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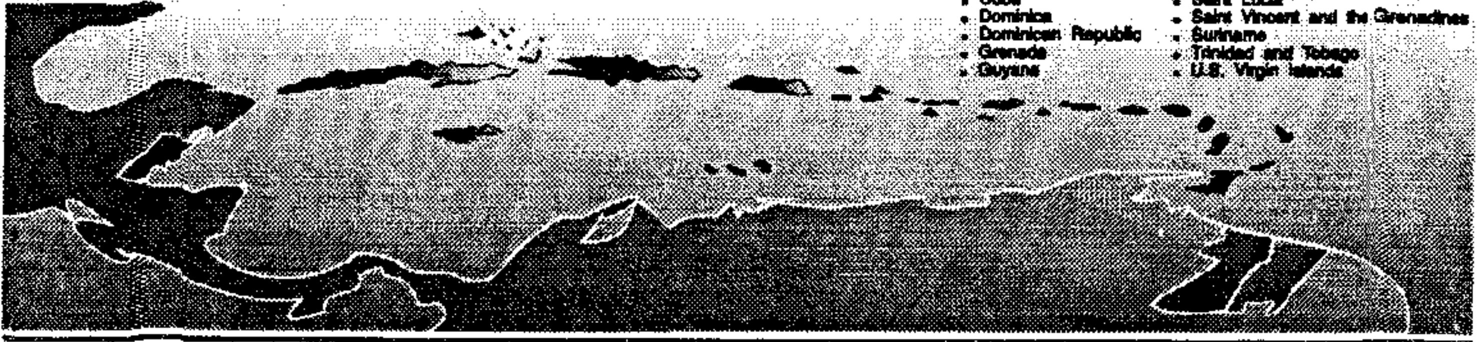

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SUMMARY OF GLOBAL ECONOMIC DEVELOPMENTS

- 1994 -

UNITED NATIONS
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN
Subregional Headquarters for the Caribbean
CARIBBEAN DEVELOPMENT AND COOPERATION COMMITTEE

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INTRODUCTION

This paper has three objectives. The first is to provide the busy policy maker with a brief overview of global economic developments in 1994 and for the first quarter of 1995, to provide background and context for more specific policy activities relating to the Caribbean. The second objective is to identify major issues or research on global phenomena which could provide lessons or early warnings for regional policy makers. Finally, for the general reader, it alludes to the pertinence of these issues for Caribbean development.

Accordingly, several subjects which seem to hold special significance for regional policy have been treated in some detail. These include an overview of basic macroeconomic indictors, focusing especially on output and inflation and a discussion of notable country performance within each of the major regions. Private capital flows and trade performance are also discussed, and under the latter, an overview of the evolution of the various integration movements in 1994 is also provided, in view of the attention which is being given to the development of regional trading blocs. Emphasis is given to developments in the hemisphere and especially in Mexico, where the causes of the crisis and the consequences for adjacent countries are discussed. Finally, global employment issues are explored, especially the respective impacts made by rapidly globalizing trade, advanced technology and domestic labour market policies, on the quality of, and demand for, employment. Lessons learned from comparisons between employment policies in the United States and the European Union are also discussed since these may provide clues for appropriate regional policy.

OUTPUT, INFLATION AND REGIONAL PERFORMANCE

The global economic expansion which became evident in 1993, quickened in 1994. It was expected to accelerate to 3.5 per cent in 1995, thus continuing the steady upward trend evident since 1991. This growth was evident in both the developed market economies and the developing countries, although in both cases performance was uneven. Performance of the countries in transition was mixed. Global expansion was greatly facilitated by trade, which showed a marked increase over 1993 and was expected to accelerate in 1995, consequent on the completion of the Uruguay Round and the consolidation of the various regional free-trade arrangements which came into effect in 1995.

Table I
GROWTH IN G.D.P.

	1990	1991	1992	1993	1994
Global Output	2.2	0.9	1.7	2.3	3.1
Industrial countries	2.4	0.8	1.5	1.3	2.7
European Union	3.0	1.2	1.1	-0.3	2.1
Developing countries	3.8	4.5	5.9	6.1	5.6
Four Asian Newly Ind. Countries	7.2	7.6	5.6	6.1	7.4
Latin America	0.3	3.4	2.5	3.4	2.8
Debtors<1>	0.6	2.5	1.2	2.7	2.7
Russia	-2.3	-13.0	-19.0	-12.0	-12.0
Central and Eastern Europe	-7.1	-11.5	-11.7	-5.7	-5.4

Source: I.M.F. World Economic Outlook; ECLAC.
<1>Fifteen heavily indebted countries

Nevertheless, several crucial issues remained to be addressed. These include a reduction in the high fiscal deficits incurred by many of the developed countries which have reduced the availability of savings globally. As economies coming out of recession continued to accelerate, this shortage was expected to manifest itself in increasing interest rates, thus limiting the potential for further global output. Unemployment rates also remained high in many countries, causing extreme poverty, especially in the developing countries but also providing evidence of marginalization and anomie in the developed and the developing countries. Increased strains were expected to be placed on countries as markets for goods and especially capital were liberalized. Expanded roles would be

