Policy options for global adjustment

The global economy remains fragile despite reasonable short-term growth prospects. Although average GDP growth in the industrial countries was marginally higher in 1987 than in 1986, it was well below the high levels of the 1950s and 1960s. Moreover large international payment imbalances persist, and there is a risk of further volatility in stock markets, exchange rates, and interest rates. This fragility is a direct consequence of lasting divergences in the macroeconomic policies of the leading industrial countries. Without significant changes in these policies the present economic uncertainty may soon be followed by a worldwide recession. For developing countries—despite considerable stabilization and adjustment efforts—the outlook remains worrying, especially for those with acute debt problems. These countries face the risk of prolonged stagnation in real per capita income, greater poverty, and social unrest.

Three issues need to be addressed if the growth prospects of industrial and developing countries are to improve.

- The leading industrial countries must persevere in adjusting their macroeconomic and structural policies so as gradually to reduce external imbalances to a sustainable level. This would improve the longer term outlook for growth in the industrial countries—a precondition for faster growth in developing countries.
- Developing countries must pursue policy reforms designed to advance their development prospects, even if the international environment is unfavorable.
- Net resource transfers from developing countries to the rest of the world must be reduced.

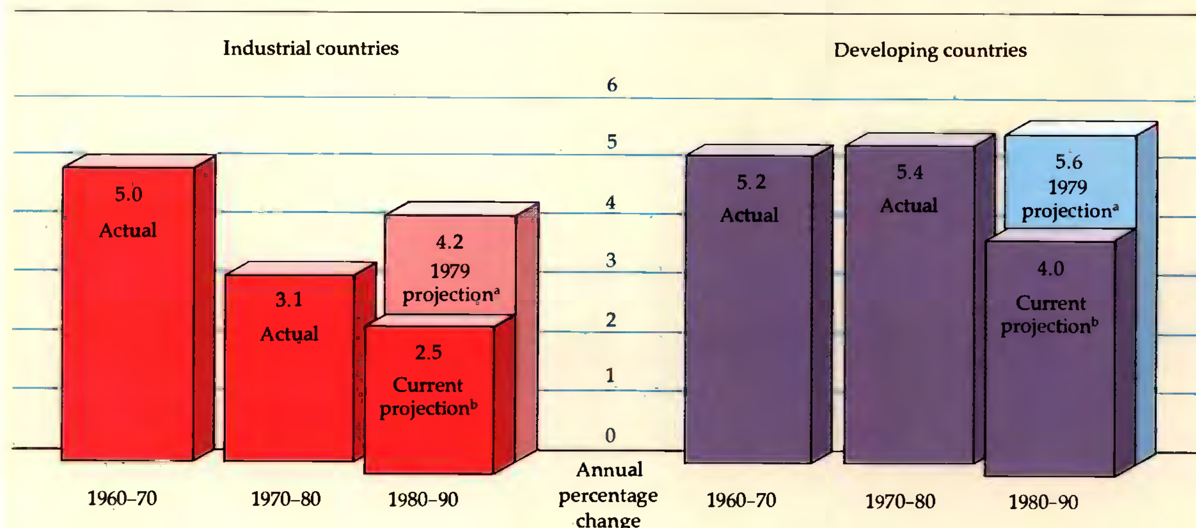
Resolving these issues poses an enormous challenge for governments in industrial and developing countries and for the international financial community. These issues are closely linked. Progress on all three would lessen the risks in the outlook and make it possible to resume healthy economic growth.

The legacy of the 1970s

The 1970s were a period of turmoil and transition for the world economy. Following the long postwar expansion, GDP growth in the industrial countries became generally more erratic. For the decade as a whole it declined to 3.1 percent a year, compared with 5.0 percent during the 1960s. The first oil price shock, mounting fiscal deficits, rising inflation, and greater rigidity in the functioning of domestic markets were the main reasons for this slowdown. The volatility of exchange rates following the collapse of the Bretton Woods exchange rate system in 1971 added to the financial tensions.

In the developing countries, economic growth during the 1970s remained largely unaffected by the slowdown in industrial countries. It averaged 5.4 percent, or broadly the same as in the previous decade. As documented in earlier *World Development Reports,* however, this relatively strong performance was achieved by a rapid accumulation of external debt and—in many countries—at the expense of growing domestic imbalances. These in-

Figure 1.1 Actual and projected growth of GDP, 1960 to 1990



a. From the central case scenario of *World Development Report 1979.* This projection did not include China, which was expected to have higher than average growth.
b. Based on actual growth for 1980–87 and projected growth for 1987–90 under the base case.
Sources: World Bank, *World Development Report 1979,* and World Bank data.

cluded large fiscal deficits, inflation, overvalued currencies, and distorted incentives for industry and agriculture. As a result many developing countries were left vulnerable to new external shocks.

Despite the increased economic uncertainty of the 1970s the global outlook toward the end of the decade generally permitted cautious optimism. The oil price shock of 1973 appeared to have been weathered successfully and without lasting damage to world trade and capital markets. A modest resurgence of growth in industrial countries, closer to the averages of the 1950s and 1960s, together with steady growth in the developing countries, seemed a likely outcome for the 1980s. Like other forecasts prepared at the time, projections for the world economy presented in *World Development Report 1979* envisaged average real GDP growth of 4.2 percent in industrial countries and 5.6 percent in developing countries for 1980–90 (see Figure 1.1).

Combining the outcome for 1980–87 and projections for the remainder of the 1980s, the average rate of growth for the decade as a whole is likely to be little more than half that projected in 1979 for the industrial countries and roughly two-thirds that projected for the developing countries. This is a large discrepancy. It underlines the reversal in world economic fortunes in three main areas.

- Sharp fluctuations in the price of oil—starting with the second price shock in late 1979—caused serious disruptions for oil-importing and oil-exporting developing countries alike. Those that had accumulated large external debts were the worst hit.
- Faced by high and rising inflation, most industrial countries redirected their macroeconomic policies to reduce inflationary pressures.
- The unexpected deterioration in the international environment—slower growth in world trade, falling commodity prices, reduced access to foreign financing, and steep increases in real interest rates—compounded the structural weaknesses and past economic policy failures of many developing countries.

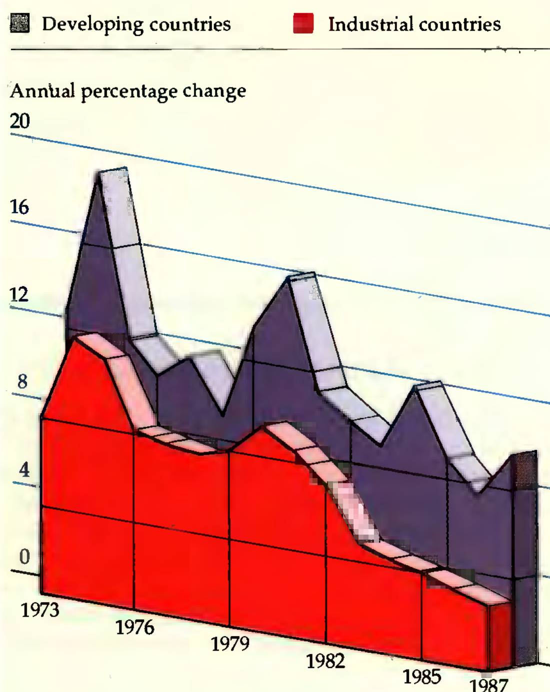
The next section reviews macroeconomic policy in industrial countries during the 1980s and its effect on the world economy. It also considers current policy options for these countries. The chapter goes on to analyze the effect of changes in the external environment facing developing countries, and explores options to deal with their trade and debt problems. It concludes with an assessment of the outlook for the world economy until 1995.

Macroeconomic policies and imbalances in industrial countries

In most industrial countries the policy response to the high inflation and widening fiscal deficits inherited from the late 1970s was rapid and vigorous. Starting in late 1979, these countries turned to strict anti-inflationary monetary policy. For the seven largest countries (the G-7) the rate of growth of narrow money (M1) declined from 10 percent in 1979 to 6 percent in 1980. Together with the second oil shock this helped to trigger a severe recession in 1981–82. Most industrial countries also shifted the emphasis of their fiscal policies, aiming for lower structural budget deficits. Although recession-related automatic stabilizers caused offsetting increases in budget deficits—in most industrial countries central and general government deficits remained high until the middle of the decade (see Table 1.1)—the new direction of fiscal policy had a procyclical effect that deepened the recession. In 1982 average GDP growth tumbled to −0.4 percent in industrial countries and to 2.0 percent in developing countries.

The United States was the main exception to the new orientation of fiscal policy; its combination of lower tax rates and higher spending caused budget deficits to rise after 1981. In the United States and the United Kingdom, among others, efforts were also initiated to curb the role of the public sector in the economy and to loosen the regulation of private enterprise. This involved far-reaching liberalization of financial markets and other sectors of the economy. The privatization of some state-owned enterprises, especially in the United Kingdom, was another part of this reformist philosophy.

Figure 1.2 Inflation, 1973 to 1987



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

Effects of the new macroeconomic policies

The new policies had rapid and profound effects. On the positive side, with the help of the drop in dollar oil prices after 1981, they successfully re-

Table 1.1 Fiscal balances in major industrial countries, 1979 to 1987
(percentage of GNP)

Fiscal entity and country or country group	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*
Central government									
United States	−1.1	−2.3	−2.4	−4.1	−5.6	−5.1	−5.3	−4.8	−3.4
Japan	−6.1	−6.2	−5.9	−5.9	−5.6	−4.7	−4.0	−3.3	−3.8
Germany, Federal Republic of	−1.9	−1.9	−2.5	−2.4	−1.9	−1.6	−1.3	−1.2	−1.4
G-7[a]	−2.8	−3.3	−3.6	−4.6	−5.4	−5.0	−4.9	−4.3	−3.6
General government[b]									
United States	+0.5	−1.3	−1.0	−3.5	−3.8	−2.8	−3.3	−3.5	−2.4
Japan	−4.7	−4.4	−3.8	−3.6	−3.7	−2.1	−1.0	−0.6	−0.8
Germany, Federal Republic of	−2.6	−2.9	−3.7	−3.3	−2.5	−1.9	−1.1	−1.2	−1.7
G-7[a]	−1.8	−2.5	−2.7	−4.0	−4.1	−3.4	−3.4	−3.2	−2.6

Note: (+) indicates a surplus and (−) a deficit.
a. Canada, France, Federal Republic of Germany, Italy, Japan, United Kingdom, and the United States.
b. Includes central, state, and local governments.
Source: IMF data.

duced inflation. For industrial countries as a group inflation dropped from a peak of 9.4 percent in 1980 to 4.8 percent in 1983 and declined further to 2.9 percent in 1987 (Figure 1.2).

On the debit side the recession speeded the rise in unemployment that had already started in the 1970s. In many countries this contributed to wage restraint, which in due course helped to restore business confidence and corporate profitability. Worringly, though, unemployment shows no sign of declining in many industrial countries; in Europe the average rate of unemployment has remained above 10 percent since 1983. That is a heavy social cost, and it has contributed to a resurgence of protectionism (see Box 1.1). Political tension associated with high unemployment may also account for the industrial countries' reluctance to expand their aid programs.

Box 1.1 The rising costs of protectionism

Protectionism broadly declined up to 1974 as tariffs were cut under successive agreements of the GATT (General Agreement on Tariffs and Trade). GATT is based on three principles: first, nondiscrimination, which requires that tariffs be equal for all trading partners of a given country; second, transparency, which favors explicit tariffs rather than nontariff barriers (NTBs); and third, reciprocity, so that if country A lowers its tariffs on imports from country B, country B should reciprocate. Through the adoption of these standards, average import tariffs on manufactures fell from about 40 percent in the early 1950s to less than 10 percent in 1974. Agricultural products and textiles—two major developing-country exports—remained the biggest exceptions to the trend toward more liberal trade.

The revival of protectionism

Liberal trade has been seriously threatened since the mid-1970s, and especially since 1980. Manufacturing has seen a resurgence of protectionism, especially in the guise of NTBs such as Voluntary Export Restraints (VERs) and import quotas. Between 1981 and 1986 the proportion of imports to North America and the European Community (EC) affected by NTBs rose by more than 20 percent. Trade between industrial and developing countries is increasingly affected by NTBs. Roughly 20 percent of developing-country exports were directly covered by such measures in 1986. One form of growing and systematic protectionism involves the successive Multifibre Arrangements. These have created a worldwide system of managed trade in textiles and clothing, and severely curtail developing-country exports. For politicians in industrial countries NTBs are attractive because of their popular appeal and because in the short term they seem to safeguard employment in declining industries.

