



## *The macroeconomic foundation*

The experience of the 1970s and 1980s indicates that macroeconomic stability is necessary for sustainable growth. Sound fiscal and monetary policies create a hospitable climate for private investment and thus promote productivity. The previous chapters have shown that macroeconomic stability certainly does not by itself lead to development—but without it all other efforts are likely to be in vain.

Countries often experience external or internal macroeconomic shocks. Flexibility in adjusting quickly to the fiscal and monetary problems that these shocks cause is crucial if growth is to be sustained. Lack of adjustment may result in high inflation, an overvalued exchange rate, and a balance of payments crisis. These lead in turn to low investment and slow growth. The contrast is illustrated by comparing the experience of the East Asian economies in the 1970s and 1980s with that of Latin America in the past decade. For a country experiencing significant domestic and external imbalances, a credible reduction in the fiscal deficit is almost always necessary to reduce inflation, and an appropriate exchange rate is needed to reduce the balance of payments deficit.

These macroeconomic prescriptions may seem straightforward, but putting them into practice rarely is. The pace and sequencing of macroeconomic stabilization policies are difficult issues in their own right. The task is all the more demanding when macroeconomic reform is merely an element of a broader program of economic reform—as this Report says it usually needs to be. Potential conflicts among various reforms need to be minimized, and complementarities need to be taken advantage of. (The purely economic aspects

of program design will be addressed later in this chapter. Some of the political difficulties raised by reform, and how they can be overcome, will be examined in Chapter 7.)

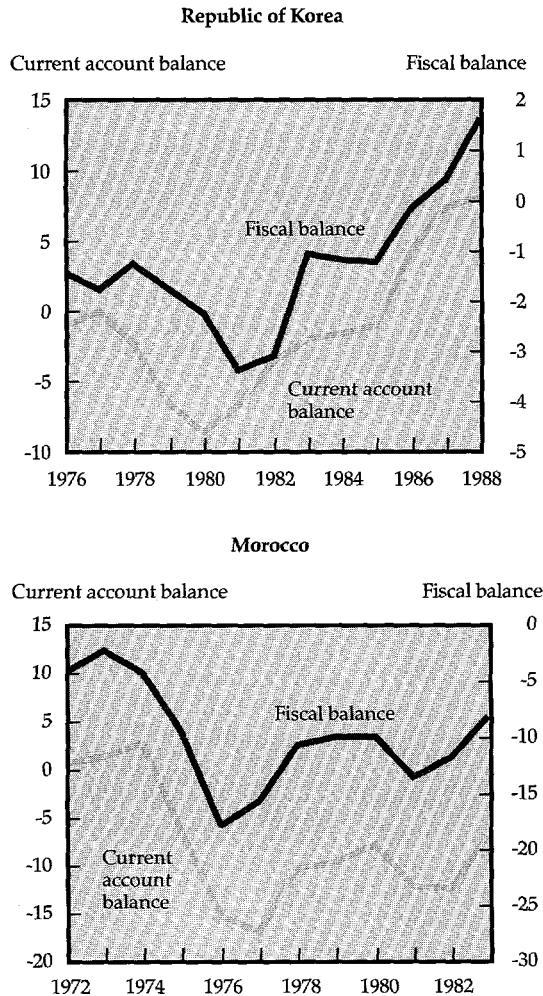
In many developing countries, long-term growth requires a higher level of investment. Countries that lack access to adequate supplies of foreign savings will find this difficult to finance. They must do all they can to encourage domestic saving. A stable macroeconomy can help greatly; it is likely to promote saving and investment alike. The microeconomic reforms suggested elsewhere in the Report should then help to ensure that these bigger volumes of investment are used more productively.

Good macroeconomic policies will also make it easier to attract foreign savings. External debt will, however, remain an obstacle to growth in many countries. A heavy burden of debt service preempts resources that could otherwise be used for domestic investment; it also acts as a disincentive for investment because it makes firms anxious about future exchange rate devaluation and higher levels of taxation. Debt and debt service reduction, in parallel with the necessary policy changes, can smooth the path of reform, improve the program's credibility with private investors, and contribute to fiscal adjustment.

### **Policies to promote stability and growth**

The adverse macroeconomic shocks of the early 1980s led to sharp declines in growth rates, and many countries have since been slow to recover. As a result, much more attention has recently been paid to the relation between macroeconomic policy

**Figure 6.1 The current account balance and the fiscal balance in Korea and Morocco, various years**  
(percentage of GDP)



Sources: World Bank data; IMF data.

and growth. The lesson is that durable growth requires sustainable policies—ones that do not give rise to accelerating inflation or unfinanceable current account deficits. Macroeconomic stability must be a top priority.

#### *Fiscal and monetary policy*

A prudent fiscal policy is the foundation of a stable macroeconomy. Taxes and public spending affect resource allocation, and fiscal deficits affect both the balance of payments (Figure 6.1) and, depend-

ing on how they are financed, the rate of inflation (Figure 6.2). Monetary policy in developing countries largely follows fiscal policy. In many countries the absence of well-developed capital markets limits the instruments of monetary policy to credit controls, interest rate ceilings, and changes in reserve requirements. The degree of central bank autonomy may affect the conduct of monetary policy: money creation is in many cases the residual source of financing, so if the central bank is obliged to finance a big deficit it may be unable to implement a restrictive monetary policy targeted at controlling inflation.

The mode of deficit financing is crucial. When a deficit is financed by printing more money than the public wants to hold, prices will rise. Inflation may bring a reduction in private wealth insofar as the value of financial assets may be eroded—the so-called inflation tax. But this effect is likely to be short-lived and to diminish as inflationary expectations strengthen; the longer the experience of inflation, the less economic agents will be willing to hold the non-interest-bearing assets on which the “tax” is levied. Moreover, if real tax revenues also fall with inflation because of delays in collection, the deficit will widen; that will cause faster money creation and even higher inflation. After a certain point, therefore, high inflation may actually reduce the inflation tax. This appears to have occurred in Ghana, Malawi, and Zaire between the periods 1973–78 and 1978–83, and in Chile between 1963–73 and 1973–78.

When budget deficits are financed by excessive domestic borrowing, they can lead to higher interest rates that crowd out the private sector. There are limits to a rapid accumulation of domestic debt; at some point, the public will be unwilling to hold more debt or will do so only at higher interest rates, further increasing the cost of debt service, as happened in Argentina and Brazil. Eventually deficits must be brought down with cuts in spending, or through higher taxes. Otherwise inflationary financing of the deficit is inevitable.

#### *Inflation and growth*

Countries with different rates of inflation have been able to achieve long periods of growth. But high and unstable inflation—and high inflation is usually unstable—is likely to reduce growth by creating an unstable economic climate, causing distortions in relative prices, and absorbing resources. Inflation requires frequent price adjustments. These tend to blur the information

embodied in relative prices. Entrepreneurial effort is diverted from production and investment decisions to short-term financial matters. Distortions in key prices such as the real interest rate and the real exchange rate are also likely to hamper growth. Corrective inflation (the increase in prices needed to achieve a change in relative prices that represents an adjustment to a real shock) can be more efficiently achieved when inflation is low and is expected to remain that way.

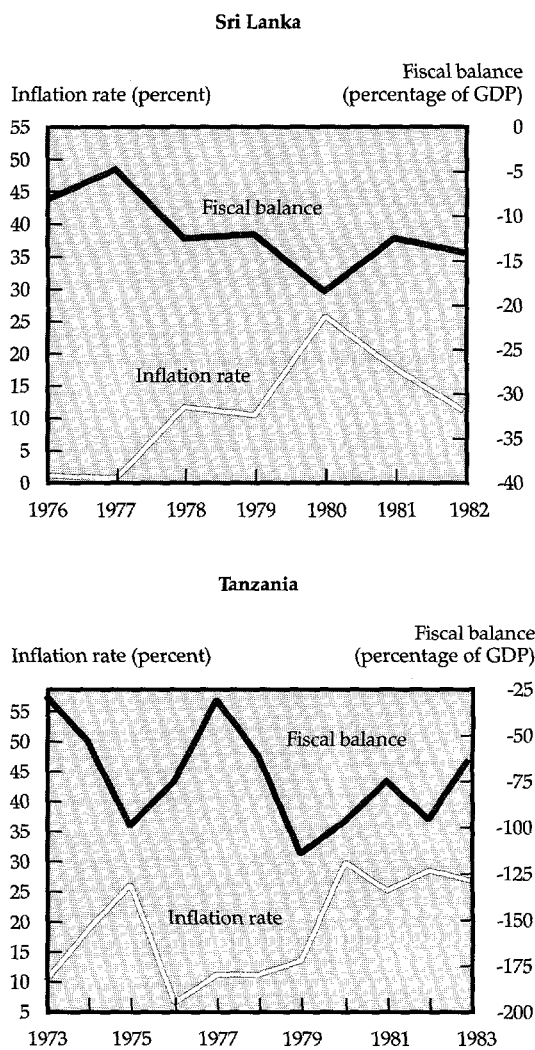
Inflation may also worsen the distribution of income by harming low-income groups (which tend to hold a larger share of their assets as cash balances) more than other groups. High rates of inflation, as in Argentina, Brazil, and until recently Israel, can also lead to nonproductive expansion of the financial system. The demand for financial-intermediation services rises with the public's attempt to protect the real value of its assets. Banks proliferate, trying to capture the part of the inflation tax that falls on non-interest-bearing deposits. In Brazil, the financial sector's share of GDP doubled between 1975 and 1987, a waste of resources caused by a demand for services that existed only because of high inflation.

