World payments trends in 1989

- *The US current account deficit fell to 2.1% of GNP in 1989, from 2.6% the previous year and 3.6% in 1987. Exports continued to grow rapidly, buoyed by strong overseas demand and a terms of trade gain resulting from the dollar's strength.*

- *The Japanese surplus fell to 2.0% of GNP in 1989 from 2.8% in 1988, as rapid domestic demand growth sustained buoyant growth in imports, and the terms of trade deteriorated.*

- *The German surplus expanded again in 1989, reaching 4.6% of GNP against 4.2% in 1988.*

- *The US current account deficit was more than matched by private sector capital inflows in 1989, providing support for the dollar. Japanese long-term capital outflows exceeded the current account surplus, but were partly offset by banking inflows resulting from heavy overseas corporate borrowing.*

- *International capital market activity remained buoyant in 1989. Within this, banking flows recovered from 1988's depressed level while activity in bond markets continued to grow robustly. Foreign direct investment remained strong.*

Economic activity remained buoyant during 1989, facilitating a further brisk expansion of world trade after several years of strong growth. The volume of world trade grew by 6.5% in 1989 against 8.9% the previous year and 6.5% in 1987.

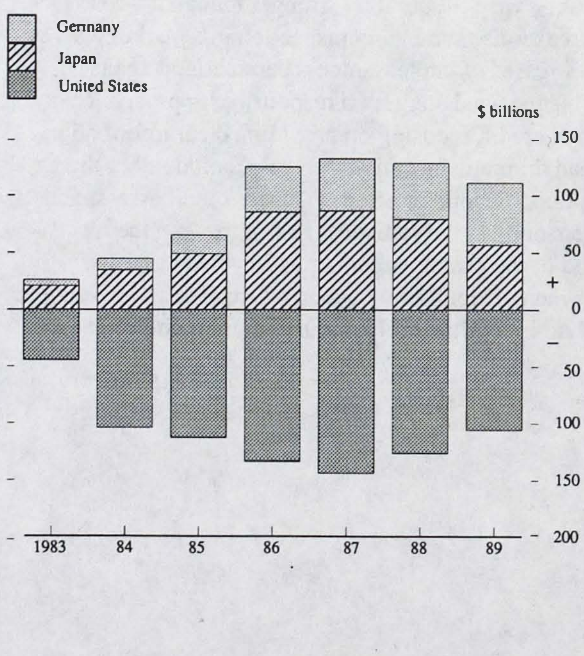
A number of factors contributed to the continued buoyancy of trade growth. These included the strength of demand growth in the industrialised world, albeit running at a slightly slower pace than in the previous two years. The reduced financing constraint on a number of developing countries also contributed, resulting in part from higher oil prices during 1989. Although non-oil commodity prices fell back in the second half of the year, tightening the financing constraint on many LDCs, commodity prices retained much of the substantial gains of 1988.

The growth in the volume of world exports accelerated during the first half of 1989 before slowing slightly in the second half. Trade growth among the industrialised countries continued briskly during the year. The United States benefited from this and from the slight slackening of financial constraints on LDCs, a particularly important market for US exporters, allowing the dollar value of its exports to rise 14.6%. This re-established the United States as the world's largest exporter, a position it last held in 1985. During the first half of 1990, the growth in the volume of world trade has appeared to maintain the slightly slower pace established in the previous six months, a pattern which is expected to prevail for the rest of this year.

Current account developments

During 1989, further current account adjustment took place in the United States and Japan. This was underpinned by a significant slowing of domestic demand growth in the United States relative to its main trading partners together with terms of trade gains for the United States, particularly against Japan. Within Europe, current account imbalances tended to widen while the EC's overall external position deteriorated only slightly. Domestic demand grew less

Chart 1
G3 current account balances



strongly in Germany than in the other major European economies, aiding a further increase in its current account surplus, while deficits widened in Spain, Italy and the United Kingdom.

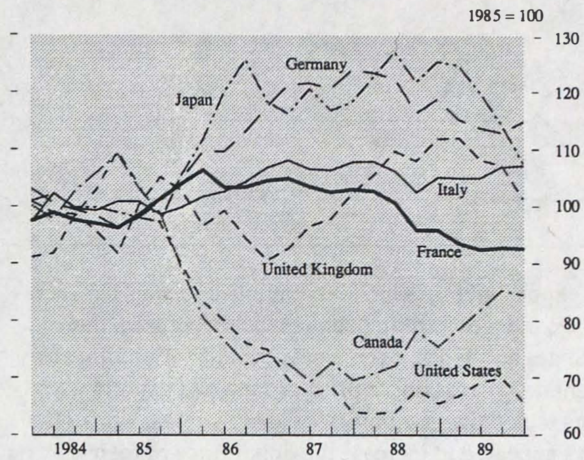
Although the combined surpluses of Germany and Japan appear to have presented something of a mirror image to the United States' deficit in recent years (see Chart 1), on a bilateral basis, Germany's current account surplus is more closely associated with deficits elsewhere in Europe. However, on such a bilateral basis the EC's modest aggregate current account surplus is, along with Japan's, to some extent a counterpart to the US deficit. Although the capital cost of German unification may alter this picture in the coming years, even if the EC current account falls into deficit, the magnitude of East German capital requirements appears relatively small set against the size of gross European savings.

After a period in which the fall in the dollar aided current account adjustment, exchange rate movements began to work against the long-term adjustment process in 1989. While the major European currencies were little changed on an effective basis, the yen showed significant weakness, especially against the dollar. However, these movements tended to work in favour of short-term adjustment by providing terms of trade gains for the United States while the associated loss of competitiveness has yet to be fully reflected in trade volumes. The corresponding improvement in Japanese, and to a lesser extent German, competitiveness has yet to have its full effect on trade volumes while the previous competitiveness losses still appear to be adversely affecting trade volumes in these economies.