In farming, large subsidies and import barriers are common, especially in Europe, Japan, and—to a lesser degree—North America and appear to have been rising in recent years. The growth of the Common Agricultural Policy (CAP), which heavily subsidizes EC agriculture and discriminates against all agricultural imports into the EC, is one of the developments that underlie this trend.

Of course protectionism is not restricted to industrial countries. Developing countries, particularly those with more inward-oriented policies, often use NTBs and import tariffs. Lack of data makes it difficult to judge the extent of protectionism in developing countries. However, numerous countries have in recent years lowered the effective rates of protection on manufactured goods as part of their structural reforms.

The costs of protectionism

Estimates of the costs of industrial countries' protection against developing countries range from 2.5 to 9 percent of the developing countries' GNP. For industrial countries the costs of their own protection range from 0.3 to 0.5 percent of GNP. The cost of protecting particular subsectors can be extremely large. For example, the cost of protecting agriculture ranges from 3 percent of total farm output in the United States to 16 percent in the EC. In the United States it is estimated that in 1983 every dollar paid to preserve employment in the steel industry cost consumers $35 and amounted to a net loss of $25 for the U.S. economy. In the United Kingdom the cost of preserving one job in the car industry was equivalent to four times the average industrial wage in 1983.

NTBs are usually much more damaging than tariffs. VERs are estimated to cost the importing country up to three times as much as the equivalent tariff protection. For example, the cost to the U.S. economy of protecting the steel industry alone was nearly $2 billion in 1985. NTBs also reduce the effectiveness of exchange rates as a way of influencing the balance of payments because trade regulations, not relative prices, determine the volume of trade. It has been demonstrated that the responsiveness of the U.S. trade balance to changes in the value of the dollar has been significantly reduced by the growing use of NTBs. Since foreign

Moreover the switch to anti-inflationary monetary policy raised interest rates sharply, especially in the United States, where it coincided with fiscal expansion. Real yields on U.S. Treasury bonds rose from an average of 2 percent in 1980 to a peak of 8 percent in 1984 (see Figure 1.3). On this account alone the developing countries would have had to carry a far heavier burden of debt service costs. The diverging paths of the industrial countries' fiscal policies—stimulation in the United States and budgetary consolidation elsewhere—sowed the seeds of persistent financial disequilibrium and the present external payments imbalances.

producers enjoy swollen profits as a result of VERs, they can afford to keep dollar prices unchanged as the dollar depreciates and thus protect their market share.

Protectionism can also involve direct budgetary costs, especially when it takes the form of subsidies. For example, it has been estimated that direct agricultural subsidies in the United States amounted to roughly $25 billion in fiscal 1987, or approximately 17 percent of the federal budget deficit. Agricultural subsidies under the CAP amounted to $33 billion in 1987 and have been a significant source of friction between members. NTBs could be replaced by revenue-earning tariffs. The revenue forgone is a hidden budgetary cost.

Finally, large agricultural subsidies and import barriers in industrial countries have led to overproduction and have pushed agricultural export prices below production cost. This has been one of the important factors explaining depressed agricultural commodity prices in recent years. Protection has harmed agricultural commodity exporters in developing countries and has reduced the income of agricultural producers and rural labor.

The Uruguay Round

The current round of GATT negotiations ("the Uruguay Round") is an opportunity to address these issues and return to more liberal international trade in manufacturing, agriculture, and services. A particularly important breakthrough would emerge from a successful negotiation of U.S. proposals for a phased elimination of farm subsidies. Developing countries have an important stake in the Uruguay Round, especially in agriculture and industry. Progress toward reduced protectionism in industrial countries and in the developing countries could be a major factor in improving the world economic outlook and the development prospects of the Third World. (See *World Development Report 1986* and *World Development Report 1987* for discussions of agricultural and industrial protectionism, respectively.)

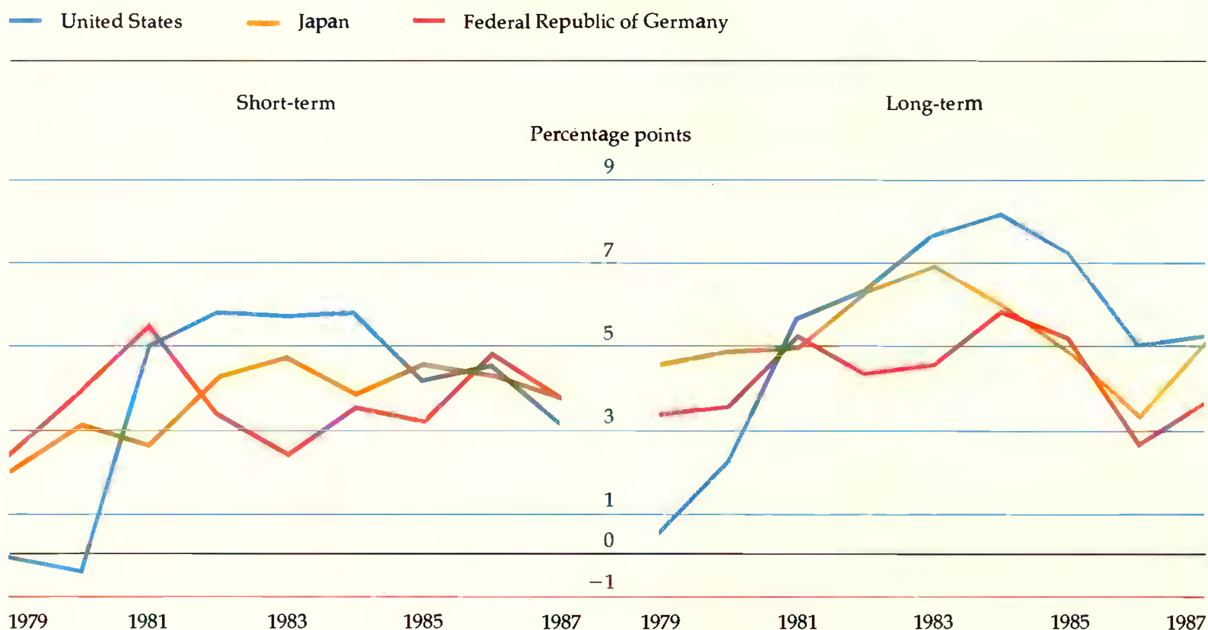
Emergence of macroeconomic imbalances among industrial countries

In the wake of the Mexican debt crisis of 1982 the U.S. government strongly expanded the money supply to avert the collapse of a banking system already weakened by recession. This was the catalyst for a strong economic recovery, further propelled by fiscal expansion and the "supply-side friendly" tax reform of 1981. The combination of lower tax revenues and higher public spending caused U.S. general and federal budget deficits, as a proportion of GNP, to rise considerably above past trends (see Table 1.1). The rate of private saving fell to its comparatively low postwar average, and private investment increased, partly as a result of the 1981 tax reform (see Box 1.2). The private saving-investment balance therefore moved from a surplus of 3.2 percent of GNP in 1982 to a deficit of 1.2 percent in 1987. Combined with a rising general government deficit, this resulted in a negative overall saving-investment balance, which was reflected in a spiraling current account deficit. In contrast, Japan and the Federal Republic of Germany followed a path of more restrictive fiscal policy. Against a background of high private saving, this led to mounting current account surpluses (see Table 1.2 and Figure 1.4).

These diverging trends of saving and spending prompted rising interest rate differentials between the dollar and other major currencies and a prolonged appreciation of the dollar (see Figure 1.5). This worsened the growing trade imbalances. The newly industrialized economies (NIEs) in East Asia were able to greatly expand their exports to the United States. By 1987 the United States' external imbalance had reached an unprecedented scale.

The capital flows that are the counterpart of these protracted payments imbalances have altered the creditor positions of the main industrial countries. The United States—long the world's largest creditor and capital exporter—is now the largest debtor. Its estimated net foreign debt was already equivalent to 6.5 percent of GNP at the end of 1986. In the same year Japan and Germany had already become the principal creditor countries, with net foreign assets of 8.5 and 10.5 percent of their respective GNPs.

Figure 1.3 Real interest rates in major industrial countries, 1979 to 1987



Notes: All rates are annual averages. The real interest rate is the nominal rate deflated by the CPI (for short-term rates) or by the GDP deflator (for long-term rates). The short-term nominal rates used are: United States, three-month bank certificates of deposit; Japan, unconditional call money before 1981 and two-month private bills for 1981-87; and Germany, three-month interbank loans. The long-term nominal rates used are: United States, ten-year treasury bonds; Japan, central government bonds with maturities of ten years or longer (OTC sales yield); and Germany, public authorities bonds with three years or more remaining to maturity.
Sources: IMF and World Bank data.

Box 1.2 Tax policy, the balance of payments, and international capital flows

Tax policy influences the balance of payments and international capital flows in many ways. It helps to determine the saving-investment balance, for example, and it affects the return on capital. These influences have become more pronounced as barriers to international capital mobility have declined. Against this background, many industrial country governments have recently adopted major tax reforms.

The structural effects of the U.S. tax reforms on the balance of payments and on international capital flows have received less attention than its effects on the federal budget deficit. The 1981 reform included investment tax credits, accelerated depreciation, and liberalized provisions for leasing capital equipment. These help to account for strong private investment in 1983 and 1984, despite high real interest rates. At the same time tax reform had an ambiguous effect on private savings; in fact private saving rates declined during the early 1980s from their high levels of the 1970s. The net effect of the 1981 tax reform on private investment and saving thus provides an added explanation for the growing saving-investment gap, the resulting current account deficit, and the international capital requirements of the United States. The 1986 U.S. tax reform weakened the investment incentives introduced in 1981 by broadly equalizing effective tax rates for all forms of income. This should help to narrow both the U.S. saving-investment gap and the current account deficit.

Another aspect of tax policy is the treatment of income earned abroad. The United States, like most other industrial countries, uses a resident-based system, which taxes the income of residents even if it is earned outside the United States, but does not tax interest income paid to foreigners. In contrast, many developing countries, including most Latin American countries, use a source-based approach to taxation, which attempts to tax only income having its source within their boundaries and does not attempt to tax the income of their citizens originating in the rest of the world. The interaction of tax policies in industrial and developing countries can thus create incentives for capital outflows from developing countries, while discouraging inward foreign investment.

Table 1.2 Current account and saving-investment balances in major industrial countries, 1975 to 1987
(percentage of GNP)

Country	Average, 1975–84	1985	1986	1987
United States				
Current account and overall saving-investment balance	−0.4	−2.9	−3.3	−3.6
Government saving-investment balance	−1.9	−3.3	−3.5	−2.4
Private saving-investment balance	1.5	0.4	0.2	−1.2
Gross private saving	17.8	16.9	16.5	14.8
Gross private investment	16.3	16.5	16.3	16.0
Japan				
Current account and overall saving-investment balance	0.7	3.7	4.3	3.6
Government saving-investment balance	−3.8	−1.0	−0.6	−0.8
Private saving-investment balance	4.5	4.7	4.9	4.4
Gross private saving	29.3	28.4	32.4	33.3
Gross private investment	24.8	23.7	27.5	28.9
Germany, Federal Republic of				
Current account and overall saving-investment balance	0.3	2.6	4.2	3.9
Government saving-investment balance	−3.1	−1.1	−1.2	−1.7
Private saving-investment balance	3.4	3.7	5.4	5.6
Gross private saving	19.8	19.9	23.1	23.3
Gross private investment	16.4	16.2	17.7	17.7

Note: The saving-investment balance is defined as gross saving minus gross investment. The overall saving-investment balance is the sum of the government and private saving-investment balances; it is by definition equal to the current account.
Source: IMF data.

Initial steps toward international macroeconomic policy coordination

Between late 1981 and early 1985 the dollar appreciated in real terms by 35 percent against the main currencies. This trend was reversed in March 1985, when it began to decline because of changing perceptions of the sustainability of the U.S. external deficit. Policymakers of the five leading industrial countries (the G-5) initially supported this adjustment. In September 1985 the G-5 reached the Plaza Agreement, which set in motion concerted intervention in currency markets to maintain an orderly decline of the dollar.

However, the U.S. current account deficit continued to widen, despite a cumulative depreciation of 34 percent in the real effective value of the dollar from its peak in early 1985 through the end of 1987. Several factors account for this.

