From recovery and adjustment to long-term growth

When the world economy is performing well, with rapid growth and low inflation, structural economic change is less difficult. Growth provides a steady increase in the demand for goods and services. This encourages a more liberal trading environment, because it allows countries to adjust more smoothly to the shifts in comparative advantage that follow changes in technology, resources, and tastes. Growth also stimulates investment and eases the absorption of new technology. Low inflation makes for orderly financial markets, greater exchange rate stability, and improved incentives to save. High inflation increases uncertainty, discourages investment and technological change, distorts relative prices, and stands in the way of sustainable growth.

In the two decades between the early 1950s and the early 1970s, the world economy achieved both high growth and low inflation. The developing countries shared in that success. They grew at more than 5 percent a year, probably the best record for any group of countries over such a period.

Without the reduction in trade barriers that was achieved after World War II, economic growth could have been a good deal slower. Only in a liberal trading environment can countries exploit to the full the opportunities provided by change. Successive GATT negotiations kept up the pressure on countries to liberalize trade and to integrate their economies with the world economy. Trade grew at 8 percent a year between the early 1950s and the early 1970s—significantly faster than world output. Some developing countries liberalized their trade regimes in the mid-1960s, became exporters of manufactures, and gained directly from the expansion in world trade. Most of the others benefited from rising demand for raw materials and foods. So, in one way or another, the developing countries that participated in the expansion of world trade experienced high output growth.

Thanks to this period of growth, some of the elements of a well-functioning world economy have been present since the early 1950s. Yet over the past ten years the system often has not run smoothly, and the developing countries have faced great strain. Output in industrial countries has fluctuated more than in earlier years, causing variations in demand for the products of developing countries. Certain sectors in industrial countries, especially agriculture, have been protected against the exports of developing countries; restrictions on imports of textiles and clothing have been growing since the 1960s. The price of oil went sharply up in the 1970s and sharply down in the 1980s. In the past few years exporters of primary products have suffered a significant deterioration in their terms of trade. Foreign capital has not always been available in the right quantity or on the appropriate terms. Overborrowing by some developing countries resulted in debt difficulties that were compounded by the 1980–82 recession in industrial countries. All the while, concessional financial resources have been too small for the tasks at hand.

Will the developing countries fare better during the next decade? This chapter tries to answer that question. The first part of the chapter reviews the current state of the world economy. The second discusses the response to the immediate problems of sluggish growth and international payments imbalances. The third part takes a longer-term per-

spective; it presents alternative paths for global output growth and for capital and trade flows over the next decade. These paths are not forecasts or predictions. Their purpose is to illustrate the outcomes that would be consistent with different sets of policies. They do not allow for new shocks to the world economy. The High case shows what is achievable rather than what is likely to be achieved; the Low case shows what may happen if governments fail to act.

The differences between growth rates in the High and Low cases are large. This emphasizes the need for policy changes. The low-growth path would mean economic and social conditions for the developing countries that they and the world must regard as unacceptable. But the rewards for correcting the present imbalances are correspondingly great.

To achieve high growth, governments must change their policies. Concerted action will make adjustment easier for all. Countries need to agree to improve the working of international markets for goods, services, and capital and to improve the efficiency of their own domestic markets. The central theme of this chapter is that such steps, together with adequate financing for investment in the developing countries, would pay off handsomely in higher levels of output, employment, and welfare in industrial and developing countries alike.

Figure 2.1 Real GDP growth, 1973–86

The weakening recovery and international payments imbalances

The world economic recovery that started in the United States in 1983 is slowing down. Meanwhile, the international current account imbalances of the past few years persist. The underlying fiscal imbalances have improved only slightly. So far, the bulk of the adjustment to these imbalances has been left to the foreign exchange markets, and the dollar has depreciated sharply against the major currencies. In spite of this, the current account deficit of the United States has been slow to respond. At the same time, progress toward the alleviation of debt problems has also been slow. Real interest rates remain high in relation to historical levels, and external financing is proving inadequate for the restoration of strong and sustained economic growth in the highly indebted countries. Low commodity prices continue to add to the difficulties facing many developing countries.

On the positive side, inflation is low in most industrial countries and has been declining in many developing countries. Governments have demonstrated their commitment to restrain monetary growth and keep inflation down. In addition, the governments of many industrial countries have cut their fiscal deficits and thus increased their room for maneuver in the future.

The weakening recovery

The strong expansion in the United States since 1982 paved the way for a moderate world recovery (see Figure 2.1). Real output in the United States fell by 2.5 percent in 1982, then rose by 6.6 percent in 1984. The decline in public sector savings contributed to the high level of the real interest rate—the price of scarce savings. This compounded the effect of tight U.S. monetary policy. High nominal interest rates led to strong demand for dollar-denominated assets and a sharp appreciation of the dollar. After about two years of rapid output growth in the United States and moderate growth in other industrial countries, the pace of recovery slackened in 1985. Real output growth in the industrial countries peaked in 1984 at 4.6 percent, then slowed to 2.8 percent in 1985 and an estimated 2.5 percent in 1986 (see Table 2.1).

Growth slowed in the developing countries too. Their output grew at 4.2 percent in 1986, compared with 4.8 percent in 1985 and an average of 6 percent a year in the two decades prior to 1980 (Table

Table 2.1 Growth of real GDP, 1965–86
(annual percentage change)

Country group	1965–73 average	1973–80 average	1981	1982	1983	1984	1985	1986
Developing countries	6.5	5.4	3.4	2.1	2.1	5.1	4.8	4.2
Low-income countries	5.5	4.6	4.8	5.6	7.7	8.9	9.1	6.5
Middle-income countries	7.0	5.7	2.8	0.8	0.0	3.6	2.8	3.2
Oil exporters	6.9	6.0	4.1	0.4	−1.9	2.3	2.2	−1.1
Exporters of manufactures	7.4	6.0	3.3	4.2	4.9	7.8	7.8	7.0
Highly indebted countries	6.9	5.4	0.9	−0.5	−3.2	2.0	3.1	2.5
Sub-Saharan Africa	6.4	3.2	−1.0	−0.2	−1.5	−1.7	2.2	0.5
High-income oil exporters	8.3	7.9	1.4	−0.5	−6.9	1.2	−3.8	8.2
Industrial market economies	4.7	2.8	1.9	−0.5	2.2	4.6	2.8	2.5

Note: Data for developing countries are based on a sample of ninety countries. Data for 1986 are estimates.

2.1). Output per capita in the developing countries rose by only 2.2 percent in 1986. The slowdown in 1985–86 was largely due to the oil-exporting group, whose output fell by 1.1 percent in 1986. Oil importers gained from the drop in oil prices, but weak prices of their non-oil commodity exports offset this. Non-oil commodity prices rose by only 0.8 percent in dollar terms in 1986.

Cheaper commodities improved the terms of trade of developing countries which export manufactures. The output of exporters of manufactures increased by 7.0 percent in 1986. Some of the more advanced exporters of manufactures experienced very high rates of growth: the Republic of Korea's output, for example, increased by about 11 percent. China and India also achieved strong growth and raised the average growth rate for the low-income countries. Although growth rates rose in Sub-Saharan Africa (excluding the oil producers), high population growth meant that per capita incomes continued to stagnate.

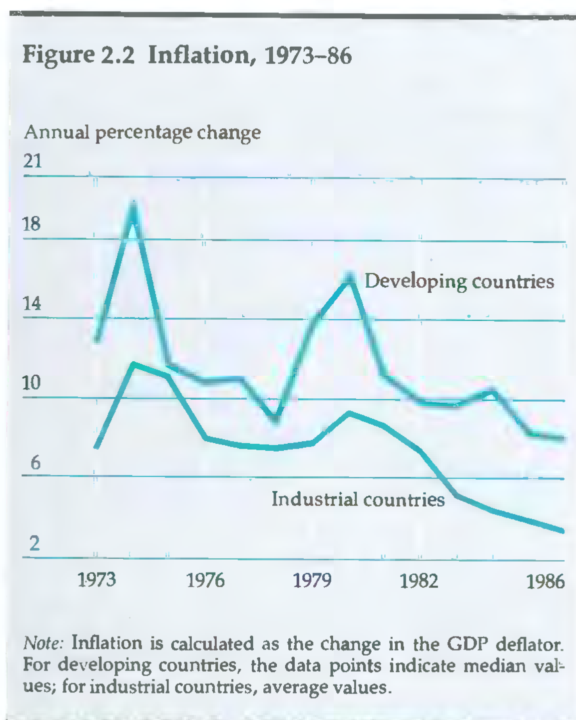


Figure 2.2 Inflation, 1973–86

Note: Inflation is calculated as the change in the GDP deflator. For developing countries, the data points indicate median values; for industrial countries, average values.

LOWER INFLATION. Average inflation in the industrial countries, as measured by the change in the GDP deflator, declined from 9.3 percent in 1980 to 3.4 percent in 1986. Inflation rates in the developing countries have also fallen since 1980 (see Figure 2.2). The trend was due partly to the drop in oil prices in 1986 and partly to falling commodity prices. Unfortunately, such once-and-for-all changes do not guarantee continued price stability. Governments will therefore need to be cautious. They can afford to permit only brief and minor deviations from a path of monetary growth consistent with low inflation. After a delay, excessive monetary growth tends to produce higher inflation.

REDUCTION OF FISCAL DEFICITS. The governments of the major industrial countries have reduced their budget deficits. The overall deficit has fallen as a percentage of gross national product (GNP) in the seven major industrial countries—from 5.4 percent in 1983 to 4.6 percent in 1986. Allowing for the effects of the economic cycle on revenue and spending, deficits have fallen even further. In the United States the federal budget deficit reached $221 billion, or 5.0 percent of GNP, in 1986. The Gramm-Rudman-Hollings Act may lead to a sig-

nificant reduction in the future. For 1987 the target deficit is $151 billion.