Indeed, recent trends suggest that the lags in the response of trade volumes to changes in competitiveness may have been lengthening. This could be related to the increasing role of supply-side responses to exchange rate movements, as the location of production gradually alters. Supply responses take some time to have an impact on the current account and these responses could still be exerting an influence on the adjustment process in the wake of the sizable exchange rate changes of 1985-87.

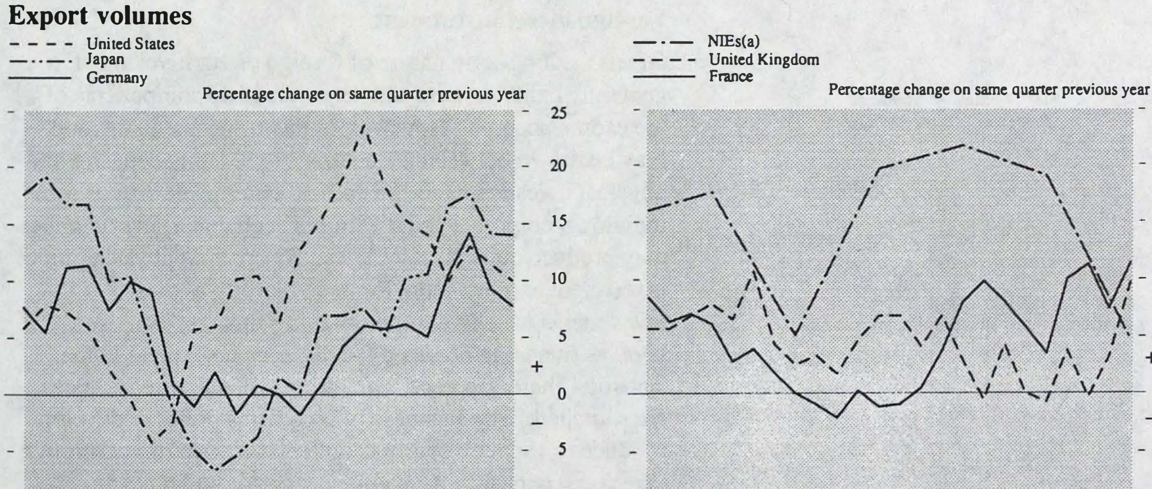
The United States and Canada experienced substantial competitiveness gains between 1985 and 1987 (see Chart 2), as a result of rapid currency depreciation. This increased the profitability of producers based in North America, which in part explains the rapid build-up of inward foreign direct investment there. The competitiveness loss in the past two years, particularly in Canada, has only partly offset the previous gain.

Chart 2
Relative trend unit labour costs



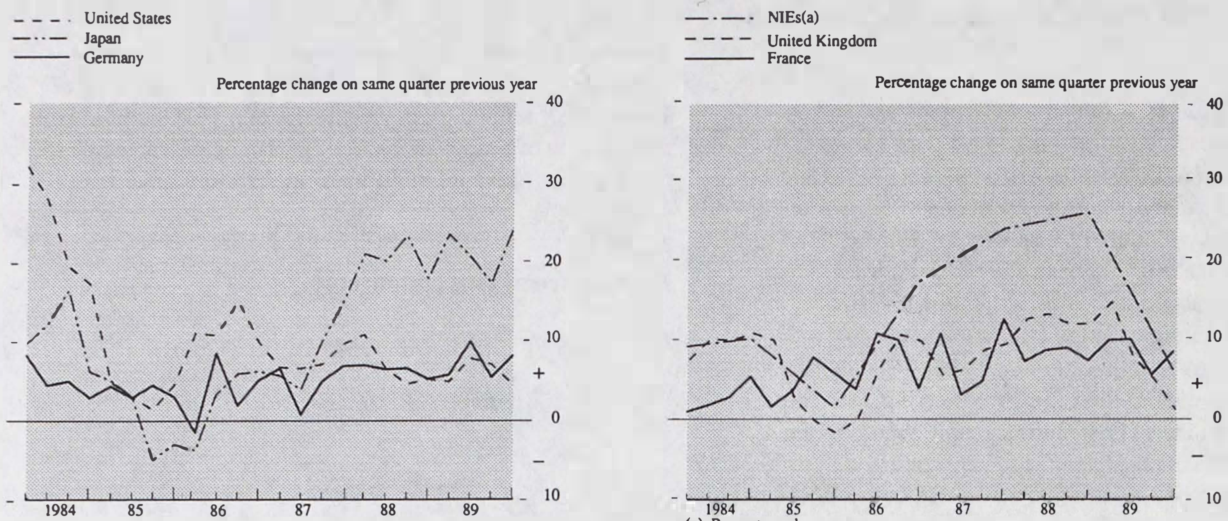
Changes in competitiveness induced by investment on the part of surplus nations in deficit ones can form an important part of the adjustment process itself, by raising productivity in the recipient nation. It is as yet unclear to what extent such supply-side adjustments will facilitate a rapid improvement in the US current account deficit with Japan, even though it would appear that Japanese investment in the United States produces direct substitutes for Japanese products and provides higher factor productivity than local US investment.

Chart 3
Export volumes



(a) Percentage changes year on year.

