2

The hesitant recovery

Industrial countries have emerged from the depths of the 1980–82 recession with growth in output being sustained for longer than in previous recoveries. In most industrial countries output started expanding after 1982, and growth has continued through to 1986 (see Table 2.1). Yet, the world economy is in an uneasy and unsettled state. Except for the United States and Japan in 1984, expansion in the industrial countries has been slower than in the early years of past recoveries.

For developing countries, growth in output has followed a similar pattern. Growth picked up after 1982, reaching its peak in 1984 (see Figure 2.1). But a downturn in commodity prices in 1985, combined with restricted capital flows and a marked slowdown in the growth of world trade, has made it difficult for developing countries to sustain this performance. As a result, many of the underlying weaknesses in developing economies began to resurface in 1985. This has refocused international attention on the policy initiatives required to attain strong and sustained growth in the medium term.

In industrial countries unemployment increased sharply during the recession of 1980–82, and it has remained at high levels in most of them during the recovery. In Europe unemployment remains at between 9 and 10 percent of the labor force. Even in the United States, where unemployment has fallen since the recession, the unemployment rate is between 6 and 7 percent. In contrast, as GDP has

Figure 2.1 Growth rate of real GDP in developing and industrial countries, 1961–85

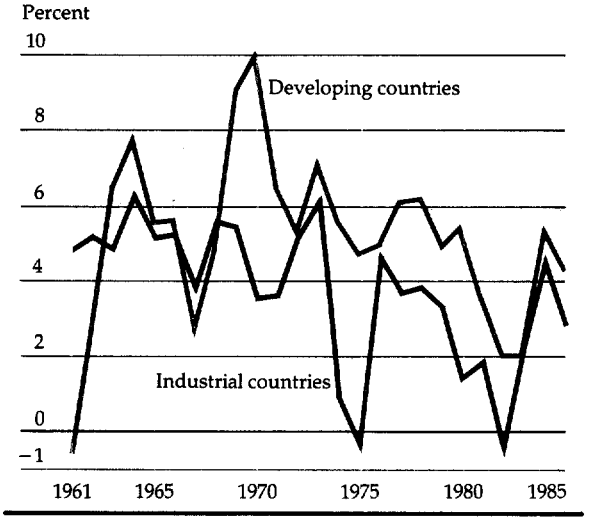


Table 2.1 Growth of real GNP in selected industrial countries, 1979–85
(annual percentage change)

Country	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
France	3.5	1.1	0.3	1.8	0.7	0.6	1.0
Germany	4.4	2.0	−0.1	−1.2	1.3	2.7	2.3
Japan	5.2	4.8	4.1	3.3	3.4	5.8	5.0
United Kingdom	1.8	−2.6	−1.4	1.5	3.7	2.3	3.3
United States	3.2	−0.2	3.4	−2.1	3.7	5.2	2.5
Average for the five	3.6	0.9	2.2	−0.2	3.0	4.2	2.8

Note: Data for 1985 are estimates.
Source: For 1979–84: World Bank data; for 1985: OECD 1985c.

grown, there have been no obvious signs of a revival of inflation. On the contrary, inflation has gradually subsided during the recovery, falling from the double-digit rates of the depth of the recession to around 4 percent in 1985.

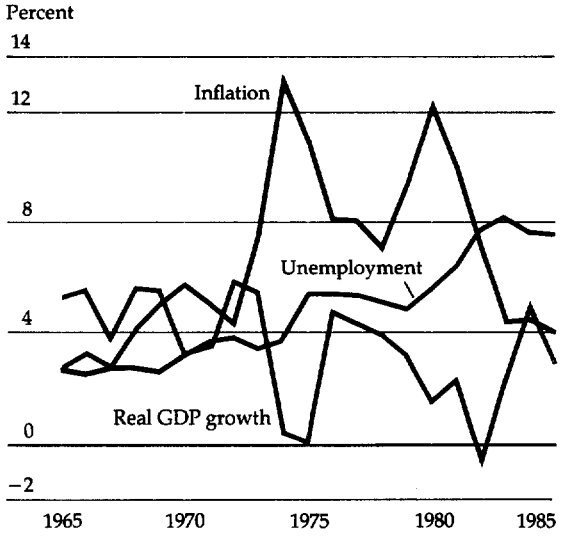
For most developing countries the early 1980s was a difficult period. Many attempted to implement badly needed domestic reforms, but found that wide fluctuations in the world economy made their task that much harder. Mounting debts, low commodity prices, and reduced commercial bank lending led many countries to cut imports and to try to expand exports. In the short run this was achieved mainly by curtailing consumption and investment through lower exchange rates, higher taxes, and reduced government spending. Although the exchange rate realignments often stimulated exports and helped import-competing industries, these short-term adjustments initially depressed incomes and employment. As a result, real per capita incomes dropped in both Latin America and sub-Saharan Africa between 1980 and 1983.

Beginning in 1984, renewed growth in the industrial countries and the policy reforms adopted by developing countries bore fruit. The developing countries as a group enjoyed a recovery, led by a marked improvement in the economic performance of many middle-income economies. But growth slowed again in 1985 as a result of three main changes: slower growth in the industrial countries—particularly in the United States—starting from the middle of 1984, a slower rate of expansion in world trade relative to industrial-country growth, and a further deterioration in developing countries' terms of trade. In addition, inflows of external capital continued to decline. While many economies should grow more rapidly this year, some—oil exporters in particular—will experience very low growth.

During the process of adjustment, however, many governments saw that fundamental changes were needed in institutional arrangements to avoid the problems that had gradually overtaken them in the 1970s and that had caused such distress in the 1980s. Many have seen the need to reform the incentive framework to reduce the distortions caused by inflation, regulations, overvalued exchange rates, trade controls, and excessive public expenditure. It is difficult to change institutions and policies even at the best of times. Many countries nevertheless embarked on programs of reform during the early 1980s. These programs may, if resolutely pursued, provide a basis for sustained growth and development.

However difficult the external conditions, domestic policies that improve the incentive framework and reduce uncertainties will contribute to growth. But the more favorable the international environment, the greater will be the benefits of policy reforms to developing countries. Thus, the performance of industrial economies is an important determinant of the progress of developing economies. To understand what has happened in developing countries, therefore, the policies and performance of industrial countries must also be reviewed.

Figure 2.2 Growth, inflation, and unemployment rates in seven major industrial countries, 1965–85



Note: Data are for Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
Source: For GDP growth: World Bank; for inflation and unemployment: OECD.

The industrial countries

Figure 2.2 illustrates the performance of the seven largest OECD economies since the mid-1960s. Behind the cycles of GDP growth, unemployment, and inflation lie some disturbing long-term trends. Each peak in GDP growth has been lower than the preceding one; peaks as well as troughs in unemployment have been rising. Progress has been made only in curbing inflation. Lower inflation, however, has been accompanied by unemployment rates roughly two to three times higher than the level in the 1960s.

Table 2.2 Budget balance as a percentage of GNP in seven major industrial countries, 1979–85

Country	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Canada	−1.8	−2.7	−1.6	−5.0	−6.2	−6.4	−6.0
France	−0.7	0.2	−1.8	−2.7	−3.1	−2.8	−3.2
Germany	−2.7	−3.1	−3.8	−3.4	−2.8	−2.3	−1.5
Italy	−9.5	−8.0	−11.9	−12.6	−12.4	−13.5	−13.1
Japan	−4.8	−4.5	−4.0	−3.6	−3.5	−2.6	−1.4
United Kingdom	−3.2	−3.9	−3.2	−2.3	−3.5	−4.0	−3.6
United States	0.6	−1.2	−0.9	−3.8	−4.1	−3.4	−3.7

Note: Negative signs indicate deficits.
Source: OECD 1985c.

Monetary and fiscal policies

After inflation accelerated at the end of the 1970s to historically high rates, most of the industrial countries attempted to reduce the rate of growth of monetary expansion. The details of the policy measures adopted in the early 1980s differed from country to country, but in substance they were similar. First, they were medium-term strategies—that is to say, they were concerned with a period of at least four to five years. Second, they encompassed both fiscal and monetary measures. Governments sought to reduce their budget deficits as a fraction of GNP as well as the rate of growth of the money supply. For the most part, they recognized that proposed reductions in the rate of growth of the money supply would be credible only if associated with a reduction in the government's need to borrow.

Despite high levels of unemployment, anti-inflationary strategies were maintained throughout the recession of 1980–82. As a result, rates of inflation in the industrial countries subsided rapidly and in 1986 were at their lowest levels in twenty years.

But governments were more successful in reducing the rate of growth of the money supply than in cutting the public sector deficit. Some OECD countries gradually brought down the high deficits that had emerged in the late 1970s. But there were exceptions, the most important of which was the United States (see Table 2.2).

Since 1981, tax cuts and expenditure growth have increased the U.S. federal deficit to $200 billion (nearly 4 percent of GNP), in spite of the recovery after 1982. Indeed, at the peak of the business cycle, one would have expected the federal budget to have been in approximate balance. But the deficit of the United States has persisted and has been large enough to draw capital from other countries.

Budget deficits and interest rates

The domestic effects of large and persistent deficits are mainly on real interest rates and expected inflation. The manifest difficulties of cutting public spending lead people to expect that revenues will eventually have to rise to finance deficits. Boosts to public revenue may come from high growth, conventional taxes, or the seigniorage of inflation (see Box 2.1). Worries about future inflation tend to keep long-term nominal interest rates higher than they would otherwise be, and large budget deficits contribute to high real interest rates.

Real interest rates were negative during the early part of the 1970s, but they rose sharply in the early 1980s. Even though they declined moderately from 1982 on—and more sharply in 1985 and 1986—they remain high. During most recessions (particularly those not associated with sharp monetary contraction), the private sector's demand for credit falls. This usually encourages a decline in interest rates. But in the recession of 1980–82 and during the subsequent recovery, this pattern was not repeated, largely because of the fiscal-monetary imbalance. One consequence was that indebted developing countries received little relief from high real interest rates. Their reliance on cheap finance in the 1970s became a heavy burden in the 1980s as interest rates increased. Like most cumulative processes, the problem matured slowly, even after the steep rises in interest rates. But it finally became pressing at the lowest point of the business cycle in mid-1982. This led to severe debt problems, the main theme of last year's Report.

Capital flows, current account deficits, and trade flows

Governments in industrial countries have generally financed their increased deficits by borrowing from domestic and external sources. Private do-

Box 2.1 Inflation as a tax

The need for revenue may lead governments to increase the money supply. The resulting increase in inflation erodes the real value of all financial assets, except those that are fully indexed—creating what is termed the inflation tax. Debtors gain and creditors lose. In a credit market that is reasonably free, financial assets that pay interest, such as bonds, are likely to have a yield that compensates for any erosion in their real value caused by steady and foreseeable inflation. Unless bonds are indexed, however, a sudden or unexpected burst of inflation is unlikely to be compensated for by suitably high nominal interest rates, and bondholders will suffer an erosion of the real value of their assets. Since the main issuers of bonds are usually governments and the main holder is the domestic private sector (although foreigners may also hold substantial amounts), a sudden or unexpected increase in the rate of inflation will reduce the real value of the government's debt. The effect of inflation is analogous to levying a tax on bonds and using the revenue to pay off debt.