#### Exchange rate policy

A competitive real exchange rate is necessary to support the expansion of the export sector and to avoid the emergence of balance of payments difficulties that might lead to calls for import restrictions. Countries that have allowed their real exchange rate to become grossly overvalued have experienced both a slowing of the expansion of their export sector and capital flight. Exchange rate overvaluation retards growth and has contributed to the decline of the agricultural sector and the deterioration of the external position of many African countries.

The equilibrium real exchange rate is not fixed for all time; its level depends on the terms of trade, real interest rates abroad, the outlook for capital flows, the level of import tariffs, the extent of capital market controls, and the composition of government spending. Correcting external imbalances generally requires adjusting the exchange rate toward its equilibrium level to redirect resources to the tradable goods sector and to reduce spending. In the short run, most of any nominal devaluation is also a real devaluation. If it is to endure, this real devaluation has to be supported by anti-inflationary policies, including in many cases lower fiscal deficits. Evidence shows that a real depreciation is

**Figure 6.2 Inflation rates and the fiscal balance in Sri Lanka and Tanzania, various years**



Sources: World Bank data; IMF data.

eroded rather quickly when fiscal and monetary policies are lax or price indexation is widespread.

A fixed exchange rate has sometimes been used to control inflation, serving as a nominal anchor for domestic policies and demonstrating the authorities' commitment to low inflation. In this case, exchange rate policy takes priority; other policies should adjust to support it.

Does this approach work? The argument, as advanced for some countries in Latin America, is that it restores the credibility of the government's commitment to reduce inflation. But as the experience

of Argentina, Brazil, and Israel shows, the fixed exchange rate will not be sustainable unless the macroeconomic fundamentals are right (that is, unless the fiscal deficit has been cut). India, Pakistan, and Thailand have maintained a fixed exchange rate for long periods of time, but this seems to have been a by-product of low inflation, rather than a means of achieving it. Inflation continued to be relatively low even after their commitment to a fixed exchange rate was abandoned.

### **Booms and busts**

No country is ever in a stable equilibrium. Economies are always adjusting to internal and external shocks. The past two decades have been unusually turbulent. Two oil price shocks and a debt crisis have rocked the world economy, and sharp fluctuations in commodity prices have had enormous effects on large producers. For some, these shocks were favorable; for others, unfavorable. Countries varied in their response. Following favorable shifts in their terms of trade, many countries pursued unsustainable policies, financing them with the windfall gains of positive shocks or external borrowing. In other countries the origin of the boom was internal; an increase in government spending, for example. The short-term effect of such booms depended on how the additional spending was divided between tradable and nontradable goods, whereas the medium-term effect depended on whether the additional spending was directed to consumption or investment.

Boom and bust episodes show it is important to pursue policies that do not give rise to large macroeconomic imbalances, to adjust quickly, and to respond cautiously to shifts in terms of trade. There is an important distinction between terms of trade shocks that give rise to a permanent change in wealth and those that do not. The windfalls from temporary changes in terms of trade should be saved. It is difficult, however, to determine a priori whether a shock will be permanent or temporary. Prudence calls for treating all favorable shocks as temporary, at least until the dust settles.

#### *External booms*

Favorable shifts in the terms of trade induced a big increase in government spending in, for instance, Mexico and Nigeria and fueled domestic booms that were already under way in Côte d'Ivoire and Morocco. Mexico grew rapidly after increases in government expenditures following major oil discoveries in 1977 and the second oil price shock.

The fiscal deficit doubled, reaching 17.2 percent of GDP in 1982, and foreign debt accumulated rapidly, setting the stage for the debt crisis of that year. Nigeria's response to the oil windfall was to increase government spending by more than the rise in revenues; the resulting fiscal deficit was financed with external borrowing and the inflation tax. The response to the second oil price boom was similar (large budget deficits and a continuing overvaluation of the currency), except that the mix of public spending shifted further toward consumption.

The investment boom in Côte d'Ivoire began with a series of sugar projects; increases in world coffee prices led to further expansion. Between 1974 and 1978, the investment-to-GDP ratio increased 10 percentage points. But even when the terms of trade began to decline, investment expansion continued, financed by domestic and external borrowing, and debt accumulated rapidly. Morocco's economy experienced two large shocks in 1974 when the price of world phosphates quintupled and military spending increased rapidly because of the conflict in the Western Sahara. In 1974-77, an ambitious investment program financed with external borrowing increased the investment-to-GDP ratio by 11 percentage points. The budget deficit tripled to 11.7 percent of GNP; however, monetary discipline cushioned the inflationary effect of these policies.

Commodity booms increase spending, raise the price of nontraded goods relative to that of traded goods, and shift capital and labor to the expanding sector. The real exchange rate appreciates, squeezing the nonboom tradables sector in a phenomenon known as "Dutch disease." When booms are temporary, a devaluation may be necessary. Indonesia, for example, devalued the rupiah in November 1978 to prevent a real appreciation of the currency. This prevented a decline in the farm sector and helped to increase Indonesia's share in world agricultural exports. Nigeria, in contrast, failed to offset the appreciation of its currency between 1974 and 1984; large premiums were charged in the parallel currency market, and foreign exchange was rationed. The oil price boom, together with poor marketing and pricing policies, disrupted the farm sector, causing a steep decline in the production of traditional cash crops and heavy migration to the cities.

#### *Internal booms*

Internal booms usually result from excessive government spending, as in Brazil in the 1970s, or

from a surge in private spending in response to changes in policy, as in Chile in 1980–81. Easy access to external financing sustained the increases in spending, but excessive borrowing created a balance of payments crisis later. Between the two oil price shocks, Brazil substantially increased its public investment, largely in public enterprises.

Countries such as Colombia experienced more moderate domestic booms but did not experience debt crises because they borrowed abroad more modestly or at low interest rates. The end of Colombia's coffee boom in the 1970s was followed by a large increase in public investment, particularly in the energy sector, that raised the current account deficit to 10.8 percent of GDP by 1983. Colombia avoided a debt crisis because its debt was small to begin with, because the authorities borrowed cautiously, and because the response to macroeconomic imbalances was swift. The lesson of such episodes is that countries should try to keep their spending consistent with their permanent income.

### Busts

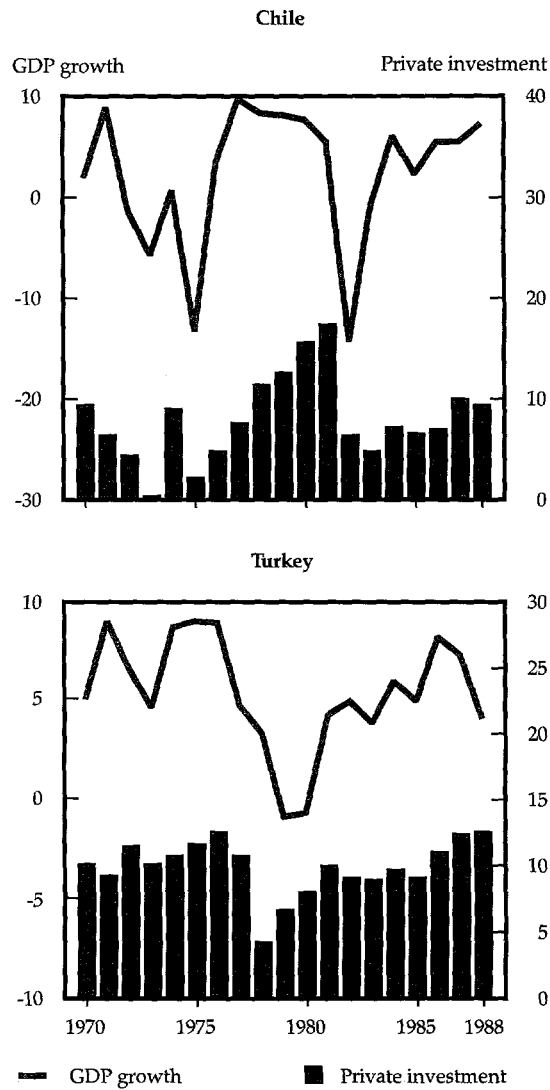
The good times generally ended with a reversal in the terms of trade or a cutoff in external financing. In several countries the landing was hard. In Mexico, prosperity ended abruptly in 1982, with lower oil prices, higher interest rates, and massive capital flight. Mexico's creditors refused to roll over the country's short-term debt, and the country suspended interest payments. The next four years saw high inflation and a decline of 10 percent in per capita income. Turkey lost its access to external financing in 1977. In the next three years, GDP stagnated, investment and consumption declined, unemployment increased rapidly, and inflation reached 100 percent. In Chile's bust of 1982, GDP fell by 14 percent (Figure 6.3).