Chart 4
Import volumes

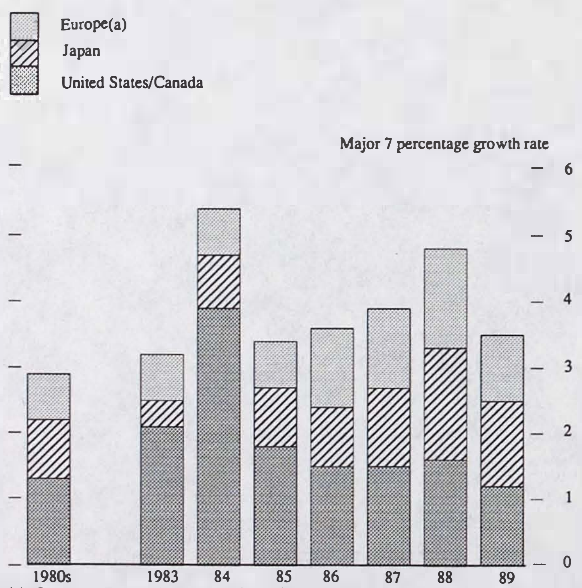


(a) Percentage changes year on year.

In 1989 export pricing behaviour continued to vary between economies, the most striking contrast being between the United States and Japan. Yen weakness did not prompt any significant drop in the dollar price of Japanese exports, as producers took the opportunity to widen margins, while US producers appeared to increase the dollar price of their exports despite the strength of the dollar. The behaviour of US exporters magnified the improvement in the US current account by producing higher local currency export prices while volumes have yet to respond to the associated loss of competitiveness.

Demand developments provided a further boost to G3 current account adjustment in 1989. Japan accounted for 37% of major 7 domestic demand growth, its largest contribution since 1982 (see Chart 5). The United States by contrast produced its lowest contribution since 1982. With demand growth somewhat above potential output in Japan and below it in the United States, relative demand provided a powerful engine for adjustment. However, in Germany domestic demand continued to rise less rapidly than in the rest of Europe, probably falling short of potential output growth. This continues a well established trend; German domestic demand finished the decade only 15% above its level ten years earlier, against increases of 31% and 32% in Italy and the United Kingdom respectively.

Chart 5
Major 7 domestic demand growth - geographical distribution



(a) Germany, France, Italy and United Kingdom.

Capital account developments

One of the most notable developments in capital flows in 1989 was the continued expansion of the role of foreign direct investment (FDI). By contrast, portfolio flows made a markedly less significant contribution to funding current account imbalances, as a result of lower net outflows from Japan and Germany and reduced US net inflows, which in turn resulted from renewed US interest in foreign assets. The United Kingdom experienced substantial net portfolio outflows in 1989 as UK institutions continued to expand their foreign portfolios.

Foreign direct investment

Given the long-term nature of foreign direct investment, it generally exhibits more stability than other components of the capital account. However, in this respect a distinction may be drawn between acquisitions of existing capacity and physical investments in 'green field' sites. The size of some individual corporate acquisitions is such that a small number may produce quite sizable flows. By contrast physical direct investment exhibits more limited volatility as these investments usually require on-going finance. But even here, as financing obtained locally does not appear in the statistics, there is potential volatility when funding sources are switched. The Japanese, whose firms prefer to develop productive capacity overseas rather than acquiring it through takeovers, appear to have quite a stable net FDI outflow although they also use local finance to fund many overseas projects. In contrast, the United Kingdom's sizable net FDI

Table A
External financing of the G7 countries
$ billions (Inflow +/outflow -)

	1986	1987	1988	1989
United States				
Identified current account	-145	-162	-129	-110
of which, trade account	*-145*	*-160*	*-127*	*-115*
Financed by:				
Portfolio investment	71	29	39	48
Direct investment	15	16	42	41
Banking sector	20	47	14	11
Other(a)	39	61	38	35
Official financing balance(b)	—	9	-4	-25
Japan				
Identified current account	86	87	80	57
of which, trade account	*93*	*96*	*95*	*77*
Financed by:				
Portfolio investment	-105	-97	-65	-31
Direct investment	-14	-18	-35	-45
Banking sector	55	80	47	42
Other(a)	-6	-12	-11	-35
Official financing balance(b)	-16	-39	-16	13
Germany				
Identified current account	39	46	49	54
of which, trade account	*52*	*65*	*73*	*72*
Financed by:				
Portfolio investment	24	5	-37	-2
Direct investment	-8	-7	-10	-8
Banking sector	-23	-4	-4	-23
Other(a)	-32	-21	-17	-34
Official financing balance(b)	-1	-18	19	12
France				
Identified current account	3	-4	-4	-5
of which, trade account	*-3*	*-9*	*-9*	*-8*
Financed by:				
Portfolio investment	2	5	8	26
Direct investment	-3	-4	-6	-10
Banking sector	-2	-11	3	-2
Other(a)	1	14	-1	-14
Official financing balance(b)	-1	—	1	5
United Kingdom				
Identified current account	—	-7	-26	-31
of which, trade account	*-14*	*-18*	*-37*	*-38*
Financed by:				
Portfolio investment	-20	27	4	-45
Direct investment	-10	-17	-21	1
Banking sector	15	4	26	26
Other(a)	20	13	23	41
Official financing balance(b)	-4	-20	-5	9
Italy				
Identified current account	3	-1	-6	-12
of which, trade account	*-2*	*-9*	*-10*	*-13*
Financed by:				
Portfolio and direct investment	-3	3	9	16
Banking sector	3	4	8	12
Other(a)	-2	-1	-2	-4
Official financing balance(b)	-1	-5	-9	-12
Canada				
Identified current account	-8	-8	-8	-17
of which, trade account	*7*	*9*	*8*	*4*
Financed by:				
Portfolio investment	16	10	10	15
Direct investment	-2	-1	-2	-1
Banking sector	-4	2	2	-2
Other(a)	-2	1	7	4
Official financing balance(b)	-1	-3	-8	—

(a) Includes balancing item reflecting unidentified net flows which may be associated with either the current or the capital account.

(b) - = increase in reserves.

outflow prior to 1989, which comprised mostly corporate acquisitions, turned round to a small net inflow last year.

