1 Adjustment and growth in the 1980s and 1990s

Economic performance in the 1980s has varied widely among countries and continents. After a sharp recession at the beginning of the decade, the industrial countries are well into their seventh year of uninterrupted growth, although at rates lower than those of the 1950s and 1960s. In parts of Asia, where much of the world's poverty is concentrated, economic growth in the 1980s has been faster than in earlier decades. But in Africa and Latin America hundreds of millions of people have seen economic decline and regression rather than growth and development (see Figure 1.1). In some countries in Latin America real per capita GNP is less than it was a decade ago (see Figure 1.2); in some African countries it is less than it was twenty years ago.

Why have some countries fared so much better than others during the 1980s? Economies differ greatly in their structures, in their domestic development strategies and policies, and in the extent to which they have been affected by external shocks. Higher real interest rates, reduced international capital flows, and lower commodity prices have made adjustment both necessary and difficult, particularly for the highly indebted countries. But some governments have been more successful than others in pursuing short-term adjustment and longer-term structural reform. In addition, markets and agents have varied in the speed with which they responded to new policies and to changed incentives.

The prospects for growth in the developing countries in the coming decade depend primarily on their own actions, but also on the environment created by the actions of the industrial countries. The industrial countries can promote growth in the developing economies in three ways: by adopting fiscal and monetary policies to maintain their own growth while reducing real interest rates, by ensuring the success of the Uruguay Round of trade negotiations and thereby keeping the international trading system open and the volume of trade expanding, and by ensuring that the international community provides the external resources that the developing countries need for growth and adjustment.

The international economic environment

The world economy in the 1980s was dominated first by sharp recession, then by steady and prolonged growth in the industrial countries, high real interest rates, declining real commodity prices, massive movements in exchange rates, and the collapse of voluntary private lending to many developing countries. The recovery of the industrial countries from the recession of 1982 has been strong and so far without interruption—the second longest recovery since World War II. But the mix of fiscal and monetary policies and the resulting pattern of trade and growth have changed over the past eight years.

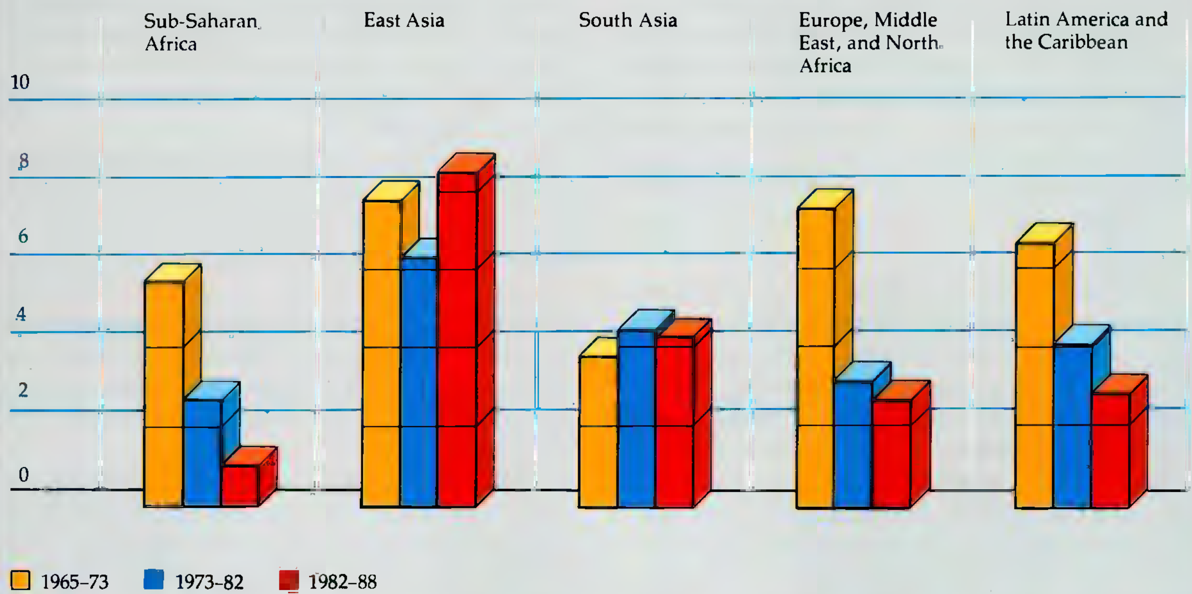


Figure 1.1 Growth of real GNP in developing countries by region, 1965 to 1988
(average annual percentage change)

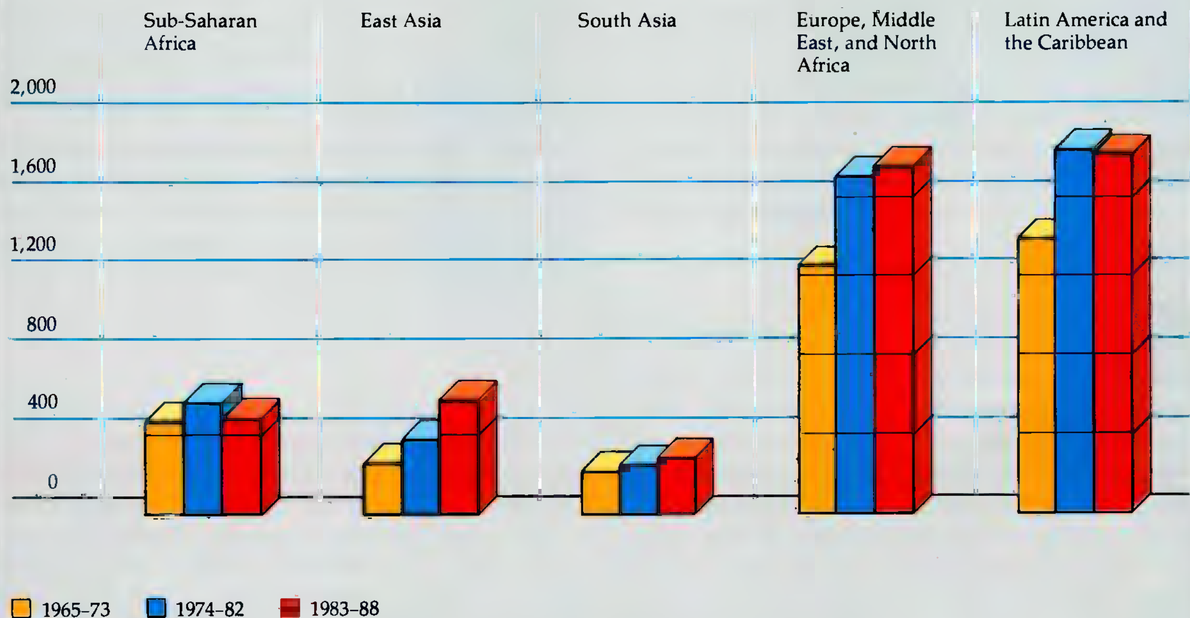


Figure 1.2 Real GNP per capita in developing countries by region, 1965 to 1988
(period average in 1980 dollars)

Note: GNP is measured at 1980 prices and exchange rates.

The early years of the recovery were led by brisk growth in the United States, where tax cuts and increased spending on defense provided the impetus. The expansionary U.S. fiscal policy, combined with anti-inflationary monetary policy worldwide, led to high real interest rates (especially in the United States), an appreciating dollar, and a boom in imports and consumer spending in the United States. As a result, the U.S. current account deficit deteriorated by $100 billion between 1982 and 1984. This, in turn, led to expectations of a decline in the dollar, which were fulfilled between 1985 and 1987.

In the Federal Republic of Germany and Japan, expansionary policies in 1987 and 1988 were consistent with low inflation because of the decline in oil prices and the appreciations of the yen and the deutsche mark. The transition to domestic-led growth was particularly successful in Japan, where the growth of consumption, imports, and especially investment (a rise of 11 percent in 1988) supported continued growth in the world economy.

The worldwide stock market crash of October 1987 clouded the outlook for economic growth at the beginning of 1988. But vigorous and concerted responses to the crash by monetary authorities in the leading financial centers, some fiscal adjustment in the United States, and cheaper oil all combined to permit steady growth with low inflation in the industrial countries in 1988. Indeed, growth in the high-income countries of the Organisation for Economic Co-operation and Development (OECD) was markedly higher in 1988 than in 1987 (4.2 percent compared with 3.4 percent). Only at the end of the year—as fears grew that pressures on capacity would increase inflation and that the new U.S. administration would not attack the budget deficit—did exchange and interest rates show some of the volatility that had characterized the earlier stages of recovery.

Interest rates

Real interest rates in the 1980s have been higher than at any time since the Great Depression. They climbed during the early part of the decade, as monetary restraint brought down inflation while raising nominal interest rates. One explanation for the persistence of high interest rates is that nominal rates are affected by the fear that inflation will return. This may help to account for high long-term nominal interest rates, but it cannot explain the persistence of high short-term rates.

