Part I  Overview and Historical Perspective

1  Overview

The economic turbulence of the past few years has subsided. The recovery of industrial economies in 1983-84, policy adjustments by many developing countries, and flexibility by commercial banks in dealing with debt-servicing difficulties have all helped to calm the atmosphere of crisis. This does not mean, however, that the world economy has regained its momentum of the 1960s or that development is again making rapid progress. Growth has slowed in most developing countries that experienced debt-servicing difficulties and in many of those that did not. Average per capita real incomes in most of Africa are no higher than they were in 1970; in much of Latin America, they are back to the levels of the mid-1970s. Dozens of countries have lost a decade or more of development.

The experience of the past few years has raised many questions about the role of international capital in economic development. Only a few years ago, there was general agreement that the more advanced developing countries could and should borrow more commercial capital from abroad. That consensus has been broken. Some people believe that the case by case approach to addressing debt difficulties is creating a sustainable balance of growth and debt servicing that will in time encourage more lending, including bank lending. Others believe that new approaches are needed if developing countries are to service their debt and resume economic growth. As with so many changes in conventional wisdom, both new and old arguments are often stylized and exaggerated. It is important not to lose sight of the fundamentals of international finance.

Capital has long flowed from richer to poorer countries. It has done so because it is relatively scarcer in economies that are at earlier stages of development, and the expected rates of return tend to be correspondingly higher. What is at issue is the nature of capital flows, their terms, and their uses. These questions were relevant in the nineteenth century and remain so today.

This Report offers a broad and long-term perspective on the role of international capital in economic development. It emphasizes that international flows of capital can promote global economic efficiency and can allow deficit countries to strike the right balance between reducing their deficits and financing them. The availability of international capital also involves risks, however: first, that it may delay the policy reforms required for adjustment; and second, that countries may borrow too much if they misjudge the way in which external economic conditions are going to evolve.

Both benefits and costs can be illustrated by recent experience. On the benefits side, most developing countries have made substantial economic progress over the past twenty years. Their GDP growth averaged 6.0 percent a year in 1960-80. The life expectancy of their people rose from an average of forty-two years in 1960 to fifty-nine years in 1982, while infant mortality was halved and the primary school enrollment rate rose from 50 to 94 percent. These advances reflected principally the efforts of developing countries themselves. But there is considerable evidence that capital flows, often accompanied by technical know-how, have played a part.

Foreign capital has also helped individual countries to cushion shocks—either internal ones such as harvest failures or external ones such as big changes in commodity prices or recessions in industrial economies. External finance can act as a shock absorber, allowing countries to adjust their spending gradually and reallocate their resources for a new environment. In the 1970s many developing countries were able, in the first instance, to pay for more expensive oil by borrowing more. Those countries that accompanied borrowing with policy reforms restored rapid growth and avoided debt-servicing difficulties. Other countries used borrowing to avoid the policy actions required for adjustment. Many of them ran into debt-servicing problems and needed to take even more drastic and costly adjustments later.
This contrast emphasizes that foreign borrowing is not a painless or riskless alternative to adjustment. The accumulation of debt makes a country more susceptible to international financial fluctuations, as the swing from negative real interest rates to unprecedentedly high positive rates has made all too plain. The need for rapid adjustment increased. Borrowers and lenders often fail to take full account of the institutional, social, and political rigidities that restrict a country's capacity to adjust.

The historical context

The ten years 1973–82 saw a big increase in the foreign finance going to developing countries. As a result, both the gross and net debt of developing countries increased sharply. Between 1970 and 1984 the outstanding medium- and long-term debt of developing countries expanded almost tenfold, to $686 billion (see Figure 1.1), despite the decline in capital flows since 1981. The most striking feature of this growth was the surge in lending by commercial banks. Their share of total new flows to developing countries increased from 15 percent in 1970 to 36 percent in 1983.