- Important trading partners of the United States—especially Canada, the Latin American countries, and the Asian NIEs—have either pegged their currencies to the dollar, devalued against it, or appreciated their currencies only recently and to a limited extent. In addition the real appreciation of the German mark has been slowed by its link to other major European currencies in the European Monetary System (EMS); its cumulative rise was only 12 percent between March 1985 and December 1987. Due to these various factors

Figure 1.4 Current account balance in industrial countries, 1980 to 1987

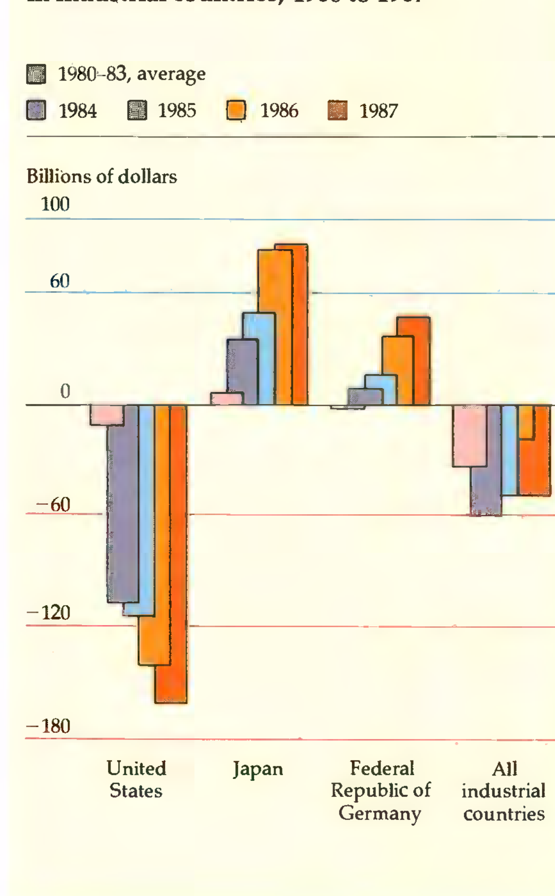
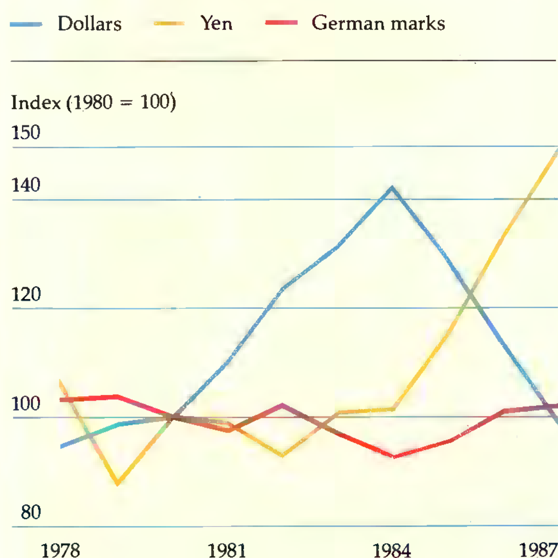


Figure 1.5 Real effective exchange rates of key currencies, 1978 to 1987



Notes: All index values are averages for December of each year. The "real effective" exchange rate is the trade-weighted exchange rate index (effective exchange rate) adjusted for relative inflation. An increase in the index indicates an appreciation of the currency.
Source: IMF data.

the dollar and the German mark returned to their real 1980 trade-weighted levels only in late 1987 (see Figure 1.5).

- Nominal trade balances take time to adjust. After a currency devaluation, prices respond faster than volumes, so current-price trade deficits tend to increase in the short run. This is known as the J-curve effect.
- Protectionist measures such as Voluntary Export Restraints (VERs) have reduced the price sensitivity of imports to exchange rate movements by encouraging foreign suppliers to reduce profit margins rather than accept quantity adjustments (see Box 1.1).
- Major U.S. corporations continue their foreign sourcing in low-cost labor markets, which adds to the rigidity of import volumes.
- Import compression after 1982 in several highly indebted developing countries—many of which, especially in Latin America, are major trading partners of the United States—accounts for a large part of the decline of U.S. exports after 1982.
- Last, but not least, the reduction of the U.S. external deficit was impeded by the persistence of the fiscal deficit. The fiscal deficit, a key element in the overall U.S. saving-investment imbalance, is not significantly affected by exchange rate realignments. Thus, as long as the general government deficit remains at or close to its 1987 level (2.4 percent of GDP), the burden of adjustment must fall on the private sector; the private saving-investment deficit will have to become a sizable surplus if the U.S. current account is to improve. This would mean a big fall in private consumption or private investment or both. To achieve such a correction solely through exchange rate adjustments would probably call for a further depreciation of the dollar.

Recognizing the importance of convergent macroeconomic policies in correcting payments imbalances, the six largest industrial countries took a further step toward coordination in early 1987. The Louvre Accord of February 1987 marked a commitment by the countries with external surpluses to stimulate domestic investment and consumption so as to reduce their savings surplus. The United States, for its part, agreed to fiscal contraction to reduce its external deficit. These commitments were reiterated by the heads of state of the G-7 at the Venice Summit of June 1987 and in the G-7 statements of December 22, 1987, and April 13, 1988.

The parties to the Accord also agreed to "cooperate closely to foster stability of exchange rates around current levels," on the grounds that a further devaluation of the dollar would be counterproductive. Japan and Germany were concerned that a further drop of the dollar would erode the international competitiveness of their exports and precipitate a slowdown in their economies. U.S. authorities were similarly concerned that it would boost domestic inflation, sap foreign confidence in dollar assets, and deter further inflows of private capital.

In line with its commitment of February 1987, Japan adopted several expansionary fiscal measures. A supplementary budget allocation of ¥5 trillion (approximately $40 billion) for additional public investment expenditure and major public works programs was announced in May 1987. The Japanese authorities have also launched a major initiative to recycle a part of the country's surplus in favor of developing countries during the next three years (see Box 1.3).

The German federal government announced steps to stimulate its economy through a tax reduc-

Box 1.3 Recycling Japan's funds

In 1987 the Japanese government pledged to recycle up to $30 billion in the form of completely untied public and private funds to developing countries, in two tranches of, respectively, $10 and $20 billion.

The first tranche consists of three parts: the creation of the Japan Special Fund of about $2 billion in the World Bank, Japanese government lending to the IMF of 3 billion SDR, and the Japanese government's $2.6 billion contribution to IDA-8 and $1.3 billion contribution to the Asian Development Fund. The Japan Special Fund will comprise grants of ¥30 billion mainly for technical assistance in connection with World Bank-supported projects and programs as well as for cofinancing World Bank-supported sectoral and structural adjustment loans. It also provides for expanded access for World Bank borrowings in the Japanese capital market, in an amount of ¥300 billion (a total of about $2 billion), to be spread over three years.

The second tranche will be provided to the developing countries during a three-year period, ending in 1990. Of this $20 billion, about $8 billion represents the additional fund raising by the World Bank in the Tokyo market in accordance with the agreement between the Japanese government and the World Bank, the establishment of Japan Special Fund for the Asian Development Bank and the Inter-American Development Bank similar to that already established in the World Bank, and contributions to multilateral development banks; more than $9 billion is for expanded cofinancing with the World Bank and other multilateral development banks by the Export-Import Bank of Japan, the Overseas Economic Cooperation Fund (OECF), and Japanese commercial banks, and/or additional OECF direct loans in support of developing countries' adjustment programs; and about $3 billion is for expanded direct loans to the developing countries through the untied-loan scheme of the Export-Import Bank of Japan.

Finally, Japan also intends to advance by at least two years its target to double its official development assistance (ODA) to developing countries under its Third Medium-Term ODA Expansion Program and to have ODA disbursements exceed $7.6 billion in 1990. In 1986 Japan's ODA rose to $5.6 billion; it replaced France as the second largest provider of ODA after the United States. Japan has traditionally extended much of its aid to developing countries in Asia, but in recent years has increased its grants to Sub-Saharan Africa.

tion program to be phased over three years. It provides for a reduction in projected 1988 tax revenue of up to DM14 billion (0.7 percent of GNP), by bringing forward parts of a reform planned for 1990.

As a complement to fiscal stimulation in Japan and Germany, the U.S. government reaffirmed its commitment to significant public spending cuts, in line with the revised targets of the Gramm-Rudman-Hollings Amendment aiming at budget balance by 1993. The federal deficit was already set to fall by more than 1 percent of GNP in fiscal 1987 because of the nonrecurring revenue effect of the 1986 tax reform and the prospect of high revenues from capital gains taxes.

The financial crisis of October 1987

While consensus on the need to correct payments imbalances now exists among the governments of the leading industrial nations, progress has been limited. Aligning economic policy to international objectives rather than domestic ones is difficult. The German government's reluctance to add to inflationary pressures with fiscal stimulation or to jeopardize its medium-term goal of budget consolidation is likely to preclude further fiscal expansion in the short term. Similarly, the United States has so far been unable to commit itself to a credible path of fiscal contraction. Moreover, even when governments agree on their joint goals, they often differ over ways and means.

The apparent stalemate contributed to a loss of confidence in financial markets. The G-7 decision to try to stabilize exchange rates before the announced fiscal measures proved damaging. In the United States it meant tightening credit after two years of modest monetary expansion. This caused a steep rise in interest rates between February and early October 1987. As a result the yield gap between bond and equity portfolios widened to more than 2 percent, well above past differentials. Allied to the perception that speculation had already driven equity prices too high, the yield gap induced a massive shift in international portfolios from stocks to higher yielding bonds. This was probably one of the triggers of the New York stock market collapse of October 19, 1987. The increasingly integrated global capital market transmitted New York's price falls to stock markets around the world.

The U.S. Treasury and Federal Reserve reacted

promptly, ensuring that liquidity in banking and financial markets was adequate to prevent a full-scale financial crisis. These steps restored some stability to the stock market, but they also provoked a temporary run on the dollar by rekindling fears of rising inflation. In late November and December 1987 the dollar dropped precipitiously. In nominal terms it reached postwar record lows against the yen and German mark. This turbulence has added greatly to the complexity of the problem and has narrowed policy options. To date, negative wealth effects associated with the stock market losses appear to have been overestimated. But uncertainty remains for the longer term, although forecasts of GNP growth for 1988 have generally been revised upward after favorable growth statistics were announced for late 1987 and early 1988.

The brightest note in the international economy is Japan's shift to domestically led growth. In 1987 its domestic demand and GNP growth accelerated to 5.0 and 4.1 percent, respectively; they are expected to decline only moderately in 1988. Japan's current account surplus declined to 3.6 percent of GNP in 1987 from a peak of 4.3 percent in 1986; the volume of exports is declining moderately, and imports are surging.

Recent trends in Europe are less favorable. High unemployment continues to restrain domestic demand and hold growth below potential in most countries of the European Community (EC). Exports and investment have been harmed by the recent currency appreciations against the dollar. Meanwhile the Federal Republic of Germany, Western Europe's largest economy, remains committed to a path of relatively restrictive fiscal policy despite real GDP growth of only 1.7 percent in 1987.

Policy options for macroeconomic adjustment in industrial countries

The risk of renewed weakness of the dollar puts policymakers in a quandary. A further rapid depreciation could push up U.S. inflation, raise domestic interest rates, and—if international investors become reluctant to hold dollar assets at prevailing yields—cause instability in financial markets. Alternatively, stabilizing the dollar might require continued currency intervention, monetary tightening in the United States, or a combination of both. This course, too, has its drawbacks. Heavy intervention might result in unwanted monetary expansion. Tighter credit and rising U.S. interest rates would increase the risk of a domestic recession and of a further disruption of the stock market. Concerted policy action by the main industrial countries therefore seems the only way to reduce payment imbalances to sustainable levels, avoid a recession in the United States, and set the stage for steady growth worldwide during the next decade.

The United States' low private saving rate means that it cannot safely maintain fiscal deficits as large relative to GNP as those of the other main industrial countries. Further fiscal action would reduce its aggregate domestic demand and its overall saving-investment deficit. To maintain adequate liquidity in financial markets and stimulate domestic investment, especially in export industries, the U.S. government should avoid tightening its monetary stance. With sufficient fiscal restraint it should be possible to achieve lower real interest rates and still contain inflationary expectations.

Fiscal contraction will be difficult. But without it tight money and the attendant risk of a domestic recession may be the only way to prevent further weakness of the dollar and stem an acceleration of inflation in the United States. Budget cuts amounting to $76 billion for fiscal years 1988 and 1989 were announced in November 1987 in the wake of the stock market crash. They are a step in the right direction. However, they may not suffice to cut the federal budget deficit to less than its 1987 level of $151 billion. Further reduction of the deficit is therefore needed.