The international payments imbalances

The recovery was accompanied by large imbalances in international payments (see Table 2.2). By the end of 1986 the U.S. current account deficit reached $126.7 billion, equivalent to about 34 percent of the country's total exports of goods and services, or 3 percent of GNP—despite the sharp depreciation of the dollar since early in 1985. This widening external deficit was mirrored by the surpluses of other industrial countries, especially Japan ($87.5 billion in 1986) and the Federal Republic of Germany ($44.3 billion). The current account deficit of the developing countries dropped from $37.4 billion in 1985 to $35.5 billion in 1986. This can be attributed to the improved current account position of the exporters of manufactures.

These current account imbalances, together with continued high unemployment in industrial countries, have increased the calls for protection, above all in the United States. The Multifibre Arrangement was tightened in the summer of 1986, and the coverage of voluntary export restraints in steel has been extended. One positive sign is that the launching of the Uruguay Round of multilateral trade negotiations in the fall of 1986 produced a commitment to a standstill in protection. It is too early to tell whether this will be honored.

LOWER COMMODITY PRICES. The period between 1984 and 1986 saw real prices for nonfuel primary commodities fall to record lows (see Figure 2.3). In 1985 the World Bank's index of thirty-three nonfuel primary commodity prices, in current dollar terms, fell to its lowest level in nine years: a 4.8 percent decline from the recession low of 1982 and an 11.1 percent fall from the postrecession high reached in the first half of 1984. For the first time in recent history, practically all commodity groups experienced price declines in 1984–86. Between the fourth quarter of 1983 and the second quarter of 1986, the current dollar index for agricultural commodities declined by 13 percent, led by fats and

Figure 2.3 Real non-oil commodity prices, 1950–86

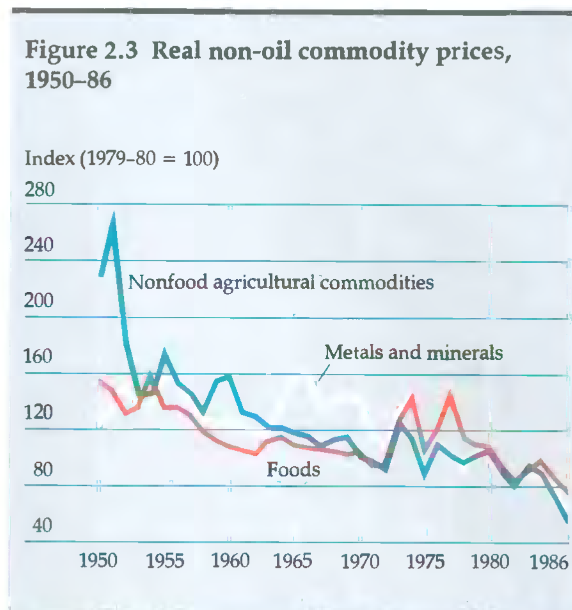


Table 2.2 Current account balance, 1980–86
(billions of dollars)

Country group	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
Developing countries	−69.1	−106.7	−103.0	−57.2	−32.1	−37.4	−35.5
Low-income countries	−17.0	−13.9	−8.9	−6.7	−8.1	−25.9	−22.0
Middle-income countries	−52.1	−92.8	−94.1	−50.5	−24.0	−11.5	−13.5
Oil exporters	1.4	−22.7	−30.0	−7.8	1.4	−2.2	−19.0
Exporters of manufactures	−33.9	−27.5	−23.3	−8.4	1.7	−8.8	6.0
Highly indebted countries	−27.9	−50.4	−52.9	−14.7	−0.7	−0.4	−12.0
Sub-Saharan Africa	−4.9	−17.8	−17.9	−12.8	−5.1	−4.0	−8.9
High-income oil exporters	88.5	74.0	26.0	1.2	1.5	12.1	−9.4
Industrial countries	−38.2	2.4	1.4	−2.9	−35.1	−24.7	21.6
United States	8.4	12.8	−1.4	−38.2	−95.8	−104.4	−126.7
Other industrial countries	−46.6	−10.4	2.8	35.3	60.7	79.7	148.3
Total[a]	−18.8	−30.3	−75.6	−58.9	−65.7	−50.0	−23.3

Note: Net official transfers are excluded. Data for developing countries are based on a sample of ninety countries.
a. Reflects errors, omissions, and asymmetries in reported balance of payments statistics on current account, plus balance of listed groups with countries not included.

Table 2.3 Public and private lending to developing countries, 1975 and 1980–86
(billions of dollars)

Country group and item	1975	1980	1981	1982	1983	1984	1985	1986
Low-income countries								
Disbursements	6.2	11.3	10.4	11.0	10.3	10.5	11.4	19.8[a]
From private creditors	1.6	3.4	3.0	3.5	3.0	3.3	3.4	10.0[a]
Principal repayments	1.4	2.5	2.5	2.7	3.1	3.3	4.4	6.8
Net flows	4.8	8.8	7.9	8.3	7.2	7.2	7.0	13.0
Middle-income countries								
Disbursements	38.6	90.2	111.6	105.6	87.6	77.0	67.6	66.4
From private creditors	28.2	71.0	88.8	82.3	63.2	52.6	46.7	43.4
Principal repayments	13.5	40.7	43.8	45.0	40.4	43.4	49.0	53.8
Net flows	25.1	49.5	67.8	60.6	47.2	33.6	18.6	12.6
All developing countries								
Disbursements	44.8	101.5	122.0	116.6	97.9	87.5	79.0	86.2
From private creditors	29.8	74.4	91.8	85.8	66.1	55.9	50.1	53.5
Principal repayments	14.9	43.2	46.3	47.7	43.5	46.7	53.4	60.6
Net flows	29.9	58.3	75.7	68.9	54.4	40.8	25.6	25.6

Note: Data for 1985 and 1986 are provisional estimates of amounts paid, not amounts due. Private nonguaranteed debt has been estimated where not reported by a country. Official grants are excluded. Data are based on a sample of ninety developing countries.
a. Largely reflects increased lending to China.

oils, nonfood agricultural commodities, and cereals. The index for metals and minerals declined by 16 percent over the same period; practically all metals and minerals contributed to this decline. Beverages and timber were the only commodity groups whose prices rose over the period.

The reasons for the depressed state of the commodity markets are complex. First, the demand for commodities in the industrial countries has been weak, especially for agricultural raw materials and metals. Second, the high prices of the mid-1970s led to overexpansion of supply in several important raw materials, especially oil and metals. But, at the same time, those high prices encouraged economy in the use of such materials and the development of alternatives. Third, the markets of some commodities have been disrupted by the agricultural policies of the industrial countries. Domestic price support programs have caused large surpluses, which have frequently led to the selling of exports at a fraction of domestic prices. Finally, changes in tastes, increased use of synthetic substitutes, and the adoption of production processes that are less intensive in raw materials have all depressed demand.

LENDING FOR DEVELOPING COUNTRIES. In 1986, net lending flows to developing countries remained at about one-third of their level in 1981, just before the outbreak of the debt crisis—although the year did see the first modest increase in net inflows for low-income developing countries since the debt crisis began (see Table 2.3). Borrowing by the highly indebted countries from private

Table 2.4 Debt indicators for developing countries, 1980–86
(percent, unless otherwise noted)

Indicator	1980	1981	1982	1983	1984	1985	1986
Ratio of debt to GNP	20.6	22.4	26.3	31.4	33.0	35.8	35.4
Ratio of debt to exports	90.0	98.0	117.6	134.8	121.2	143.7	144.5
Debt service ratio	16.0	17.5	20.6	19.4	19.5	21.4	22.3
Ratio of debt service to GNP	3.7	4.0	4.6	4.5	4.9	5.3	5.5
Ratio of interest service to exports	6.9	8.3	10.4	10.1	10.3	10.8	10.7
Total debt outstanding and disbursed (billions of dollars)	428.6	490.8	551.1	631.5	673.2	727.7	753.4
Private debt as a percentage of total debt	63.1	64.5	65.0	65.8	65.7	63.9	63.5

Note: Data are based on a sample of ninety developing countries. Data for 1986 are estimates.

sources amounted to \$6.8 billion, or about a quarter of the 1980 level. Most of it was "concerted" lending as part of debt restructuring.

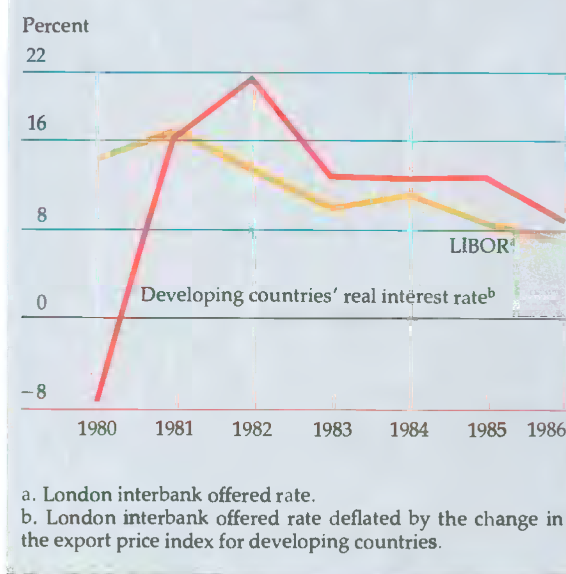
The broad debt indicators showed little improvement during 1986 (see Table 2.4). Despite a slight decline in the ratio of debt to GNP, debt service as a proportion of exports of goods and services increased. This largely reflected reduced export earnings. For some of the major oil exporters, the drop in oil prices implied a sharp deterioration of their creditworthiness. That made debt restructuring necessary for Mexico, Nigeria, and other countries (see Box 2.1).

Nominal interest rates continued to decline in 1986. But the deterioration in the export prices of the debtor countries limited the improvement in the "real" terms of their borrowing. The real interest rate for developing countries (the nominal LIBOR deflated by the export price index for developing countries) decreased from 12.1 percent in 1985 to 8.1 percent in 1986 (see Figure 2.4).

The central issue for the highly indebted middle-income countries is their need to finance new investment. The commercial banks have agreed to some debt restructuring packages, but there have been difficulties and delays. As the banks have strengthened their financial position, they have seemed increasingly reluctant to provide new financing. Still, new approaches are emerging. In 1986, schemes for converting debt to equity began to be adopted (see Box 2.2). Chile and Mexico have employed this approach, and others, such as Nigeria and Argentina, are considering similar plans.