On every measure, the debt servicing abilities of developing countries deteriorated, particularly after 1974, as their debt increased (see Figure 1.2). The ratio of debt to GNP more than doubled, from 14 percent in 1970 to almost 34 percent in 1984. The ratio of debt service to exports rose from 14.7 percent in 1970 to a peak of 20.5 percent in 1982, declining to 19.7 percent in 1984. Interest payments on debt increased from 0.5 percent of GNP in 1970 to 2.8 percent of GNP in 1984 and accounted for more than half of all debt service payments in that year. These averages conceal wide regional and country differences.

Dramatic though the recent growth of foreign borrowing has been, it is not unprecedented. As Chapter 2 makes clear:

- The volume of international capital flows has often been larger in relative terms than in the 1970s. Between 1870 and 1913, Great Britain invested an average of 5 percent of its GNP abroad, rising to almost 10 percent just before World War I. For France and Germany, the figure was 2 to 3 percent of GNP. As a proportion of the recipient country's GNP, capital inflows were also often larger in earlier periods. Inflows to Canada, for example, averaged 7.5 percent of its GNP between 1870 and 1910 and accounted for 30 to 50 percent of its domestic investment. During the investment booms in Argentina and Australia, foreign capital was roughly half of all gross domestic investment. By contrast, net capital inflows to all developing countries averaged 2 to 3 percent of their GNP between 1960 and 1973, while financing 10 to 12 percent of their gross investment; since then, net capital inflows have been between 3 and 6 percent of their GNP and have financed 10 to 20 percent of their gross investment.

- The structure of financial flows to developing countries has changed several times. In the years before World War I, private bond markets were the main source of capital. In the 1930s, following the Great Depression and widespread defaults by borrowers in both industrial and developing countries, commercial lending to developing countries virtually stopped. It was replaced after World War II by an expansion of official flows, mainly on concessional terms; the largest part was bilateral aid, but some was channeled through the new multilateral agencies such as the World Bank and later the

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**Figure 1.1 Net capital flows and debt, 1970–84**

- **Net flows to developing countries**
  - Official development assistance
  - Commercial bank lending
  - Bilateral nonconcessional lending
  - Direct foreign investment
  - Multilateral nonconcessional lending
  - Other

- **Debt outstanding and disbursed**
  - All developing countries
  - Middle-income oil importers
  - Middle-income oil exporters
  - Low-income countries

**Source:** For net flows: OECD Development Co-operation; for debt: World Bank data.
International Development Association. Along with private direct investment and supplier credits, official finance provided the bulk of external capital for developing countries until the late 1960s, when commercial banks started to play a prominent role.

- Debt-servicing difficulties have been common and usually have been caused by a combination of poor domestic policies and a deteriorating world environment. The fifty years before World War I saw several debt repudiations, including the Peruvian and Turkish crises in the 1870s and the Argentinean and Brazilian crises of the 1880s and 1890s. Defaults, however, were not confined to developing countries: some borrowers in the United States, for example, defaulted on their debts in these years. In the 1930s defaults were widespread, starting with Germany in 1932. Argentina
was the only country in Latin America to service its debt on the terms contracted during these years. Except in the 1930s, countries were able to resume borrowing (albeit on more expensive terms) once they had reformed their policies.

By historical standards, debt-servicing difficulties in the 1960s and 1970s do not seem unduly serious. In 1955-70 seven developing countries (Argentina, Brazil, Chile, Ghana, Indonesia, Peru, and Turkey) were involved in seventeen debt reschedulings. There were also some debt reschedulings for low-income countries, including India, but these were designed to provide additional finance when official lenders could not increase new lending. In the 1970s, despite the sharp fall in their terms of trade in 1973-74, an average of three developing countries a year rescheduled their debts.

It is only in the 1980s that debt problems have multiplied. The number of reschedulings rose to thirteen in 1981 and to thirty-one (involving twenty-one countries) in 1983 and a similar number in 1984 (see Figure 1.3). Countries have restructured their repayment schedules, sometimes for several years at a time, in the context of agreed upon programs of policy reform. Low-income countries, however, particularly in Africa, have yet to benefit from the kind of multiyear rescheduling that some major debtors have negotiated.