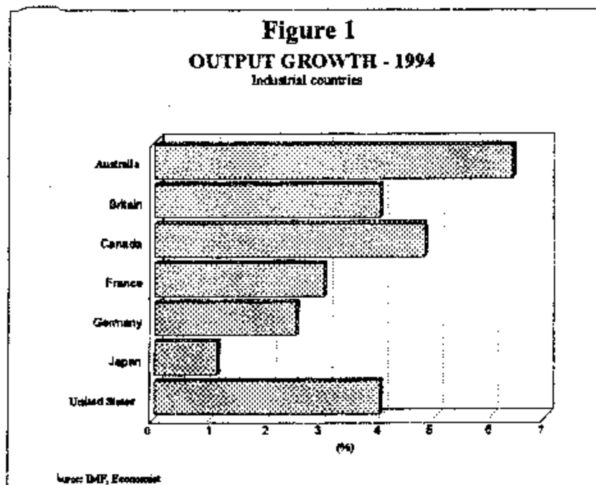

Figure 1
OUTPUT GROWTH - 1994
Industrial countries

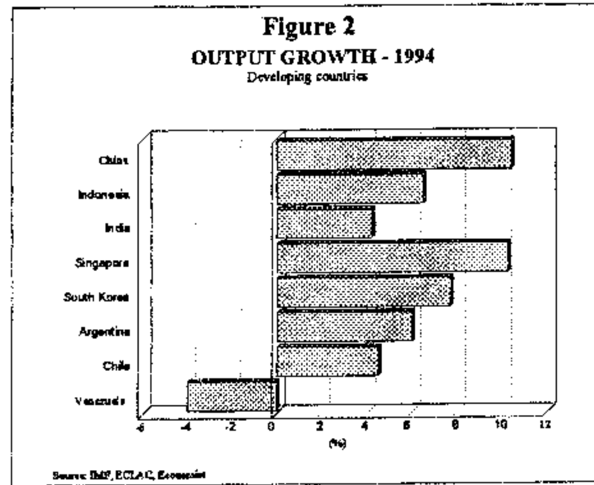

Figure 2
OUTPUT GROWTH - 1994
Developing countries

necessary for domestic central banks, and they would need to be given greater independence in the pursuit of monetary policy even as they would be expected to coordinate policies more effectively with respect to global capital movements. The task of global economic cooperation was also complicated by the incorporation of countries in transition and by changing power relationships caused by rapidly growing economies, such as China.

Output in the developed market economies as a whole increased more rapidly in 1994 than in the previous year, with Japan and Western Europe emerging from recession and joining the United States, Canada[1], Great Britain and Australia, countries which were already in an advanced phase of the economic cycle. Leading the industrial countries out of the recession was the United States, now judged to be approaching full capacity utilization, so that interest rates were increased in order to stave off inflationary pressures and hopefully prolong the expansionary phase. Similar policies were also initiated in the United Kingdom and Australia, where economic performance was strong. But capacity utilization in the European Union, as a whole, was also rising quickly, being 82.6 per cent in January 1995, compared with 78.3 per cent one year earlier and this was beginning to create inflationary pressures.

Developing country output continued to expanded quickly in 1994, though at a slightly slower rate than in 1993. Underlying the respectable out-turn for the group as a whole were wide divergences in performance, for while some stagnated or declined, others were among the outstanding global performers. Divergence was to be partly explained by economic policies. Some countries were able to expand their exports benefiting from increased global demand, others to expand their productive capacities from the surge in global capital, while some suffered its destabilizing effects and still others were denied access to capital flows because investors lacked confidence in them. These global flows, which remained relatively abundant in 1994, were expected to moderate in 1995, given the increased performance of the developed countries and consequent rising interest rates.

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[1] Canadian growth was projected to remain strong in 1995-1996, though concerns remained about the ratio of public debt/GDP which exceeded the OECD average by a considerable margin, the federal government deficit which was 7 per cent of GDP in 1993.

Table II
INFLATION AND INTEREST RATES

	1990	1991	1992	1993	1994
Inflation<1>					
Industrial countries	5.0	4.5	3.3	2.9	2.4
U.S.A.	5.4	4.2	3.0	3.0	2.7
Developing countries	65.6	36.0	38.7	46.2	47.5
Newly Ind. countries	7.1	7.7	5.9	4.6	5.8
Latin America	480.6	136.2	165.8	236.4	244.8
Interest rates<2>					
U.S.A.	7.5	5.4	3.4	3	4.4
LIBOR	8.4	6.1	3.9	3.4	5.0

Source: I.M.F. World Economic Outlook.
<1>Percentage change in consumer prices
<2>Short term interest rates, in percent.

Economic performance in **sub-Saharan Africa** was generally disappointing, the international Monetary Fund (IMF) estimating that per capita incomes fell by over 8 per cent, for the region as a whole, between 1990-1993. Many countries continued to suffer from political instability which not only caused substantial loss of life but also made consistent economic programmes well nigh impossible. Yet, the external environment afforded them opportunities in 1994. The terms of trade of the commodity exporting countries improving slightly, consequent on the reactivation of developed country economies and the increased demand for their products. Some countries such as Kenya, Uganda and some countries in the French Franc Zone (CFA) also received private capital inflows to stimulate investment while further measures were taken to reduce the indebtedness of the poorest and increase concessional funding to them as outlined in the Trinidad terms. Nevertheless, concerns linger that the stock of debt accumulated by some of the poorest countries remains unmanageable. Finally, the reintegration of South Africa into the mainstream of economic activity in the region was expected to give a significant stimulus to that country and to adjacent economies once the political difficulties, still evident, were resolved.

In the Middle Eastern countries, output was sluggish following the completion of construction activities in 1992-1993, which had served to stimulate some economies in the region. The decline in oil prices underlay the economic stagnation. Several countries were implementing adjustment programmes to cope with the reduced government revenues from oil and reduce the prevailing high levels of inflation. The peace process, if it can be sustained, holds the potential to increase investor confidence in a wide range of activities in the region, thus shifting it away from its excessive dependence on oil and spreading prosperity to non-oil countries.

The performance of **the Asian countries** was mixed. The four Newly Industrializing Asian Countries (NICs) continued to have outstanding performance, with growth rates increasing steadily