These cases show how large the costs of unsustainable policies can be. That is why it is far better, whenever possible, to anticipate rather than react to emerging macroeconomic imbalances; the transition to a sustainable path will then be far less painful. Fiscal adjustment can be more moderate, making it easier to protect investment in infrastructure, education, and health from cuts.

### From stabilization to growth

In the 1980s many countries embarked on programs of stabilization and structural reform. Stabilization policies work mainly on the demand side to reduce inflation and external deficits (though

**Figure 6.3 The growth of GDP and private investment in Chile and Turkey, 1970–88**  
(percent)



Sources: World Bank data; Pfeiffermann and Madarassy 1989.

they also have supply-side effects). Structural policies are concerned with the supply side; they address the efficiency of resource use, emphasizing reforms in specific sectors—especially trade, finance, and industry. It is possible to postpone structural reforms during stabilization, but the converse is rarely true: structural reforms are unlikely to succeed unless they are preceded or accompanied by stabilization. Similarly, stabilization is unlikely to be sustainable without structural reforms.

Adjustment programs—usually supported by the International Monetary Fund (IMF) and the World Bank—address internal and external imbalances and, in varying degrees, incentives and institutions. In the short run, stabilization can lower output growth. The benefits take a lot longer to come through, as do the gains from structural reform. Several studies have found a strong association between adjustment programs and improvements in the balance of payments, but the effects on growth are less clear. One study found a negative effect on growth immediately after a program; but, for countries where programs had been in place for three or more years, several Bank studies have found a positive effect on growth (Box 6.1).

Adjustment programs very often include measures to reduce the fiscal deficit. Some countries have cut their primary deficits (which exclude interest outlays) by as much as 10 percent of GDP. The composition of the reduction varies from case to case. Ghana, Jamaica, and Mexico, for instance, reduced both current and capital outlays; Côte d'Ivoire and Indonesia cut mainly capital spending; Morocco cut mainly current spending. In

many countries macroeconomic stability has been an elusive goal. In Brazil and Argentina, the inability to reduce the fiscal deficit has been a major cause for the failure of several stabilization attempts.

Fiscal reform often involves difficult trade-offs. Cutting capital spending may create less political resistance than cutting current spending (mainly wages and subsidies). Abolishing inefficient investment projects is fine, but cuts in productive investment in infrastructure and education, for example, are likely to hurt long-term growth. All sorts of spending should be reviewed; dispensing with some programs, especially in military spending, will do much less harm than dispensing with others. On the revenue side, tax reform has a role to play. Exemptions, inefficient tax collection, narrow bases, and low compliance all mean that high tax rates are needed to raise relatively little revenue. In Pakistan, for instance, the agricultural sector (one-fifth of GDP) is exempted altogether from direct income taxes; there are many exemptions for industry, too.

A further complication for many countries' adjustment was the burden of public debt. Although domestic and foreign public debt often grew si-

### **Box 6.1 What the assessments of adjustment programs say about income performance**

Since the early 1980s, many developing countries have launched economic adjustment programs. These programs—usually supported by the IMF and the World Bank—address internal and external imbalances and, to varying degrees, incentives and institutions.

Have they succeeded? Answering this question is not straightforward. Changes in external factors may affect performance during the course of an adjustment program. Even without such changes, it may be difficult to say how the economy would have performed if the program had not been implemented. And the mere fact that a program is supported by the IMF or World Bank does not necessarily mean that policy reforms have been pushed through.

Adjustment programs usually include stabilization measures as well as structural reforms. In the short run, stabilization may lower output growth. The efficiency gains and growth in output that are expected from structural reforms typically take much longer.

Several assessments examined performance before and after an IMF program but without controlling for external factors or estimating a counterfactual scenario. These studies found improvements in the balance of payments, but the evidence on growth and inflation was inconclusive.

Other assessments compared changes in the performance of countries that had programs with changes in a control group of nonprogram countries. These studies found improvements in the balance of payments in the program countries relative to the control group, but no conclusive evidence on growth. Another study found moderate improvements in economic performance. The drawback of this approach is that unless the two groups share the same initial conditions, the group participating in the program or receiving a loan may not represent a random sample of the overall set of countries.

A third approach is to construct a counterfactual scenario, guided by the country's history of similar macroeconomic imbalances. Studies of this kind have found a strong association between the program or loan and improvements in the balance of payments, a negative effect on investments, but little effect on growth. Khan (1990) found a negative effect on growth immediately after the program. World Bank studies have found a positive effect on growth, but only for early loan recipients (countries for which three or more years had elapsed since initiating the reform).

multaneously, the underlying processes were different. Domestic debt expanded with the shift from external to internal financing; public external debt grew as government guarantees were extended to public enterprises, and as private debt, amortization, and interest payments were re-scheduled. This shift of external liabilities to the public sector further weakened the fiscal position. In Turkey, continued deficits and the shift to more costly domestic financing helped to increase the public debt from about 12 percent of GDP in 1980-81 to 30 percent in 1987-88. And there is another dilemma: when the external debt is a public liability, devaluation may be in conflict with fiscal adjustment. In Turkey a real depreciation of the currency improved the current account position, but it increased interest payments denominated in domestic currency and hence the fiscal deficit.

#### *The social effects of adjustment*

Labor markets play an important role in determining the outcome of adjustment. Downward flexibility of real wages will cushion the effect on output and employment of policies that are intended to reduce domestic absorption. The evidence suggests that real wages are in fact flexible. In Bolivia, Chile, and Ghana, real wages declined significantly during adjustment. However, when labor markets bear a disproportionate share of the adjustment burden, the fall in real wages may cause an excessive decline in aggregate demand, which in turn may jeopardize the recovery of output. In Malaysia in the mid-1980s, changes in the exchange rate, interest rate, and commodity prices all helped to cushion the effect of adjustment on real wages and employment. As a result, the subsequent recovery was faster.

Recently attention has focused on the short-run effect of adjustment on the poor. Fiscal consolidation often involves cuts in government programs and a temporary rise in unemployment. Different groups are affected in different ways by fiscal cuts. The needs of the persistently poor and the newly poor (those who lost jobs as a result of adjustment) are not the same; nor are those of urban and rural households. Special programs, as in Bolivia and Ghana, can include temporary measures to protect the groups that are most at risk. This is a worthy goal in its own right, but it may also help to maintain political support for adjustment.

The evidence on countries that undertook strong programs does not point to a clear relation between adjustment and changes in employment or the social indicators. The social effect of new

policies may take longer to emerge than the relatively short period considered in most studies. A review of the trends in social indicators shows that most countries made progress in the 1980s, although progress was slowest in the countries where the indicators were poor to begin with. Lack of good data, and the difficulty of projecting what would have happened if adjustment had not been undertaken, make most evaluations of the effects of adjustment inconclusive.

#### **The art of reform**

The scope of the economic reforms that are needed in the developing world varies widely. Some countries urgently need to rationalize prices and incentives; others need to privatize state-owned enterprises or invest in education, health, and infrastructure. Everywhere such measures need to be grounded in macroeconomic stability. Experience shows that the surest path to development is to improve policies in all these respects. But how are such diverse elements to be combined? In what order should reforms be undertaken, and how quickly? There are few hard rules, but history does suggest some general principles.

Reforms have to deal with trade-offs among policies—the so-called competition of instruments problem. For example, reform of the financial sector often calls for distressed financial institutions to be restructured; in the short run, this may raise public spending and make it harder to cut the budget deficit. Adopting positive real interest rates will lower the burden of credit subsidies but increase the cost of servicing domestic debt. Lower tariffs may initially reduce government revenues (as in Mexico and Morocco), whereas shifting from quantitative restrictions to tariffs will generally raise them (as in Indonesia and Peru); the net effect may be a bigger fiscal deficit. These trade-offs make it harder for governments to adopt programs which, taken as a whole, appear to add up. Yet it is essential that programs not merely add up, but are seen to do so.

Many reform programs have successfully dealt with conflicts and tradeoffs. But reforms have also failed. In Tanzania in 1977, in the aftermath of a coffee boom, import controls and foreign exchange licensing were removed without complementary changes in exchange rates and macroeconomic policy. Within months, the balance of payments turned sharply negative and the country lost most of its foreign exchange reserves. The reforms were abandoned, leaving the external sector more restrictive than before. Zambia in 1985

adopted an ambitious program to cut public expenditure, auction foreign exchange, and reduce subsidies to urban consumers amid significant internal political opposition within the government. A year later, however, the price of copper, the dominant export, fell sharply while the country's fiscal and monetary situation deteriorated. Consumer subsidies on some food staples were removed overnight while stockpiles of others were not at hand. Urban unrest followed, and the government, strongly dependent on urban political support, reversed the reforms.