The similarities with the past should not obscure some differences as well. Developing countries have become more vulnerable to debt-servicing difficulties for three related reasons. First, loans have far outstripped equity finance. Second, the proportion of debt at floating interest rates has risen dramatically, so borrowers are hit directly when interest rates rise. Third, maturities have shortened considerably, in large part because of the declining share of official flows and debt—and by even more than Table 1.1 suggests, if account is taken of the way in which higher inflation and interest rates have front-loaded repayments.

Another major and disturbing difference today is that many of the countries with debt-servicing difficulties are in the low-income group. This is partly because their aid receipts have been erratic. The dollar value of receipts of net official development assistance (ODA) by all developing countries in 1975 was two and a half times the level in 1970, stagnated between 1975 and 1977, almost doubled between 1977 and 1980, and has declined since then. In real terms the pattern is similar, but the fluctuations are less marked. This pattern is explained by variations in bilateral ODA, particularly flows from OPEC countries, since multilateral ODA increased steadily between 1973 and 1980 and has declined since then. Many low-income and lower-middle-income countries borrowed commercially and accumulated large amounts of debt. In earlier periods, the poorest countries had obtained virtually all their foreign capital in the form of direct investment, especially for export-earning activities, or official flows on concessional terms.

The historical perspective reveals certain broad characteristics of debt-servicing problems. The financial links between industrial and developing

Table 1.1 Composition and terms of capital flows to developing countries in selected periods

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<td>Direct foreign investment as a percentage of net capital flows</td>
<td>19.8</td>
<td>15.5</td>
<td>12.9</td>
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<tr>
<td>Floating interest rate loans as a percentage of public debt</td>
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<td>26.5</td>
<td>37.9</td>
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<td>Average years maturity on new public debt commitments</td>
<td>18.0</td>
<td>15.0</td>
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Source: For investment: OECD Development Co-operation; for terms: World Bank data.
countries depend on three variables: (a) the policies of industrial countries; (b) the policies of developing countries; and (c) the financial mechanisms through which capital flows to developing countries. No analysis of international finance is complete unless it takes account of all of these variables. In doing so, it reveals a much wider range of country experience and why some countries have borrowed and encountered debt-servicing difficulties, while others have not. It also highlights the fact that the economic difficulties of the early 1980s were the product of individual economic decisions that seemed rational when they were made.

Policies of industrial countries

As Chapter 3 makes clear, the fiscal, monetary, and trade policies of industrial countries largely determine the external climate for developing countries. The connection is not simply that rapid growth in the industrial world pulls up the growth of developing economies, though it helps to do so. Nor is it just that prolonged recession and increased protectionism in the industrial countries cause difficulties for developing countries. Increasingly, the links are financial, through changes in the availability of finance and movements in interest rates and exchange rates.

This became clear in 1979-80, for example, when U.S. monetary policy switched from targeting interest rates to targeting monetary aggregates. Interest rates became more volatile. Latin America, with a higher proportion of floating rate debt, was more affected by this change than either East Asia or Africa. The result was abrupt increases in debt service payments. Developing countries find it difficult to make sudden and large changes in debt service payments. The strains felt by many developing countries were increased in the early 1980s by the recession in the industrial countries, which reduced export volumes and weakened commodity prices at a time when real interest rates were rising (see Figure 1.4 and Chapter 3, Figure 3.6). It is hardly surprising that the combination made it difficult for many countries to service their debts.

The recovery in the industrial countries has helped to ease some of the liquidity pressures on developing countries. World trade grew by about 8.5 percent in 1984, and world output increased by 4.2 percent. In developing countries GNP grew by 4.1 percent, and the volume of their exports increased by an estimated 8.9 percent, compared with less than 4 percent a year in 1981 and 1982. Real interest rates have softened a little but remain at historically high levels. The world recovery in 1983-84 did not lead, however, to the normal cyclical rise in commodity prices in dollar terms. This was in part due to the U.S. dollar’s further appreciation, as well as to technological and other factors affecting the demand for commodities. Thus net primary commodity exporters (including Brazil) benefited less than countries that are net commodity importers (such as the Republic of Korea). In addition, developing countries continue to be affected by protectionist measures in the industrial economies.