In developing countries, however, the bond market tends to be small and to have low, controlled interest rates. Most bonds are held by banks, primarily to satisfy reserve requirements; other bondholders are often involuntary lenders to government. In these circumstances bonds are rarely a principal source of financing and thus will yield little tax in response to a sudden or unexpected inflation. On the international capital markets, bank loans tend to be denominated in foreign currency, usually the dollar, so there is no real erosion of these assets as a result of domestic inflation.

In countries where the financial system is rudimentary, the main financial asset is currency. Governments usually have a monopoly on issuing notes and coin (although there are exceptions: Liberia and Panama use dollars), and the currency is held almost entirely by domestic residents. Cash pays no interest, so the erosion of its real value cannot be offset during inflation. Since notes and coin are a government liability and an asset of the private domestic sector, the reduction in their real value is similar to a tax on currency. It reduces the outstanding real liabilities of government.

There is a limit to the size of this taxation. The greater the tax rate, the more those who are being taxed try to avoid it. The higher the rate of inflation, the smaller the amount of money (in real terms) which the public will be willing to hold, and so the narrower the tax base. This can be seen in the extreme case of the last stages of hyperinflation, when people largely give up using money and switch to barter. Nonetheless, although the tax base (that is, the quantity of money in real terms) may become very small, the slow adjustment of prices to the accelerating growth of the money supply usually still guarantees some tax revenue. But when the pace of monetary expansion slows, revenues can fall sharply.

Theoretically, the maximum tax revenue from infla-

mestic residents or foreigners buy additional government paper—currency notes, Treasury bills, government bonds, or public deposits—to finance the public deficit.

When foreign capital, attracted by high real interest rates, finances the deficit, the result is a current account deficit in the balance of payments. In 1985 in the United States, for example, the federal government deficit of about $200 billion was financed to the tune of $87 billion by the financial surplus of the domestic private sector (including state and local governments), but the remaining $113 billion came from foreigners through the current account deficit.

The funds to finance fiscal deficits must of necessity come from one of three sources: increased domestic private savings, reduced private investment, or lower exports net of imports. In spite of high real interest rates, the increase in the U.S. federal budget deficit in 1982 was not accompanied by an offsetting increase in domestic private savings. Thus, the deficit had to be financed by reduced domestic investment or by increased foreign borrowing. During the recovery, however, private investment increased at a faster rate than domestic savings, partly in response to earlier tax cuts that favored investment. As a result, a growing proportion of the financing burden of the increased budgetary deficit was borne by imports of capital. The large current account deficit in the balance of payments reflected this (see Table 2.3).

The way the burden of financing a budget deficit is shared among savings, investment, and capital imports is determined by interest rates, expected returns on investment, and exchange rates. All of these are, in important respects, determined by monetary and fiscal policies. Since 1981, when the U.S. budget deficit began to increase, the Federal Reserve Board has pursued a tight monetary policy. As a result, interest rates have been high by industrial-country standards. Although the negative effect that high interest rates had on domestic investment was offset by the positive effects of other policy changes, higher interest rates at-

tion is obtained when the proportionate increase in the price level equals the resulting reduction in real currency balances. Thus, at the margin, what the government gains from an additional notch of inflation is exactly offset by people reducing their real currency holdings.

Many governments increase the money supply at a rate far greater than that which would theoretically maximize real public revenue. Although periods of high inflation occasionally occur accidentally, the main cause is usually the government's immediate need for cash to pay its bills. To obtain the cash, the government simply prints more money.

In more sophisticated monetary systems, checking accounts are important as a means of exchange. Banks usually pay little or no interest on checking accounts, and so check balances are similar to currency. With inflation, the banks are the immediate recipients of the reduction in the real value of checking accounts, since these appear as liabilities on their balance sheets. But, by increasing reserve requirements or taxation, the government usually acquires the banks' gains and prevents them from profiting unduly from inflation.

Like any other form of revenue raising, the inflation tax must be judged on its merits. But inflation as a tax has disadvantages not shared by alternative forms of taxation. It distorts relative prices (because some prices increase faster than others), generates uncertainty, and falls heavily upon low-income holders of cash. Furthermore, inflation erodes other kinds of government revenue. Lags in the collection of taxes and delays in adjusting some tax rates to rising prices mean that the real revenues of government fall as inflation increases. In practice, this more than offsets any tax increase attributable to "bracket creep," and even tends to outweigh the inflation tax itself. Except at low levels of inflation, raising revenues by inflationary finance is likely to pay off only in the short run.

The lower and more stable the inflation, the more likely it is that a government will be able to raise substantial resources by seigniorage. Seigniorage is the benefit the central bank derives from being the monopoly supplier of domestic currency. Domestic residents will hold a larger stock of cash, in real terms, if prices are known to be stable. Such stability also makes a currency attractive to foreigners whose own economies are unstable and inflationary. This is vividly illustrated by the substantial (and often illegal) foreign holdings of dollars by many Latin American countries. In Ghana, there were substantial holdings of, and transactions in, the CFA franc of neighboring Côte d'Ivoire. Because of the relative stability of their economies, the United States and Côte d'Ivoire were able to acquire real resources in exchange for their currency notes. The desire of foreigners to share in Switzerland's stability has enabled Swiss banks to import capital at very low cost. These are the significant and continuing benefits of a stable financial system.

tracted an unprecedented net inflow of foreign capital. This, in turn, was one of the factors that contributed to the appreciation of the dollar relative to other major currencies (see Table 2.3).

During 1985 and in early 1986, however, interest rates fell faster in the United States than in other industrial countries, and the dollar weakened. This partly reflects the recent strengthening of the U.S. commitment to reduce the federal budget deficit during the next five years. The concerted efforts of the Group of Five countries have also assisted in bringing about an orderly adjustment. But a decline in the current account deficit or in the demands of the United States on the world's savings will take time. This is due in part to lags in the process of adjustment as U.S. export and import

Table 2.3 Current account balances and exchange rates in Germany, Japan, and the United States, 1981–85

Country and item	*1981*	*1982*	*1983*	*1984*	*1985*
Germany					
Current account balance (billions of dollars)	−5.4	3.2	4.2	6.1	13.2
Exchange rate index	100.0	100.5	102.4	109.5	111.5
Japan					
Current account balance (billions of dollars)	4.8	6.9	20.8	35.0	49.7
Exchange rate index	100.0	105.7	97.6	93.6	93.2
United States					
Current account balance (billions of dollars)	6.4	−8.0	−40.8	−101.6	−113.6
Exchange rate index	100.0	93.6	90.7	86.9	86.7

Note: The exchange rate index is calculated relative to SDR 1981 = 100. Data for 1985 are estimates. Current account balance includes official transfers.
Source: IMF.

substitution activities begin to expand in response to the weakened dollar. It is also apparent that capital has been attracted into the United States because of the country's political stability, low taxes, lack of exchange controls, and wage restraints.

The large current account deficit in the United States and high dollar interest rates have had different—and offsetting—effects on the rest of the world. Increased deficits stimulated the exports of, and thus the aggregate demand of, the United States' trading partners. Countries that do not export to the United States also gained from the indirect effects. Where there was spare capacity, this promoted an increase in exports and GDP that, for some trading partners, more than offset the cost of higher interest payments.

Part of the increase in the U.S. current account deficit since 1981 was mirrored by an improvement in the current account balances of the rest of the OECD countries. For example, Japan's surplus rose sharply, reaching the equivalent of about 30 percent of the increased deficit of the United States.

Developing countries were also successful in capturing part of the buoyant U.S. demand, particularly in manufactures. Their manufactured exports, which had close to zero growth in 1982, grew by 10 percent in 1983 and by more than 16 percent in 1984. But the smaller increase in the U.S. current account deficit in 1984–85 was not offset by an expansion in the imports of other OECD countries. The result has been a marked slowdown in developing countries' export growth. In addition, up until 1985 some of the newly industrialized countries in Asia had lost competitiveness in the U.S. market because their exchange rates did not depreciate in real terms against the dollar by as much as the exchange rates of their competitors in industrial countries.

The large increase in the U.S. current account deficit from 1981 to 1984 eased the adjustment of the trade and current accounts in many developing countries, particularly the heavily indebted ones. But this was offset, in part, by higher world interest rates. Although it is difficult to measure the net impact on developing countries, it is clear that those which adjusted most quickly and exploited the booming export market made a net gain.

However, the export opportunities that existed in 1983–84 for developing countries are unlikely to return unless other OECD countries expand import demand and thereby reduce their current account surpluses. Again, though, there is an offsetting effect: if the U.S. budget deficit declines, interest rates will fall and capital hitherto absorbed by the government will be redirected to alternative investments. This would provide increased opportunities for those developing countries that have implemented the reforms necessary to attract foreign lenders or investors. Capital could again flow voluntarily from OECD countries to more productive uses in developing countries—as it normally does. The OECD's current account surpluses and the developing countries' deficits would be as rational and sustainable as their investments would be profitable.

Public sector spending and controls

One of the main causes of budget deficits in industrial countries, particularly in Europe, has been burgeoning public expenditure. In all industrial countries, public spending expanded faster than GDP between 1964 and 1983 (see Table 2.4). Excluding defense, the fastest growing items of public spending were social benefits—health services, welfare, social security, and pensions. They are hard to cut because their size is dictated by the number of people claiming guaranteed (and usually indexed) benefits. Interest payments on public debt have also grown much faster than GDP.

Governments in industrial countries have ex-

Table 2.4 Total public expenditure as a percentage of GDP in selected industrial countries, 1964–83

Country	*1964*	*1968*	*1972*	*1976*	*1980*	*1983*
Canada	28.9	33.0	37.2	39.4	40.9	46.8
France	38.0	40.3	38.3	44.0	46.4	51.5
Germany	35.9	39.1	40.8	48.0	48.4	48.6
Italy	31.8	34.7	38.6	42.2	46.1	57.4
Japan	..	..	21.8	27.9	32.4	34.8
United Kingdom	33.6	39.2	39.8	45.6	45.1	47.2
United States	28.3	31.3	32.0	34.5	35.0	38.1
Average for all industrial countries	30.6	33.7	33.3	37.4	39.3	41.6

Source: OECD 1985c.

panded their subsidies to manufacturing (particularly the steel and shipbuilding industries) in the hope of easing the strains of structural change. But it is the unanticipated rapid growth of subsidies to agriculture that has recently drawn most attention. In the United States, agricultural production has been encouraged by a number of measures, including the setting of target prices above world prices for wheat and corn. In Western Europe, internal prices of many agricultural products are kept even further above world prices, and exports are subsidized.

The result has been to encourage domestic production and depress domestic consumption, especially in Europe. The resulting flood of surplus grain, sugar, meat, poultry, and dairy products at depressed world prices has been particularly damaging to those developing countries that are trying to stimulate the output of agricultural products in which they often have an absolute advantage. The implications of these policies are the subject of Chapter 6 in Part II of this Report.