### *Credibility*

If reform is to succeed, investment must respond. Expectations are crucial. The private sector may choose to wait and see, and let the government prove its commitment to the new policies. But this may be a vicious circle, because if it takes too long to restore confidence and investment, the program may fail for that reason alone. If the reforms are credible, however, additional transfers of resources from abroad will raise confidence and fuel an even greater investment recovery than the program was counting on.

Credibility can be improved by first achieving macroeconomic stability. This may reduce the extent of the competition of instruments problem. Even then, in countries with a record of aborted programs, the private sector may be rightly skeptical about the government's bold new initiatives. The longer the history of high inflation and unsuccessful remedies, the harder the task—witness Argentina and Brazil, as compared with Chile and Mexico. Often, the government has no choice but to rebuild its reputation, and then guard it jealously. In this respect, it is important not to promise too much. It may also be necessary for policy to “overshoot” (as Poland's arguably did in the currency devaluation of January 1990), to prove that this time the reformers really do mean business.

### *Macroeconomic stability*

Low inflation is vital not just because it makes the reform program more credible, but also because without it other elements of the program will be directly undermined. Macroeconomic instability contributed, for instance, to the failure of several trade reforms. Reforming the trade regime usually calls for a real devaluation of the currency in response to the effects of reductions in tariffs and nontariff barriers. An expansionary fiscal policy, however, contributes to a currency appreciation,

adding pressures for a reversal of the reforms. Expansionary monetary and fiscal policies are the single greatest threat to trade reform.

Macroeconomic stability also makes reform of the financial sector more likely to succeed, and thus supports the development of capital markets that can foster private investment. The aim of financial reform is to increase savings and to see them used more efficiently. In many cases it involves removing interest rate ceilings to achieve positive real interest rates, and abolishing regulations that affect the size and allocation of bank credit. Close links with world financial markets require domestic interest rates to be high enough relative to international rates for investors to keep their financial assets in the country. For this to work, macroeconomic stability and strong bank supervision both need to be in place. Otherwise, expectations of inflation, exchange rate devaluation, or government borrowing may push real interest rates too high, increasing the fiscal deficit and contributing to further macroeconomic instability. Excessively high interest rates and inadequate supervision of the banking system (especially in the presence of deposit insurance) may cause defaults and instability in credit markets. In Argentina, Chile, the Philippines, Turkey, and Uruguay, rapid interest rate liberalization under conditions of macroeconomic instability and inadequate bank supervision led to financial crises that severely damaged their economies.

### *Timing*

The timing of reforms involves political considerations. New governments are in a strong position to initiate reforms: they are less obligated to defend the status quo, and their clients and opponents may not yet be well organized. Economic crisis also improves the conditions for reform by strengthening coalitions that favor reform and helping to subordinate special interests. (These issues are further discussed in Chapter 7.) Economic and political crises are opportunities for radical change. In Indonesia, reformers designed their plan for liberalization (complete with estimates of effective protection) well before the crisis of 1983. When the choice came to implement it, the homework had already been done.

### *Speed*

Should reform be gradual or “shock therapy”? Some principles are set out in Box 6.2. Gradualism may sometimes be justified when reform faces par-



## Box 6.2 The speed of reform

### The case for gradualism

- Gradualism in implementing reforms is defined here to mean that reform is spread out over more than two years. Indonesia, the Republic of Korea, Mauritius, Morocco, and Turkey have used a gradual approach. Trade liberalization through the GATT was also a steady but gradual process.

- In an economy with rigid prices and wages or other structural distortions that prevent optimal adjustment, shock therapy may have perverse effects. If the policy shift is sudden, potentially viable factories may collapse and potentially productive employees may be dismissed from their jobs. In such a distorted climate, a gradual policy change may reduce the overall costs of adjustment by spreading out the adjustment over time. If there are imperfections in the market that prevent private economic agents from choosing the most appropriate pace of adjustment, gradualism in policy reform may have the same effect by allowing agents to spread out the costs of adjustment.

- Gradualism allows for midcourse adjustment. As reforms occur under distorted economic conditions, there is considerable uncertainty about the outcome of any specific reform. Structural reforms, no matter how ambitious, will not eradicate all market failures and distortions. Unexpected interactions between reforms and any remaining market failures could lead to disappointing results.

- Gradualism allows for political fine-tuning. Policymakers have time to learn about the probable gainers and losers and to forestall opposition. Policymakers can defuse potential opponents by giving them something they want from reform and can mollify losers through temporary transfers that help them through the transition.

- Gradualism may be the preferred approach to reform when there is a substantial administrative constraint or when new institutions have to be built. If capital markets are not well developed, for instance, a rush to privatize may result in an underpricing of assets and less than optimal allocation.

### The case for shock treatment

- Shock treatment implies that reforms are implemented quickly in a concentrated period lasting less than two years. Bolivia, Ghana, Mexico, and Poland introduced reforms to eliminate substantial distortions during a short period. Chile carried out most reforms, and Mexico liberalized trade rapidly.

- If reform improves welfare, the optimal policy is to implement the program rapidly so that the welfare gain is achieved as quickly as possible. It may be that adjustment costs increase more than proportionately with the length of time taken to implement a reform. Although it might then make sense for the private sector to spread the *adjustment* over time, it does not follow that *policy reform* itself must be introduced gradually. Indeed, the cost of relocating labor and capital may often be less when the relocation is spread over time. Workers have time to acquire new skills, capital can be allowed to become obsolete, and factories can be reconfigured or modernized.

- Concerns with the cost of adjustment should affect the speed of reform only when inefficiencies prevent the private sector from adjusting at a socially optimal rate. But these inefficiencies can work both ways. When reforms lack credibility or capital markets work poorly, adjustment may be too slow from a social perspective—making a case for even more drastic reform than otherwise.

- Rapid action can improve the political sustainability of reform if it prevents a joint assault by special interest groups against changes that are in the general interest. Bold changes are especially necessary if a government lacks credibility. In countries where policies have vacillated and reform programs have come and gone, private agents are likely to respond sluggishly to the announcement of yet another reform package—especially if it is gradual. A conclusive reform can help to reshape expectations about the government's commitment and so contribute to its success.

- Adjustment usually occurs in a climate of crisis. Governments do well to capitalize on the broad, potentially short-lived mandate for reform that crisis confers by front loading the reform program.

ticularly large economic uncertainties. And, by their nature, some reforms take longer than others: price reforms can be done quickly, but new institutions (such as contract laws) take time to develop. Many gradual reforms have worked.

But some gradual reforms (for example, in Japan, the Republic of Korea, and Thailand) may have succeeded because they took place in rela-

tively strong and stable economies. In general, the analytical case for speed is strong. Often, erring on the side of speed appears to be best because swift actions bring the benefits of reform more quickly. Speed also makes sense if the political opportunity for reform is unlikely to last. Gradualism may not be feasible for economies in acute crisis or for governments with limited credibility.

## *Scope*

Comprehensive packages of reform exploit the complementarities stressed throughout this Report and therefore promise the greatest benefits. The dangers of partial reform are all too clear. Stabilization has caused stagnation for lack of policies to promote investment (Bolivia and the Philippines in the 1980s); trade liberalization has failed in economies with distorted factor markets, macroeconomic instability, and inappropriate exchange rate policies (Argentina, Brazil, and Sri Lanka in the 1960s; Peru, the Philippines, Portugal, Turkey, and Uruguay in the 1970s); domestic deregulation or privatization has created monopolies in the absence of trade reforms that check domestic market power (Poland and Togo in the 1980s); financial sector reform failed because of high inflation (Argentina in the 1970s, Israel in the early 1980s, and Turkey in the early 1980s). In all these cases, broader programs attacking interrelated ills would have been more likely to succeed.

## *Sequencing*

To achieve these benefits, it might seem that reforms should be implemented simultaneously. Often, this is indeed desirable. Import liberalization, for example, makes domestic producers more efficient. But the reallocation of resources may be hampered by controls and other rigidities in the financial markets or elsewhere. In this case deregulation should proceed at roughly the same pace as trade reform, so that the program raises output rather than unemployment and financial speculation. Equally, introducing domestic reforms without liberalizing import policy can cause even more resources to be misallocated in highly protected sectors.

Because it may not be practical to implement reforms simultaneously, the need for sequencing is implied. Effective sequencing usually calls for strong initial steps against the most costly distortions, taking care to avoid back-and-forth movements of resources. This suggests the following order for reform. At the outset comes macroeconomic stabilization, which can either precede or accompany structural reform. Many kinds of structural reform (the substitution of quantitative restrictions by tariffs, for example) complement stabilization. Next comes the liberalization of product markets, including deregulatory reform. It would be preferable not to delay domestic reforms until after trade reform. In the area of the

liberalization of the external sector, the trade account best precedes the capital account. Asset markets adjust faster than goods markets, so the premature deregulation of capital flows can lead to speculation and financial instability.