For the future, the effects that industrial countries have on developing countries will depend primarily on what happens in two areas of policy: real interest rates and protectionism. Interest rate developments are explored in detail in Chapter 3. The analysis there concludes that large budget deficits in industrial countries remain an obstacle to lower interest rates. As a proportion of national income, combined budget deficits of all levels of government rose substantially between 1979 and 1984 in nine of the principal industrial countries except the Federal Republic of Germany and Japan. In 1984 the combined deficits of these industrial economies, adjusted for inflation, were 2.3 percent of their national income. The U.S. deficit has grown the fastest over the past five years. Credible measures are needed in these countries to reduce public sector reliance on domestic and foreign savings; this could lower interest rates and foster growth. The United States has recently
announced steps that, when implemented, would permit significant reduction in its fiscal deficits in the next few years. Avoiding a recessionary impact of such a policy change will require careful coordination with monetary policy in the United States and with monetary and fiscal policies in the other large industrial countries.

The second issue of vital concern to developing countries is protectionism. To service their foreign debts, the biggest debtors will need to run large trade surpluses in the next few years. Yet many import restrictions—on steel, sugar, and beef, for example—have affected primarily major debtors including Argentina, Brazil, Korea, and Mexico. Other restrictions, such as the Multifibre Agreement, affect a broader range of countries. The harder the big debtors find it to service their debt, the greater the strains on the world's banking system.

When developing countries cannot earn the foreign exchange to expand their imports, exporters in the industrial countries are also damaged. To take one example, this was an important factor in explaining why U.S. exports of manufactures to major debtors fell by 40 percent between 1980–81 and 1983–84. Such harm is widespread, since industrial economies run a surplus on trade in manufactured goods with developing countries. And protectionism acts as a brake on the adjustment and growth that the industrial countries themselves so badly need.

Over the longer term, protectionist barriers in the industrial world can have a profound effect on development strategy. They suggest to governments in developing countries that a strategy based on export growth is highly risky, and thus encourage a return to the inward-looking policies of earlier years. Evidence is abundant that such policies are bad for growth and employment in the developing countries and also reduce the scope for industrial countries to promote improvements in productivity in their own economies.

Policies of developing countries

The past dozen years have underlined, as discussed in Chapter 4, the crucial role of domestic policies in determining the performance of developing countries—particularly in the use they make of foreign finance. Foreign finance can promote growth through higher investment and technology transfers. It can allow countries to adjust gradually to new circumstances in the world economy. But it can also be misused, so that countries end up with more debt but no corresponding increase in their ability to service it.

In the 1970s it was right for countries to borrow when real interest rates were low or negative—but only if they followed appropriate policies and invested in economically justified projects. Caution in defining borrowing limits was required. It was wrong to assume that low interest rates would continue, and it is always expensive to reverse investment decisions. These mistakes are quickly exposed when world conditions deteriorate, as they did in the early 1980s.

Developing countries suffered in 1979–84 from a combination of more expensive oil, historically high real interest rates, prolonged recession in industrial economies, and more trade barriers. Despite this, as many as 100 countries have continued to service their foreign debt without interruption. Some have experienced only small shocks (for example, some countries that are oil exporters) or have benefited from workers' remittances (for example, certain Asian and Middle Eastern countries). Some had borrowed only a little or mainly on concessional terms in the 1970s (for example, China, Colombia, and India). And some who borrowed undertook economic policy reforms that facilitated debt servicing (for example, Indonesia and Korea).

Countries that ran into debt-servicing difficulties, however, were not necessarily those that had suffered the biggest shocks. They were countries that had borrowed and failed to adjust or had not tackled the new problems with sufficient urgency. Among these were the low-income countries of Africa, in which development is a long-term process constrained by weak institutional structures, a shortage of skills, and often (as in the past ten years) natural disasters as well. These countries have traditionally used concessional capital from abroad to finance the bulk of their investment. In the 1970s they were faced with higher import bills. Many African countries that had commodity booms were able to borrow on commercial terms when interest rates were low. They used this foreign finance partly for consumption and also for investment in large public projects, many of which contributed little to economic growth and to increased exports needed to service the debt. Capital inflows enabled some countries to postpone policy reforms. Debt-servicing difficulties could have been expected and did occur. The net result has been a further setback to their economic development.