For Sub-Saharan Africa, there were welcome increases in concessional flows in 1986. But the debt servicing problems of countries in Africa continue to be severe. Although recent progress with long-term restructuring of official debt is promising, greater and continued coordination of new aid and long-term restructuring of debt is still needed to improve the efficiency of assistance.

Figure 2.4 Interest rates, 1980–86



a. London interbank offered rate.
b. London interbank offered rate deflated by the change in the export price index for developing countries.

The adjustment of the highly indebted developing countries

For several of the highly indebted countries, low commodity prices, high real interest rates, sluggish growth in the industrial countries, and in some cases their own macroeconomic and trade policies mean that present levels of debt cannot be reconciled with present levels of growth. This situation is often referred to as the "debt overhang." Many debtor countries expanded their exports during 1983–84; this helped to stimulate domestic economic activity and was an important source of income growth through 1986. The achievement of some of the indebted countries in generating trade surpluses to service debt has been remarkable. But the counterpart of that has been lower domestic consumption and investment, with adverse effects on long-run productivity improvements.

Adjustment is needed and must be sustained. Recent difficulties in maintaining the momentum in some countries show the dangers of complacency. Continued improvement requires new investment in the competitive sectors of the economy so as to generate growth and increase the supply of tradables. Trade policy has an important role here. Chapter 5 of this report shows that the countries which provided equal incentives for exports and import substitution have been less affected by external shocks.

The adjustment of Sub-Saharan Africa

For Sub-Saharan Africa as a whole, GDP grew by less than 1 percent in 1986. This reflects, however, the economic decline in the oil-exporting countries, especially Nigeria; 1986 was a much better year than 1984 or 1985 for most other countries. Weather again proved favorable in 1986, and agricultural production continued to expand, rising by almost 4 percent.

Some twenty-five countries in the region, which

Box 2.1 Recent developments in debt restructuring

In 1986, twenty-four countries renegotiated their debts with official creditors or commercial banks in multilateral forums. The total debt so restructured is estimated at $71.1 billion, of which $43.7 billion came from recasting the terms of the 1984 multiyear bank agreement with Mexico (see Box table 2.1). Aside from this, the volume of debt restructuring with commercial banks was about the same in 1986 as in 1985.

Commercial bank consortia continued to improve the terms of relief by offering lower margins and somewhat longer maturities. Four multiyear restructuring agreements (MYRAs) were concluded. The other agreements restructured only those debts falling due in the coming year. Official creditors continued to reschedule debts in a series of short-term agreements, mostly through the Paris Club, at terms and conditions that did not change significantly in 1986.

Commercial bank agreements

Commercial bank debt relief covers (a) restructuring of principal payments falling due during an agreed consolidation period; (b) the related extension of new long-term loans; and (c) understandings to maintain or extend short-term credit lines. Debt relief agreements may contain one or more of these components. During 1986, eight countries negotiated debt relief agreements with commercial bank consortia: Brazil, People's Republic of the Congo, Côte d'Ivoire, Mexico, Nigeria, Poland, Uruguay, and Zaire. The most sweeping agreement was with Mexico. In addition to restructuring previously rescheduled debt of $43.7 billion, it committed new long-term loans of $6.0 billion, provided contingency arrangements for additional long-term loans of $1.7 billion, and reduced the spreads on existing bank debt to 13/16 percent. The agreement with Brazil rescheduled long-term debt falling due in 1985 and deferred payments on 1986 maturities pending further negotiations. Nigeria reached an agreement in principle with the commercial bank steering committee on long-term debt falling due in 1986–87 and arranged for new long-term money. Those negotiations were completed following approval of Nigeria's economic adjustment program by the International Monetary Fund (IMF) and the World Bank. Poland had earlier rescheduled all principal due to banks from March 21, 1981, through December 31, 1987. In June 1986, however, Poland found it necessary to reschedule principal due during 1986 and 1987 under these earlier

Box table 2.1 Amount of debt relief, 1983–86
(billions of dollars)

Item	*1983*	*1984*	*1985*	*1986*
Debt restructuring[a]				
Banks	33.8	100.5	13.1	57.4[b]
Official creditors	8.4	3.9	16.3[c]	13.7
Total	42.2	104.4	29.4	71.1
New money disbursed[d]	13.0	10.4	5.3	2.6[e]
Short-term credit facilities[d,f]	27.9	36.7	35.0	35.0

Note: Data for 1986 are provisional.
a. Debt restructuring with commercial banks is recorded in the year of agreement in principle; debt restructuring with official creditors is recorded in the year in which the agreement is signed.
b. Includes changed terms of Mexico's 1984 agreement ($43.7 billion).
c. Includes $10.3 billion relief for Poland, covering 1982–84 maturities.
d. Arranged in conjunction with debt restructuring.
e. Does not include $3.5 billion for Mexico scheduled to be disbursed in early 1987, other than $0.8 billion from bridging loans.
f. Agreements to maintain or expand existing trade credit lines or to provide other short-term credits.
Source: International Monetary Fund and World Bank data.

account for a large proportion of Africa's population and output, are implementing major programs of structural reforms or are about to do so. These include policies to keep real effective exchange rates competitive, increase agricultural incentives, maintain budgetary and monetary restraint, reform public enterprises, and improve the allocation of public funds. In some countries such efforts have been under way for several years; in others the adjustment process has barely begun. But resistance to further reform is hardening in the face of stagnating or declining per capita consumption. The fragile political consensus which provided the initial momentum must be strengthened and supported, especially with increased flows of assistance.

agreements. In addition to these reschedulings, Zaire arranged to defer principal due in 1986 on previously rescheduled debt.

The agreements with Congo, Côte d'Ivoire, and Uruguay were MYRAs. Brazil is currently negotiating for one. The global volume of debt restructured by MYRAs in 1986, however, was far below the level for earlier years, excluding the September revision of Mexico's earlier agreement.

An encouraging feature in 1986 was the ability of a few countries, previously dependent on new money arrangements under rescheduling, to obtain new commercial loans: a short-term revolving credit arrangement in the case of Ecuador and long-term loans negotiated under cofinancing agreements with the World Bank in the case of Côte d'Ivoire and Uruguay. In general, however, the failure of commercial bank lending to revive for other countries after the introduction of MYRAs, as had been anticipated, remains a matter of concern.

Agreements with official creditors

In 1986, eighteen countries renegotiated debt with official creditors, mainly through the Paris Club, as compared with twenty-one in 1985. Thirteen of these were Sub-Saharan African countries (Congo, Côte d'Ivoire, The Gambia, Guinea, Madagascar, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Tanzania, Zaire, and Zambia); two were European (Poland and Yugoslavia); and three were Latin American (Bolivia, Cuba, and Mexico).

The conditions and terms of relief extended in 1986 were little changed from earlier years. Most agreements rescheduled 95 to 100 percent of eligible maturities (principal and interest on loans from governments and on guaranteed export credits). However, the Côte d'Ivoire, Niger, and Yugoslavia agreements excluded interest; the Mexico agreement covered only 60 percent of interest due for a portion of the consolidation period. The Côte d'Ivoire MYRA, like the Ecuador MYRA of 1985, rescheduled a declining proportion of future principal payments due: 80 percent in 1986, 70 percent in 1987, and 60 percent in 1988.

Policies for the short term

The combination of international payments imbalances, sluggish growth, increasing protectionism, and the debt problems of many developing countries is an unpromising base for sustainable growth in the world economy. The more so because policy options have narrowed since the beginning of the 1980s. Adjustment with growth starts with setting the macroeconomic conditions straight. In industrial countries the fiscal imbalances underlying the current account imbalances must be corrected. In developing countries the macroeconomic environment must provide a stable platform for medium-term adjustment with growth.

International payments imbalances

The U.S. fiscal expansion that began in 1981 provided a strong stimulus for growth. But it was an unsustainable one. Unless the United States makes progress in reducing its fiscal deficit, international payments imbalances will be harder to reduce. Increased protectionism and new fears of inflation might then prevent the world economy from returning to a path of long-term growth.

The U.S. current account deficit has been slow to adjust. There are several reasons for this. First, although the dollar fell sharply after the beginning of 1985, its trade-weighted value by December 1986 was still only 6.4 percent lower than its average level in 1982. Over that slightly longer period, therefore, the dollar's fall has done little to change the relative price of U.S. goods. Second, exporters to the United States have not yet raised their dollar prices by the full amount of the depreciation. They accepted lower profits to maintain their share of the market, and their goods remain attractive to buyers in the United States. Third, the ratio of the prices of nontraded goods to traded goods in the United States is still rising. This provides little incentive for resources to switch to the export and import-competing sectors of the economy (see Figure 2.5). Fourth, import and export volumes respond only slowly to any change in relative prices caused by an exchange rate adjustment. Finally, and most important, there remains the underlying fiscal imbalance in the United States. Until that is corrected, or until expenditure falls relative to income for some other reason, the current account deficits will persist.

If the United States does reduce its fiscal deficit, growth in the world economy may slow unless other countries offset the loss of demand. This means that countries which have relied on export demand for output growth may have to shift the emphasis to domestic demand, perhaps through a fiscal expansion. Policies that tackle structural economic rigidities in labor markets and in the markets for goods and services need to accompany these shifts in demand. Such policies not only ease

Box 2.2 Debt-equity swaps

The existing exposure of commercial banks to developing countries is a key constraint to new spontaneous lending. Recently, a secondary market trading developing countries' debt instruments at a discount has emerged. The volume of transactions was initially quite limited, and price quotations on the discounted debt have been regarded as rather artificial in view of the thinness of the market. The market is becoming better organized, participation has widened, and the variety of transactions has increased. In 1986 the volume of trading in such instruments was about $7 billion, or less than 1 percent of the external debt of developing countries. New interpretations of accounting and banking regulations in the United States have contributed to this development. A bank taking a loss on a sale or swap of a loan to a developing country would not be required to reduce the book value of other loans to that country, provided the bank considers the remaining loans collectible.