In the 1980s, governments made numerous attempts to cut public spending but had little success. The rates of growth of public expenditure have been cut, but this has not reduced on average the level of overall spending either absolutely or relative to GDP.

Higher public spending and greater public sector involvement in the economy were indirectly responsible for other problems that hindered growth in the industrial countries:

• *Marginal tax rates.* In the 1950s and 1960s, many governments thought that high public spending would not only offset cyclical downturns but also promote long-term expansion in GDP. That view lost favor, however, after the experience of the 1970s, when growth in GDP faltered but the growth in public spending did not. The higher level of public spending meant that average rates of taxation had to increase. What mattered more than the average tax rate, however, was the extent to which tax varied with changes in income and wealth—the marginal rate of tax. To preserve a "progressive" tax structure (that is, one in which the better-off pay proportionately more tax), marginal tax rates had to increase by at least as much as average tax rates. In real terms, marginal tax rates on interest income often exceeded 100 percent. For example, if interest rates are 20 percent and inflation is 15 percent, the real return on a marginal investment of $100 is $5. But if tax is levied at a marginal rate of 25 percent on the nominal yield of $20, the income net of tax is only $15. Thus, the tax payment absorbs all of the $5 of real income, and the marginal real tax rate is 100 percent. One result of the failure to reduce public spending was, therefore, the erosion of incentives for wealth creation.

• *Benefits.* Along with the increase in tax rates came an increase in benefits. Again, it was not the level of benefits that mattered, but the marginal loss of benefit as one moved into or out of employment. Other social benefits, from housing subsidies to free school meals, were also reduced or withdrawn as one earned additional income. The combined disincentive effects of the marginal tax and benefit rates reached very high levels—particularly for those workers with average (or slightly below average) wage levels and with ordinary family commitments. Combined marginal tax-benefit rates of 85 percent became common. For some income groups the combined rate exceeded 100 percent. For example, in the United Kingdom in December 1984 the combined marginal tax-benefit rate for a married man with two dependent children and an income between one-half and two-thirds of the average wage reached 180 percent. At such high rates, it pays people not to work.

• *Regulations and controls.* A proliferation of regulations and controls sharply increased business costs and introduced distortions. For example, with the aim of promoting jobs in areas of high unemployment, governments directed capital through planning controls and fiscal incentives. Unfortunately, capital investment was channeled into industries which could not survive without government subsidies. As a result, capital-intensive, rather than job-intensive, industries were attracted to these areas, which created low-productivity capital but few jobs.

Of more importance has been the increase in government intervention in the labor market, which created damaging rigidities in the wage structure. In addition to specifying minimum wage levels, governments reduced the flexibility of management to change conditions of employment. Employment protection measures often protected incumbents, but at the cost of hindering the creation of new jobs with higher productivity.

Controls and regulations were more common in Europe than in the United States and Japan. The resulting market rigidities and the erosion of incentives were widely acknowledged in the 1970s to be slowing growth in Europe. This weaker performance had important effects on developing countries too. European growth had been an important

factor in the growth of world demand in the 1960s. The halving of that growth from the level of the early 1970s was a significant change in the international economy, and it made the problems of adjustment that much more difficult in both Europe and the developing countries.

By the 1980s, as Europe's unemployment rate increased to levels not seen since the 1930s, European governments began gradually loosening controls and regulations. They have also made considerable progress in financial deregulation and in reducing the scope of credit rationing.

• *Protection.* Although the 1980s have seen steps, however slow and hesitant, to dismantle domestic constraints to efficiency, the restrictions on international trade have increased. This reverses the long process of reducing trade restrictions and jeopardizes the principle of nondiscrimination that was pursued so successfully in the 1960s.

Most of the increase in protection has taken the form of nontariff barriers (NTBs). Table 2.5 shows how NTBs on the imports of industrial countries increased between 1981 and 1984. The NTBs in 1984 affected $9.4 billion more imports (based on

Box 2.2 Protectionism: who pays?

It is often claimed that tariff and nontariff barriers to trade are justified as a way of saving jobs in domestic industries. But protection has many direct and indirect effects that need to be considered. Nontariff barriers against imports result in higher domestic prices for the products that substitute for imports. Although the domestic industries producing these substitutes may gain, consumers or industrial users of the products lose. The net result is always a loss in real national income, a loss that is variously described by economists as an efficiency loss, a welfare loss, or a deadweight loss. If protection is proposed as a means of saving jobs, then the question arises as to how much real national income needs to be sacrificed to do so.

The efficiency losses or costs of nontariff barriers used by the United States and the EC against imports of clothing, automobiles, and steel have been estimated at well above a billion dollars in each case (see Box

Box table 2.2 Effects of selected nontariff barriers in the clothing, automobile, and steel industries
(millions of dollars, unless otherwise noted)

Effect	Clothing		Automobiles,	Steel,
	United States, 1980	EC, 1980	United States, 1984	United States, 1985
Efficiency loss in the protecting country	1,509	1,409	2,192	1,992
Increased payments on imported goods	988	1,050	1,778	1,530
Loss of consumer surplus on imports	408	289[a]	229	455
Resource cost of producing the additional quantity domestically	113	70	185	7
Jobs saved through protection (thousands)	8.9	11.3	45.0	28.0
Efficiency loss per job saved (thousands of dollars)	169.6	124.7	48.7	71.1
Average labor compensation (thousands of dollars per year)	12.6	13.5	38.1	42.4
Ratio of efficiency loss to average compensation	13.5	9.2	1.3	1.7
Lost revenues for exporters	9,328	7,460	6,050	1,508
Ratio of increased payments on imported goods to lost revenues for exporters	0.11	0.14	0.29	1.01

Note: The nontariff barriers are: for textiles, the Multifibre Arrangement; for automobiles, the voluntary export restraint (VER) agreement between the United States and Japan; and, for steel, the VERs between the United States and major suppliers.
a. Excludes tariff revenues forgone because of quotas.
Source: Kalantzopoulos, "The Costs of Voluntary Export Restraints" (background paper).

Table 2.5 Share of imports subject to nontariff barriers in industrial-country markets, 1981 and 1984

	Percentage of imports from:			
	Industrial countries		*Developing countries*	
Market	*1981*	*1984*	*1981*	*1984*
EC	10.3	10.7	21.1	21.7
Japan	12.3	12.4	14.5	14.5
United States	7.2	9.2	12.9	16.1
All industrial countries	10.5	11.3	19.5	20.6

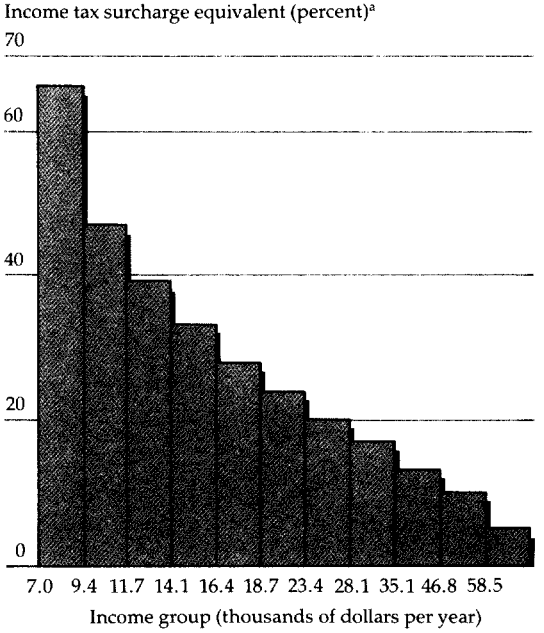
Note: Data are based on 1981 weighted averages for all world trade in all products except fuels. Nontariff barriers do not include administrative protections such as monitoring measures and antidumping and countervailing duties.
Source: World Bank estimates based on UNCTAD data.

table 2.2). However, the number of jobs saved in the protected industries was small, so that the cost per job saved exceeded the average labor compensation in each case. For each job saved in clothing, for example, the U.S. economy as a whole sacrificed about $169,600 to protect a worker earning about $12,600. Clearly, the resources wasted in the process could have been better used in other activities and in retraining and reallocating the affected workers. This example demonstrates that saving jobs is not a tenable defense of protectionism.

It is also sometimes thought that foreign producers do not necessarily lose from nontariff barriers, especially under so-called voluntary export restraints, since those who are able to sell despite the barriers receive higher prices. While the higher prices paid for imports represent a transfer to some foreign producers, nontariff barriers reduce the volume of imports and thereby lead to losses in the total revenue received by foreign producers. In the case of clothing, for example, the transfer to foreign producers amounted to only one-tenth of their loss of revenue in 1980. Only in the case of steel in 1985 was the price increase large enough to offset the loss in export volume.

Not only is protectionism very costly, it does not assist poorly paid workers. Indeed, it penalizes them. Import restraints are equivalent to a sales tax and often apply to necessities. When they do, they weigh heaviest on those who spend proportionately more of their income on these items: the poor. The impact of such a sales tax on different income groups can be seen by treating the tax as a surcharge on income tax. Box figure 2.2 does so by weighting the price increases caused by protective measures on clothing, sugar, and automobiles in the United States in 1984 by the average amount that different income groups spent on those goods. It shows the regressive effect of the protection tax and the distortionary effect on income distribution. Existing import restrictions in the United States may amount to as much as a 66 percent surcharge on lower-income families, but only a 5 percent surcharge on higher-income families.

Box figure 2.2 Income tax surcharge equivalent of the cost of tariff protection in the United States, 1984



Note: Income groups are based on the 1972–73 consumer expenditure survey of the U.S. Department of Labor and are adjusted for consumer price inflation in 1984.
a. Cost of protection as a percentage of income divided by the applicable federal income tax rate.
Source: Hickok 1985.

1981 weighted averages) than did those in place in 1981. Moreover, this figure understates the increase because it takes into account only new restrictions, not the effects of tightening existing ones. Although the NTB coverage for the United States has declined since 1984 as a result of the lifting of voluntary export restraints on Japanese automobiles, the decline has been offset by increased protection for the U.S. steel industry.

Restrictions have been imposed on a larger number of small trade flows from developing countries and a smaller number of large trade flows from industrial countries. In 1984, 20.6 percent of industrial countries' imports from developing countries were subject to NTBs—nearly two times the corresponding figure for imports from industrial countries. This was primarily due to restrictions on the clothing, textile, and footwear exports of developing countries. The tightening of existing NTBs on these items continues to restrict developing countries' most important manufactured exports. But recent NTBs have also been imposed on such products as steel and electrical machinery—products which developing countries are beginning to export. So, while developing countries have been encouraged to open their economies to trade, their access to the markets needed to obtain the most benefit from trade liberalization has been restricted.

It is a widely recognized irony that, although the prosperity and high level of employment of the 1960s were made possible in part by the dismantling of trade restraints, protectionism is now advocated on the grounds that it will create jobs. In point of fact, it will delay recovery, inhibit the creation of jobs, and prolong the decline of uncompetitive industries (see Box 2.2).

The developing countries

In the first half of the 1980s, real GDP growth slowed throughout most of the developing world, and per capita incomes declined in many countries. At the lowest point of the recession, in 1982–83, GDP growth fell to 2.0 percent (see Table 2.6). Although the growth in GDP quickened significantly in 1984, it slowed again in 1985 and during the first part of 1986.