The second group of countries with debt difficul-
ties includes many countries in Latin America and some major debtors. The reasons for their financing problems are more complex, but three common features are (a) fiscal and monetary policies that were too expansionary to achieve a sustainable external balance; (b) overvalued exchange rates that prevented exports from competing on world markets and encouraged capital flight; and (c) increased domestic savings efforts but investment increases that were even larger. Some countries, such as Chile and Uruguay, attempted comprehensive economic reforms, but parts of their policy package were defective and the timing of measures taken was inappropriate. Other countries borrowed heavily and undertook some policy changes (for example, Brazil, Ivory Coast, and the Philippines), but they underestimated the length and depth of the recession and the large rise in interest rates in the early 1980s. Many of these countries are now in the process of reforming their policies, with results that are thus far encouraging.

The diverse experiences of developing countries emphasize certain basic lessons for policy. One can be summarized as the need for flexibility. A characteristic of foreign finance is that it requires both borrowers and lenders to take account of uncertainty. The best way of doing so is to be able to respond flexibly to changes in the external environment. Countries as varied as India, Indonesia, Korea, and Turkey have adapted their economic policies to changed circumstances. The most critical changes in the short term are the ability to reduce fiscal deficits and adjust real exchange rates and real interest rates. When for political or other reasons countries cannot adjust their policies quickly, they should be conservative in resorting to foreign borrowing.

A second lesson is that the policies required to make best use of external finance are essentially the same as those that make best use of domestic resources. A country must earn a return on its investments which is higher than the cost of resources used. In the case of foreign finance, however, a country also has to generate enough foreign exchange to cover interest payments, plus remittances of dividends and profits. This depends on three groups of policies:

- Key economic prices must be aligned with opportunity costs. These encourage activities in which the country has a comparative advantage and increase the flexibility of productive structures. Subsidies, when used, should be carefully targeted, for example, to the poorest segments of society. When oil prices rose in 1973–74, many countries—including both oil importers and oil exporters—delayed raising their domestic energy prices, thus increasing pressures on their balance of payments; many other countries avoided these pressures by raising energy prices earlier. Furthermore, investment decisions are influenced by the appropriateness of pricing structures, including interest rates. Governments need to evaluate carefully their own investment programs and to create a framework of incentives to ensure that private investors allocate resources in the most efficient way. Countries such as Brazil, Ecuador, Ivory Coast, Nigeria, Peru, and Turkey combined negative real interest rates with overambitious or inefficient investment programs. By contrast, Colombia and Malaysia had more appropriate interest rate levels and investment incentives.

- Exchange rates and trade policies also play an important role. In the 1970s and early 1980s many countries—notably Argentina, Chile, Mexico, Nigeria, the Philippines, Turkey, and Uruguay—allowed their exchange rates to become overvalued and their trade policies to become distorted. This biased production toward the domestic market, stimulated imports, and provoked capital flight. Comprehensive trade and price reforms by Turkey, following difficulties it experienced in the late 1970s, produced good results.