Another explanation for high interest rates is the decline in the world's saving rate, which appears to have fallen (the data are imprecise) by 2 percentage points in the 1980s, to 11 percent in 1987. Part of this decline is a result of the increase in the U.S. federal budget deficit, which in 1987 amounted to about 8 percent of world saving of just under $2 trillion. Lower saving by other governments and declining private saving rates in many countries also played a role.

World growth can now be maintained with a policy mix in which monetary policy loosens as fiscal policy tightens, with the extent of monetary expansion determined by concerns about future inflation. This combination, including a significant reduction in the U.S. budget deficit and other increases in world saving, would help to reduce real interest rates. That, in turn, would contribute to higher investment and thus to growth led from the supply side.

Lower interest rates would assist growth in developing countries by reducing the cost of financing new investments and easing the burden of the existing debt. The low interest rates of the 1950s and 1960s are unlikely to return, however; real interest rates on safe government bonds may be expected to remain well above the postwar average of 1 percent.

High interest rates have reduced the extent to which developing countries can rely on foreign borrowing to finance development. Higher real interest rates lower the ratio of debt stock to exports that a country can sustain and thereby make net transfers of resources to lenders necessary sooner. Ratios of debt stock to exports that may have been sustainable at the interest rates of the 1970s are not sustainable at the interest rates of the 1980s.

More than in the past, developing countries will have to rely on their own saving to finance investment. This underlines the need for greater efficiency in their financial systems—both to encourage saving and to allocate investment more effectively.

World trade

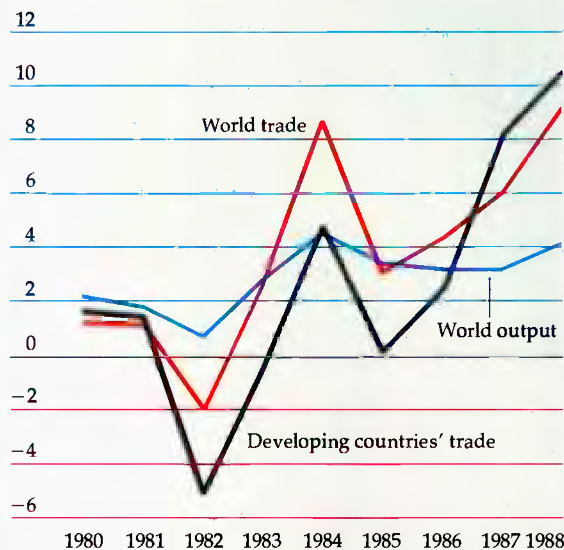
Growth in the developing world has been affected not only by the growth of imports by the industrial countries but also by the changing source and composition of import demand. Figure 1.3 shows the relationship between world economic growth and world trade. The recession of 1982 hurt world trade overall, but developing country trade fell proportionately more. In general, the volume of world trade fluctuates more than world growth,

and developing country trade is even more volatile. Resilient economies can absorb these shocks and rebound rapidly. For example, open economies that depend on manufactured exports, such as some of the newly industrialized economies of East Asia, were particularly hard hit by the slump in world trade in 1982. But these outward-oriented countries experienced faster export growth during the 1980s, and their economies have grown much more quickly than those of countries that pursued more inward-oriented policies.

Export growth not only contributes directly to economic growth but, more important, also permits more imports and a rapid modernization of production. The result is efficient domestic industry that meets the market test of international competition. High export growth among East Asian countries and low export growth in Latin America and Africa have significantly changed the regional distribution of developing country exports during the 1980s (see Figure 1.4).

The volume of world trade increased by more than 9 percent in 1988—the fastest growth in the 1980s. Trade patterns have been strongly affected by the expansion of domestic demand in Japan and the delayed effects of exchange rate movements. Import volume in Japan was up by 17 percent in 1988, compared with an 8 percent increase in the European countries; the yen moved significantly more against the dollar than did the European currencies. The middle-income countries of East Asia sharply increased their exports to Japan, and East Asian intraregional trade increased by 30 percent.

Figure 1.3 Growth of output and trade, 1980 to 1988
(annual percentage change)



Note: Trade growth is defined as the average of the growth rates for export and import volumes.
Source: IMF and World Bank data.

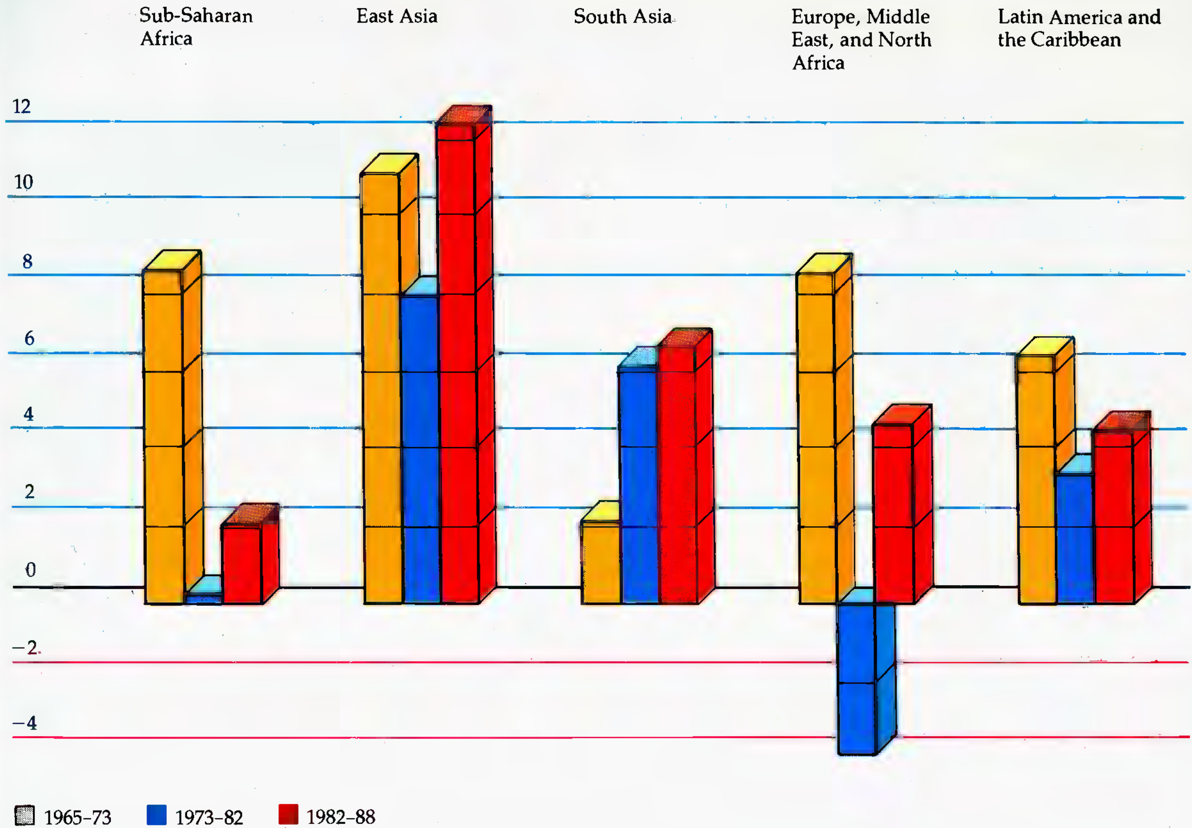
Oil and commodity prices

Massive swings in the price of oil and a prolonged decline in the real prices of other commodities have posed short- and long-term adjustment problems for producers and consumers alike in the 1980s. The real price of oil (deflated by the unit value of manufactures) more than doubled from 1978 to 1981, peaking at six times its 1973 level. It then drifted downward for several years, collapsing to its pre-1973 level late in 1988, when the market price dipped below $11, before quickly rebounding to $20 in the first part of 1989. The real prices of most other commodities continued to decline during the 1980s, except for minor price run-ups such as the revival of metal prices in 1988 (see Figure 1.5).

The large swings in the relative prices of commodities (especially oil) have made it harder for governments (especially in commodity-producing countries) to manage demand and exchange rates. Oil price increases and the surge in the value of oil exports put upward pressure on the producers' exchange rates and thereby harmed non-oil exports and encouraged imports. This difficulty—known as the Dutch disease—has been faced by high-income countries (such as the Netherlands and the United Kingdom) and low-income countries (such as Nigeria and Egypt) alike. When the commodity boom passed, trade deficits followed. Moreover, in some countries oil taxes supported public spending programs that have since been difficult to curb. As a result of the decline in the price of oil since 1982, gross domestic product (GDP) in the oil-exporting countries grew by only 1.6 percent annually between 1982 and 1988, compared with 5.0 percent between 1973 and 1982.