A few of the debtor countries whose liabilities are being traded at a discount have utilized the existence of the discount market to encourage a flow of private investments and to gain other advantages. The popular term for the conversion of discounted debt into local currency assets is a "debt-equity swap." "Debt conversion" would be a more appropriate term, since conversion of external debt instruments into domestic obligations can take place not only for foreign direct investment purposes, but also for more general purposes by residents or nonresidents of the debtor country. In essence, a foreign investor wishing to buy assets in a debtor country can, through a debt-equity swap, obtain local currency at a discount. The foreign investor, in effect, obtains a rebate on the purchase of the currency equivalent to the discount on the loan less the transactions costs of the debt-equity swap.

Chile has a well-developed legal framework for the conversion of external debt into domestic assets. There is a similar procedure for the conversion of debt using foreign currency holdings by domestic investors.

Box figure 2.2 explains the detailed steps involved in the debt conversion. Although they seem complicated, the central steps are conceptually simple.

Debt-equity swaps are open only to nonresidents who intend to invest in fixed assets (equity) in Chile. The first step is to locate and buy at the going discount a Chilean debt instrument denominated in foreign currency. Next, with the intermediation of a Chilean bank, the foreign investor must obtain the consent of the local debtor to exchange the original debt instrument for one denominated in local currency and the permission of the central bank to withdraw the debt. Finally, the foreign investor can sell the new debt instrument in the local financial market and acquire the fixed assets or equity with the cash proceeds of the sale.

The main difference between the debt-equity swap and the straight debt conversion is that the debt conversion is available to resident or nonresident investors with foreign currency holdings abroad. Also, once the conversion has taken place, the investor faces no restriction on the use of the local currency proceeds.

The debt conversion scheme allows the debtor country first to reduce the stock or the rate of growth of external debt. Second, it is a means to attract flight capital as well as foreign direct investment. Third, debt-equity swaps imply a switch from the outflow of interest and principal on debt obligations to the deferred and less certain outflows associated with private direct investment.

For the commercial banks the swaps provide an exit instrument or a means to adjust the risk composition of their portfolio. For banks that wish to continue to be active internationally, losses on the outstanding portfolio can be realized at a time and on a scale of the bank's own choosing and by utilizing a market mechanism.

The emergence of an active market in debt instruments of developing countries offers opportunities to both debtors and lenders. There are, however, obstacles to its development. Debtor countries must ensure that transactions take place at an undistorted exchange rate, otherwise the discounts on the debt may be outweighed by exchange rate considerations. In addition, long-term financial instruments in the domestic markets are needed to ensure that the conversion into domestic monetary assets does not increase monetary growth above established targets. The incentives for foreign investors will be nullified if the broader domestic policy environment is not conducive to inflows of

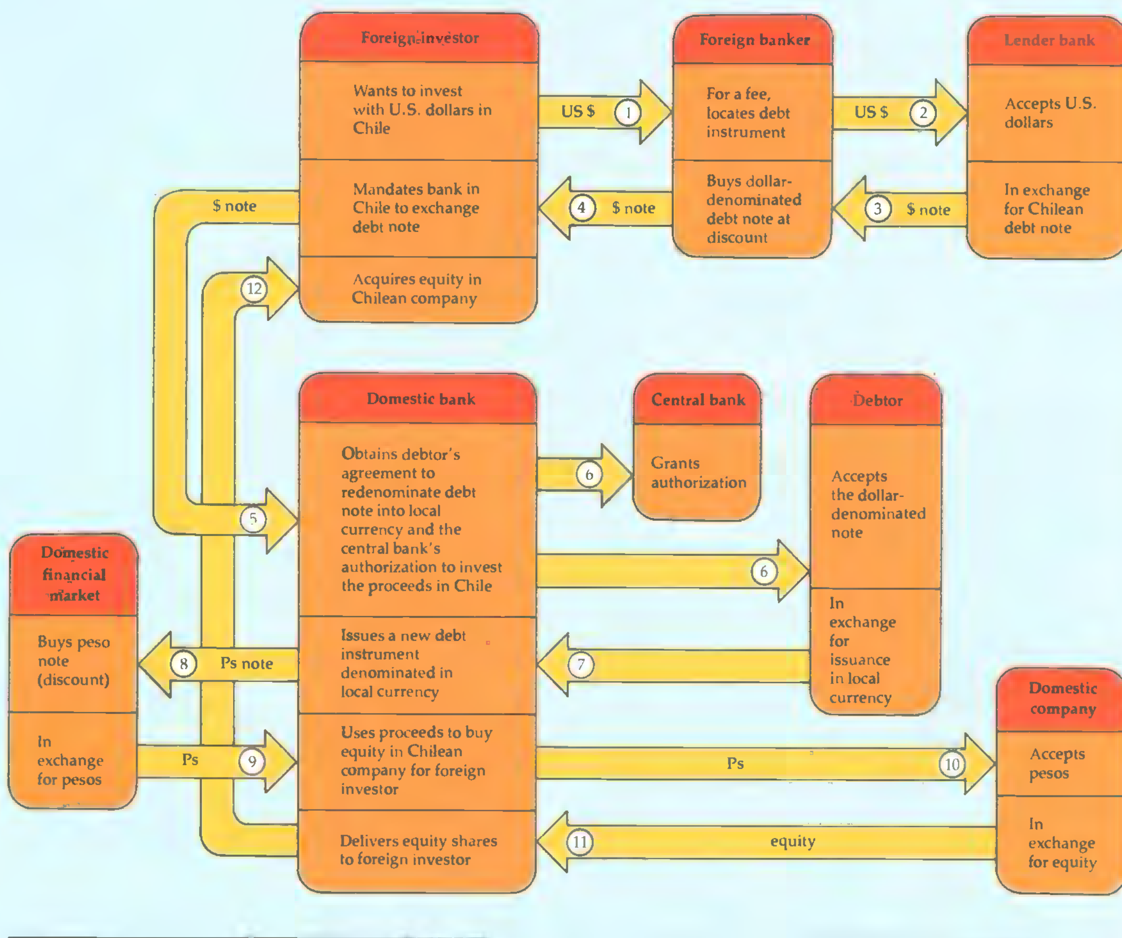
the short-run adjustment, they also improve the prospects for long-run growth.

International coordination of macroeconomic policies is important too. This is not a matter of altruism. It reflects a shared responsibility for global adjustment. The industrial countries need to assess how their policies will affect world demand in the light of the substantial shifts in trade flows that adjustment will require.

For the United States to become a net capital exporter again, interest payments on the debt accumulated during the years of large current account deficits will have to be more than offset by substantial surpluses on trade in merchandise and services. Although such an adjustment will not take place abruptly, it still amounts to a profound

foreign investment. Finally, a minimum regulatory framework is required. Documentation for debt restructuring must be adjusted to allow for prepayment for debt conversion purposes. Clear rules will facilitate the transactions. Overregulation, particularly in the form of administrative procedures for investment approval, would be a deterrence.

Box figure 2.2 Debt capitalization



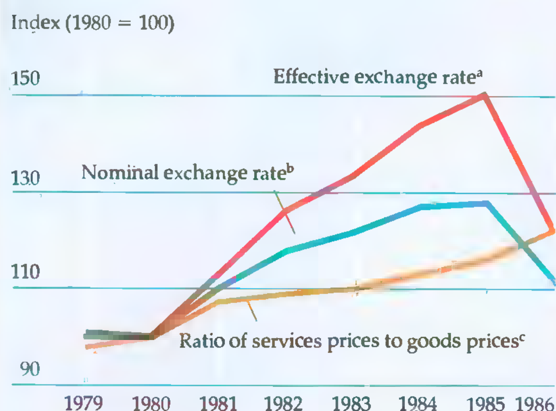
change in recent patterns of international trade—one that cannot easily come about without multilateral trade liberalization.

Sustained stabilization in developing countries

Reduced fiscal imbalances and a more open international trading environment are necessary but not sufficient steps to create the basis for sustained adjustment with growth in developing countries. Progress in two other areas is essential: macroeconomic stabilization and additional external capital. (For an example of a multifaceted stabilization and adjustment program, see Box 2.3 on Indonesia's recent experience.)

A stable macroeconomic environment is a pre-

Figure 2.5 The dollar exchange rate, 1979–86



a. The trade-weighted exchange rate as calculated by the IMF; period average.
b. The SDR-dollar exchange rate; period average.
c. The ratio of the U.S. price index of services to the price index of manufactures and commodities, excluding fuel; end of period index.
Source: For exchange rates, IMF; for the ratio of prices, U.S. Department of Labor.

requisite for a successful transition to sustainable economic growth. Maintaining macroeconomic stability typically requires keeping the fiscal deficit to a low fraction of GNP, guarding against rapid monetary expansion, and maintaining a realistic exchange rate. All three elements of this policy mix are necessary for economic growth. Mere reliance on monetary policy in the presence of large budget deficits and overvalued exchange rates, for example, will raise interest rates and deter investment. Similarly, reliance on trade and exchange controls will distort prices. Public sector deficits can be cut by reducing support to inefficient public enterprises or by broadening the tax base. But reducing deficits by curtailing investment reduces the growth on which creditworthiness depends, and an unduly tight rein on maintenance hampers capital efficiency at a time when all efforts should be made to raise it.

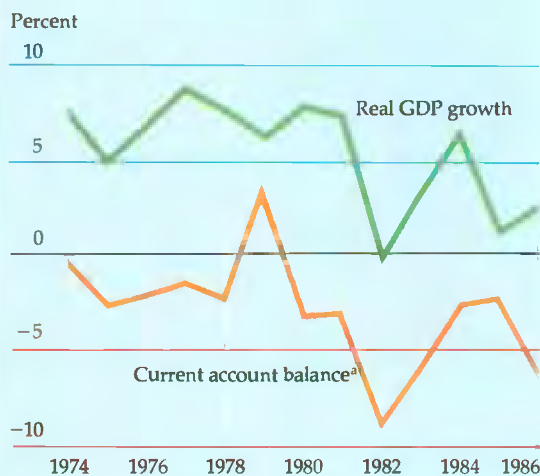
Reforms without financial support cannot go far in restoring growth. There are limits to how much consumption can be cut without endangering social and political stability. In addition, adjustment requires new investment to shift resources to the export and import-competing sectors. But, equally important, financial support should be an aid to adjustment—permitting short-term growth and allowing structural reforms to be brought in over time—not an alternative to it.