- Efforts to raise domestic savings should be strengthened despite the availability of external capital. The correct role of foreign finance is to supplement domestic savings; it must not substitute for savings. The danger of poor savings performance was well understood by many governments. In fact, many developing countries managed a creditable performance on savings in the 1970s, with two-thirds of a sample of forty-four developing countries increasing their domestic savings ratios. They included such diverse economies as Cameroon, India, Korea, Malawi, Malaysia, and Tunisia. In other cases, including Morocco, Nigeria, and Portugal, inadequate domestic savings efforts contributed to overborrowing. Improvements in savings performance require measures by both public and private sectors. In the public sector, tax measures, realistic pricing of public goods and services, and cuts in spending are required to reduce deficits and increase public savings. If higher public spending is financed by borrowing more from abroad rather than by increasing fiscal revenues, cumulative strains are put on budgets (since governments have to pay debt interest) and the balance of payments. Mexico's experience in 1981–82, when the budget deficit
more than doubled as a proportion of GNP to meet increased public consumption and was financed partly by external capital, sowed the seeds for its debt crisis in 1982. As for private savings, domestic interest rates that are kept low curtail savings, contribute to capital flight, lead to credit rationing, and increase the pressures for borrowing abroad. Government policies of adjusting exchange rates by less than the rate of inflation and of subsidizing foreign borrowing artificially lower the domestic currency cost of borrowing, thereby inducing capital inflows. This was the case in Argentina, Chile, and Uruguay.

Managing foreign borrowing and debt

Policies determining the level of domestic savings and investment also determine the need for foreign borrowing, so the management of capital flows should be an integral part of macroeconomic management. Certain aspects of debt management deserve special attention, and these are discussed in Chapter 5.

The first issue is whether and how governments should regulate foreign borrowing and lending by the private and public enterprise sectors. The answer depends fundamentally on a government's macroeconomic and incentive policies; in general, less government intervention is needed the more that prices, interest rates, and exchange rates reflect opportunity costs. Although some governments have constructed elaborate controls over capital inflows and outflows, experience strongly suggests that these are no substitute for sound macroeconomic policies. Nonetheless, some procedures for regulating capital movements—prior approval for borrowing, minimum maturity or deposit requirements, or withholding taxes—have sometimes proved a helpful complement to fiscal, monetary, and trade policies.

The second broad area of concern is the composition of capital flows and debt. This involves decisions about (a) the terms of foreign borrowing—interest, maturity, and cash flow profiles; (b) the currencies in which liabilities are denominated; (c) the balance between fixed rate and floating rate instruments; (d) ways of sharing risk between lenders and borrowers, including the balance between debt and equity; and (e) the level and composition of a country’s reserves. It is not possible to formulate precise rules for external debt management that will apply to all countries. The experience of the past few years, however, argues for prudence by developing countries in deciding on both the volume of foreign borrowing and its composition, and in maintaining enough reserves to give a country time to adjust to domestic or international pressures without unduly jeopardizing its economic growth. If the capacity to borrow abroad is not stretched to its limits, it will provide a cushion in times of particular need.

Many countries fail to manage capital flows effectively because of inadequate data, a lack of technical expertise about financing options, and an absence of institutional arrangements to integrate debt management with macroeconomic decision-making. In all these areas, institutional development is an important priority.

Financial mechanisms

Developing countries account for only a small proportion of international flows of capital, so their influence on the international financial system is limited. The system itself changes in response to three main factors. The first is the external environment. For example, changes in regulations, financial innovation, and high and volatile inflation in the 1970s led investors to lend on floating rate rather than fixed rate terms. The second factor is the demand for the services of financial markets and institutions, which is heavily affected by imbalances in global payments. For example, OPEC countries in the 1970s and early 1980s initially preferred to keep their surpluses in highly liquid form, so commercial bank deposits and lending increased. More recently, the large current account deficits run by the United States, which have their counterpart in surpluses in Japan and other industrial countries, have led to a much larger role for international asset markets. The third factor is the preferences of financial institutions. For example, in the 1970s commercial banks chose to lend abroad to satisfy their own portfolio and profitability objectives (see Chapter 8).

In the short term, developing countries have to make the most of the opportunities presented by the international financial system. From a longer-term point of view the critical policy questions are: how can the stability of external capital flows be enhanced and lending by banks be restored? what arrangements can be made for future capital flows, including enough concessional assistance to meet the needs of low-income countries?

The answers lie in five areas:

- Longer maturities. Developing countries can borrow long term, though seldom directly from the market; they rely almost exclusively on the
intermediation of the World Bank and regional development banks. These institutions will remain the primary sources of longer-maturity capital for developing countries in the next few years. They need to have the capability to provide more financing to developing countries, since the prospects for expansion of private financing are not good. Financial innovation to expand the range of maturities available to developing countries would help them to manage their debt and reduce refinancing risks.