Countries that depend on commodity exports should save more—run larger current account surpluses or smaller deficits—while export revenues are temporarily high. It is difficult, however, to distinguish between temporary and permanent changes in commodity prices. Was the upturn in metal prices in 1988 part of a medium-term trend,

Figure 1.4 Growth of export volume in developing countries by region, 1965 to 1988
(average annual percentage change)



Note: Exports are measured at 1980 prices and weighted by U.S. dollar value.

or was it a temporary blip? Moreover, despite the uncertainties, it may be politically difficult for poor producers to take a conservative view of the likely course of commodity prices. Some exporters of oil and other commodities, such as Chile, Indonesia, Kuwait, and Morocco, have succeeded in spreading risk, both by diversifying production and through financial and fiscal management. But many others, to their detriment, have not.

Structural adjustment policies and challenges

The setback to development in Africa, Latin America, and Eastern Europe in the 1980s followed two decades of rapid growth. Yet this growth was often founded on development strategies that failed to emphasize economic efficiency and international competitiveness and that drew finance from abroad by distorting the domestic financial system. External shocks precipitated the crisis of the 1980s. But internal structure determined how countries would respond. Faced with changed circumstances, countries now have no choice but to adjust. During the 1980s governments of countries at all income levels and, remarkably, of all ideological stripes have come to recognize the need for reforms to increase economic efficiency and flexibility.

At the most abstract level, adjustment programs use changes in fiscal, monetary, and sectoral policies, in regulations, and in institutions to alter relative prices and the level of spending and thereby redirect economic activity. The real exchange rate and the real interest rate are key relative prices.

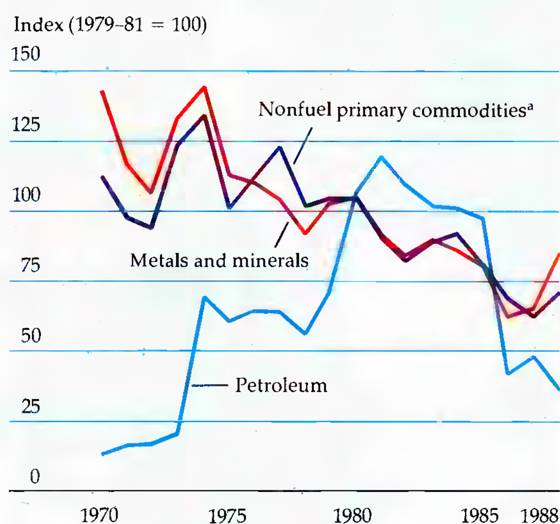
They affect both economic activity and saving, as well as exports and imports and the rate of investment. Changes in taxes, subsidies, and quantitative controls move resources between sectors. Ensuring that adjustment achieves a balanced change in spending and an appropriate sectoral reallocation is critical for growth and development. The domestic financial system plays an important role. It mobilizes domestic saving and directs it to the most profitable investments.

Structural adjustment is complicated and slow. It is especially difficult now—and all the more necessary—because many developing countries are in dire financial straits. Countries need external resources to offset the costs of adjustment. In the 1980s both the International Monetary Fund (IMF) and the World Bank have helped finance economic programs contributing to the adjustment process. Fifty-nine countries received long-term structural adjustment loans from the World Bank between 1980 and 1988. The programs consist of a series of operations, worked out with the borrower, that are conducted within a medium-term macroeconomic framework which is often supported by the IMF.

Many governments have made progress toward restructuring their economies, especially with regard to trade reform and exchange rate policy. But further reforms will be necessary. In some cases industrial policies in support of earlier import-substitution strategies have maintained a protectionist stance, despite trade reform. In other cases inefficient financial systems continue to distort interest rates. In many countries the failure of fiscal reforms is undermining the adjustment achieved so far and preventing further progress. Unsustainable fiscal deficits create economic uncertainty, contribute to high inflation, and subvert the domestic financial system.

In East Asia the newly industrialized economies and several others have pursued sound macroeconomic policies and maintained the competitiveness of their exports. They have generally adapted well to the shocks of the 1970s and early 1980s. The populous economies of South Asia have also achieved good results. Their success has more to do with macroeconomic stability, prudent fiscal and external borrowing policies, and rural modernization than with internationally competitive trade policies. But economies are not prisoners of their geography. Chile has pursued one of the most wide-ranging programs of economic liberalization, despite setbacks in the early 1980s, and seems to be shedding the problems that beset many of its neighbors.

Figure 1.5 Real commodity prices, 1970 to 1988



Note: Real prices are annual average prices in dollars, deflated by the annual change in the manufacturing unit value (MUV) index, a measure of the price of industrial country exports to developing countries.

a. Based on a basket of thirty-three commodities.

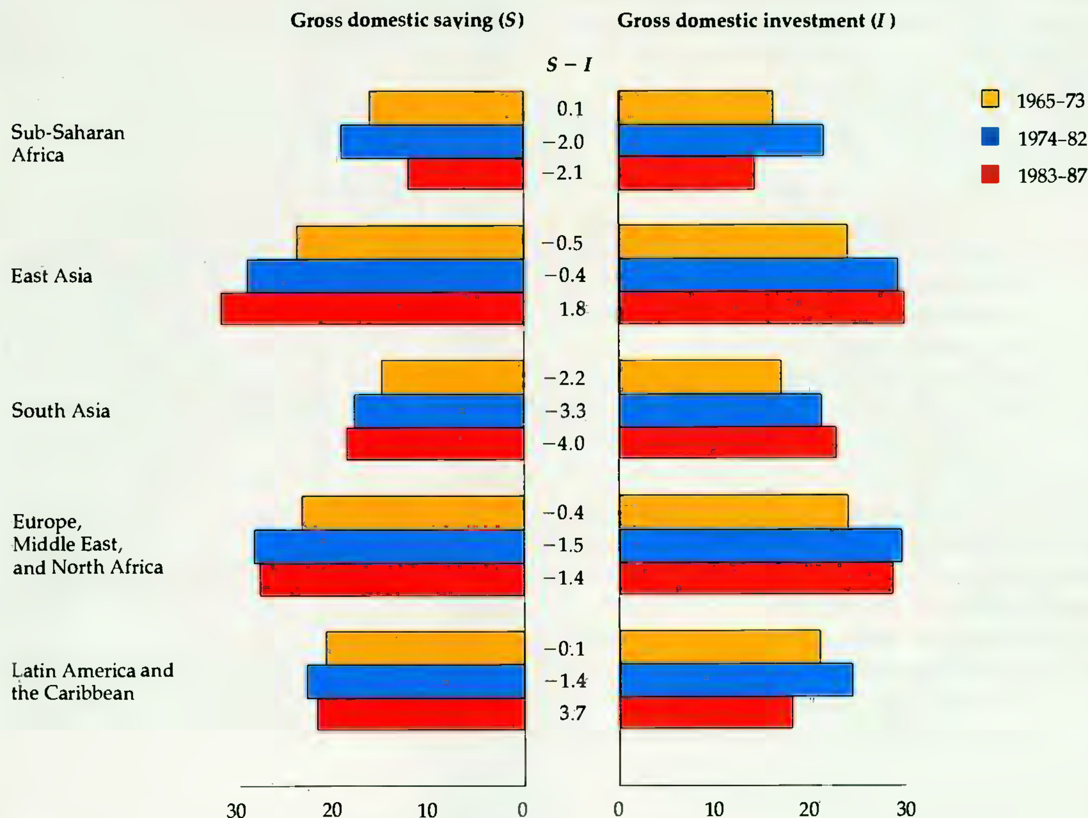
Challenges for successful adjusters

Successful adjusters, especially those in East Asia, not only increased domestic saving and maintained high investment during the 1980s (see Figure 1.6) but also achieved export-led growth. In the future their growth will need to depend less on external demand; domestic consumers should reap some of the fruits of successful investment in manufacturing. Domestic saving rates may therefore return to their somewhat lower levels of the 1970s.

Maintaining competitiveness requires support for the development of infrastructure and human capital. In most countries such programs are government funded. They call for long-term investment strategies. Sound fiscal policy is a prerequisite.

Moreover, as the successful adjusters become more integrated with the international capital markets, and as they compete with the next generation of exporters of manufactured goods, the efficient allocation of domestic saving will become even more important. A domestic financial system

Figure 1.6 Saving and investment rates in developing countries by region, 1965 to 1987
(percentage of GNP)



Note: Saving and investment are measured at current prices.

based on market principles will contribute to this end.

Adjustment in Sub-Saharan Africa

The gravest development problems are in Sub-Saharan Africa. Unfavorable external conditions (including a prolonged fall in the terms of trade of primary goods exporters) and inadequate domestic policies have caused economic, social, and environmental decline.