Box 2.3 Indonesia: adjusting to low oil prices

Appropriate and well-timed stabilization and adjustment policies can help to soften sudden external shocks, such as rapid declines in the terms of trade. The experience of Indonesia during the recent turbulent period in the international oil market is a case in point (see Box figure 2.3A). Despite steadily declining oil revenues since 1982 and a sudden collapse in international oil prices in 1986, Indonesia has managed to maintain macroeconomic stability. How did it do this? The answer lies in its stern adherence to a multifaceted adjustment program that has sought to constrain domestic demand in line with resource availability and that at the same time has attempted to stimulate growth through improvements in efficiency.

Oil and, more recently, liquefied natural gas have played a central role in the Indonesian economy. In 1980–81 these two commodities accounted for almost a quarter of the country's economic output, more than three-quarters of its export earnings, and more than two-thirds of its government revenues (see Box figure

Box figure 2.3A Indonesia's GDP growth and current account balance, 1974–86



a. As a share of GNP.

Policies for medium- and long-term growth

Since the breakdown of the Bretton Woods system of fixed exchange rates in 1971, the volatility of the world economy has revealed structural rigidities in both the industrial and the developing countries.

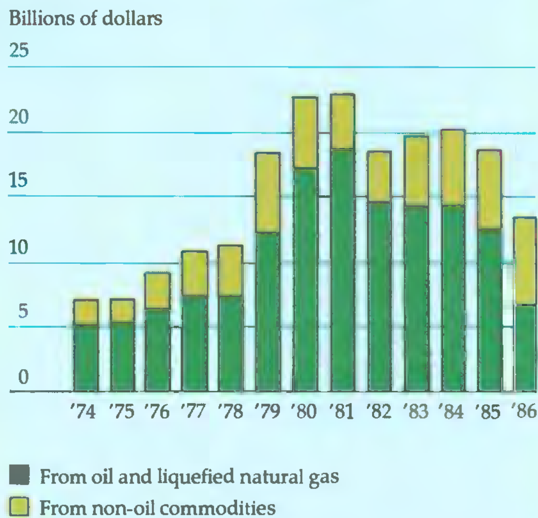
2.3B). So when the global oil market weakened steadily after 1981, the country's resource position eroded at an alarming rate. The current account deficit jumped upward sharply, and the government's budgetary position, already under strain from several large public investment projects, suddenly began to look untenable. The government quickly took a range of measures aimed at curtailing demand and restoring financial stability. It canceled or postponed several large public investment projects in 1983 and saved about $10 billion of foreign exchange in the process; maintained an austere fiscal stance; devalued the rupiah by 28 percent; reduced domestic subsidies on petroleum products; reformed the financial sector to raise private domestic savings and increase investment efficiency; and reformed the tax system to broaden the tax base and increase public savings.

But no sooner had these measures restored macroeconomic stability—by 1985 the current account deficit was down to 2.1 percent of GNP and inflation was at only 4 percent—than the economy was hit yet again when in 1986 international oil prices collapsed from $28 a barrel in January to $10 a barrel by August. In the face of such a large external shock, and in the absence of any adjustment, the current account deficit was expected to widen to an unsustainable level.

Anticipating its payments difficulties, the government once again responded quickly. It introduced a wide range of measures to curb domestic demand further to stabilize the economy and addressed structural issues to improve the efficiency of resource use. The main elements of this strategy are described below.

- The government introduced an austere budget that kept current expenditures flat in nominal terms and cut capital expenditures by almost 25 percent. In doing so, the government gave priority to current projects, the provision of counterpart funds for foreign-financed projects, the start-up of new projects that focused on equity and employment, and the funding of operations and maintenance expenditures.
- The rupiah was devalued by 31 percent to compensate for the sudden decline in oil revenues and to preempt speculative outflows of capital.
- Trade policy was changed from its previous emphasis on import substitution. For example, "producer-exporters" were given the option of importing their inputs free from licensing restrictions and exempt from import duties. More important, the government began to dismantle the cumbersome system of import licensing restrictions and to move toward a system of protection based only on tariffs.
- Finally, the government reformed significantly the regulatory environment for foreign investment. In particular, the requirement for local participation was relaxed, the duration of investment licenses was extended to thirty years, and changes were introduced to treat foreign investors more like local investors.

Box figure 2.3B Indonesia's export earnings, 1974–86



The combination of demand restraint, devaluation, and trade reform is expected to contain the destabilizing effects of the dramatic deterioration in Indonesia's terms of trade. In addition, the reforms—particularly those of trade and industrial licensing policy—are expected to provide a policy environment conducive to efficient industrial development and a rapid increase in manufactured exports. Finally, by husbanding government resources and stimulating private savings through the financial reform, Indonesia has succeeded in maintaining its credit standing in the international capital markets.

Prospects for the medium term and beyond depend on the willingness of governments to deal with these rigidities. In addition to discussing the reforms that might be necessary, this section sets out alternative paths of future growth (see Tables 2.5 to 2.9).

The High case

The High case assumes that the industrial and developing countries adopt a variety of medium- and long-term adjustment policies. Specifically, it assumes that fiscal and international payments im-

Table 2.5 Economic performance of developing and industrial countries, 1965–95
(average annual percentage change)

Country group and indicator	1965–73	1973–80	1980–86	1986–95 High	1986–95 Low
Developing countries					
Real GDP	6.5	5.4	3.6	5.9	3.9
Low-income countries	5.5	4.6	7.4	6.7	4.6
Middle-income countries	7.0	5.7	2.0	5.4	3.6
Oil exporters	6.9	6.0	0.8	4.4	3.6
Exporters of manufactures	7.4	6.0	6.0	6.9	4.3
Highly indebted countries	6.9	5.4	0.6	5.4	3.5
Sub-Saharan Africa[a]	6.4	3.2	−0.4	4.0	3.2
Merchandise export volumes	4.9	4.7	4.4	7.3	3.6
Manufactures	11.6	13.8	8.4	10.3	5.1
Primary goods	3.7	1.2	1.3	3.6	2.2
Merchandise import volumes	5.7	6.1	0.8	7.8	4.1
Industrial countries					
Real GDP	4.7	2.8	2.3	4.3	2.5
Inflation rate[b]	6.1	10.1	1.7	2.7	3.3
Real interest rate[c,d]	2.3	1.3	5.9	2.5	4.6
Nominal interest rate[d]	6.8	9.3	11.1	6.5	9.4

Note: All growth rates for developing countries are based on a sample of ninety countries.
a. Excluding South Africa.
b. Industrial countries' weighted GDP deflator expressed in dollars.
c. Average six-month dollar-Eurocurrency rate deflated by the GDP deflator for the United States.
d. Average annual rate.

Table 2.6 Growth of GDP per capita, 1965–95
(average annual percentage change)

Country group	1965–73	1973–80	1980–86	1986–95 High	1986–95 Low
Developing countries	3.9	3.2	1.5	3.9	2.0
Low-income countries	2.9	2.5	5.4	4.8	2.8
Middle-income countries	4.4	3.3	−0.3	3.2	1.4
Oil exporters	4.3	3.2	−1.8	1.9	1.1
Exporters of manufactures	4.8	4.1	4.3	5.3	2.7
Highly indebted countries	4.2	2.9	−1.8	3.1	1.2
Sub-Saharan Africa[a]	3.6	0.3	−3.4	0.7	0.0
Industrial countries	3.7	2.1	1.6	3.9	2.0

Note: All growth rates for developing countries are based on a sample of ninety countries.
a. Excluding South Africa.

Table 2.7 Change in the volume of trade in developing countries, 1965–95
(average annual percentage change)

	Exports of goods					Exports of manufactures				
				1986–95					1986–95	
Country group	1965–73	1973–80	1980–86	High	Low	1965–73	1973–80	1980–86	High	Low
Developing countries	4.9	4.7	4.4	7.3	3.6	11.6	13.8	8.4	10.3	5.1
Low-income countries	2.0	4.7	5.4	7.5	3.9	2.4	8.2	8.4	11.3	6.0
Middle-income countries	5.3	4.8	4.2	7.2	3.6	14.9	14.8	8.4	10.2	4.9
Oil exporters	4.1	−0.9	0.2	4.8	2.3	10.1	3.4	20.9	13.4	7.3
Exporters of manufactures	8.4	9.8	8.1	8.7	4.4	11.6	14.0	9.0	10.3	5.1
Highly indebted countries	3.1	1.1	1.3	6.4	3.7	13.4	10.2	5.9	10.9	5.5
Sub-Saharan Africa[a]	15.0	0.1	−1.9	3.9	2.0	7.5	5.6	4.0	9.6	4.4

Note: All growth rates for developing countries are based on a sample of ninety countries.
a. Excluding South Africa.

balances are reduced in a way that maintains growth in the industrial countries. To do this, each government will need to consider the scope for stimulating demand as the pattern of trade shifts. Second, it assumes that unemployment in the industrial countries is reduced substantially by 1995. The European countries are assumed to reduce unemployment by improving the flexibility of their labor markets and by making further efforts to bring the young and long-term unemployed back into the active labor force. Third, it assumes that governments halt the recent advance of protectionism in the industrial countries and thereby increase international trade flows and improve the efficiency of their economies. (Improved efficiency in the steel industry is a case in point; see Box 2.4.) Fourth, it assumes that the developing countries themselves adopt adjustment programs to restructure their economies and spur employment and income growth.

This combination of favorable macroeconomic and structural policies, labor force growth, and improved productivity owing to technological progress implies that industrial countries can grow at an average annual rate of just over 4 percent in the next decade—faster than in 1973-80 and 1980-86, but slower than in 1965-73. The smaller fiscal deficits implicit in this scenario would permit real interest rates to fall to an average of 2.5 percent during the period—close to their historic average and down from 4.1 percent in 1986.

