customarily accompanied by expanded bureaucratic interventions in other parts of the economy, establishment of inordinate levels of tariff protection for pet white elephant projects, which distorted the domestic terms of trade against the rural economy, etc. You recognize the model whose outlines I am sketching. The unfortunate experiences of the LDCs with such policies are also well
documented in last year's World Development Report. While some countries pursued these policies in the 1970s when they were still flush from the bonanza of their newly-found oil export earnings or expectations of continued buoyant markets for their other commodity exports, other countries discovered it was easy to do so by borrowing on the international financial markets from commercial banks which thought that the expression "sovereign risk" -- when applied to the loans made to profligate LDC governments -- meant "risk free". That bubble finally burst, of course, in 1982.

18. Quite naturally, this development model included a characteristically adverse treatment of domestic financial institutions and financial markets. Financial institutions tended to be unviable and financial markets were abused. Few financial instruments were developed and their use was primarily restricted to the government sector. As a result, these markets remained stunted and largely inoperative as vehicles for mobilizing domestic financial resources and encouraging the flow of such resources towards economically efficient production and commercial undertakings. Nor were the links between domestic financial markets and external financial markets nurtured or permitted to develop. Financial flows from abroad, in either the form of debt or equity instruments, were not permitted to be efficiently intermediated in domestic financial markets in order to encourage an efficient use of domestic resources or to expand
the trade links between domestic and foreign product markets. Time after time black markets and underground economies developed and flourished as open commodity and financial markets were suppressed. Capital flight from these countries was of epidemic proportions.

19. Thus while the developed countries characteristically generously subsidized their agricultural sectors, the custom among the LDCs was to heavily tax their agriculture. On the trade policy front, the developed countries maintained that since their agricultural policies were domestic issues, they were not negotiable in the MTN fora. The LDCs, rather than aggressively pursuing the MTNs as an instrument for joining the international trading community on standard terms and conditions, instead sought to promote special treatment and dispensations from complying with GATT rules. Unfortunately, under this guise they too often erected and shielded highly protected and inefficient production systems which have subsequently proved to be untenable in a more resource constrained world.

World Bank Initiatives in This Difficult Environment

20. Once abused, financial markets can be very stern taskmasters, whether they be domestic financial markets or international financial markets. This is very apparent today on the international markets, which have swung from the virtual unquestioning acceptance of LDC creditworthiness
during the 1970s to the other extreme of notable reluctance to undertake uncollateralized or sovereign lending to the LDCs today. Both the International Monetary Fund and the World Bank are attempting to participate in the process of reestablishing the standing of LDCs in the international financial markets. In the case of the Bank, this has involved expanding its range of lending instruments beyond the traditional credit operations in support of specific project investments. These new instruments are the structural and sectoral adjustment loans, designed to support and abet the LDCs' programs and policies of structural reform.

21. Such loans have risen from about 8% of the World Bank's annual loan commitments ten years ago to almost 19% in FY 1986. More than thirty countries have participated in such operations, although the bulk of the resources so lent have tended to be concentrated in multiple operations in about a dozen or so countries. Under the aegis of these relatively quick-disbursing operations, the Bank has sought to facilitate the adjustment required to achieve sustainable growth and the mobilization of external financing to support a country's adjustment efforts. The adjustment programs undertaken are of a varied nature, but they would typically include:

(a) Efforts to improve domestic resource mobilization performance, including revenue
enhancement, expenditure rationalization, and liberalization of domestic financial markets:

(b) Improving the efficiency of public sector resource use, e.g., rationalizing both the current and capital expenditure budgets and strengthening or divesting public sector enterprises:

(c) Reform of the structure of economic incentives, on both the external front by reducing the trade regime's anti-export bias and making more transparent the nature of protection, and on the domestic front by disengaging the government from seeking to fix prices and/or distort market signals; and

(d) Institutional strengthening in any of a number of areas considered to be fundamental underpinnings to a resumption of an efficient growth process, e.g., customs services, market information services, agricultural extension service, formation of human capital, etc. The intention, of course, is not to further stretch or expand the government's involvement in the economic arena, but rather to refocus it and concentrate its limited skilled human and
financial resources in a more supportive role for the expansion of productive activities.