But averages conceal wide differences in individual performances. One of the most worrisome aspects of the early 1980s has been the continued decline in low-income African countries. Inappropriate domestic policies, a weakening of their terms of trade, and reduced capital inflows have resulted in low, and even negative, growth rates. The average annual GDP growth rate for low-income Africa declined from 2.7 percent during 1973–80 to 0.7 percent in 1982 and reached a record low of 0.2 percent in 1983. Although growth picked up in 1984 and 1985, per capita incomes have continued to decline.

Two groups of middle-income countries were also hard hit. First, oil exporters—hitherto protected from external energy shocks, if not from inappropriate domestic policies—faced lower oil prices and falling export volumes. As a result, real GDP, which had grown by 5.8 percent a year in 1973–80, fell by almost 2 percent in 1983 and has grown by less than 3 percent in every year since 1981. Second, heavily indebted countries that had

Table 2.6 Real growth of GDP, 1965–85
(annual percentage change)

Country group	*1965–73 average*	*1973–80 average*	*1981*	*1982*	*1983*	*1984*	*1985*
Developing countries	6.6	5.4	3.5	2.0	2.0	5.4	4.4
Low-income countries	5.6	4.7	5.0	5.3	7.8	9.4	7.8
Africa	3.9	2.7	1.7	0.7	0.2	0.7	2.1
Asia	5.9	5.0	5.4	5.8	8.6	10.2	8.3
China	7.8	5.4	4.9	7.7	9.6	14.0	10.6
India	4.0	4.1	5.8	2.9	7.6	4.5	4.0
Middle-income oil exporters	7.1	5.8	4.4	1.0	−1.9	2.5	2.5
Middle-income oil importers	7.0	5.5	2.1	0.8	0.8	4.1	3.0
Major exporters of manufactures	7.6	5.9	1.6	1.2	0.8	4.4	3.1
Brazil	9.6	6.8	−1.5	1.0	−3.2	4.5	7.0
Other middle-income oil importers	5.4	4.5	3.4	−0.6	0.8	3.1	2.8
High-income oil exporters	9.2	7.7	1.6	−1.7	−7.1	1.3	−5.0
Industrial market economies	4.7	2.8	1.9	−0.6	2.3	4.6	2.8

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

Table 2.7 Change in export prices and in terms of trade, 1965–85
(annual percentage change)

Country group	1965–73 average	1973–80 average	1981	1982	1983	1984	1985
Change in export prices							
Developing countries							
Food	5.0	9.6	−8.2	−8.8	5.6	2.0	−8.1
Nonfood agriculture	4.2	10.5	−14.4	−8.6	5.7	−2.0	−10.0
Metals and minerals	2.4	4.8	−7.6	−8.5	−0.1	−1.7	−4.9
Fuels	7.9	27.2	12.5	−3.2	−12.4	−2.1	−2.5
Manufactures	7.2	8.1	0.2	−3.2	−2.5	−1.9	1.3
Industrial countries							
Manufactures	5.4	11.0	0.5	−1.4	−2.6	−1.8	1.3
Change in terms of trade							
Low-income countries							
Africa	0.1	−1.8	−11.8	−0.9	4.8	5.0	−5.6
Asia	3.2	−2.4	1.1	1.2	−1.2	1.5	−1.9
Middle-income countries							
Oil exporters	−0.4	8.5	5.4	0.2	−7.7	0.3	−2.9
Oil importers	0.0	−3.0	−4.4	−0.6	2.3	0.1	−0.1
All developing countries	0.8	1.5	−1.0	−0.1	−1.3	0.4	−1.1

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

not used borrowed funds efficiently were caught by rising interest rates, falling voluntary private lending, and declining export earnings. Per capita incomes and imports fell sharply in some of the biggest debtors, particularly in Latin America.

By contrast, those more outward-oriented economies (such as Korea and Malawi) that maintained domestic macroeconomic stability and adjusted to external changes were soon able to reattain high growth rates after 1982. India and China also continued to grow vigorously, pushing up the overall growth rate for low-income countries in Asia. If India and China are excluded from the low-income Asia group, the average growth rate for the region since 1980 falls to approximately 5.0 percent.

India benefited from domestic policy changes as well as from a large, expanding domestic market and good harvests; these offset, to some degree, fluctuations in the world economy. This was also true in China, but its economy gained more from far-reaching domestic reform. While there are recent signs that the challenge of managing monetary and fiscal policy in a more open economy may have introduced a degree of macroeconomic instability, China's strong growth provides a vivid illustration of the potential gains to be made from undertaking domestic reforms that raise the productivity of existing resources. A detailed analysis of the Chinese policy changes in agriculture is provided in Chapter 5.

In 1984, oil-importing developing countries had reason to hope for a revival in growth and a remission of the debt problem. World merchandise trade volumes increased by 9 percent. Developing countries increased their export volumes by 10.7 percent and benefited from a slight (0.4 percent) improvement in their terms of trade. For many developing countries the extra export earnings and rescheduling of existing debt permitted the first increase in per capita incomes and imports since 1980. Those countries which had already implemented significant domestic reform programs, particularly the reduction of disincentives to exports, gained most—Mauritius, Thailand, and Turkey, for example.

In 1985, however, the hopes of 1984 were moderated. Slower growth in industrial countries and in world trade reduced the rate of growth of developing-country exports, and commodity prices fell (see Tables 2.7 and 2.8). The expansion in total world merchandise trade slowed markedly to 3 percent, breaking the normal relationship in which total trade expands at a faster rate than total world production. World market prices, particularly of primary commodities, also declined. Overall, the terms of trade for developing countries declined by 1.1 percent in 1985; low-income countries and oil exporters fared the worst. As net capital flows into developing countries also declined, many governments were forced to slow the growth in imports.

Although many developing countries have

Table 2.8 Growth of exports from developing countries, 1965–85
(annual percentage change)

Item	1965–73 average	1973–80 average	1981	1982	1983	1984	1985
Change in export volume by commodity							
Manufactures	11.6	13.8	8.6	0.1	10.0	16.6	3.3
Food	3.3	3.9	9.7	−2.3	−1.1	7.6	3.9
Nonfood agriculture	3.1	1.1	2.5	−1.6	1.5	1.0	4.5
Metals and minerals	4.8	7.0	−2.6	−2.8	0.5	3.4	4.8
Fuels	4.0	−0.8	−9.2	0.6	2.3	7.1	−1.4
Change in export volume by country group							
Low-income countries							
Africa	4.6	1.3	−4.5	−9.3	−0.2	4.9	2.0
Asia	0.6	6.8	9.1	6.3	7.2	6.6	3.8
Middle-income countries							
Oil exporters	4.3	0.0	−7.2	−1.9	3.6	8.6	−0.8
Oil importers	7.1	9.0	7.4	−0.4	5.0	12.8	3.7
All developing countries	5.0	4.6	2.1	−0.5	4.7	10.7	2.3

gained from the recent decline in interest rates and oil prices, the situation for others has worsened considerably. For a group of low-income African countries, the deterioration in their terms of trade, declining private capital flows, and the increasing proportion of their debt that is ineligible for rescheduling have combined to create a serious problem. Things are no better for many middle- and high-income oil exporters, because they bear the direct costs of the rapid decline in oil prices. In addition, the slowdown in their growth rates has had negative effects on those developing countries that supply them with migrant laborers. In some developing countries, remittances from migrant workers are a significant source of foreign exchange earnings. But the reduction in remittances has been mitigated by the lower cost of oil imports and the decline in interest rates.

At the end of 1985, some countries faced considerable short-term constraints on the resources that they could earn or borrow from abroad. As discussed at the end of this chapter, this has serious implications for developing countries in the near term. But in the medium term it is how efficiently resources (whether domestic or foreign) are used which determines a country's economic performance—and this, in turn, depends upon domestic policy. It is to that issue that we now turn.

Domestic policies

Developments in the world economy during the early 1980s have obviously made it more difficult for developing countries both to adjust and to maintain growth in the near term. However, growth inevitably slows down when adjustment is not undertaken. And, over the longer term, the divergent performance of developing countries faced with similar external trends points to the overriding importance of domestic policy. Those countries that have used external resources to facilitate adjustment to changed external circumstances have been able to resume growth after a brief slowdown. Those that continually borrowed to avoid making changes often found that debt accumulated without contributing to the increased output needed to service it.

Table 2.9 provides one measure of how closely growth is related to domestic policy, as measured by the level of investment and the efficiency with which resources are used. It lists net investment as a proportion of GDP and the capital used per unit of extra output for twenty-four developing economies. The ten economies with the lowest rates of growth had an average rate of net investment of only 10.8 percent of GDP, whereas net investment in the high-growth economies was 18.4 percent. The low-growth economies also used twice as much capital to produce each extra unit of GDP than did the high-growth ones. It was estimated that the inefficient use of resources, measured by the high incremental capital-output ratio, is a more significant determinant of performance for the group of ten low-growth economies than the level of net investment.

The fact that countries in both groups experienced similar changes in their external circumstances indicates that domestic policies are of primary importance in determining performance over the medium term. Previous *World Development Re-*

ports have argued that developing countries benefit if they adopt:

- Stable monetary and fiscal policies—that is, policies necessary to ensure that their budget and current account deficits are sustainable.
- Microeconomic policies that minimize price distortions in goods and factor markets largely by opening the economy to international trade and abandoning discrimination against agriculture.
- Appropriate and stable real exchange rates.

MONETARY AND FISCAL POLICIES. During a recession, public revenues fall and public spending often rises. This increases the budget deficit and the need for extra finance. The more severe the recession—such as that of 1980–82—the more pressing the need. Since 1980, with the exception of 1984, many developing countries have experienced a decline in tax receipts. But many governments could increase their tax receipts without impairing the efficiency of their economies. For example, trade reforms such as replacing quotas with tariffs, auctioning import licenses, and reducing high tariffs and exemptions can often increase revenue and reduce distortions.