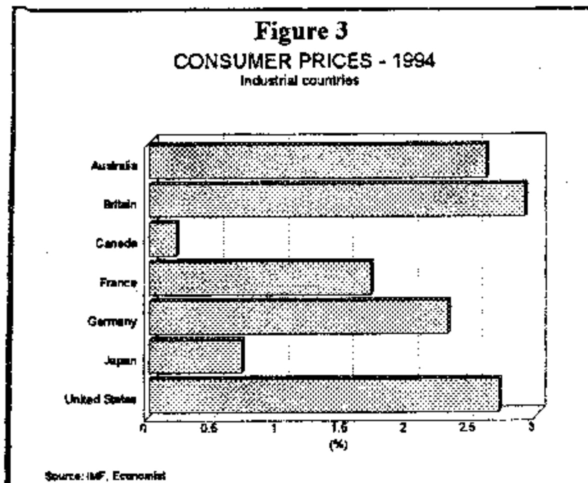

Figure 3
CONSUMER PRICES - 1994
Industrial countries

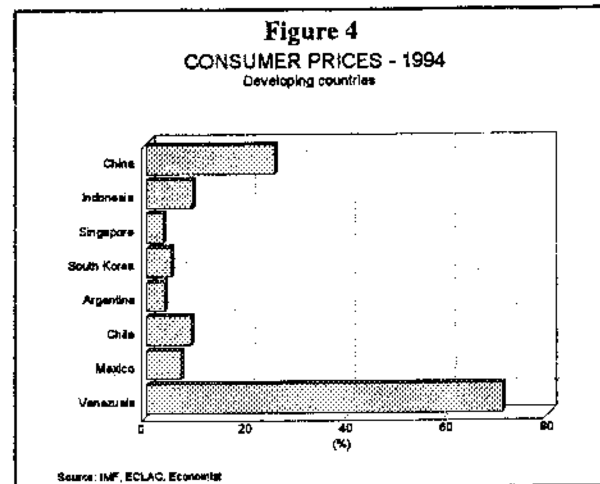

Figure 4
CONSUMER PRICES - 1994
Developing countries

since 1992. Strong growth continued in Indonesia, Malaysia up 8.9 per cent and Thailand up 8.4 per cent. Of greater long-term significance, however, was the performance of China and India, the third and fifth ranking economies globally, if measured on the basis of purchasing power parities[2]. Their significance was illustrated by the fact that, together with Indonesia, they were expected to have a market of 700 million middle class consumers by the year 2010, roughly comparable to the population of the United States, Europe and Japan, combined.

In **China**, output doubled since 1985 and for 1994 continued to race ahead, with growth in excess of 10 per cent. This out-turn represented a strenuous effort, commencing in mid-1993, to **contain** an economy which was judged to be overheating. The effort was only partly successful, since inflation registered over 25 per cent in 1994, having been in excess of 15 per cent in four of the last seven years and showing an upward trend since 1990. China continued to make policy changes to the foreign exchange regime, the financial sector and tax policy, but strains were becoming evident in the society at large because of the uneven impact of inflation, the uneven distribution of benefits from global opening, both regionally and between citizens, and fears were being expressed about the consistency of future policy, given the imminent change of the top leadership. Possible consequences of such strains include increasing social unrest, geographic fragmentation, or a reversion to greater political and economic controls.

Output growth in **India** was not comparable with China, the increase since 1984 being 54 per cent, with 4.2 per cent recorded in 1994. The adjustment programme of 1991-1992 initiated several reforms, moving the economy to one that was more market driven and open. These continued in 1994, with major tax reform and sectoral reforms in communications and mining. Difficulties were, however, experienced in meeting fiscal targets and this was in part responsible for increased inflation, which registered 10 per cent.

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[2] The use of purchasing power parity measurement seeks to provide a more realistic international comparison by taking account of what domestic currency can actually buy in each country.

In **Latin America** performance was quite strong, the region recording the second highest level of output growth in 14 years. Per capita incomes increased and inflation continued to decline, if the performance of Brazil was excluded. Various factors accounted for this performance, including developed country demand, strong capital inflows, reform policies in most countries and growing trade within the region, consequent on growing market integration.

Negatives included interest rate increases, which increased debt servicing costs and forced up domestic rates, especially in those countries needing inflows to finance current account deficits. Also, growth did not manifest itself in significantly increased employment, since reforms focused on increased productivity while poverty remained a pressing concern.

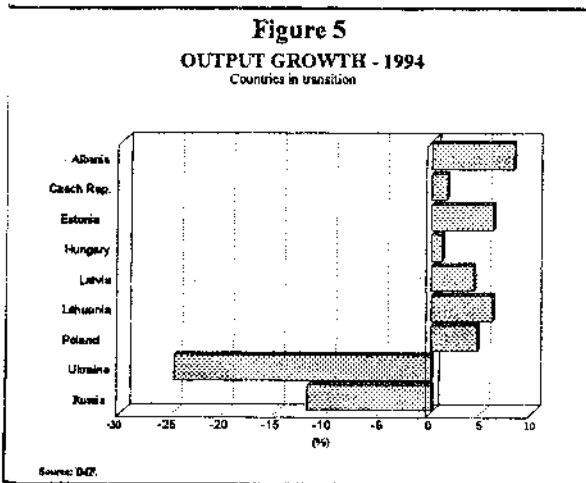
Strongest performance was recorded by Argentina (6.0 per cent), Guyana (8 per cent) and Peru (11 per cent). The majority of countries clustered around growth rates of 3-5 per cent. Caribbean and Central American countries were estimated to have performed less well than the larger countries, averaging about 3 per cent. Economic contraction was experienced in Haiti (-10 per cent), Honduras (-1.5 per cent) and Venezuela (-4 per cent) and contraction was expected to continue in Cuba.

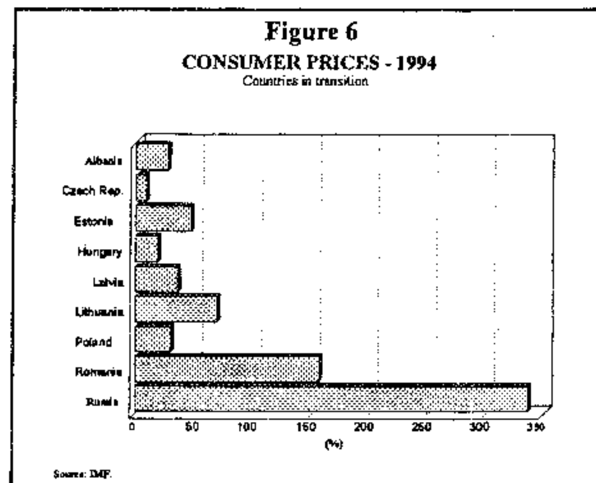
Trade expanded significantly for the region over 1993. Exports increased by 14 per cent, because of increased developed country demand and improved prices. Imports grew faster, at 15 per cent, so that the trade deficit widened and together with raised factor payments, expanded the current account deficit to US$ 50 billion, 8 per cent over 1993. Capital inflows for 1994, more than covered this deficit, although the volume of inflows did not match 1993. By far the largest deficits were to be found in Mexico[3] and Argentina.

Price stability, remained a policy priority in 1994 and was rewarded with some success. Average rates of inflation, excluding Brazil, moved progressively from 49 per cent in 1991 to 16 per cent in 1994. Even in Brazil, where political and structural factors had greatly complicated adjustment policy, progress was evident in 1994, as the "Real Plan" managed to reduce inflation from 50 per cent per month early in the year, to 3 per cent per month by year end. Since fiscal discipline was applied, a dramatic reduction in inflation was achieved, most notably in Argentina, from 1300 per cent in 1990 to 3 per cent in 1994 and Peru, from 7500 per cent in 1990 to 17.5 per cent in 1994. Fiscal deficits were the important contributor in all cases of increased inflation in 1994, in Costa Rica (where the deficit was 8 per cent of product), Honduras, the Dominican Republic and Venezuela. In Venezuela, the fiscal burden was in part due to the need to avert insolvency in the commercial banking system, with the outcome that it is currently 80 per cent State-owned.