A counterpart to the build-up of Japanese outflows has been the surge in US net inflows in 1988 and 1989 (see Table B). The growing FDI component of capital flows may have been a significant factor in increased market confidence concerning the sustainability of the US external deficit. In the United States, net FDI inflows exceeded $40 billion for the second year running in 1989. In Japan, net FDI outflows reached a record $45 billion, nearly 80% of the current account surplus, compared with $35 billion in 1988. Approximately one third of gross Japanese FDI outflows in 1988 related to manufacturing investment, motivated by firms' desires to strengthen their presence in their main

Table B
Net FDI flows
$ billion (- = net outflow)

	1986	1987	1988	1989
Japan	-14.3	-18.4	-34.7	-44.9
Germany	-8.4	-7.2	-9.9	-7.5
United Kingdom	-10.0	-17.2	-20.5	0.7
France	-2.5	-3.6	-6.3	-9.6
Canada	-2.1	-1.2	-2.3	-0.9
United States	15.4	15.8	42.2	40.5

overseas markets, partly due to worries about increased protectionism, and to take advantage of cheap labour sources, especially in South East Asia. In the United Kingdom direct investment made only a modest contribution to funding the current deficit in 1989, although this represented a significant change from recent years when the United Kingdom experienced sizable net FDI outflows.

Outside the major overseas economies, the continued increase in direct inward investment in LDCs in 1989 partly reflected various debt/equity conversion schemes, although other investments also increased. Much of this new investment was concentrated in South East Asia's rapidly expanding developing economies (particularly Thailand), which enjoyed a rapid build-up of inward investment from Japan and the newly industrialised economies of the Far East (NIEs), due to low labour costs and buoyant local demand.

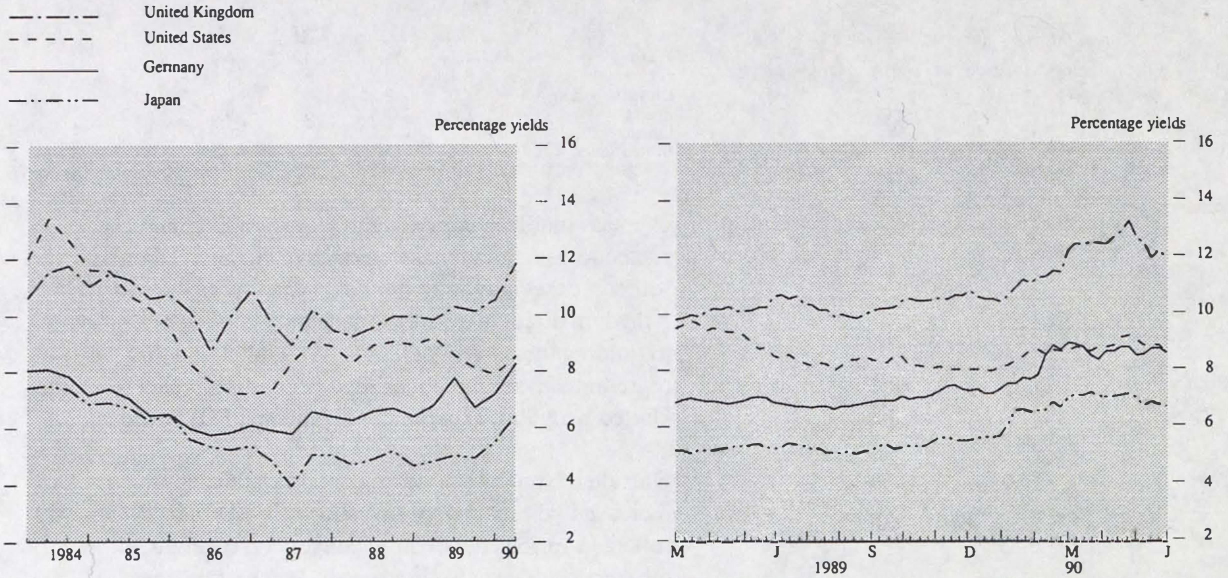
International bank lending

Cross-border bank lending recovered slightly in 1989 after a sharp decline in 1988. Since 1987 total international capital market activity has grown robustly, but within this, banking flows have lost share to bond markets. It is possible that this reflects the changing cost of different channels of finance, as banks adjust to tighter capital adequacy ratio requirements, while reduced interbank activity also played a role.

Private sector borrowing expanded rapidly in 1989, with syndicated credits showing particularly strong growth. Banks have been keen to develop this business, much of which is related to the financing of corporate restructuring (mergers and acquisitions), in part because of fee income available from advice on mergers and from related activities such as sales of hedging instruments. Restructuring activity was particularly buoyant in the United States, while Japanese corporations continued to make substantial calls on overseas finance.

Sovereign borrowing remained depressed despite a slight easing of the financing constraint on the main LDC borrowers, with western commercial banks still reluctant to provide new money. The slight expansion of lending to Eastern Europe in 1989 over 1988 masks an actual decline during the course of the year. The decline accelerated in the first quarter of 1990, when non-guaranteed lending, at $35 million, nearly dried up relative to previous quarters. Bankers have become more cautious about lending to Eastern European governments and enterprises given the uncertainties over short and medium-term prospects. Uncertainty was compounded in May 1990 by Soviet difficulties in meeting trade-related hard currency payments.