Firm action along these lines can reduce the United States' external deficit, stabilize its ratio of net foreign liabilities to GNP, and gradually restore stability in currency markets. But rapid fiscal contraction and lower U.S. imports would depress the world economy. Unless a slowdown in domestic demand in the United States can be offset by increased demand in the countries with external surpluses, the correction of imbalances will be protracted and the risk of recession will increase. Under these circumstances Japan should maintain, and Germany accelerate, the growth of domestic demand by using a combination of monetary accommodation, fiscal expansion, and structural reform.

An accommodating monetary stance in both countries would help to keep down their interest rates, ease further downward pressure on the dollar, and permit a more flexible U.S. monetary policy. Fiscal stimulation will continue to be limited by domestic policy concerns. In Japan the need to reduce the existing burden of government debt is seen as paramount; Germany is unwilling to jeop-

ardize its successful reduction of fiscal deficits. As a minimum, however, both should refrain from further procyclical fiscal tightening. In Germany additional stimulation of investment—and improved investment efficiency—through tax cuts and reduced market rigidities would also be desirable. Appropriate steps include eliminating domestic subsidies, improving the flexibility of labor markets, and deregulating domestic trade and distribution. Finally, both countries could reduce barriers to trade, which combined with stronger domestic demand would also create new and much needed export opportunities for developing countries.

In contrast to Germany, several countries in Europe already face considerable pressure on their current accounts and are likely to incur deficits in 1988 and 1989. Since they also face rising domestic inflation, they are ill placed to offset the effect of U.S. contraction. However, smaller European countries with a strong external position—the Benelux group and Switzerland—could also contribute to the international adjustment process by increasing domestic demand, increasing imports, and improving the efficiency of their markets through structural reforms.

Finally, the two largest Asian NIEs could increase the momentum of global adjustment by reducing their current account surpluses. Lower import barriers and further currency appreciation in these countries would reinforce the benefits of increased domestic demand growth and of concurrent fiscal contraction in the United States.

These combined steps could translate into significant benefits for the global economy: a gradual reduction of international payment imbalances, greater financial stability, and falling unemployment would move the world economy to a higher growth path for the next decade. The benefits for developing countries would also be important. Strong growth in industrial countries would assist them directly through greater demand for their exports. In addition lower U.S. trade and budget deficits would lessen U.S. dependence on foreign savings and result in lower interest rates. This more favorable external environment would make it easier for developing countries to service their debt. If combined with measures to restore the creditworthiness of problem debtors and to facilitate new lending, the improvement in the global economy would also permit a reduction in the net resource transfers by developing countries. This, in turn, would enhance their prospects of sustained adjustment with growth.

Developing countries in the world economy

Until the end of the 1970s GDP growth in developing countries remained generally strong, continuing the trend of the 1960s (see Table 1.3). After 1980 their growth rates dropped from an average of 5.4 percent a year during 1973–80 to 3.9 percent for 1980–87. China and India were important exceptions because of major growth-promoting policy reforms during the 1980s (see Box 1.4). The decline can be traced in part to unforeseen changes in the world economy. These changes not only had a direct adverse effect; they also exposed the unsustainability of the macroeconomic policies that many developing countries had adopted during the 1970s. Those most profoundly affected had four things in common:

Table 1.3 Growth of real GDP, 1965 to 1987
(annual percentage change)

Country group	*Average, 1965–73*	*Average, 1973–80*	*Average, 1980–85*	*1986*	*1987*
Industrial countries	4.5	2.8	2.4	2.7	2.9
Developing countries	6.5	5.4	3.2	4.7	3.9
Low-income	5.5	4.6	7.4	6.4	5.3
Excluding China and India	3.4	3.4	3.0	4.8	4.5
China and India	6.1	4.9	8.6	6.8	5.4
Low-income Africa	3.6	2.0	0.7	3.7	3.0
Middle-income	7.0	5.7	1.6	3.9	3.2
Oil exporters	7.0	5.9	0.9	0.3	0.8
Exporters of manufactures	7.4	6.0	5.8	7.2	5.3
Highly indebted countries	6.9	5.4	0.1	3.5	1.7
High-income oil exporters	8.7	8.0	−2.5	−8.1	−2.9

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

- High levels of external debt
- Major macroeconomic imbalances, such as large fiscal deficits and high inflation
- Distorted and inflexible markets
- Unresponsive policies.

External factors impinged on these highly vulnerable economies in two main ways: through trade and through finance.

International trade

A healthy international trading environment is important for strong economic growth in developing countries. Most have small domestic markets that make them highly dependent on trade. Moreover their foreign exchange earnings can be volatile; exports often comprise only a small number of primary commodities, such as grains, tropical beverages, vegetable oils, or minerals. In 1985 primary commodities accounted for 72 and 51 percent of the total exports of low- and middle-income countries (excluding China and India), respectively. The proceeds from these exports are needed to pay for imports of manufactures, which are vital for continuing industrialization and technological progress. Shifts in the relative prices of commodities and manufactures can therefore change the purchasing power of the developing countries' exports dramatically, often with major repercussions for growth.

Between 1980 and 1986 the real prices of primary commodities fell sharply (see Figure 1.6). Several factors were at work. Slower growth in industrial countries had depressed demand. Over the longer term, shifts in technology continued to reduce the demand for industrial raw materials. Meanwhile supply had expanded. Growing subsidies and trade protection—as provided, for example, by the EC's Common Agricultural Policy—caused overproduction in the industrial countries. Output had also expanded in developing countries in response to the high prices of the early 1970s. Past investment in infrastructure, new techniques, and improved domestic policies also contributed.

Crude oil prices fell even more sharply than those of other primary commodities (see Figure 1.6). This posed serious adjustment difficulties for

Box 1.4 Economic progress and policy reforms in India and China

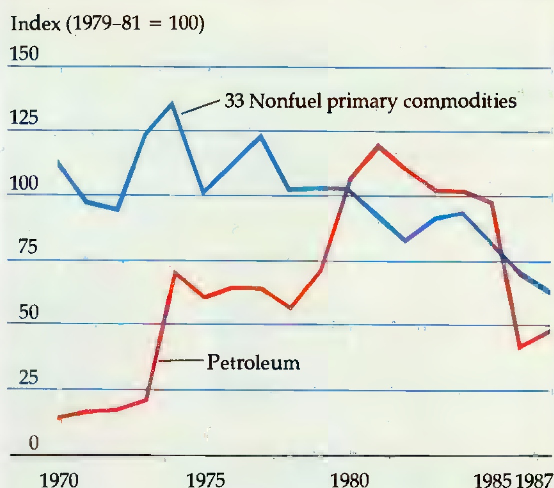
Among low-income countries India and China stand out with strong growth despite the worsening environment of the early 1980s. China, whose GDP had grown an average of 5.4 percent between 1973 and 1980, grew at 10.3 percent between 1980 and 1987; growth peaked at 12.7 percent in 1985. Average annual population growth remains relatively low at 1.6 percent, and the long-term per capita GDP is growing unusually quickly for the developing world. In some areas deep poverty persists. However, China's health, literacy, and life expectancy place it on a par with many middle-income countries. India suffered from declining terms of trade in the 1970s because of rising oil prices. Agricultural output also fell due to bad weather. GDP growth recovered in the early 1980s and averaged 5.0 percent during 1980–87. But population growth remains high, so per capita income growth averaged only 2.8 percent a year, and nearly half of India's population continues to live in poverty. Nutritional deficiency, infant mortality, and illiteracy also remain extremely high in many areas.

Considering their low income levels, both countries have uncommonly high saving rates and relatively low per capita external debt. China stands out with gross domestic savings of 34 percent of GDP in 1986, compared with 21 percent in India in 1987. For 1987 estimated long-term external debt as a share of GDP stood at 7 percent for China and 15 percent for India. In both cases this debt is predominantly from official bilateral and multilateral sources. Finally, both countries have achieved growth with low current account deficits: India's has averaged less than 2 percent of GDP since 1980, and China's has declined from a post-1980 peak of 4.2 percent of GDP to a small surplus in 1987.

Economic policies and internal reform in China

China owes much of its recent success to wide-ranging domestic reforms and sound economic management. It is undertaking a delicate transition from a strictly centrally planned economy to one where market forces are increasingly brought into play. The thrust of the most recent reforms was provided by the Central Committee of the Chinese Communist Party at its meeting of October 1984 and confirmed at the Thirteenth Party Congress in October 1987. The "command economy" is giving way to indicative planning, with the focus on long-term guidance, and reliance on free market transactions is increasing. These reforms build on those begun in 1979.

Following the gradual opening of the economy and the revitalization of agriculture after the communes were disbanded, economic reforms have been extended to industry and the towns. Price reform is a key



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

all oil exporters, including the high-income, oil-exporting countries. Growth in the latter group declined by an average of more than 3 percent from 1980 to 1987, compared with strong growth of 8 percent during 1973 to 1980. This abrupt shift in economic fortunes resulted directly from falling oil prices.

Starting in mid-1987, a better balance of supply and demand for non-oil commodities led to a small rise in the composite index of real commodity prices. Despite this improvement real commodity prices at the end of 1987 were still some 32 percent below the average for 1980–84.

Developing countries have differed greatly in their ability to respond to these changes. After the last significant peak in non-oil commodity prices in the late 1970s East Asia offset the decline in prices by stepping up the volume of primary commodity exports; the purchasing power of these exports therefore remained approximately unchanged (see Figure 1.7). In contrast, in Latin America and South Asia the volume growth of commodity exports was insufficient to compensate for declining prices, and their purchasing power declined. In

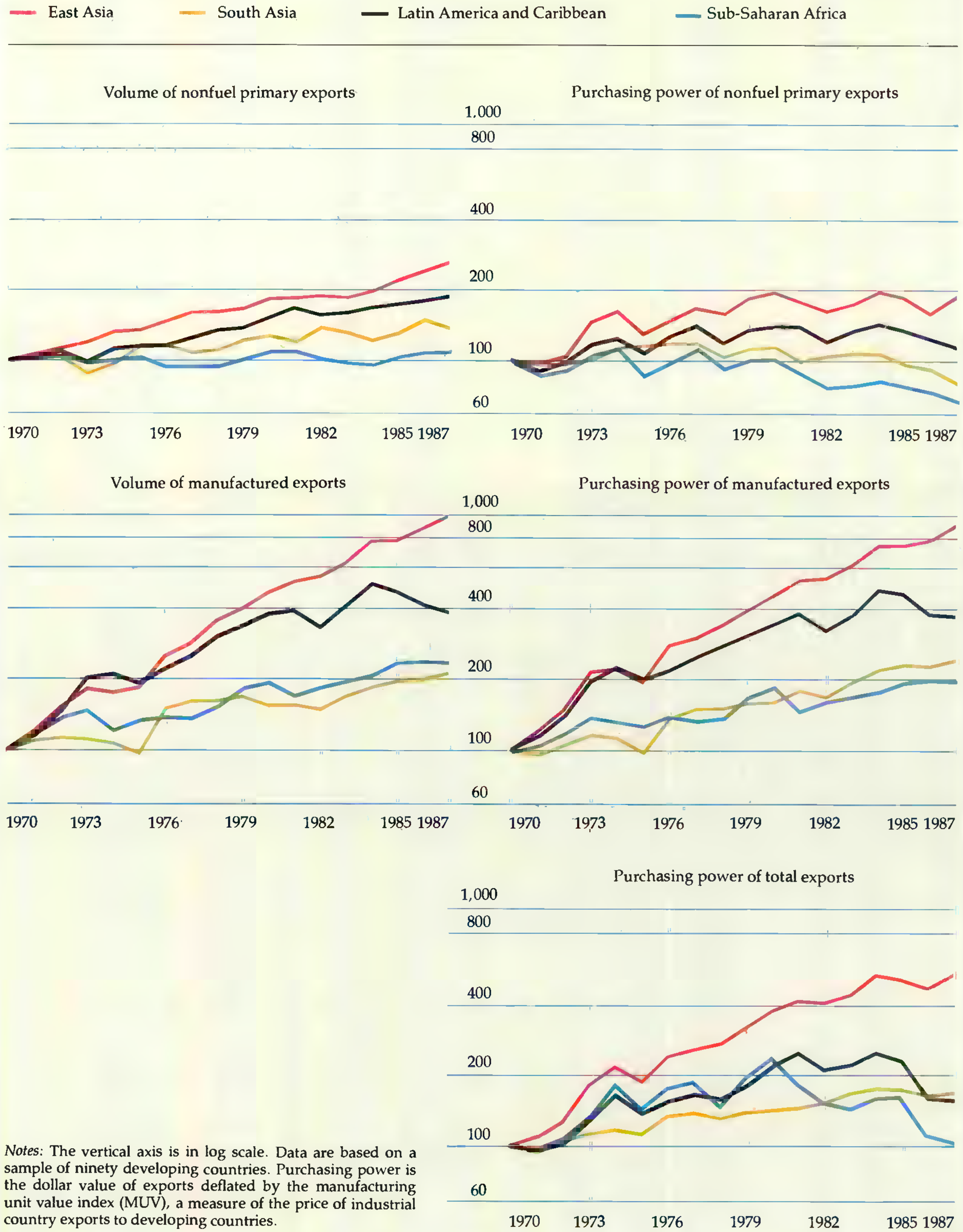
element. Macroeconomic management—including fiscal, credit, and pricing policies—is taking on a greater role. For example, a profit tax system has replaced the remittance of all enterprise profits to the state budget. Similarly, forced agricultural procurement has been replaced by contracts negotiated between farmers and procurement agencies. After a reform and decentralization of the banking system, interest rates are beginning to reflect the scarcity of capital. Management procedures are being reassessed at all levels. Foreign investment in joint ventures has been stimulated through tax and cost incentives, special economic zones, and special status for certain coastal cities. In January 1988 the government announced that it was aiming for export-led growth. The program has had its problems, however. Price reform has greatly increased the supply of food and consumer goods, but high inflation followed the fiscal and credit expansion after 1985.