After reasonable growth in the 1960s and early 1970s, the region's economic performance deteriorated. Export growth was robust before the 1973 oil shock but stalled thereafter; it has recovered somewhat but not to previous levels. Saving and investment rates fell sharply in the early 1980s (Figure 1.6) and are today less than two-thirds of the developing country average. The collapse in saving is partly attributable to fiscal deficits, which expanded during the 1980s. Private saving did not increase either—but it is extremely difficult to increase saving when income is falling. Most important, the combination of slow growth and rapidly expanding populations reduced per capita incomes and left many people close to starvation. Average caloric intake is no higher than twenty years ago.

Nevertheless, some adjustment—painfully slow and not always sustained—is occurring. Many governments have started to reduce their role in the economy and are focusing their spending on priority areas. This means curbing spending on the civil service, on subsidies, and on state-owned enterprises. Some African governments (for example, in Ghana) have cut spending by creating a roster of the civil servants to ensure that only bona fide workers—and no "ghost" or "phantom"

workers—are on the payroll. An alternative is to release workers with a lump-sum benefit. This increases the short-run cost of reducing the size of the government, and may encourage the better workers to leave, but in some countries it has provided an impetus for the development of private entrepreneurship. A sweeping removal of subsidies may not be possible, but targeting them to the truly needy further reduces costs; many subsidies benefit urban dwellers who are relatively well-off. Ghana's program has kept adjustment on track while helping the poor. Subsidies to unprofitable state-owned enterprises are a big drain on budgets. Several African countries have experimented with privatization (Niger and Togo), liquidation (Benin, Ghana, and Mali), or rehabilitation under management contracts (Senegal). Not all of these efforts have been successful.

It is essential to correct overvalued exchange rates. This promotes a more sustainable pattern of consumption, encourages the export sector to diversify, and may yield faster export growth. Côte d'Ivoire and Mauritius show how quickly exporters can respond to improvement (and deterioration) in real export prices.

Adjustment also aims to reverse the bias against agriculture. Taxes in many poor countries (not only in Africa) discourage domestic food production and encourage food imports. Better incentives and agricultural modernization can raise the incomes of the rural poor, increase food security, and generate foreign exchange. Policies of this sort include price decontrol (Mali, Niger, Nigeria, Somalia, and Uganda) and the reform or abolition of agricultural marketing boards (Nigeria, Senegal, and Somalia). Higher farm output has also been achieved through broadly conceived extension services, which combine changes in farming methods with improvements in credit delivery, marketing, and the supply of inputs.

Regional integration has been a political aspiration since African independence. Cooperative arrangements have continued in Francophone Africa but have often broken down elsewhere. Small internal markets and low purchasing power are barriers to international competitiveness and the rationale for regional integration. As governments have moved to more market-oriented policies, at least one impediment to integration has been removed. But even if agreement on its political aspects could be reached, the benefits of integration will not be attained unless regional transport and communications systems are upgraded.

Even as economic performance improves, it will be offset by rapid population growth in much of Sub-Saharan Africa. In several countries (Kenya, Senegal, and Somalia), fairly strong economic growth in the 1980s has yielded low or negative growth in per capita GNP. Excessive population growth also exacerbates the problems of food security, education, urbanization, and environmental degradation.

Adjustment in the highly indebted countries

The shocks of the 1980s also hit the highly indebted middle-income countries, most of them in Latin America, extremely hard. High commodity prices and cheap external financing fueled public investment and social welfare programs during the 1970s. When the external environment deteriorated and commodity prices fell, many countries postponed adjustment and continued to rely on external borrowing. Sharply rising real interest rates and falling commodity prices raised the cost of external capital dramatically in the 1980s, which led to a halt in voluntary financing. Wrenching adjustments became necessary.

Per capita incomes in the middle-income debtors declined on average during the 1980s. Restrictive domestic policies and real devaluations reduced imports, which often led to trade and even current account surpluses. These policies, combined with the lack of external financing, meant that net investment in some countries, such as Argentina, fell to zero.

The task of adjustment encompasses trade reform, fiscal and public sector reform, and control of inflation and debt. Most of the countries have made substantial progress in at least one of these areas. But the macroeconomic situation remains unstable, and rates of investment are still low (Figure 1.6).

Primary budget deficits (that is, excluding debt service payments) have been reduced, but public sector borrowing requirements remain high. Consolidated, inflation-corrected deficits are still nearly double the average for the developing world as a share of GDP, and interest payments account for a big share of spending. Since domestic financial markets are in most cases too shallow to provide financing on the required scale, central banks have accommodated government spending by expanding the monetary base. Inflation is higher than elsewhere; several of the countries have seen triple- and even quadruple-digit inflation.

Heterodox anti-inflationary programs (based on wage and price controls and the fixing of the exchange rate) have been tried, sometimes repeat-

edly, in Argentina, Brazil, and Mexico. Most of these attempts have met with outright failure. Their chief defect has been a lack of fiscal improvement. Stabilization programs that leave the fundamentals inconsistent with low inflation are bound to fail. Where the fiscal deficit has been cut appropriately—as in Mexico—the programs have been more successful.

Some highly indebted countries (Costa Rica, Côte d'Ivoire, and the Philippines) have adopted fiscal programs with moderate success, although the programs have yet to be sustained. Often, several years of austerity have been followed by a burst of spending that reverses the earlier gains. Such instability retards saving, investment, exports, and growth. Nonetheless, some debtor countries have made good progress on fiscal reform. Chile, Colombia, Mexico, Morocco, and Uruguay have all reduced their budget deficits through tax reform, higher revenues, and lower spending.

Some countries, again including Chile, Mexico, and Morocco, have also pursued trade reform. For example, since 1985 Mexico has liberalized its trade regime and maintained its competitiveness. Costa Rica and the Philippines have focused on labor-intensive manufactured exports; in these countries the share of manufactured exports increased steadily between 1982 and 1987, and manufactures now account for about half of all exports.

Adjustment in the centrally planned economies

The centrally planned economies face a formidable challenge in moving toward decentralized decisionmaking and greater reliance on markets. The prices of many of their products have little to do with costs. The responsibilities of managers for production and investment are badly defined. Financial systems are rudimentary, and the tools of macroeconomic management are underdeveloped. Few mechanisms allow labor and capital to be reallocated as economic conditions change.

Governments in many of these economies have recognized the need for reform. The task is daunting, but the benefits could be immense. The experience of China during the past ten years demonstrates this. The reform of agriculture, the opening of the economy to foreign trade, technology, and investment, and the new reliance on incentives in the industrial sector have led to an average growth rate of more than 10 percent a year during the 1980s.

Although prices still play a relatively modest role in the Chinese economy, the exchange rate adjustments of the early 1980s were essential in making Chinese enterprises more competitive. China has become a major exporter of manufactures in a very short time. The Chinese government also avoided relying too much on external borrowing. It postponed ambitious industrial investment programs in the late 1970s and again in the early 1980s. More recently it has faced difficulties in macroeconomic policy. Domestic credit has been allowed to expand too quickly, which has led to inflationary pressures and shortages.

Economic reforms in Eastern Europe, although similar to those in China, have had less spectacular results, and some countries are in considerable difficulty. Several factors explain this. One is that low costs of production, at present exchange rates, have enabled China to compete successfully against middle-income exporters of manufactures. In contrast, costs in Eastern Europe are generally higher; competing against the newly industrialized economies of East Asia and the lower-income members of the European Community (EC) has therefore been difficult. Moreover, some of the countries tried to modernize their industries with heavy investment financed by foreign borrowing and without reforming economic management. This proved costly when real interest rates rose in the 1980s.

Development issues

The slow pace of adjustment in many countries is a major concern. But the task is neither simple nor purely economic. It requires institutional capacity and political skill. It is inhibited by vested interests, for it affects acquired rights, income, benefits, rents, and costs. Where economic structures have been in place for some time, the pain of adjustment can be enormous. If reform is to last, it must not be rushed. The burden will have to be fairly shared. And support from the international community must be forthcoming.

Poverty, population growth, and the environment

In many countries poverty cannot be separated from rapid population growth. As per capita incomes rise, population growth rates eventually decline. That process has been at work in such countries as the Republic of Korea and Thailand, as it was earlier in the high-income economies. But the demographic transition is still at an early stage in some low-income Asian countries, such as India

and Bangladesh. Africa's population is growing faster than has that of any other region of the world in this century. In some countries fertility rates are close to the biological limit. This strains the capacity of the economy to maintain the standard of living and reduces the ability of the government to provide social services, including education and health. Yet some societies remain unconvinced of the need to reduce population growth.

The links among poverty, environmental degradation, and population growth are often direct. As more and more people in poverty press upon limited natural resources in rural areas, they begin to deplete the stock of renewable resources. In South Asia the long-term deforestation of watersheds has caused severe erosion. Population pressure on the fragile land base in Africa and the Middle East has become serious. The arid and semiarid areas of the world are likely to face a crisis of water scarcity by 2000. Desertification and deforestation—often irreversible—have reduced the land available for agriculture, wildlife habitats, and recreation.