Chart 6
Ten-year government bond yields



International bond markets

Gross borrowing on international bond markets rose strongly in 1989, by some $33 billion to $259 billion, following equally strong growth in 1988. The increase was concentrated in the equity-related sector, especially issues of bonds with attached equity warrants by Japanese companies. This allowed Japanese corporations to issue equity without incurring the costs of direct flotation on the Tokyo stock market. The OECD countries further increased their share of total borrowing to 89%. This increase was concentrated almost exclusively in the United States and Japan, offsetting reduced borrowing from several other OECD countries including the United Kingdom. The upward movement of bond yields in most countries during 1989 (see Chart 6) may have reflected greater pessimism about prospects for inflation, although the prospect of additional capital requirements associated with the future development of Eastern Europe may have provided an impetus to real yields. The lower interest premium of dollar assets partly reflected reduced concern on the part of investors about the possibility of a dollar depreciation.

Detailed country/regional analysis

United States

The improvement in the US current account in 1988 continued during last year, with the deficit falling to $110 billion in 1989 from $129 billion. As a percentage of GNP this represents a significant decline from 2.6% to 2.1%. The improvement was broadly spread through the year and continued in the first quarter of 1990 when the quarterly deficit was the lowest since the first quarter of 1984. The IPD balance also held up well despite a continued rise in the recorded net foreign debt position of the United States. Services contributed a record $20 billion net, up from $12 billion in 1988, buoyed by higher earnings on tourism and financial services.

The relative weakness of US domestic demand played a leading role in reducing the deficit, with import volumes showing the slowest growth of any of the seven largest industrial economies. Demand growth was particularly sluggish in comparison with that of the United States' two main trading partners—Canada and Japan. US export volumes have remained buoyant since the 1985-87 depreciation of the dollar and the continuing benefits of this competitiveness gain have underpinned the gains from relatively strong overseas demand since 1987. Buoyant export volumes were compounded by terms of trade gains from the rise in the dollar during 1989, while much of the effect of the associated loss in competitiveness has yet to be felt.

The US deficit has become markedly more geographically concentrated in recent years, as it moved toward balance with Europe while the shortfall with the Far East remained stubbornly high. However, the latter masks an impressive US export performance with Japan, where the persistence of a bilateral deficit of around $50 billion in 1989 resulted from much faster percentage growth in exports (around 18%) than imports (7%) given the much lower base of US exports to Japan.

With a renewed private sector appetite for dollar assets, the pressure on the US currency has been generally upward in the last eighteen months, with capital inflows more than sufficient to finance the current deficit. Greater investor confidence in the US economy stemmed from a number of factors. Japanese investors increasingly shrugged off worries of a falling dollar, taking unhedged dollar positions. The progress made in reducing the current account deficit diminished market fears of a major currency realignment in the foreseeable future. This assessment implies a reduced risk premium for dollar investors, and this in turn allowed nominal interest differentials to narrow significantly without adversely affecting the dollar.

Japan

The Japanese current account surplus fell to $57 billion in 1989, more than $20 billion below the 1988 figure. The reduction in the surplus was concentrated in the final three quarters of the year with a slight rebound recorded in the first quarter of 1990. A higher services deficit more than offset a slight increase in Japan's net IPD inflows. Powerful domestic demand growth helped to maintain import volume growth, partly related to increasing capacity constraints but also aided by government pressure on firms to increase foreign sourcing. Terms of trade losses from the yen's weakness during 1989 and a continuing volume response to the yen's previous strength contributed to the declining surplus.

The remarkable strength of Japanese domestic demand over the last three years has been a significant factor in the lower current account surplus. However, during 1989 Japanese policy-makers became increasingly concerned at a weakening yen and land price boom. The subsequent tightening of monetary policy, together with continued yen weakness, is likely to foreshadow a shift towards positive net external demand in 1990, after four years of negative external contribution.

Import volume growth has remained strong in Japan, reflecting the strength of domestic demand, the earlier loss of competitiveness and a reduction in structural barriers. However, on the basis of recent estimates the income elasticity of demand for imports has been around half that of the United States during the 1980s, suggesting that a sizable reduction of the Japanese current account surplus is likely to require a considerably faster rate of demand growth in Japan than in its main trading partner, even allowing for reduced structural barriers.

Recent years have seen increasing evidence of structural changes in Japanese trading patterns. These include a rapid build-up of low technology manufactured imports, largely from the newly emerging Asian economies. This may suggest that pressure on Japan to pursue a more open trade policy might be taking effect, with the Japanese government encouraging firms to source components from abroad. Alternatively, it is possible that an exchange rate threshold was reached during the yen's previous rise at which such imports became viable. Added to this have been supply pressures as domestic demand has risen more rapidly than potential output.

In contrast to the position in the United States, investor confidence in Japan weakened significantly in 1989, prompted by political worries and concerns about possible future interest rate increases. Bank of Japan apprehension about the inflationary implications of a falling yen prompted heavy support for the currency and a tightening of the monetary policy stance in 1989. Japanese capital account outflows again consisted predominantly of longer-term investments, while Japanese corporations continued to maintain a high level of short-term overseas borrowing. Bond and equity bear markets in early 1990 reflected domestic political and economic uncertainties, rather than any reduced demand for savings instruments from the Japanese private sector. Japanese capital continued to be funnelled abroad at a significant pace in 1989 and early 1990, and this was a significant factor in the weakening of the yen.

Germany

In 1989 the German current account position benefited from domestic demand growth somewhat below potential output, reflecting subdued growth in personal consumption and government spending. In contrast, demand was strong in the rest of continental Europe, allowing German export volume growth to reach almost 9%, the fastest rate recorded in the 1980s. As a result the German current account surplus rose from $49 billion in 1988 to $54 billion in 1989. Export volumes grew rapidly to meet buoyant foreign demand for capital goods, and benefited from improved competitiveness due to a moderate 1% increase in deutschemark export prices and the relative weakness of the deutschemark in the first half of the year. The balance on services and IPD together moved into surplus for the first time since 1986. This resulted from a surge in investment income caused by rising world interest rates and effects related to the introduction of withholding tax early in the year.