In such circumstances, the developing countries would find it much easier to pursue their own reforms. (These are discussed further in Chapters 6 and 7.) In the High case their output would grow on average by roughly 6 percent a year in 1986-95, compared with 3.6 percent in 1980-86 and 6.5 percent in 1965-73. Exports would grow at an average rate of about 7 percent a year, compared with 4.4 percent during 1980-86. As a result, the debt service ratio of all developing countries taken together would fall from 22.3 percent in 1986 to roughly 13 percent by 1995 (Table 2.8). Their imports could grow by 7 to 8 percent a year. In sum, a more favorable economic environment resulting from successful adjustment by the industrial countries would facilitate policy reforms in the developing countries and thus lead to faster growth in the world economy.

The Low case

The Low case, by contrast, assumes no major policy changes. The United States fails to cut its budget deficit by much, and European unemployment stays high. That would mean slow growth in the industrial countries, a rising tide of protectionism, and no hope of further trade liberalization. The Low case shows the developing countries growing at an average of close to 4 percent a year. Although a little higher than during the early 1980s, that is more than a percentage point lower than they achieved in 1973-80. And their growth could be considerably lower than this if they undertake no reforms at all, and if the international environment deteriorates.

The long-term adjustment issues

The first of the assumptions underlying the High case is that short-term macroeconomic policies are brought back into balance. This was dealt with in the previous section of this chapter. The rest of the chapter considers the other three assumptions, which are all matters of longer-term economic policy.

Exports of primary goods					*Imports of goods*					
			1986-95					*1986-95*		
1965-73	*1973-80*	*1980-86*	*High*	*Low*	*1965-73*	*1973-80*	*1980-86*	*High*	*Low*	*Country group*
3.7	1.2	1.3	3.6	2.2	5.7	6.1	0.8	7.8	4.1	Developing countries
1.7	2.8	3.1	2.6	1.6	0.9	5.7	7.9	5.7	2.3	Low-income countries
3.9	1.1	1.1	3.7	2.3	6.7	6.1	−0.5	8.2	4.6	Middle-income countries
4.0	−1.0	−1.1	3.3	1.6	4.5	10.3	−6.3	5.8	3.2	Oil exporters
5.5	3.4	6.0	3.6	2.5	9.9	5.9	5.7	8.8	4.6	Exporters of manufactures
2.4	−0.4	0.0	4.4	3.0	6.7	5.5	−6.9	7.5	4.4	Highly indebted countries
15.3	−0.1	−2.2	3.3	1.8	3.8	7.6	−7.9	4.9	2.9	Sub-Saharan Africa[a]

Table 2.8 Current account balance and its financing in developing countries, 1986 and 1995
(billions of dollars)

Item	All developing countries			Low-income countries			Middle-income countries		
		1995			1995			1995	
	1986	High	Low	1986	High	Low	1986	High	Low
Net exports of goods and nonfactor services	3.3	−61	−35	−23.9	−32	−26	27.3	−29	−9
Interest on long-term debt	55.7	60	69	4.1	11	10	51.5	48	59
Official	15.3	25	27	2.7	6	6	12.6	19	21
Private	40.4	35	42	1.4	5	4	38.9	29	38
Current account balance[b]	−35.5	−74	−68	−22.0	−30	−25	−13.5	−44	−43
Net official transfers	15.2	27	25	4.6	10	9	10.6	17	16
Long-term loans, net	25.6	50	34	13.0	28	19	12.6	21	15
Official	12.3	39	34	5.9	15	14	6.4	24	20
Private	13.3	11	0	7.0	13	5	6.2	−3	−5
Debt outstanding and disbursed	753.4	997	958	108.6	273	241	644.7	723	717
As a percentage of GNP	34.4	24	24	17.9	23	21	42.4	24	25
As a percentage of exports	144.5	76	96	159.7	154	180	142.2	64	83
Debt service as a percentage of exports	22.3	13	18	16.2	15	19	23.2	13	18

Note: The table is based on a sample of ninety developing countries. Data for 1986 are estimated. Details may not add to totals because of rounding. Net exports plus interest do not equal the current account balance because of the omission of private transfers and investment income. The current account balance not financed by official transfers and loans is covered by foreign direct investment, other capital (including short-

Structural barriers to growth in industrial countries

Europe's unemployment is at least partly due to the lack of flexibility in its labor markets. This lack of flexibility manifests itself in several ways. One of the most important is that real wage growth has sometimes exceeded productivity growth. This means that employers are unwilling to hire additional workers because the cost would exceed the value of the increase in output. The gap between wages and productivity can arise, in turn, because of wage-setting practices whereby the wage level of the most prosperous regions or sectors applies countrywide. Geographical or occupational immobility prevents workers from closing the gap. High costs of firing and high nonwage costs also keep the real wage (as perceived by employers) high.

Another element of the explanation for persistent unemployment in Europe focuses on the effects of long spells out of work. Employers may regard those who have been unemployed for long periods as unemployable. The unemployed themselves may come to agree. As a result they stop competing for jobs. Because they then cease to apply any downward pressure on real wages, unemployment persists.

More flexible work arrangements are in the interest of employers and employees alike (see Box 2.5). Rules and regulations differ greatly from country to country. Each government needs to review its regulatory instruments and weigh the tradeoff between the protection of existing workers and the risk of stifling new employment. Too many rules protect the employed at the expense of the unemployed.

Education and training are keys to a more flexible work force. Because of their effect on occupational mobility, deficiencies here may be greater obstacles to curing unemployment than rigidities in the labor markets. To meet the challenge of a changing world, education should be a continuing process that starts with broad training and is followed by retraining and updating of skills as necessary.

Another big obstacle to economic efficiency in most industrial countries is agricultural policy. *World Development Report 1986* discussed the issues in detail. It concluded that the policies reduce national income; farmers use inputs inefficiently because artificially high food prices mislead producers into using too many resources. These policies also induce consumers to purchase less food than they would otherwise. The economic losses are substantial. On top of this is the indirect cost of the distortions which high agricultural prices cause in the long term—such as the diversion of fixed investment and research from industry to agriculture.

Oil exporters			Exporters of manufactures			Highly indebted countries[a]			Sub-Saharan Africa[a]		
	1995			1995			1995			1995	
1986	High	Low	1986	High	Low	1986	High	Low	1986	High	Low
−2.5	16	19	13.4	−54	−38	18.8	24	31	−3.0	−6	−4
16.7	12	17	17.8	29	30	31.9	27	37	3.9	4	4
3.3	5	6	4.7	8	9	5.6	8	9	1.9	3	3
13.4	7	11	13.1	21	21	26.3	19	28	2.0	1	1
−19.0	8	5	6.0	−59	−47	−12.0	7	3	−8.9	−10	−9
1.5	2	2	4.7	7	7	0.8	2	2	3.4	7	7
7.8	−10	−6	4.5	53	32	6.8	−7	−5	5.7	2	2
2.8	6	5	2.4	14	11	2.4	9	7	2.5	5	5
5.0	−16	−11	2.1	39	21	4.4	−16	−12	3.3	−3	−3
210.6	173	204	227.5	471	386	374.3	366	400	71.4	83	83
48.7	24	28	21.7	20	19	50.7	25	29	48.4	31	30
251.0	86	123	82.0	64	72	267.8	108	146	221.3	126	145
41.7	20	28	12.7	10	13	37.6	26	37	30.4	17	21

term credit and errors and omissions), and changes in reserves. Ratios are calculated using current price data.
a. Excluding South Africa.
b. Excludes official transfers.

Trade reform

Trade reform means policies that reduce protection. An open trading system is a powerful force for sustained growth and industrial expansion. With trade, enterprises are not bound by narrow domestic markets, but can expand to sell their goods and services in the international market. The economic efficiency gains from trade liberalization in industrial countries are essential if output is to grow as in the High case.

Chapter 8 of this Report describes the increase in protectionism since 1974. International trade has become progressively more discriminatory and managed. The principal tool of this recent protection has been the nontariff barrier, which breaks the link between domestic and foreign prices in several major sectors. Fortunately, protection has increased much less than demands for protection. Many trade barriers have proved surmountable and therefore less costly to exporters in developing countries than they might have been. But existing levels of protection still cause higher prices for consumers, inefficient resource allocation, and a structure of industry and trade which changes in comparative advantage are gradually rendering obsolete.

Improved access for the manufactured exports of developing countries to the markets of industrial countries is a crucial element of the High case. Similarly, the prospects for increased exports by industrial countries depend on expanding markets in the developing countries. In the High case, imports by developing countries could reach $1.3 trillion by 1995. The Low case shows a much slower rise, to less than $1.0 trillion by 1995.

Greater flexibility in the international trading system is desirable on other grounds as well. The increasing internationalization of production, described in Chapter 3, gives rise to patterns of trade and investment that do not always fit traditional notions. Cheaper and better international communications and transportation have transformed the economics of intrafirm trade in intermediate goods. Increasingly, international trade is in processes or components, not in finished products. In addition, the automation of manufacturing has reduced the proportion of low-skilled workers. These developments have widened the scope for specialization among countries and heightened the need for an international trading environment that grants access and flexibility.

Adjustment in developing countries

Three sorts of policies are needed to achieve faster growth. First, outward-oriented trade policies. Second, policies to foster macroeconomic stability.

Box 2.4 Restructuring of the steel industry—a continuing story

In the 1960s, world steel production increased almost without interruption. Expecting continued increases in steel demand, the steel industry planned projects to expand capacity through the late 1960s and the early 1970s. But by the time these projects came on stream in the late 1970s, the growth of world steel demand had ceased almost completely; in fact it had declined substantially in some years. In the latter half of the late 1970s, steel companies canceled or postponed indefinitely many of their investment plans and closed some of the existing capacity. What little expansion has been initiated since the 1970s has taken place mostly in developing countries and has been primarily in the category of scrap- or direct-reduction-based small-scale mills. Although the net increase in steel-making capacity has been minimal, the problem of excess capacity has persisted because of the lack of growth in demand.