It would be fair to criticize this as a counsel of perfection. Political considerations, and a host of other factors, both economic and noneconomic, interfere with a reforming government's planning. But in broad terms, this approach to reform avoids many of the obstacles that have driven governments off course during the past twenty years.

## **Investment and saving**

Comprehensive programs of economic reform are the key, for many countries, to increasing both the quantity and quality of saving and investment. During the 1980s, saving and investment declined in the middle-income countries. Gross investment, which had averaged about 26 percent of GDP in the period 1974–80, declined by 3 percentage points. Lower foreign saving accounted for two-thirds of the decline in total saving. Investment remained fairly stable in low-income countries (excluding China and India) because higher foreign saving compensated for lower domestic saving (Table 6.1). The reduction in investment reflects in part the decline in public investment, which was inevitable for many countries where unsustainable expansion in public investment had taken place, usually in the latter part of the 1970s.

During the past two decades, both the aggregate level of investment and the private and public shares have varied significantly across countries and over time. For example, the relative stability of both public and private investment and the high level of the latter in the Republic of Korea contrast sharply with the declining trends and low private investment in Argentina, the wide fluctuations of private investment in Jamaica, and the dramatic turnaround in the composition of investment in Côte d'Ivoire (Figure 6.4). Such vast differences in investment behavior raise questions about what determines private investment and what role government policy plays in raising it.

## *The quantity and quality of investment*

Countries that have kept inflation low and real interest rates moderate, and that have allowed sufficient credit to flow to the private sector, have been more likely to have high levels of private investment as a share of GDP. A large external debt

**Table 6.1 Investment and saving, 1965–89**  
(percentage of GDP)

Economy group	Gross domestic investment			Foreign savings <sup>a</sup>			Gross national savings <sup>b</sup>		
	1965–73	1974–80	1981–89	1965–73	1974–80	1981–89	1965–73	1974–80	1981–89
<i>Low-income</i>	19.6	24.4	26.4	1.2	1.1	3.4	18.4	23.3	23.0
China	24.8	31.0	34.9	-0.3	-0.1	5.5	25.2	31.1	34.4
India	17.1	21.3	23.9	1.7	1.1	3.6	15.3	20.3	20.4
Indonesia	13.7	23.6	29.5	2.6	-3.0	2.7	11.1	26.7	26.9
Kenya	21.0	24.1	23.7	4.4	8.9	7.1	16.6	15.2	16.6
Nigeria	14.1	22.2	12.0	4.3	-1.3	2.7	9.7	23.5	9.3
<i>Low-income, excluding China and India</i>	14.1	19.6	19.1	2.8	2.3	6.2	11.3	17.2	12.9
<i>Middle-income</i>	21.6	26.4	23.2	3.0	5.3	3.4	18.1	21.0	19.7
Brazil	20.5	23.8	19.8	1.9	4.6	1.8	18.5	19.2	18.0
Korea, Rep. of	23.3	30.0	29.8	8.2	7.1	0.8	15.1	22.9	29.0
Morocco	14.3	26.0	24.4	2.7	14.5	13.0	11.7	11.5	11.4
Malaysia	21.2	27.3	30.7	-1.5	-1.2	3.3	22.7	28.5	27.4
Philippines	20.5	29.3	20.1	1.4	5.4	2.4	19.0	23.9	17.7
Thailand	23.9	26.6	25.8	2.4	5.1	4.2	21.5	21.5	21.6

a. Gross domestic investment minus gross national savings.

b. Excludes net transfers from abroad.

Source: World Bank data.

and wide policy swings that raise the variability of output and the real exchange rate deter private investment. And to the extent that public and private investment are complementary, cuts in public investment have also contributed to the decline of private investment.

**FINANCIAL CONDITIONS.** Statistically, cross-country differences in macroeconomic conditions explain differences in investment quite well. This is presumably because variability in output makes investors wary, and more likely to postpone projects. Inflation increases the riskiness of long-term projects and distorts information about relative prices, and so it may also dampen private investment. Macroeconomic stability increases confidence and thereby fosters private investment.

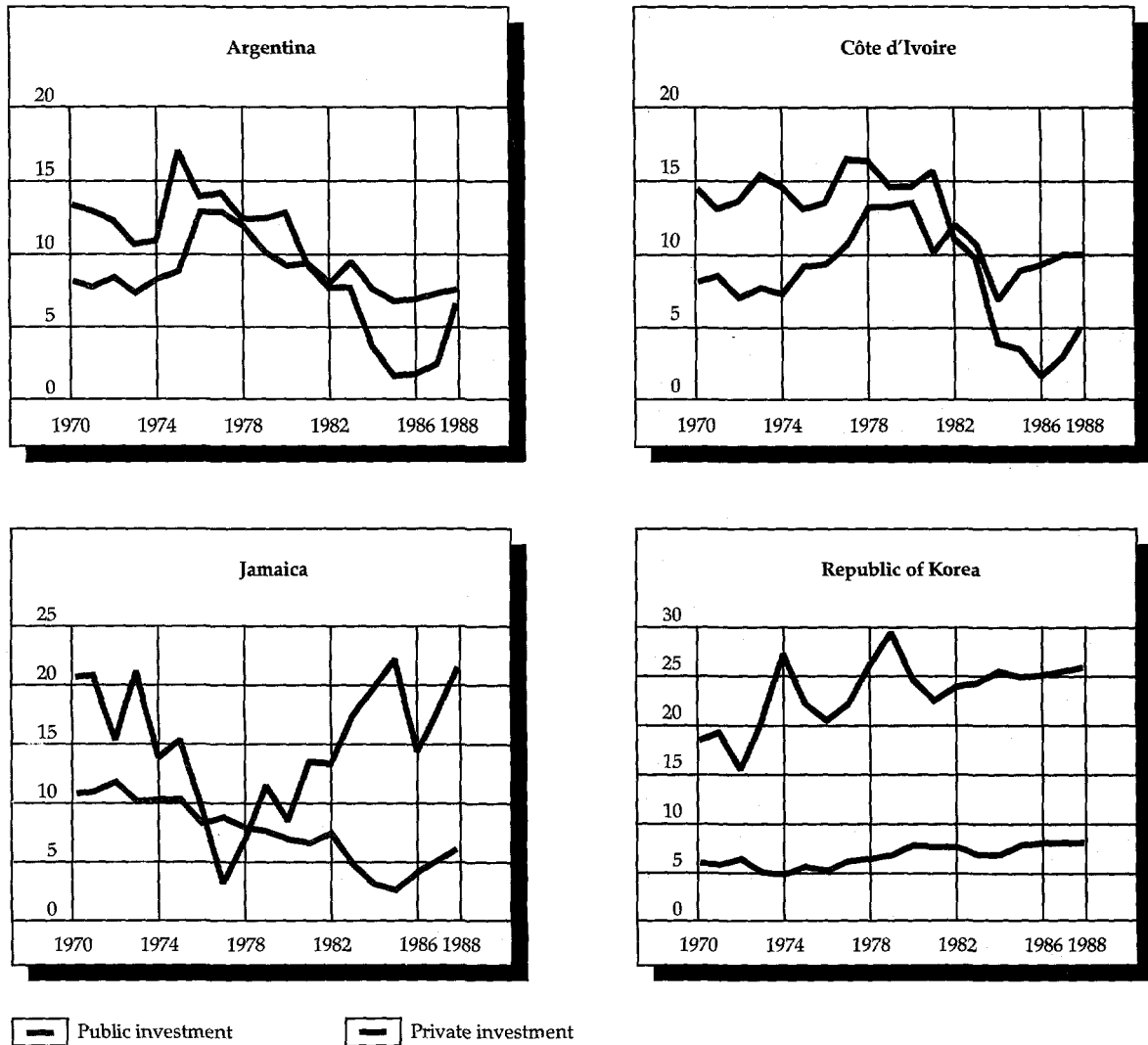
Macroeconomic policy also affects investment by influencing the quantity of credit available for the private sector's use. Evidence supports the hypothesis that credit flows have a positive and statistically significant effect on private investment. Because interest rate ceilings are an important tool of monetary policy for many developing countries, the quantity rather than the price of credit becomes the relevant variable for investment decisions. Tighter monetary policy or a change in the composition of credit that favors the public sector reduces private investment. When bank loans are a main source of financing, which is often the case, lower government borrowing releases resources for private investment.

In general, countries with positive real flows of credit to the private sector, such as Colombia, Indonesia, Korea, and Thailand, have also had stable levels of investment. Investment has tended to decline in countries where the flow of private sector credit was negative. Even without widespread credit rationing, not all firms are able to borrow as much as they would like. This is particularly true in the absence of adequate collateral and an efficient system to settle disputes, when credit allocation is linked to a firm's reputation rather than to the rate of return of the project. In Egypt, where credit availability is important to investment decisions, government borrowing seems to have crowded out less well-known firms, but not those with well-established reputations.