Economic policies and internal reform in India

As well as striving for greater efficiency, competitiveness, and productivity, India's main challenge is to alleviate poverty and provide employment. The Seventh Plan, for 1985–90, addresses these problems directly. Overall it calls for maintaining the growth achieved under the Sixth Plan and aims for real GDP growth of 5 percent a year. In agriculture the plan gives the highest priority to completing irrigation schemes; in industry it emphasizes improvements in productivity. The plan stresses the need to keep food supplies up and prices down, both to protect the real income of the poor and to raise employment and productivity. It also emphasizes changes in economic policy. Unlike its predecessors the Seventh Plan calls for a greater role for the private sector and promises to provide the incentives needed to encourage private industrial investment. Measures taken during the Sixth Plan have already given entrepreneurs greater freedom. The Seventh Plan envisages further progress by easing licensing requirements and introducing more flexibility into pricing. It also calls for continued trade liberalization and emphasizes the promotion of exports.

In line with this plan several major initiatives have been undertaken to reform trade, industry, and public finance, for example by liberalizing imports of high technology products. Joint ventures with foreign investors are also being encouraged. The government is promoting exports by simplifying procedures, reducing export taxes, and facilitating forward cover of foreign exchange receipts.

Figure 1.7 Volume and purchasing power of exports by developing regions, 1965 to 1987
(index 1970 = 100)



Notes: The vertical axis is in log scale. Data are based on a sample of ninety developing countries. Purchasing power is the dollar value of exports deflated by the manufacturing unit value index (MUV), a measure of the price of industrial country exports to developing countries.

Sub-Saharan Africa purchasing power declined sharply as commodity export volumes stagnated. All these regions faced similar trends in prices. The differences between trends in purchasing power must therefore be attributed to varying degrees of flexibility in supply response. That response, in turn, depended in no small measure on the domestic policy environment (see *World Development Report 1986*).

The growth in the value of manufactured exports from developing countries also slowed considerably after 1980, from an average of 25 percent during the 1970s to 9 percent after 1980, while the rate of growth in the volume of exports declined from 13 to 9 percent during the same period. Again these declines were most pronounced in Latin America and Sub-Saharan Africa, where they compounded the loss in the purchasing power of non-oil commodity exports. However, even the best performers experienced a decline in the growth of exports of manufactures during the early 1980s, mainly caused by the recession and rising protectionism in industrial countries (see *World Development Report 1987*, chapter 8).

Changes in the purchasing power of total exports capture the overall effect of these changes in prices and trade volumes (see Figure 1.7). The four major country groups discussed above fared quite differently after 1980. The purchasing power of East Asia's exports rose by 45 percent from 1980 to 1987, after doubling during the preceding five years. In South Asia purchasing power of exports improved moderately, while in Latin America it fell by 26 percent. Sub-Saharan Africa fared worst. The purchasing power of its exports was cut by more than half between 1980 and 1987; this fully reversed the gains of the 1970s. The divergence can only be partly accounted for by differences in the structure of trade. Economic flexibility in responding to essentially similar external forces is the major factor. However, GDP growth in almost all developing countries has been retarded since 1980 by the slowdown in international trade (see Table 1.3).

To sum up, growth and trade policies in industrial countries have a direct bearing on export opportunities for developing countries. Steady growth and more liberal trade policies in industrial countries have benefits for the wider world economy. But the developing countries' own policies help to determine how vulnerable they will be to such external factors. Prudent macroeconomic policies and outward-looking trade strategies give developing countries greater resilience and flexibility. Box 1.5 illustrates the scope and need for domestic adjustment in Sub-Saharan Africa. With sound policies in place developing countries can generally preserve domestic growth, even in periods when the external environment deteriorates. In contrast, failure to adjust makes growth less certain.

External finance

Besides trade, the cost and availability of international finance are the other main external determinants of the economic performance of developing countries. The debt crisis has had a profound impact. One of the most urgent tasks facing the international community is to find ways of reducing the drag exerted by the continuing debt overhang on economic growth in the developing world.

DETERIORATION IN THE AVAILABILITY AND COST OF EXTERNAL FINANCE. Developing countries have traditionally been net importers of capital; their domestic savings are generally insufficient to meet their investment needs. The availability and cost of such external finance depend mainly on the overall size of the pool of exportable savings in capital-surplus countries and on the competing claims on that pool. During the 1980s both moved against the developing countries.

Between 1974 and 1982 the two oil price shocks had created a temporary savings surplus in high-income, oil-exporting countries. Their surplus funds were recycled to developing countries. This process is now well understood. In addition to increasing their development aid, high-income, oil-exporting countries placed much of their surplus oil revenue with international commercial banks in the form of short-term Eurodollar deposits. This contributed to raising liquidity in the international banking system because credit demand in the industrial countries had been depressed by the oil price shocks. Liquidity and monetary expansion in the industrial countries drove real interest rates down. It also prompted banks to compensate for the slack in their traditional markets by lending more to developing countries.

Commercial lending to developing countries—along with official lending and aid—grew very rapidly during this period. As a result the total medium- and long-term debt of developing countries rose fourfold in nominal terms, from about $140 billion at the end of 1974 to about $560 billion in 1982. In real terms it more than doubled (see Figure 1.8). Loans to central governments and

Box 1.5 Policy reform in Sub-Saharan Africa

In contrast to other developing regions, Sub-Saharan Africa has shown consistently weak economic performance over an entire generation. To make matters worse, during the 1980s per capita income has fallen to about three-quarters of the level reached by the end of the 1970s. Rapid population growth and external shocks have contributed to this, but weak economic management was a major cause. Africa's poor economic performance has now begun to erode the region's productive base and human resources. By the mid-1980s gross investment levels in many countries were too low to maintain the capital stock, and health care and education are now deteriorating.

However, many African governments have started to improve past policies. Their reform efforts can best be described as a slow process of important policy change that is gaining momentum. Changes cover a broad range of policies in many countries. Although reform was initially prompted by the austerity of the early 1980s, many African leaders now recognize that further reforms are essential for improved economic performance. At the U.N. Special Session on Africa in 1986, African governments submitted a Program of Action for African Economic Recovery and Development. That program recognizes the failures of past policies and stresses the need for sustained reform.

Commitment and action vary among countries. On balance, however, about half of the countries in Sub-Saharan Africa are already committed to serious reform. In some areas, especially where institutional and managerial changes are involved, progress is difficult to quantify. In other areas, such as fiscal and monetary policies and price incentives—where better data are available—the signs of progress are clear (see Box table 1.5). A number of countries have made positive adjustments. These include lowering real exchange rates, reducing fiscal deficits, and raising export crop prices. Policy reform has been greatest in countries whose adjustment programs have been sufficiently strong and sustained to be supported by World Bank program lending. Other countries have sometimes allowed policies to worsen.

Most adjusting countries have also taken steps to restructure public employment; rationalize and improve management in public enterprises; lift price and trade controls, both domestically and externally; and strengthen government economic management—especially in public investment programming.

The severity of Africa's structural economic imbalances and the vulnerability of African economies to the external environment often obscure the impact of reform efforts on economic performance. Moreover it takes considerable time to increase growth, and progress is often spread unevenly across countries and sectors. Although comparisons between countries with and without strong reform programs can be made difficult by the uneven effects of exogenous factors such as export prices and weather, evidence shows that adjustment is generally conducive to growth. For example, excluding countries recently affected by strong external shocks (both positive and negative), growth in reforming countries accelerated from an average of 1 percent during 1980-85 to nearly 4 percent during 1986-87. By contrast, growth in nonreforming countries, also 1 percent in the earlier period, barely increased during 1986-87. In most cases reform has helped to alleviate poverty by raising agricultural incomes and improving the efficiency of public spending on infrastructure and key social services.

Reform efforts in Africa are impressive. But given the uncertain global prospects and severe constraints such as high population growth, countries with adjustment programs must deepen existing reforms. Others still need to adopt and implement adjustment programs. Industrial countries and multilateral financial institutions, in turn, must persevere in their support of African adjustment through increased aid and debt relief.

Box table 1.5 Key reform indicators

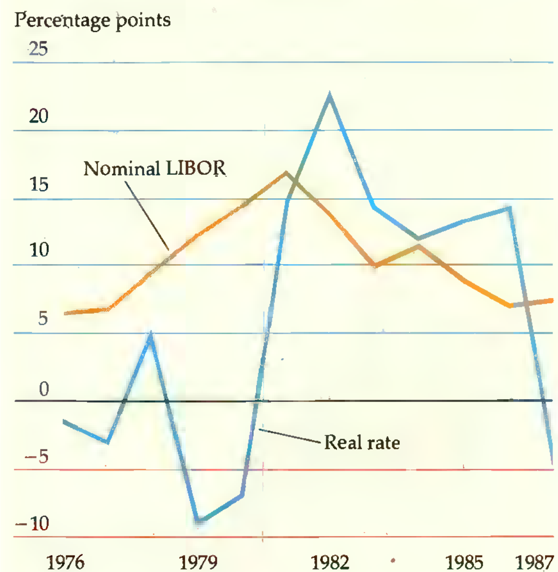
Indicator of reform	*Period*	*Countries with strong reform programs*	*Countries with weak or no reform programs*
Fiscal deficit	1980-82	8.2	7.4
(percentage of GDP)	1987	5.2	8.1
Real effective exchange rate			
(1980-82 = 100)	1987	69	79
Inflation	1980-82	19	16
(annual percentage)	1987	15	38
Commercial bank lending rates	1980-82	−3.5	−2.2
(real)	1987	4.7	−11.6
Agricultural incentives			
Export crop prices			
(real, 1980/81-82/83 = 100)	1986/87	153	114
Food crop prices			
(real, 1980/81-82/83 = 100)	1986/87	122	94

Note: Depending on available data, twelve to seventeen countries have been included in the group of reforming countries and six to ten in the group of nonreforming countries, depending on the indicator. Averages are unweighted.

state-owned enterprises were especially favored by commercial banks. Because of their sovereign status these entities were considered to be low risk. Developing countries were happy to take advantage of this unaccustomed access to cheap loans with few strings attached. They stepped up their commercial borrowing. This enabled them to maintain domestic growth and to finance major public investment programs, especially in the energy sector. With hindsight it is clear that lending and borrowing decisions were often imprudent and resulted in excessive indebtedness in a number of countries. New funds were often channeled into low-yielding investments. And in a number of countries borrowings fueled a flight of capital that drained the pool of resources for investment even as the burden of foreign debt mounted.