But not all environmental degradation results from the pressure of population growth. Intensive use of hydrocarbons by high-income countries and deforestation in sparsely populated tropical areas are starting to have global effects. The same is true of the growing amounts of hazardous materials that are generated mainly by industrial countries. Some developing countries are experiencing serious air and water pollution. Increasingly—although with differing degrees of urgency—developing country governments are attempting to curb the adverse externalities of growth.

Protectionism and trade

The acknowledged success of outward-oriented development is partly responsible for the move toward market-based policies. Moreover, the high-income countries recognize the role of trade in promoting growth and industrial development in the low- and middle-income countries—and thus have accorded them a variety of concessions and preferences. (These include the Generalized System of Preferences, the EC's Lomé Convention, and the U.S. Caribbean Basin Initiative.) Despite this, and despite the encouraging growth in world trade in recent years, the world's trading system has become markedly less liberal. Governments have reduced conventional tariff protection but have raised other barriers to trade instead.

Specific "safeguard actions" taken by industrial countries increasingly discriminate against the developing countries. Voluntary restraint agreements for steel, bilateral agreements for textiles, the tighter Multifibre Arrangement (MFA), and lower quotas on sugar and other agricultural products have their greatest effect on the exports of the developing countries. The share of developing country exports that face nontariff barriers (NTBs) is roughly 20 percent, about twice the share of industrial country exports. Much of the discussion of NTBs focuses on manufactured goods, but the proportion of agricultural exports from the developing countries facing NTBs is higher (26 percent, compared with 18 percent for manufactures).

Another disturbing departure from the principle of nondiscrimination embodied in the General Agreement on Tariffs and Trade (GATT) is the increase in bilateral trade agreements. Bilateral arrangements could—although they need not necessarily—discriminate against nonmembers (see Box 1.1). If they do, they might greatly harm the world trading system.

The rise of bilateralism and the increasing use of nontariff barriers underline the importance of the Uruguay Round of trade negotiations. These talks are tackling complicated issues such as trade in services, the protection of intellectual property rights, and the politically contentious matter of agricultural trade reform. Progress on agriculture would be particularly welcome for some of the highly indebted countries, such as Argentina and Brazil. Agreements on trade in financial services might prepare the way for greater integration of domestic financial systems and international capital markets, resulting in improvements in efficiency and resource allocation.

Many developing countries have significantly liberalized trade in the course of their broad structural adjustment programs. These steps have benefited the countries taking them. However, it is often believed that countries which liberalize unilaterally lose a bargaining chip that might have been used at the GATT negotiations to increase their access to export markets. In fact, credit is given in the GATT for the binding of (that is, acceptance of treaty limits on) tariffs. Such commitments can be negotiated and traded even after tariffs have been unilaterally reduced.

Developing countries can also improve their export prospects by following an appropriate exchange rate policy. Many developing countries have corrected their overvalued exchange rates in the 1980s; real effective exchange rates have declined for most developing countries (see Figure

Box 1.1 Project 1992 and the developing countries

The European Community (EC) plans to "complete the internal market" by 1992 by removing barriers to the free circulation of goods, services, and factors of production. The aim is to promote European specialization, strengthen competition, and increase efficiency. But Project 1992 is bound to have substantial implications for non-EC countries. The EC market accounts for about 30 percent of the export earnings of the developing countries.

To achieve the free movement of goods and services within the EC, three measures will be required, each of which has an impact on the developing countries. The first is the *abolition of border controls.* These are used to enforce national quantitative restrictions (QRs). They affect mainly imports of textiles and clothing covered by the Multifibre Arrangement, but other imports from developing economies, such as bananas from Latin America and toys from Asia, are also affected. The EC may convert national QRs into community-wide QRs. What happens will depend on the outcome of the Uruguay Round.

The second measure is the *elimination of technical barriers* to trade. This will proceed along two separate avenues: mutual recognition (most barriers) and harmonization (health, safety, and environmental regulations). The principle of mutual recognition implies that products legally marketed in one member state, whether manufactured in the EC or imported into the EC, can circulate freely throughout the EC. This should be especially welcome to relatively small suppliers in the developing countries, since the added costs of technical barriers are particularly onerous for them.

The third measure is the *opening up of public procurement.* This will extend to four key areas not covered by the relevant GATT code: energy, telecommunications, transport, and water supply. To the extent that public procurement concentrates on high-technology sectors, the change will matter more to the industrial than to the developing countries.

If Project 1992 promotes faster domestic growth without raising external trade barriers, Europe will import more, and the developing countries would benefit. The distribution of the new demand among exporters will depend on its composition and on existing trade preferences. The main focus of Project 1992 is on trade in manufactures. The effects of the single market on developing countries will depend on their competitiveness and on the EC's trade policy toward them. The nature of EC trade preferences toward different groups of developing countries may also change as a result of the introduction of a unified market.

1.7). Countries with an appropriate real exchange rate have usually experienced faster and more stable growth than the rest. As development proceeds, it becomes even more important to adopt and maintain an industrialization strategy that is neutral toward production for domestic or foreign markets.

In the Uruguay Round the developing countries are for the first time playing a significant role in multilateral trade negotiations. Thirteen developing and industrial countries have formed the Cairns Group to promote their common interests as agricultural producers. The developing countries have recognized their stake in the world trading system. This reinforces the need for a successful conclusion to the Uruguay Round and for adherence to the spirit as well as the letter of the principles of the GATT. The proposed strengthening of the GATT, including its surveillance of countries' trade policies, should help to bring this about. The failure of the Uruguay Round would not only hamper the growth of world trade but also represent a rejection of the development strategy that has been promoted by the international community and multilateral organizations, at the very time that developing countries are coming to accept it.

The debt problem

Although many developing countries have had difficulty in servicing their external debt, from the start of the debt crisis in 1982 the focus has been on the seventeen highly indebted middle-income countries whose debts are primarily to the commercial banks. This reflects the systemic risk that the failure of creditor banks might have posed to the international financial system in the early years of the crisis. Although some banks remain at risk, the debt strategy they have followed since 1982 has sought to remove this systemic risk by building up appropriate provisions for doubtful assets. In the past few years the debt problems of Sub-Saharan Africa have won official recognition. These problems differ from those of the other highly indebted countries in that the debt is owed mainly to governments. Nonetheless, virtually all the debtor countries have been adversely affected by the rise

in real interest rates and the decline in commercial bank lending since 1982.

Systemic collapse has been avoided. But for most of the highly indebted countries the debt crisis has become a growth crisis as well. In 1988 they grew by less than 2 percent, failing to respond both to high export demand and to the rapid growth of the high-income countries. (Export volume increased by about 6 percent, and dollar unit values rose by more than 15 percent in a delayed reaction to the sharp depreciation of the dollar.) Their situation did show one sign of improvement during 1988, however. The ratio of debt stock to exports declined for the first time since 1982. Nevertheless, two major Latin American debtors (Argentina and Brazil) experienced significant economic instability during the year.

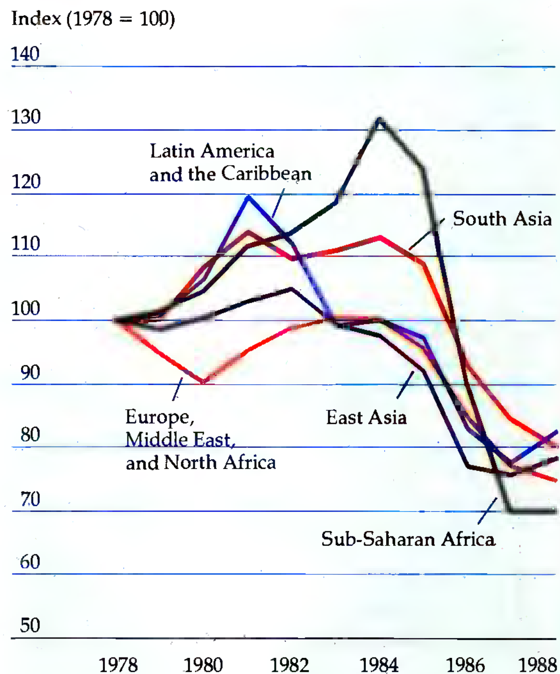
Korea has shown that it is possible to grow out of a heavy debt burden. But when commercial creditors are reluctant to increase their exposure in countries with debt problems and domestic savings are transferred abroad to service the debt, borrowers cannot finance the investment they need to generate growth. The resources for investment could come from higher domestic saving or from repatriated capital. Before 1982 the highly indebted countries received about 2 percent of GNP a year in resources from abroad; since then they have transferred roughly 3 percent of GNP a year in the opposite direction. Domestic saving would have had to rise by 5 percent of GNP—or in other words by about a quarter—to offset this change in net transfers. Despite strong fiscal contraction in some countries, none of the countries has succeeded in restoring adequate net investment (see Box 1.2).