Cross-country evidence also suggests that high real interest rates reduce private investment. Investment decisions depend on the internal rate of return on investment (the marginal efficiency of capital) and the cost of capital. The cost of capital depends partly on the mix of financing, bonds, equity, and bank borrowing. Because bank borrowing represents a main source of financing, an increase in its cost relative to the marginal efficiency of capital will reduce investment. This interest rate effect is likely to be stronger in countries which have well-developed financial markets and which use open market operations, rather than credit ceilings, to control the money supply.

In principle, a real currency depreciation has an ambiguous effect on investment. It may reduce it

**Figure 6.4 Differing patterns of private and public investment in four countries, 1970-88**  
(percentage of GDP)



Source: World Bank data.

by increasing the cost of imported intermediate inputs and capital goods, and by reducing the quantity of credit in real terms, as prices rise following the depreciation. But it may also encourage investment by improving profitability in the traded goods sector and, sometimes, by increasing the supply of foreign exchange, which can be used to pay for additional imports of capital goods.

One study found that a real devaluation may in practice reduce investment in the short run, especially if it lowers output. (In that case investment

would fall unless all the burden of adjusting to changes in relative prices fell on private and public consumption.) In the medium term, however, and if the real devaluation is expected to last, investment is likely to rise, in part as a result of the sustained improvement in the profitability of exports. In Chile and Indonesia, investment fell in the short term in response to large real devaluations but recovered in the medium term with the expansion of the traded goods sector. Recovery took about five years in Chile and three years in

Indonesia. The negative effects of a devaluation may persist longer in low-income countries because of a slower supply response.

Evidence suggests that countries with a heavy debt burden have lower investment ratios. A large debt is likely to be associated with external credit rationing or high risk premiums, which reduce private investment. The debt overhang also acts as an implicit tax; it discourages investment because it implies that eventually some combination of higher taxes, currency depreciation, and lower domestic demand will be required to effect the required external transfer.

**PUBLIC AND PRIVATE INVESTMENT.** Several countries have achieved fiscal adjustment, in part by cutting public investment or postponing capital outlays. Cuts in health care, education, and infrastructure programs may slow private investment and growth in the medium term. But public investment can lower private capital formation if it uses scarce resources or if its output competes directly with private goods. The complementary and crowding-out effects of public investment are not incompatible. In the short run, the financing of public infrastructure may increase interest rates or reduce credit to the private sector and so crowd out private investment. In the medium term, however, it can increase productivity and private investment. The evidence on the net effect is inconclusive, mainly for lack of data. Some recent research, however, does suggest that public and private investment are complementary. Other cross-country work suggests that investments in infrastructure (as opposed to, for example, investments in state-owned enterprises or military hardware) are especially likely to promote private investment.

This is plausible. Studies of individual countries show that firms' operating costs rise and investment falls when infrastructure is weak. Government investment in infrastructure seems to have promoted private investment in Egypt, for instance. In Korea, public investment appears to have a positive effect on private investment in both the short and long runs. An implication of these results is that capital outlays on infrastructure should continue during periods of fiscal adjustment; they are more likely than other types of public investment to complement and increase private investment.

**THE COMPOSITION OF PRIVATE INVESTMENT.** Private investment consists of both equipment and structures. Some degree of complementarity

should exist between the two, but at the margin it is likely that they make different contributions to growth. Equipment investment (mainly machinery) appears to be more closely associated with productivity growth than the rest. Discrimination against capital goods (through high tariffs or taxes) will increase their price and reduce the share in total investment of investment in equipment. This matters because new equipment is likely to embody new technology and to bring important external economies.

#### *Determinants of saving*

Individuals save to smooth their consumption over time. Their saving rate depends on current income, expected lifetime income, and the expected return on savings. Saving patterns change over an individual's lifetime, with the peak coming during a person's prime earning years. The larger the fraction of income received by workers at the peak of their earnings, the higher the overall saving rate. Demographic factors also influence saving; the lower the dependency ratio (the proportion of the population below fifteen and above sixty-five years old), the higher the saving rate. Faster-growing economies also tend to have higher saving rates because the gap between the lifetime income of active workers and that of retired workers is large, and because the aggregate saving rate moves closer to the saving rate of active workers. Faster growth is the best way to increase saving. These factors seem to explain the high rate of saving in Japan (Box 6.3).

In many developing countries, agriculture accounts for a significant part of household income. Agriculture—and the income derived from it—is subject to considerable uncertainty, which can spread to other economic activities closely linked to agriculture. At the same time, imperfections in financial markets may prevent households from borrowing against future income. All this makes the rate of saving more responsive to changes in expectations about future income; and the more uncertain the future, the larger will be the demand for savings as a "buffer stock."

Evidence shows a strong correlation between growth rates and saving rates. Changes in the growth rate explain most of the fluctuations in the saving rate in the Republic of Korea, for instance. As the economy expanded rapidly, Korea's national saving increased from less than 10 percent of GNP in the mid-1960s to 32.8 percent in 1986. Variability in income growth rates is also related to variability in saving. Indonesia and Myanmar had

### Box 6.3 Determinants of household saving in Japan

Household saving in Japan is higher than in most other countries. During the period 1970–86, it was 23 percent of household income; in the United States, 14.3 percent; in the United Kingdom, 10.4 percent; and in Sweden, 7.8 percent.

Some of these differences can be explained by conceptual discrepancies. The procedures used to calculate saving rates in the United States and Japan differ in three main ways. First, depreciation is evaluated at historical cost in Japan but at replacement cost in the United States. Second, capital transfers are excluded from both savings and disposable income in Japan but are included in the United States. Third, interest paid by households to businesses or foreigners is excluded from personal income in Japan but is included in the United States. An adjustment for these factors would lower Japanese household saving by 3–4 percentage points. Other differences affecting cross-country comparisons are the treatment of consumer durables, private pensions and life insurance, and social security funds. After all such adjustments, Japanese saving remains high.

Various explanations have been advanced: (a) cultural factors, such as the Confucian heritage, a high

degree of risk-aversion, the weakness of demonstration effects, and the prevalence of intergenerational transfers; (b) demographic and socioeconomic factors, such as the age structure of the population, the distribution of income, and the high labor force participation of the aged; (c) institutional factors, such as the bonus system and the unavailability of consumer credit; (d) government policies, including tax breaks for savings (until recently) and a low level of social security benefits; and (e) economic factors, such as rapid rates of growth, and high and rising land and housing prices.

A review of the literature on saving in Japan suggests that the low proportion of the aged, the country's growth rate, and the bonus system can each account for 2–3 percentage points of the gap between Japan's saving rate and other countries. Other factors which may have in the past contributed to the high saving rate (such as tradition, tax breaks for savings, the underdeveloped social security system, the extended family, and the unavailability of consumer credit) are becoming less important. As Japan's demographic structure becomes similar to that of other countries, its household saving rate is likely to decline.

variable and sometimes negative real growth rates during the 1960s, and low and variable saving rates. In recent years, however, as real growth rates stabilized, both countries experienced a rapid increase in saving rates.

**THE ROLE OF THE FINANCIAL SECTOR.** Because few developing countries have easy access to external savings, most of any increase in investment will have to be financed domestically. The financial sector can play an important role by increasing the efficiency of the transformation of savings into investment. Evidence suggests that distortions of this sector that result in negative real interest rates are associated with low growth. Negative real interest rates may reduce aggregate savings, diminish the savings available for investment, and distort its allocation among investment alternatives. Financial reform, when well-managed, usually leads to moderately positive real interest rates. The net effect of higher real interest rates is ambiguous in principle. The empirical evidence suggests that an increase in the real interest rate has a positive, though small, effect on saving. Positive real interest may also increase the share of savings channeled through the financial system. Once that sys-

tem works reasonably efficiently, this is also desirable.

Government policies can do little in the short run to influence the demographic and cultural factors that affect private saving. In the absence of capital inflows from abroad, therefore, the increase in savings needed to finance higher investment will require higher public saving—that is, smaller public deficits.

**PUBLIC SAVING.** The effect on private saving of higher public saving depends on how that increase is achieved—through lower expenditures or higher taxes. A World Bank study of a sample of developing countries found that less than half of the increase in public saving obtained by cutting government consumption will be offset by lower private saving; in the case of a tax increase, slightly more of the increase in public saving will be offset. Permanent changes in taxation and spending have a smaller effect on private saving than do temporary measures, because most households are likely to adjust saving rather than consumption when they believe measures are temporary. Reducing government deficits appears to be the best way to increase national saving.

## Global economic conditions

The world recession of 1980–83 and the increase in international interest rates showed how great an effect macroeconomic developments in the industrial countries can have on developing countries. The developing world's exporters of manufactured goods appear to be most sensitive to fluctuations in industrial countries' growth—more so than the countries that export mainly primary goods. Also, Asian and Latin American countries with close trade links to the United States benefited more from its 1983–84 expansion in demand for imports than many African countries, which had stronger links with the European markets.