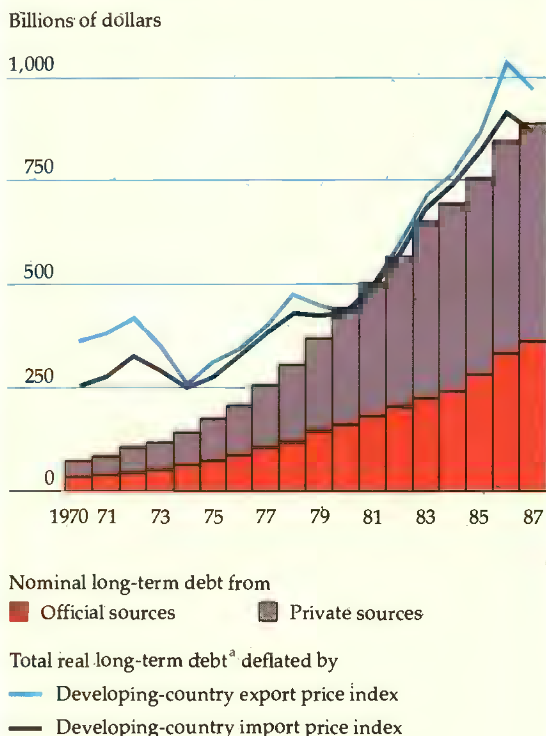
The early 1980s were a turning point. The shift toward anti-inflationary macroeconomic policies in industrial countries led to a rapid rise in nominal interest rates. Developing countries with large foreign debts were hit hard. The combination of higher interest rates and lower export prices for non-oil commodities led to soaring real costs for all forms of new and existing debt (see Figure 1.9). The Mexican debt crisis of August 1982, triggered in part by these factors, precipitated an abrupt loss of confidence in the creditworthiness of many highly indebted countries. Voluntary lending to most of them came to a standstill. Finally, from 1982 onward, the rapid deterioration of the U.S. saving-investment balance caused the United States to stake a bigger claim on the world's savings at a time when the savings surplus of the high-income oil exporters was falling along with the price of oil.

Figure 1.9 Interest rates on external borrowings of developing countries, 1976 to 1987



Note: The nominal rate is the average six-month dollar LIBOR during each year; the real rate is the nominal LIBOR deflated by the change in the export price index for developing countries.

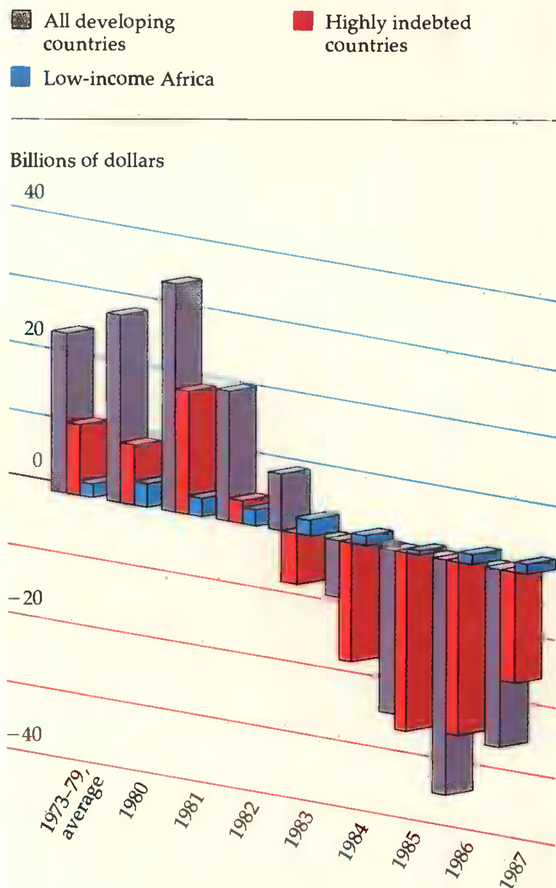
Figure 1.8 Long-term external debt of developing countries, 1970 to 1987



a. Real debt is the nominal dollar value of debt, deflated by the relevant price index using 1980 as the base year.

IMPLICATIONS OF THE DETERIORATION IN EXTERNAL LENDING. Rising debt service and the cut in lending led to a reversal of net resource transfers to developing countries. In the five years to 1982 developing countries received positive net resource transfers of $147 billion through long-term lending (including concessional loans). Since 1982 resource transfers have become negative, totaling $85 billion. The shift in resource transfers was especially

Figure 1.10 Net resource transfers to developing countries, 1973 to 1987



Note: Net resource transfers are defined as disbursements of medium- and long-term external loans minus interest and amortization payments on medium- and long-term external debt.

pronounced for the highly indebted, middle-income countries. Their net resource transfers of $61 billion in 1978–82 became a net loss of $93 billion—or more than 2 percent of their aggregate GDP—in the next five years (see Figure 1.10). In addition, as interest costs soared and export revenue stagnated, the cost of servicing their long-term external debt increased as a proportion of exports of goods and services from 27.1 percent in 1980 to 38.8 percent in 1982 (see Table 1.4).

The drain of resources forced many countries to undertake rigorous domestic adjustments. Limited access to foreign financing meant that current account deficits had to be cut back after 1982 (see Table 1.5). This in turn meant that trade balances had to move strongly into surplus. For the seventeen highly indebted countries, for example, an aggregate trade surplus of only $2 billion in 1982 had to be turned into an average annual trade surplus of $32 billion during 1983–87. This could be achieved only through import compression, lower investment, and reductions in per capita consumption; between 1980 and 1987 the imports of the highly indebted countries declined at an average annual rate of 6.3 percent, investment at 5.3 percent, and per capita consumption at 1.6 percent. In the twenty-two debt-distressed, Sub-Saharan African countries per capita consumption dropped by about 3.2 percent a year and investment by 2.6 percent a year between 1980 and 1986. The debt crisis of the 1980s thus dealt a double blow to the more vulnerable developing countries. Reductions in per capita consumption lowered economic welfare immediately, while large cuts in investment threatened the potential for future growth.

THE DEBT OVERHANG PERSISTS. The outright financial collapse that many had feared has not happened. It was averted through a combination of debt reschedulings by private and official creditors, expanded lending by international agencies, and substantial adjustment efforts in the debtor countries themselves. At the same time commercial banks have managed to reduce their exposure to debtor countries and build up their reserves and capital. More recently, substantial loan loss provisions have further strengthened the banks against possible defaults or debt moratoria. Finally, regulatory changes governing capital adequacy and portfolio risk have made a return to the excessive lending of the 1970s less likely. In many important ways, therefore, the past few years have seen considerable success in averting what might have been a deeper crisis.

However, the debt overhang remains an obstacle to growth in the debtor countries and a threat to the world economy. The outstanding long-term debt of developing countries has continued to increase since 1982 (see Figure 1.8); the total external debt of highly indebted countries rose from $390 billion in 1982 to an estimated $485 billion at the end of 1987. Valuation effects caused by the decline of the dollar account for most of the increase since 1985. The rest reflects increased official lending—especially in support of stabilization and adjustment programs—and, to a lesser extent, involuntary bank lending as part of debt reschedulings.

Most indicators of creditworthiness continued to

Table 1.4 Debt indicators in developing countries, 1975 to 1987
(percent)

Country group and debt indicator	*1975*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*[a]
All developing countries									
Debt service ratio	13.7	16.2	17.9	21.0	19.7	19.5	21.8	22.6	21.0
Debt-GNP ratio	15.7	20.7	22.4	26.3	31.4	33.0	35.9	38.5	37.6
Highly indebted countries									
Debt service ratio	24.0	27.1	30.7	38.8	34.7	33.4	33.9	37.7	32.7
Debt-GNP ratio	18.1	23.3	25.6	32.4	45.4	47.5	49.5	54.1	55.9
Low-income Africa									
Debt service ratio	10.2	13.6	14.6	14.2	14.2	15.1	17.9	19.9	34.7
Debt-GNP ratio	25.2	39.8	44.2	48.0	55.1	62.0	68.9	72.1	76.2

Notes: Data are based on a sample of ninety developing countries. The debt service ratio is defined as the dollar value of external debt payments (interest and amortization) on medium-and long-term loans expressed as a percentage of the dollar value of exports of goods and services. The debt-GNP ratio is defined as the dollar value of outstanding medium-and long-term debt expressed as a percentage of dollar GNP.
a. Estimated. Ratios do not assume further buildup of arrears. This accounts for the sharp increase in the debt service ratio for low-income Africa in 1987.

deteriorate until 1986. Despite a modest improvement in 1987 they are still worse than in 1982. In other words, despite drastic cuts in the growth of aggregate domestic demand (from an annual average increase of 5.8 percent between 1973 and 1980 to less than 1 percent during the next seven years), the highly indebted countries have seen little improvement in exports and a severe decline in economic growth. Poverty is on the rise (see Box 1 in the Overview). In several countries the economic and social costs of prolonged retrenchment are causing adjustment fatigue.

Negotiations between creditors and debtors have gradually become more confrontational. In 1985 Peru announced that it would limit the servicing of its long-term public debt to 10 percent of its export revenues. In 1986 it applied the ceiling to private sector debt as well. In February 1987 Brazil suspended debt service payments on medium- and long-term debt owed to commercial banks; after protracted negotiations with its creditors it started to clear up its payment arrears in early 1988. In November 1987 U.S. bank examiners came close to declaring Brazilian debt "value impaired," which would have required large write-offs by creditors. Unilateral restrictions on debt service threaten economic performance in the longer term because they inevitably disrupt access to short-term trade finance and to longer term development funds.

Future defaults and moratoria might yet occur. This danger remains a potential threat to the stability of the international financial system. Moreover, import compression in the highly indebted coun-

Table 1.5 Current account balance, 1973 to 1987
(billions of dollars)

Country group	*Average, 1973–79*	*Average, 1980–82*	*1983*	*1984*	*1985*	*1986*	*1987*
Industrial countries	−5.1	−34.9	−23.3	−60.8	−50.4	−19.7	−50.3
Developing countries	−27.5	−82.2	−44.7	−18.5	−23.5	−21.3	2.1
Low-income	−3.4	−9.7	−2.7	−4.2	−22.4	−16.6	−9.6
Excluding China and India	−3.6	−8.5	−4.9	−4.2	−5.7	−5.3	−5.9
China and India	0.1	−1.1	2.2	0.0	−16.8	−11.2	−3.6
Low-income Africa	−2.3	−5.8	−3.5	−2.9	−2.9	−3.2	−4.4
Middle-income	−24.1	−72.5	−42.1	−14.3	−1.1	−4.7	11.7
Oil exporters	−5.8	−15.6	−5.9	3.2	0.1	−18.5	−8.8
Exporters of manufactures	−10.2	−25.9	−5.8	5.2	−4.7	10.3	25.9
Highly indebted countries	−14.2	−43.4	−13.9	1.0	0.6	−11.4	−7.2
High-income oil exporters	22.7	53.6	−0.2	1.7	7.4	2.7	1.0

Notes: The total current account balance for industrial, developing, and high-income, oil-exporting countries is less than zero primarily because of counting and measurement discrepancies in the balance of payments reporting, especially on trade in services and on the income of foreign assets.

tries is hampering the export growth of the industrial countries—especially the United States. From 1980 to 1986 the U.S. trade balance with Latin America turned from a surplus of around $2 billion to a deficit of $13 billion. As long as debt service continues to absorb a large part of the debtors' export revenues, their imports will not revive and global economic growth will suffer.

Dealing with the debt overhang: the need for a comprehensive framework

There can be no simple, single solution to the debt problem: a comprehensive framework is needed. Its main objectives should be, first, to enable debtor countries to allocate more resources to investment and consumption and, second, to strengthen their creditworthiness, thus eventually permitting a resumption of voluntary commercial lending. Debtors and creditors alike stand to gain from such an approach. As creditworthiness is restored, the secondary-market discounts on outstanding debt—which exceed 50 percent for many of the highly indebted countries—would drop. Moreover the debtors' improving growth prospects would enable them to import more from the industrial countries. That would assist in the global correction of external imbalances.

A framework to reduce the burden of debt must have two elements. First, the debtors need to grow faster and export more. Second, the cost of debt service must fall. With the right policies in both industrial and developing countries, these elements can go hand-in-hand.

STRUCTURAL ADJUSTMENT. The key to faster growth and better export performance is the more efficient use of domestic resources in both the public and private sectors. Macroeconomic stabilization needs to be supported by sectoral policy reform in trade, agriculture, industry, energy, and human resources. This affects the use of public resources directly and influences the use of private resources through improved incentives of taxes, subsidies, and regulation. Countries such as Colombia, Indonesia, Republic of Korea, and Thailand were able to avoid major debt problems mainly because of their relatively sound economic policies. In other countries, though, once access to foreign capital was lost, investment dropped. As a result those countries found it harder, economically and politically, to reform domestic policies. The programs of structural adjustment that are now being pursued in several highly indebted countries are therefore designed to permit faster economic growth by improving the economies' supply response.