- **Hedging.** The nature of the financing instruments used in the 1970s meant that developing countries assumed the risks of adverse developments in the world economy. One of the central functions of a financial system—effective risk sharing—was not efficiently served. Instruments for hedging risks already exist in many financial markets: it would be desirable to make greater use of them in lending to developing countries.

- **Commercial risk sharing.** Whereas conventional bank loans do not involve sharing of commercial risks, foreign direct and portfolio investment does (see Chapter 9). The introduction of equity-based instruments in lending to developing countries is another area in which progress could be made.

- **Secondary markets.** As most commercial lending to developing countries in the 1970s was done by banks, it tended to increase risks by concentrating assets in a single group of creditors. The expansion of secondary markets for some kinds of liabilities of developing countries could widen the range of lenders and so increase the stability of lending. Such a development, although desirable, must be a phased process. In the long run, secondary markets could also provide an extra indicator of country creditworthiness, making it easier for lenders to diversify their risks.

- **Aid volume and effectiveness.** Low-income countries need a considerable quantity of aid, more than is available at present. They also need to use aid efficiently (see Chapter 7). Donors can improve their own efficiency by focusing their aid primarily on development objectives and by coordinating their efforts within programs agreed upon with the recipient.

**Prospects and options**

How much and what kind of foreign finance will developing countries need in the years ahead? That question can be answered only by analyzing the global outlook for growth, trade, interest rates, and so on. Traditionally, *World Development Reports* present alternative scenarios for the future. Such scenarios, it must be emphasized, are not predictions; their outcome depends on the policies adopted in industrial and developing countries. Nor do they allow for exogenous shocks to the world economy. Last year's Report contained scenarios to 1995. The discussion in this year's Report, in Chapter 10, is in the context of last year's scenarios, but pays greater attention to the next five years.

The next five years are a period of transition. During that time, about two-thirds of the debt of the developing countries will have to be rolled over or amortized. The constructive and collaborative actions taken by debtors, creditors, and international agencies in recent years need to be continued. Their objective is to accelerate the return to creditworthiness of countries that are pursuing sound economic policies, but have sizable short- to medium-term debt-servicing requirements. They need in particular to be extended to countries—several middle-income exporters of primary commodities and many low-income African countries—in which debt-servicing difficulties and development problems are intertwined. Consideration needs to be given to the extent to which multiyear debt restructurings for official credits and other arrangements might be considered on a case by case basis, as part of the overall financing package supporting stabilization and adjustment, particularly in low-income sub-Saharan African countries committed to strong adjustment efforts. Beyond that, much will depend on whether industrial and developing countries successfully pursue policies for structural adjustment.

Over the past few years, many developing countries have made progress in dealing with their financial difficulties. The economic situation, however, continues to remain fragile in many countries. Growth of GDP in 1980–85 is currently estimated at slightly more than one-half that of 1973–80. Exports have grown at close to 6 percent a year, but the pressure of continued high interest payments has meant that imports could grow at only a little more than 1 percent a year. Substantial trade surpluses run by many developing countries have been used to meet greatly increased interest payments. The high level of real interest rates is thus one of the critical variables whose course will influence outcomes in the next five years. Developing countries need to keep the rate of growth of export earnings above the rate of interest—even if the current account net of interest payments remains in balance—if the principal debt ratios are to return to more sustainable levels. This will
depend not only on their own policies, but also on the rate of growth of industrial economies and whether protectionist measures are rolled back.