The German authorities intervened to break the fall of the deutschemark against the background of the strengthening dollar in the first half of 1989. The deutschemark rapidly appreciated in the second half of the year, as a result of renewed private sector interest in German assets.

France

France's current account deficit rose in dollar terms from $3.6 billion in 1988 to $4.6 billion (0.4% of GNP) in 1989. A deterioration in the trade balance was entirely offset by an improvement in both net services and the net IPD position. Domestic demand growth was roughly in line with that experienced by Italy and the United Kingdom but somewhat above that of Germany, contributing to the trade deterioration, with strong investment causing a build-up of capital goods imports. This was accompanied by a modest terms of trade deterioration. A rapid build-up in portfolio inflows was one of the most notable developments in the French capital account during 1989.

United Kingdom

The United Kingdom's current account deficit widened in 1989, reaching $31 billion (3.7% of GNP) against $26 billion in 1988, with a brisk rise in import volumes as domestic demand still outpaced the ability of the supply side of the economy to respond. At the same time, however, export growth was quite strong, with buoyant demand from continental Europe. A further slowing of UK demand growth this year should accelerate the process of diversion of output towards export markets already evident in 1989, and this should allow a modest reduction in the current account deficit.

Net invisible earnings also deteriorated, falling from around $3 billion per quarter in the first half of 1989 to an average of only $0.5 billion per quarter in the second half of the year. The poor UK performance was largely related to the IPD account where a build-up in bank liabilities to the overseas sector, together with higher short-term sterling interest rates, raised the level of interest paid to foreign residents. In addition, IPD was adversely affected by higher official transfer payments to the EC. Services also fared badly, in part as a result of several large insurance claims.

Sterling experienced considerable downward pressure in 1989, and there was some official support for the currency. Large private sector portfolio outflows, associated particularly with institutional purchases of overseas equity as well as outflows associated with the current deficit, were largely financed by short-term banking inflows. UK corporations also continued to recycle banking inflows by engaging in foreign acquisitions.

Italy

The Italian current account deficit widened to $11.6 billion in 1989 (1.4% of GDP) from $6.2 billion in 1988. A doubling of the surplus on services in 1989 was insufficient to prevent a deterioration in Italy's invisibles deficit as a worsening net IPD position resulted from higher interest rates on a larger stock of foreign held Italian assets. Much of the deterioration in the trade balance relates to the strength of Italian demand. However, the current account deficit was more than covered by private sector inflows, attracted by the high level of interest rates and the prospect of further financial liberalisation.

Canada

The Canadian current account deficit doubled in US dollar terms in 1989 from $8 billion to $17 billion (3% of GNP). The deterioration can be ascribed in part to a halving of the trade surplus from $8 billion in 1988 to $4 billion last year. Through 1989, as US monetary policy eased, Canadian policy was progressively tightened and the short-term interest differential approached 500 basis points by the year's end, providing considerable support for the currency, which appreciated further against the US dollar. But the impact of the tightening did not feed through fully in 1989, with import volumes still expanding by 7%, while the loss in competitiveness suffered by the export sector contributed to a decline in export volumes, the first since 1982. The resulting sizable external deterioration owed much to a 2.9 percentage point domestic demand 'gap' with the United States, which accounts for 70% of Canadian exports. Canada continued to enjoy long-term capital inflows as the major counterpart to the current account deficit, with net portfolio inflows still the largest component. Net portfolio investment reached US$15 billion in 1989, over 50% above the level of the previous year.

Smaller OECD countries

The aggregate current account position of the smaller OECD economies deteriorated quite significantly in 1989 to $32 billion from $17 billion in 1988. Among individual countries the Spanish deficit widened markedly to $11 billion against $4 billion the previous year. Australia also experienced a worsening deficit at $17 billion against $11 billion in 1988. Overheating characterised both of these economies during 1989, after several years of above potential output growth.

Asian newly industrialised economies (NIEs)[1]

The trade performance of the Asian NIEs as a whole weakened markedly last year. They experienced a coincidence of factors that have adversely affected export growth. These include the crisis in China (affecting Hong Kong), serious labour unrest (South Korea) and the combined squeeze of appreciating currencies and rapidly rising labour costs (South Korea and Taiwan). The combined current account surplus fell to $25 billion from $32 billion in 1988, although this still represents the third highest dollar surplus recorded by the NIEs. Export volume growth slowed from 19% to less than 5% in 1989, with the deterioration in the current account only contained by an equally severe slow-down in import volume growth from 26% to 6% (see Charts 3 and 4).

With hindsight, the high trade growth rates achieved in the 1985-88 period resulted from rather exceptional circumstances, with a rapid expansion of demand in NIE export markets. An additional boost was provided by the loose coupling of their currencies to the dollar during a period of dollar weakness. As world trade has slowed, some underlying weaknesses have emerged. Taiwan has so far failed to move into the higher-value-added product areas quickly enough to compensate for rising labour costs. And South Korea arguably overextended its export sectors, some of which (particularly cars) have subsequently seen considerably reduced export shipments.

OPEC nations

A 23% rise in average oil prices to $16.70 per barrel coupled with an average extra 2.1 million barrels a day of OPEC output in 1989 resulted in a marked turnaround in the current account position of OPEC member states from a deficit of $19 billion to a surplus of $5 billion. Nominal exports rose from $121 billion in 1988 to $155 billion in 1989 as a result of the improved oil position. Despite the gain in revenue, most OPEC states continued to restrain demand for imports in an attempt to improve their reserve positions. Imports rose by a mere $4 billion in 1989. Identified movements in the external assets of the oil exporting countries were predominantly into bank deposits and US government paper.[2]

(1) South Korea, Taiwan, Hong Kong and Singapore.
(2) Table C is in the same format as the table which used to be published in the quarterly article 'International financial developments' in the section 'Balance of payments positions', which was discontinued after the February 1990 *Bulletin*. It is planned to include the table annually in future in articles in this series. There have been some substantial revisions to the data following a review of compilation methods.