How governments raise revenue determines the efficiency effects of the tax system. As in industrial countries, high marginal tax rates can have far-reaching negative effects. Not only do they encourage tax avoidance and the proliferation of tax exemptions, but also they are distortionary and, as a result, do not accomplish the objectives of raising revenues or improving income distribution. In early 1986, Jamaica undertook tax reforms to address these problems. By adopting a single personal income tax rate above a threshold level, the

Table 2.9 Growth, net investment, and capital-output ratio in twenty-four developing economies, 1960–84

Country or territory	*Average annual percentage change in GDP per capita*[a]	*Net investment (as percentage of GDP)*[b]	*Incremental capital-output ratio*[c]
Economies with low growth			
Ghana	−1.7	6.4	12.1
Somalia	−1.0	12.6	8.6
Zambia	−0.5	13.6	7.9
Jamaica	0.3	16.7	13.0
Chile	0.6	11.7	7.4
Peru	0.7	9.8	4.7
Mali	1.0	11.0	4.8
Argentina	1.3	14.0	7.0
Bolivia	1.3	8.8	4.0
Uruguay	1.7	6.0	5.3
Group average	0.4	10.8	7.2
Economies with high growth			
Philippines	2.5	16.8	4.3
Malawi	2.6	17.3	4.3
Colombia	2.7	13.6	3.9
Turkey	3.1	13.8	3.6
Dominican Republic	3.3	12.9	3.1
Mexico	3.4	15.7	3.3
Malaysia	4.3	16.4	3.3
Brazil	4.4	19.3	3.7
Thailand	4.5	17.4	3.3
Greece	4.6	18.2	4.5
Hong Kong	6.1	26.6	3.9
Korea	6.4	17.0	2.7
Botswana	7.3	28.6	3.2
Singapore	7.4	23.8	3.3
Group average	4.5	18.4	3.6

a. The exponential real growth rate per capita averaged over the period.
b. Calculated as gross domestic investment minus depreciation divided by GDP averaged over the period.
c. Calculated as the ratio of the average annual share of gross investment in GDP to the exponential real growth rate of GDP for the period. This ratio cannot be derived from the first two columns because it does not use per capita growth rates or the same definition of investment.
Source: Cavallo, Cottani, and Khan (background paper).

government eliminated high marginal tax rates as well as many complex exemptions. This reduced the distortionary effects of the income tax system and the discrimination against lower income classes. Another desirable reform that many developing countries could undertake is to broaden the tax base away from border taxes (especially on agricultural exports) and simultaneously lower marginal tax rates. This would make their economies more efficient and reduce the impact that volatile commodity prices have on tax revenue.

The main fiscal problem, though, is spending. As in industrial countries, public spending in the developing countries remained high during the early 1980s—and in many cases increased in real terms. In most developing countries increased government expenditures led to record fiscal deficits in 1982 and 1983. Although both spending and deficits have since fallen, even the reduced levels of 1985 are unsustainable in the long run. Spending cuts were often made in the areas of maintenance and investment—which will slow medium-term growth—and many heavily indebted countries are finding it difficult to reduce current expenditures further because of large interest payments on outstanding debts. The burden that this places on the budget is particularly heavy for those economies which failed to direct the previously borrowed funds into efficient activities, which would have increased output and thereby the tax base. As few developing countries have full-fledged bond markets, most governments have financed their budget deficits (after deducting overseas aid) by borrowing from the banking system—or by printing money.

Large increases in the money supply, generated by fiscal deficits, have been the main cause of the rapid increase in inflation in most Latin American and some African and Middle Eastern countries during the 1980s. Governments and central banks have sometimes tried to suppress the symptoms of inflation by overvaluing domestic currencies and controlling prices of politically sensitive goods or services. This has added to the public sector deficit and thus has exacerbated, rather than reduced, inflation. In contrast, some low-income countries in Asia (for example, India and Indonesia) have pursued prudent fiscal and monetary policies and reduced their inflation to more manageable levels.

As in industrial countries, governments in developing ones have found it easier to increase budget spending and the rate of monetary growth than to reduce them. However, as developing countries with high inflation rates have learned, macroeconomic stability is needed to achieve sustained growth. This lesson is particularly relevant to the oil-exporting countries that are struggling to bring public expenditure in line with the recent drop in oil prices and the inevitable decline in public revenues.

At least as important as the level and growth of public spending is the use to which these resources are put. Many overambitious public investment programs included large, expensive projects which yielded low returns. To some extent, the slower growth of developing countries in the 1980s reduced the actual return on some public investments, particularly in the energy field, even though they may have been attractive at the planning stage. But many projects would have had low rates of return even under normal conditions. These projects were not only unproductive in comparison with other projects, but they utilized resources that would have been more productive if directed to operation and maintenance programs. Such programs are essential in keeping the existing capital stock working efficiently. In much of sub-Saharan Africa, the basic infrastructure—highways, waterworks, railroads, and power—is in an alarming state of disrepair.

Cuts in public investment, and ever-larger proportionate decreases in maintenance expenditure, were often the results of the exigencies of stabilization programs. But, just as in industrial countries, many large items of current expenditure were not reduced. These included spending on government employees, defense, and state pensions, as well as transfers and subsidies to state enterprises. One of the main policy issues, therefore, is how to control popular government programs while at the same time ensuring that the essential role of government is performed efficiently.

DISTORTIONS AND GOVERNMENT POLICIES. Since few governments have been able or willing to broaden the tax base, higher public spending has been financed domestically partly by accelerated inflation but mainly by increasing marginal rates of taxation. In developing countries, as Part II argues, the burden of higher marginal tax rates falls heavily on agriculture, either implicitly or explicitly, and domestic manufacturing is often subsidized. This antiagriculture (and often antiexport) bias weakens incentives to invest in a sector in which developing countries are frequently competitive—agriculture. These price distortions are probably most serious in Africa because of overvalued exchange rates and the operation of compulsory mar-

keting schemes for export crops. As China's recent experience has shown, developing countries can attain much faster rates of growth by correcting policy-induced price distortions. Some reforms, such as lower, more uniform tariffs or the abolition of maximum prices on domestically produced staple foods, can be implemented without any loss of tax revenue. Indeed, revenue can be increased.

Labor markets are no less distorted in developing countries than they are in industrial ones. Wage costs to employers in the formal sector have often been raised because of legislative interventions by governments. For example, minimum wage laws and regulations against layoffs, ostensibly designed to protect poorer workers, have benefited (when effective) better-off workers in the formal economy at the expense of output and jobs. Wage indexation has slowed the adjustment of real wages to changes in the terms of trade and has made it harder to reduce inflation.

Although some wage indexation schemes have been dismantled, the reform of labor markets has been slow. High wage costs and subsidized capital, especially in the formal economy, reduce output and encourage the substitution of capital for labor. This not only leads to lower rates of job creation, but also limits growth, because investment is used to substitute for labor rather than to expand capacity.

Nearly all developing countries control interest rates and ration credit according to various "planning priorities." Low interest rates on bank deposits (often below the rate of inflation) depress savings and encourage the holding of physical assets. This stifles the development of the financial sector. In the early 1980s, Mexico provided an example of how much financial markets can suffer. In this period about 60 to 70 percent of credit in Mexico was administratively allocated or subsidized. As a result, most of the credit was channeled to relatively inefficient public enterprises or agricultural programs, and the private sector was left to compete for the remaining smaller share of nonallocated or nonsubsidized credit. This inevitably drove up real interest rates in the "free" market to more than 30 percent, crowding out relatively profitable private sector investments. Distortions in credit markets have been increased by rapid inflation, as the experience in Latin America during the 1970s illustrates, because governments are often reluctant to allow interest rates to rise to a commensurate level.

Many developing countries have recognized the need to reform their credit markets. Reforms usually begin with extra indexation and more frequent adjustment of controlled interest rates. For example, countries such as Argentina, Brazil, and Chile have reduced controls on interest rates. As a result of continued budget deficits, tighter monetary policy, and restricted inflows of foreign savings, interest rates in these countries have risen and are often high in real terms. If supported by credible macroeconomic policies designed to restore and maintain stability, these high rates will encourage the required increase in domestic savings. Adjustment of interest rates on deposits is also necessary to stem capital flight, a significant problem in a number of heavily indebted countries. But, although tentative reforms have been started, few developing countries have capital markets which generate or allocate credit efficiently.

EXCHANGE RATE AND TRADE POLICY. Governments in developing countries intervene in the conduct of international trade and commerce by means of a host of measures such as exchange rate management, import tariffs and restrictions, export taxes, and exchange controls. These trade-affecting policies have a powerful influence on the patterns of domestic production and consumption and thus on efficiency and growth.

Many governments have tried to maintain their official domestic exchange rates—particularly in the face of changing international economic conditions—by supporting them with restrictive trade and exchange controls and foreign borrowing. An overvalued exchange rate depresses the price of tradable goods relative to that of nontraded goods and encourages expansion of the nontraded sector at the expense of the tradable sector. If the government also protects import-competing goods, the disincentive to export production is even stronger.

The case for adjusting the exchange rate to reflect changes in external factors, such as a lasting shift in the terms of trade, seems clear. If the price of a country's exports declines, the preexisting equilibrium in terms of the domestic price level and employment can be maintained only by running down reserves or by borrowing from abroad. If the change in export prices is permanent, this is not a sustainable strategy. If domestic prices and wages do not adjust downward, the exchange rate will have to be devalued. Oil-exporting countries, as they come to grips with the decline in oil prices, face this issue. It is also clear that if the domestic inflation rate is higher than those of one's trading partners, an adjustment in the nominal exchange

rate will be needed to maintain competitiveness.

What is less obvious is that domestic policies which seem to be unrelated to the exchange rate may also have a significant effect on the real exchange rate (defined here as the ratio between the price of traded goods and the price of nontraded goods). By changing the relative domestic demand and supply of nontraded and traded goods, commercial policy, monetary and fiscal policy, and capital inflow all affect the real exchange rate. Unless exchange rate policy is compatible with these policies, an unsustainable current account imbalance

Box 2.3 Inconsistency in macroeconomic policymaking: the case of the Philippines, 1980–83

In 1980, after a decade of rapid growth, the Philippine economy confronted problems of short-term stabilization and longer-term structural adjustment. The current account deficit (which had been negligible earlier in the decade) rose to 5 percent of GNP by 1979 and was financed mostly by heavy foreign borrowing. High and variable protection diverted resources from agriculture and traditional exports, areas in which the Philippines has a comparative advantage, toward relatively inefficient activities. Growth in GDP was achieved, but at a high cost. Each additional unit of output required about 35 percent more capital than in comparable Asian countries.

These problems were exacerbated by the downturn in the world economy after 1979. The government's ability to delay further adjustment by borrowing more was limited by large existing debt obligations that weakened the country's creditworthiness. In 1980, therefore, the government began to implement a comprehensive series of reforms. One of the main components was a trade liberalization program designed to reduce the level and variance of effective protection to production activities so as to increase efficiency and improve the allocation of resources. The aim was to stimulate exports so that the economy could expand without being constantly constrained by the current account deficit.

By the end of 1982 the government had made progress in implementing the first stage of the program. By reforming import tariffs and adjusting the system of domestic sales taxes (see Box table 2.3), the government had succeeded in lowering effective protection rates (EPRs) and in making them more uniform across activities. Most quantitative restrictions had been removed on schedule. A number of export promotion schemes had been introduced to offset, to some degree, the remaining bias against exports.

However, beginning in late 1982 the pace of liberalization slackened, and in some cases measures were reversed. Why? Undoubtedly, external factors made adjustment more difficult. By the first quarter of 1984 the Philippines' external terms of trade were 53 percent lower than in 1973 and 16 percent below their previous low in 1977. High interest rates and protectionism in potential export markets worsened the current account balance. But what turned a difficult economic situation into an unsustainable one was the government's domestic macroeconomic policy.

Until 1983, partly because they expected an early resumption of world economic growth, the Philippine authorities continued to expand public spending and to finance it through foreign borrowing. As a result, the budget deficit increased from 1.3 percent of GDP in 1980 to 4.2 percent in 1982, and the current account deficit grew from 5.8 percent in 1980 to 8.0 percent by 1982. Most of the increase in public spending was due to investments made by relatively inefficient public corporations. They accounted for 60 percent of total public investment, and since only 15 percent was financed domestically, large foreign loans were required. As a result, the public sector's share of medium- and long-term debt increased from 50 percent in 1974 to an average of 74 percent in 1979–82.