The importance of financial markets in transmitting the effects of industrial countries' policies increased with the integration of world markets and the accumulation of external debt by developing countries. After 1979–80, when interest rates became more volatile, several Latin American countries with a high proportion of floating rate debt suffered a sharp increase in debt service payments. The consequent balance of payments problems were further compounded by the effects of the world recession and the reduction in the availability of external financing.

How important are external factors for developing countries? World Bank simulations suggest that, other things being equal, an increase of 1 percentage point in the growth of the OECD could raise the developing countries' growth over the long term by 0.7 percent. Conversely, a 1 percentage point increase in LIBOR could reduce growth by 0.2 percentage point. A 1 percent increase in the growth of the OECD is also estimated to lead to a 0.2 percent increase in exports from developing countries. These effects, however, vary across countries, depending on their trade patterns and the structure of their external debt.

The role of external factors needs to be stressed. In the short term, unfavorable external shocks, higher interest rates, a decline in the terms of trade, or inadequate external flows may derail the implementation of any well-designed adjustment program. Over the long term, a strong world economy could encourage the adoption of economic reforms. This would improve domestic efficiency and ensure that countries would fully benefit from the continued expansion of global markets. Although the quality of economic management is what matters most, global economic conditions are important in shaping the outlook for developing countries.

## External resources and growth

External resources enable developing countries to raise their growth rate by financing additional investment or smoothing adjustment to external shocks. External finance could in principle help an economy out of a low-growth trap, enabling it to "take off" despite structural or political limitations to increased domestic saving. Concessional aid enables countries to alleviate poverty and increase long-run growth. Industrial countries share the responsibility for ensuring that capital flows are used to aid, rather than hinder, development. For concessional flows to be effective, external aid and finance agencies must coordinate their programs and design projects which carefully evaluate the needs and administrative capabilities of the countries they assist. These agencies must also end policies such as the tying of aid.

The debt crisis illustrates the costs of misused capital flows. The returns from foreign inflows and the ability to repay foreign borrowing depend on the efficiency of those investments, which in turn vary with country policies. In many countries during the 1970s, investment was channeled to public sector undertakings which had low rates of return. Particularly in the late 1970s and early 1980s, some developing countries used external financing to maintain unsustainable levels of consumption in the face of shortfalls in export revenues or shifts in terms of trade. In other cases, alongside macroeconomic mismanagement, external borrowing financed capital flight (Box 6.4).

A significant share of foreign capital may be used to finance consumption instead of investment, reducing the long-run effect of inflows on growth. Although a fraction of inflows will always translate into consumption increases, even without domestic distortions, a recent study found that for some countries, the share of external transfers used in consumption has been exceedingly high. The additional consumption spending from an additional dollar of foreign loans in the 1960s and 1970s was 88 cents for Bolivia, and 99 cents for Colombia. Yet in the Republic of Korea, which increased domestic savings from 6 percent in the early 1960s to 30 percent by the mid-1980s, foreign savings were largely channeled to investment. Many studies, however, have found that foreign capital inflows—especially before the late 1970s and early 1980s—have been positively associated with an increasing share of domestic investment in GDP.

Despite the cost of using foreign inflows to post-

### Box 6.4 Capital flight

Capital flight is an elusive concept. Statistically, it is hard to distinguish from the normal capital flows generated by trade relations and by growing world financial integration. Some authors define it as capital that leaves a country in response to perceptions of abnormal risk at home. Capital flight has also been defined as that part of foreign assets that does not yield an investment income recorded in balance of payment statistics. Alternatively, it can be defined as all capital outflow, because any outflow entails some loss for the domestic economy. So defined, capital flight can be measured as the stock of external assets acquired by residents or as net short-term capital outflows from the nonbank private sector (*hot money*). The error and omissions entry of the balance of payments is usually incorporated in these measurements under the assumption that a large part of capital flight consists of illegal transactions that appear only in this item. When capital flight takes the form of underinvoicing of exports and overinvoicing of imports, it will not be captured in balance of payments entries. None of these definitions is entirely satisfactory, and all of them pose measurement problems. At best, they provide only a range of estimates.

The extent of capital flight has varied widely. For the period 1980-84 it has been estimated at about \$16-17 billion for Argentina, \$40 billion for Mexico, and \$27 billion for Venezuela. In some years, capital flight in Argentina and Venezuela was equivalent to half savings in those countries. In Brazil capital flight has been relatively small, but it seems to have increased during the late 1980s.

Capital flight, however defined or measured, is

above all a symptom of macroeconomic mismanagement—in many instances compounded by political instability. As investors choose from among domestic financial assets, inflation hedges (consumer durables or land), and foreign assets, they make their decisions on the basis of domestic inflation and interest rates, foreign interest rates, and the expected rate of depreciation of the currency. If investors fear a devaluation, they will move their funds abroad to avoid a capital loss. Similarly, high inflation rates and repressive financial policies that keep real interest rates too low will encourage residents to invest abroad or to stockpile.

Because capital flight generally occurs during a period of scarce foreign capital inflows, it imposes heavy costs on an economy. As a symptom of macroeconomic mismanagement, it also increases domestic instability—both financially (because hot money flows can impede the pursuit of domestic economic objectives) and politically (because it reduces the political legitimacy of efforts to service external debt). Capital flight also harms domestic growth by diverting savings out of the country. It shrinks the tax base, which reduces government income and shifts more of the burden onto low-income citizens. And it contributes to the debt problem by increasing the cost of borrowing (which rises with the amount borrowed), reducing the resources available to repay debt.

Reversing capital flight requires restoring confidence in the economy and the government through a resumption of growth and the adoption of sustainable policies. Unfortunately, it is much easier for a government to lose credibility than to regain it.

pone adjusting to permanent shocks, access to capital has been nevertheless essential in some countries to successfully cope with short-term shocks. Korea (following its economic crisis in 1980), Turkey (during 1980-82), and Indonesia (during the mid-1960s) all received capital inflows while implementing adjustment. Because all three faced their economic problems before the 1982 debt crisis, they had the enormous advantage of continued access to capital inflows and favorable borrowing conditions during the adjustment period.

To facilitate adjustment to shocks, the World Bank introduced adjustment loans in 1980. These loans, which accounted for about 25 percent of total World Bank lending by the end of the 1980s, were intended to provide balance of payment support for macroeconomic stabilization and long-term structural reforms in trade, domestic and la-

bor markets, financial markets, and public sector management. By allowing expenditures to be higher than otherwise, the loans were intended to cushion the short-run adjustment costs to output, employment, and consumption. The evidence suggests that such lending was reasonably successful in allowing countries to improve their balance of payments position, and that a majority of participants adhered to agreed policy reforms. Although the evidence is not conclusive, early loan recipients were more likely to show a positive growth effect (see Box 6.1). But the share of investment in GDP has not recovered for many countries.

#### *A legacy of debt*

The period of abundant inflows of financial resources to the developing world came to an abrupt



**Table 6.2 Indicators of external debt for developing economies, 1970–89***(average percentage for period)*

Economy group	Total external debt <sup>a</sup>			Interest payments <sup>b</sup>			Net transfers <sup>a</sup>		
	1970–75	1976–82	1983–89	1970–75	1976–82	1983–89	1970–75	1976–82	1983–89
Low-income	10.2	14.8	28.5	2.9	4.3	9.8	1.1	1.2	0.7
Low-income, excluding China and India	20.5	28.5	60.7	2.9	5.3	11.8	2.7	2.4	1.0
Middle-income	18.6	34.6	54.9	5.1	11.0	15.4	1.9	1.9	-2.7
Argentina	20.1	46.1	80.3	14.1	17.9	41.6	-0.3	2.7	-5.4
Brazil	16.3	28.2	42.0	12.1	28.5	30.3	3.3	0.8	-2.5
Morocco	18.6	55.1	109.5	2.8	13.0	17.1	1.8	6.8	-1.7
Philippines	20.7	45.8	79.2	4.2	14.1	20.5	1.2	1.8	-3.4

Note: Variables are yearly averages calculated for the period; economy averages are weighted using the share of GNP in 1981.

a. As a share of GNP.

b. As a share of total export receipts.

Source: World Bank data.

end in 1982, setting off the debt crisis. With the crisis, increased private flows went primarily to meet the debt servicing needs of debtor countries, and little additional capital was available for investment and sustained growth. As the crisis persisted throughout the 1980s, many debtor countries began to experience a reversal in resource transfers (Table 6.2), lower investment and growth, and higher inflation. Contributing to the crisis was a complex brew of policy error (large fiscal deficits, overvaluation, and a bias against exports), external shocks (rapid increases in world interest rates, falling commodities prices, and world recession), and the overly expansionary lending policies of 1979–81.