Regional debt increased by about 6 per cent, mainly due to Mexico and Argentina, over one half of which comprised bonds, the remainder being in multilateral or bilateral loans. Brady plans were

[3] The deficit incurred by Mexico exceeded 50 per cent of the regional total and was partly covered by short-term capital flows. Capital flows were less than 1993 due to reduced confidence and capital flight in the latter part of 1994. These issues are discussed in greater detail in the Annex.





applied in Brazil, Ecuador and the Dominican Republic thus reducing commercial debt. These measures, taken together with increased exports, reduced the debt to export ratios for the region to 280 per cent, the lowest since the debt crisis began.

Unemployment worsened in most countries, though it remained low by Caribbean standards, mostly below 10 percent. The increase had diverse causes: contracting output in Venezuela affecting mainly non-tradables; stabilization and adjustment policies in Argentina causing public sector layoffs; contracting domestic demand in Chile, with consequent layoffs in non-tradables sectors; and, in many countries, increasing numbers of new entrants to the labour force. Labour reallocation was evident in Argentina, Mexico and Peru, consequent on trade liberalization, increased competition and closure of uncompetitive firms, while in most countries policies to increase labour productivity led to higher growth rates, though with reduced labour.

The countries in transition, for the most part, made progress in their programmes of stabilization and opening to the global economy, consequent on the collapse of traditional arrangements about five years ago. This progress was uneven, however, since some started adapting themselves early, while others had accepted the need for formal programmes only in late 1994 and some had not yet done so. Similarly, some countries adopted radical reforms while others took a more cautious wait-and-see approach. Currently, the state of transition could be divided into three distinct categories[4].

The first category, made substantial progress in liberalizing prices, trade and exchange rate regimes, in stabilizing their economies and implementing structural reforms. Albania, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia all fell into this

[4] Statement by the Managing Director of the IMF, in Madrid on 21 December 1994, which provides information for this section.

category, where over 50 per cent of Product[5] now originated from the private sector and inflation was below 30 per cent. All 10 countries registered positive growth in 1994.

In the second category, which comprised Bulgaria, Kazakstan, Kyrgyz Republic, Macedonia, Moldovia, Romania and Russia some progress was made towards liberalization, though somewhat less towards stabilization, and policy reversals were common. Inflation still remained above 50 per cent, mainly because of inconsistent monetary and fiscal policies, although private activities now accounted for one third[6] of Product. Domestic programmes in Russia seemed, in the first half of 1994, to be operating in an environment which gave them favourable odds for success. Fighting in Chechnya towards the end of the year, however, once more raised the spectre of instability which could put economic policies in jeopardy.

The third group, comprising the late or non-starters in the adjustment process, had not made much progress in stabilizing their economies and recorded inflation rates of about 1000 per cent in 1994. The Ukraine adopted an IMF programme in 1994, and programmes were initiated in Armenia and Georgia, after a period of warfare which made stabilization difficult. Belarus and Uzbekistan were preparing to embark on IMF programmes in 1995.

PRIVATE FINANCIAL FLOWS

Private financial flows to the developing countries seem to have peaked in the second half of 1993. While flows slowed in the first half of 1994, they were still above those of the early 1990s and were three times that of foreign aid to the developing countries in 1994. A seeming revival of private flows in the second half of 1994 was overpowered by developments in late 1994 which increased caution to emerging markets. Rising interest rates also played a major role in reversing the trend of growing flows to the developing countries in 1994 and this contraction is expected to continue for the immediate future.

In early 1994, the share of developing country participation in **bond issues** fell to 12 per cent of the global total, compared with 20 per cent in late 1993. Latin America accounted for 34 per cent of developing country issues in the first half of 1994 with Mexico accounting for almost 48 per cent of the Latin American share, Argentina for 27 per cent, with a number of others accounting for the rest. Asia increased its percentage of developing country issues from 34 per cent in 1993 to 50 per cent in 1994. Hong Kong and Korea accounted for half of the Asian total, with China being also a major issuer. Flows to the countries in transition fell steeply from 1993, being only just over 1 billion for the first half of 1994, compared with almost 10 billion in 1993.

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[5] In the Czech Republic this proportion was two thirds.

[6] One half of Product in Russia.

The trends in **Foreign Direct Investment (FDI)** mirrored those for bonds. On average, FDI flows to the developing countries between 1991-1993 were in real terms 2.5 times those for the 1980s, though the beneficiaries were to be found in only a few countries in Latin America and Asia. Flows to Latin America doubled after 1990 and in 1992-1993 were almost three times the average for the 1980s. Asia received almost half the FDI going to the developing countries, China being the biggest recipient accounting for 40 per cent of Asia's share. FDI inflows to the countries in transition had grown quickly since 1990, accounting for 10 per cent of the developing country share in 1993.

GLOBAL TRADE AND MARKET ARRANGEMENTS

Trade expanded rapidly in 1994 providing the motor of global economic expansion. The volume of trade grew quickly for the developing and the industrial countries, although the export receipts derived from such trade differed. In all cases, the value of trade grew more slowly than the volume, indicating a fall in prices for the goods traded. Nevertheless, the developing countries, as a group, experienced a steeper fall in export prices than the developed countries, so that their terms of trade declined. Within the group of developing countries, the fuel exporters experienced a decline in their terms of trade for the fourth successive year, while the non-fuel exporting developing countries and the industrial countries experienced slight increases in their terms of trade.

The rapid increase in global trade was underpinned by more sophisticated arrangements to facilitate it. The most significant of these was the completion of the Uruguay Round and the formation of the **World Trade Organization (WTO)**, coming into effect on 1 January 1995, with 78 founding members. Developing countries were expected, by the World Bank, to gain between US$60-100 billion per year from trade liberalization achieved in the Uruguay Round. One controversial issue which the WTO had to face was the denial of China's bid for original membership, since it had not liberalized its markets sufficiently in farm products, industrial goods and services. China argued its need for special status, because of low income per capita, while others argued that as a major trading country, with annual two-way trade of US$234 billion, it should meet the norms of global trade. Difficulty was also experienced by groupings jockeying for the right to name the Director of the WTO.