The government compounded the problems created by its expansionary fiscal policies by adopting an exchange rate which was not consistent with the opening up of the economy. Given the declining terms of trade and the liberalization program, an exchange rate deval-

Box table 2.3 Effective protection rates, 1979 and 1985

	Average EPRs (percent)		*Standard deviation*	
Sector	*1979*	*1985*	*1979*	*1985*
All[a]	14	8	53	35
Primary and agricultural	−2	−5	29	21
Manufacturing	27	20	53	32
Exports	−11	−10	15	12
Importables	43	29	104	51

a. EPRs include the effect of sales taxes on protecting domestic production.
Source: Philippine Institute of Development Studies.

will occur, which will have the same effect on an economy as a change in the terms of trade.

A recent study investigated the effects of real exchange rate misalignment and instability on economic performance. The study examined the impact of these two factors on growth, net investment, and exports during the period 1960–83. While it is difficult to define misalignment precisely, in this case a counterfactual example was used to define what the real exchange rate would have been had sustainable domestic policies been pursued. Real exchange rate instability was defined as the coefficient of variation (that is, the variance of the rate relative to its mean). The results are shown in Figures 2.3 and 2.4.

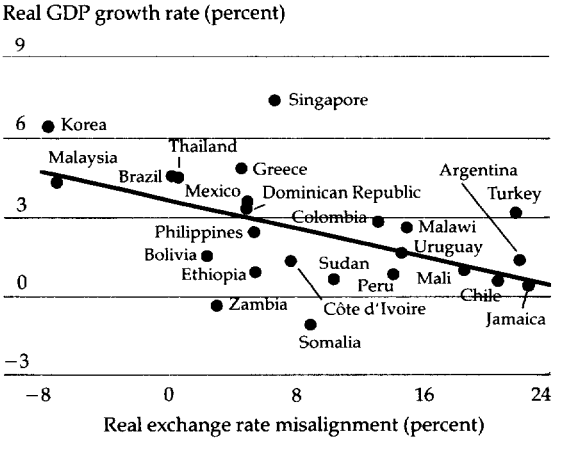
The study found that, on average, a 10 percent increase in the misalignment of the real exchange rate was associated with a GDP growth that was

uation would have been necessary to maintain a sustainable current account. Moreover, since the currency was overvalued before 1980, even holding the real exchange rate at that level would have been inappropriate. But between the first quarters of 1979 and 1984 the real exchange rate appreciated by 17 percent. This undermined the trade reforms. What was needed was real devaluation. A real devaluation would have partially compensated existing efficient manufacturers of import substitutes for the effect of reduced tariffs and, more important, would have provided a uniform stimulus to new exporters and new manufacturers of import substitutes.

The appreciation of the exchange rate and the widening public sector deficit discouraged domestic savings and reduced the flow of controlled credit to the private sector. As expectations of a devaluation increased and the government kept deposit interest rates low, domestic savings declined. As in many other countries, the more obvious it became that the status quo could not be maintained, the greater became the incentive to transfer savings abroad. This, in turn, exacerbated the pressure on the external account.

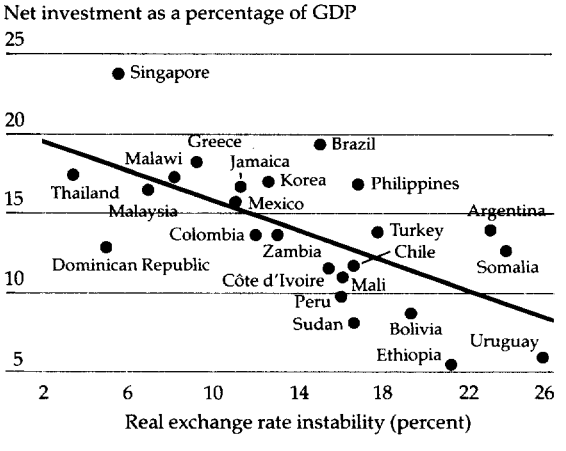
The inconsistency between the policy of liberalization on the one hand and the monetary, fiscal, and exchange rate policies on the other brought about a crisis in 1983. The government responded by delaying or reversing some of the liberalization measures. In December 1982 a 3 percent import surcharge was imposed as an "emergency" measure. By the end of 1985 it had been increased to 5 percent and an additional 1 percent tax had been imposed on foreign transactions. The second phase of the program to reduce quantitative restrictions on imports was also delayed. The momentum for reducing trade taxes was lost as the government attempted to raise revenue and reduce the growth in imports. Also, although some export incentives were increased, most of the benefits were captured by existing exporters, especially exporters of electronics. As Box table 2.3 shows, the same pattern of distortions remained in 1985, including the strong bias against exports, particularly agricultural and primary goods. Faced with worsening domestic and external deficits, the government attempted to regain control by increasing restrictions and taxes on trade instead of changing the public expenditure and exchange rate policies which had caused the imbalance.

Figure 2.3 Exchange rate misalignment and real GDP growth in twenty-four developing economies, 1960–83



Source: Cavallo, Cottani, and Khan (background paper).

Figure 2.4 Exchange rate instability and net investment in twenty-four developing economies, 1960–83



Source: Cavallo, Cottani, and Khan (background paper).

0.8 percentage points lower and an export growth that was 1.8 percentage points lower than would have prevailed without the increase in misalignment (see Figure 2.3). In high-growth economies such as Korea and Thailand, the real exchange rate was far less out of line than in poor performers such as Jamaica and Ghana, where misalignment (before recent reforms were undertaken) averaged 23 and 73 percent, respectively, for the period 1960–83. For the same group of countries, a 10 percent average increase in the real exchange rate's instability was found to be associated with a reduction of 4.8 percentage points in the net investment ratio (see Figure 2.4).

When the two measures are considered together, they explain more of the variation in the indicators of economic performance. Misalignment seems to be more important than instability in explaining changes in GDP and export growth, while instability seems more important in explaining changes in investment. One would expect this. Exchange rate overvaluation discourages export and GDP growth; investment decisions are affected mainly by uncertainty about relative prices.

The underlying message is simple: a flexible exchange rate policy is critical if the economy is to adjust and resources are to be allocated and used efficiently. Those developing countries that do not allow their exchange rates to change will be forced to resort to other measures, such as trade barriers or foreign exchange controls, to avoid running down reserves. This will lead to wasted resources and efficiency losses. Indeed, a number of countries, particularly in Latin America, have recently improved their exchange rate policies significantly. Nevertheless, although permitting the exchange rate to adjust is necessary to maintain the openness of an economy, it cannot substitute for adjustment in other policies. If the cause of an unstable macroeconomic situation is monetary or fiscal policy, that is where reforms must be made (see Box 2.3).

In addition to managing their exchange rates, many developing countries impose a complex array of taxes and quantitative controls on imports and (to a lesser extent) exports. These trade policy measures are directed at such goals as protecting domestic industries, raising revenue, and shoring up international reserves. They create an unstable set of disparate incentives that cut across a broad range of domestic production activities and consumption goods. But within this variability is a ba-

Table 2.10 Change in U.S. interest rates and the export prices of developing countries, 1978–85

Item	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Six-month dollar LIBOR	9.5	12.1	14.3	16.6	13.3	9.9	11.2	8.7
Export price index (percentage change)								
Oil exporters	3.2	36.6	46.3	6.3	−4.4	−9.2	−1.0	−3.6
Oil importers[a]	3.8	19.4	12.0	−2.1	−4.8	−1.0	−1.3	−1.6
U.S. GDP deflator (percentage change)	6.7	8.5	8.9	9.2	6.0	3.8	3.8	3.5
U.S. real interest rate[b]	2.6	3.3	5.0	6.8	6.9	5.9	7.4	5.2

a. Includes China.
b. Defined as six-month dollar LIBOR deflated by the U.S. GDP deflator.

Table 2.11 Debt indicators for developing countries, 1980–85
(percent)

Indicator	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Ratio of debt to GNP	21.1	22.8	26.8	31.8	32.7	33.0
Ratio of debt to exports	90.1	97.5	116.4	134.3	130.4	135.7
Debt service ratio	16.1	17.7	20.7	19.4	19.8	21.9
Ratio of debt service to GNP	3.8	4.1	4.7	4.6	5.0	5.3
Ratio of interest service to exports	7.0	8.3	10.4	10.0	10.5	11.0
Total debt outstanding and disbursed (billions of dollars)	431.6	492.5	552.4	629.9	674.1	711.2
Private debt as a percentage of total debt	63.3	64.5	64.9	66.1	65.7	64.5

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

Table 2.12 New commitments to public and publicly guaranteed borrowers in developing countries 1978–84
(billions of dollars)

Item	1978	1979	1980	1981	1982	1983	1984
All developing countries							
Total commitments	83.7	95.1	93.1	103.0	99.2	87.2	69.9
Private source	53.4	64.0	50.1	64.2	61.4	49.6	36.3
Official source	30.3	31.0	42.9	38.8	37.7	37.6	33.6
Bilateral	16.5	16.4	23.5	19.5	17.4	16.2	13.6
Multilateral	13.8	14.6	19.4	19.3	20.3	21.4	20.0
Low-income Africa							
Total commitments	3.8	4.5	5.2	3.7	3.6	3.1	3.0
Private source	1.1	1.6	1.5	0.8	0.5	0.2	0.4
Official source	2.8	2.9	3.8	2.9	3.1	2.9	2.6
Bilateral	1.6	1.4	1.9	1.2	1.4	1.4	0.9
Multilateral	1.2	1.5	1.9	1.7	1.7	1.5	1.7
Heavily indebted countries[a]							
Total commitments	50.8	62.2	54.6	79.0	61.7	41.8	29.9
Private source	42.4	54.4	44.7	65.9	49.2	28.7	20.1
Official source	8.4	7.8	9.9	13.1	12.5	13.1	9.7
Bilateral	3.6	2.5	4.5	5.9	5.0	4.7	3.5
Multilateral	4.8	5.3	5.4	7.2	7.5	8.4	6.2

a. Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. These countries accounted for nearly half of all developing countries' debt at the end of 1985.

sic pattern of encouraging manufacturing activities relative to agriculture and import substitution activities relative to exports.

There is a convincing body of quantitative evidence from cross-country studies that developing countries with less distorted trade policy regimes (particularly those that are less biased against exports) have fared better in terms of growth performance, coping with external shocks, and employment creation. Recognition of this has encouraged some reappraisal of trade policies and led to certain reforms to promote efficiency and growth. The basic objectives are to simplify and unify trade incentives and, most important, to reduce the biases against agriculture and exports. The reforms generally involve a commitment to follow a more appropriate exchange rate policy and to implement an import liberalization program. Components of such a program should include the removal of quantitative restrictions on imports and lower, more uniform tariffs and other charges on imports.