Net transfers to developing countries became negative in the second half of the 1980s (Figure 6.5). Principal and interest arrears (a form of implicit financing) reached about 6.9 percent of developing-country debt in 1989. Current account deficits fell from 3 percent of GNP in 1980 to less than 1 percent in 1987–89 as developing countries began to export more goods and nonfactor services than they received. Direct foreign investment has increased substantially from the level of the early 1980s, in part as a result of debt swaps. Most of the expansion in DFI has been concentrated in East Asia; China, Indonesia, Korea, Malaysia, and Thailand account for about one-fourth of foreign investment in developing countries. Any expansion of DFI in other countries is likely to depend on their political and macroeconomic stability, and on their rules on taxes and remitted profits.

Most of the low-income countries' debt is owed to official creditors, bilateral and multilateral; a large part of the stock of private export credits is also officially guaranteed. At the end of 1989 the debt of the severely indebted low-income coun-

tries was equivalent to their combined GNP. Official creditors have engaged in debt forgiveness and rescheduling, and they have provided new flows at highly concessional terms. Otherwise these countries would have had to devote more than half of their export earnings to servicing debt; in fact less than half of the scheduled amount was paid. Debt relief has been concentrated on official debt. Bilateral creditors have rescheduled under the Paris Club arrangements, offering highly concessional conditions—the so-called Toronto terms. Under these terms, bilateral official creditors who have extended nonconcessional loans may choose between canceling one third of the consolidated amount, adopting the longer repayment used for concessional debt (twenty-five years' maturity and a grace period of fourteen years), or cutting the interest rate. The debtors concerned are likely to require further debt and debt service reduction if they are to achieve higher investment and growth.

For commercial debt, under the Brady Initiative, official creditors have offered to support debt and debt service reduction for countries that adopt adjustment programs and take measures to encourage direct foreign investment and the repatriation of capital. Reductions take place through debt buybacks—the exchange of old debt for new par-value bonds at a reduced interest rate or for discounted, partially collateralized bonds.

Several countries, starting with Chile in 1985, have used debt-equity swaps to reduce their external debt and encourage direct foreign investment. When the buyback is financed by selling stock in publicly owned enterprises, there is no fiscal effect; the government already owns the asset. But when the operation involves swapping public debt for private assets, the government needs to raise money to acquire the private assets. How it is done

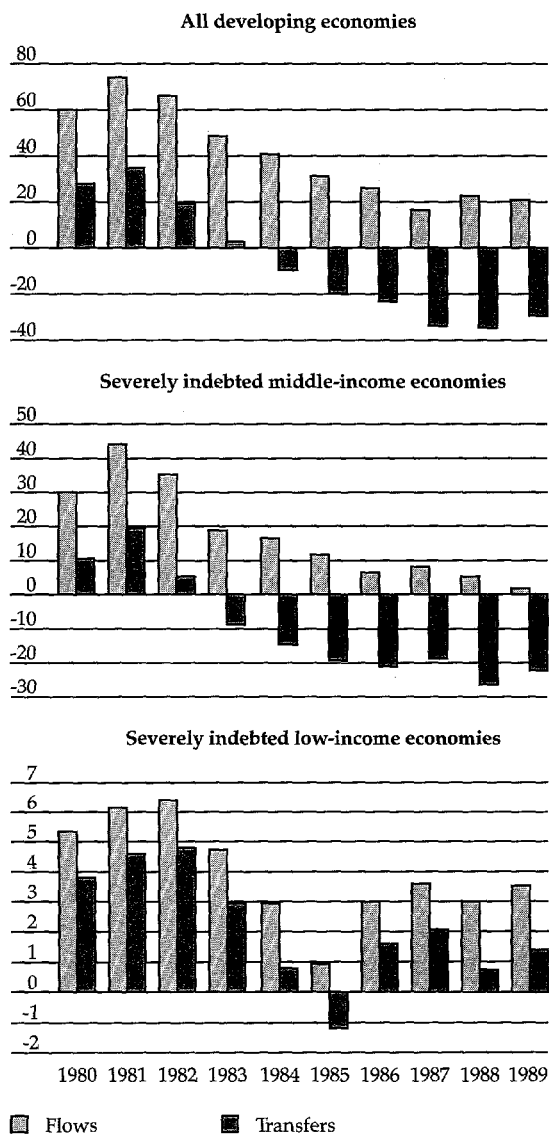
matters. Argentina, Brazil, and Mexico suspended their formal swap programs in 1989 in part because of concerns about their inflationary effects; this is particularly strong when the central bank prints money to retire the debt. Some new swap programs are linked to privatization efforts; for instance, those for the telephone company and pub-

lic airline in Argentina. Mexico's new swap program is restricted to state-owned enterprises, infrastructure, and other development projects. Other types of debt swaps have also been introduced: debt-for-trade swaps in Peru and Yugoslavia, and debt-for-nature and debt-for-health swaps in other countries.

By 1990, new debt agreements based on the Brady Initiative had been implemented in Costa Rica, Mexico, and the Philippines, and negotiations were under way in Morocco, Uruguay, and Venezuela. In addition to their direct economic effects, these agreements have favorably influenced expectations. Following Mexico's announcement of an agreement in July 1989, real interest rates declined substantially and capital inflows rose (Box 6.5). The Brady Initiative also led to a significant rise in the price of debt in the secondary market. It stabilized after the announcement of the initiative in March 1989 and then began to rise in the four countries with Brady plans. The price continued to fall for other countries that continued to accumulate arrears, such as Argentina and Brazil. When other policies are adequate, debt relief may provide the right spark for an economic recovery and improve incentives for reform. Peru's recent experience clearly illustrates that stopping debt service does not solve the stabilization problem, and the experiences of Argentina and Brazil show that reducing the fiscal deficit remains the crux of the matter. The failures of Argentina and Brazil to reach debt settlements deepened the skepticism about the likelihood of success of their stabilization efforts. The experiences of Chile, Mexico, and Venezuela show how debt renegotiation can support domestic policies by increasing overall confidence and encouraging the return of expatriated capital.

Despite progress, the debt crisis continues to threaten development. Factors that could sustain and augment progress include the implementation of strong, credible adjustment programs in highly indebted countries; expanded country coverage of commercial debt and debt service reduction; more concessional rescheduling for the poorest debtor countries; and a reduction of the stock of debt owed to bilateral agencies. Private lending is likely to grow only modestly as commercial banks rebuild their capital. Yet additional private financing could take the form of repatriation of assets through instruments such as project and trade-linked finance, direct foreign investment, joint ventures, and debt and equity issues abroad. Official flows are likely to grow somewhat faster than

**Figure 6.5 Net resource flows and net transfers to developing economies, 1980-89**  
(billions of dollars)



Note: Data are for all economies reporting transactions to the World Bank and refer to long-term debt, excluding IMF.  
Source: World Bank 1990d.

### **Box 6.5 The 1990 Mexican debt agreement**

Since the 1982 debt crisis, Mexico has negotiated rescheduling and new money packages in 1983-84 and in 1986-87. These agreements, which involved complex negotiations, failed to provide medium-term relief on the external front. In 1985 Mexico introduced important reforms of external trade and of the financial sector, privatized many state-owned enterprises, and overhauled regulations on direct foreign investment. Despite these efforts, external debt continued to cloud the horizon. Large external transfers created uncertainty about future exchange rate and tax policies. To prevent capital flight, Mexico had to pay very high real interest rates on its domestic debt, which increased its fiscal deficit and threatened the substantial fiscal reforms that had been undertaken in recent years. Medium-term debt relief seemed to be the missing ingredient for the success of the reform effort.

In March 1990, Mexico and its commercial creditors implemented a debt restructuring agreement. Banks could choose from a menu of options that included new money and two facilities for reducing debt and debt service: an exchange of discount bonds against outstanding debt, or an exchange of bonds against outstanding debt without any discount (par bond) but

bearing a fixed interest rate. About 13 percent of creditors chose the new-money option, 40 percent chose the discount bond (at 65 percent of par), and 47 percent chose the par bond at 6.25 percent interest. Bonds are to be paid in a single installment at the end of 2019. Their principal is secured by the pledge of U.S. Treasury zero-coupon bonds, and the interest payments are secured for eighteen months. The collateral funds were drawn from country reserves and loans from the IMF, World Bank, and Japan. Participating banks were eligible to take part in a new debt-equity swap program linked to the privatization of public enterprises.

The debt-restructuring agreement is expected to reduce Mexico's net transfers abroad by about \$4 billion a year during the period 1989-94. About half the reduction comes from the rescheduling of amortization. These reductions will improve Mexico's fiscal position and should have a beneficial effect on growth. The agreement has also altered expectations by diminishing the uncertainty about future exchange rate and tax policies. Following announcement of the agreement in July 1989, real interest rates declined substantially and capital inflows revived.

the industrial countries' income, with multilateral institutions remaining as the link between the international capital markets and many developing countries. Whether net transfers grow either in the

form of new lending or debt reduction is likely to depend on whether countries adopt policies to maintain macroeconomic stability and improve their creditworthiness.