Essentially, the WTO gave a new fillip to the General Agreement on Tariffs and Trade (GATT) process and elevated this multilateral body to a status sufficient to oversee the burgeoning regional and bilateral free trade arrangements. It would be expected to mediate such disputes as might arise between trade blocs and protect those countries left out of them or too weak to negotiate bilaterally. The first major test was the need to mediate in a dispute between the United States and the European Union regarding the newly accepted member, Sweden, which was required to increase its tariffs on certain electronic goods to meet the common external tariff of the European Union. The United States sought compensation in accordance with established GATT norms.

Pressure was anticipated for the WTO to pay greater attention to issues such as trade and the environment, competition policy, rules on investment, and trade and labour standards. While some

Table III
GLOBAL TRADE INDICATORS

	1990	1991	1992	1993	1994
World Trade Volume	4.6	2.6	4.7	4.0	7.2
Export volumes					
Industrial countries	5.7	2.9	4.2	2.4	6.0
Developing countries	6.4	7.4	7.8	8.9	9.1
Import volumes					
Industrial countries	4.6	2.2	4.3	1.8	7.2
Developing countries	6.9	10.1	11.2	9.3	7.2
Export values<2>					
Industrial countries	2.9	-2.1	-0.6	-4.8	0.5
Developing countries	0.7	-3	-1.4	-1.2	-1.0
Import values<2>					
Industrial countries	3.6	-3.3	-2.2	-6.3	-0.7
Developing countries	-0.8	-0.1	-1.5	0.3	0.7
Terms of trade					
Industrial countries	-0.7	1.2	1.5	1.6	1.2
Developing countries	1.5	-3		-1.5	-1.7
Fuel exporters	9.9	-10.9	-1	-5.3	-8
Non-Fuel exporters	-1.8	0.1	0.2	-0.3	0.2

Source: I.M.F. World Economic Outlook.
<1>Annual changes in Percent
<2>Valued in S.D.R.

of these issues were on the GATT agenda they were given new impetus in limited agreements such as NAFTA. Clearly, liberalized trade will require greater harmonization of several other policies. In all the instances listed valid issues were being raised. Yet there was no universal agreement that environmental matters and labour standards had an equal claim for inclusion **in trade discussions**, with issues such as the rules on investment or competition policy. Interests seeking to limit the pace of trade liberalization were responsible for the inclusion of environmental and labour issues while those seeking to expand it want the inclusion of investment and competition policy. While it has been possible so far to circumscribe environment and labour issues and minimize their immediate negative effects, linkage provides a permanent avenue for unnecessarily complicating and inhibiting future trade discussions. It was, therefore, argued that labour standards properly remain the province of the International Labour Organization while environmental matters should be directed to the appropriate forum dealing with the environment.

The spectacular growth of **regional trading arrangements** or proposed regional trading arrangements, however, overshadowed even the developments in the GATT. In all regions, with the

exception of Africa, far-reaching plans were being made to liberalize trade in some form of free trade movement. While these developments seemed in part to respond to fashion and in part to the perceived need for defensive coalitions, solid political and economic bases existed to support them.

In the **Western Hemisphere** the consolidation of markets proceeded rapidly in 1994, though developments in Mexico at the end of the year had dampened enthusiasm for market consolidation in North America. **The North American Free Trade Agreement (NAFTA)** completed its first year of operation in 1994. Trade expansion was significant. Canada, originally the most reluctant of the NAFTA partners, seemed to have more than held its own from the agreement, as its exports to the United States rose by 21 per cent and to Mexico by 22.7 percent. Its imports from the United States increased by 19 per cent and from Mexico by 20.7 per cent. Full-time private sector jobs increased by 431,000 in 1994, in part stimulated by strong exports and unemployment fell to 9.7 per cent, the lowest in four years. This impetus from trade also helped to explain the high rates of growth experienced in Canada and in December, Prime Minister Jean Chretien proposed that this impetus could be increased by a free trade arrangement between NAFTA and the European Union. Exports from the United States to Mexico also increased, by about 20 percent, while Mexican exports to the United States grew slightly faster. The latter, nevertheless, continued to experience chronic deficits in its trade and current accounts. Trade between the United States and Canada grew twice as fast as its trade with Europe and Asia in 1994.

The issue of widening NAFTA remained alive, despite proposals in December for the establishment of a **Free Trade Area of the Americas (FTAA)** by 2005[7]. Chile had indicated an interest in negotiating entry to NAFTA in 1995 and the existing parties to that agreement agreed. These negotiations were expected to establish the bench marks by which other applicants would qualify for free trade status, either in NAFTA or in the FTAA. Other countries also expressed a desire to accede to NAFTA, presumably because they judged it a quicker route to market access. The United States indicated a preference for a "NAFTA type" arrangement for the FTAA, presumably referring to the inclusion of side-agreements in areas such as labour legislation and the environment, although these issues are unlikely to receive the same measure of support from a Republican Congress. The logic of consolidating the Latin American market was compelling for the United States. It was projected[8] that trade between Latin America and the United States would surpass trade between the United States and the European Union by 2000 and exceed the combined trade of the European Union and Japan by 2010. Mexico became the second largest consumer of American products in 1994, surpassing Japan. Investment to Mexico surged from 15 billion in 1993 to projected 20 billion in 1994, though this surge was mainly in short-term funds and greatly complicated Mexico's task of economic management.

In South America, **MERCOSUR** entered a new phase, that of a customs union, on 1 January 1995, with tariffs abolished on 95 per cent of goods traded between Argentina, Brazil, Uruguay and

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[7] It remains to be seen if the enthusiasm for including Chile will survive developments in Mexico.

[8] Projections by the United States Commerce Department.

Paraguay. A common external tariff was adopted for imports, ranging from 0 to 20 per cent and averaging 12 per cent, with few exemptions. Since the free trade process began four years ago, trade tripled, reaching US$12 billion in 1994. It was serving to knit the Argentine and Brazilian markets and producers together, based on an integrated market comprising over 190 million people and a combined product of US$800 billion between them. Over 300 joint Brazilian/Argentine enterprises were registered by the end of 1994, compared with about 10 such ventures in 1990. Chile and Bolivia planned to sign trade treaties with MERCOSUR in June 1995, while The Group of Three also proposed to do so by the end of 1995. Discussions between MERCOSUR and the European Union were also initiated, in late 1994, with a view to reducing trade barriers between them. Brazil favoured a MERCOSUR-type free trade arrangement for the hemisphere over the NAFTA-type proposed by the United States. Brazil also favoured initial contacts with the European Union, since the bulk of its trade is conducted with that grouping.