Table C
Identified deployment of oil exporters' funds[(a)]
$ billions

	Dec. 1988 levels	1989 Q1	Q2	Q3	Q4	Dec. 1989 levels
Industrial countries						
United Kingdom:						
Sterling bank deposits	13.5	0.6	- 1.0	-0.3	-0.5	10.8
Eurocurrency bank deposits	40.5	1.3	4.3	-0.1	-1.0	44.9
Government paper	4.8	—	—	0.9	-0.7	4.5
Other investments	13.7	-2.3	1.7	0.3	0.4	15.2
	72.5	-0.5	5.0	0.8	-1.7	75.4
Other EEC:(b)						
Domestic currency bank deposits	6.5	-0.1	0.9	-0.8	0.3	7.2
Eurocurrency bank deposits	20.5	—	1.5	-1.1	2.3	23.0
Other investments	88.8	-1.1	-0.8	0.5	1.5	117.2
	115.8	-1.1	1.5	-1.4	4.2	147.4
United States:						
Bank deposits	17.1	0.9	1.6	-0.8	0.3	19.0
Government paper	35.9	5.8	- 0.3	5.1	-2.4	50.0
Other investments	39.2	0.7	0.5	1.0	1.1	53.5
	92.2	7.3	1.7	5.2	-1.0	122.6
Other:						
Domestic currency bank deposits	6.0	-1.4	0.9	-0.6	1.4	5.7
Eurocurrency bank deposits	33.5	1.2	- 0.2	1.4	0.3	36.3
Other investments	60.9	-2.1	- 3.0	-0.3	-0.4	77.3
	100.5	-2.2	- 2.3	0.5	1.4	119.4
Offshore centres:						
Bank deposits	51.9	0.9	0.9	-2.4	5.1	56.4
Placements with ldcs	65.9	—	—	0.1	—	66.0
OEC credit to non-banks	13.0	—	—	—	—	13.0
IMF and IBRD(c)	33.7	-2.3	-2.7	-0.1	0.8	29.8
Total identified additions(+)/reductions (-) in deployed assets	**545.5**	**2.1**	**4.1**	**2.7**	**8.7**	**629.9**
Net funds available for deployment		-5.1	2.9	3.0	5.4	
of which:						
Net movements in external borrowing etc		*-4.3*	*1.4*	*0.5*	*3.4*	
Current balance		*-0.8*	*1.5*	*2.5*	*2.0*	

(a) The oil exporting countries covered are defined in the notes and definitions to Table 16 of the statistical annex in the February 1990 *Bulletin.*

(b) Includes Spain and Portugal.

(c) Includes holdings of gold.

Non-oil less developed countries (LDCs)

Between 1981 and 1987 the severe external financing constraints facing non-oil LDCs following the onset of debt servicing difficulties restrained imports, thereby improving the trade balance. The current account also improved over this period despite the increased burden of interest payments. However, 1988 and 1989 saw a deterioration of the trade and current accounts resulting from a slight easing of the financing constraint on most LDCs and renewed weakness in commodity prices. A weakening of commodity prices in the second half of 1989 led to a slight terms of trade deterioration. Export volume growth also declined to 7.9% from 12% in 1988 in line with the general slow-down in LDC export markets.

In *Latin America*, deteriorations in the Brazilian and Mexican current accounts in 1989 were the result of recovery in domestic demand and in the latter case the initial effects of Mexican trade liberalisation. In *Asia* (excluding China and the NIEs), aggregate export and import volumes both showed growth in excess of 14%, buoyed by rapid industrialisation in Malaysia and Thailand. *Sub-Saharan African* economies suffered the greatest terms of trade losses, associated with price weakness in many tropical foodstuffs.

Centrally planned economies (CPEs)

Foreign trade reforms in the CPEs are causing considerable dislocation of historical trading links, with the virtual breakdown of the Comecon trading system. On their hard currency trade the CPEs experienced their first collective deficit of the 1980s in 1989. The Soviet Union's difficulties in meeting trade-related payments since the beginning of 1990, together with faltering oil output (its main hard currency earning industry), point to a further worsening in its current balance this year.

The advent of trading blocs?

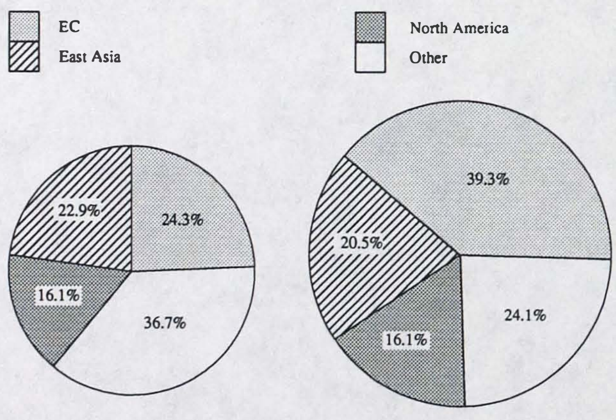
The run-up to 1992 and the EC internal market, the US/Canadian Free Trade Agreement and the growing integration of the expanding East Asian economies illustrate the increasing convergence of countries into 'regional' blocs and point to a trend which seems likely to have a significant effect on the international trading system in the 1990s. This note examines whether trade has become more concentrated within regional blocs during the 1980s, and considers the implications this may have for inter-regional trade.