The international environment

At the root of the poor performance and debt problems of developing countries lies their failure to adjust to the external developments that have taken place since the early 1970s, coupled with the magnitude of the external shocks. Many developing countries tried to offset the effects of external shocks, higher inflation, and lower growth by borrowing more, mostly at short-term maturities and floating rates. The shift in favor of commercial bank lending at floating rates in the 1970s left developing countries vulnerable to an increase in interest rates and to reductions in the volume of private lending. The 1979 oil price increase and the recession of the early 1980s exposed these weaknesses.

The monetary and fiscal policy mix pursued by industrial countries after 1979 drove interest rates up at the same time that the export prices for many developing countries declined. In 1982, oil-importing developing countries were paying a nominal rate of interest of around 13 percent for commercial loans while their export prices declined by 5 percent (see Table 2.10). These external developments made the process of stabilization and adjustment that much more difficult (see Box 2.4).

As interest rates rose and developing countries continued to borrow, their creditworthiness indicators deteriorated. Between 1980 and 1982, the proportion of debt to GNP rose from 21.1 percent to 26.8 percent; that of debt to exports rose from 90.1 percent to 116.4 percent; and the debt service ratio (interest payments plus amortization as a percentage of exports) increased from 16.1 percent to 20.7 percent (see Table 2.11). Although the ratio of

Box 2.4 Reacting to a debt crisis

"The international debt crisis" is a threadbare phrase, but it does express the fact that although many different countries have experienced debt problems, their experiences have certain features in common. At the same time, differences in the ways countries have reacted (or failed to react) to these problems suggest guidelines for policymakers in the future. A debt crisis usually has its origin in an unusually large inflow of capital. This inflow adds to total spending and pushes GDP beyond the level that would be achieved with domestic resources alone. As capital flows in, the trade account moves into deficit and the real exchange rate tends to appreciate.

The onset of a debt crisis occurs when these movements are sharply reversed. The reduced capital inflow requires a corresponding improvement in the balance of trade, which is brought about in part through a reduction in spending and in part through a real exchange rate depreciation.

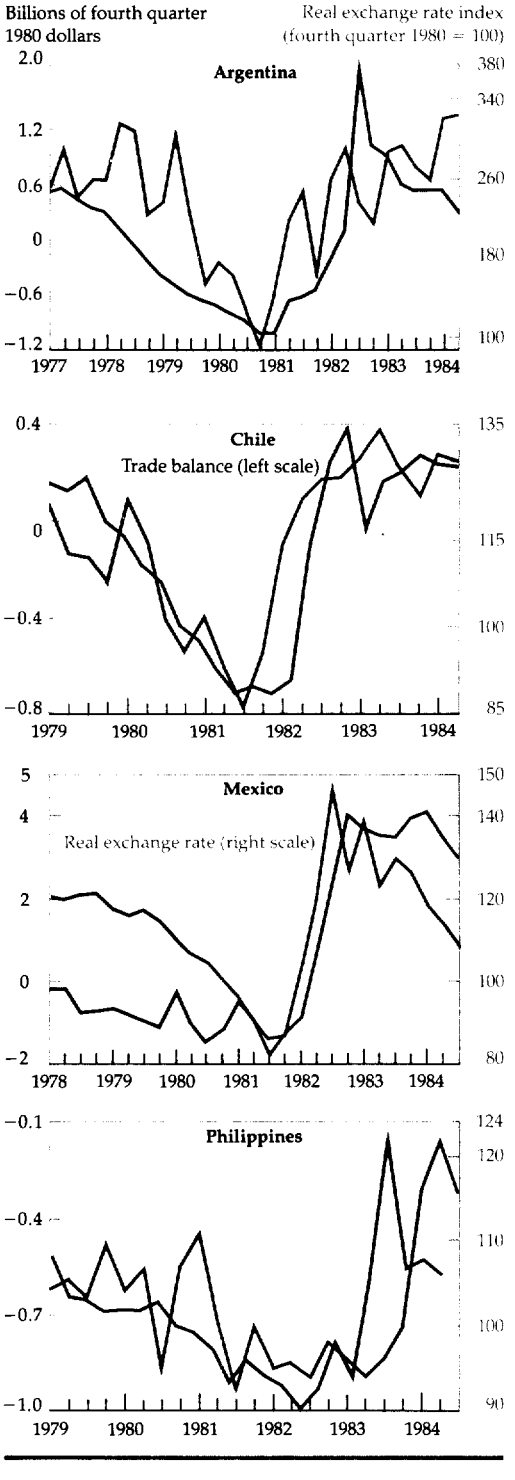
Box figure 2.4A shows how in four countries the real exchange rate fell during the period of capital inflow and increasing trade deficit and then rose as the trade balance improved in response to a debt crisis. Also, as Box figure 2.4B shows, real GDP rose to a peak during the period of large capital inflows, then fell sharply as the country adjusted to the reduction in these flows. These oscillations partly reflect the direct impact of foreign capital on GDP, but the decline in GDP is also associated with the tighter monetary and fiscal policies adopted in an attempt to improve the trade balance.

The triple pressure—from reduced capital flows, tighter macroeconomic policies, and a falling real exchange rate—produced a sharp decline in the volume of imports in all four countries (see Box figure 2.4B). In the short term, imports tend to bear the brunt of the trade account's adjustment because exports respond only with a lag.

Different countries' exports responded differently in the wake of a debt crisis, the story here being complicated by other factors such as weather cycles and world price movements of principal export commodities. Thus, Argentina's export volumes rose by 10 percent in the first year of adjustment (1981), only to fall back to near their 1980 levels in the following two years. Chile's exports stayed roughly constant in volume terms, despite a substantial real devaluation, mainly because of declining world copper prices. The exports of Mexico and the Philippines grew, but only moderately, in the years following their debt crises (1982 and 1983, respectively).

One important difference among countries that faced a debt crisis is the way in which inflation impinged on their adaptation to the crisis. Box table 2.4 summarizes the experience of eleven countries. It shows the maximum real exchange rate devaluation achieved by each country as it adjusted to the crisis (column 3). It also

Box figure 2.4A Movements in the trade balance and real exchange rate in Argentina, Chile, Mexico, and the Philippines, selected years, 1977–84



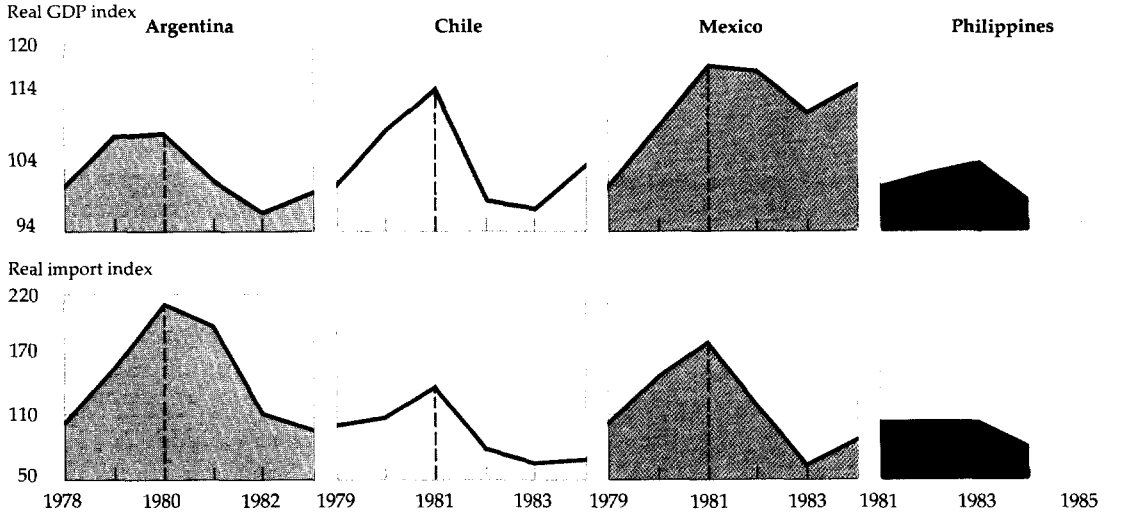
shows the contemporaneous rise in the consumer price index (column 4). Since a devaluation of the nominal exchange rate increases the internal prices of tradable goods, it is almost inevitable that a large devaluation will entail a rise in the general price index. (Otherwise, a major fall in the prices of nontradable goods would be required.) The policy challenge is to limit this price rise. The figures in column 5 can be taken as an index of how successfully different countries met this challenge. Venezuela, the Philippines, Uruguay, and Chile were the most successful; Argentina, Bolivia, Peru, and Brazil saw inflation increase more than might be expected from the extent of their real devaluations.

Box table 2.4 Real devaluation and inflation in countries that faced a debt crisis

Country	*Time periods being compared (year and quarter)*		*Ratio of real exchange rate*[a] (3)	*Ratio of CPI*[b] (4)	*Inflation relative to real devaluation*[c] (5)
	Precrisis trough (1)	*Postcrisis peak* (2)			
Argentina	1980 IV	1984 I	2.57	53.34	20.75
Bolivia	1982 III	1984 II	1.59	18.83	11.85
Brazil	1982 III	1984 III	1.48	7.23	4.89
Chile	1982 I	1984 III	1.45	1.61	1.11
Mexico	1981 IV	1983 III	1.50	3.13	2.08
Peru	1982 I	1984 III	1.11	5.86	5.28
Philippines	1982 III	1983 IV	1.36	1.19	0.87
Portugal	1979 III	1983 III	1.48	2.15	1.45
Turkey	1979 IV	1984 II	1.92	5.65	2.94
Uruguay	1982 III	1984 II	2.00	2.09	1.05
Venezuela	1983 II	1984 II	1.74	1.11	0.64

a. Measured from peak to trough.
b. Consumer price index at peak divided by consumer price index at trough.
c. Column (4) divided by column (5).
Source: Harberger, "Reacting to a Debt Crisis" (background paper).

Box figure 2.4B Changes in real GDP and real imports in Argentina, Chile, Mexico, and the Philippines, selected years, 1978–84



Note: The GDP index is calculated from *International Financial Statistics* data with the starting year equal to 100. The real import index is calculated by deflating nominal imports by an SDR-weighted index of wholesale prices of major industrial countries. The broken line indicates the onset of the debt crisis.
Source: IMF *International Financial Statistics*, various years.

debt to exports improved slightly in 1984, all the major creditworthiness indicators deteriorated again in 1985, primarily because the drop in export earnings exceeded the benefits derived from lower interest rates.

The deteriorating creditworthiness of developing countries did not go unobserved by creditors. By 1982 they had become reluctant to extend new loans to public borrowers. Table 2.12 provides estimates of new loan commitments to all developing countries. It also splits out two of the most vulnerable subgroups—low-income Africa and the most heavily indebted developing countries. New commitments of capital from private sources to all developing countries declined from a peak of $64.2 billion in 1981 to $36.3 billion by 1984. The onus of most of the reduction fell on the most heavily indebted developing countries. For this subgroup new private commitments fell by more than two-thirds between 1981 and 1984. Official new commitments to all developing countries also declined during this period, from $38.8 billion to $33.6 billion, principally because of reductions in bilateral commitments. It should be noted, however, that the data in Table 2.12 understate the amount of long-term lending actually made, because the table excludes new loans that are made when existing obligations are rescheduled.