One factor said to have contributed to the speed of market consolidation in the Southern Cone in 1994 was the absence of territorial disputes, which had torpedoed previous attempts at integration. The recent border dispute between Peru and Ecuador in early 1995, which was proving intractable and could escalate, was, therefore, worrying for those in favour of speedy market consolidation. The cost of the border hostilities was also endangering the fragile economic reactivation in Peru and fiscal targets were already out of reach in both countries. Moreover, trade between both countries (which signed a free trade agreement in January before the dispute erupted) had been curtailed, and the hostilities were further inhibiting the flow of trade from Peru to Colombia and Venezuela, which needed an overland route through Ecuador. Hostilities were also only narrowly averted on the border between Colombia and Venezuela.

The Group of Three, comprising Colombia, Mexico and Venezuela entered into a free trade agreement in January 1995. Intraregional trade increased by 250 per cent since 1990, while trade between Colombia and Venezuela grew by 400 per cent in 1994 alone.

In the **Caribbean**[9] moves were also being made to consolidate subregional markets, at various multilateral and plurilateral levels. Agreement was reached by the 22 States signatory to the final act, to incorporate their Caribbean islands and adjacent mainland States in Central and South America into the **Association of Caribbean States (ACS)**. While the full work programme and modalities of the ACS were still to be finalized, trade development and external relations featured as two of its tasks. Within CARICOM, moves were revived to tighten its relationship into a single market and economy and to widen its membership to include Suriname, in 1995. Simultaneously, CARICOM established a joint commission with Cuba to increase its links with that country, even as Cuba was taking far reaching measures to restructure its economy to better interact with market economies. Farther afield, a trade agreement between CARICOM and Colombia came into effect in 1995 to complement one signed previously with Venezuela.

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[9] Mention is made of the Caribbean here simply for completeness, since these issues are treated in greater depth elsewhere.

Market consolidation was also proceeding in Asia, through the **Asian Pacific Economic Cooperation (APEC)** forum , which proposed to establish a free trade agreement between 18 countries, including those in NAFTA, Australia and the East Asian countries. This group accounted for45 per cent of global trade and 50 per cent of Global Product. The 14 Asian APEC countries also accounted for 30 per cent of United States exports in 1994. The agreement to eliminate barriers to trade and investment was to take effect by 2010 for the developed members and 2020 for the less developed. The agreement intends to include a code of conduct to outlaw discrimination against foreign investment, to promote the advancement of global liberalization, to unify standards and coordinate macroeconomic policy. While wide disparities still existed between potential member countries, from the United States and Japan at one extreme, to China and Papua New Guinea at the other, the momentum for greater cooperation was expected to build as tariffs fell. Production sharing and specialization, which was expected to give stimulus to further integration, had already started to accelerate. The notion of using the group to further promote global liberalization could mean that it would develop and advocate ideas which would then be put to the GATT, for worldwide implementation. It was noteworthy that Europe rejected the United States' call for a new round of trade talks at the recent G7 summit. Agreement by APEC and FTAA on future trade issues might be used to weaken any opposition by the European Union to subsequent talks.

The **European Union** continued to widen its membership and consolidate its market, with the accession of Austria, Finland and Sweden, on 1 January 1995. Norway, the other potential member, rejected membership by national referendum. This stage of widening followed the creation of the European Economic Area (EEA) which extended most aspects of the European Union market to five of the seven EFTA countries. Formation of the EEA was expected to provide similar benefits to those adumbrated in all similar agreements, in the form of greater market access, increased competition, better economies of scale and further induced growth effects. The European Commission estimated that the benefits to the European Union, of full integration with the EEA, would be between 4.5 and 6.6 per cent increase in European Union GDP.

A further stage of **widening** of the European Union was started with the Europe Agreements, setting out future terms of association for Bulgaria, the Czech and Slovak Republics, Hungary, Poland and Rumania. These agreements aim at a free trade area by 2003 and also contain provisions for harmonizing labour and capital movements, competition policy and national legislation to make them more compatible with those of the European Union. By the end of 1994, access to European Union markets was liberalized for most industrial products, restrictions on steel were to end by the close of 1995 and those on clothing and textiles cease by the end of 1997. Trade between these countries and the European Union was growing quickly, up 76 per cent between 1989 and 1993, moving from 25 per cent to 50 per cent of their total trade.

Despite the advances made in consolidating and widening the European Union, strains were beginning to show as the differing interests of core members surfaced. The most evident conflict related to further widening to the East, which was pushed by Germany, anxious for a tighter relationship with its Eastern neighbours within the European Union. Germany feared the growth of nationalist tendencies, ethnic instability, and increased linkages with former allies to the East if they are not granted an alternative within Europe. Ethnic stresses, in conjunction with political and

economic evolution, if left uncontrolled, were believed by Germany to create a volatile combination along its borders.

Britain wanted Eastern membership to proceed quickly, but within a looser European Union. France advocated a deepening of existing relationships. Neither did it have the same priority as Germany in the East, focusing instead on **North Africa**, and fearing that Islamic fundamentalism in Algeria would further influence existing North African migrants in France and also create a wave of new migrants to it. The poorer European Union members, Spain, Portugal, Greece and Ireland feared the dilution of transfers, if the Union progressed eastward. Neither could the Common Agriculture Policy (CAP), as currently constituted, be sustained with new Eastern members, so that this controversial issue would need to be reopened, a factor which further strengthened positions for and against Eastern expansion.

Moreover, the European economy was still not strong, output having contracted by 0.4 per cent in 1993 and was expected to expand by only 2.5 per cent in 1994. Germany showed a 2.8 per cent increase in 1994, but consumer spending was flat consequent on higher taxes levied to pay for unification. Unemployment remained at 11 per cent, twice that of the United States. Costs of unification led to higher interest rates since Germany borrowed to finance the cost rather than further increase taxation. The role of the Mark in the European Monetary System (EMS) was evident in increasing instability in exchange rates throughout the Union and complicating the transition to a common currency and a European Central Bank.