The Baker initiative of 1985 stressed the need to maintain net flows of funds from official and private lenders. Although net flows of long-term capital from official creditors averaged nearly $6 billion a year over the past three years, net flows from commercial banks fell to an average of less than $2 billion a year.

During 1988 and 1989, governments and creditor banks alike concluded that debt reduction would have to be an element in resolving the debt crisis. Creditor governments agreed at the 1988 Toronto summit to grant debt relief to the poorest and most heavily indebted countries, such as the countries of Sub-Saharan Africa. The Paris Club subsequently agreed on the equivalence among the various types of debt relief granted by different creditor governments. For private creditors, the menu approach that has been developed since 1986 has created a variety of voluntary methods of debt reduction. These include debt buybacks (in which a debtor buys back part of its foreign debt with either international reserves or new foreign exchange), exit bonds, and debt-equity swaps. In all these cases the benefits for the debtor vary according to the discount at which it acquires its existing debt. In 1988 the commercial banks reached a major refinancing agreement with Brazil—at $82 billion, the largest on record—which contained financial innovations allowing for debt reduction. But for the highly indebted countries in general, the net reduction in external obligations achieved to date has been small.

The prolongation of the debt crisis, and particularly its manifestation in the low growth rates of heavily indebted countries, led the international community to reevaluate the debt strategy in 1989.

Figure 1.7 Real effective exchange rates in developing countries by region, 1978 to 1988



Note: The real effective exchange rate is the trade-weighted exchange rate adjusted for relative inflation. An increase in the index indicates an appreciation of the currency. The regional index values, which are based on a total sample of eighty-three developing countries, are annual averages weighted by the dollar value of exports.
Source: IMF and World Bank data.

Box 1.2 Debt concepts

A variety of concepts are used to measure and assess the economic burden of external debt.

Debt stock, which is often reported as debt outstanding and disbursed, measures the total debt liabilities of the debtor. The payment obligation arising from this is *debt service* and comprises interest and principal payments. The debt stock does not necessarily predict the debt service because currency revaluations, interest rates, and the maturity structure of the debt all affect debt service.

Two concepts describe the net effect of borrowing and repayments on the flow of financial resources. *Net flows* refers to disbursements minus principal repayments. It measures whether new financing exceeds debt being retired. If debt levels remain prudent, net flows should be positive in all but the most advanced low- and middle-income countries because of continued external financing for domestic investment. *Net transfers* refers to disbursements minus interest and principal repayments. Negative net transfers imply that total debt service payments exceed gross inflows, that net real resources are being transferred from the economy, and that a trade surplus is thus required. When the real interest rate exceeds the growth rate, any borrower must expect eventually to make net transfers to its creditors. At that stage the borrower's income should have risen sufficiently for its saving to finance the transfer. The increase in the real interest rate in the early 1980s forced many developing countries to make net transfers abroad much earlier than they had expected.

Moratoria (the suspension of contractual debt service payments), *arrears* (overdue service payments), *new money* (additional borrowing), *rescheduling* (changing the time profile of repayments without altering the total debt obligation), and *debt relief* are all ways of altering either the pattern or size of repayment flows. Forward-looking and sustainable changes in debt structure are more likely to create the environment needed for domestic investment and growth than are arrears or annual renegotiations.

Box table 1.2 shows how the burden of debt of the developing countries has changed during the 1980s. Debt stocks in Latin America and Sub-Saharan Africa have grown as a share of GNP during the 1980s, but private credit flows now represent a much smaller share of gross disbursements, especially to Latin America.

Net flows remain positive, except to middle-income East Asia; these countries are repaying debt out of efficiently invested borrowing. In most developing countries net transfers have turned sharply negative. Except in Sub-Saharan Africa and low-income Asia, resources are being transferred to creditors at rates significantly higher than those at which resources were received in 1981.

Box table 1.2 Long-term lending to developing countries, 1981 and 1987
(billions of dollars, unless otherwise noted)

	All developing countries		*Sub-Saharan Africa*		*Middle-income East Asia*		*Low-income Asia*		*Europe, Middle East, and North Africa*		*Latin America and the Caribbean*	
Item	*1981*	*1987*	*1981*	*1987*	*1981*	*1987*	*1981*	*1987*	*1981*	*1987*	*1981*	*1987*
Total long-term debt outstanding and disbursed	503	996	50	109	50	102	60	142	134	260	209	384
As a percentage of GNP	23	42	26	85	28	40	8	16	30	47	27	52
Gross disbursements of long-term lending	124	87	11	9	14	11	11	21	28	27	61	20
Private sources	92	49	6	3	10	8	5	10	17	18	53	10
As a percentage of total	74	56	58	32	75	73	45	48	62	68	88	49
Multilateral sources	12	22	2	4	2	2	3	6	2	5	3	6
Net flows[a]	77	16	8	5	10	−9	6	11	14	3	39	5
Private sources	53	−2	4	1	7	−8	2	4	7	7	34	1
Multilateral sources	10	12	2	3	1	0	2	5	2	2	2	3
Net transfers[b]	35	−38	6	2	6	−16	4	5	4	−12	16	−19

Note: Data are based on the sample of 111 countries participating in the Debtor Reporting System.
a. Gross disbursements minus principal repayments.
b. Gross disbursements minus the sum of interest and principal payments.

Although the details of the new strategy are still being worked out, the overall framework is clear. Debt reduction will receive official support and official funding from the IMF and the World Bank, provided it takes place in the context of strong, effective adjustment programs. The strategy will continue to treat each country separately and is likely to evolve as particular countries reach new agreements with their creditors and official agencies. It will aim to reward those countries that have tried hardest to restructure their economies. Very few creditor governments will be willing to contribute resources directly, but they are reviewing regulatory and accounting obstacles that might impede debt relief by private creditors. They will also encourage the creditor banks to waive the clauses in existing agreements that make debt reduction difficult to arrange.

The new strategy recognizes that debtor countries will continue to need new money from abroad. The question arises whether debt reduction is consistent with new lending from existing creditors. The stakes for banks in some of the larger countries are high enough for them to continue to provide new money, even as they simultaneously agree to reduce debt. But some banks will not want to reduce debt and provide new money at the same time. Official financing will continue. Increasingly, countries will have to look to new forms of external finance, such as direct and portfolio equity investment, and to the return of flight capital.

The most critical component of the debt strategy remains continued adjustment by the debtor countries. Without strong adjustment, no debt strategy can restore growth. It is the goal of the new strategy to ensure that countries that do pursue serious adjustment policies will be able to return to growth.

The debt crisis illustrates the fundamental tension between dependence on private markets on the one hand and government intervention on the other—a theme that recurs later in this Report. Because commercial banks were heavily exposed when the debt crisis began in 1982, creditor governments intervened to ensure the stability of the international financial system. Individual debtor governments, such as those of Argentina, Chile, and Yugoslavia, acquired large amounts of private debt in the belief that doing so would help them to preserve relations with the commercial banks. If the exposure of the banks had been small enough to pose no threat to their solvency, they might have reached agreements with the debtors on their own. And then the crisis would have taken a very different course.

Growth prospects

Uncertainty after the stock market crash of 1987 reduced expectations of growth early in 1988. Those expectations were confounded by a year of strong growth, which has bolstered the prospects for a gradual return to trend growth of about 3 percent for the high-income OECD countries. Expansion in Japan and Europe, especially in Germany and the United Kingdom, broadens the basis for sustained growth. Moreover, the high rate of investment in 1988 should increase capacity and productivity, which will help to ease inflationary pressures.

Lingering uncertainties, however, cloud the medium-term forecast. They concern the policy changes needed to reduce large domestic and international imbalances and to offset growing inflationary pressures in several of the large economies. The United States can continue to run a current account deficit only if foreign investors and governments are willing to purchase its assets. This, in turn, depends on their expectations with regard to economic stability in the United States, the U.S. fiscal deficit, and U.S. interest rates relative to those in other economies. Moreover, within Europe, major imbalances could strain the European Monetary System. The scale of these international imbalances, concern about inflation, and needed adjustments in monetary policy are likely to cause volatility in interest rates and exchange rates over the near term.