The heavily indebted middle- and low-income developing countries became unable to service their debts normally. The causes and circumstances varied from country to country, as the contrast between Brazil, Mexico, and Turkey demonstrates. But attempts to restore macroeconomic stability and growth had certain policy components in common. Because an improvement in export performance in response to policy changes can take time, countries began addressing their severe external imbalances by focusing on reducing spending, particularly spending on imports. Many countries embarked on stabilization programs, often with assistance of the International Monetary Fund (IMF). Policies designed to reduce government expenditure, increase taxes, realign the exchange rate, and restrict credit were implemented to move the economy toward internal and external balance in the near term.

As a result, there was a sharp reduction in the overall current account deficit of developing countries, from the trough of $105.6 billion in 1981 to $34.1 billion in 1984 and $40.6 billion by 1985 (see Table 2.13). Initially, this was achieved mainly by a drastic reduction in imports. The adjustment of the external account followed partly from necessary adjustments in exchange rates and cuts in public spending, but also partly from a more worrisome increase in import restrictions and tighter rationing of private sector credit. Toward the end of the period, however, particularly in 1984, the increase in exports brought about by exchange rate adjustments and trade policy reforms made a significant contribution to reducing the external deficit. The buoyant world economy in 1984 supported this adjustment effort.

But during 1985 a combination of adverse developments in the world economy and, in some cases, inappropriate domestic policies hindered further progress. Even those economies that had made credible policy changes continued to face considerable problems in restoring growth. Because debtors needed to run trade surpluses to service their debts, slower growth in industrial countries and the larger relative decline in the growth of world trade volumes in 1985 made it difficult to expand exports. Because export prices also declined, many developing countries attempted to adjust by contracting imports and domestic investment further.

The overall decline in developing countries' export prices is shown in Table 2.7. Since 1980, nonoil commodity prices have fallen by 26 percent in dollar terms, or by 23 percent relative to the price

Table 2.13 Current account balance in developing countries, 1980–85
(billions of dollars)

Country group	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Low-income countries	−15.5	−12.5	−6.7	−4.3	−7.9	−22.0
Africa	−5.8	−6.3	−5.5	−4.4	−4.6	−5.1
Asia	−9.7	−6.2	−1.2	0.1	−3.3	−16.9
Middle-income oil exporters	1.5	−27.3	−35.8	−11.0	−1.9	−5.5
Middle-income oil importers	−53.8	−65.8	−57.9	−37.1	−24.3	−13.0
All developing countries	−67.8	−105.6	−100.4	−52.4	−34.1	−40.6

Note: Data for developing countries are based on a sample of ninety countries. Data for 1984 and 1985 are provisional estimates. The current account balance excludes official transfers.

Table 2.14 Public and private long-term capital flows to developing countries, 1975 and 1980–85
(billions of dollars)

Country group and item	*1975*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
All developing countries							
Disbursements	46.4	102.6	121.9	115.5	95.3	86.8	92.9
From private creditors	31.4	75.3	91.4	84.2	64.8	54.3	55.5
Principal repayments	15.8	43.8	47.3	49.3	42.8	46.8	57.4
Net flows	30.6	58.9	74.6	66.2	52.5	40.0	35.5
Low-income Africa							
Disbursements	2.0	4.2	4.0	3.3	3.0	2.5	3.4
From private creditors	0.8	1.6	1.3	0.9	0.6	0.3	1.7
Principal repayments	0.4	0.8	0.8	0.9	0.8	1.0	2.0
Net flows	1.6	3.4	3.1	2.3	2.2	1.4	1.4
Heavily indebted countries[a]							
Disbursements	21.3	53.1	69.0	57.6	38.3	32.5	31.9
From private creditors	17.3	45.9	60.5	48.3	28.8	22.6	18.5
Principal repayments	8.9	24.7	26.1	25.7	18.1	18.2	21.8
Net flows	12.4	28.4	42.9	31.8	20.2	14.3	10.1

Note: Data for 1984 and 1985 are provisional estimates of amounts paid, not amounts due. Private nonguaranteed debt has been estimated where not reported by a country. Official grants are excluded. Data are based on a sample of ninety developing countries.
a. Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. These countries accounted for nearly half of all developing countries' debt at the end of 1985.

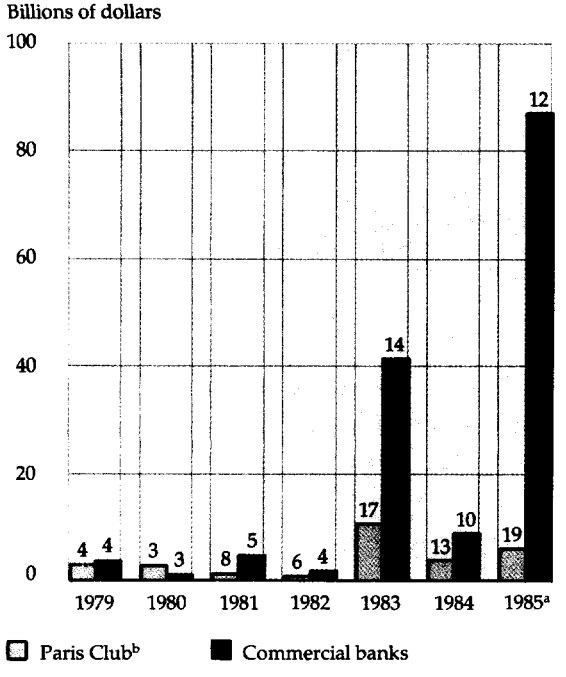
of manufactures. This fall can be attributed to slower growth in demand from industrial countries, the strength of the dollar until early 1985, and high real interest rates that increased the cost of holding inventories. The fall in agricultural prices has been accentuated by large increases in the supply of agricultural raw materials, which were triggered in part by price support measures and trade protection in industrial countries. The fall in the price of metals has reflected worldwide overcapacity and, in some cases (tin, for example), the breakdown of previous agreement among producers to constrain supply and inventory levels. But the decline in the price of primary commodities relative to the price of manufactures also reflects an underlying trend toward more efficient use of materials and increased substitution of synthetics. Cyclical fluctuations do, however, play an important role; since 1980, with the exception of 1984, their effect has generally been unfavorable.

In addition, net long-term capital flows to developing countries have continued to decline since 1981 (see Table 2.14). By 1985, net long-term inflows were approximately $35.5 billion, down 52 percent from the $74.6 billion reached in 1981. For the group of heavily indebted countries, the decline has been approximately 76 percent, from $42.9 billion in 1981 to an estimated $10.1 billion in 1985. Net flows to low-income Africa have been cut to less than half their 1981 level, dropping from $3.1 billion to $1.4 billion. In the case of low-income Africa, however, official grants remain important—these increased slightly, from $3.2 billion in 1981 to $3.3 billion in 1984.

In real terms, the drop in net capital flows was even larger. In addition, total interest payments by developing countries on external public and private long-term debt amounted to $57.6 billion in 1985 (up from $41.8 billion in 1981), which represented 11 percent of their export earnings. Thus, developing countries paid out approximately $22 billion more in long-term debt service in 1985 than they received in disbursements of long-term lending. The heavily indebted countries accounted for most of this net transfer.

In response to the growing debt problems of developing countries, rescheduling agreements increased markedly in both number and value in 1983 (see Figure 2.5). The dip in the value of reschedulings recorded in 1984 reflects the slippage of several agreements that were agreed to in principle in that year but not signed until 1985. As a result, reschedulings reached a record value of $93 billion in 1985. The most prominent example was Mexico's $49 billion multiyear rescheduling agreement (MYRA). Important agreements were also

Figure 2.5 Debt rescheduling, 1979–85



Note: The figures above the bars indicate the number of rescheduling agreements.
a. Excludes $26.4 billion of renegotiated commercial debt agreed to in principle but not completed.
b. Includes rescheduling in all official forums.
Source: World Bank *World Debt Tables*, 1985–86 edition.

concluded for Argentina, Chile, Ecuador, and the Philippines.

Yet, the underlying pace of rescheduling agreements with private creditors has slackened in comparison with 1983. Of the eleven reschedulings that had been agreed to in principle in 1984 but not completed, only three were signed in 1985. It is clear that some major debtors still have a long way to go in restoring their access to voluntary commercial lending.

The debt overhang

Monetary and fiscal reforms, the reduction of distortions to minimize efficiency losses, and appropriate exchange rate policies—all these are parts of a necessary process of long-term adjustment for developing countries. But the pressing short-run problems of some developing countries have led them to undertake major adjustments quickly. In addition, some countries have adopted policies that have produced often unnecessary conflicts between short-term stabilization and longer-term growth.

Partly as a result of unavoidable stabilization measures, real wages have declined at the same time that interest payments on public debt have increased. This has made it difficult for either individuals or governments to increase gross domestic savings. Since many countries have also had their access to foreign savings curtailed, gross domestic investment has been reduced. This will retard recovery over the medium term, even if policy changes create profitable investment opportunities. In addition, despite high interest payments, some governments have not reduced other items of public expenditure in line with declining national income. The resulting budget deficit has led to tighter credit rationing or higher real interest rates and thus has exacerbated the crowding out of profitable private investment. It has also been observed that higher import tariffs have often been applied to raise tax revenue as well as to reduce the trade deficit. But this lowers the relative incentives to export, thereby reducing the export growth required to restore creditworthiness. In some cases the distortions have been made worse by recourse to additional export taxes as a quick and easy source of government revenue.

The problems are particularly serious in low-income Africa. Export earnings have fallen at a time when private capital inflows and domestic savings have slumped. So, on top of the rapid population growth and inefficient use of investment that characterized much of low-income Africa throughout the 1970s has been added an absolute shortage of savings in the early 1980s. The resulting decline in productive investment is jeopardizing future growth. As the next chapter argues, special efforts are needed to reform institutions and incentives in many African countries, and these reforms must be supported by a coordinated international effort to increase resource flows.

The so-called debt overhang is restricting the access of many heavily indebted countries that are undertaking credible economic reforms to the resources needed to increase investment and stimulate growth. The recent fall in the price of oil, though it has helped oil importers, has worsened matters for those major debtors—Indonesia, Mexico, Nigeria, and Venezuela—that depend heavily on crude oil exports. It lowers their immediate export earnings and weakens their ability to attract more commercial capital.

Thus, many developing countries enter the second half of the 1980s confronted with the problem of how to stabilize and restore growth within,

what is for some, an inhospitable world environment. The lower interest rates and declining oil prices have undoubtedly helped many developing countries in 1985 and the first half of 1986. But the slower growth in world trade, declining or stagnant export prices, increased trade barriers, and reduced net capital inflows have overwhelmed these gains for many others. Those developing countries that have not attempted to stabilize their economies, or have faltered mid-course, will have to press ahead with the types of policy reform discussed in this chapter. But, in any event, domestic reform efforts will succeed more readily in an improved international environment. Sustained growth—of the type experienced in the 1960s—can be achieved. But it will take a commitment to policy reform by both developing and industrial countries and a reduction in international trade restrictions. The policies and international initiatives needed to attain adjustment with growth are the subjects of Chapter 3.