Germany also envisaged an expanded scope for the North Atlantic Treaty Organization (NATO), or a European equivalent, to incorporate the Eastern members. Strains were also surfacing within NATO as to whether these countries should be included and if so how to secure inclusion without alienating Russia. Further strains were also evident within NATO, because of the different interests of members over the handling of Bosnia, where Russia was also a major player. The issue of defining and managing a common foreign and defence policy had so far proved to be a major embarrassment for the European Union.

In conclusion, the political need to embrace adjacent countries in more permanent socio-economic arrangements, either to neutralize fragmentary tendencies, contain emerging players or to re-configure old alliances, was as relevant to the relations between the European Union and the countries in transition, or to Asia, regarding China and North Korea, as it was to developments in the Western Hemisphere.

Simultaneously, the economic rationale for free trade, while traditionally based on firm economic foundations, was now being clearly demonstrated in practical terms, to even the most sceptical layman. The static concerns of trade diversion and trade creation, while still relevant, were being overshadowed by dynamic considerations such as market consolidation and the building of critical mass to encourage large scale production or long-term strategic planning. Efficiency was also being promoted by harmonizing regulations and competition policy and market enlargement was being used to stimulate higher investment, faster technological growth and improved human capital accumulation.

Ultimately, this meant that producers would have access to lower cost inputs and larger potential markets on which to base investment decisions. It also meant that consumers had a wider variety of high quality products at lower prices to choose from. Workers also derived higher incomes from employment arising from internationally traded products than for those relegated to the domestic market only. At the same time, workers and other interests earning rents from protected markets opposed market opening.

Yet, as was shown in the European Union and more spectacularly by recent developments in Mexico[10], the consolidation of markets was likely to absorb a number of other policy issues, ultimately requiring joint management of wider macroeconomic and eventually even political issues. Developments in Mexico had a negative feedback into emerging markets generally and in Latin America especially. They also had negative impacts on NAFTA partners both of which were burdened by vulnerable economic policies[11]. The subsequent rapid depreciation of the dollar followed attempts by the United States to support the collapsing peso, using 50 per cent of its Exchange Stabilization Fund at a time when economic fundamentals made the dollar vulnerable.

Investors, damaged or frightened by recent Mexican instability, sought security in German or Japanese currencies, which appreciated commensurately. Continued flight from the dollar could create a snowball effect with holders of dollar denominated assets seeking to dump them. The implications to be drawn at the regional level also held for globalization, with the need for more rigorous policies of national economic management, greater harmonization of policies among close trading partners and better surveillance at the multilateral level becoming evident.

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[10] These issues are discussed in greater detail in the Annex.

[11] The Canadian credit rating was being threatened because of its high debt and the lack of credibility of its fiscal policies. The latter was caused, in part, by sensitivity to the implications of fiscal contraction for the impending Quebec referendum. In the United States, the fiscal deficit was not being credibly managed, in the view of international investors, and reemerged to haunt the policy makers whenever there was uncertainty in the money markets.

UNEMPLOYMENT

Table IV UNEMPLOYMENT RATES (%)	1990	1991	1992	1993	1994
Industrial countries	6.1	7.0	7.7	8.1	8.2
Seven major industrial	5.7	6.6	7.2	7.3	7.3
European Union	8.6	9.1	10.0	11.2	11.8
United States	5.5	6.7	7.4	6.8	5.7
Germany	6.2	6.7	7.7	8.1	8.2

Source: I.M.F; National data

Figure 7
UNEMPLOYMENT - 1994
Industrial countries

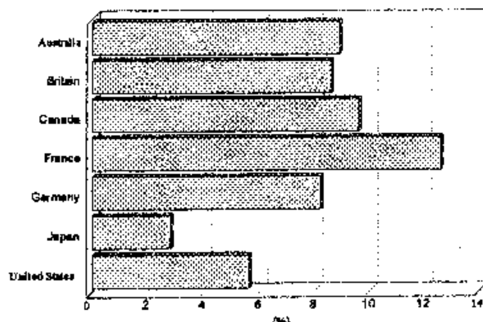
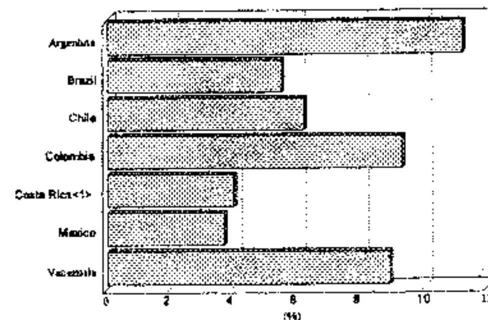


Figure 8
UNEMPLOYMENT - 1994
Urban unemployment in Latin America



Source: ECLAC <1>Refers to 1993

Unemployment remained a concern of global proportions. Despite the quickening economic tempo experienced by the industrial countries, unemployment rose slightly. The increase was more significant in the European Union, where it reached almost 12 per cent and has been an intractable problem. Unemployment has tripled or quadrupled in the various member countries since the 1960s and early 1970s when it was in the low single digits. It rose by 9 percentage points from the 1960s to the early 1980s, falling slightly to 8.5 per cent in the long expansion of the 1980s, but climbed again as Europe entered the most recent recession. In Spain, it was currently 24 per cent and nearly 20 per cent in Finland, a country formerly noted for low unemployment. The number of jobs generated in Europe was low, being only 18 per cent higher in 1994 than in 1960 and almost all of these were in the public sector. Comprehensive social security programmes served to mitigate the worst social effects of unemployment but were believed by some to have contributed to its increase. Moreover, with high and growing average rates of unemployment, the cost of sustaining the safety net was becoming unsustainable.

Conversely, unemployment which peaked in the United States at 7.7 per cent per annum in 1992, fell by December 1994 to 5.4 per cent and in some industrial States such as Michigan, Illinois and Ohio it was just above 4 per cent. In contrast to the performance in the European Union, the

United States increased jobs by 100 per cent since the 1960s, almost all of which were in the private sector. This performance was, however, achieved in the face of lagging productivity growth and at the expense of declining average household income, increasing income disparities and reduced job security. In Japan, which had sustained a stable and low unemployment rate, job growth was also strong and concentrated in the private sector.

The structural unemployment rates[12] in Europe and the United States differed markedly. In the former, it was tending upward over time, now resting at about 9 per cent, while that for the United States seemed to remain constant over time, at about 6 per cent. It was believed that contributing to this trend was the hesitancy shown by European industries to take on new workers on the upswing of the business cycle since labour legislation made it difficult and expensive for them to reduce employment and economic activity as the cycle entered a downturn. By contrast to these countries, the structural unemployment rate in Japan remained low over time, at about 2 per cent.