22. Very clearly, with the Bank's total annual lending commitments running on the order of $16 billion, even allocating as much as a quarter of this amount to support adjustment programs in a selective group of receptive LDCs would make only a minor dent in the financial resource transfer needs of these countries in order to resume growth. In past two years the long-term debt service bill for the LDCs has topped US$ 100 billion. Thus the Bank has actively sought to enlist the cooperation of commercial lenders to cofinance with it. On some occasions, the Bank and the Fund have also participated in broader adjustment endeavors arising out of Paris Club agreements among the official bilateral lending agencies. And, of course, The International Finance Corporation -- our private investment affiliate -- is engaged in assisting private sector investment and encouraging the development of domestic private capital markets and financial instruments in order to strengthen these countries' efforts at domestic resource mobilization and provide a more receptive environment for foreign private investment.

Can the GATT Help?

23. Very clearly, unless the heavily-indebted LDCs can expand their manufactured and agricultural exports, it would
be unlikely that their production of goods and services could grow at a sufficient rate to permit them to resume regular servicing of their external financial obligations--much less to be considered as creditworthy in the international financial markets for an expansion of capital flows on commercial terms. On the other hand, driven by the need to expand their exports--agricultural and others--in order achieve the current account balances which would permit servicing their external debt, LDC successes in this regard have already been the occasion for some gnashing of teeth by the developed country producers and legislators. These expanded supplies of farm commodities from the LDCs have tended to coincide with a compression of their demands for imported agricultural commodities, thus seemingly catching the traditional OECD commodity exporters between the blades of a very sharp pair of scissors.

24. Thus, in addition to the compression of demand for agricultural commodities owing to the slowdown in world income growth during the decade of the eighties, we are observing a reshuffling of the patterns of trade in agricultural commodities. This reshuffling is a logical concomitant of the restructuring of LDC economies which we alluded to earlier, as they are removing the anti-agricultural bias which characterized their past development policies. On the other hand, we should rather confidently expect that a resumption of LDC growth rates would provide a
solid underpinning to the expansion of their demands for OECD agricultural exports.

25. It would be futile to try to return the heavily-indebted LDCs to acceptable levels of creditworthiness by standard capital market criteria solely through restructuring that existing debt, writing it down or some other combination of "financial engineering" exercises. Nor can these countries solely rely on the benefits of their domestic adjustment policies -- fundamental as these may be to their longer-term economic health -- in order to return to an efficient and sustained growth path. Expanded trading opportunities must underpin this growth recuperation.

26. Unfortunately, the experience of recent years appears to be to the contrary. Thus the GATT Secretariat reported in March of this year that for a group of sixteen of the most indebted LDCs, over the five years 1981 - 1986 their exports were off by nearly 10% and their imports were down by more than 25%. This was a mixed group of countries, including such relatively good export performers as Thailand and South Korea. In the same report, the Secretariat noted that in 1986 the growth of world trade in agricultural products continued to be well below the average rate of 4% per annum which was observed during the decades of the sixties and seventies.

27. In the past, the protectionist agricultural policies of
the developed countries have tried to shelter themselves behind the claim that they are "domestic" policies rather than trade measures and therefore non-negotiable. This fiction is no longer tenable. The introduction of market responsive discipline in lieu of heightened governmental efforts to administratively manage commodity markets must form the underpinning for future commodity trade growth. It is hard to imagine that continued OECD agricultural protection, by impeding and distorting the opportunities for efficient LDC agricultural and economic growth, can do anything else than limit the capabilities of these countries to regain their creditworthiness on international financial markets. Greater recognition must be given to the role that expanded LDC farm production, contributing to overall LDC economic growth, will necessarily play in bringing about a resumption of increasing demand for agricultural exports of the OECD countries themselves. Since agricultural trade protectionist measures remain as one of the most glaring exceptions to the more liberal trading environment achieved by the consecutive rounds of MTN negotiations, it is most appropriate that they are assigned such a high priority in the Uruguay Round.