Economic integration has become increasingly apparent in the three main industrialised blocs.(1) The incentive for smaller nations to integrate economically is particularly noticeable in Europe. The EC has also made the most significant advances in terms of political integration, though arguably North America has established greater internal economic ties, largely as a result of geographic factors. By comparison East Asia remains in the rudimentary stages of integration, though East Asian intra-regional trade (trade between countries within a bloc) is expanding rapidly.

Economic integration remains the driving force behind closer intra-bloc links, and trade is its most tangible symbol. In 1988 intra-bloc trade within the three identified blocs was valued at $935 billion (measured by exports). This represents some 35% of total world trade and its exclusion significantly alters the geographic picture of trade (as illustrated in Chart 7). Of course, excluding intra-bloc trade increases the share for non-bloc nations. But surprisingly, North America maintains its share of world trade with intra-bloc trade excluded, and East Asia actually increases its share. The EC is thus clearly the main intra-bloc trader—a reflection of the fact that it comprises highly integrated economies. A similar picture would arise if US inter-state trade were recorded.

Chart 7
World trade 1988

$ billions



Percentage excluding intra-bloc trade (total $1,773 billions)

Percentage including intra-bloc trade (total $2,708 billions)

Table D
Intra-trade as a percentage of total trade

	1982	1985	1988
European Community			
Exports	53.9	54.4	59.5
Imports	50.1	52.7	57.7
North America			
Exports	28.3	38.0	34.6
Imports	27.4	28.0	26.7
East Asia			
Exports	31.1	25.9	26.9
Imports	31.1	32.2	35.7

In trade integration, the EC has made steady progress during the 1980s. Intra-bloc trade appears to be moving toward 60% of total EC trade (see Table D), with the collapse of the oil price since 1985 accelerating this process by reducing EC trade with OPEC. In North America intra-bloc exports rose rapidly between 1982 and 1985 without any corresponding rise in the intra-bloc share of imports. This asymmetry relates to US fiscal expansion providing a massive boost to US imports from all sources including Canada, expanding total imports and Canadian intra-bloc exports. In East Asia a divergence between export and import values has emerged as the intra-bloc share of imports has grown while with exports it has fallen back. This reflects the build-up of huge surpluses with Europe and North America.

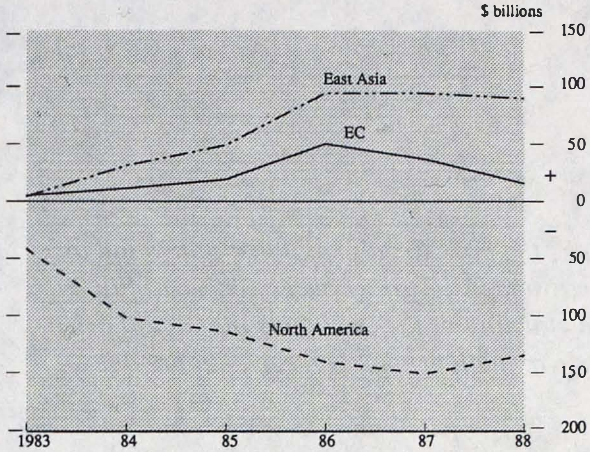
The industrial countries as a whole accounted for an expanding proportion of world trade during the 1980s as oil and other primary product prices fell. However, intra-bloc trade has held a roughly constant share of trade between industrial economies. In particular, the amount of trade conducted between the East Asian states and non-Asian industrial nations has expanded very rapidly. North American intra-bloc trade fell to 40% of all North American trade with industrial nations in 1988 from 44% in 1982, and the EC's rose only marginally from 73% in 1982 to 73.5% in 1988. This suggests that regional economic integration may just be part of a broader process of increased integration amongst industrial economies, albeit an important part.

Table E
External trade balances
$ millions

	1982	1985	1988
European Community	-44,000	-17,900	-27,900
North America	-23,000	-128,400	-131,500
East Asia	+600	+65,000	+114,700

(1) The three main regional blocs considered here are: the EC, East Asia (comprising Japan, Korea, Taiwan, Hong Kong, Singapore, Thailand, Malaysia, Indonesia, the Philippines and Brunei); and North America (comprising the United States and Canada). Although these blocs have increasingly become identified as the leading industrial 'regions', they obviously do not represent an exclusive list of 'trading' blocs.

Chart 8
Current account balances



As regional integration becomes increasingly apparent, it might be expected that the focus of attention concerning trade and current account balances will shift to a regional level also. Indeed, it may be argued that the focus of attention should be less on G3 current account imbalances and rather more on inter-regional imbalances. For example, the German trade surplus during the 1980s has been associated with deficits on the part of a number of other EC countries. The EC as a whole has run trade deficits throughout the 1980s (see Table E). However, positive services and net IPD inflows from outside the region have produced a consistent current account surplus in recent years (see Chart 8), although this dwindled to just $16 billion in 1989.

The sizable imbalance that does exist on a regional level prevails between East Asia and North America. Indeed, much of both the current and capital account imbalances result from direct flows between the two blocs. The direct trade imbalance of $94 billion in 1988 represented over 80% of East Asia's overall external trade surplus. Although East Asia's success in penetrating US markets has partly stemmed from competitive advantage in the goods market, particularly in areas such as consumer electronics, it also reflects the low rate of desired savings in the United States and much higher rates in many East Asian countries, and to this extent is mutually beneficial.

In so far as the advent of regional trading blocs is the result of decisions motivated by reasons of economic efficiency, there is no reason to suppose that it poses any threat to inter-regional trade. Indeed, the 1980s saw sustained growth of roughly equal magnitude in both intra-regional and inter-regional trade among the industrial nations, suggesting that both can contribute to greater efficiency of production. Continued support for a freer international trading system, and multilateral fora for settling trade disputes, should help to ensure that the benefits of removing trading blocs' internal barriers are not offset by greater protectionism at an inter-bloc level.