Recent analyses of unemployment focused on three main causes: technological changes, which tended to substitute machines for labour; globalization, which in accordance with international trade theory was expected to transfer unskilled jobs away from the developed to those developing countries paying lowest wages; and domestic labour regulations.

The weights given to these factors varied among the analysts and also in the analysis from country to country. There was no consensus on the quantitative impact that technology had on job creation. Some argued that jobs were not replaced by machines, but that unskilled jobs were displaced by high skill jobs needed to create, programme and maintain machines. The impact of globalization was judged to depend on the proportion of the economy dedicated to international trade and the extent of liberalization in that economy. With respect to domestic regulations, salient issues clustered around labour mobility, the ease with which labour could transfer between enterprises or sectors and its overall cost, which included the wage as well as other ancillary costs such as those borne by enterprises for the provision of the social safety net.

In view of the openness of Caribbean countries and the difficulty which the region had experienced over the last 30 years in reducing the high chronic rates of unemployment, current thinking on these issues merited more serious study in the region. This was especially true since the tempo of job creation or job diversion would be greatly quickened as Caribbean countries opened their economies to the full impacts of international trade.

Further impetus was given to the quest for sustainable policy positions by the heightened awareness created in recent global meetings dealing with the panoply of social issues. Expectations were increased with respect to entitlements, targets were discussed regarding the reduction of poverty and unemployment and the establishment of social security schemes. New participants were incorporated, properly, into the policy debate which was, nevertheless, incomplete. Consensus needed to be built around those interventions which could contribute, simultaneously, to growth and equity so as to guarantee sustainability over the long run.

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[12] The rate of unemployment remaining at the peak of the economic cycle. This is thought to be close to the minimum rate of unemployment sustainable without creating excess demand for labour and setting off a wage-price inflationary spiral.

Annex

LESSONS FROM THE MEXICAN CRISIS

Developments in Mexico required intense policy attention in the latter part of 1994 and they will continue to remain in the spotlight in 1995. Various attempts have been made to establish causal links between Mexico's economic instability and its membership in NAFTA. Speculation was rife about the snowball effect which these developments might have on current and future NAFTA membership as well as on other developing countries. It might, therefore, be useful to comment on some of the developments leading to and lessons flowing from the Mexican crisis.

Recent Mexican macroeconomic policy was linked with a strong peso. Short-term capital inflows which became positive in 1989, induced by confidence (flowing from economic reforms and impending membership in NAFTA) and favourable interest rates, were used to cover chronic current account deficits which grew steadily after 1988. The deficit, which ultimately reached US$30 billion or the equivalent of 7.6 per cent of GDP in 1994, reflected underlying disequilibrium and the need for peso depreciation. The strong peso policy was justified as a means to contain inflation and this objective was in fact being achieved, since it fell progressively from 30 per cent in 1990 to 6.5 per cent in 1994. The policy was inherently unsustainable, particularly during the election campaign. Subsequently, as capital inflows declined and then reversed, reserves were used to maintain the peso but as reserves became rapidly depleted (they stood at US$3.5 billion in January 1995 compared with US$ 26.6 billion one year before) defence of the peso had to be abandoned. At best, it was a high risk policy, dependent on sustained confidence and timely and judicious economic policy and low interest rates in the United States. In the course of 1994 all these conditions were to change.

Doubts about the credibility of the ruling party were created by political developments in Chiapas and by assassinations of two of its leading figures, rumoured to be as a consequence of party in-fighting. Doubts were increased by the uncertain touch shown by the new policy team's initial handling of the currency depreciation and the low credibility of concomitant support measures and together these factors triggered the crisis. The credibility and timeliness of policy were adversely affected by contradictions facing the Administration in its political and economic agendas. Delays in depreciating the currency were justified on political grounds, in the first instance to allow the passage of NAFTA, secondly, by the election campaign and, finally, to give the new government time to make a smooth transition. The other option of containing demand, the judicious policy at this juncture, was not deemed to be politically beneficial. In fact, the money supply was expanded by 20 per cent improving the Administration's prospects at the polls. Subsequently, its credibility was so eroded that calls were made for the Mexican Central Bank to be reformed as a currency board, to constrain its capacity to pursue monetary policy. This call came despite recently granted "independence", since its acquiescence to the political dictates convinced many that it was unlikely to pursue a politically neutral monetary policy.

Bilateral measures to solve Mexico's macroeconomic problems proved unreliable and cumbersome as the United States was unable to obtain congressional approval for a US$40 billion package to assist Mexico. This delay of nearly one month further reduced confidence in Mexico, so that a multilateral alternative was necessary, of US $50 billion comprising a US$20 billion contribution from the United States' Exchange Stabilization Fund, the remainder being contributed by the Bank of International Settlements (BIS) and the I.M.F., the latter having the responsibility of overseeing the 18 month stand-by credit. Even this joint action was unable to dispel doubts of its adequacy.

The crisis provided a reminder that integration into the global market and particularly capital account convertibility, required a high level of prudence and competence in macroeconomic management. Mexicans misjudged the pace at which such flows could reverse, assuming that the new Administration would be given time to gradually adjust the economy. It also provided a reminder that markets were interlinked, since uncertainty caused by Mexico soon impacted on other NAFTA members and could inhibit the future pace of its widening. Instability also became evident in Canada and there was a subsequent run on the United States dollar, in part because Canada and Mexico were its two largest trading partners. Feedback into United States policy was also feared, speculation being that the Federal Reserve would be inhibited from further raising interest rates, conscious of Mexico's vulnerability. Furthermore, concerns were expressed that United States credits to Mexico would increase the deficit and/or reduce its capacity to defend its currency. The visibility of Federal Reserve Chairman, Greenspan in this crisis pointed to the significance of the Mexican crisis for United States interests. This was underscored subsequently when, according to the Washington Post of 15 February 1995, both National Security Adviser Anthony Lake and Secretary of State Warren Christopher asserted that Mexico was an urgent national security problem for the United States.

Nervousness engendered in Mexico was quickly transmitted to other emerging markets where investors looked more carefully at the macroeconomic fundamentals, often moving funds to safer if less lucrative havens. As a consequence of this experience and the increased demand for capital in the industrial countries, the phase of rapid flows to emerging markets evident in 1994 is likely to slow.