Faced with a problem of growing excess capacity, most of the industrial countries took measures to rationalize their steel industries, starting with the closure of inefficient mills. The European Community (EC) has reduced its annual steel production capacity by about 20 million tons since 1977, and a further reduction of 10–15 million tons is planned for the next five years. Around 15 million tons of capacity, or close to 10 percent of capacity, have been eliminated in the United States during the past three to four years, and a further 10 percent reduction can be expected during the next five years. Apart from the closing of obsolete plants, recent activity in the Japanese steel industry has been in investment directed at increasing continuous casting, implementing energy-saving measures, as well as refurbishing existing older facilities.

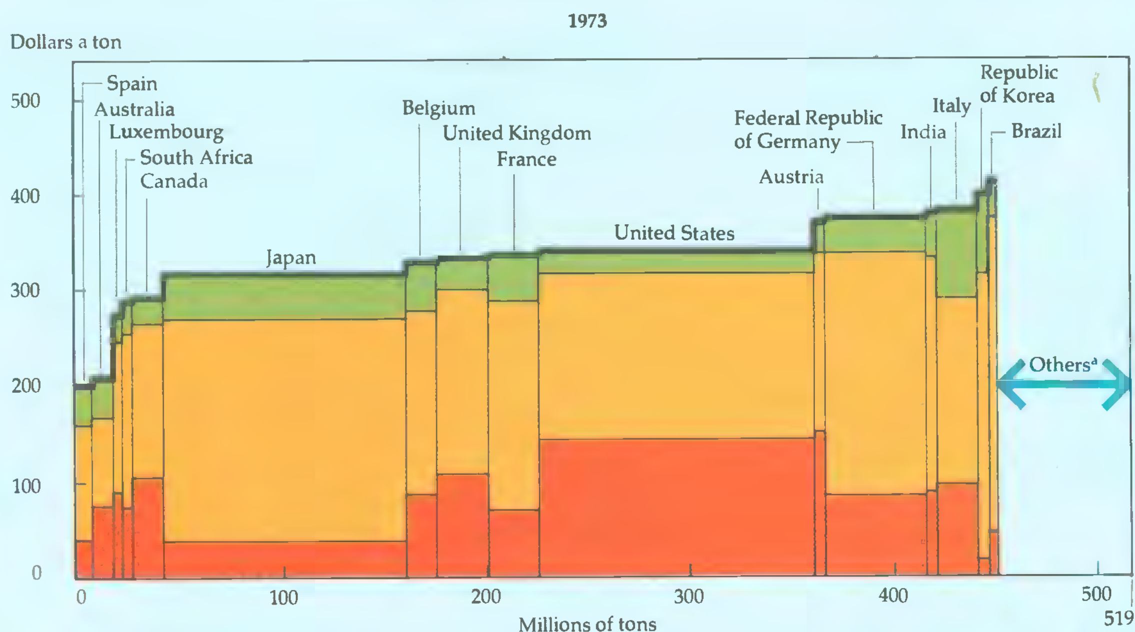
Labor productivity also improved over the past five years. The European industrial countries, Japan, and the United States employed a total of 1.8 million workers in their iron and steel industries in 1974; in 1984 the total had fallen by 44 percent to close to 1 million.

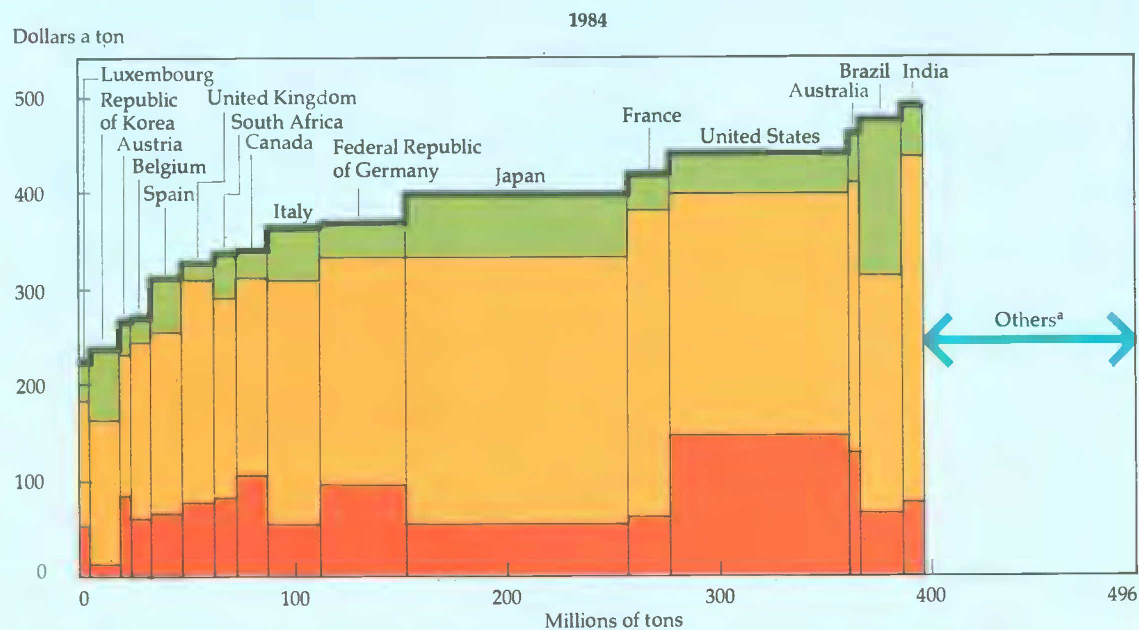
Box figure 2.4 illustrates the change in the steel industry since 1973. It shows the volume of steel production (plotted cumulatively on the horizontal axis) and the average operating costs per ton (on the vertical axis) of the sixteen leading producers. These two variables allow comparison of a country's competitive position and market share in 1973 and in 1984. Cross-country comparison should be exercised with caution. First, the steel products of the countries in question are not necessarily homogeneous. Second, the data for the operating costs are estimated on the basis of cost information from an average of 65 percent of each country's steel producers. For Brazil, India, and Spain, data are available for between 13 and 30 percent of the firms. These caveats notwithstanding, the bold line in the graph is an approximate long-term cost curve for the world steel industry.

The box figure shows among other things that Brazil and the Republic of Korea, both small, high-cost producers in 1973, have increased their market share and improved their competitive position substantially. Also, steel production in the United States declined from 1973 to 1984, but operating costs there increased more than in the rest of the world, and the country's competitive position was further eroded.

The adjustment of the steel industry has met many barriers in both industrial and developing countries. Preventing a further downward adjustment in capacity and a continued shift in the international division of steel production is costly to individual countries and to the world economy. Calls for protection and overall resistance to adjustment have been the dominant features of this industry despite the progress reported above. If governments prevent markets from determining the future international structure of the steel industry, costs will rise across the board. Governments should thus strive to reduce tariff and nontariff protection of their domestic steel industry. Steel remains an important generic input to much industry and construction. Few countries can afford to subsidize local, inefficient industry simply to prolong an eventually inevitable shift in the structure of production. Being able to compete in the international market for steel remains the best test of the viability of a country's steel industry. In the past ten years the European Community and the United States adopted measures to protect their domestic products from lower-priced imports, while they restructured domestic production. These measures are already costly to domestic consumers and represent a substantial barrier to the exports from developing countries with competitive steel industries.

Box figure 2.4 Costs in the world steel industry, 1973 and 1984





Labor cost
Material cost
Interest and depreciation cost

Note: The horizontal axis shows the total output of the world steel industry, with producers ranked in ascending order of unit costs. The bold line therefore represents the long-run cost curve for the world steel industry.

a. Other countries' steel production for which no cost data are available.

Source: Paine Webber and World Bank data.

Box 2.5 Labor market flexibility and employment: the view of European employees and employers

A recent survey of the employees and employers in the European Community concluded that the interests of firms and employees in achieving greater flexibility in the labor market are not necessarily in conflict. The survey asked employees and employers in industry and retail and wholesale distribution about their opinion of measures to increase the flexibility of labor relations. In particular they were asked about measures pertaining to work hours, dismissal and redundancy procedures, flexibility of working time, wage differentials, and temporary and part-time work.

The survey found that most European workers are much more innovative and performance-minded than is commonly supposed. More than half of the employees surveyed said that they would accept a more flexible organization of working hours, that they are interested in payment by performance, that they are willing to accept voluntary temporary wage cuts during hard times, and that, if given the choice, they would prefer an increase in wages to a general reduction in working hours.

When asked what institutional changes in the labor market would be most likely to persuade them to employ more labor over the next twelve months, the industrial employers answered: shorter periods of notice and simpler legal procedures for redundancies and dismissal, more fixed-term contracts, better-trained job seekers, wider wage differentials, greater emphasis on productivity in determining wages and salaries, lower starting salaries, and more flexible working hours. For employers in retail and wholesale distribution, the answers were: lower starting pay, shorter periods of notice and simpler legal procedures for redundancies and dismissal, wider wage differentials, and more flexible working hours. The employers said that if the most important institutional changes happened they would raise employment over the next twelve months by 2.7 percent in industry, 3.2 percent in retailing, and 2.5 percent in wholesale distribution. The total employment gain would be about 2.3 million jobs, equivalent to nearly 10 percent of the number of unemployed in the nine countries covered by the survey. The calculation of this potential employment increase does not take into account indirect effects attributable to increased disposable income or long-term increases in potential output.

Third, policies to improve the allocation of resources. (The role of the World Bank in the support of adjustment is discussed in Box 2.6.)

TRADE POLICIES. Since a basic goal of adjustment is to increase international competitiveness, trade policies are an important element in medium-term adjustment. By maintaining realistic exchange rates and replacing quantitative restrictions with tariffs, governments can reduce the bias against exports which faces producers in many developing countries. Removing protection altogether is a desirable long-term goal. Carefully designed trade reforms allow countries to move toward an outward-oriented trade strategy which will not only improve their trade performance but also help them achieve higher rates of economic growth.

MACROECONOMIC POLICIES. Lower fiscal deficits, achieved primarily through the reduction and redirection of public expenditures, are essential to increase savings and improve resource allocation. Fiscal deficits accommodated by monetary expansions have provoked inflation, discouraged savings, and distorted investments. In many cases fiscal deficits have been allowed to explode in order to finance poorly functioning public enterprises. Often there is scope for higher revenues through improved management of such enterprises or the substitution of tariffs for quantitative trade restrictions. Macroeconomic stability, achieved through lower budget deficits, will also make it easier to reform the financial system. Market-determined interest rates, along with a stable exchange rate, will stem capital outflows and thus increase the supply of finance for domestic investment.