Accordingly, the World Bank has prepared two views of the next decade. One scenario is predicated on adjustment with growth. It assumes that credible policy actions are taken to reduce the macroeconomic imbalances within and among the industrial countries. Such measures include a program to reduce the U.S. budget deficit, followed by an easing in monetary policy (more so in the United States than elsewhere). Real and nominal interest rates therefore fall, as compared with the 1980–88 averages, and the dollar depreciates further against the currencies of the other big industrial countries. Structural adjustment policies of the kind discussed above enable the low- and middle-income countries to take advantage of growth; the lower interest rates ease their debt burden. This combination of plausible adjustments by both high-income and low- and middle-income governments yields, overall, good prospects for

Table 1.1 Selected economic indicators in the adjustment-with-growth and low scenarios
(average annual percentage change)

Indicator	Trend for 1965–87	Recent experience, 1980–88	Scenario for 1988–95	
			Adjustment with growth	Low
High-income OECD countries				
GDP growth	3.1	2.7	2.6	2.4
Inflation (local currency)	6.4	5.6	4.2	4.1
Nominal rate of interest[a]	8.8	10.2	8.6	9.5
Real rate of interest[a,b]	3.0	5.5	3.0	4.0
Low- and middle-income countries				
Merchandise export volume	3.8	5.4	5.1	4.1
Manufactures	12.0	10.0	7.4	5.7
Primary goods	1.3	2.5	2.8	2.7
Merchandise import volume	4.3	0.5	5.7	4.6

Note: The adjustment-with-growth scenario assumes the adoption of policies (by the major industrial and developing countries) that reduce structural rigidities and imbalances and allow for a gradual return to trend through the year 2000. The low scenario assumes that some needed policy changes are not made, interest rates remain high, growth falters, and there is increased protectionism.
a. Average six-month rate on Eurodollar deposits.
b. Nominal interest rate deflated by the GDP deflator for the United States.

world growth through the year 2000. Even so, many low- and middle-income countries would be unlikely to achieve the high growth rates they experienced in the 1960s and 1970s.

The alternative is the low scenario. It assumes that the appropriate policy actions are taken neither in the high-income countries nor in certain of the low- and middle-income countries. Crisis is averted through continued financing of the imbalances, but the low scenario entails great macroeconomic uncertainty, higher real and nominal interest rates, increased protectionism, and lower growth.

Key factors underlying these two scenarios are summarized in Table 1.1. With adjustment, real GDP growth in the high-income OECD countries averages 2.6 percent over the medium term (1988–95) and rises to trend growth of about 3 percent by the year 2000. Inflation measured in local currencies averages about 4 percent a year. Some adjustment by the United States as well as other increases in world saving lower real interest rates to 3.0 percent from their average of 5.5 percent in the 1980s. Merchandise exports of the low- and middle-income countries should grow by more than 5 percent a year, with the demand for manufactured exports rising at more than 7 percent a year. A bias toward investment helps to raise commodity prices in nominal terms, but in real terms (deflated by the unit value of manufactures) they are expected to continue to decline through 1995. This underlines the need for the developing countries that rely on primary commodity exports to diversify their economies.

Without appropriate policy changes, the low scenario shows growth in the high-income OECD countries slowing to 2.4 percent a year in the medium term and through 2000. That is significantly less than the average for the 1970s and 1980s. Growth in trade is correspondingly lower. More important, the failure to right macroeconomic imbalances keeps real and nominal interest rates high (about 4 and 10 percent respectively). Lower external demand and higher interest rates reduce the prospects for growth in the low- and middle-income countries to below the averages of the 1980s.

How does the adjustment-with-growth scenario in the high-income countries affect the growth prospects of the low- and middle-income countries? The answer largely depends on their own policy adjustments and on population growth. East and South Asian countries, which have stable macroeconomic environments and a substantial share of manufactures in exports, are expected to grow at about 6 percent a year (see Table 1.2). Some of them are likely to "graduate" to the high-income category. Moreover, because their population growth is expected to slow, per capita income in some countries rises by more than 5 percent a year. Per capita income in the region as a whole rises by 4.3 percent a year. Prospects for internal financing of investment in physical and human capital are good. Even in the low scenario, the Asian development effort is expected to continue to succeed.

As structural adjustment proceeds, real GDP growth in Sub-Saharan Africa is expected to aver-

age 3.2 percent a year through 1995, before accelerating in the second half of the decade. But with population growing at nearly the same rate, per capita real income for the region stagnates. Even with an optimistic view of adjustment, the region's per capita income will not return to the level of the mid-1960s over the projection horizon. More, and more effective use of, external financing will be needed to keep Sub-Saharan Africa from falling further behind. These prospects reinforce the view that policies—internal and external—require continued adjustment.

If certain countries in Latin America and in Europe, the Middle East, and North Africa make the necessary economic adjustments, and if these policies revive investment, these regions could do better over the next decade than they have in the 1980s. Per capita income is expected to grow again in Latin America, but at only about 1 percent a year; this rate is probably insufficient for the economic revitalization that is necessary for Latin America to keep pace with other parts of the world. Per capita income should grow more strongly than hitherto in the developing countries of Europe, the Middle East, and North Africa. But without internal reform, external stimulus, and lower interest rates, there is a real danger that the economic situation in much of the middle-income world could deteriorate further.

Debt reduction scenario

Recent discussions of debt relief suggest a third scenario. This combines a reduction in the debt burden of the highly indebted countries with the shift in the macroeconomic policy mix of the industrial countries that is part of the adjustment-with-growth scenario. Under this illustrative scenario, debt stocks are reduced by 20 percent over three years.

The reduction in net resource transfers in the form of interest payments associated with the reduction in debt stocks could be as much as $5 billion to $6 billion over three years. If the reduction in interest payments is used to import needed investment goods, investment rates would rise by several percentage points. As a result of the debt reduction, GDP for the highly indebted countries could be about 1 percent higher at the end of the three years.

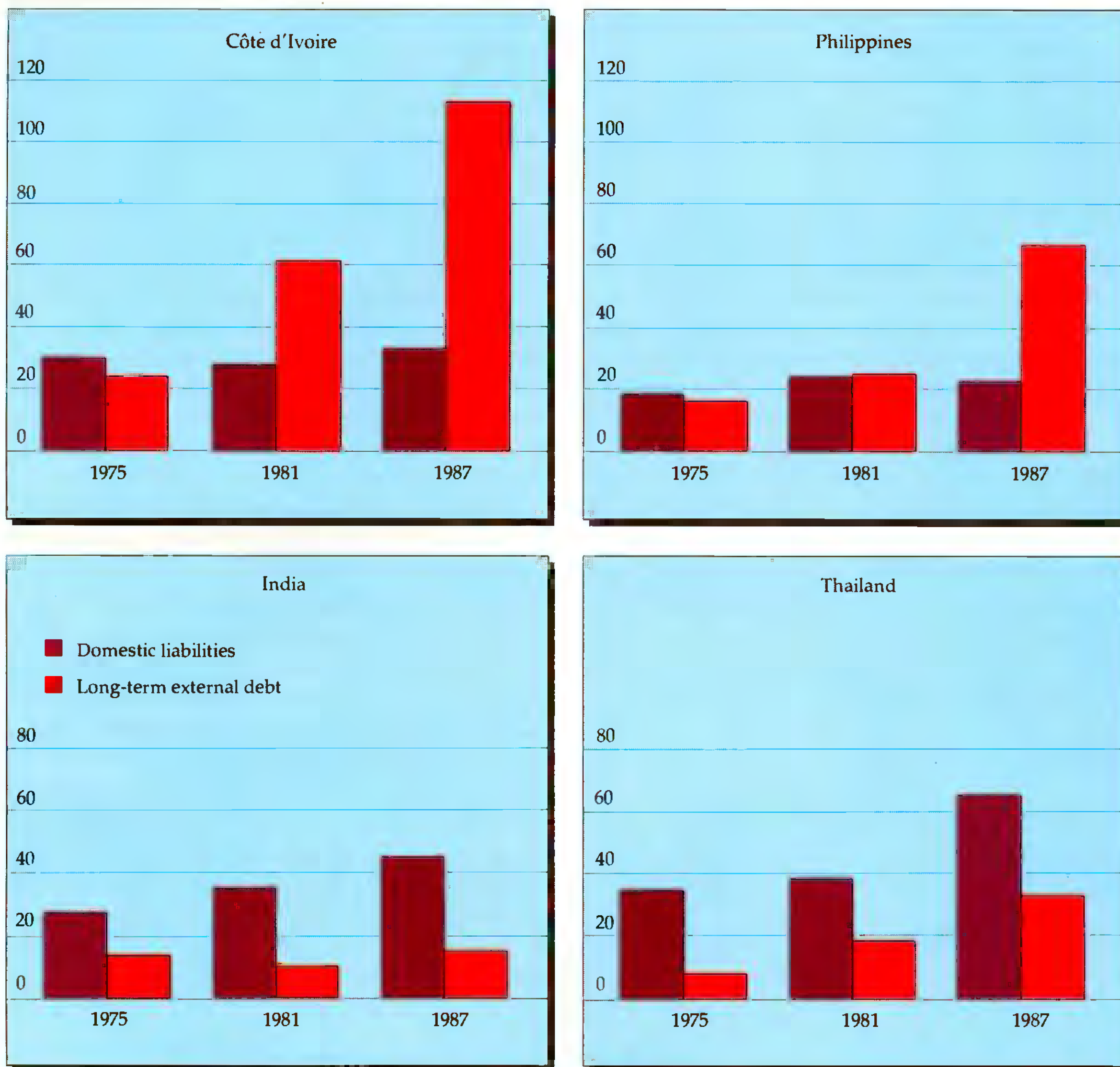
Even though all countries are treated similarly in this scenario, some countries fare better than others because countries react differently to increases in imports and investment. For example, the potential increase in GDP for Argentina, Brazil, Mexico, and Nigeria could be as much as 2 percent each. Recent initiatives envisage different countries receiving different levels and kinds of debt reduction on the basis of their adjustment programs.