NEW EXTERNAL CAPITAL INFLOWS. Capital inflows from official and commercial sources can help to finance new productive capacity and provide support for policy reform and growth. This has been the rationale for the balance of payments support provided by the IMF and the World Bank. For the foreseeable future, however, new lending is likely to remain scarce. In any case it will help only if used efficiently. Turkey shows that a combination of good policies, ample supplies of external funds—including aid—and a favorable external environment can successfully restore creditworthiness through growth. For low-income countries, new external capital, especially from official sources, is essential. Unfortunately, many low-income countries have suffered a decline in lending from industrial country governments. For example, disbursements of long-term bilateral official loans to low-income African countries declined from $2.1 billion in 1981 to $1.2 billion in 1986, reinforcing the fall in net resource transfers. Japan's recent initiative to increase grants and concessional flows to developing countries is, therefore, most welcome (see Box 1.3).

A BETTER TRADING ENVIRONMENT. As discussed above, favorable prices for developing-country exports and unimpeded access to growing markets in industrial countries can greatly strengthen the effectiveness of both domestic policy and external finance. Slower growth and increased protection in the industrial countries have narrowed export markets and depressed commodity prices for the debtors. The industrial countries should reverse the trend of rising protectionism—for their own benefit, as much as for that of the developing countries.

LOWER INTEREST RATES. Long-term solvency depends directly on the cost of debt. A simple rule of thumb is that if the real interest rate exceeds the rate of growth of exports, the debt service ratio will tend to rise. Between 1981 and 1986 this condition held for the developing countries in general, and for the highly indebted countries in particular. Conversely, lower interest rates can significantly reduce the debt service burden over time. For the highly indebted, middle-income countries, at their present level of external indebtedness, every percentage point decrease in the cost of debt service

would lower their interest burden by an estimated $5 billion and reduce their debt service ratio by about 4 percentage points. Economic policies in the industrial countries—especially the stance of U.S. fiscal and monetary policy—determine interest rates worldwide. A return to low and stable interest rates would significantly improve the prospect of a gradual release from the debt overhang.

Debt restructuring and debt relief. Another approach is to alter the profile of debt service through debt restructuring. Depending on its terms, restructuring may involve nothing more than a deferral of debt service, leaving the discounted present value of total debt service unchanged. Alternatively it may involve an element of debt relief. This, in turn, might be either "nonconcessional," in the case where a trade in debt instruments lets the debtor share in a market discount, or "concessional," in the case where it involves the provision of public funds or explicit forgiveness of debt.

The need for alternative forms of debt restructuring—and their feasibility—will vary from country to country and over time. At its outbreak the debt crisis was commonly viewed as a problem of lack of liquidity; debt restructuring emphasized rescheduling with generally little relief. Subsequently awareness grew that the debt problems of some countries involved more fundamental issues of solvency, and a secondary market developed for the debt instruments of highly indebted developing countries. The development of this market resulted in a range of nonconcessional instruments for debt restructuring and relief, generally known as the "menu approach." It includes transactions such as debt-equity swaps, securitization, and interest capitalization (see Box 1.6). For some of the highly indebted countries these instruments have been used effectively in combination with domestic policy reforms and new money packages from commercial and official sources. The World Bank is actively supporting these developments (Box 1.7).

Concessional debt relief usually follows the recognition by creditors that a country's limited prospects for growth and expanded exports will limit its ability to regain solvency, even with effective domestic policy reform, injections of new money, or changes in the timing and structure of debt. Precedents for concessional debt relief exist. One example is the United States' cancellation of large war debts after World War II. This contributed to the successful postwar reconstruction of Europe. In contrast, the debts and reparation obligations after World War I were among the factors that led to protracted economic difficulties. Moreover bilateral official debts of some low-income developing countries have been forgiven by many industrial countries. Expanded programs of concessional debt relief for the poorest countries, complementing domestic policy reform and supported by additional aid, are undoubtedly needed, especially for Sub-Saharan Africa. The debt of these countries consists mostly of official claims, so decisions about debt relief lie squarely with industrial country governments. The Venice economic summit of June 1987 endorsed the principle of concessional relief for the poorest countries. Recent progress and further options in this area are discussed in the World Bank's *World Debt Tables 1987–88.*

The issue of debt relief for the highly indebted, middle-income countries is more complex because prospects for medium-term growth are reasonable for some countries, assuming satisfactory domestic policies. Moreover some countries have succeeded in significantly expanding their exports with realistic exchange rate regimes and appropriate incentive frameworks. The bulk of their debt is owed to commercial creditors. Because of the substantially better economic prospects and higher per capita income of the middle-income countries, most official donors have not been willing to provide concessional financing in face of the growing demands of low-income countries and the scarcity of aid resources. Under these circumstances restructuring and nonconcessional relief (that is, debt reductions not exceeding market discounts) have been seen as the appropriate course of action for addressing their debt problems, with few exceptions. There nevertheless are a few highly indebted, middle-income countries whose per capita income figures are misleading because they reflect an enclave economy based on mineral exports. In such countries the debt is so great, compared with the productive potential of the nonmineral part of the economy, that with the nonconcessional instruments available a return to creditworthiness and growth remains very far off. If the international environment were to deteriorate substantially, many more countries could fall into this category. There is the challenge for creditors, debtor countries, regulators, tax authorities, and multilateral financial institutions to find new financial options, including ways to pass on current market discounts on debt to the debtor countries under case by case, market-based approaches.

In sum, progress is needed simultaneously on many fronts. Measures to improve the interna-

Box 1.6 Comparing alternative financial options to reduce the debt overhang

The Baker Initiative of September 1985 proposed a change of course in dealing with the debt overhang. It emphasized the importance of resumed lending to support growth and adjustment in highly indebted countries. Despite its merits this initiative has fallen short of its objective to date. Commercial lending failed to reach projected levels because of the banks' perception that "defensive" lending may not improve the value of loans already in their portfolio. Large discounts in the secondary market for developing-country debt play a crucial role in this respect: lenders assume that the market will value new loans at much less than book value.

Under these circumstances commercial banks have divergent long-term interests in their dealings with the developing countries because of the varied size and composition of their loan exposure. This stands in contrast with the period immediately after 1982, when most commercial lenders shared an interest in concerted lending to protect the financial system and gain time to reduce their individual exposures to developing countries. Now that both objectives have largely been accomplished, many smaller banks are trying to leave the debt-restructuring process—even at the cost of substantial write-offs—to redirect their lending to more traditional activities. The core of concerted lending now comprises the major international banks that have established branch networks in debtor countries or whose corporate clients are also active in those countries. Thus, depending on their business strategies, banks are eager to explore new options to reduce the risk of participating in "new money" packages, to improve the quality of existing exposures, or to seek "exits" to eliminate or reduce such exposures. Some of these options—which make up the so-called "menu approach"—are reviewed below. They can be attractive to borrowers as well as lenders. They can be a source of new funds for reducing exchange rate risk on existing debt and a means of reducing the debt burden through debt relief. All depend on voluntary cooperation between debtors and creditors.

- *Foreign direct investment (FDI)* can generate inflows of new capital. As distinct from loans, the return on FDI varies with the quality of the investment and the state of the economy; by definition investors share these risks. But potential political unrest and the unfavorable economic climate in most highly indebted countries may lead prospective foreign investors to seek appropriate risk coverage before committing themselves. The Multilateral Investment Guarantee Agency sponsored by the World Bank could play a useful role in this context. Even so the volume of investment flows is unlikely to make up for the current shortfall in lending or to provide a positive net inflow of resources. As investments bear fruit, foreign profit remittances through dividend transfers could exceed normal servicing of interest-bearing debt and thus put additional strain on the current account of debtor countries.
- *Debt-equity swaps* are a variation on FDI. They convert foreign currency debt into domestic currency investment, rather than serve as a channel for new money. Such swaps alter the debtors' obligation and reduce their interest-bearing external debt. As discussed in the *World Development Report 1987*, debt-equity swaps have covered substantial amounts of debt, especially in Chile and Mexico. They could become vehicles for the repatriation of flight capital. However, since domestic currency is usually offered at a discount to investors, swaps can distort the allocation of resources: investments of marginal economic return may be undertaken. In addition the increase in the domestic money supply resulting from the conversion of foreign currencies may prove inflationary. On balance, though, debt-equity swaps are a useful item on the "menu." If used carefully, they can help to revive the momentum of productive investment. They can be used as "exits" by existing creditors if the original loan is sold to a third party before the swap, and they can provide a vehicle for repatriating flight capital.
- The *conversion of existing loans into local currencies* is a variety of swap. It too can be a vehicle for repatriating flight capital, as well as alleviating the drain on foreign currency resources. The most serious drawback is that since domestic interest rates in the debtor countries are usually high, increased debt-servicing costs may exacerbate domestic fiscal problems.
- Other forms of noninterest-bearing capital include instruments such as *performance bonds* or *commodity-indexed bonds*. Service is conditional and tied to the debtor's economic growth, or to an export price index for major commodities. Innovations of this sort are unlikely to reduce the debt overhang significantly, but they can be another source of "new money."
- *Financial engineering and liability management* are techniques that aim to cushion interest rate and currency shocks to debtor countries through hedging. For instance, interest rate swaps and interest rate caps reduce the interest rate sensitivity of existing liabilities by converting floating-rate borrowings into fixed-rate liabilities or by putting a ceiling on future interest rates. Similarly currency swaps can hedge currency exposure and alter the currency mix of a debt portfolio to match the composition of the debtor's export revenues. Financial hedges of this type involve a risk for the provider of the hedge that the purchaser—in this instance the debtor country—will not fulfill his obligations when the contract matures. This restricts use of these techniques to borrowers that have remained creditworthy, unless the risk can be guaranteed by a creditworthy

third party.

• *New contractual arrangements* between debtors and lenders are another possibility. Debt-equity swaps and the renegotiation of interest spreads over LIBOR (London Interbank Offered Rate) and of loan maturities in debt reschedulings have set the legal precedents. One idea is to subordinate existing debt to future loans, thus giving the latter senior status. This could prevent new credits from being marked down in line with secondary-market prices and thus make it easier to attract new lenders. But current creditors might object if this practice became widespread. *Securitization*, which transforms traditional bank loans into negotiable securities, is another legal variant. It can be a channel for debt relief if the exchange of securities for loans reflects market prices and passes the discount on to the debtor. Mexico's novel scheme of December 1987 was a hybrid. It combined the features of securitization (by exchanging existing loans for tradable securities) and subordination (by deeming the collateralized securities "senior" to the remaining old loans). In this case "seniority" stems from the fact that the collateral (a zero-coupon U.S. Treasury bond with a present value equal to that of the new securities) guarantees the repayment of principal, although not of the interest on the new bonds. Despite its limited success this scheme sets a precedent for market-based debt relief: it passed some of the market discount to the debtor.

• In the same vein *partial write-offs* of existing loans could be an effective way of sharing the burden between debtors and creditors as well as providing debt relief. But write-offs raise delicate operational, accounting, and regulatory problems. Views differ over the banks' contention that partial write-offs are incompatible with existing accounting practices because these require an "all or nothing" approach. Clarification of these rules is essential. Partial write-offs recognize that the book value of developing-country loans is at odds with their market value, and they secure tax deductions. If set between existing secondary market value and nominal principal, they can provide an equitable formula for limited debt relief. They can thereby improve the borrowers' creditworthiness and debt-servicing capability, as well as improve the market value of existing loans.

• Finally, *partial or complete interest capitalization* is a constructive alternative to accumulating new loans to finance interest due. However, under U.S. banking regulations capitalization is currently tantamount to nonpayment: the loans involved would be declared nonperforming. A change in regulations will be needed to make this approach viable. Moreover, automatic interest capitalization may prove unacceptable to commercial creditors, most of whom will prefer to keep the refinancing of interest a matter for negotiation.

tional outlook, domestic policy reform, new money, and creative debt-restructuring approaches are all necessary. The right mix of ingredients will vary from case to case. Prospects for the next decade will depend on how effectively the broad policy framework outlined above can be implemented by all those concerned: industrial and developing country governments, commercial banks, and multilateral financial institutions. The next section examines the outlook for the world economy under alternative policy scenarios.

The outlook for the world economy until 1995

Growth in the world economy to the mid-1990s will largely depend on the extent to which governments in industrial countries address the policy issues identified above. This section presents alternative growth paths: a "base case," which assumes that the industrial countries will leave their policies broadly unchanged, and a "high case," which assumes that they will change them to conform with the guidelines spelled out in this chapter.