COMPLEMENTARY POLICIES TO IMPROVE RESOURCE ALLOCATION. Fewer price controls would allow prices to reflect the true costs of resources and would encourage the expansion of activities in line with changing incentives. Fewer investment regulations would help to reduce barriers to entry, encourage foreign direct investment, and ease technological progress. Fewer labor market regulations, such as high minimum wages, would promote labor market flexibility and higher employment.

Even if the policy changes needed for the High

case materialize, some groups of developing countries are likely to fare much better than others. Overall, Sub-Saharan Africa has relatively poor prospects compared with other developing countries. Even in the High case, its output growth would be about 4 percent a year, and its per capita income in 1995 would still be below the 1980-86 average. The region's export volumes, dominated by primary commodities, would grow at roughly 4 percent a year up to 1995 because of faster economic growth in the industrial countries.

Exporters of manufactures have the best prospects. Their output growth in the High case is slightly below 7 percent a year up to 1995. Growth in exports of manufactures would reach around 10 percent a year, thanks to the more open trading environment and to strong growth in the industrial countries. Per capita incomes would therefore be able to grow by more than 5 percent a year in the group of exporters of manufactures.

Oil exporters face a relatively hard time in the next decade—although they are likely to fare better than they did in the first half of the 1980s, when their output growth fell to 0.8 percent a year. Their pressing need, of course, is to reduce their dependence on fuel exports. In the High case, their manufactured exports increase by about 13 percent a year during 1986-95, and this makes up for part of their decreased earnings from fuel exports.

The scarcity of external finance for the highly indebted countries makes adjustment toward an outward-oriented trade strategy and export growth particularly urgent—and difficult—for them. Their principal source of growth in the High

Table 2.9 External financing, by type of flow, 1973-95
(billions of dollars)

	Level					*Period average (mean value)*			
				1995				*1986-95*	
Country group and type of flow	*1973*	*1980*	*1986*	*High*	*Low*	*1973-80*	*1980-86*	*High*	*Low*
All developing countries									
Deficit on goods, services, and private transfers	9.0	69.1	35.5	74	68	42.6	58.9	44	48
Official development assistance, net	8.7	22.8	21.7	45	42	15.7	21.4	35	36
Grants	4.7	11.5	14.1	27	25	8.0	12.7	21	21
Concessional loans	4.0	11.3	7.6	18	17	7.7	8.7	14	15
Direct private investment	4.9	10.0	12.4	22	20	7.2	11.4	17	17
Nonconcessional loans, net	11.6	47.0	18.1	32	17	34.0	39.7	12	8
Official	2.0	9.0	4.8	21	17	5.8	10.2	13	12
Private	9.6	38.0	13.3	11	0	28.2	29.5	−1	−4
Other capital	−5.0	1.6	−0.7	3	−1	−3.7	−11.3	4	2
Sub-Saharan Africa									
Deficit on goods, services, and private transfers	1.7	4.9	8.9	10	9	5.0	10.2	7	7
Official development assistance, net	1.5	5.1	5.2	11	11	3.3	4.9	9	9
Grants	1.0	2.6	3.1	7	7	1.8	2.7	6	6
Concessional loans	0.5	2.5	2.1	4	4	1.5	2.2	3	3
Direct private investment	0.1	0.0	0.0	2	2	0.7	1.0	2	2
Nonconcessional loans, net	0.9	5.2	3.7	−2	−2	3.0	3.5	−2	−2
Official	0.2	1.2	0.4	1	1	0.7	1.0	1	1
Private	0.7	4.0	3.3	−3	−3	2.3	2.5	−3	−3
Other capital	−0.9	−1.2	−2.2	0	0	−1.0	−0.7	0	0
Highly indebted countries									
Deficit on goods, services, and private transfers	2.4	27.9	12.0	−7	−3	18.2	21.8	1	5
Official development assistance, net	0.9	1.6	0.6	3	3	1.2	1.4	2	2
Grants	0.4	0.5	0.7	2	2	0.4	0.8	1	1
Concessional loans	0.5	1.1	−0.1	1	1	0.8	0.6	1	1
Direct private investment	2.7	4.6	3.2	7	7	3.4	4.6	6	6
Nonconcessional loans, net	6.3	27.5	6.9	−9	−6	20.0	20.1	−2	1
Official	1.0	3.6	2.5	7	6	2.2	4.2	5	4
Private	5.3	23.9	4.4	−16	−12	17.8	15.9	−7	−3
Other capital	−1.3	0.5	−7.0	−2	−3	−0.2	−10.9	0	−1

Note: The table is based on a sample of ninety developing countries. Totals for Sub-Saharan Africa exclude South Africa. The deficit on goods, services, and private transfers not financed by ODA, direct investment, long-term loans, and other capital is covered by foreign exchange reserves. Period averages exclude the base year of the corresponding period.

Box 2.6 The role of the World Bank in support of structural adjustment

The World Bank has often stressed the need to identify investment priorities and to undertake only projects with a high rate of return. But the Bank also stresses the importance of the macroeconomic environment. It is increasingly being recognized that it is virtually impossible to have a good project in a bad policy environment. To improve the policy environment the World Bank has supported efforts to adopt appropriate policies in a variety of areas. The Bank emphasizes:

- Mobilizing domestic savings through fiscal and financial sector policies.
- Improving public sector efficiency by rationalizing public investments and improving the efficiency of public enterprises.
- Improving the efficiency of private sector investments by reforming trade and domestic policies.
- Reforming institutional arrangements to support adjustment with growth.

The World Bank's increasing emphasis on macroeconomic policies has been reflected in changes in its lending program. Although project and sector investment activities have continued to absorb the largest portion of World Bank loans and credits, new instruments have been introduced—such as the structural adjustment and the sector adjustment loans and credits—which focus directly on support of developing countries' programs and policies of structural reform. Structural adjustment loans focus on macroeconomic policies and institutional change at the country level—although they frequently emphasize reforms of importance to particular sectors in which adjustment is most urgently needed. The purpose of sector adjustment loans is to promote the introduction and effective implementation of sectoral policies necessary for sustained economic growth.

Most aspects of macroeconomic and sector policy in medium-term adjustment are addressed in Bank nonproject lending. The exception is monetary and exchange rate policy; here the Bank defers to the International Monetary Fund and works along with it to support individual programs that place emphasis on different policy issues which reflect country priorities and objectives.

The main goals of the Bank's sector and structural adjustment loans are to facilitate the adjustment required to achieve sustainable growth and to help mobilize the external financing that can support the country's adjustment efforts. Although the final objective is to achieve sustainable growth compatible with available resources (including foreign financing), achieving this objective is a medium-term target. Thus, adjustment programs focus mostly on the policy framework needed to promote sustainable growth in the medium term. This has also meant that reforms need to be supported with a series of Bank lending operations over a period of several years. In all cases, reform programs have required a firm commitment on the part of governments to sustain the course of the reform effort over time. But reform programs need to be flexible, and the Bank has supported modifications in policy packages in the light of domestic and international developments. Where policy reforms toward desirable structural change give rise to transitional costs that affect the poor, the Bank has worked with governments to develop programs that address this problem.

The size of the World Bank's lending program depends primarily on the adoption and implementation of appropriate adjustment programs. In recent years more countries have embarked on serious policy reform, and lending for adjustment with growth will increase. Discussions among shareholder governments on arrangements to increase the Bank's lending capacity through a general capital increase are continuing. During the past year, negotiations were successfully concluded on the Eighth Replenishment of the International Development Association (IDA8). Donor governments have agreed to provide $12 billion in new resources which will be committed by IDA during fiscal 1988–90. This amount represents, in real terms, about the same level of resources as that available to IDA during the past three years from IDA7 and the temporary Special Facility for Sub-Saharan Africa. About half of the IDA8 funds will be used for operations in Sub-Saharan Africa, and more than a fourth of the total will probably be used to support adjustment programs in African and other IDA recipient countries, partly in conjunction with the IMF's Structural Adjustment Facility.

case is exports; long-term lending would be about the same in both the High and the Low case. The lower real interest rates of the High case would also help to reduce the debt service burden. All in all, the highly indebted countries as a group could achieve output growth of about 5 percent. In other words, there will be no quick recovery of the output lost during the first half of the 1980s.

The seventeen highly indebted middle-income countries are in deep trouble if the Low case comes to pass. Higher real interest rates, increased protection, and stagnating exports would make it impossible for them to reduce the debt overhang. Debt service would barely change from its current level of 37.6 percent of exports by 1995. Several of these countries have made remarkable adjustment

efforts which have improved their chances of resuming growth. But for this to continue, and for orderly servicing of debt to be maintained, the momentum of reform must not slacken. The industrial countries have a vital part to play—and not just as providers of external finance. The High case depends on their participation. Without many of the elements of that scenario, the highly indebted countries may find it politically intolerable to maintain the servicing of their external debt. Significant interruptions in servicing could damage the financial system and make it harder for the debtor countries to return to normal levels of borrowing from the private capital market.

Conclusion

Nineteen eighty-six was the second successive year of sluggish growth in the world economy. There was little progress in reducing international payments imbalances, and the debt problems of the developing countries persisted. Another year of limited progress has made decisive policy action in the near future all the more important. The low-growth path presented in this chapter illustrates the state of the world economy that would materialize if little or no action is taken. It is a picture of stagnation, if not decline. Domestic policies to achieve economic efficiency and flexibility in the medium and long term, combined with progress during the Uruguay Round in liberalizing international trade, could yield a high return in output and employment growth.

There is no viable alternative to adjustment. The longer governments wait to implement the required policy changes, the harder the task will be. Countries will certainly gain from their own policy reforms, but concerted action would ease and accelerate the process. This does not mean that any country can or should rely on the adjustment of others to improve its own prospects. It is essential that each country improve the conditions for its own interaction with the rest of the world in order to benefit from improved global economic conditions.