Two simulations—a Low and a High—have been prepared for the period 1985–90 and are discussed in detail in Chapter 10. Both simulations assume that developing countries continue with their present course of policies, which in many cases (as in some low-income Asian economies) imply substantial policy reforms and adjustment efforts. Policy improvements are in three principal areas—key economic prices, exchange rates and trade policies, and domestic savings. These contribute to efficiency in the use of resources and to export competitiveness. As for industrial economies, the difference between the simulations is that the Low one assumes a set of policies that fail to address current problems and as a result lead to further problems, whereas the High one embodies policy changes that result in greater progress in adjustment. The Low simulation makes three basic assumptions: no progress in reducing budgetary deficits and in improving the monetary-fiscal balance so that real interest rates remain high; a failure to tackle labor market rigidities so that unemployment stays high and real labor costs continue to increase; and a substantial increase in protection. By contrast, the High simulation assumes reduced fiscal deficits compared with the Low simulation, thus permitting improvements in the monetary-fiscal balance and a resultant lowering of real interest rates; reductions in labor market rigidities such that unemployment declines and the increase in real labor costs slows down; and an increasing success in adjustment that results in a steady decline in protection.

For developing countries, the implications of these assumptions are far reaching. In the High simulation their output grows at a healthy 5.5 percent a year (or 3.7 percent a year per capita), and there is a major improvement in all the major debt indicators. The Low simulation produces a different and more problematic outcome: growth slows to 4.1 percent a year (or 2.3 percent a year per capita). If there is a sizable reduction in economic growth, however, the impact on debt servicing is even more striking. A combination of high real interest rates and protection makes debt servicing considerably more difficult. The main debt indicators deteriorate; for a large number of countries debt service ratios reach high levels. The volume of concessional aid declines as a result of slower growth in industrial economies, and “involuntary” lending, in the face of deteriorating creditworthiness, continues to be required.

The two simulations outline a continuing bleak outlook for many low-income African countries. In the High simulation, their average per capita income stagnates at present reduced levels; in the Low simulation, there is yet another period of falling per capita incomes. Special efforts are therefore needed to deal with these prospects. Additional external assistance is not, by itself, the solution to Africa's problems. It must be based on major changes in African programs and policies. Nonetheless, such reforms are unlikely to be sustained without additional external assistance, over and above that projected in the High simulation.

The challenge for the next five years is to ensure that the world reaches the High case. How it could do so will be implicit in many of the chapters in this Report and is made explicit in Chapter 10. It is quite clear that foreign capital will play a significant part in meeting the challenge of faster growth; it is also possible that its legacy from the past ten years will act to slow growth, unless creditors, debtors, and the international community continue to ease the pressure of debt.

In contributing to the resumption of growth and the restoration of creditworthiness of the developing countries, the World Bank is addressing investment and institutional development issues crucial to sustaining longer-term progress. Against the background of growing strength in domestic institutions in borrowing countries and much greater resource scarcity than in the 1960s and 1970s, Bank assistance is helping governments to strike an appropriate balance between additional investments and the maintenance of existing capacities, to achieve greater selectivity and efficiency in public sector investments, and to develop a framework of policy and institutional arrangements conducive to the growth of activities in the private sector.

The financial resources provided directly by the Bank make important contributions to restored growth and momentum in development, but they can never be more than a rather small proportion of the total resources required. The Bank is, therefore, strengthening its catalytic functions, particularly with respect to aid coordination in sub-Saharan Africa, cofinancing with commercial banks and export credit agencies, and the promotion of private investment. In addition to its direct lending, the tasks of complementing and—to the extent possible—exercising a constructive influence on capital flows from other sources are also important factors in shaping the future role of the Bank.
In dealing with all these issues, the Report starts with a historical perspective on the role of international finance in economic development (Chapter 2). It then assesses the policies of industrial economies from the perspective of developing countries (Chapter 3). The importance of developing countries' policies in deriving benefits from foreign capital is taken up in Chapter 4; and issues in managing capital flows are covered in Chapter 5. The Report then discusses the main mechanisms through which foreign capital flows to developing countries. Chapter 6 gives an overview of the international financial system and its relations with developing countries. Chapter 7 examines issues in official development finance. Chapter 8 outlines the evolving relationship between the developing countries and international capital markets; and Chapter 9 examines the possibilities for a bigger role for direct and portfolio investment in developing countries. The Report ends by looking at prospects for the future and the policies needed to promote faster growth.