The base case

The assumptions underlying the base case scenario are as follows.

- Driven by circumstance as much as by design, fiscal policy in the United States will gradually, but fitfully, become more restrictive. The federal budget deficit will follow the broad targets set by the amended Gramm-Rudman-Hollings Act.
- Fiscal action in Japan and Germany will be confined to preventing a significant decline in domestic demand.
- Monetary policy in the major industrial countries will avoid increases in real interest rates.
- Industrial countries will pursue no major structural reforms, and protectionism will persist at roughly its present level.
- The world economy will encounter no shocks, such as a sharp change in the price of oil.
- Developing countries will continue their adjustment efforts at a pace similar to that in the recent past.

Under these conditions exchange rates and financial markets are likely to remain highly volatile. The threat of further stock market crashes, rising inflationary expectations, and the restrictive influence of U.S. fiscal contraction would depress domestic demand in the United States. This would be

Box 1.7 How the World Bank supports the highly indebted, middle-income countries

The World Bank's strategy for assisting the highly indebted, middle-income countries is based on the premise that the resumption of growth is an essential condition for their return to creditworthiness. The resumption of growth, in turn, hinges both on domestic policy reforms and on the adequacy of external finance. It also requires a supportive, international economic environment—above all, access to growing export markets and favorable interest rates.

More specifically the Bank's strategy calls for:

- Policy analysis and dialogue with member governments to identify the needed structural changes and to gain agreement on the required reforms
- Financial support for implementing structural reforms, often in the form of fast-disbursing, policy-based operations
- Sustained investment financing, refocused as necessary on rehabilitating and restructuring projects, enterprises, and investment programs, as well as expanding productive capacity
- Continued efforts to alleviate poverty, including measures to cushion the effect of adjustment on the poorest groups
- Assistance in mobilizing financial support from commercial and official lenders.

The difficulties faced by the debtor countries require a sustained policy effort and continuing external assistance as part of a medium-term adjustment framework. The Bank's support is tailored to specific country circumstances and problems. The pace of lending and the mix between adjustment and project lending varies among countries and depends on a variety of factors, such as the borrower's efforts to reform, project lending opportunities, and the Bank's own guidelines on prudential exposure levels. Typically lending plans are made up of a series of operations, each intended to address specific adjustment and investment requirements.

The Bank plays a catalytic role by mobilizing the needed new financing from commercial banks (and other sources) or by encouraging other forms of financial relief, including debt conversion and reduction. The Bank's efforts have focused particularly on commercial lenders. These provided by far the largest financing to the middle-income countries in the past but have reduced their net lending precipitously in recent years. As a result reforms in many countries are in danger of being underfunded.

The Bank's catalytic influence has traditionally been achieved through the example of its own lending and the signal of its confidence in the policy reforms undertaken by the debtor. Beyond this the Bank can—and does—play a more specific role on a case-by-case basis, by making use of formal linkages between its own lending and that of other lenders and, more rarely, by providing partial guarantees on commercial financing.

Changing priorities within the banking industry have widened the possibilities for providing cash flow relief both through new money and through the consensual debt reduction schemes summarized in Box 1.6. Consistent with its charter and policies, the Bank will seek to foster these market developments as a means of financial relief for its borrowers. For example, the Bank and its affiliate, the International Finance Corporation, have supported debt conversion by their assistance for policy reforms aimed at privatizing public enterprises. The Multilateral Investment Guarantee Authority will further enhance these schemes. The Bank has also supported market-based debt reduction schemes, as in Mexico, by agreeing to the establishment of a collateral trust by the debtor.

In performing a catalytic role, the Bank seeks to ensure, on a case-by-case basis, that the financing plan it supports is well designed and reflects an adequate level of burden sharing by commercial banks. Credit enhancement is provided only when it is seen as essential to close the transaction and when the added exposure that it entails for the Bank is acceptable in light of the Bank's overall country exposure.

only partly offset by increases in export demand resulting from the recent depreciation of the dollar. Growth in the other industrial countries and in the East Asian NIEs would also slow down, because of the slump in exports to the United States and the instability of financial markets. The U.S. current account deficit might fall to around 2 percent of GNP in the early 1990s, or roughly half its level in 1987. The ratio of U.S. net external liabilities to GNP would stabilize by the early 1990s. The current account surpluses of Japan and Germany would be correspondingly smaller.

This reduction of imbalances, although painful in the short term, would avoid a major world recession. For the longer term the scenario can be regarded as cautiously optimistic, since it sets the stage for somewhat faster growth in the early 1990s. If, subject to the assumptions above, macroeconomic policies in industrial countries are reasonably well managed, a modest economic recovery could follow in the early 1990s. Investor and consumer confidence might improve, and, in response to more stable financial markets, real interest rates would decline. As capital stocks were re-

built, the capacity for noninflationary growth and reduced unemployment would also improve. Under these circumstances real GDP growth in industrial countries should eventually return to rates similar to those of the turbulent 1970s and 1980s. Between 1987 and 1995, however, average industrial country growth would be 2.3 percent, or slightly less than that for 1980–87 (see Table 1.6).

For many developing countries, especially the highly indebted, middle-income countries and the low-income countries of Sub-Saharan Africa, this base case is decidedly unpromising. The prospect is for the demand for developing-country exports to slow down and for the real cost of servicing foreign debt to remain close to its 1987 level. Their economic growth will therefore be weak at best. For the most vulnerable countries—Sub-Saharan Africa, the highly indebted countries, and the oil-exporting countries—per capita incomes would stagnate or increase only slowly from their current depressed levels (see Table 1.7). The countries' debt service burden would remain high (see Table 1.8). The tensions in the international financial system would remain, and the willingness of both creditors and debtors to search for cooperative solutions to the debt problem would continue to be strained.

This is a fragile situation—one that could rapidly deteriorate. For example, a tightening of U.S. money supply intended to stabilize the dollar might trigger a world recession instead. The process might begin as a repetition of the events of late 1987: a steep drop in stock markets worldwide followed, after a lag, by a further substantial fall in the dollar as international investors flee to other currencies. This could damage investment and consumption worldwide, enough to induce a deep recession. Dollar interest rates would rise as the flow of foreign capital to the United States dried up. The developing countries might therefore si-

Table 1.6 Growth of real GDP, 1973 to 1995
(average annual percentage change)

Country group and indicator	*1973–80*	*1980–87*	*1987–95*	
			Base	*High*
Industrial countries	2.8	2.5	2.3	3.0
Developing countries	5.4	3.9	4.2	5.6
Low-income countries	4.6	7.4	5.4	6.5
Middle-income countries	5.7	2.4	3.6	5.1
Oil exporters	5.9	1.0	2.7	3.7
Exporters of manufactures	6.0	6.3	5.0	6.5
Highly indebted countries	5.4	1.1	3.2	4.8
Sub-Saharan Africa	3.3	0.2	3.2	3.9
Memo items				
Inflation rate[a]	8.2	4.1	4.0	3.2
Real interest rate[b,c]	1.3	5.6	2.6	2.1
Nominal interest rate[c]	9.3	10.5	8.1	7.7

Note: All growth rates for developing countries are based on a sample of ninety countries.
a. Weighted average of industrial countries' GDP deflators expressed in local currency.
b. Average six-month U.S. dollar Eurocurrency rate deflated by the GDP deflator for the United States.
c. Average annual rate.

Table 1.7 Growth of real GDP per capita, 1973 to 1995
(average annual percentage change)

Country group	*1973–80*	*1980–87*	*1987–95*	
			Base	*High*
Industrial countries	2.1	1.9	1.8	2.6
Developing countries	3.2	1.8	2.2	3.6
Low-income countries	2.5	5.5	3.5	4.6
Middle-income countries	3.2	0.1	1.5	3.0
Oil exporters	3.2	−1.6	0.2	1.3
Exporters of manufactures	4.0	4.6	3.4	4.9
Highly indebted countries	2.9	−1.3	1.0	2.5
Sub-Saharan Africa	0.5	−2.9	0.0	0.7

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

Table 1.8 Current account balance and its financing in developing countries, 1987 and 1995
(billions of dollars)

	All developing countries			Highly indebted countries			Sub-Saharan Africa		
		1995			1995			1995	
Item	*1987*[a]	*Base*	*High*	*1987*[a]	*Base*	*High*	*1987*[a]	*Base*	*High*
Net exports of goods and nonfactor services	27.6	−24.4	−41.0	25.3	35.0	30.8	−3.0	−4.3	−3.7
Interest on long-term debt	55.9	73.3	75.4	30.1	36.3	35.9	3.7	5.8	5.6
Official	17.0	26.6	26.5	6.7	9.0	8.8	2.1	3.5	3.4
Private	38.9	46.7	48.9	23.4	27.3	27.1	1.5	2.4	2.2
Net official transfers	16.0	21.7	23.2	1.1	2.3	2.2	3.7	7.6	7.8
Current account balance	2.1	−40.6	−52.1	−7.2	1.3	−1.6	−7.2	−5.0	−4.0
Long term loans, net	30.4	43.8	64.8	14.3	−7.7	−4.4	5.2	4.4	3.3
Official	19.6	35.3	36.9	6.9	5.6	5.0	3.3	7.3	6.8
Private	10.8	8.6	27.9	7.5	−13.3	−9.4	1.9	−2.9	−3.5
Debt outstanding and disbursed[b]	886.0	1,113.8	1,184.7	441.4	447.1	456.9	92.9	129.7	125.7
As a percentage of GNP	37.7	23.9	22.5	53.6	28.9	25.9	73.1	58.9	53.0
As a percentage of exports	145.3	94.5	85.4	300.4	172.8	155.3	263.3	215.9	190.6
Debt service as a percentage of exports[b]	20.2	15.6	13.7	35.2	37.3	33.0	25.5	24.5	22.5

Notes: Data are based on a sample of ninety developing countries. Subcategories may not add to totals because of rounding. Net exports plus interest does not equal the current account balance because of the omission of private transfers and investment income. The current account balance not financed by loans is covered by direct foreign investment, other capital (including short-term credit and errors and omissions), and changes in reserves. Ratios are calculated using currrent price data.
a. Estimated.
b. Based on long-term debt only.

multaneously have to face deteriorating exports, commodity prices, terms of trade, and debt service costs. The magnified risk of debt defaults would then feed back on prospects for the broader world economy. In short the risk of a sévere setback for the global economy is real. The steps necessary to avoid it are well worth taking.

The high case

The best way to avoid these risks is for the industrial economies to adopt the economic policies that lead to the "high-case" scenario.

• Prompt and convincing steps to reduce payments imbalances, as suggested here, would rapidly restore confidence and equilibrium to financial markets worldwide. In the short term, private investment and consumption would rise, and inflation and real interest rates could be held within reasonable bounds.

• Renewed efforts at structural reform—through higher and more efficient private investment, the elimination of bottlenecks in labor markets, and the reduction of protectionism and agricultural subsidies—would greatly improve the industrial economies' potential for growth. Steps toward further integration and internal liberalization are currently envisaged in the EC by 1992. This too could make an important contribution to longer term economic revival in the industrial countries.

Under these conditions it should be possible to achieve real annual growth rates of around 3 percent during 1987–95 in the industrial world (see Table 1.6) and perhaps even higher rates toward the end of the decade. The principal obstacle to achieving this result appears to lie not in the task of identifying the appropriate policies, but in finding ways to overcome political opposition to them.

An improved medium-term outlook for the industrial countries would greatly help the developing countries, too. By combining the direct effect of a more favorable external environment (higher export demand, improved commodity prices, and lower interest rates) with its indirect benefits (greater acceptability of domestic policy reform, improved access to external capital, and lower net resource outflows), the high case projects better economic performance in the developing world (see Tables 1.6 to 1.8). As in the past these improvements will be unevenly spread across countries. Highly indebted countries and exporters of manufactures would see substantial improvements in growth of per capita incomes. In contrast, even in this optimistic case, Sub-Saharan Africa would recoup the losses of the past only very slowly. Continued high population growth and the

ongoing effect of existing structural rigidities mean that even apparently modest improvements pose a challenge.

The outlook for the developing countries depends critically on their own domestic policies. Whatever the international environment, they must seek to adjust in ways that minimize the effect of any deterioration in that environment on their growth and to maximize the benefits from any improvements. The rest of this Report discusses the role public finance can play in supporting effective adjustment over the short and medium term and in setting the stage for successful long-term development.