The models underlying this scenario tie investment directly to resource flows and thus omit two key unquantifiable elements in debt reduction. First, a reduction in the debt overhang is likely to increase the probability that the country can meet future interest obligations; this will significantly improve the investment climate and thereby both increase investment and at some stage encourage the return of flight capital. Second, if debt reduction leads to a sharp decline in new money, and

Table 1.2 Growth prospects in the adjustment-with-growth and low scenarios
(average annual percentage change)

	GDP growth				GDP per capita growth			
			Scenario for 1988–95				Scenario for 1988–95	
Country group	Trend for 1965–87	Recent experience, 1980–88	Adjustment with growth	Low	Trend for 1965–87	Recent experience, 1980–88	Adjustment with growth	Low
Low- and middle-income countries	5.0	4.0	4.6	3.7	2.7	2.0	2.7	1.8
Excluding China and India	4.8	2.6	3.8	3.0	2.2	0.2	1.5	0.7
Sub-Saharan Africa	3.4	0.5	3.2	3.1	0.6	−2.5	0.1	−0.1
Asia	6.2	7.3	6.0	4.9	4.0	5.5	4.3	3.2
Europe, Middle East, and North Africa	4.6	2.9	3.5	2.8	2.4	0.7	1.6	0.8
Latin America and the Caribbean	4.7	1.7	3.1	2.3	2.1	−0.6	1.2	0.4
Seventeen highly indebted countries	4.6	1.3	3.2	2.3	2.0	−1.2	1.0	0.2
High-income OECD countries	3.1	2.7	2.6	2.4	2.3	2.1	2.1	1.9

Figure 1.8 Domestic and external liabilities in selected developing countries, 1975, 1981, and 1987
(percentage of GNP)



Note: Domestic liabilities are defined as total liquid liabilities of the financial system (*International Financial Statistics*, line 55l), expressed in local currency. External debt is total long-term debt outstanding and disbursed, expressed in U.S. dollars at current exchange rates.
Source: IMF and World Bank data.

possibly even to an increase in negative net transfers, investment will drop. These considerations reinforce the view that continued and powerful structural adjustment by the debtor countries remains the most important ingredient in dealing with the debt problem.

Beyond the debt crisis

All the evidence points to continued low capital flows to the developing countries in the coming decade. Official flows cannot fully offset the sharp reduction in private flows. This underlines the

Table 1.3 Selected capital flows to developing countries, 1981 and 1987
(billions of dollars)

Country group	Official development assistance: Total 1981	Total 1987	Official grants 1981	Official grants 1987	Foreign direct investment 1981	Foreign direct investment 1987
All developing countries	24.5	30.4	14.5	20.0	10.2	9.5
Sub-Saharan Africa	7.1	11.1	4.9	7.3	1.3	0.8
Middle-income East Asia	1.8	2.2	0.9	1.5	1.8	2.5
Low-income Asia	5.3	7.2	2.7	3.5	0.2	1.3
Europe, Middle East, and North Africa	8.2	6.3	5.1	5.0	1.3	0.8
Latin America and the Caribbean	2.1	3.6	0.9	2.7	5.6	4.1

Note: Data are based on the sample of 111 countries participating in the Debtor Reporting System. Data exclude certain countries with significant flows associated with offshore banking activities.
Source: OECD and World Bank data.

need for developing countries to adopt economic policies that increase domestic saving and ensure that resources are used as efficiently as possible. In this, the financial sector can play a crucial role.

There is little doubt that over the past fifteen years many developing countries have relied too much on external borrowing and too little on domestic resources. In a sample of thirty-eight developing countries for which data on the liabilities of the domestic financial system were available, external debt at the end of 1986 exceeded domestic debt by more than 50 percent. For Latin America, external debt was on average two-and-a-half times greater than domestic bank liabilities. This shows how much these countries have come to depend on external financing. Figure 1.8 illustrates the range of experience. In countries with rapidly expanding external debt and shallow domestic financial systems, such as Côte d'Ivoire and the Philippines, external liabilities were two to five times greater than domestic bank liabilities. India and Thailand, in contrast, have relatively deep domestic financial systems; they have consciously limited their recourse to external financing.

One lesson of the debt crisis is that commercial bank lending at floating rates is not the ideal form of financing for long-term development. It exposes the borrower to interest rate and exchange rate fluctuations, and it does not tie the borrower's payments to the outcome of the investment. Alternative forms of finance—foreign direct and portfolio investment and commodity bonds, for example—distribute risk between creditor and debtor. Borrowing countries may also hedge their currency exposures by adjusting the currency composition of reserves and borrowings to reflect the likely impact of exchange rate and commodity price changes on their future cash flows.

Foreign direct investment has been an important source of financing for economies at all levels of income (see Table 1.3). It frequently brings additional benefits: access to new technologies or to markets in which the foreign investing firm is active. It is also likely to bolster competition in domestic markets. During the 1980s foreign direct investment in developing countries has been stable, averaging $10 billion to $15 billion a year (about 10–15 percent of total capital inflows). The relative stability of the aggregate flow masks important changes in its size, sourcing, and composition in different low- and middle-income countries. The direction of foreign direct investment is strongly influenced by political and economic stability and by policies toward trade and capital flows. Restrictions on profit repatriation and access to foreign exchange are especially important (see Box 1.3). Foreign direct investment has to be serviced through profit remittances, and it may be a more expensive source of finance than borrowing. But as long as it provides access to international markets, better technology, and greater domestic competition, it should be welcomed by most developing economies.

Other forms of risk sharing between developing countries and the international capital markets have been very little developed to date. Some oil bonds have been sold, and some deals have been collateralized by commodity exports. The rapid financial innovation of the past decade can be expected to spread to developing countries in due course.

Foreign aid also remains an important source of external finance, particularly for low-income countries in Sub-Saharan Africa. Some industrial countries, notably Japan, have expanded their overseas development assistance in the 1980s. By early 1989 Japan had extended nearly 90 percent of the $30 billion program announced in 1987 to "recycle"

Box 1.3 Foreign equity investment

Economic policies that promote sustainable growth are also likely to attract foreign equity investment. Investor surveys show that growth and stability of the host economy are key factors in determining the attractiveness of a foreign investment. In part, this is because equity investment is relatively illiquid and sometimes requires a lengthy development phase before earning positive returns. When the foreign investment produces for the host market, as in Brazil and Korea, the investor's concern with the long-term macroeconomic environment is reinforced.

Industrial and trade policies also strongly influence foreign investment. Outward-oriented strategies supported by tax, foreign exchange, and other policies usually attract more foreign equity investment, especially to the export processing sectors. Transparent and consistent investment policies are important. Singapore, for example, treats foreign investments on essentially the same terms as domestic investments. It has attracted large flows which, along with domestic investment, have contributed to rapid growth.

Mauritius shows that policies to provide incentives for foreign investment can work, provided the macroeconomic environment is stable. To attract foreign investment and diversify from its traditional reliance on raw sugar, it adopted an Export Processing Zone program in 1970. Mauritius successfully expanded the share of manufactures from almost nothing to 24 percent of total exports by 1977. But growth slowed in the late 1970s and early 1980s, partly because of failures in macroeconomic policy (currency overvaluation, fiscal overexpansion, and a tax policy that discouraged domestic saving). Foreign investment plummeted. The country adopted a structural adjustment program in the early 1980s that called for better credit allocation, an expansion of term finance for the private sector, and investment policies aimed at further export diversification. Growth and foreign investment have revived.

funds to developing countries. Saudi Arabia continues to provide 3 percent of GDP in development aid, and Kuwait has recently provided 2 percent. In general, however, low oil prices in the 1980s have prevented the high-income oil-exporting countries from maintaining their aid programs.

Moving beyond the debt crisis calls for effort by debtor and creditor alike. Credible and sustainable structural adjustment is necessary to encourage the return of flight capital and to ensure that domestic and external resources are made available and are put to productive use. And creditors need to be more imaginative in their lending; they must tailor the form and maturity of financial flows to the characteristics of the projects being financed. The creativity of the international capital markets should be brought to bear on the problems of the debtor countries.